Can, Should, & Will the U.S. Federal Income Tax Be Replaced by a National Consumption Tax?

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What's wrong with the income tax?

American voters don't like any taxes – they'd like to get government goods & services for free. BUT ALSO:

1. Complexity: any modern system dealing with complex economic transactions will have a problem. But the existing tax system is especially bad due to (a) decades of dysfunctional tax politics plus (b) the fundamental difficulty of measuring changes in asset value.

Once we fall back on a realization requirement, tax sheltering & horrendously complex rules to counter it are inevitable.

2. Why tax saving? Discouraging it may be undesirable. Plus, among 2 equal earners, should the saver pay more tax than the one who consumes sooner?

3. Do we need it for progressivity? Possibly not, even if one favors significant progressivity. (Can adjust rates; do indefinitely deferred taxes count?; tax on bequests?)

What might a national consumption tax look like?

Politicians (mainly on the right) talk mainly about a national sales tax. But almost no serious academic (including on the right) supports this.

This reflects how awful retail sales taxes (RSTs) generally are in the U.S. The non-U.S. vote around the world is unanimous, at more than 100 nations to zero: RST is not a good consumption tax design.

Main RST problems: (a) massive base exclusions in a misdirected effort to offer backdoor progressivity; (b) often levies "cascading" tax on inter-business transactions; (c) pathetically easy to evade (just turn off the cash register).

This is why everyone else in the world uses a value-added tax (VAT) – albeit, in addition to, not instead of, the income tax.

While no peer country has *just* a consumption tax, we actually know a lot about how to do it.

Implementing a national consumption tax

2 goals: comprehensive & neutral; ability to impose graduated rates (as even “flat tax” proposals generally do).

This would be 1 more problem for the RST. Can’t ask corner drug store to charge different tax rates on candy, depending on whether being bought (or consumed?) by Bill Gates or a homeless person.

2 ways to get to a feasible national consumption tax with graduated rates, which I’ll call (based on their starting points for illustrative purposes) the “income tax route” & the “RST route.”

There is no definitive consensus about which of these two designs is better, but both appear feasible (leaving aside the politics for now).

A national c-tax: the income tax route

Haig-Simons income definition: $Y = C + \Delta W$. Thus, $C = Y - \Delta W$.

Accordingly, income minus saving (and plus dissaving) equals consumption. Hence, the "consumed income tax" or "cash flow tax."

Dissaving means borrowing or using one's savings.

Thus, if you start with an individual income tax but all saving is deducted & all dissaving is included, you have a consumption tax.

This might involve requiring "qualified accounts" for deductible saving. Traditional IRA-style, deposits are deducted & withdrawals taxed.

One could also allow the use of Roth IRA-style yield-exempt accounts, but only for "arm's length" (e.g., not stock in your own company). Possible advantage: self-help income averaging.

No corporate tax needed; no realization issue; durable assets (homes).

A national c-tax: the RST route

RST: tax all final sales to consumers; ignore all other sales.

Step 1: convert the RST into a VAT via matching inclusions & refunds for inter-business sales.

E.g., suppose a forester sells a tree trunk to Rawlings for $40, it makes a baseball bat & sells it to a store for $100, parents of little leaguer buy it for $150.

RST: only the last stage is taxed.

VAT: matching taxes & refunds at prior stages. E.g., if 25% tax-exclusive, $10 tax & refund at Stage 1; $25 at Stage 2.

3 important points: (a) tax is not really being “collected in stages,” (b) cross-matching & the paper trail discourage tax fraud,(c) perfectly matched deduction & inclusion don’t otherwise matter.

From VAT to flat tax or X-tax

Add one more step & we can have a c-tax with graduated rates.

RST & VAT ignore payments to workers. But it would (ultimately) make no difference if these were also deducted & included.

Suppose we do this but apply graduated rates to workers on their earnings.

Flat tax: just a zero rate & the general positive rate. X-tax: same but with multiple rates; top rate for workers = business rate.

Now we have graduated rates that could look like those in the existing income tax (or indeed be higher / steeper).

Special X-tax issues / problems

Note that financial flows (e.g., interest payments) are ignored – so we need special rules for financial institutions.

With destination-basis tax, no deductions for import purchases or inclusion for export sales.

Not actually an export subsidy (although a legal problem under the GATT / WTO ?), but no more transfer pricing issues!

How different is the X-tax from an income tax? For items that are included / deducted, the only difference is expensing for everything rather than capitalization. (No big deal?)

The reason an income tax can't ignore items (such as financial flows & wages) that a consumption tax can ignore is that it might need to include one side while capitalizing the other.

Pluses and minuses

I myself would consider a “pure” version of the consumed income tax or the X-tax a huge improvement over present law.

More efficient, MUCH simpler. My main concern would go to high-end progressivity, but there a realization-based income tax isn’t great either.

But of course the real question is what either tax would look like once it (hypothetically) got through Congress.

Hard to predict (though I’ve tried),* but the end result might be quite stomach-turning.

* See Shaviro, *Simplifying Assumptions: How Might the Politics of Consumption Tax Reform Affect (Impair) the End Product?* In John W. Diamond and George R. Zodrow (eds.). FUNDAMENTAL TAX REFORM: ISSUES, CHOICES, AND IMPLICATIONS. Cambridge, MA: MIT Press, 2008.

Political prospects for c-tax enactment

I am very pessimistic.

In principle, it seems to have Third Way / centrist political potential, yet a progressive consumption tax has never gained political traction.

Why not? Perhaps, intuitive appeal of taxing all income; concern about deferral of the tax on unconsumed wealth.

Right wing wants to end progressivity, not rationalize it; left wing (such as it is) is concerned about the super-rich.

I consider enactment of an add-on VAT far more likely (although even this seems impossibly remote at present).

I'd question devoting significant political capital to it, with the long-term fiscal outlook so dire & the political system so dysfunctional.