Consumption taxation

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Taxation based on consumption, as opposed to some other measure of ability to pay, most notably income.

Forms of consumption taxes

To understand the different ways in which consumption taxes can be implemented, it is useful to begin with the Haig-Simons definition of income: income (Y) equals consumption (C) plus changes in wealth (W) ($Y = C + \Delta W$). First, note that the key difference between income and consumption taxation is the inclusion or exclusion of ΔW in the tax base. Changes in wealth—or savings—are not taxed by consumption taxes but are taxed by income taxes. Second, note that this relationship suggests that consumption can be taxed directly (e.g., via a sales or excise tax) or indirectly by imposing an income tax with deductions for increases to savings (and inclusion of withdrawals from savings in the tax base). A national sales tax on all goods and services would be one way to implement a consumption tax, while an income tax with IRA treatment of all savings would be a way to implement the consumption tax indirectly. The expenditure tax proposed by Kaldor (1955) is an example of this indirect approach. Recently, it has been revived as a component of the Nunn-Domenici USA Tax Plan.

Value-added taxes (VATs) provide a third method of implementing consumption taxes. Value added in production is the difference between the sale price of produced goods and services and the cost of goods and services used in production. A VAT can be viewed as a national sales tax where the tax is collected in increments at each stage of production, from the producers rather than from the retail seller. A key feature of a consumption-style VAT is that investments by the firm are deducted (expensed) rather than depreciated. The effective tax rate on investment equals zero if a firm can expense its investment. While taxes are paid on the returns to that investment (i.e., on the value of goods and services generated by the investment), those taxes can be viewed as the government's share of the return to the investment because of its equity stake in the investment following the tax deduction resulting from expensing.

As described above, all financial transactions are ignored when calculating value added. All cash proceeds into the firm (stock sales, proceeds from borrowing) are ignored, as is all cash out (dividends, interest, debt repayment). This approach is often characterized as the R (for real transactions) base approach, a terminology credited to Meade (Institute for Fiscal Studies 1973). Alternatively, one can include all financial transactions ($R + F$ base). Thus, all cash proceeds are included as taxable income, and all cash outflows are deducted. So long as the same tax rate applies to all transactions, these two approaches generate the same tax consequences to a firm. The present discounted value of taxes paid on proceeds from borrowing, for example, should just equal the present discounted value of taxes saved by deducting principal and interest on that debt. The $R + F$ approach is better suited for use in taxing financial services where value added is difficult to disentangle from financial activities (borrowing and lending).

As an accounting identity, value added is allocated to workers (wages) and capital owners (dividends and retained earnings). However, as noted above, investment expensing means that the taxes on value added allocated to capital owners are offset by the reduction in taxes due to expensing. In other words, the only capital owners who will incur the burden of a consumption tax are those who own capital before a consumption tax is implemented (ignoring transitional rules). This gives rise to the distinction between "old" and "new" capital and is an important issue in tax reforms.

It is often claimed that a consumption tax is a combination of a wage tax plus this lump sum tax on old capital. There are (at least) two important observations to make about this claim. First, if a future observer sees that individuals file tax returns paying taxes on their wage income only, that observer will not be able to say if this is a "wage" or a "consumption" tax. To distinguish between the two forms of taxation, the observer would need to know what happened to old capital at the time of the reform. If a wage tax has been enacted along with a levy on existing capital, then the observer would be looking at a consumption tax. In other words, the distinction between a wage tax and a consumption tax based on treatment of old capital may mislead an observer. We would enact what looks like a consumption tax, but what really is a wage tax, by forgiving the tax on old capital and vice versa.

Second, the claim would suggest that in the absence of old capital, wage and consumption taxes are equivalent. But consider an entrepreneur who thinks up a great idea after the new law has been enacted and sells it for $1 million. (Or perhaps he finds oil on a previously worthless piece of property and sells it for $1 million.) All consumption financed by this $1 million would escape taxation under a wage tax. A personal cash flow tax would tax all cash coming to an individual, with a deduction for any savings (into qualified accounts); in this case, the consumption financed by proceeds from the sale of the idea would be taxed. In certain cases, the U.S. Treasury staff's blueprints (U.S. Treasury Department 1977) allow for a tax prepayment option in which additions to savings are not deducted, nor are the principal and return from that savings taxable (when withdrawn for consumption). While tax prepayment is a useful—perhaps essential—option for certain assets (houses, jewelry, etc.), it could not be used for taxing returns such as our entrepreneur receives. In this context, the tax prepayment approach would be identical to a wage tax.

Variations on these approaches to taxing consumption abound; generally, the focus on how one implements a consumption tax follows from administrative and distributional concerns arising from windfall gains and losses in the transition from some existing tax system to the consumption tax system. One popular variant is the Hall-Rabushka Flat Tax, which is a two-part tax. The business tax is essentially a VAT with a deduction allowed for compensation to workers. The second tax is a personal tax on compensation at the same tax rate. Described this way, the shifting of the labor tax component from the business tax to a personal tax has no economic effect. The motivation for shifting the labor tax component is to allow a generous personal exemption to effect greater tax progressivity. A slight variant on the Hall-Rabushka Flat Tax is Bradford's (1987) X Tax. It differs in having a progressive rate structure on the personal tax, the top rate of which equals the business tax rate.

An important unresolved question is whether bequests and gifts should be included in the base of a consumption tax when the tax is explicitly levied on consumption. Clearly, the receipt of gifts should not trigger a consumption tax liability. One might argue that the gift of a bequest (or other monetary gift) should be treated as consumption (and hence taxed) because the bequest generates consumption benefits for the donor. An altruistic motive (e.g., Blinder 1974) might justify the consumption benefits of the gift. However, the donor of a gift derives utility from his or her ability to increase the bequest recipient's utility. Because the purchasing power of the gift is reduced by the consumption tax, the donor now receives less utility from a given bequest. In effect, the donor has been taxed on the gift, and explicit inclusion of the bequest in the consumption tax would constitute double taxation. Under a strategic bequest motive (e.g., Bernheim et al. 1985), the gift can be viewed as a payment for services from the recipient. Because these services (visits, home care, affection) are likely to be untaxed, the consumption tax should properly tax bequests. The Meade Commission's approach to taxing bequests was to propose a separate wealth tax to "encourage dispersion in the ownership of wealth" (Institute for Fiscal Studies 1973: 518).

Historical antecedents

The intellectual arguments for consumption taxation can be traced back to Thomas Hobbes. Writing some 350 years ago, he argued that ". . . the Equality of Imposition consisteth rather in the Equality of that which is consumed, than of the riches of the persons that consume the same" (Hobbes 1651: 387). His argument was based on the logic that the state provides protection for the enjoyment of life and that taxes are the price of that protection. Because consumption is the material manifestation of the enjoyment of life, so should consumption be the base of taxation. Or as Hobbes put it, "For what reason is there, that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged, than he that living idlely getteth little, and spendeth all he gets: seeing the one hath no more protection from the Commonwealth than the other?"

More recently, Kaldor (1955) argued for an expenditure tax as a surtax to coexist with the current income tax in the United Kingdom. More recently still, the Meade Commission (Institute for Fiscal Studies 1973) in the United Kingdom and the U.S. Treasury Department (1977) have made forceful cases for consumption taxation. Despite these proposals, no country has shifted its tax system wholly to a consumption base. However, there has been a shift in the mix from income toward consumption taxation in a number of ways in the last 20 years. First, the European Community (EC) passed two directives in 1967, in which it mandated all EC members to implement VATs. As a result, the mix of consumption and income taxes has shifted to the point where consumption taxes (VATs, excise taxes, etc.) constitute between 15 and 25 percent of tax revenues for the EC countries (see Metcalf 1995). Second, there has been a tremendous growth in defined contribution pension programs and other tax-deferred savings programs in the United States and other industrialized countries. Current estimates are that roughly 50 percent of personal savings in the United States receive consumption tax treatment (Gale 1995).

Rationale for consumption taxation

There are three major reasons that many economists have advocated a shift from income to consumption taxation: simplicity, efficiency, and fairness. The essential argument for simplicity is that income is difficult, if not impossible, to measure accurately, while the measurement of consumption is relatively straightforward. Most of the complexity in the current income tax system arises from the need to measure income. Two oft-cited examples are depreciation and capital gains. A consumption tax of any of these forms would eliminate these problems. Capital expenditures are expensed (deducted) under a consumption tax and capital gains are ignored. On the other hand, efforts to achieve distributional goals can add complexity to a consumption tax. For example, every VAT in place in Europe and other industrialized countries has exemptions and multiple rates, which add considerable complexity to the tax code. Transitional concerns are also likely to add complexity. For example, most serious consumption tax plans in the United States have gone to great lengths to preserve basis in existing assets and to prevent the taxation of withdrawals from savings accumulated before tax reform.

The major case for efficiency is that a consumption tax eliminates the intertemporal consumption distortion by ending the tax on savings. Moreover, reducing the effective tax on capital will encourage economic growth through greater rates of investment. With respect to the effect of consumption taxation on savings, the intertemporal distortion depends importantly on the rate of return subject to taxation. As Bradford (1995) has shown, a consumption tax only exempts the risk-free return from taxation. Given that the risk-free return is a small component of the total return on savings, the efficiency gains from a consumption tax vis-à-vis an income tax may be modest. Moreover, while a consumption tax may reduce intertemporal distortions, there still remains a distortion between the consumption of purchased goods and nonpurchased goods—most notably leisure. In addition, when comparing income and consumption taxes, a higher tax rate would be required to raise the same amount of revenue with the consumption tax versus the income tax, given the nontaxation of savings.

Finally, some economists have argued for a shift to consumption taxation based on fairness. Hobbes employed a benefits principle to justify consumption taxation. More recently, Kaldor (1955) argued that the difficulties associated with taxing income are so great that a shift to an expenditure tax would in fact raise more revenue from the very wealthy than income tax does—a view at sharp variance with conventional wisdom.

The common perception is that a consumption tax would be highly regressive compared with an income tax. This follows from the fact that the savings rate relative to income rises with income. Whether a consumption tax need be more regressive than an income tax depends on (1) the degree of progressivity of the income tax being replaced, (2) the structure of the consumption tax being contemplated, and (3) the way in which progressivity is measured. Ignoring the first point here, there are several comments to be made. First, progressive elements can be built into a consumption tax: progressive rate structure and personal exemptions, to name two. Second, conventional measures of progressivity in the tax code use annual income to measure economic well-being. This approach biases measures of tax progressivity in a downward direction. If people are making consumption decisions on the basis of lifetime income, then consumption income ratios will be very high for "low" income individuals and very low for "high" income individuals who might have the same lifetime income. Not all economists are convinced by the lifetime income analysis, however. A revenue-neutral tax shift from income to consumption taxation would undoubtedly result in high-income taxpayers receiving a tax cut. This fact creates substantial political difficulties for the enactment of a consumption tax. It should be noted, however, that much of the objection here is really an objection to the ending of the double taxation of capital income that occurs under the current income tax system. The same problem would arise in a shift to an integrated income tax system.

Conclusion

In practice, consumption is inherently easier to measure than income, and the dynamic efficiency gains from encouraging savings and investment could be large. However, that argument is weakened by the difficulties associated with transiting from the current income tax system to a proposed consumption tax system. In addition, concerns about the fairness of moving from an income to a consumption tax base loom large in the tax reform debate.

To date, the transitional difficulties have stood as a major obstacle to wholesale change. However, there has been piecemeal change, and the current U.S. tax system is a hybrid of an income tax and consumption tax system that has gradually shifted from a predominant reliance on income as the tax base toward a greater reliance on consumption as the tax base. In so doing, we have come (perhaps unconsciously) to the result proposed by Kaldor 40 years ago: "However inadequate the system of income taxation may be in relation to the objectives which it seeks to attain, it is inconceivable that, within any foreseeable period, it should be wholly abandoned in favor of an alternative system based on personal expenditure. The most that can be hoped for therefore is to introduce a spending tax that can be operated side by side with the income tax, and that would take some of the weight off the income tax without imposing an excessive administrative burden" (Kaldor 1955: 224).

Additional readings

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