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Lower-Income Households Spend Largest Share of Income

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There is a considerable amount of interest in replacing the federal income tax (and possibly all federal taxes) with a broad-based tax on consumption or retail sales. President Bush has fueled that interest by saying that overhauling the tax code would be a priority in a second term and calling a broad-based federal sales tax "an interesting idea that we ought to explore seriously."

A major issue in the debate on the merits of replacing an income tax with a consumption tax is that consumption taxes tend to be regressive. Consumption is a much larger share of income for lower- and middle-income households than for those with high incomes. Data from the Consumer Expenditure Survey suggest that families earning less than $30,000 (in 2003 dollars) spend virtually all of their income while those with incomes exceeding $200,000 spend less than 40 percent.[1] This pattern is most pronounced for necessities, such as food, housing, and clothing. Families earning $10,000 to $20,000 spend three-quarters of their incomes on those items, compared with one-sixth of income for those earning more than $200,000.

Proposals for consumption taxes often include measures aimed at reducing their regressivity, such as demogrants for low-income households, tax exemptions for some necessities, or even progressive rates. All of those options raise issues, but most salient is the fact that effective tax rates for high-income households would have to be very large to achieve the same degree of progressivity as the current tax system. Otherwise, the tax burden would inevitably shift onto at least some lower- and middle-income households.

[1]Many researchers have commented on the implausible ratio of consumption to income for those with very low incomes. Income is probably underreported, especially for low-income households, which is a special risk because the focus of the survey is consumption rather than income. It also excludes gifts from friends and relatives.

Consumption as a Percentage of Income, by Type

Income	All Expenditures	Food	Housing	Clothing	Necessities[1]
$1-10K	254%	52%	81%	10%	143%
10K-20K	137	25	45	5	75
20K-30K	104	18	31	4	54
30K-40K	87	15	24	4	43
40K-50K	75	13	21	4	37
50K-75K	68	11	18	3	32
75K-200K	56	8	15	3	26
Over $200K	37	5	9	2	16

Source: Consumer Expenditure Survey: 93:1-98:2.
Note: Income is composed of earned and unearned income, and government transfers.
All items in 2003 dollars.
[1]Necessities are defined as food, housing, and clothing.