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Replacing the Income Tax with a Progressive Consumption Tax

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The major problem with the income tax is that it does not treat everyone fairly. People with high levels of lifetime consumption can be taxed at much lower rates than people with lower lifetime consumption. It enables some very high net worth individuals to pay very low taxes while maintaining high levels of consumption. It also taxes people based on their contribution to available resources through work and investment rather than on their reduction of available resources through consumption.

Specific examples of problems with a progressive income tax include:

1. It discriminates against workers in professions with long training programs such as medical doctors. They often have low consumption in medical school, residency and fellowship programs, and accumulate debt. When they finish their training their taxes are high even though their disposable income is low. We are using the tax system to discourage people from becoming doctors just when our health care needs are greatest.
2. It favors "trust account babies" whose distributions of principal, bequests, and gifts from relatives are not taxed. Tax avoidance techniques such as stock option GRATs enable even large bequests to avoid taxes.
3. Because taxes are only levied on realized gains while unrealized gains compound free of taxes, the tax code penalizes portfolio rebalancing to control risk. When one or two investments do very well, the investor is penalized for diversifying away from those investments. The social cost is that the recipient is bearing risk from the concentrated portfolio with no compensating gains to society. This problem is exacerbated by stepping up basis at time of death which lets accrued gains on inherited assets completely avoid taxes, creating further incentives to avoid rebalancing.
4. By borrowing against their assets, investors can avoid income tax while maintaining a high standard of living (the deadweight loss from portfolio concentration remains).
5. It favors homeowners over renters. The implicit income from an owner-occupied dwelling is not taxed, while the income needed to pay rent is taxed, and the income received by the landlord is also taxed resulting in higher rents. This discrimination against renters reduces labor mobility leading to higher rates of unemployment and lower labor force participation rates. It also discriminates against younger workers and minorities which have lower rates of home ownership.
6. Gifts and bequests to high income recipients are taxed at the same rate as gifts and bequests to poorer friends and relations. The recipients of gifts, bequests and distributions of principal from trusts are not taxed while their hard-working relatives are taxed on the income they earn. The distributions of principal could be from long deceased ancestors and thus is similar to welfare in its negative social effects on both the recipients and society as a whole. A progressive consumption tax creates an incentive to shift consumption into the hands of people who are consuming less. These could be relatives, friends and heirs of high income earners or recipients of charitable giving. Income being transferred will eventually be consumed, and thus taxed, but the rate would depend on the spending level of the recipient.

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7. The excessive complexity of the tax has resulted in highly intelligent people spending their time facilitating tax avoidance, rather than working in more productive ways. Examples of differential tax treatment of income include:

    a. wage income vs. long- and short-term capital gains

    b. qualified vs. unqualified dividends and interest income

    c. active vs. passive income

    d. dividends on preferred shares vs. bond interest

    e. profits from trading real estate and commodities vs. trading equities and bonds vs. trading futures.

    f. special tax treatment for gains on assets held in insurance vehicles

    g. special rules for investments in domestic vs. foreign funds.

How would a progressive consumption tax work?

All spendable inflows would be aggregated regardless of source and netted against investments and deductible expenses. Inflows would include wages, commissions, bonuses and royalty payments; money received from the sale of assets or from borrowing; income from dividends, interest, rents, leases, insurance policies, annuities, and social security; money received from gifts, and bequests; distributions of both income and principal from trust accounts, LLCs, partnerships, and S corporations and other pass through entities. The rental value of owner-occupied properties (including second and third homes), yachts, and art should eventually be included in taxable consumption. However, as discussed below, during the transition, most residences that were owned at the time the consumption tax was implemented should be exempted from the consumption tax.

Expenses that are currently deductible could continue to be deductible. Additional deductible expenses should include purchases of financial and real assets, interest payments, repayment of principal on debt, contributions into 401(k) accounts, IRAs and other pension plans, social security contributions, and purchases of annuities; currently deductible expenses with the exception of taxes paid for consumption goods might also be deductible; more about that below. Money that is held in a bank account, money market fund or similar vehicle would count as an investment. Cash gifts and loans would be deductible by the giver but included as taxable cash inflows to the recipient.

Transfers of assets would not be subject to tax until the asset was sold or cash withdrawn from a bank account and used to finance consumption (loans collateralized by those assets would be taxed if the borrowed money was used to finance consumption).

The determination of what should be considered as “taxable consumption” or conversely as a deductible expense should reflect societal values. Most deductible expenditures such as charitable contributions or state and local taxes would continue under the consumption tax. However, amenities such as municipal golf courses and beaches are forms of consumption that should be financed solely through user fees. Those fees would be included in taxable consumption and not be deductible by the residents. Otherwise, residents of high-income communities could avoid the consumption tax by paying for amenities through tax deductible property taxes. This bias is already present in the current income tax but will become more severe under a progressive consumption tax because the maximum tax rate on consumption will need to be higher than the tax rate on income in order to collect the same revenue.

Non-Cash Income from Owner-Occupied Housing

Owner-occupied housing is both an investment and consumption. Only the consumption portion would be subject to the consumption tax. The consumption value is equivalent to the rent that the owner occupier could get from renting out the property. Under a consumption tax, only the "imputed rent" would be taxed.[2]

Switching to a consumption tax would require temporary transition measures. For existing property owners, the money that was used to purchase a home or vehicle had previously been subject to income tax. While this issue also arises for all assets that are currently owned, the problems are particularly acute for owner-occupied housing. Large unanticipated tax change on a person's residence can force people to disrupt their lives and damage a community if the consumption tax induced homeowners to relocate. In addition, there are not enough appraisers to compute the rental value of all the property that would be subject to the consumption tax, nor are there sufficient resources for the courts to adjudicate the concomitant disputes. Consequently, primary residences that were owner-occupied at the time of the legislation should be exempted from the consumption tax until they are sold.[3]

However, in the *long run*, the tax system should not distort the choice of home ownership versus renting. A renter pays taxes on the income that he then spends on rent. Homeowners avoid this tax because the wealth that is tied up in their home is generating tax exempt consumption. Another way of seeing this is to note that renters are taxed on the income from savings that they have to spend on rent, and the landlord is taxed on the rental income he receives, while that income never appears on the tax returns of owners. This is not only unfair to demographic groups with low levels of home ownership, but it damages the national economy. Homeownership reduces mobility due to high transaction costs from relocating. It keeps workers stuck in areas with poor employment prospects. Providing tax incentives for individuals to have a large fraction of their wealth invested in a single highly leveraged asset causes them to bear large risks. The exposure to a single asset can have very harsh consequences when local real estate prices crash and the homeowner's equity is wiped out. This problem is especially severe if the price crash is local so she cannot benefit from lower housing costs in other markets. On the other hand, many people find it easier to save through home ownership. To the extent that homeownership is no longer subsidized, it is important to use the tax revision to ensure continued solvency of the social security system.

Note that the tax subsidy for owner-occupied housing that we are discussing is not the deductibility of mortgage interest. The owner of a rental property also gets to deduct his interest expense. The discrimination against renters arises from taxing the income being generated to pay rent but not taxing the free rent that a homeowner gets. This distortion should be eliminated as currently occupied homes are sold and new homes bought. The initial windfall gain to existing homeowners from not taxing the implicit rental value of their homes while reducing their income tax rates would be somewhat offset by the fall in property values as markets adjust to the tax on the implicit rental value of owner-occupied dwellings.

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[2] The imputed rent would include not only the value of the owner-occupied dwelling but also the value of all land that was contiguous to it as well as recreational property that could only be accessed with the permission of the owner.

[3] From an administrative standpoint appraising all the homes in the U.S. at once is not feasible. We can't make use of current appraised values since the rules vary by jurisdiction. For instance in some jurisdictions there are caps on changes in appraised value; in other jurisdictions homes are only reappraised when they are sold or when improvements are made. In areas with low property taxes homeowners have had little incentive to challenge appraisals; they are more likely to challenge those appraisals if the appraised value becomes subject to federal tax.

Expensive Consumer Durables

The rental value of privately owned planes, yachts, jewelry, art, second homes and any other luxury good that is worth more than $2 million should be immediately subject to a consumption tax equivalent to the usage value of the luxury good. Although the income used to buy those assets may have already been taxed, the owners reaped the benefit of the tax-free use of the asset rather than having had to pay tax on the income needed to rent goods of equivalent value. Consequently, it seems fair to tax the usage value of those goods.

Employer Provided Benefits

The value of employer provided health insurance and other benefits would be taxed at the same rate as if the individual had received the money and spent it on health insurance or the other benefits. Health insurance could be tax deductible or partially tax deductible but the tax treatment of health insurance should not depend on whether the insurance was paid by the employer or the employee.

Tax Rates of the Consumption Tax

Consumption averages around 80% of personal income. Consequently, for a progressive consumption tax to raise the same revenue as an income tax, average tax rates on consumption will need to be higher than the tax rates on income. Furthermore, the percentage of income that is consumed falls sharply with lifetime income, especially at the highest levels. For instance, there are some individuals who report income of $100 million per year. It is almost impossible to spend more than $10 million per year on non-investment goods (buying a baseball team would not be taxable consumption).

A large fraction of consumption is driven by the purchase of status goods. Cutting down on everyone's consumption at the high end has little effect on the wellbeing of high income individuals except to the extent that they are comparing themselves to high income individuals in other countries. A high tax rate on consumption by very high income people will decrease the value of expensive homes, artwork, private jets, yachts, and jewelry. That seems like a bearable cost. Most of the value of an expensive home stems from its location and taxes don't destroy views or beach access. Similarly, taxes won't cause valuable paintings or jewelry to disappear. Even if the consumption tax causes fewer yachts and private jets to be built, or diamonds to be mined, that doesn't seem to be a major loss to society. On the other hand, tax cuts to the poor that enable them to pay for health care or heating have important positive effects on the welfare of society.

Consequently, we should exempt all consumption below 80% of the median level from the consumption tax.[4] Once consumption exceeds 80% of the median we should tax consumption at a progressive marginal

[4] The median could be adjusted for regional differences in the cost of essential goods and services such as differences in average heating and cooling costs for a similarly sized home in different regions, differences in the cost of groceries in different regions, and differences in rental prices of housing. The argument would be that equity requires us to tax consumption rather than the cost of the consumables. A person having the same standard of living in Alaska and in Mississippi should pay the same tax even though the person in Alaska is spending more to maintain that standard of living. There is also an efficiency argument: people may be living in a high cost region because their higher productivity in that region outweighs the higher cost of living. The tax system should not distort that decision. On the other hand, if the point of a consumption tax is to tax people according to the value of the resources that they consume and thus are not available to others, then we should not adjust for cost differences. Consuming an orange in Alaska requires considerably more resources than consuming the same orange in Florida. The difference in the cost of supplying the good is reflected in the price. There is also an argument that the higher cost of rental housing in some regions reflects the value of other amenities, so that by not adjusting for regional differences in rental prices we are indirectly taxing the value of those non-pecuniary amenities. Given the tradition of not adjusting the federal

rate. A progressive consumption tax enables us to implement a higher top tax rate because the scope for tax avoidance is much less. Consumption outside the U.S. would not avoid the consumption tax since it would not be either an investment or a deductible expense. The incentive to hide transfers of cash would only arise if the recipient had a higher level of consumption than the person making the transfer.

Coordination with Payroll Tax

Ideally the consumption tax would be chosen at a high enough rate to replace the payroll "FICA" tax. The payroll tax penalizes employers for hiring low skill workers. Due to mobility of capital it is probable that most of the burden of the payroll tax is either borne by workers or passed on to consumers. The payroll tax also encourages firms to replace low skilled workers with machines or to outsource low skill work. On the other hand, there seems to be less resistance to the payroll tax than to the income tax or the corporate profits tax. A middle ground would be to eliminate the upper limit of wages subject to the payroll tax. This would raise revenue and eliminate the bias against hiring low and middle income workers.

Questions Asked About A Progressive Consumption Tax

1. Wouldn't a progressive consumption tax disproportionately benefit the wealthiest households who consume a small fraction of their income?

This is potentially the most serious problem with a progressive consumption tax. To address this issue we would either need very high tax rates for very high levels of consumption,[5] or else combine the consumption tax with an alternate minimum income tax focused on very high incomes.

Although marginal tax rates on consumption can exceed 100% without causing excessive distortions in the economy, taxing consumption at the rates needed to avoid a tax cut for the very wealthy is unlikely to be politically tenable. Therefore, we should combine the progressive tax with an alternate minimum income tax. Anyone whose income from interest, dividends, wages, capital gains, gifts, bequests, distributions from trust accounts, IRAs and pass through entities exceeds $1 million would file both an income tax form and a consumption tax form. Their tax obligation would be the maximum of either their consumption tax obligation or 25% of their income over $1 million.

2. Wouldn't the consumption tax increase the political power of high wealth individuals who can accumulate wealth that is not subject to taxation?

Since contributions to political campaigns are not tax deductible they would be subject to the consumption tax. By making the consumption tax more progressive the effective tax rate on political contributions by the wealthy would increase relative to the tax rate on contributions by lower income individuals. This would encourage a broader base of financial support for political campaigns. We could

income tax to reflect regional price differences, and the difficulty in adjusting regional price differences for quality differences, the gain from adjusting for regional cost differences is probably not great enough to outweigh the political costs.

[5] If we wanted to totally eliminate the income tax without unduly benefiting the super-rich, consumption between $1,000,000 and $2,000,000 per year could be taxed at 70%. Consumption between $2,000,000 and $5,000,000 per year could be taxed at 100%. Consumption above $5,000,000 per year could be taxed at 125%. Consumption above $10,000,000 per year could be taxed at 150%. High income individuals would still have an incentive to earn income. If their marginal dollar of income is not consumed it would be in the zero percent tax bracket. Their net taxes may not rise. For instance, if high income individuals were to consume 20% of their income then even a 150% tax rate would only entail a 30% marginal tax on their income. If the high income individual gave their marginal dollar of income to their friends or relatives or to charity then the effective tax rate would be the tax bracket of the recipient.

also allow for tax deductibility of total political contributions by an individual of up to a limit of $500 per year to encourage broader participation.

3. How would the consumption tax affect the poor?

If we define the poor as those with the lowest level of consumption, a consumption tax could make them better off. Only the top 60% of the population with the highest consumption would pay the consumption tax. Also, since the consumption tax provides data on household consumption, the consumption tax would be combined with transfer payments to ensure that transfers go to people who are truly needy, as defined by low levels of consumption. People who are paying off large student loans might qualify for a consumption subsidy, even if their reported incomes were above the poverty line. On the other hand, no one with a middle class standard of living would get government assistance. By basing taxes and subsidies on consumption rather than on earned income or lack of assets, we would reduce the extraordinarily high tax rates on earned income and savings for low income people. The consumption tax could start with a subsidy to everyone, and the subsidy would phase out as consumption increased. A household in the 40th percentile of consumption that was subject to payroll tax would receive a transfer just equal to their payroll tax. That household would not receive subsidies from the federal government nor would they be making direct payments to the federal government. People with lower levels of consumption would be eligible for transfers from the federal government.

4. Doesn't the consumption tax impose double taxation on current savings when those savings are used to finance consumption?

Some of net savings is unrealized capital gains, pensions, and IRA and 401(k) accounts and thus has not been taxed. However, there is considerable wealth that was already subject to the income tax. Consequently, when that wealth is used for consumption, it will be taxed again under the consumption tax. We partially addressed this problem by exempting from the consumption tax the wealth that is currently invested in owner-occupied housing (unrealized gains on the value of that housing would also be exempted from tax). We also would exempt from the cash flow calculations distributions of principal from IRA accounts that were funded with after tax dollars. Also, reinvested income from current savings would not be taxed. Other assets that are being used to finance future consumption would be subject to the consumption tax. Those financial assets are disproportionately held by high net worth individuals. They typically benefitted disproportionately from a tax code that only taxed capital gains on realization not accrual, and that did not tax the implicit income from tax-free usage of homes and luxury goods. They are likely to also disproportionately benefit from the unrealized gains in owner-occupied residences that we are exempting from the consumption tax. Moreover, even after the consumption tax goes into effect, unless they consume an exceptionally high proportion of their income, their tax rate will be less than 25% of their income above $1,000,000. That does not seem to be imposing an undue burden on a particularly wealthy sector of the population.

Alternative Means of Addressing Shortcomings of the Income Tax

If the political obstacles to implementing a consumption tax are insurmountable, some of the problems of the income tax described in the opening paragraphs can be partially addressed through an overhaul of the income tax and by making up for lost revenues with a value added tax.

1. Earned and unearned income, gifts, bequests, distributions from trust accounts, pensions, 401(k) accounts, and social security payments would all be taxed at the current tax rates for ordinary income. Since the receipt of gifts, inheritances and distributions from trusts would be taxable, the estate tax would be eliminated. The upper bound on income subject to FICA tax would be eliminated, and FICA tax would be imposed on all income, not just earned income. Gifts, bequests

and distributions of certain assets such as the family home or family business or heirlooms would not be taxed until the asset is sold, but at that time the cost basis would be set to zero so the entire value of the distribution would be included in taxable income to the recipient when the asset is sold. Income generated from an inherited property or business could be subject to a surtax to partially offset the incentive to bequeath wealth in that form.

2. The like-for-like exchange treatment for real estate, commodities and collectibles, which allows tax deferment on profits from those trades if the revenue is reinvested, would be extended to include all investments including all financial assets. This would eliminate the bias in favor of trading in real estate, commodities and collectibles and eliminate the bias against portfolio diversification. To improve economic allocation of assets, reinvested gains from the sale of an investment would avoid tax even if the money is reinvested in a different asset class. This tax treatment of reinvested revenue from sale of investments would also be extended to the corporate sector, so firms would not be penalized for protecting their stakeholders from economic fluctuations.
3. To eliminate the bias in favor of home ownership, rental expenses for a primary residence up to 50% of median income would not be subject to tax, and the maximum deductibility of mortgage interest would also be limited to 50% of median income.
4. To avoid discriminatory taxation of doctors and others with professions requiring long training programs, we would allow individuals who are more than 25 years old to average their income over the previous 3 years in computing their taxable income.

Sincerely,

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