

REPLACING THE INCOME TAX  
WITH A PROGRESSIVE  
CONSUMPTION TAX

Daniel N. Shaviro  
NYU Law School

# Paper's Main Objectives

Broader dissemination and acceptance of existing literature that has carried the day in certain academic circles, but that elsewhere is unknown or mistakenly disparaged.

Underlying purpose is very practical: move towards new consensus of the experts that would be necessary for fundamental tax reform (of the kind I discuss) to occur.

A second purpose: separate the **income vs. consumption tax** debate from the **progressivity** debate.

# Some Excluded Topics

- Transition from an income tax to a consumption tax
- Problems of coordination with other countries' tax systems that still use income
- What measures (income, consumption, etc.) to use in need-based transfer systems.

The rationale for ignoring these topics here is that clarifying our thinking about tax reform is an important first step no matter what.

# Progressive Consumption Taxes

Existing consumption taxes (RSTs, VATs) are necessarily flat-rate because collected from business.

Two main prototypes for a progressive consumption tax:

(a) Consumed income tax: looks like current income tax, but saving & investment are expensed; dissaving is taxed. (Postpaid or yield-exempt)

(b) X-tax or flat tax: looks like VAT, but with payments to workers deducted/included to permit rate graduation. (Prepaid, base is R only)

# Simplification Compared to Existing Income Tax

## Some Issues That Could Be Eliminated:

Realization, debt vs. equity, rules of corporate and partnership taxation, interest deduction rules, ordinary income vs. capital gain, loss disallowance rules, AMT, foreign tax credit limitations, possibly transfer pricing.

## Some Issues That Would Remain:

Personal vs. business expense, household taxation, personal deduction issues, tax exemption, devices to encourage saving (?), “bundling” of real and financial transactions, auditing to detect fraud.

# Are Consumption Tax Simplification Hopes Politically Unrealistic?

Interest group politics is unlikely to improve any time soon.

BUT – complexity problems under the income tax are largely structural in character. (Realization, entity taxation, debt vs. equity, etc.)

It is admittedly possible that tax preferences as such will cause greater complexity problems for business under a consumption tax (cf. zero-rating in European VATs).

# Why Not Consumption Taxation?

The choice between income and consumption taxation is an old, old debate.

But the main reason (apart from transition) for preferring income taxation is progressivity.

The fact that better-off individuals tend to save more relative to their earnings merely means that consumption tax rates must be (nominally) more graduated.

But note deeper concerns that consumption taxes simply fail to reach “capital income” or wealth (suggesting that higher rates would miss the target).

I call this the “Bill Gates problem.”

# Three Grounds for the Belief That Consumption Taxes Exempt Wealth

## 1. The coupon-clipper problem.

This may be politically fatal but should not dupe experts.  
(Cf. corporate integration, treatment of interest in X-tax.)

## 2. The Cary Brown problem.

If expensing = yield exemption, isn't Bill Gates' capital income being exempted?

## 3. The unspent wealth problem.

Are rich people never taxed if they never spend their wealth? And don't they benefit from deferral?

# Expensing and Yield Exemption

This universally accepted equivalence (subject to constant rates, etc.) can be illustrated as follows:

Suppose  $r = 10\%$  for all investment,  $t = 50\%$ .

(a) Yield exemption: invest \$100, end up after-tax w/ \$110.

(b) Expensing: invest \$100 before-tax (\$50 after-tax), end up with \$110 before-tax (\$55 after-tax).

After-tax  $r$  is still 10%. But better still, why not scale up the investment to \$200 before-tax (\$100 after-tax)?

Now the after-tax cash flows are (\$100), \$110, just as under exemption.

# Does This Show That a Consumption Tax Would Exempt Bill Gates?

This is really a question about the effect of exemption on Microsoft, ostensibly exempted by expensing.

But did Microsoft really make Bill Gates rich by earning an ordinary return?

Note the four components of  $r$  :

- (1) pure return to waiting,
- (2) inflation premium,
- (3) adjustments for risk (expected premium, actual outcome),
- (4) extra (inframarginal) or labor returns.

# Income vs. Consumption Taxation and the Pure Return to Waiting

The consumption tax exempts this (per Cary Brown) while the income tax reaches it.

But – evidence from short-term Treasuries suggests that the real risk-free rate has historically averaged about 1%.

Per the literature, this suggests that it is no big deal (or at least a lot less important than people thought).

??? – but clearly this is not the Bill Gates problem.

# Income vs. Consumption Taxation and Inflation

Neither tax in pure form would reach inflationary gain.

The actual income tax does. Lauded by some (such as Vickrey) as a concealed wealth tax.

This view would oppose moving towards Haig-Simons income taxation in this regard, no less than shifting to consumption taxation.

In the actual income tax, inflation may aid tax planning. E.g., the wedge between real & nominal interest can facilitate income-shifting to tax-exempts.

# Income vs. Consumption Taxation and Risk

Much discussed, and much misunderstood.

Income tax & consumption tax both offer involuntary insurance (winners pay more tax than losers).

Taxpayers can reverse this effect by investing more riskily before tax. E.g., shift from risk-free to risky asset.

Result: w/ portfolio adjustments, TPs can eliminate the effect of BOTH taxes on BOTH the expected return & the actual risky outcome, but under the income tax they still pay tax on the risk-free return for the entire portfolio.

# Risk Illustration

Suppose  $r = 2\%$  for risk-free, expected 10% (+30% or -10%) for risky,  $t = 50\%$ , full loss offsets are allowed.

*TAX-FREE WORLD*: Invest \$100 in risk-free asset, \$100 in risky asset, end up with  $\$102 + (\$130 \text{ or } \$90) = \$232 \text{ or } \$192$ .

*INCOME TAX, SAME PORTFOLIO*: end up with \$216 or \$196.

*INCOME TAX w/ PORTFOLIO ADJUSTMENT*: Invest \$200 in risky asset, end up w/ \$260 or \$180 before-tax = \$230 or \$190 after-tax.

Same as in the tax-free world except for the tax on the risk-free rate as applied to the entire portfolio!

*CONSUMPTION TAX w/ expensing*: Invest \$200 before-tax (\$100 after-tax) in each asset, get  $\$204 + (\$260 \text{ or } \$180) = \$464 \text{ or } \$384$  before-tax, end up w/ \$232 or \$192 after-tax.

# Common Responses to the Risk Illustration

Lots of people who accept the Cary Brown illustration hate & reject this one (without seeing the similarity). E.G.:

1. “But the actual income tax doesn’t have full loss offsets.”
2. “But people aren’t smart enough to adjust their portfolios.”  
(With implicit assumption that they actually start out investing in a no-tax world.)
3. “But they’ll run out of risky investments that offer 10%.”
4. “But then the whole society’s investments are riskier.  
[Pause.] Gee, maybe that’s good?”

## But the real point is ...

Income and consumption taxes similarly (and in the stylized hypothetical identically) tax or fail to tax risk premia *ex ante* and actual risky outcomes *ex post*.

Risk is distinct from time or waiting - and we should not think consumption taxes uniquely exempt risky returns merely because, in practice, such returns often are intermingled with waiting.

If Bill Gates and Microsoft were merely very lucky:

(a) consumption taxation would have reached them unless they responded by scaling up the bet.

(b) the actual income tax did not reach them if they scaled up the bet (even if we observe taxes being paid).

# Income vs. Consumption Taxation and Inframarginal or Labor Returns

This is the return to skill or having a “great idea” (e.g., for Bill Gates, make lots of money off other people’s ideas).

Assuming this can’t be scaled up (Bill Gates could not have doubled Microsoft or started two of them), it is reached by both an income tax and a consumption tax.

(And with scaling up it would be reached by neither.)

# Summing Up (So Far) on Income vs. Consumption Taxation

1. The conclusion in the policy literature is correct, stylized hypotheticals notwithstanding.

That is, only taxation of the riskless rate (1% historically?) separates the two systems theoretically. So a properly designed consumption tax has no “Bill Gates problem.”

2. BUT - suppose Bill Gates & heirs hold \$1 billion forever, paying income tax @ 40% on the 1% riskless rate.

The annual income tax burden of \$4 million may seem comparatively trivial, but has a PV of \$400 million if discounted at the 1% riskless rate.

# Taxing Unconsumed Wealth

Bill Gates Problem, Take 2: Suppose we think of the X-tax as a VAT or RST w/ graduated rates, rather than as an income tax w/ expensing.

Doesn't Gates avoid the tax on unconsumed wealth?

Same issue, different version: Suppose A earns \$100K, B earns \$1M, both spend \$100K. Don't consumption taxes err by taxing them the same when B is better-off?

The answer is NO in both cases. Tax burdens, not current tax payments, are of interest, and unspent wealth bears the full burden of the tax.

Neutrality re. the timing of consumption (as opposed to favoring later consumption) is the whole point of a consumption tax!

# The Easy Case: One-Year Deferral

Suppose  $r = 10\%$ ,  $t = 50\%$ .

*Year 1:* A earns \$200K, consumes \$100K & pays \$100K tax.

B earns \$1.2M, consumes \$100K & pays \$100K tax, saves \$1M. (Instead of consuming \$600K & paying \$600K tax.)

*Year 2:* B w/draws \$1.1M, consumes \$550K, pays \$550K tax.

B deferred \$500K of taxes by saving for a year, but paid market interest on the deferral, so no tax benefit.

The Year 2 tax had a \$500K present value in Year 1, & reduced the value (i.e., purchasing power) of B's wealth no less than if paid in Year 1 but debt-financed.

## The Harder (?) Case: Indefinite Deferral

Nothing on the prior slide relied on deferral's being for one year only. (E.g., immediate effect on purchasing power.)

Second-order considerations?? (E.g., the government won't wait for the money, or people will default on deferred obligations.)

Even with permanent deferral, the government has an asset and the taxpayer has a liability.

If deferral is not permanent, note that future tax rates may be likely to exceed current ones (given the fiscal gap).

# The Henry Simons Retort

“In a world where capital accumulation proceeds as it does now, there is something sadly inadequate about the idea of saving as [merely] postponed consumption.”

Income tax advocates mention, e.g., the “security, political power, and social standing” one gets from wealth even if never consumed (Murphy & Nagel 2002, 115).

It therefore ostensibly is false that “savings and wealth are subsidiary to consumption and derive their value entirely from it.”

Ostensibly, a consumption tax misses these aspects of wealth by not imposing a tax prior to consumption.

# Retort to the Retort

This critique of consumption taxation is fallacious.

Wealth is subsidiary to consumption, because wealth is only worth what it can be used to buy. (Otherwise, it is just Monopoly money.) So a consumption tax reaches wealth's intangible value via purchasing power.

The Simons critique rests on money illusion, or thinking that wealth has inherent rather than merely use value.

There are also other responses. E.g., is consumption just consumption? (Veblen et al) And rational consumers choose given all intangible returns.

# Is the Case for Income Taxation Therefore Fallacious?

That would be overstating it. The fallacy is supporting it due to the Bill Gates problem, conceived of in terms of exemption for capital income or unspent wealth.

It remains true that taxing the return to waiting can have significant effects over a long period (albeit on efficiency as well as distribution).

And other arguments for income taxation may be plausible, whether or not correct.

E.g., consider political economy claims that a consumption tax will be less progressive than an income tax.