

Fairness and Consumption Taxation AEI Panel Discussion, October 2008

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Outline of Comments

- Despite potential similarity between an income and consumption tax, income taxes are perceived as fairer
 - Why?
- Do deviations from 'pure' income tax make the current income tax fairer?
- Importance of *ex post* taxation with respect to resolution of uncertainty

Difference between Income and Consumption Taxes

- Taxation of savings
- What is capital income?
 - Return to waiting
 - Risk premium
 - Luck
 - Inframarginal returns
- Key difference lies in the tax on the return to waiting

What is the Real Return to Waiting?

- Historical real (i.e., inflation adjusted) return to waiting is modest
- Suggests that pure income and pure consumption tax are more similar than commonly perceived

Does the US Tax Capital Income?

- Gordon, Kalambokidis & Slemrod
 - What would be the revenue consequences of eliminating capital income taxation?
 - Depends on the year
 - Probably fairly modest
 - Conclusion: overall, the US does not raise substantial revenue by taxing capital income
- So, why is it so important for fairness?

General Perception: Consumption Taxes are Regressive

- What drives this perception?
 - “Consumption” vs. “commodity” taxes
 - Tax rate on goods vs. people
 - Correlation in saving **rates** and income
 - Not obvious to economists!
 - Dynan, Skinner & Zeldes (*JPE*, 2004)
 - The rich save more (higher rate)

More on Perceived Income Tax Progressivity Advantage

- Transitory income & lifecycle income
 - Capital income varies over the lifecycle
 - Useful to consider “lifetime earnings” in measuring fairness
- U.S. doesn't have a “pure” income tax
 - “Pure” tax base is not the right comparison
 - Real income tax may have progressive aspects
 - E.g., corporate tax

Progressivity vs. Fairness

- Taxing capital income favors:
 - People with steep age-earnings profiles
 - Less incentive to save to smooth consumption
 - People who prefer to consume early
 - Less desire to save
- Is it fair to burden people based on the timing of the receipt of income or their preferences for timing of consumption?

Income Range for Fairness?

- How important is the top 1% of the income distribution for progressivity measures?
 - Both consumption and income taxes have problems with the top of the income distribution
 - Are there other tax instruments for reaching to top of the income distribution?
 - Estate / inheritance taxation?

Current System is Not a Pure Income Tax

- Do deviations from pure income tax increase progressivity?
 - Additional tax on corporations
 - Tax on nominal instead of real returns
 - Favorable treatment of owner-occupied housing
 - Favorable treatment of retirement savings

Double Taxation of Corporations

- Incidence analysis
 - Common perception: corporations bear the tax
 - Professional opinion
 - Complicated issue
 - Open economy: labor may bear some (much?) of the tax
- Myriad of distortions created by double taxation

Tax on Nominal Returns

- Taxing nominal returns (instead of real returns) raises the tax burden on capital
- Unclear why this imperfection would improve progressivity
- In fact, many people feel that taxing inflationary gains is unfair
- Consumption taxes: do a better job accounting for inflation

Favorable Taxation of Housing

- Owner-occupied housing is untaxed
- Distributional aspects of tax preference?
 - Renters?
 - Tax preference increases with MTR
- Seems unlikely to improve progressivity

Consumption Tax Treatment of Pensions

- Progressivity depends on saving rates by income
- Creates opportunities for tax arbitrage
- Why single out specific goal of saving for consumption tax treatment?

Tax Fairness & Uncertain Returns

- Income & consumption taxes can share the risk of investment
 - Insurance role of tax system
- In contrast, government does not share investment risk with a wage tax
 - Despite similar incentive effects for wage and consumption taxes, they may not have the same distributional effects

Ex Ante vs. Ex Post Taxation

Save \$100 in Current Wages, Constant Tax Rate of 20%		
	Yield-Exemption (Roth IRA)	Cash Flow Tax (Traditional IRA)
Unlucky Investor ($r = -10\%$)		
Tax Now	20	0
Tax Later	0	18
Consumption Later	72	72
Lucky Investor ($r = 300\%$)		
Tax Now	20	0
Tax Later	0	80
Consumption Later	320	320

Tax Equivalence

- For incentives, wage tax is similar to a consumption tax
 - Wage tax = “Tax prepaid” consumption tax
- Equivalence is not so obvious for evaluating fairness
- *Ex post* taxation shares risk so that it is perceived as being fairer

Implications for Tax Design

- How does the X-tax tax different risks?
 - Business risks *Ex post*
 - Casino gambles *Ex ante*
 - Art collector (dealer?) ?
- Note: bonds and bank accounts face yield-exemption (*ex ante* taxation) but we don't think they have much risk