Progressive Consumption Taxation: The X Tax Revisited, Robert Carroll and Alan D. Viard (AEI Press, 2012)
Outline

• The case for the X tax (chapters 1-3)
• Implementation (chapters 4-9)
• The VAT alternative (chapter 10)
• Conclusion
The Case for the X Tax
Why tax consumption?

• Income tax imposes second tax on savers, penalizing saving and investment
• Consumption tax doesn’t penalize saving and investment – still penalizes work
• Consumption tax avoids complexity of income accounting
Replacing income tax system

- Partial replacement would offer limited economic gains, almost no simplicity gains, could fuel spending
- Complete replacement best
- But, complete replacement by sales tax or standard VAT would be too regressive
A different way to tax consumption

• National consumption equals wages plus business cash flow (capital income minus investment)

• So, wage tax plus business-cash-flow equals consumption tax

• Two-part tax can be more progressive than single tax on all consumption
Bradford X tax

• Tax households’ wages at graduated rates
• Tax firms’ cash flow at flat rate equal to tax rate on highest-paid workers – expense all investment, ignore financial transactions
• Identical to Hall-Rabushka flat tax, except for graduated tax rates on wages
• X tax looks like an income tax, but …
X tax is consumption tax

- Households not taxed on capital income
- No firm-level tax on marginal new investment – expensing cancels out tax on future payoffs
- Firm-level tax falls only on investments made prior to reform and new investments with above-normal returns
- No saving/investment disincentives
X tax is progressive

• Top tax rate applies to those best off:
  – Highest-paid workers
  – People who invested prior to reform
  – People with above-normal investment returns

• Can set tax rates to roughly match progressivity of current system

• Current corporate tax, unlike cash-flow tax, may be partly shifted to workers
Basic X tax design is simple

• Only wages, not capital income, reported on household tax returns
• Business taxation simplified
  – Expensing eliminates capitalization, depreciation, inventory accounting, etc.
  – No need to track financial transactions
Our proposal

• Adopt X tax
• Repeal individual and corporate income taxes, estate and gift tax, UIMC
• Keep payroll, excise, and customs taxes – fold self-employment tax into payroll tax
Tax rates

• Rates will depend on revenue, distribution, base broadening

• *Illustrative* top rates: 38.8% on cash flow, 35% (plus 3.8% HI tax) on highest-paid workers

• High tax rates less harmful under X tax:
  – No saving disincentive
  – Less work disincentive at top
Implementation
No border adjustment

• Competitiveness advantage is illusory – exchange rates adjust

• Border adjustment would transfer wealth to foreign holders of U.S. capital

• Special tax regime on multinationals to address transfer pricing
Other issues

• To make expensing work, give firms generous tax relief for negative cash flows
• Use reasonable-compensation rules to distinguish wages from business cash flow
• Provide transition relief
• Special tax regime for financial firms
• Treat purchases of homes and durables as consumption
Other issues (continued)

• Don’t tax transfer payments
• Maintain most income-based means tests in transfer payment programs
• Continue current treatment of employer-sponsored retirement plans
• Options on homeownership, charity, state and local taxes, health insurance and other fringe benefits
The VAT Alternative
VAT alternative

- Partial replacement of income tax by VAT inferior to complete replacement by X tax
- Often discussed, many countries do this
- Fed accommodation (one-time price level increase) likely
- Some X tax recommendations carry over to VAT, some must be modified
- Combating possible money machine
Conclusion
Conclusion

- Simulations suggest reform may boost long-run output by several percent – estimates are extremely uncertain.
- Long-run gain is financed by short-run decline in consumer spending.
- X tax offers efficient, fair, and simple tax system.