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# A Tax on Consumed Income

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# A TAX ON CONSUMED INCOME

## SUMMARY

It is often argued that a tax on consumed income would be equitable, efficient, simple, promote increased personal savings, and help reduce the Federal budget deficit. As a result, some advocate replacing the current income tax with a consumption based tax. Upon examination, however, the supporting evidence for these claims is less than conclusive. There appears to be insufficient theoretical or empirical evidence to conclude that a consumption based tax is inherently superior to an income based tax.

While a personal consumption tax can be designed to achieve any desired level of progressivity with respect to consumption, its progressivity with respect to income could only be approximated. In addition, a consumption tax would involve a redistribution of the tax burden by age group, with the young and old generally bearing more of the total burden than those in their prime earning years.

Investment and savings transactions might prove difficult to account for and monitor under a personal consumption tax. If these transactions were not fully accounted for, however, then taxes would be assessed on the basis of expectations rather than outcomes. This would reduce the tax base and make it more of a wage tax then a consumption based tax.

Nor can a definitive assessment be made of the effects of taxing consumption on either economic efficiency or the aggregate level of savings. Although the relative price distortions between present and future consumption would be eliminated, a consumption based tax would require an increase in marginal tax rates. This action, in turn, would increase the distortion between the relative price of market and nonmarket activities. The cumulative effect on overall economic efficiency cannot be ascertained theoretically. Since savings would no longer be subject to tax, many might find that they could actually save less and still achieve their saving objectives. Because of the offsetting nature of these income and substitution effects, a consumption tax would not necessarily produce an increase in saving.

A positive aspect of taxing personal consumption is the ease with which the individual and corporate tax systems could be integrated. In addition, the problems introduced by separate provisions for capital gains, attempts to distinguish between real and nominal income, and depreciation procedures would essentially be eliminated.

There would be pronounced difficulties encountered during a transition from an income to a consumption based tax. Regardless of the transitional strategy adopted, there is a potential for creating widespread windfall gains and losses.

# TABLE OF CONTENTS

HISTORICAL PERSPECTIVE . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 2

CONSUMPTION TAX DESIGN . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 3

EQUITY CONSIDERATIONS . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 5

ECONOMIC EFFICIENCY AND EFFECTS ON SAVING . . . . . . . . . . . . . 6

SIMPLICITY . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 7

TRANSITIONAL ISSUES . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 9

CONCLUSIONS . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 10

# A TAX ON CONSUMED INCOME

Continued large Federal deficits, concern over low rates of private saving, and disenchantment with the current individual tax system have prompted a renewed interest in revising and reorienting the individual income tax. Critics argue that the current income tax is inequitable in its distribution of the tax burden, that it contains numerous features that are detrimental to efficient economic behavior, and that accumulated alterations have produced a tax code of byzantine complexity.

To address these issues, some have suggested a shift in the current emphasis of personal taxation away from an income to a consumption base. This new emphasis on consumption based taxes has included proposals for value-added taxes (VATs), national sales taxes, and personal consumption taxes (also referred to as a tax on consumed income, an expenditure tax, a cash flow tax, and in some instances, a flat-rate tax).[1] It is the latter type of tax, a tax on consumed income, that has received the most recent attention, especially since the publication of a report by the Strengthening of America Commission, cochaired by Senators Sam Nunn and Pete Domenici. Among other things, the commission's report calls for phasing out the current income tax and replacing it with a tax on consumed income.

Although our current personal tax structure is referred to as an income tax, it actually contains elements of both an income and a consumption-based tax. For example, the current tax system includes in its tax base wages, interest, dividends, and capital gains, all of which are consistent with an income tax. However, at the same time it excludes items such as contributions to individual retirement accounts and certain forms of income from capital, practices which are consistent with a consumption-based tax.

This ambiguity in the tax base combined with the confusing array of exclusions, deductions, and exemptions has prompted many analysts to suggest that a basic public policy goal should be the establishment of a tax system that is based on a consistent set of principles. Promoting consistency in the personal tax system is one of the factors that appeals to proponents of a consumption tax. Moreover, consumption tax advocates argue that replacing the income tax with

[1] For information on VATs see: U.S. Library of Congress. Congressional Research Service. *Value-Added Tax: Concepts, Policy Issues, and OECD Experiences*. Report No. 92-938E, by James M. Bickley. Washington, 1992. For information on flat-rate taxes see: U.S. Library of Congress. Congressional Research Service. *Flat Rate Tax Proposals*. Report No. 92-406E, by Gregg A. Esenwein. Washington, 1992.

a consumption tax would remove the bias against savings and produce an increase in personal saving.

One should be careful, however, that the claims of consumption tax superiority are analyzed in the appropriate context. In many cases, comparisons are made between a theoretically pure consumption tax and our current income tax. These comparisons are not very useful. The appropriate comparison, when considering the merits of a consumption tax, is between a theoretically pure consumption tax and a theoretically pure income tax.

This report describes consumption taxes and examines the merits of a consumption versus an income tax base. Specific issues include evolution of consumption taxes, consumption tax design, implementation, equity/efficiency (including savings response)/simplicity characteristics, and transitional considerations.

## HISTORICAL PERSPECTIVE

The idea of taxing consumption is not new. As far back as 1651, Thomas Hobbes proposed that it would be more equitable to tax a person on the basis of what he takes out of the common pool of resources (what he consumes) rather than what he adds to the pool of resources (what he saves and invests). In Hobbes's view, saving and investment were advantageous social acts, while consumption was selfish and antisocial behavior.

This sentiment was echoed and amplified by John Stuart Mill who further argued that taxing income created a double taxation of savings. Savings were taxed once when originally earned as income and then taxed again when the savings earned interest. This double taxation of savings distorted an individual's decision on whether to save or consume by favoring current consumption over future consumption (saving).

The idea of taxing consumption received renewed emphasis in the mid-20th century by Irving Fisher, a professor at Yale University. Fisher expanded on the proposal that taxing income created a double tax on savings and argued that switching to a consumption tax would increase savings and lead to an overall improvement in economic performance.[2] In 1942, with the support of Fisher and Milton Friedman of the University of Chicago, Secretary of the Treasury Morganthau proposed to increase Federal revenue through a supplemental consumption tax. The proposed tax was never implemented.

More recent interest in consumption taxes surfaced with the publication, in 1977 of the Department of Treasury's *Blueprints for Basic Tax Reform*, a study which contained a detailed analysis of a cash flow type consumption tax.

[2] Today, most economists discuss this issue in terms of the efficiency loss caused by the price distortions between current and future consumption under an income tax, rather than in terms of the double taxation of savings.

The Treasury revisited the issue in 1984, when it considered a tax on consumed income as one of its four options for major tax reform. The Reagan Administration at one time hinted that it was considering some form of a consumption tax as either a supplement or an alternative to the income tax. Although the idea was later dropped in favor of reform of the existing income tax system, legislative interest in consumption taxes continues today. In fact, even President-elect Clinton has indicated that he believes that the current tax systems favors consumption at the expense of saving and investment.

## CONSUMPTION TAX DESIGN

A personal consumption tax would not be quite as complex as it might first appear. Individuals would not have to keep detailed records of their expenditures over the tax period and then total the individual expenditures to arrive at their tax base. In actual practice, there would only be minor differences between how the current income tax system works and how a personal consumption tax would work.

The easiest way to understand how a personal consumption tax would work is to first define the concept of income. In its broadest sense, income is a measure of the command of resources that an individual acquires over a given time period. Conceptually there are two options an individual can exercise with regard to his income: he can consume his income or he can save his income. This relationship between income, consumption, and saving allows a useful accounting identity to be established. That is, income, by definition, must equal consumption plus saving.

Under a personal consumption tax an individual would add up all of his income — wages, interest, dividends, capital gains, royalties, etc. — and then subtract out his net savings. The result would be the consumption base on which the tax is assessed. Record keeping requirements under a personal consumption tax would be similar to those under the current income tax.

The difficulty in consumption tax design, however, involves defining and accounting for net savings. The only way to accurately measure net saving would be to set up various accounts similar to Individual Retirement Accounts (IRAs), a method sometimes referred to as a qualified accounts approach. Investments (saving) in qualified accounts would be subtracted from an individual's tax base and not taxed until withdrawn and used for consumption. Interest earned in qualified accounts would also be excluded from the tax base until withdrawn and used for consumption. A comparison of the account balance at the beginning of the tax period and the end of the tax period would show if the taxpayer was a net saver or dissaver over the accounting period.

The procedure for dealing with loans would be similar to that used for investments in qualified accounts. Since a loan is a form of dissavings (it increase the resources an individual has command over) it should be included in the tax base if it is used for consumption. However, while the proceeds of a loan would be included in the tax base, principal and interest payments on the loan would be deducted from the base.

In the case of loans extended through credit cards and charge accounts, it should be relatively easy to apply a qualified accounts approach. That is, if an item were purchased on credit, the value of that item would be included in the tax base. At the same time, repayments of credit card charges (both principal and interest) would be subtracted from the tax base. Account balances could be compared at the beginning of the tax period and at its end to determine whether or not the taxpayer was a net saver or dissaver. Increases in the account balances would be added to the tax base while decreases would be subtracted.

Purchases of consumer durables would have to be handled differently. The acquisition of consumer durables, automobiles and houses for example, represents an investment rather than current consumption. Consumer durables return a flow of services over their lives and the annual yield of this investment should theoretically be reflected in accounting for income. For example, when an individual acquires a home it provides him with shelter, a service the individual would otherwise have to purchase through current consumption (rent). The value of this service (shelter) could conceptually be measured by the amount of rent he would have had to pay had he leased the house rather than purchased it. In practice, under either an income or consumption based tax, estimating the implicit value of the flow of services that result from the purchase of consumer durable is extremely difficult if not impossible.

Because of the complexity of using qualified accounts for certain investments and transactions such as acquisition of consumer durables, a method referred to as a tax prepayment approach is often suggested as an alternative. Basically, with tax prepayment saving (investment) would occur outside the purviews of the tax system. Investments would not be deducted from the tax base and proceeds from the investment would not be included in the tax base when used for consumption.

For example, the tax prepayment approach would be applied to the purchase of owner-occupied housing in the following manner. The initial purchase price of the home would not be deducted from the tax base, but at the same time the mortgage loan amount would not be added to the tax base. During the period of owner occupancy the implicit rental value of the home would not be added to the tax base nor would the payments of principal and interest on the mortgage be deducted. When the home is sold the proceeds would not be added to the tax base, since, in effect, the tax would have been prepaid.

It is worth emphasizing, however, that a consumption tax under which all transactions are handled using the tax prepayment approach would be identical to a tax on labor (wage) income. That is, only consumption financed by wage income would show up in the tax base under the tax prepayment approach. To see how these two tax bases would be equivalent, consider the following simplified two-period example.

In the first period, assume that a taxpayer earns $100 in wages and saves $10. Since, under the tax prepayment approach, the investment occurs outside the tax system, the $10 is not deducted from the tax base and hence, tax is assessed on the full $100 of wages. Now if the investment earns 10 percent, by the beginning of the second period it would have earned $1. The taxpayer could then withdraw his funds and consume, in addition to his wages in the second period, an extra $11 ($10 initial investment plus $1 of capital income). Yet once again, his tax base in the second period would only reflect his wage income in that period since the investment occurred outside the system. In essence, the consumption financed by the $1 of capital income would not be subject to tax and the tax base in both periods, regardless of the actual amount of consumption that occured, would only be the wage (labor) income.

Only if the qualified accounts approach is used for some transactions would the consumption base be larger than the wage base. That's because the return to capital, at any point in time, will exceed additions to the capital stock and therefore, at least the part of consumption financed by capital income would be subject to tax.

## EQUITY CONSIDERATIONS

One of the most frequently voiced concerns about a consumption tax is that it would be unfair because it would be a regressive tax. The tax burden would fall more heavily on lower income individuals, who consume a relatively larger percentage of their income acquiring basic necessities, than it would on upper-income individuals. By adjusting the value of personal exemptions, standard deductions, and tax rates, a consumption tax could be designed to achieve progressivity with respect to consumption. However, its progressivity with respect to income could only be approximated.

Probably more important than the progressivity issue are the horizontal equity (equal treatment of equals) issues associated with taxing consumption. A consumption tax would tax young people and retired individuals more heavily relative to their income than middle-aged individuals. These two groups tend to consume more relative to their earnings; young people borrow to finance current consumption and older people draw down their pool of savings to finance their retirements. Consequently, they would bear a heavier tax burden relative to their income under a consumption tax than they would under an income tax. Middle-aged individuals, who are in their prime earning years and saving for retirement would face a lighter tax burden relative to their income than they would under an income tax.

Another horizontal equity concern of a tax on consumed income is that if a tax prepayment approach were used then taxes would be assessed on the basis of expectations rather than outcomes. Recall that with a tax prepayment approach investments are not deducted from the tax base and the returns on the investments are not included in the tax base. This creates the potential for windfall gains and losses in that two individuals who make similar investments would pay the same tax even though one might realize a profit while the other might experience a loss. The assessment of tax based on expectations rather than outcomes is a problem inherent to the tax prepayment approach.

It is sometimes argued that a consumption tax would assess tax liabilities on a lifetime perspective. That is, in present value terms, an individual's lifetime tax burden would not be affected by decisions to consume now versus later, nor by decisions to defer the realization of income. In contrast, it is argued that an income tax tends to discriminate in favor of both those who consume early rather than later, and those who postpone the realization of income and defer the payment of their taxes.

When analyzing this argument it should be remembered that economic theory precludes the comparison of utilities between individuals. A difference in consumption patterns implies that individuals have different preferences and valuations of consumption at different points in time. As a result, economic theory cannot, without the interjection of subjective value judgements, easily differentiate between income or consumption as the appropriate tax base in these cases. An income tax is based on the proposition that individuals with an equal change in ability to pay in one year pay equal taxes, while the consumption tax is based on the premise of equal tax on those who consume the same amount in one year.

## ECONOMIC EFFICIENCY AND EFFECTS ON SAVING

The economic efficiency or inefficiency of a tax system can be judged by its effects on relative prices. If the tax system distorts relative prices it is inefficient, since this distortion prevents the efficient allocation of resources. With the exception of lump sum or head taxes, all taxes, regardless of whether they are based on income or consumption, distort relative prices and affect economic behavior.

Both an income and a consumption tax distort the choice between labor and leisure. For example, in the presence of a tax on income, the price of leisure is reduced relative to an individual's wage income. That is, to acquire an extra hour of leisure, an individual would need to give up less, depending on his marginal tax rate, than an hour's worth of wages.

An income tax also distorts the choice between present and future consumption (saving). Under an income tax, resources for future consumption (saving) are subject to tax. This reduces the resources an individual would have available for consumption in the future and hence, raises the price of future consumption relative to the price of present consumption.

In contrast, a tax on consumption is neutral with respect to the choice between present and future consumption. The relative price of future consumption in terms of present consumption is the same as if there were no taxes. It is argued that removal of the distortion between present and future consumption would increase economic efficiency. It is not clear, however, that adopting a consumption tax would actually increase overall economic efficiency.

Under a consumption tax which yielded revenue equal to an income tax, the tax rates on the consumption base would have to be higher than the tax rates on the income base. This would occur because, by definition, consumption is smaller than income. Given the smaller base, tax rates would have to be higher on consumption to raise the same revenue as an income based tax.

Although taxing consumption would eliminate the distortion between present and future consumption, the fact that the tax rates would be higher would increase the distortion between work and leisure choices. The efficiency gain from removing the present/future consumption distortions might be offset by the efficiency loss inherent in the larger distortion between work and leisure decisions.

This same ambiguity is present as regards the response of savers to an increase in the after tax return to saving. Under a consumption tax, the return to saving, which would be exempt from tax, would increase and as a result taxpayers would substitute future consumption (saving) for present consumption. There is, however, an additional effect that would occur simultaneously with the substitution effect that might actually cause saving to decline. An increase in the after tax rate of return means that an individual could save less and still achieve the same amount of future consumption. This income effect makes individuals richer and could induce them to consume more in the present. Because of the offsetting nature of substitution and income effects, it cannot be demonstrated theoretically whether a consumption tax would in fact increase saving. The empirical evidence is also inconclusive. As a result, it cannot be determined with any certainty that a consumption tax would increase the level of saving in the economy.[3]

## SIMPLICITY

Most of the complexity in the existing income tax structure can be traced to three general problems: the attempt to differentiate between real economic income and nominal income; the existence of separate personal and corporate taxes; and the use of the tax system to promote specific social and economic goals. While adoption of a tax on consumed income would eliminate the problem of measuring real versus nominal income and facilitate the integration of corporate and individual taxes, it is doubtful that it would have much effect on the complexities introduced by the use of the tax system to promote social and economic goals. The same factors that have influenced the design of the income tax would, in all probability, exert similar influences on the final design of a consumption tax.

[3] For more information on the effects of taxes on saving see: U.S. Library of Congress. Congressional Research Service. *Federal Tax Policy and Saving.* Report No. 91-178E, by Gregg A. Esenwein. Washington, 1991.

The complexities in the current tax system associated with inflation accounting for capital income would disappear under a consumption tax. Under the qualified accounts approach, investments would deducted from the tax base and proceeds would be included when realized and consumed. Since both the deduction from the base and addition to the base are measured in current year dollars, the problem of accounting for inflation is eliminated.

At the same time, however, extended use of the qualified accounts approach for handling investment transactions would tend to increase the record keeping requirements of the system. The alternative prepayment approach would also eliminate inflation accounting problems and would not require as extensive record keeping, but, as pointed out earlier, reliance on the prepayment approach moves the tax away from a consumption base and closer to a wage base.

A tax on consumed income would also make it easier to integrate the corporate and individual tax systems, and, as a consequence, decrease the overall complexity of the tax system. All investments in corporate stock would be deducted from an individual's tax base in the year the stock was acquired. All earnings from the investment, whether in the form of dividends or capital gains, would be added to the individual's tax base when realized and used for consumption. This alleviates the problem of taxing dividends twice: once at the corporate level as corporate profits and again at the individual level as income.

The bias in favor of retained earnings would also be eliminated under a consumption tax. The current tax system creates a bias such that corporations tend to retain earnings rather than pay out dividends in order to avoid their double taxation. In addition, under a tax on consumed income overall complexity would decrease because there would be no need for depreciation schedules or investment incentives like the investment tax credit.

Even under a tax on consumed income, however, other problems associated with the current income tax system would remain and some might intensify. For instance, the problem of defining the appropriate unit of taxation, the family or the individual, would remain whether the tax base was income or consumption. Another problem independent of the tax base is the appropriate procedure for accounting for and taxing items such as fringe benefits.

A problem that might intensify under a consumption tax would be that of tax compliance. To obtain equal revenue, the tax rates on a consumption base would have to be higher than those applied against an income base. Higher tax rates would produce a greater incentive for individuals to under-report their market activities. This would be especially evident for investments handled through qualified accounts. Under current law, only part of the proceeds is subject to tax; under a consumption tax the entire proceeds, if used for consumption, would be subject to tax at higher rates.

## TRANSITIONAL ISSUES

Many difficult transitional problems would be encountered during any major reform of an existing tax system. They would be especially acute in a switch from an income to a consumption based tax with the potential for creating widespread windfall gains and loses. Those who had based their behavior and decisions on the existing set of tax rules might find themselves in an unfavorable position, while others would benefit fortuitously.

The transitional problems associated with switching from an income to a consumption based tax are often divided into two major groups, carryover problems and price changes.[4] Carryover problems include how to treat wealth existing at the date of transition and how to deal with provisions of the former tax code which extend beyond the transition date. Wealth existing at the date of transition could have been accumulated from income that had been fully taxed, partially taxed or not taxed at all. Fully taxing consumption financed from this wealth would create severe inequities, especially for retired individuals, since some of their wealth may have already been taxed under the previous regime. On the other hand, exempting all consumption financed by this wealth would produce windfall gains for some and significantly lower the revenue yield of the new tax.

One means of avoiding this problem would be to require individuals to inventory their existing wealth at the time of transition. Consumption from the inventoried wealth could then be taxed accordingly depending on whether the wealth had previously been subject to tax. This requirement would create logistical problems and probably induce widespread tax evasion, since it would be advantageous for individuals to under-report or under-value their assets and thus acquire consumption tax free.

Other carryover problems involve the appropriate treatment of various provisions of the previous tax code which overlap the transition date. Many elements of the current income tax are designed to extend over several years, for example, the amount and timing of short-term capital losses that can be used to offset ordinary income. It would be difficult to integrate these carryover provisions from the old income tax into the framework of the new consumption tax. Failure to do so, however, would penalize individuals who had based their behavior on the expectation of the continued availability of these provisions.

Adopting a tax on consumed income would also create problems because it would change relative prices. Assets which had received preferential treatment under the previous tax system, unless the preference were continued under the consumption tax, would fall in value relative to other assets. For instance, consider the change in relative prices that might occur with respect to owner-

[4] For a more detailed discussion of these transitional problems see: U.S. Department of Treasury. *Blueprints for Basic Tax Reform*. Washington, 1977; and *Tax Reform For Fairness, Simplicity, and Economic Growth*. Washington, 1984.

occupied housing. Under a tax on consumed income, if the loan amount was not included in the tax base, then the interest and principal payments on a home mortgage would not be deductible. Since current tax preferences are reflected in the market price of existing homes, elimination of this preference would reduce their market value. Many home owners would experience marked reductions in the equity of their homes. On the other hand, the value of corporate stock would increase since corporate earnings would no longer be subject to double taxation under a consumption tax.

## CONCLUSIONS

A personal consumption tax is an old idea receiving renewed interest. It is often argued that a personal consumption tax would be equitable, efficient, simple, promote increased personal savings, and help reduce the Federal budget deficit. Upon examination, however, the supporting evidence for these claims is less than conclusive. There appears to be insufficient theoretical or empirical evidence to conclude that a consumption based tax is inherently superior to an income based tax.

While a personal consumption tax can be designed to achieve any desired level of progressivity with respect to consumption, its progressivity with respect to income could only be approximated. In addition, a consumption tax would involve a redistribution of the tax burden by age group, with the young and old generally bearing more of the total burden than those in their prime earning years.

Another equity concern is that if investment transactions were not fully accounted for through IRA type arrangements, then, to a certain degree, taxes would be assessed on the basis of expectations rather than outcomes. Moreover, allowing investment transactions to occur outside the tax system would reduce the tax base and make it more of a wage tax then a consumption based tax.

Nor can a definitive assessment be made of the effects of taxing consumption on either economic efficiency or the aggregate level of savings. Although the relative price distortions between present and future consumption would be eliminated, a consumption based tax would require an increase in marginal tax rates. This action, in turn, would increase the distortion between the relative price of market and nonmarket activities. The cumulative effect on overall economic efficiency cannot be ascertained theoretically. Since savings would no longer be subject to tax, many might find that they could actually save less and still achieve their saving objectives. Because of the offsetting nature of these income and substitution effects, a consumption tax would not necessarily produce an increase in saving.

A positive aspect of taxing personal consumption is the ease with which the individual and corporate tax systems could be integrated. In addition, the problems introduced by separate provisions for capital gains, attempts to distinguish between real and nominal income, and depreciation procedures would essentially be eliminated.

There would be pronounced difficulties encountered during a transition from an income to a consumption based tax. Regardless of the transitional strategy adopted, there is a potential for creating widespread windfall gains and losses.

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