

A Comparison of Income and Consumption Taxes

A Presentation to
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Tax Reform

by

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Elements of Tax Reform

- Tax Base -- Income, consumption, wages, hybrid, other
- Tax Base exceptions -- Deductions, credits, exemptions, exclusions
- Tax Rates -- Graduated or flat
- Collection methods

Tax Reform in Theory and Practice

- In theory: easy to write down better tax systems.
- In practice: the changes needed to allow tax proposals to survive the political process, lobbyists, the tax shelter industry, and public opinion make taxes more complex, less efficient, and less fair.
- The proof: tax systems that exist in the U.S. and everywhere else.
- Cleaning out the tax base would likely be a bigger (and harder) reform than changing from an income tax to a consumption tax.
- We don't necessarily face a choice between consumption and income taxes. Many countries have both.

Comparing Consumption and Income Taxes: A Caveat

- On many issues, there can be almost as much variation *among* different prototypes as there is *between* income and consumption taxes.
- For practical purposes, "income tax" = the current U.S. system. The "consumption tax" = a European Value-Added Tax or the U.S. tax system with expanded tax-preferred saving and no interest deductions.

Progressivity

- Income taxes are more progressive than consumption taxes in practice. The ratio of consumption to income falls dramatically at higher income levels. A revenue-neutral shift to a consumption tax will therefore generally raise tax burdens on low- and middle-income households relative to an income tax.
- A progressive income tax acts as a partial insurance mechanism. When income falls by x percent, tax liabilities fall by more than x percent. When income rises by x percent, tax liabilities rise by more than x percent. In a consumption tax, these features are often muted.

In Practice, Income is a Better Measure of Ability-to-Pay

- In theory, consumption is the ideal measure of households' ability to pay taxes. In practice, it is not, and it may actually be quite a poor measure of ability to pay.
- When people face restrictions on their borrowing, current income is a better measure of ability to pay taxes than is current consumption.
- People have different tendencies for saving, so a given level of consumption does not allow a distinction between high-income person who saves a lot and a low income person who saves little. An income tax generally would allow that distinction.
- In many situations, consumption may be an extremely poor measure of ability to pay. For example, a family has young children and one of the spouses stays at home; someone gets sick and faces large health expenses; a couple gets divorced and faces large legal expenses.

In Practice, the Income Tax Need Not Be More Complex

- Taxes are complex for many reasons: to provide equity, to administer social policy, to reduce evasion, as a response to political factors. All of these sources would remain under a consumption tax, but could be simplified under either tax.
- Another source of complexity is the effort to tax capital income. This might be done more simply in a consumption tax. Of course, it could be done more simply than it currently is in the income tax, too.
- There are two ways in which a consumption tax is likely to be more complex than the current tax code.
 - Although a consumption tax could eliminate the differential tax treatment of many of the difficult distinctions in the code (e.g., debt versus equity), it would inevitably create new "pressure points" (e.g., financial versus non-financial flows).
 - Conversion to a consumption tax would create complexities with (a) state income taxes, (b) tax treaties, (c) corporate accounting system, (d) other income reporting systems (e.g., college financial aid, mortgage applications, etc).

In Practice, Income Taxes Don't Hurt Growth Very Much, and a Poorly Designed Consumption Tax Could Reduce Growth

- In order to raise growth by significant amounts, a consumption tax needs to (a) be revenue-neutral, (b) broaden the tax base by removing deductions and tax preferences, (c) impose a tax on old capital--that is, not provide transition relief to existing assets, and (d) be consistent in the taxation of interest income and expense.
- Evidence shows that "reforms" that do not meet these standards have little effect on long-term growth. Realistically, a poorly designed consumption tax reform could reduce economic growth.
- Conversion to a consumption tax could blunt the incentive to have special accounts for pensions and 401(k)s. Non-tax approaches – like automatic enrollment and automatic escalation of contributions – are more promising methods of raising saving and operate in the income tax.

Taxing the Underground Economy

- It is a myth that the consumption tax is more effective at taxing the underground economy than the income tax is.

Dealing with Unstable Tax Systems

- Instability is, or should be, a first-order consideration in tax reform. We have had at least 12 major reforms in the past 25 years, with no end in sight.
- Income taxes deal with instability better than consumption taxes do. In particular, the rate of return to saving and investment varies dramatically with relatively small changes in consumption tax rates, but not with small changes in income tax rates.

Transition Issues

- Transition to a consumption tax would require addressing numerous issues. These are not "just" transition issues. They are central to the efficiency, equity, and simplicity of a consumption tax.

Conclusion

- The income tax is a fair, proven mechanism for raising revenue, consistent with long-term U.S. economic growth. It could be improved, but should not be scrapped.
- Wholesale moves to a consumption tax are likely to be fraught with problems and will likely deliver much less than hoped for or promised.