by Gene Steuerle

Taxing the Capital Income of Only The Poor and the Middle Class

Perhaps the most significant and divisive tax debate of the past three decades has been over whether taxes on income ought to be replaced with taxes on consumption. Almost all of the large-scale reform efforts proposed during that period have sought that goal, even though the methods vary widely. A national retail sales tax, the Hall-Rabushka flat tax (which one of its authors, Robert Hall, has declared is not and should not be flat), and the X-tax of the late David Bradford have as a primary feature the taxation of consumption rather than income.

But would the adoption of any of these taxes actually remove the taxation of capital income? From what has been proposed so far, no. Each would effectively leave capital taxes on the poor and the middle class and remove them only from wealthier members of society. To understand why, we must recognize that the income tax — or its replacement — is not the only program conditioned on income. It is part of a vast array of tax and transfer programs. For some policy purposes, these programs can be considered in isolation; when it comes to abandoning income taxation, this single-minded focus is not possible.

Most taxpayers and tax reform advocates are well aware of the many types of subsidies in the tax code, whether for charitable contributions, health insurance, research, or hundreds of other items. By one account, most of these subsidies can be labeled tax expenditures, because they often perform almost exactly the same economic function that a direct spending program would. The tax expenditure label is useful because it allows us to refer to its less well-known inverse: expenditure taxes. Just as much spending is contained within taxes, many taxes are contained within spending programs. Take the case of food stamps. In some income ranges, the amount of food stamps is reduced by $1 for every $3 of additional income of the household. Similar phaseouts of benefits are applied in programs for Pell grants and other higher education assistance, welfare (Temporary Assistance to Needy Families), Medicaid, rental housing vouchers, school lunch programs, child care vouchers, supplemental security income, and countless other direct spending programs. All of those programs effectively contain mini-income taxes within them.

Some of those layers of income tax systems that fold on top of layers of spending programs are layered, in turn, into the tax system. Thus, there is a vast array of implicit income taxes contained in the spending that is contained within the tax system! A prime example is the earned income tax credit, which is a wage subsidy administered by the IRS. The credit amount is phased out as income increases, and that phaseout operates just like an additional income tax on those earned-income recipients who face it. In some income ranges, for instance, their credit amount is reduced by 21 cents for every additional dollar of income. Similarly, the following tax subsidies or programs are phased out as income increases: HOPE scholarship credits, lifetime learning credits, Keogh and individual retirement account deductions, dependent exemptions, dependent and child-care credits, and much more.

For some reason, advocates of consumption taxes never deal with how those various ''income tax layers'' within spending programs would be handled. I have personally approached many of those advocates, especially those for whom I have the most respect as being academically rigorous. None has been able to answer my question of what they would do about all of those ''income tax'' systems imbedded in spending programs or in subsidy and spending programs in turn imbedded back into the tax system.

Still, let's consider the choices. Suppose we were to phase out benefits not on the basis of income, but of consumption. Then we would provide earned income tax credits and food stamps and even welfare to frugal millionaires, and grant richer people Medicaid (and Medicaid nursing home assistance) if they would temporarily lower their levels of consumption. We would base higher education aid, whether in the direct spending or tax system, on the basis of consumption spending. If it was an annual accounting system, a household could simply increase assistance by postponing consumption out of earnings.

Presume for the moment that this is acceptable on equity grounds. Then the question arises of how we would administer it. Under most forms of consumption taxes, there is really no government record keeping of consumption. The national retail sales tax advocates extol the lack of government information as a virtue for taxpayers, but what would they do about all those other systems? Presumably they might try to require that Social Security numbers be entered at the time of every purchase, although that could prove quite cumbersome and intrusive and ultimately unworkable. For consumption taxes that are paid over primarily by businesses at a flat rate (one of the tax bases in various flat tax and X tax schemes that start with a type of value added tax), one of the primary simplifications was that attribution to individuals was not required for that source of consumption to be taxed. That is, the flat rate helped remove the requirement for attribution since it was the same rate no matter when was the recipient. Therefore, we wouldn't know how much individuals consumed out of their dividends and interest. A separate or additional tax base in some of those consumption tax schemes is wages paid

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out of the business sector, but then many wage earners save, so information on wages is also inadequate to measure their level of consumption.

An alternative form of consumption tax requires that taxpayers and financial intermediaries report to tax authorities on both income and the change in net saving (such as deposits less withdrawals from accounts — a limited wealth accounting of sorts). A proposal by former Sen. Sam Nunn and Sen. Pete Domenici was of that type. However, in this form of consumption tax, the government really needs both income accounting and partial wealth accounting for all assets to be able to approximate consumption at the individual level. For compliance reasons, it also needs good wealth accounting for the $50 trillion or so of wealth that might be deposited in new accounts but not represent new saving.

Well, suppose we abandon all attempts to phase out the availability of benefits on the basis of either income or consumption, and revert instead to wages as the basis for measuring when to reduce benefits. Then, of course, rich people could qualify simply by not working for awhile. Admittedly, that can already be done by workers who have no saving; we would simply be adding the wealthy to the mixture.

How about asset tests? Admittedly, they are horribly unreliable: Some elderly currently transfer assets to kids or hide it to qualify for Medicaid. We could extend those asset tests to almost every form of benefit that is now income-conditioned, and impose a much stricter accounting system. But then aren't we really back to income accounting? Only in this case we essentially are phasing out benefits on the basis of some imputed income from wealth rather than on realized income from wealth. It might even be a fairer system, given that realization of accrued income from capital is a choice the taxpayer can make. However, now we have replaced realized income accounting with wealth and imputed income accounting. Once again, that raises issues of both complexity and enforcement that may be worse than the current income tax accounting on which many systems currently rely.

Another alternative is to use a consumption tax base for purposes of applying a set of statutory tax rates like those now applied to income, but to continue all the implicit income taxes in the EITC, food stamps, higher education incentives, housing and health benefits, and so forth. Then we would need to continue almost in its entirety an income reporting system that includes capital income. Separately, we would track consumption for the new consumption tax system. From what I have seen of all consumption tax proposals to date, that is implicitly what they are proposing, at least indirectly. That is, those proposals do not change the income accounting required in all those other programs such as food stamps or EITC, even though they may eliminate the income tax.

Interestingly, the end result of this last system is that higher-income taxpayers would essentially face a consumption tax on income, at least in the years that their income was high enough that they were not eligible for any of the income-conditioned programs.

All the rest — all the lower- and middle-income households who receive educational or work-related or child or welfare or health benefits — would remain primarily in a system that phased out their benefits on the basis of income. Although they might not need to file an income tax return with IRS, they would need to fill out income tax forms for those other programs, because the IRS form no longer would be available to be sent as a substitute.

Marginal tax rates — the tax rates paid for earning an additional dollar — would remain high on capital income for many of those lower- and middle-income households. Today those rates rise as high as 50 to 100 percent from all the phaseouts; if their statutory income tax rate bracket formerly was 15 percent, their implied marginal income tax rate from all the other programs might fall to 35 to 85 percent.

Is that what is really sought? Is it to reduce tax on capital for those who already have a lot of saving and to keep it high on those who often have very little in the way of saving? I doubt that's what those economists and theoreticians have in mind. But then maybe they are not really the ones driving the process in the first place. After all, that is exactly the direction the nation's tax and transfer systems have been moving for some time now.

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