OnTheRecord

A Conversation with **Alan D. Viard**

Benefits of a Progressive Consumption Tax

Alan D. Viard, a resident scholar at the American Enterprise Institute, reviews the budget outlook, the need for tax reform and the benefits of moving to a progressive consumption tax. He also discusses his forthcoming book, *Progressive Consumption Taxation: The X Tax Revisited*, which he coauthored with Robert Carroll of Ernst & Young. The book will be published by AEI Press in the spring.

Q. What is the long-term budget outlook?

A. If current tax and budget policies are maintained, spending on Medicare, Medicaid and other health programs and, to a lesser extent, Social Security will grow much more rapidly than federal revenue during the upcoming decades. The Congressional Budget Office (CBO) laid out the grim arithmetic in its June 2011 analysis of the long-term budget outlook.

In its "alternative fiscal scenario," which reflects a continuation of current policies, CBO projects that spending on federal health programs will soar from 5.6 percent of GDP in 2011 to 10.4 percent in 2035. The increase will be driven by rising health care costs, reinforced by the aging of the population and health care reform provisions that expand Medicaid and offer new subsidies for private health insurance. CBO also projects that Social Security spending will rise from 4.8 percent to 6.1 percent of GDP over this period, due to population aging. Total federal spending will persistently exceed revenue, which CBO assumes will hold steady at 18.4 percent of GDP, its average in recent decades. The resulting deficits will steadily add to the government's debt. The federal debt, which has typically been below 40 percent of annual GDP and has reached 69 percent due to the recent recession, will rise to 187 percent of annual GDP in 2035.

Q. How are Congress and the president likely to ward off the projected shortfalls? What is the role of tax reform in addressing these fiscal imbalances?

A. Due to the political obstacles that either party would face acting alone, the fiscal imbalance is most likely to be addressed in a series of bipartisan agreements. These will include both tax increases and cuts to entitlement spending, particularly Social Security and Medicare benefits. Federal tax revenue will rise above its 18.4 percent average share of GDP. Although entitlement spending will increase as a share of GDP, it will grow more slowly than CBO current-policy projections. A key part of the entitlement cuts will involve requiring recipients of Medicare and the other health programs to pay a larger share of their own health care costs; schemes to reduce the overall level of health care costs are unlikely to yield big results.

Although the richest 2 or 3 percent of the population, those with incomes above $250,000 or so, have a large share of the nation's income, it will not be possible to close the fiscal gap solely by raising their taxes. People at more modest income levels, including the broadly defined middle class, will end up bearing part of the tax increases and nearly all of the entitlement cuts.

As federal revenue becomes a larger share of GDP, there will be pressure to reform the tax system to make it less economically inefficient. Because consumption taxation is less inefficient than income taxation, the federal tax system is likely to move toward consumption taxation, in some form and to some extent, over the upcoming decades.

Income taxes are more inefficient than consumption taxes because they penalize saving and investment. Under an income tax, a worker who spends his wages immediately is taxed only once—he pays tax on his wages. But, the income tax metes out harsher treatment to a worker who saves her wages and then spends her savings and interest at a future date. This worker pays tax on her wages and also pays tax on the interest she earns on her savings. As a result, she gets hit with a bigger percentage tax burden than the worker who spends his wages up front. In contrast, a consumption tax puts the same percentage burden on both workers, provided that the tax rate stays the same. Although consumption and income taxes both penalize work, the income tax is more inefficient because it also penalizes saving.

Q. What are the different ways that our tax system could move toward consumption taxation?

A. The most likely, although not the most desirable, would be to adopt a value-added tax (VAT) alongside the individual and corporate income taxes. The VAT is essentially the same as a retail sales tax but is collected in installments at each stage of business production. Many countries, including most of the European democracies, have VATs alongside income taxes.

It would be better to completely replace the income tax system with a consumption tax, which would fully eliminate the income tax's penalty on saving and investment. That approach would also avoid the temptation for increased federal spending that might

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arise if the government had access to both an income tax and a consumption tax. But, it's hard to imagine that the income tax system should, or ever would, be completely replaced by a VAT or a sales tax. The problem is that VATs and sales taxes are regressive, meaning that they impose heavier tax burdens on people who are less well off.

The best approach is the complete replacement of the income tax by a progressive consumption tax, one that imposes heavier tax burdens on people who are better off. There's nothing impossible or self-contradictory about a progressive consumption tax, although it requires the use of an unfamiliar tax system. One type of progressive consumption tax is the personal expenditures tax (PET). Under the PET, households would file annual tax returns on which they would compute their consumer spending by subtracting their net saving from their income. Households would be taxed on their spending, with higher tax brackets applying to those with higher spending.

Although the PET has some advantages, I view the "Bradford X tax" as the best way to implement progressive consumption taxation.

Q. What is the X tax and how is it different from the current tax system?

A. The Bradford X tax was proposed by David Bradford of Princeton University in 1986. It is a modification of the "flat tax" proposed by Robert Hall of Stanford University and Alvin Rabushka of the Hoover Institution in 1983. The tax has two components, a household tax on wages and a business-firm tax on business cash flow.

Households are taxed only on their wages, not on any income from saving, such as interest, dividends or capital gains. Higher tax brackets apply to workers with higher wages. Workers with the lowest wages pay no tax and may receive cash from tax credits. If desired, it would be possible to allow some deductions on tax returns, such as charitable contributions, medical expenses, and state and local taxes.

Businesses, regardless of whether they are corporations, partnerships or sole proprietorships, are taxed on their business cash flow at a high flat rate equal to the tax rate paid by the highest-wage workers. Firms are allowed to immediately deduct all business expenditures, including purchases of equipment and buildings, rather than depreciating them over a period of years. Firms do not deduct interest expense or any other financial outlays.

Although the X tax may look like an income tax, its economic properties make it a consumption tax. The wages on which workers are taxed plus the business cash flow on which firms are taxed add up to consumption. Two key features of the X tax guarantee that it imposes no saving and investment disincentives. First, households are not taxed on income from saving. Second, firms immediately deduct their investment costs, which cancels out, on the margin, the tax later imposed on the proceeds of those investments.

The X tax is progressive because it imposes the highest tax rates on high-paid workers and on people who consume from business cash flow while imposing lower tax rates on lower-paid workers.

Q. What are the advantages of the X tax?

A. Switching from the income tax to the X tax is likely to boost saving and investment, which are key factors driving long-run growth. Based on economic simulations, a reasonable middle-ground estimate is that the switch may boost long-run output by about 5 percent. The increased output will show up only gradually; in the short run, living standards will decline as households cut back on consumer spending and increase saving.

The X tax is also simpler than today's individual and corporate income taxes. Under the X tax, households report only their wages on their tax returns. Wages are generally the easiest type of income to report, as the necessary information can be taken directly from the W-2 form. Business firms can immediately deduct all of their business costs, so they can avoid the complexities of depreciation, amortization and inventory accounting.

Q. Are there any disadvantages to the X tax that critics might seize upon?

A. As Bob Carroll and I discuss in our book, the X tax faces some challenges with respect to the taxation of business firms, international transactions and financial institutions. We outline ways in which these challenges can be addressed. We also discuss transitional issues and the tax treatment of housing, pensions and fringe benefits, and other special topics.

The biggest problems, though, may relate to popular perceptions of the X tax. The fact that the household component of the X tax applies to workers' wages, but not to investors' interest, dividends and capital gains, may pose political problems. Also, because the X tax looks like an income tax, it may be difficult to explain to Congress and to the public that it is a consumption tax.