A Consumed Income Tax:
A Fair and Simple Plan for Tax Reform

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Last words (first)

- It is time to get the fair timing of tax down right
- We should tax people when they spend, not when they work, save, give, or die

A consumed income tax

- From where we are:
  - Place all savings accounts on traditional IRA, 401(k) models
  - Remove *all* limits on contributions to and withdrawals from such accounts
  - Include debt in tax base
  - Repeal capital gains preferences
  - Repeal gift and estate tax
  - Repeal corporate income tax

Three types of tax

- Income, prepaid consumption and postpaid consumption (a/k/a consumed income tax)
- Income = Consumption + Savings (I = C + S) (Haig Simons)
- Two forms of consumption tax
  - Prepaid = wage tax = Roth IRA
    - pay tax now, not later
  - Postpaid = spending tax = consumed income tax = traditional IRA
    - pay tax later, not now
    - C = I – S
  - Equivalent under constant rates

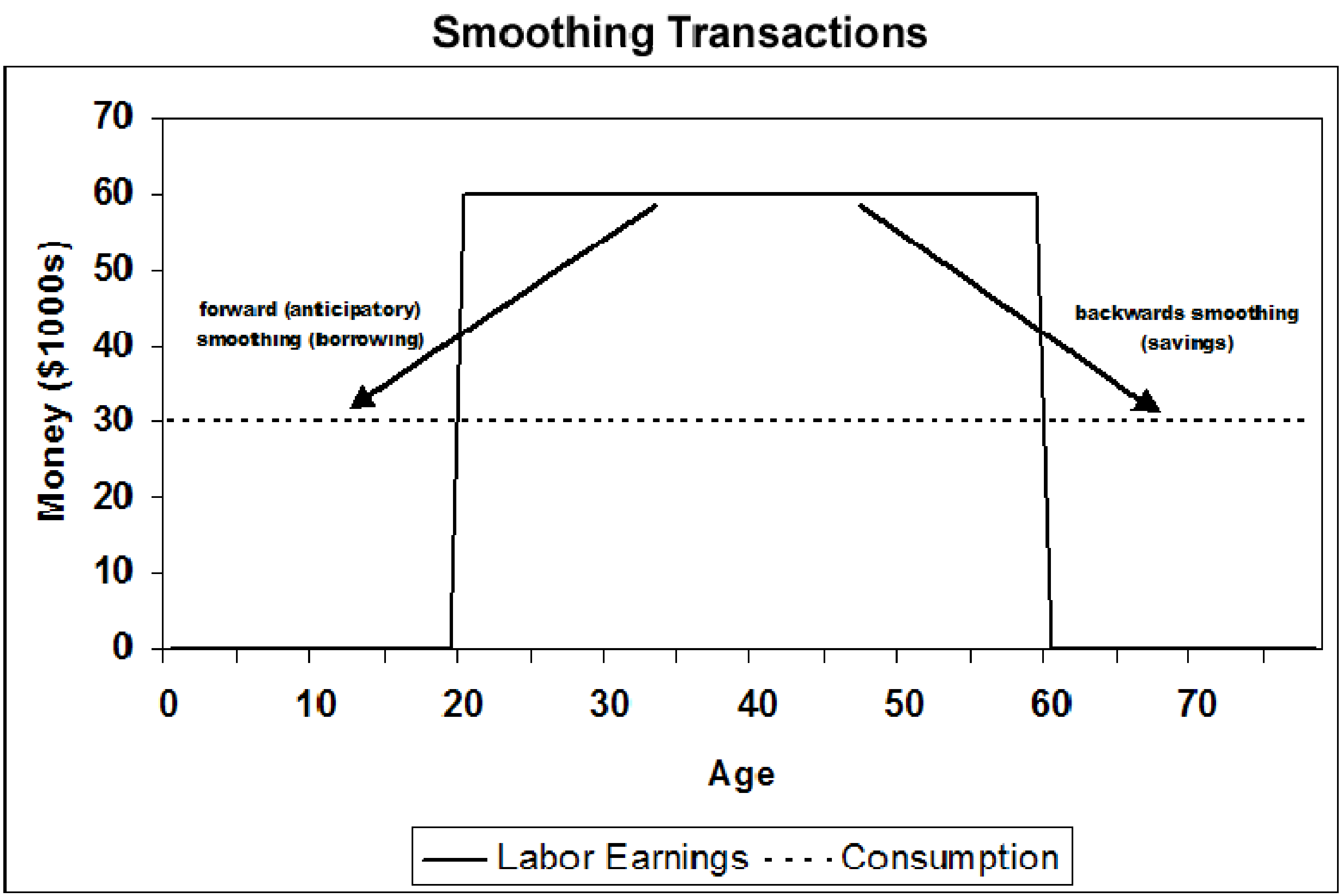
Three types of tax

- Key insight:
  - Equivalence of prepaid and postpaid consumption tax does NOT hold under progressive rates

- Given progressive rates:
  - Income tax: double taxes ALL savings
  - Prepaid consumption tax: ignores ALL savings
  - Consumed income tax: splits the difference, by design

Two types of savings

- Two uses of capital
  - Smoothing
    - Translating uneven earnings into “smoothed” or even consumption – moving earnings to times of greater need
      - Such as retirement, education, medical needs
  - Shifting
    - Using capital to raise or decrease standard of living
- Three taxes, again
  - Income tax: double taxes both uses
  - Prepaid consumption: ignores both uses
  - Consumed income: favors smoothing, falls on shifting


Smoothing Transactions
Money ($1000s)
70
60
50
40
30
20
10
0
forward (anticipatory)
smoothing (borrowing)
backwards smoothing
(savings)
0
10
20
30
40
50
60
70
Age
Labor Earnings
Consumption

A note on “hybrids”

- BAD hybrids:
  - Cut and paste, mix and match income and consumption models
  - Income plus prepaid consumption:
    - Savers put “old” savings into Roth-style accounts
    - No help for middle class living paycheck to paycheck
    - Result is no new savings
  - Income plus postpaid consumption
    - Taxpayers put money into traditional IRAs and run up debt
    - Result is tax deduction with (again) no new savings
  - See McCaffery 2005b

A note on “hybrids”

- GOOD hybrid:
  - Tax some but not all savings
    - “smoothing” or savings for ordinary uses – retirement, education, medical needs lowers taxes
    - “shifting” or using the yield to capital as a source of enhanced consumption, raises taxes
- Progressive consumed income tax does this, by design, by taxing people when they spend
  - Moving from high earnings periods to those of greater need lowers taxes
  - Living “better” off the yield to capital raises taxes
  - See graphics in appendix, McCaffery (2005a)

A consumed income tax

- A consistent consumed income tax:
  - Encourages savings for ordinary purposes
  - Taxes capital when its yield is used to elevate or enhance lifestyles, not otherwise
  - Discourages consumptive debt
  - Encourages real savings, across generations
  - Mistake to think needs higher rates
    - No capital gains preference
    - Pick up debt-financed consumption

Take home points

- Tax reform is needed
- We do not have, have never had, and will never have an income tax
- Not all consumption taxes are created equal
- Prepaid consumption taxes = wage taxes
  - No burden on wealthy
  - No marginal incentive to save
  - Where we are headed
- Postpaid consumption taxes = consumed income tax = spending taxes
  - Can be progressive
  - Eliminate need for separate capital taxation
    - Capital gains
    - Gift and estate
    - Corporate income
  - Where we should be headed

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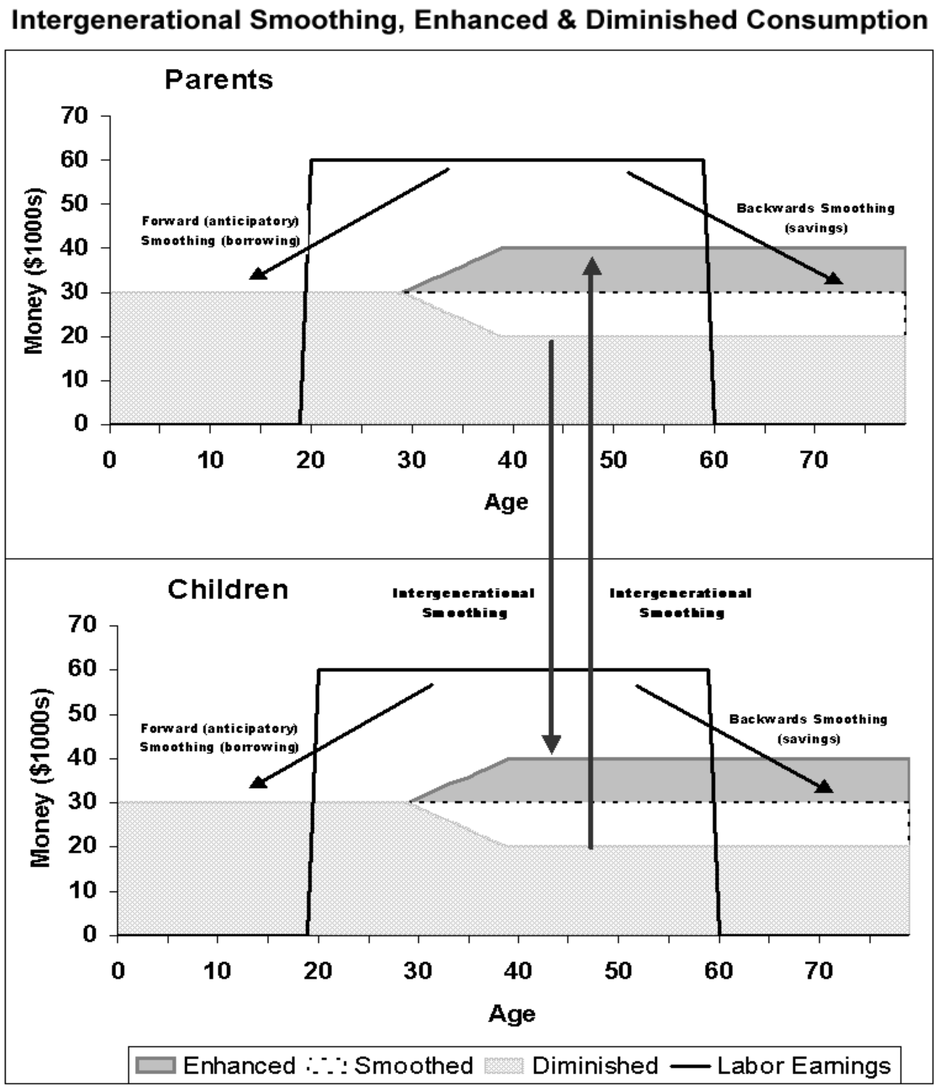
Two types of savings

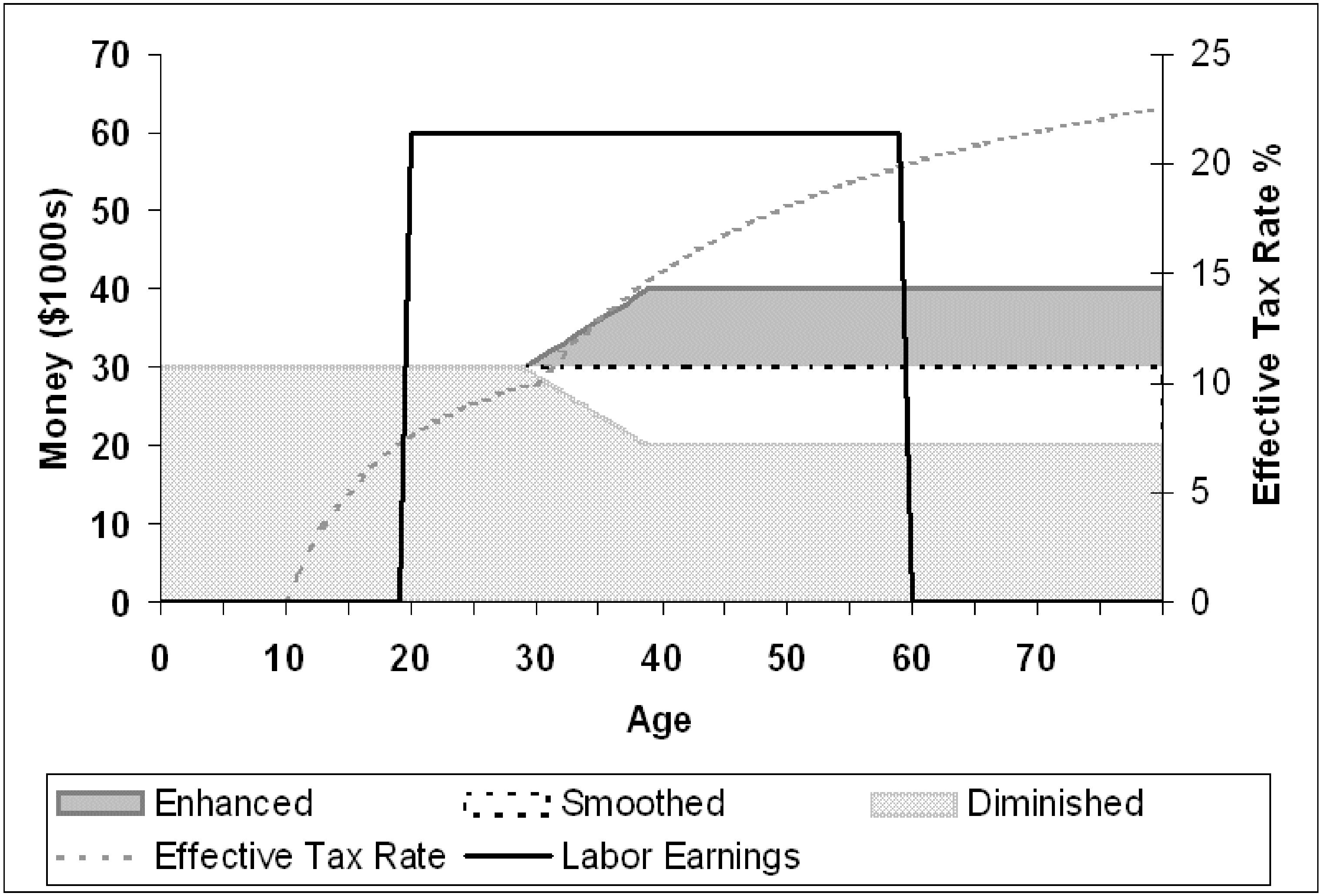
- Two norms of capital:
  - Ordinary savings
    - Don’t “double tax” people saving for ordinary needs, such as retirement, medical, and educational ones
  - Yield to capital
    - Do include the yield to capital in the tax base, tax people living off capital
- Two uses of capital
  - Smoothing
    - Translating uneven earnings into “smoothed” or even consumption – moving earnings to times of greater need
  - Shifting
    - Using capital to raise or decrease standard of living

Further graphics

- Smoothing and shifting capital transactions, within and between generations, and with progressive tax rates
- Much more detail in McCaffery 2005a


Intergenerational Smoothing, Enhanced & Diminished Consumption
Parents
Forward (anticipatory) Smoothing (borrowing)
Backwards Smoothing (savings)
Money ($1000s)
Age
Children
Intergenerational Smoothing
Intergenerational Smoothing
Forward (anticipatory) Smoothing (borrowing)
Backwards Smoothing (savings)
Money ($1000s)
Age
Enhanced
Smoothed
Diminished
Labor Earnings

Income Consumption Patterns, Effective Tax Rates



Where we are heading

- “Income” tax:
  - Basic tax planning obviates taxation of yield to capital
    - Tax planning 101:
      - Buy
      - Borrow
      - Die
    - See McCaffery, 2002, Fair not Flat
  - Low capital gains, dividend taxes
  - Increasingly prepaid savings accounts
    - Roth IRAS
    - Medical and educational savings accounts

Where we are heading

- Add on:
  - Payroll tax
  - Weak gift and estate and corporate income taxes
- You get:
  - Relatively flat, highly burdensome wage taxes (prepaid consumption)

Where we should be going

Towards a progressive *postpaid* consumption tax, a progressive consumed income tax

- Practical points
  - C = I – S
  - Could use VAT plus rebates at lower end, ala Graetz proposal
  - Need to pick up debt in tax base
- Mistake to think needs higher rates
  - No capital gains preference
  - Pick up debt-financed consumption

Implementation points

Since a consumed income tax is analytically equivalent to a sales tax or VAT, we could use a VAT or a sales tax set at the lowest non-zero marginal tax rate plus a rebate (= VAT/sales tax rate times “zero bracket” upper limit), then subtract the VAT/sales tax rate from the consumed income tax rate schedule, to get a two-tax system. See next two slides.

Consumed income tax, one-tax system (illustrative)

Consumed Income	Marginal Tax Rate %
$ 0 – 20,000	0
$20,000 – 80,000	10
$80,000 – 160,000	20
160,000 – 320,000	30
Over 320,000	40

Consumed income tax, two-tax system, with 10% VAT and $2,000 rebate

Consumed Income	Marginal Tax Rate %
$ 0 – 80,000	0
$80,000 – 160,000	10
160,000 – 320,000	20
Over 320,000	30

Transition issues

- Main problem is "pre-enactment basis"
  - But query how much basis there is, today
  - Alternatives are to ignore (Kaplow 1995) or allow some form of credit/amortization
- Challenge is to tax debt
  - Cash flow, financial reporting
- Simplification gains come from:
  - Unified approach to savings
  - No need for concept of "basis"
  - No capital gains
  - No gift and estate tax
  - No corporate income tax

Housing and charitable deductions

- Housing can be treated as savings, at least up to a certain principal value
  - Hence not only mortgage interest but also principal payments deductible
- Charitable contributions deductible from consumed income

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Sources

- McCaffery, Edward J. 2002. *Fair not Flat: How to Make the Tax System Better and Simpler* (U. Chicago Press 2002, 2006 (paper)), see www.fairnotflat.com)
- McCaffery, Edward J. 2005a. “A New Understanding of Tax.” *Michigan Law Review* 103: 807-938)
  - Note: this article has many footnotes with extensive sources for further reading and exploration
  - Available on ssrn, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=705383#PaperDownload>
- McCaffery, Edward J. 2005b. “Good Hybrids/Bad Hybrids.” *Tax Notes.* June 27, 1699-1705.
  - Available on ssrn, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=757310#PaperDownload>