Consumption Tax

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Introduction

Tax systems have been argued for more than 30 years in the USA. With the first comprehensive tax reform proposal in 1975, the process of alteration has begun. Gerald Ford suggested some limitations on tax exemption and deduction to maintain the fairness in the income tax system. In 1981, Reagan Administration decreased the tax rates and enacted an inflation-adjusted tax rate in order to eliminate the tax burden due to the inflation. In 1986, President Reagan signed into law the Tax Reform Act of 1986, one of the most far-reaching reforms of the US tax system. In 1988, although taxation was an important tool for the election campaign of George H. W. Bush with his phrase of “read my lips: no new taxes”, he increased the tax rate for high-tax-bracket taxpayers. In 1993, Bill Clinton increased the highest personal income tax rate and the corporate tax rate.[1] However, with these reforms and modifications, US tax system became complicated and inefficient. After 1994, many economists and politicians have argued that the current income tax system should be totally transformed into a consumption tax system. In this paper we start with a detailed definition of a consumption tax with its components. Furthermore, we explain its advantages and disadvantages. Finally we conclude the paper with the implementation of a consumption tax.

What is a Consumption Tax?

Income tax taxes both savings and consumption which make up the income together. However, consumption tax is a tax only on consumption, not on savings. To see the tax base, we start with the income and expenditure sides of Gross National Product (*GNP*):

(1) $$GNP = C + I + G + X - M + R^f = W + R + R^f$$

where C is consumption, I is gross investment, G is government spending, X is exports, M is imports, W is wage income, R is domestic gross capital income, and R^f is net foreign income (foreign income of domestic residents less domestic income of foreign residents). We can easily conclude that:

(2) $$C = W + R - I - G - X + M$$

Each component of consumption is taxed under a consumption tax. It is obvious that consumption tax taxes all returns while forgiving taxes on government

[1] See Brownlee (2004)

spending, investment, and exports. For the sake of simplicity we assume that consumption tax has no impact on government expenditures, thus we omit G:

(2') $$C = W + R - I - X + M$$

If we plug the balanced current and capital accounts:

(3) $$(X - M + R^f) = I^f$$

where I^f is net foreign investment, into (2'), the tax base becomes:

(4) $$C = W + (R - I) + (R^f - I^f)$$

which denotes that consumption tax is a tax on wages plus net cash flow from domestic and foreign activities. To get a better idea of what a consumption tax is, in the next sections, we discuss the components of the tax base in detail.

Consumption Taxes and Wage Taxes

If the net present value of an investment made today is zero, this means that the cost of the investment (I or I^f) is equal to the present value of the return on that investment (R or R^f). With a constant tax rate over time, the cash flows of such investments would have no impact on the present value of government revenues.

T	0	1	2	3
(1) CP_0	600			
(2) CF_t		320	280	240
(3) DEP_t	600			
(4) Tax $Base_t$ (2)-(3)	-600	320	280	240
(5) Tax_t	-240	128	112	96
(6) After-Tax CF_t (2)-(1)-(5)	-360	192	168	144

Table 1: Zero-present-value investment under a consumption tax

With an interest rate of 20% and a tax rate of 40%, NPV after tax of such an investment would be equal to zero (NPV_τ = 0). Present value of collected taxes would also be equal to zero, which means that under a consumption tax, collecting tax from zero-present-value investments would have no impact on government revenues.

Thus, *Blueprints for Basic Tax Reform* gave taxpayers a choice under a consumption tax of whether assets held at arms length would be subject to tax or both investments and returns would be ignored by the tax system.[2] With the variable tax rate over time, the ability to choose between these two forms of taxation allows the taxpayers to shift their tax bases from high-rate years to low-rate years while holding the present value of the tax base constant.

Similar case also holds for risky assets. Assuming that the taxation of gains and losses is symmetrical, investors would increase their risky position in order to

[2] See U.S. Treasury, 1977, reprinted as Bradford et al., 1984

offset the reduction of risk due to the consumption tax. Since after-tax cash flows would be identical under both forms of taxation, including the cash flows from risky assets into the tax base or just leaving them would have no impact on government revenues.

As a result, whether the investments are safe or risky, excluding from a consumption tax the cash flows on new investments would have no impact on the economy.[3]

However, some components of $(R - I) + (R^f - I^f)$ include the cash flows of existing investments. Transition from a different tax base to a consumption tax base would cause some unfair levy on the sale of existing investments. Thus, *Blueprints* suggested a different treatment (nonqualified assets) for such assets under a consumption tax.

Origin versus Destination Basis

Another issue is about the origin and the destination basis. Since the current and capital accounts balance, under a destination-based consumption tax, the cash flows from foreign assets would be included into the tax base through the border tax adjustments on imports and exports ($- X + M = R^f - I^f$). However, some origin-based consumption taxes, such as Hall-Rabushka flat tax, would provide no special treatment for the cash flows from the cross-border investments. Nevertheless, assuming no differences between these two tax systems in terms of domestic and foreign price levels, an accurate currency appreciation for the adopting country due to the switch from an origin-based consumption tax to a destination-based consumption tax would offset the advantage of exporters and the disadvantage of importers caused by the destination-based consumption tax. For example, assume that Country A has an exchange rate of e (per one unit of Country B's currency) under an origin-based consumption tax at rate of t. In Country A, exports are taxable at a rate of t but imports are simply tax-exempt. This is clear because under an origin-based taxation, goods are taxed at their origin. The opposite case holds for the destination-based taxation; exports are tax-exempt, imports are taxable. If Country B shifts from an origin-based to a destination-based consumption tax system, the price of imported goods in Country B will rise by $(1 + t)$ due to the double taxation. Similarly, since exported goods (from Country B to Country A) are not taxed, the price of exported goods will

[3] See Auerbach, 2006

decrease by (1 + t). If e rises, the disadvantage of importers and the advantages of exporters (in Country B) will decrease. Thus, an accurate appreciation (an appreciation by (1 + t) for this example) will offset the inequality due to the switch to a destination-based tax system.

In spite of the simplicity of this analysis, some economists argue that a shift to a consumption tax with the effects of border adjustments may decrease the consumption which, in the end, will cause unbalanced current and capital accounts. Another argument is about the maintenance of uniform border adjustments among all industries. If border adjustments only apply in a particular industry, the currency correction will not be fully accurate which, as a result, will lead to an inequality in the international trade. Furthermore, some economists believe that in a country which has a pegged (fixed) exchange rate (in stead of floating exchange rate); the accurate currency depreciation will never occur because the exchange rate is not allowed to float freely. However, in order to maintain its competitiveness, others believe that the correction will be enforced by the government. Suppose that Country A in our previous example pegs its exchange rate to the currency of Country B. If Country A does not devalue its currency after the switch to a destination-based taxation in Country B, the competitive position of Country A will be damaged because of the high prices of its goods. Thus, Country A will enforce a currency devaluation which means an appreciation of the currency of Country B.

Border adjustments also affect both the values of domestically-owned assets held abroad and the values of foreign-owned assets in a country. Currency correction due to the border adjustments in a country will decrease the values of domestically-owned assets held abroad and increase the values of foreign-owned assets in that country.

The Treatment of Financial Assets and Liabilities

Another important issue in a consumption tax is the treatment of financial activities. It is obvious from the expression (4) that gross capital income is taxable and gross investment is tax deductible. However the tax base does not include the financial position because considering the economy as a whole, the cash flows from financial assets offset the purchases of financial assets. If we plug these components to the tax base, we conclude that:

(4’) $$C = W + (R - I) + (R^f - I^f) + (F - J)$$

where F is the net flows from financial assets and J is the net purchases of financial assets.

Including these two terms in the tax base means a tax burden on the returns from existing financial assets and a tax coverage for the financial liabilities. However some economists argue that flows from financial assets and liabilities do not offset each other if we consider only the private sector. They think that the net cash flows between the government and the private sector would also be included in the tax base.

Another argument is about the cash flows of business sector. Assuming all businesses are subject to the same tax rate, all flows of business sector would net out in terms of revenue, except the flows between the business sector and the household sector. In such a situation firms can shifts their profits from real to financial activities. Thus an alternative tax base was described as "$R + F$" base cash flow tax. In such a tax base, all components of F would be distinguished from R. However, although "$R + F$" base differentiates the financial transactions between the business sector and the household sector, it ignores the net flows between firms and their shareholders. In such a situation firms can manipulate their payments between debt and equity.

Timing of Tax Payments

This section examines the effects caused by the timing of tax payments under the two choices the taxpayers have. Still assumed that the present value of the investment made today is zero, the tax-exempt approach imposes no taxes at all because neither the cost of the investment is deductible nor the returns are taxed. This approach turns out to be less costly because there is no tax imposition at all. Under the cash flow treatment the effective tax burden is the same, namely zero, because the allowed deductions for the cost of the investment and the imposed taxes on the returns offset each other. But, if the tax rates are not constant over time, the effective tax burden of the cash flow treatment will not be zero.[4]

[4] See Auerbach (2006)

T	0	1	2	3
(1) CP_0	600			
(2) CF_t		320	280	240
(3) DEP_t	600			
(4) Tax $Base_t$ (2)-(3)	-600	320	280	240
(5) Tax_t	-240	128	98	72
(6) After-Tax CF_t (2)-(1)-(5)	-360	192	182	168

Table 2: Decreasing tax rates over time

Referring to the above mentioned example, in which by using a constant tax rate and an interest rate of 20% the net present value will be zero. Now the tax rates vary over time. In the first period, the tax rate is 40%, in the second 35% and in the third 30%. With these variant tax rates the net present value is no longer zero, but 23,1. Consequently, the investment improves with decreasing tax rates over time.

T	0	1	2	3
(1) CP_0	600			
(2) CF_t		320	280	240
(3) DEP_t	600			
(4) Tax $Base_t$ (2)-(3)	-600	320	280	240
(5) Tax_t	-180	96	98	96
(6) After-Tax CF_t (2)-(1)-(5)	-420	224	182	144

Table 3: Increasing tax rates over time

For the sake of completeness, table 3 illustrates the effect by increasing tax rates. With tax rates of 30% in period 0 and 1, of 35% in period 2 and 40% in period 3 and with an interest rate of 20% a net present value of -23,61 will be obtained. Thus, increasing tax rates make the investment become less attractive.[5]

The result of the variation of tax rates is that the effect, on the one hand, will distort investment decisions and, on the other hand, will have an effect on governments' revenues. This effect can be positive or negative, depending on the variation of the tax rate. The circumstance of varying tax rates seduces economist to suggest other possibilities. One possibility might be to carry the basis of the investment plus interest forward instead of immediate deductions and then use the depreciations consistent with the timing of economic depreciation. This might avoid the distortion effect caused by different tax rates but, as the taxpayers once again have to calculate depreciations, this proposal leads to a complication of a consumption tax.[6]

[5] Self-provided examples
[6] See Auerbach (2006)

Taxation Level

One might think of imposing a consumption tax on three different levels:

1. On the business level in form of a value-added tax,
2. On the individual level in form of a cash-flow expenditure tax that taxes consumption while the net savings are subtracted from the individual income base under the assumption that all income is consumed when not saved or
3. On the business and the personal level by establishing a VAT on the business level and by moving the taxation of wages to the individual level.

All these three approaches lead to a taxation of consumption, theoretically, in practice, however, appear different effects. One may not only think of the statutory incidence, i. e. the group or person that is responsible to remit the taxes to the government, but also of the economic incidence that refers to the group or person that is burdened with the tax.[7] To achieve fairness in a tax system each one should pay that percentage of his income that he is able to pay. Therefore, a tax system requires progressivity which can only be reached on the individual level because it is related to individual circumstances. As it can easily be seen, a business VAT cannot render this claim. Further on, the price level, the wages and the returns of investments will be influenced by the selected level. For instance, the business level forms the statutory incidence; consequently, business is responsible to remit the taxes to the government. Thus, the business shifts the economic incidence to the individuals by increasing the prices for the consumers, by paying lower wages to their employees and lower returns to their shareholders. Imposing taxes on the business level might lead to a slow adjustment of the economy. At last, there is the discussible idea that a consumption tax can collect taxes effectively from those who do not pay any taxes in an income tax system. But this counts only for an indirect system as the business level VAT because everyone has to pay taxes on its purchases. A consumption tax on the individual level will provide the same possibilities not to file a tax return as in an income tax system. [8]

[7] Definition according to Tax Foundation, Washington;
see http://www.taxfoundation.org/news/show/152.html
[8] See Auerbach (2006)

Hybrid Tax Systems

When discussing or proposing a new tax system one might think of a combination of taxing income and taxing consumption. It should be noted that a hybrid system also leads to a combination of the effects of an income tax and a consumption tax. Therefore, it should be investigated carefully if such a system can profit from the benefits of a consumption tax or not. If only a part of the income is taxed as consumption there may be a distinction in the treatment of assets which distorts again the capital accumulation and leads to the effect that taxpayers start to borrow money for investments in tax favored assets instead of saving the money.[9] This part of the paper outlined the basic idea of a consumption tax and showed some effects caused by different designs of such a tax. With the knowledge of what a consumption tax is, the next part discusses advantages and disadvantages of implementing a tax that is based on consumption.

Pros and Cons of a Consumption Tax

A first and important idea why economists think of implementing a consumption tax is the consideration of the equity in a tax system. Looking at the horizontal equity, which says that the tax treatment of individuals in equal economic situations should be the same, it is to say that income taxes and consumption taxes have a different view on it. As in an income tax system only the annual tax burden is taken into consideration, a consumption tax system has a view on the taxpayer's whole lifetime income. Many economists hold that considering the lifetime income and creating a consumption tax base is the better index of the ability to pay[10]. Moreover, because the saved income is not taxed until it is consumed, the taxpayers are able to accumulate interest income at a pre-tax rate of return.[11] Thus, many economists think that a consumption tax avoids discrimination between households that dispose of the same lifetime income but have different preferences concerning the moment of consumption. Saving, and therefore the household that prefers to consume later, is no longer discriminated as under an income tax system.[12]

[9] See Auerbach (2006)
[10] The idea that taxes should vary according to the level of wealth or income, www.bookkeeperlist.com/definitionsa.shtml.
[11] See Anderson (1994)
[12] See Fuest, Huber (2005)

An example might be helpful to point out this difference between income and consumption tax. In the case of a taxpayer earning 50.000 € a year and deciding to use all income for consumption, he has to pay, with an assumed tax rate of 30%, taxes in the amount of 15.000 € in both tax systems and can spend the residuum of 35.000 €. The difference appears when the taxpayer decides to save all income for one year. First, in an income tax system he has to pay taxes anyway and therefore, he can only save 35.000 €. In the consumption tax system he can save the whole income of 50.000 € as only consumed income is taxed. After one year he has earned 20% from these amounts, that is 7.000 € in the income tax system which leads to an after-tax income from interest of 4.900 € as he has to pay 30% taxes. This amount added to his after-tax income of this year means that he can use 39.900 € for consumption. In the case of the consumption tax he gets 10.000 € from interest payments and, granted that the whole income is consumed, he has to pay taxes of 18.000 € and it remains 42.000 € for consumption. This example shows that future consumption in the income tax system is discriminated just as saving, because there only remain 14% of the 20% which were earned by saving. With a consumption tax the taxpayer can spend 7.000 € more than one year earlier that exactly respond to the interest payment.[13]

However, others might argue against a consumption tax by means of the vertical equity, which says that tax treatment of individuals in unequal economic situations should be different and, consequently, aims at the progressivity of a tax. A consumption tax would be regressive and discriminate the individuals that earn the lowest income because they have to pay a higher percentage of their income to the government. Such a system is commonly seen as unfair.[14]

To discuss the advantages and disadvantages of the consumption tax there are often other determinants taken in consideration: economic efficiency, administrative feasibility, internationality of such a tax system and political reasons. These are addressed below.

Economic Efficiency

As in a consumption-based tax system only cash flows are taxed, such a design is able to create a neutral tax system. Therefore, some distortions caused by the income tax will be reduced. Because saved income is not taxed anymore, the

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[13] Example according to Ehrbahr (2007)

[14] See Anderson (1994)

capital accumulation will increase by getting returns on a pre-tax rate instead of returns on a post-tax rate. Regarding the example above, the taxpayer would be able to invest, when he decides to save all income, the pre-tax amount, namely the 60.000€ (income plus interest). Being taxed by an income tax he could only earn 20% of the post-tax income, namely 39.900€.

Furthermore, distortions in the allocation of capital are reduced or even gone because the tax wedges which are caused by different depreciation schemes in an income tax system and which distort the ranking of projects are eliminated with the help of the immediate expense.[15] Due to the fact that a consumption tax does not discriminate between equity and debt[16], the distortions of firms' financial structures will be reduced. Hence, from the perspective of economic efficiency, the money is taken where it earns most and this leads in the long term to more savings, more investment, more innovation and as a result to a higher living standard and higher family incomes.[17]

But on the other hand, because full and immediate expense seems to reduce it and saved income is not included, the tax base in a consumption-based tax system will decrease, and as a result the revenues will decrease as well. To avoid this, a higher tax rate is needed to raise the same revenues as in an income-based tax system. This higher tax rate may have an influence on the location decisions of firms which normally prefer subsidiaries in countries with low tax rates.[18]

Administrative Feasibility

The consumption tax is viewed as a simple system which is easy to administer because, as only cash flows are taxed, firms do not have to consider depreciation rules (because the payments for assets and investments are immediately expensed) and inventory tax accounting rules. Likewise, they do not have to measure the after tax Present Value before making an investment and capital gains are irrelevant (because they are not taxed). Beyond, the problem to measure inflation will disappear because it becomes unnecessary to calculate historical costs to measure, for example, depreciation or capital gains. Every cash flow, whether it is deductible or taxable, is considered in the year in which it is realized.

[15] See Shome, Schulte (1993)
[16] "The exemption of marginal returns implicit in immediate expensing" – Shome, Schulte (1993)
[17] See Hubbard (1997)
[18] See Fuest, Huber (2005)

But it should be noted that there still exist a few administrative problems as gifts, bequests and inheritances and reporting. It seems to be the widespread opinion that the successor should include the received gift or inheritance into his tax base. The question that has to be solved is if the donor should be allowed to deduct the gift or inheritance from the consumption tax base or not. If it is deductible, the double taxation on both levels will be avoided but there also exists the opinion that a person who decides to give away a part of his wealth should not be exempted from taxation although this is not the traditional way of consumption. Reporting is another problem which has, with the help of effective audit techniques, to work out very well in order to report all sales proceeds.[19]

Tax Evasion

The consumption tax, as mentioned above, seems to be very simple but this simplicity creates new challenges for the government to avoid tax evasion. There can be mentioned the possibility of income shifting from a high-tax country to a subsidiary in a low-tax country which is a strong incentive in a system of a consumption tax and can appear in the form of transfer pricing[20], capital leasing on a low rate or selling assets that are already expensed at understated prices.[21]

Internationality

To this day there are no successful efforts to implement a consumption tax system. Hence, there is an international absence of experience and coordination. It is not clear if such a tax system is compatible with the existing international tax regimes. It is possible that countries risk their existing and important tax treaties and new long and costly negotiations are required. A consumption-based tax system has to make sure that income received by foreigners is taxed in the host country[22] and that double taxation of income received by a domestic inhabitant is avoided.[23] Therefore, the countries are afraid of implementing a tax system without knowing a successful benchmark.[24]

[19] See Anderson (1994)
[20] The price at which goods or services are transferred between one country and another within the same organisation http://www.oup.com/uk/booksites/content/0199267529/student/glossary.htm.
[21] See Shome, Schulte (1993)
[22] because if it is not consumed in the host country it is exempted from taxation.
[23] Because foreign income tax might not be creditable against a consumption tax.
[24] See Anderson (1994) and Shome, Schulte (1993)

Policial Reasons

This point is a strong drawback of a consumption-based tax system and probably the reason why it has not been implemented yet and will not be implemented in the next few years. There is a lot of resistance of special interest groups that are afraid of being negatively affected by a consumption tax. One strong argument is the misallocation of the total tax burden account of the taxpayers in low-tax brackets because only rich people have the resources to save and invest and, therefore, they benefit from such a system.

The so far discussed points are the most important ones according to the literature. Moreover, another important point is the transition to a consumption tax which is discussed in the next chapter.

The Transitional Effects of a Consumption Tax

Switching the tax system to a consumption tax would have several important effects. Firstly, some economists believe that switching to a consumption tax would increase saving and real output per person which leads to an increase in the real GDP in the long run. According to the study of Altig and others, a transition from an income tax to a consumption tax would cause an increase in real output by 9.4% in the USA.[25] This increase reflects greater saving and investment as well as an increase in the labor supply. The capital stock and the labor supply would rise by 24.5% and 4.6% respectively in the long run.

Secondly, economists argue that a transition to a consumption tax might negatively affect the real value of existing capital. The study of Altig also shows this negative effect. According to the study, a switch to a consumption tax would reduce the real value of existing capital by 9.4% in the long run. This reduction would hurt richer and older people who own much of this capital. Thus, some proposals of consumption tax have suggested a transitional relief for these people in order to avoid the unfairness due to the transition.

Thirdly, the transitional effects on interest rates have been discussed by economists. The most common belief is that switching from an income tax to a consumption tax would lower the pre-tax interest rate. Since the consumption tax encourages people to save more, the supply of credit for financial markets would increase the consumption tax. Furthermore, since the consumption tax does not

[25] See Altig et al. (2001)

allow the tax deduction of interest expenses, the demand for credit would decrease with the consumption tax. As a result of these two effects, the equilibrium interest rate would decrease.

Moreover, a shift from an income tax to a consumption tax would cause the average price of consumer goods and services to rise relative to production costs and wages. Consumers would pay a higher price for goods and services due to the higher tax rate. Since wages are a large fraction of production costs, the price paid by consumers would increase relative to the wage rate received by workers.[26] The argument is about how this increase in consumer prices relative to the wages would occur. Some economists believe that the after-tax consumer price level would remain constant while the wages decrease. However, according to most of the economists, since workers would be reluctant to take a wage cut, and efforts to reduce the wage rate might cause many workers to leave their jobs which means an increase in the unemployment rate, it is more likely that the after-tax consumer price level would increase while the wages remain constant.

Furthermore, some drawbacks of income tax system still could not be avoided despite of shifting to a consumption tax. An example is transfer pricing by multinational corporations. Transfer pricing is shifting of profits from high-tax to low-tax countries using the prices of goods, services, and intangibles traded between corporations and their subsidiaries. Transfer pricing would continue to be a problem under some consumption taxes, although it would be eliminated border adjustments.[27]

Another issue is about the depreciation of assets. Since full and immediate depreciation is allowed for new assets, a transition to a consumption tax would cause a short-term revenue loss for the government due to the tax coverage of immediate depreciation. On the other hand, not allowing the remaining depreciation deductions on the existing assets would cause large losses on owners. These assets would be only partially written off at the time of switching to a consumption tax system. Thus, some economists argue that some temporary rules for depreciation are essential to avoid these transitional problems.

[26] See Garner (2005)
[27] See Edwards (2003)

Conclusion

As it could be seen in the first chapter there are a lot of issues which have to be taken into consideration e.g. financial treatment or timing issues when designing a consumption tax system. Therefore, it should be figured out very well how these decisions are made as they lead to different effects. Besides, a consumption tax system in general has a lot of advantages, especially regarding the administrative issues and inter-temporal neutrality. But such a tax system still has a few drawbacks as the international adoption and especially the transition from an income tax system to a consumption tax system is strongly discussed.

This paper shows that the consumption tax is a good alternative to the income tax system but it will be unlikely to be implemented because the political pressure against this system is very strong and until now this pressure has avoided the implementation of a consumption tax and probably will avoid it in the next few years as well.

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