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

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

Edward McCaffery

Abstract

These are slides from a presentation to the President's Advisory Panel on Tax Reform, given in Washington D.C. on May 11, 2005, updated, with additional slides, and sources at the end. The principal goal is to summarize the mechanics and analytics of a consumed or cash-flow income tax, a progressive spending tax, based on a rearrangement of the Haig Simons identity, $\text{Income} = \text{Consumption} + \text{Savings}$, to generate $\text{Consumption} = \text{Income} - \text{Savings}$. A consistent spending tax simply features unlimited deductions for savings, along the lines of traditional Individual Retirement Accounts (IRAs), plus the inclusion of debt as a cash-flow input (the fatal flaw of the 1990s USA Tax Plan was its failure to include debt in the tax base). Progressive rates can be maintained, even increased.

The critical point is that such a progressive postpaid consumption, cash-flow or (all equivalently) spending tax is not equivalent to a wage tax, and does not systematically exempt the yield to savings from the tax base. Instead, a consistent progressive spending tax stands between an income tax, which double taxes all savings, and a prepaid consumption, yield exempt, or (all equivalently) wage tax, which never taxes any savings. A consistent progressive spending tax taxes the yield to capital when (but only when) it is used to elevate material lifestyles, not when capital transactions (savings, investing, borrowing) are used to smooth out, in time, a taxpayer's labor market earnings. This is an attractive ideal, as argued at greater length in McCaffery 2005a.

It is also noted that such a progressive spending tax is a normatively attractive "hybrid," in that it taxes some but not all savings, and in a principled and appealing way, in contrast to the flawed practice of engrafting consumption tax elements (of either sort, pre or post paid) onto an income tax base. See McCaffery 2005b.

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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



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

A consumed income tax: a fair and
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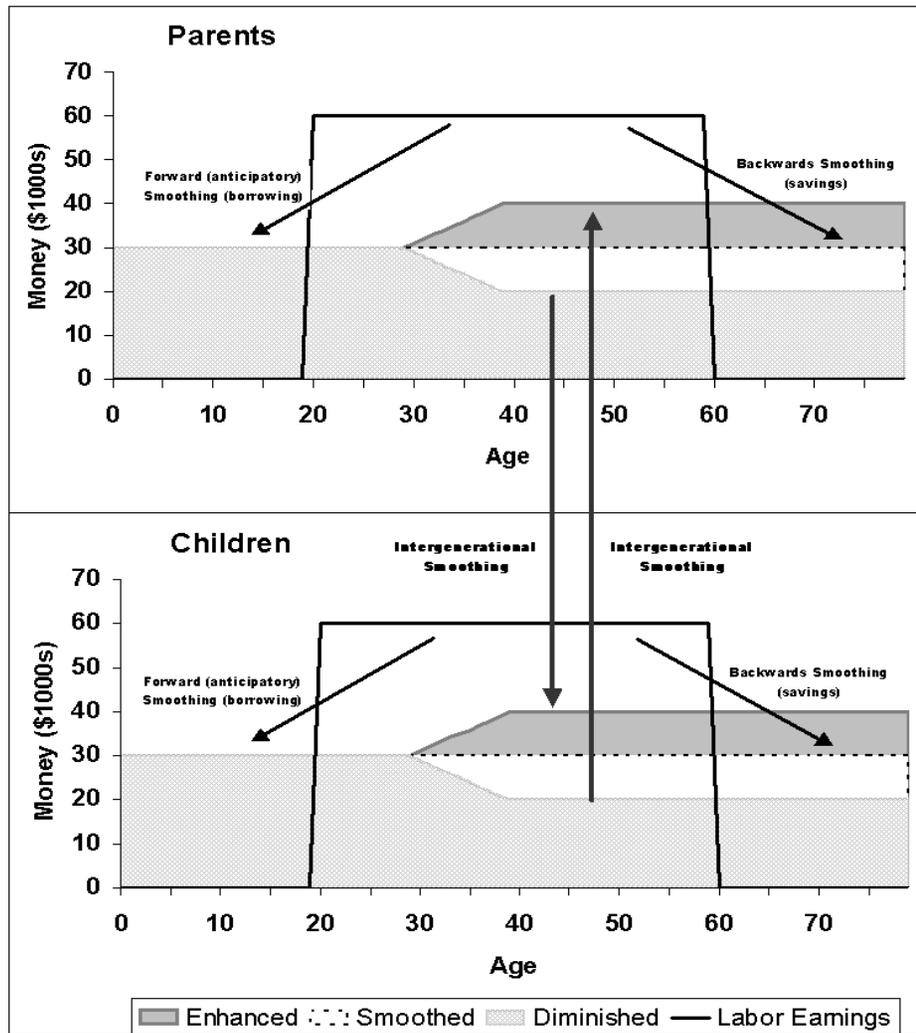
Two types of savings

- 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
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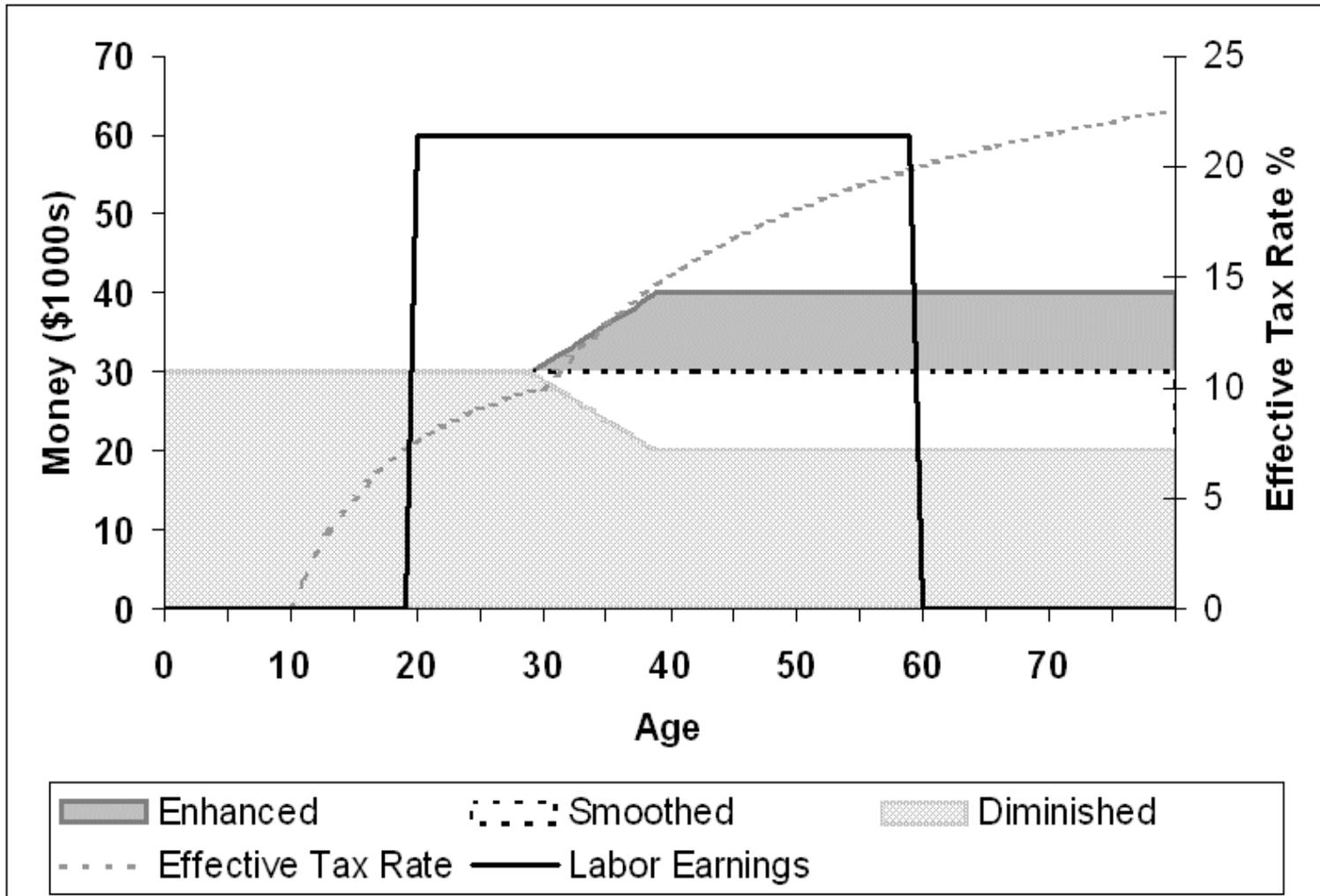
Further graphics

- 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



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>