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by Murray Weidenbaum

The United States is a low-saving, slow-growing economy which would benefit from taxing consumption instead of income. That change would provide a powerful incentive to increase the nation's saving and investment and, hence, economic growth and living standards. Raising the level of investment in new factories and production equipment would also enhance American competitiveness in an increasingly global marketplace.

So why has no progress been made to replace the present tax structure? The answer is that the idea of a general consumption tax has not attracted national attention. The debate so far has focused on the specific type of consumption tax, the value-added tax. The VAT is a "bottom up" tax levied on individual purchases. However, there is an alternative type of consumption tax which meets all the major concerns of the critics.

A "top down" consumption tax would be collected much as the income tax is, levied directly on the taxpayer. The annual taxpayer return would continue to comprise the heart of the collection system. However, one key change would be instituted: the portion of income that is saved would be exempt from taxation. In theory, all of the current exemptions and deductions could be continued. In practice, shifting to a new tax base would also provide the opportunity to overhaul the proliferating array of special benefits that are currently in the tax code and perhaps to eliminate many of them.

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Let us explore the major critiques and see the extent to where they pertain to the VAT specifically or to taxes on consumption generally.

"It's Unfair"

Opponents of a tax based on consumption contend that it is unfair because it is regressive — the poorer people pay a larger share of their income than richer taxpayers. After all, they note, we all know that conventional sales taxes hit low income people harder than high income people because the wealthier you are, the more you save.

A "bottom up" consumption tax is regressive. That regressivity can be reduced by exempting food and medicine or by making special refunds to low-income tax payers. But such variations make tax collection more complicated.

However, a "top down" consumption tax need not be regressive at all. Like the income tax, each taxpayer faces a rate table and that table could be made just as progressive (or regressive, for that matter) as policymakers desire. Under a revenue-neutral shift from the income tax to a "top down" consumption tax, the average taxpayer would experience no change in tax burden. However, above-average savers would pay less than they do now and below-average savers would pay more.

"It's Inflationary"

A second argument against consumption taxes is that they are inflationary. Unlike income taxes, sales taxes such as a VAT show up directly in the prices of the products we buy. In fact, with inflation escalator clauses (such as cost-of-living adjustments in wage contracts and many federal entitlement programs), the imposition of such a tax would generate several rounds of inflation because many other prices and wages would rise subsequently.

This is true only in the case of taxes levied on sales. Even then, the inflationary impact only occurs when the tax is initially imposed or increased. However, a top-down consumption tax — like the existing income tax — would not have any direct impact on prices. It would not be inflationary because it is levied on taxpayers and not on the goods and services they buy.

"It's an Administrative Burden"

The critics note correctly that the enactment of a value-added tax in the United States would require establishing a new tax-collection system and new recordkeeping on the part of taxpayers. Thus, overhead costs would rise in both the public and the private sectors.

In contrast, a top-down consumption tax would rely on the existing IRS tax collection system. From the viewpoint of the taxpayer, the current bookkeeping and ancillary administrative requirements would be reduced. Existing restrictions would be eliminated on Individual Retirement Accounts, Keogh accounts, and other specialized investment vehicles. All saving would be exempt from the new tax. To a typical taxpayer, the change proposed here is essentially the equivalent of adopting a universal IRA and using an amended rate table.

"It Would Finance an Even Larger Federal Sector"

Many conservative critics worry that adding a new consumption tax such as the VAT to the existing array of revenue sources would enable the government to finance an even larger public sector than we now have. Moreover, that would be unfair to state and local governments that traditionally depend so heavily on sales tax revenues. I think they are right.

However, none of these shortcomings applies to a top-down consumption tax. Converting the existing income tax does not generate an additional source of income for the U.S. Treasury, merely a more sensible revenue structure. Similarly, states and localities would not encounter a new federal levy on the products and services that they now tax.

Conclusions

A "top down" consumption tax would achieve most of the benefits intended for a VAT with few of the shortcomings. Converting the income tax to a consumption tax — unlike adopting a new tax on value added — does not require setting up an additional collection system. Nor is it regressive or inflationary. Unlike a VAT, transforming the existing income tax does not provide the federal government with a new revenue source; therefore, the public sector is not likely to grow more rapidly than under the existing tax structure.

To conclude, the shift in emphasis in U.S. taxation from income to consumption should on balance generate positive results, especially in helping to move the economy to a more rapid expansion path and, thus, enable the American people to enjoy a higher living standard. Moreover, a consumption-based tax structure that is initially revenue neutral compared to the income tax system that it displaces would, in the long run, generate more revenue for the U.S. Treasury. This would be one of the few pain-free ways of reducing the federal budget deficit!