The Case for a Consumption Tax

By David A. Weisbach

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Should investment income be taxed differently than wage income? Tough question. Essentially it boils down to whether a consumption tax is preferable to an income tax with a rate structure that is blind to the source or character of income.

Tax Analysts invited two law professors to share their views on the subject. On this page, we present Prof. David A. Weisbach’s arguments in favor of a consumption tax. On p. 1353 we present the pro-income tax view, articulated by Prof. Martin J. McMahon Jr.

The debate over the choice between income and consumption taxation has been ongoing since the beginning of the modern economy, seemingly without end. Those who argue for an income tax usually claim that taxing capital income is central to a fair tax system because those with capital income appear to have a higher ability to pay. Moreover, reducing taxes on investment income would seem to reduce the progressivity of our tax system, a result that is particularly worrisome at a time of growing inequality.

I will show here, through a simple example, that those arguments are wrong. They miss a basic point: A tax on investment income is implicitly a tax on labor earnings because it reduces the amount that can eventually be purchased with those earnings. By replacing that implicit tax on earnings with an equivalent explicit tax, such as a consumption tax, we can make everyone better off. Equally progressive consumption taxes that raise the same revenue as before, in present value. (I leave that calculation to the reader.)

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It seems difficult to object to this change in Joe’s taxation: He is better off and nobody is worse off. If we care about taxing those with the ability to pay, we would still prefer to tax only Joe’s wages or consumption. He pays either way — the only question is how best to make him pay. The argument also does not elevate efficiency over equity — the amount Joe pays is the same so there is no reduction in equity. Nor does the analysis depend on assumptions about macroeconomic effects of increased investment, other disputed effects of taxing investment income, the reason for saving, the nature of interest income, or arguments about the double taxation of savings.

Joe, of course, is just a single individual. We need to think about the issue system wide. The premise of consumption tax, we can make everyone better off.1

1There is an important subtlety in the taxation of capital income under a consumption tax. Properly structured consumption taxes would tax economic profits, so they do not eliminate the tax on capital income. The true difference between income and consumption taxes is with respect to pure time value returns. To keep the discussion manageable, I will generally ignore this subtlety.
concerns about progressivity and the tax on investment income is that those who earn more save more. By making the appropriate adjustments for each income class, we can preserve the progressivity of the current system while making each income class better off. That is, if Joe was better off and we make equivalent adjustments at each income level, individuals at each income level would also be better off, just like Joe. Joe also paid the same tax after the adjustment. If adjustments like that one envisioned are made at each income level, those at each income level would similarly pay the same tax, thereby retaining progressivity. Those adjustments would mean that the explicit tax on wages or consumption would go up more for those who earn more. The overall set of tax rates would look more progressive — nominal marginal rates would be more graduated than under current law. Nevertheless, there would be no additional burden on work because we will have merely replaced the implicit burden on work from the tax on investment income with an explicit burden.

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As when we considered only Joe, it is difficult to see the objection. Those with a higher ability to pay end up paying the same tax, only in a more efficient fashion. Therefore, ability-to-pay arguments do not change the conclusions. Progressivity is retained and could even be increased (because the tax system is more efficient, there is more slack that can be used to increase redistribution). By making the suggested adjustments, we are able to pluck the same goose with less hissing. That, to me, seems like a idea worth considering.

One way to think about the argument is to analogize a tax on investment income to a luxury tax. Both seem to have good distributive properties because they tax items that only the well-off have. A luxury tax, as we know, is not a good method of redistributing. It both reduces work incentives by reducing what earnings can purchase and distorts what is purchased with those earnings. A better system is to just increase the progressivity of the tax on earnings and let people purchase what they want with their after-tax earnings. The same argument applies to taxes on savings.

Although I believe that argument is compelling, there are objections. Some argue that we do not know enough about savings elasticities to determine whether increasing the nominal tax on wages and reducing the tax on savings is efficient. That argument is wrong for the reasons just illustrated. There is no trade-off between the two. An increase in savings elasticity increases the benefit of reducing or eliminating the tax on investment income, but even with very low savings elasticities, the argument holds. The only question is the size of the gains from eliminating the tax on investment income, not the fact of the gains. (If the timing of consumption were perfectly inelastic, the two taxes would be equally good — the tax on savings would still burden labor supply but would not change consumption decisions.)

Perhaps savings bring benefits beyond consumption — say, power and prestige. Robert Frank argued the opposite — prestige and status come from too much consumption — but maybe he had it backwards. Power and prestige from savings come from the ability to direct the money, from the possibility of future consumption. They come from the fact that bank accounts are not Monopoly money. Taxing that future consumption reduces the power and prestige from savings. If the concern is that rampant inequality distorts the political system, the answer might be a combination of more redistribution and changes to political institutions, such as the campaign finance rules. But recall that eliminating the tax on investment income produces efficiency gains that can be used to increase redistribution. Thus, those who worry about these issues (I count myself among them) should be in favor of eliminating the tax on investment income.

What about lucky winners — the individuals who put a few thousand dollars in, say, an Internet stock, and walk away with millions in a few years? Most tax systems that we are likely to consider — certainly both income and consumption taxes — tax those individuals the same way. In a consumption tax, those lucky individuals end up with more consumption and are taxed when they consume. If they defer their consumption, they are taxed on the future value of their winnings. In an income tax, they are taxed when they receive their winnings. The only difference is timing. Timing is important, but it is not the primary issue regarding lucky winners — the winnings themselves are the issue. Therefore, the taxation of the lucky is not really an issue.

A final concern is whether reducing or eliminating the tax on investment income would encourage the creation of dynasties. Many think that might be bad for a variety of reasons. One part of the dynasty problem is existing wealth. Transition to a new tax system such as a consumption tax, however, has at least as great, if not a greater potential for taxing existing wealth as does continuing the current tax system. The other major part of the puzzle is dynasties from newly created wealth. If, however, the adjustments imagined above are made, those who create new wealth will be taxed at the same rate as they are now, only in a more direct and efficient manner.

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The argument I have made for a consumption tax did not mention compliance and administration costs. It is beyond dispute that the major source of complexity in an income tax is the attempt to tax capital income. Indeed, taxing capital income appears to be sufficiently difficult that our current tax system comes very close to not doing
so at all, despite the thousands of pages of code, regulations, and cases that attempt to do so. We might be able to do better than we do now, but I doubt we could ever get rid of the overwhelming complexity that attempting to tax capital income imposes. There are potentially enormous reductions in administrative and compliance costs to eliminating the tax on capital income. Combined with the efficiency or equity gains illustrated above, the case is compelling.

There are obviously additional issues. A short essay like this can barely scratch the surface. In particular, the design of a progressive consumption tax still needs further work. Transition, the taxation of financial institutions, and the taxation of cross-border flows are among the important and difficult issues that need to be worked out. Those are important but we should not let those potential difficulties divert our attention from the goal, which is to have a tax system that is fair and efficient — which, I believe, means a progressive consumption tax.