

# **The Consumption Tax: Macroeconomic Effects and its Potential as a Tool for Discretionary Fiscal Policy**

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Over the last thirty years the concept of taxing consumption, as opposed to income or labor, has been posited by many, each time being dismissed as either too complex, unnecessary, or critically unsupported by research. Much has been written on the potential benefits and drawbacks of the implementation of various proposals and their ability to affect savings, investment and the equitable distribution of income, especially in the long run. While these are certainly important issues and should continue being researched, particularly if such a proposal begins to become a political reality, I believe that an important potential benefit of a consumption-type tax is not being considered. This paper proposes that in addition to the macroeconomic effects of such a proposal, which will be discussed later in this paper, policymakers should also consider the potential for a National Retail Sales Tax to act as a tool for discretionary fiscal policy, complementing the actions of the Federal Reserve in their attempts to promote economic growth and stabilize the economy. But first, what is a consumption tax and how does it differ from the current system of taxation in the United States?

As mentioned before, a consumption tax is a tax whose base is consumption rather than income or labor, which have been the primary sources of federal revenue in the U.S. for most of the last century. A consumption tax can take various forms, such as a National Retail Sales Tax, a Value Added Tax or a Flat Tax. A National Retail Sales Tax would take the form of a tax on every good purchased in the U.S., from oranges to BMW's and everything in between. In a practical sense, rather than expecting stores across America to change their prices whenever the government dictates it, the tax would be imposed at the time of sale, entered into the cash register before the opening of the store and posted outside either on paper or in a digital format of some sort. A Value Added Tax, much like those found in Europe, is also a method for taxing consumption, albeit before the customer ever sees the final product. These taxes provide many of the general benefits attributed to consumption-type taxes, in addition to the theoretical arguments, such as those posed by John Laramer of the Harvard Law Review. In essence, he believes that it is more appropriate in a free society to tax what an individual takes out of the communal pie rather than what they put in. If income is seen as representative of the productive contributions one makes to society then an income tax does in fact "fine" heaviest those individuals contributing the most to our collective wealth. A consumption tax, in contrast, taxes only that which an individual removes from society and is thus, from this perspective, more fair. As interesting as this line of inquiry may be, these arguments are theoretical in nature and are therefore rather unsuited to inform the pragmatic decisions of policymakers. In this regard, a VAT is significantly less well-suited to act as a fiscal policy tool and is not considered in this paper. A Flat Tax has many fundamental problems in it as well, primarily its inherent regressivity in a country more-or-less dedicated to some form of progressive taxation. It is for these reasons that an NRST, combined with a rebate system to insure that the poor pay very little to no taxes and progressivity is maintained, will be the form of consumption tax

considered here. Now that the form of the tax has been decided, what are some of the potential benefits and drawbacks of the implementation of a consumption tax?

The primary microeconomic argument in support of a consumption tax is based on a concept known as the power of deferral. For example, assume one dollar is put aside for retirement at a 9% compound interest rate. In the absence of taxes this will grow to eight dollars in 24 years. Now assume that the same dollar is put aside for retirement at a tax rate of 33%, giving only .67 cents to invest. Since you can only collect at an effective rate of 6%, the remainder of the yield going to taxes, after 24 years you will have only \$2.67 to spend in retirement. This situation is an example, albeit a dramatized one, of the current system which employs both income and capital gains taxes. Now assume that you are able to defer taxation until retirement, only being taxed once, at the same 33% rate, when the money is actually spent in retirement. You will now have \$5.33 to spend in retirement, twice as much than with the other system of taxation although the tax rate is the same. The drawback to this is that the government's revenue equation is exactly the opposite as that of the individual investor and no matter what your opinion on the appropriate level of government spending, the fact remains that the government needs to collect revenue to function. This leads to the more compelling macroeconomic justifications.

The most widely discussed potential macroeconomic benefit of a consumption tax is that it would almost certainly raise the savings rate in the U.S. By eliminating part of the return on investment an income tax penalizes savings. Many economists believe that this tax wedge results in lower saving, less investment, less innovation and capital formation and thus a lower standard of living in the long run than if savings were not taxed. In essence, the income tax creates a bias in favor of current consumption at the expense of savings and future investment. Other potential benefits include a lower real interest rate, as postulated by Alan Garner of the Federal Reserve Bank of Kansas City. Bachman, Haughton and Tuerck of Suffolk University propose that the absence of business taxes would help make American products more competitive overseas. Arduin, Laffer and Moore of the ALM Econometrics Group believe that it would also increase the tax base while making it much harder to cheat given its simplicity. The IRS estimates that 40% of Americans are out of compliance with the current tax code costing 372 billion dollars in lost revenue. They also estimate that Americans spend six billion hours and 265.1 billion dollars on tax filing, record keeping and tax reduction advice. These costs of compliance would drop an estimated 90% under a consumption tax, restoring billions to the economy. The aforementioned literature also concludes that a consumption tax would lead to higher output, more savings, higher take home pay for workers, faster employment growth, more capital formation, lower mortgage rates, and a more efficient and stable revenue system.

Both Hubbard in the American Economic Review and Cheng in the Journal of Finance discuss some of the potential drawbacks, such as the inherent trade-off between efficiency and fairness. They conclude that measures which would be most effective at alleviating the regressivity of the system would also do the most in terms of limiting the potential benefits of a consumption type tax. And even if fairness is the primary motive,

there is still a choice between the mitigation of lifetime wealth disparities and the preservation of pretax relative price of present and future consumption as equity goals. Hall and Ritter both discuss the potential disruptions from the move to a consumption tax including a potential rise in the after tax interest rate, a decline in the value of existing capital goods, a decline in the value of housing and a sharp rise, equal to the amount of the tax, in the price level. And Ballentine proposes the potential for increased tax rates, because the tax base will no longer include savings, making it less neutral between work and leisure, potentially lowering output as real taxation rises. Advocates claim that any negative effect from this will more than be offset from increases in investment and savings. In fact, most research does conclude that a consumption tax would increase output per person if the reform eliminated tax related distortions to work, save, and invest. Most research suggests that switching to a consumption tax would increase GDP between 1% and 7.5% in the long run. Whalley postulates that consumers will need to have a money illusion, essentially making wages sticky in a downward direction, for changes in a consumption tax to affect real consumption. He concludes that a dollar of consumption taxes will reduce consumption by more than will a dollar of income taxes. In fact, he concludes that a dollar of consumption taxes will reduce income by the full dollar. This finding forms the basis for my proposal with the consumption tax as a fiscal policy tool.

I propose that a Federal Tax Advisory Board should be modeled after the Federal Reserve's Board of Governors. They would be appointed by the President and approved by congress for terms long enough to make them apolitical. FTAB would have the power to raise or lower the National Retail Sales Tax in response to economic conditions with the intent of manipulating aggregate demand. This would work much like traditional Keynesian fiscal stimulus, such as changing government expenditures or the rate of taxation, but with significantly diminished inside and outside lags. The group could use much of the same data as the Fed, such as the beige and green book, as well as generating its own policy options and forecasts (blue book). As an example of how they would function, imagine a situation in which all of the tell-tale signs of a looming recession are upon us and the federal funds rate is already on the way down but not fast enough to prevent it. FTAB would have the power to almost immediately increase individual expenditure by dropping the NRST by an appropriate amount.

Some of the advantages to a system like this would be the near elimination of inside lags after certain economic parameters have been reached, thereby conferring congressional authorization to act. Outside lags would be reduced to the amount of time it takes store register the price change and customers to react. In essence, we could mimic the 2001 recession, the shortest and shallowest since World War Two due primarily to well-timed tax cuts, without the necessary foresight or luck. Much like a semi-automatic stabilizer congress would set a limit contingent on certain economic parameters being reached. This would then give the board the ability to raise or lower the NRST by up to five percent. The next step in this research would be to run a series of regressions to determine the effect of a change in consumption tax rates on aggregate demand and consumer spending and determine the appropriate base level tax rate. The particular effects of a consumption tax on output and expenditure should also be more

closely determined, particularly in the “medium-run,” a time frame long enough to allow the effects to take place but not so long as to be worthless from a public policy point of view. Much thought need also be given to the interactions and potential disruptions of policy between the Fed’s decisions and those of the Tax advisory board. This is a potentially powerful and therefore potentially very dangerous tool for discretionary fiscal policy.

In addition to all of the potential benefits mentioned above, it should also be mentioned that this would give policymakers a way to regulate the economy as we enter a liquidity trap. This is an interesting idea with a lot of potential and given the current state of taxation and expenditure, it deserves further research.

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