

Tax Consumption, Not Work

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The payroll tax takes a bigger bite out of the incomes of more than 70 percent of American families than any other tax. Yet the dedicated tax for Social Security and Medicare has many shortcomings. It is regressive, inefficient, and insufficient to meet the needs of the programs it supports. It makes little sense to attempt only incremental changes in such a problem-plagued tax program. Addressing its shortcomings will require wholesale reform. By eliminating the payroll tax and replacing it with a progressive consumption tax, we could combine the economic benefits of a tax on consumption with the fairer tax structure that comes with progressive rates—creating a rare win-win situation in tax reform.

When the payroll tax was introduced nearly 70 years ago, the tax rate was 2 percent on the first \$3,000 of wages. Today, the tax rate is 12.4 percent on the first \$94,200 of wages for Social Security, and 2.9 percent on total wages for Medicare.

This regressive tax is levied only on wages, kicks in at the first dollar of earnings, and since it is capped, higher-income earners face lower effective tax rates. Interest, dividends, and capital gains, as well as many forms of nonwage compensation such as health care and pension benefits—all of which go disproportionately to upper income earners—are not taxed.

Nor is the payroll tax adjusted for family size or situation. The income tax is structured to reflect individual family circumstances through dependent deductions, child credits, and numerous other adjustments, but the payroll tax makes no such accommodations for differing family needs. Take two breadwinners, each earning a salary of \$75,000. The first is a single, young person, and the second is a working parent with a stay-at-home spouse raising three children. Each faces the same payroll tax liability of \$11,475, split equally between employer and employee, irrespective of their strikingly different financial situations. This is one of the least family-friendly tax policies on the books.

Not only is the payroll tax unfair, it is inefficient and creates economic distortions. It is a tax on wages, with half paid by the worker and half paid by the employer. This provides an incentive for workers and employers to place greater value on nontaxable forms of compensation, such as health care benefits, and for employers to skew salary compensation in favor of workers earning over the taxable maximum (since each marginal dollar of pay is not subject to the 12.4 percent Social Security levy). Although it is generally believed that the portion of the payroll tax paid by employers is passed along to employees in the form of lower wages, this is not necessarily the

case at the bottom of the income scale and during certain periods in the business cycle. Requiring businesses to shoulder half the burden of the payroll tax deters job creation, particularly for entry-level and low-income workers. Above that level, it hides the true cost of the tax from those who actually bear the burden. Neither is desirable.

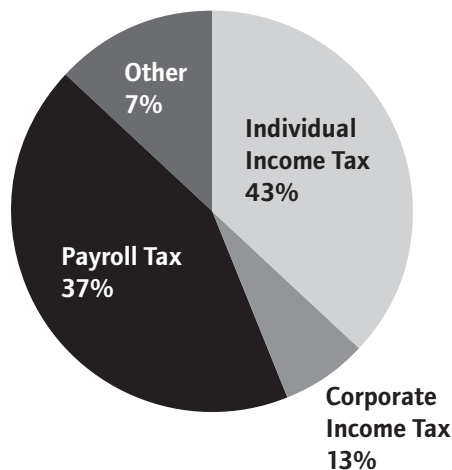
Finally, the payroll tax will not be sufficient to meet the needs of the programs it funds. Social Security spending is expected to surpass revenues in 2017, and Medicare is currently running cash deficits. Ensuring that the revenue base for these two programs is sufficient to meet payments is essential to any reform program.

A Win-Win Tax Swap

While the shortcomings of the payroll tax are apparent, most proposed reforms are incremental in nature and offer only a partial fix. Instead, the payroll tax should be eliminated and replaced with a tax that is both fairer and better for the economy.

However, the payroll tax accounts for over a third of the federal government's revenues, and figuring out how to raise revenues to replace close to \$1 trillion in payroll taxes will be a challenge. Generally speaking, the larger the tax, the larger the damage caused to the economy.

THE PAYROLL TAX AS A SHARE OF FEDERAL REVENUES



Source: Congressional Budget Office.

Emphasizing *what* is taxed, however, can help mitigate the negative economic effects. There are only five basic things that can be taxed—people, incomes, wages, wealth, and consumption. The current federal system primarily taxes incomes and wages.

Given that the low level of domestic saving is a serious economic problem, we ought to consider a consumption tax. A higher tax on consumption would encourage citizens to save more and spend less—a change that would have profound and persistent positive effects on the economy.

Individual saving is necessary for people to prepare for large outlays over their lifetime—for buying a home, funding their children's education, and retirement, as well as for the unexpected costs of illness or unemployment.

The cumulative savings of individuals, businesses, and government are also profoundly important in macroeconomic terms. Net national saving provides the capital for productive investment, and over time low saving rates can lead to lower standards of living. In countries where domestic saving is low, either domestic investment will decline or capital has to be borrowed from abroad, leaving the country indebted to overseas creditors. Our dependence on other countries to supply us with investment capital leaves us economically vulnerable. The only way to overcome this vulnerability is to increase domestic saving levels.

The problem with most consumption taxes, however, is that they are extremely regressive. Lower earners spend most, if not all, of their earnings on basic necessities, leaving them with little left over to save, while those with more disposable income have greater flexibility in choosing how much to spend and how much to save. While switching to a flat rate consumption tax would have positive effects on the economy, it would do little to address the unfairness of maintaining the regressive payroll tax during a time of increasing earnings inequality.

Making Consumption Taxes Progressive

There is nothing that says a consumption tax must be a flat rate tax. A progressive consumption tax is a much better idea.

With a progressive consumption tax, individuals would be taxed on what they spend, not what they earn, thereby creating an incentive to spend less and save more. Since lower-income families have to spend a higher share of their earnings on basic necessities, higher levels of spending would be taxed at progressively higher rates. And whereas most consumption taxes are levied at the time of purchase—as with sales taxes or value-added taxes—a progressive consumption tax would be levied on an annual basis, just like an income tax. This is what would allow for the introduction of a progressive rate structure.

Each year, the tax base would be calculated by totaling an individual’s income for the year and subtracting the amount that person saved. Progressive tax rates would then be applied to the total level of spending. Tax rates might look something like this:

<i>Spending</i>	<i>Tax Rate</i>
\$0–\$15,000	0%
\$15,000–\$75,000	12%
\$75,000–\$200,000	20%
\$200,000+	35%

A low-income earner who made and spent \$20,000 would have an effective tax rate of 3 percent (12 percent of \$5,000); a moderate earner making \$50,000 who spent \$45,000 would have an effective tax rate of 8 percent (12 percent of \$30,000); a well-off individual who made \$150,000 and spent \$120,000 would have an effective tax rate of 16 percent; and a rich earner who made \$500,000 and spent \$300,000 would have an effective tax rate of 22.4 percent. The tax rates and brackets could be altered to achieve different revenue and distributional goals.

Spending would be calculated by totaling all forms of income—including borrowing—and subtracting all saving. Any withdrawals from saving would be counted as income for the period. Thus if a worker earned \$100,000, deposited \$15,000 in a saving account but also withdrew \$5,000, his spending tax base for the year would be \$90,000.

Spending Equals Taxable Cash Flow...

- Wages, Salaries, and Other Forms of Compensation
- Interest, Dividends, and Capital Gains
- Withdrawals from Saving Accounts
- Gifts, Bequests, and Winnings Received
- Pensions, Social Security, Government Benefits, and Insurance Payments
- Borrowing

...Minus Qualified Saving

- Deposits in Saving Accounts and Investments
- Interest Payments
- Family Allowance and Any Special Allowances
- Gifts and Bequests Made

Qualified saving would include things like bank deposits and purchases of stocks and bonds. Consumption investments, such as the purchase of art, stamps, or rare coins would not be counted as saving. First, such purchases are made at least in part for the pleasure of the collector and thus ought to be considered as consumption. Second, their investment characteristics are the result of potential asset appreciation rather than the productive employment of capital to promote economic growth. Since one purpose of a progressive consumption tax is to stimulate national saving and the related macroeconomic benefits, productivity-enhancing investments ought to be favored.

Special allowances would be made for investment in human capital such as education, as well as for certain hardship expenses such as particularly high health care expenses. However, it would be desirable to keep the new tax base as simple and transparent as possible. Since a progressive income tax would run alongside the existing (and, it is hoped, improved) income tax, it would be preferable to make any adjustments for human capital and hardship exemptions in the

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income tax base where they already exist. The broader the tax base, the fewer distortions there would be. The creation of a new tax should not be

Replacing the payroll tax with a progressive consumption tax would stimulate job creation, higher wages, and higher levels of personal saving.

an excuse to start peppering the tax code with new targeted tax breaks.

In order to spread out the cost of large outlays for housing and consumer durables, taxpayers would be able to pay the tax on such items in installments over a longer period of time. It would be preferable not to subsidize housing under a progressive consumption tax in the same way as we now do through the income tax, in that the current structure leads to overconsumption

of housing and underinvestment in other areas. The home mortgage interest deduction, which subsidizes borrowing for purchasing a home or using it as collateral, would have to be redesigned to avoid creating a huge loophole whereby individuals could borrow more money than needed to purchase a home and deposit the excess funds in saving accounts, thereby reducing the level of consumption that would be taxed under the progressive consumption tax.

The tax would be adjusted for family size, providing a consumption deduction for each family member. In order to avoid situations where individuals were left with tax liabilities they could not afford at the end of the year, there would be monthly withholding—much like that for income tax—based on the previous year’s level of consumption.

In order to avoid any abrupt economic disruptions, the transition from a low-saving to high-saving economy should be managed by gradually phasing in a consumption tax over a number of years.

While the tax is not as simple as a flat sales tax, most of the information needed to calculate the tax is already provided for the income tax, and the advantages in terms of both compliance and progressivity make this approach to taxing consumption far preferable.

The Advantages of a Progressive Consumption Tax

Replacing the payroll tax with the progressive consumption tax offers a number of distinct advantages. It will almost certainly increase national saving, probably by a significant amount. Given the economic challenges the country currently faces, from highly overleveraged individuals to record budget deficits, few macroeconomic objectives are more important.

At the same time, the progressive nature of this consumption tax proposal would be a vast improvement over the distributional effects of the payroll tax. If payroll taxes were used to finance individual saving accounts, a flat or even a regressive payroll tax structure might be justifiable, since individuals would receive the full benefit of their own contributions. However, a regressive tax structure used to finance a large portion of entitlement programs—including a number of subsidies that flow from low to high income—as well as other government spending programs, hardly makes sense.

Finally, a progressive consumption tax offers the potential for a workable political compromise. There is an ongoing divide between conservatives and liberals over the priorities and structure of desirable tax reform. Conservatives tend to favor a more efficient consumption base, which is generally associated with flat tax rates, as being better for the economy, while liberals favor a progressive tax structure and place less emphasis on the economic effects of taxes. A progressive consumption tax would allow the more efficient base to be combined with a fairer tax structure, giving both sides something to support.❖