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A Flat Consumption Tax Would Be Fair and Efficient

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Congress has the power to design a tax system to fund the necessary functions of government. It also has a responsibility to design a tax system that is fair and efficient. A flat consumption tax is the least economically destructive tax system. Relative to the current income tax system, a consumption tax has the potential to increase economic growth substantially.[1]

The term consumption tax should *not be confused with* an additional tax in line with the current system. Rather, Congress should implement a consumption-based tax system to *replace* the current, broken system. There are a number of consumption tax systems. Any tax plan that does not double-tax saving and investment is a consumption tax, including a flat tax, the New Flat Tax, a national retail sales tax, and a business transfer tax.[2]

One of the biggest reasons why replacing the current hybrid income-consumption system with a consumption tax would be a tremendous boon for the economy is it would eliminate the heavy taxation that the current system places on investment. One of the ways a consumption tax eliminates that heavy burden is by not taxing capital gains and dividends. Many observers argue that the lack of such taxes is an enormous giveaway to the rich.[3] However, a consumption tax is an entirely different method of taxation than the current system.

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A reform plan that establishes a consumption tax should be evaluated on its merit independent of the current system. A consumption tax can both encourage much stronger economic growth and apply a fair and equitable tax burden without applying a tax on capital gains and dividends.

Consumption Taxes Do *Not* Tax Capital Gains and Dividends

The current tax system suppresses production in part because it taxes investment at multiple levels. It taxes business investment twice, for instance. Business investment makes up the majority of total investment in the United States.[4] The corporate income tax levies an initial layer of tax at the business level. Capital gains taxes and dividends taxes are then a second layer of tax at the shareholder level. Capital gains taxes apply to retained earnings, since capital gains represent the capitalization of expected future taxable earnings, while dividends taxes apply to distributed earnings.

Once combined, the two sets of taxes cause the tax rate on business investment to exceed 50 percent.[5] Such a high rate is a strong discouragement for businesses to invest and for investors to take risks.

A consumption tax mostly removes tax on business investment. At the business level, it allows businesses to expense their investments in capital. In other words, they can deduct the entire cost of an asset from their taxable income at the time they purchase it, rather than over many years as is the case under current depreciation rules. Expensing eliminates tax on the normal returns to capital investment. A residual tax remains on returns that are greater than normal, or *supra normal*. At the shareholder level, a consumption tax does not add a second layer of tax because it does not have capital gains taxes or dividend taxes.

Capital gains taxes and dividends taxes would run counter to a consumption tax's nature and purpose. In fact, if a consumption tax did include them, it would not be a consumption tax. It would be much closer to the current hybrid system and would forfeit much of the enhanced growth it could bring to the economy.

Big Benefits of a Consumption Tax

The economic benefits to Americans at all income levels would be immense once Congress implements a consumption tax. The empirical data show that a consumption tax could increase the size of the economy by about 15 percent over 10 years.[6]

That impressive growth would largely arise from investment that is being suppressed under the current tax environment. Investment would rise because a consumption tax would remove the existing steep disincentives for business to make new investments and for investors to take the risk to fund them. Higher investment in the economy would create new jobs and increase productivity, which would increase wages. Those benefits would lift all boats, helping all Americans.

Distribution and Fairness Concerns

A flat consumption-based tax is by definition progressive, even without capital gains taxes and dividends taxes, because the more a person earns, the more taxes he pays. In fact, John Rawls, perhaps the most liberal philosopher of the 20th century, wrote in *Justice as Fairness* that "a tax on consumption at a constant marginal rate" was the best tax system.[7]

A consumption tax can also adhere to the current standard of progressivity without sacrificing its positive growth effects. For instance, The Heritage Foundation's New Flat Tax is a consumption tax, and hence, by definition, does not have capital gains taxes or dividend taxes. Yet its distribution (the percentage of the tax burden that various income groups pay) is consistent with the distribution of the current system.[8]

A major reason why the burden under a consumption tax can remain consistent with the current system is that shareholders would still bear most of the burden of the tax on businesses, the same as they do the corporate income tax today.[9] Shareholders tend to be high-income. A consumption tax, other than a national retail sales tax, would retain a statutory tax on businesses. The business tax would be in addition to the tax that shareholders would pay on their wage income, which a consumption tax would also tax.

1. Curtis S. Dubay and David R. Burton, "A Tax Reform Primer for the 2016 Presidential Candidates," Heritage Foundation *Backgrounder* No. 3009, April 7, 2015, http://www.heritage.org/research/reports/2015/04/a-tax-reform-primer-for-the-2016-presidential-candidates.
2. David R. Burton, "Four Conservative Tax Plans with Equivalent Economic Results," Heritage Foundation *Backgrounder* No. 2978, December 15, 2014, http://www.heritage.org/research/reports/2014/12/four-conservative-tax-plans-with-equivalent-economic-results.
3. Jared Bernstein, "Marco Rubio's Tax Plan Gives a Huge Gift to the Top 0.0003 Percent," *The Washington Post*, November 5, 2015, https://www.washingtonpost.com/posteverything/wp/2015/11/05/marco-rubios-tax-plan-gives-a-huge-gift-to-the-top-0-0003-percent/ (accessed November 6, 2015).
4. News release, "Gross Domestic Product: Third Quarter 2015 (Advance Estimate)," Bureau of Economic Analysis, October 29, 2015, Table 3, Line 28, http://bea.gov/newsreleases/national/gdp/2015/pdf/gdp3q15_adv.pdf (accessed November 6, 2015).
5. The effective tax rate equals the corporate income tax rate plus the capital gains and dividends rate multiplied by the remaining 65 percent of corporate profit after taxes (35 percent + (23.8 percent x .65)) = 50.5 percent.
6. Andrew Lundeen, "Slow Economic Growth Does Not Need to Be the New Normal," Tax Foundation, May 15, 2014, http://taxfoundation.org/blog/slow-economic-growth-does-not-need-be-new-normal (accessed March 16, 2015); Robert Carroll, "The Excess Burden of Taxes and the Economic Cost of High Tax Rates," Tax Foundation *Special Report* No. 170, August 14, 2009, http://taxfoundation.org/article/excess-burden-taxes-and-economic-cost-high-tax-rates (accessed October 30, 2015); and Dale W. Jorgenson and P. J. Wilcoxen, "The Long-Run Dynamics of Fundamental Tax Reform," *American Economic Review*, Vol. 87, No. 2 (May 1997), pp. 126–132. More empirical examples are available upon request.
7. John Rawls, *Justice as Fairness: A Restatement* (Belknap Press, 2005), p. 161.
8. J. D. Foster, "The New Flat Tax: Easy as One, Two, Three," Heritage Foundation *Backgrounder* No. 2631, December 13, 2011, http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three.
9. Eighty-two percent according to the Treasury Department: Julie-Anne Cronin et al., "Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology," U.S. Department of Treasury, Office of Tax Analysis, May 2012, http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2012-05-Distributing-the-Corporate-Income-Tax-Methodology-May-2012.pdf (accessed November 6, 2015).

Distributional Criticisms of Consumption Taxes Miss the Larger Picture

The current system is an enormous drag on the economy; it has large negative effects on Americans of all income levels, most especially on the middle class and the poor. Tax reform would fix this problem and help middle-class and poor families that are falling behind to find better jobs and earn higher wages. Analyses should focus on how well tax reform plans achieve that central goal.

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