Consumption as a Tax Base

The consumption tax, or the expenditure tax, sometimes also referred to as a "spendings tax," closely resembles the income tax except that the tax base is **spending**, not **income**. The direct taxation of personal expenditures for consumption is one of the oldest - yet least tried - ideas in the history of taxation. A number of distinguished economists for over a century have argued that it is the "ideal" form of taxation. Let us first present the arguments in favour of consumption or expenditure as a tax base. Then we shall analyse the other side of the story.

The Basics

A simple relationship between consumption and income is:

Consumption = Labor earnings + Current capital income – Saving, while

Income= Labor earnings + Current capital income

Thus, an income tax is levied on taxable income, but a consumption tax is levied on taxable income minus saving. The key difference between an income tax and a consumption tax, therefore, lies in the treatment of saving. **A consumption tax excludes current saving from the tax base.**

The Pros

Income tax 'unjust', distorts choice of individual, encourages consumption and leisure

Irving Fisher and other earlier advocates of the consumption tax argued that the income tax involved ***"double taxation"*** of savings. This was because first, income tax does not distinguish between the part that would be spent and the part that would be expended. Moreover, interest earning from income would again be taxed. This, they argued, **distorted the choice** of individuals in favour of consumption. Thus, not only is the income tax unjust but it **encourages consumption and leisure** at the expense of **thrift and enterprise.** Let us explain this point in slightly some detail, though the 'good' effect of **consumption tax on work effort (enterprise)** is quite **debatable.**

The present value of the consumption tax —the value of current and future tax payments discounted to the present—is the same, whether the household consumes now or later. In contrast, an income tax places a higher tax burden on savers because households pay their tax on taxable income with no deduction for new saving. The capital income received from the new saving will also be taxed as a part of current capital income in some future period.

Therefore, under the income-based system, households face a higher overall tax burden on capital income and have less incentive for new saving. This is why Consumption as a tax base is considered to be superior, as it supposedly encourages savings. We know that savings help an economy to invest more and grow faster, and a consumption tax may be more conducive to investment and growth than an income tax.

[**Note**: *The cons of IT is the pro of CT]*

Consumption tax is a better measure of Ability to Pay

Nicholas Kaldor, writing in 1955, broadened the case for the expenditure tax by arguing that spending was a **better measure of ability to pay (ATP) than income**. Kaldor viewed the individual's taxable capacity as his "spending power" which includes all the various forms of economic wealth (stocks of wealth as well as recurrent and irregular flows of money). All these sources must be reduced to a common denominator for tax purposes. Also, allowance should be made for differences in individual needs which make some persons more or less able to pay than others with the same spending power. Kaldor argued that the calculating a person's spending power against his needs is best done by the individual himself when he decides on the scale of his living expenses. He viewed income as unsuitable as a measure of taxable capacity because it does not takes into account spending power in other forms and also takes no account of differences among individuals as to the need to save. Thus, while consumption tax takes into account all spending; income tax cannot touch some spending by the rich which is out of capital.

Consumption tax is an anti-inflationary tool

During times of inflation, consumption tax can be an effective tool to curb demand. Thus, it can automatically contribute to reducing demand and thereby control inflation.

Relative effects on incentives to work

An imposition of an income tax may reduce the incentive to work. As leisure can be considered as a normal good, imposition of an income tax will reduce the opportunity cost of leisure (make leisure cheaper) as one hour of leisure will now cost less (previously it was equal to the hourly wage rate w (say), now it will be equal to w minus tax payable). As the 'purchase' of a normal good will increase if its price falls, work effort will decrease and leisure will increase when income taxes are imposed.

In respect of the effect on work effort, however, there is no clear theoretical model or empirical evidence to suggest that it is more conducive to work effort. Indeed, it is often argued that a consumption tax may reduce work effort by a greater degree. Why? A consumption tax is likely to have a higher tax rate than an income tax if the taxes are to be revenue neutral, because the tax base under a consumption tax is necessarily smaller than the tax base under an income tax. So, a higher tax rate under a consumption tax would be expected to decrease the relative value of work to a greater degree than under an income tax, and therefore decrease work effort to a greater degree.

Empirical evidence does not, however, suggest a significant difference in the impact on work effort of income tax and consumption tax.

The Cons

The point that consumption tax spares and thus encourages savings can be challenged

Some economists have argued that savers do not escape taxation under a consumption tax. If households save in the present, they do not pay tax **now** on the amount of their saving, but the savers or their heirs will eventually pay a consumption tax at some point in the future when they use their accumulated wealth for consumption. Because the saver's assets earn a return over time, there will be more wealth to spend in the future and more taxes on this consumption.

Consumption tax is unfair on retired persons

It has also been argued that switching to a consumption tax from income tax is unfair on retirees and older workers because such households own a large share of existing wealth, accumulated from years of savings. For existing assets, savers were taxed in the past on their income and would be taxed in the future when they consume their wealth.

Consumption tax is unfair on the poor and favours the rich

Some economists oppose the expenditure tax on the ground that the exemption of saving would favour the rich since they are better able to save large portions of their incomes. Apart from the inequity involved, some feel that this would lead to greater concentrations of wealth in the hands of a few.
Kaldor argued that this objection overlooked the fact that the rates of an expenditure tax can be made steeply progressive in order to tax the rich as heavily as desired.

Consumption tax may aggravate recession

While consumption tax is anti-inflationary in character, it lacks the automatic stabilizing effect of the income tax in periods of recession. In fact, it has the potential to aggravate recessionary trends.

Consumption tax administratively more complex than income tax

The administration of the expenditure tax has always been considered quite formidable and, by many economists, a great drawback to its actual use. In fact, the advocates of consumption tax also do not claim it to be administratively simpler. Discussion of the economic and social merits of the tax, therefore, is frequently viewed as purely an academic exercise, with little relevance to tax policy in the real world.