It's Time for the Progressive Consumption Tax

So you think we need tax reform? OK then, let's start by getting rid of the Federal income tax.

Actually, we don't have a Federal income tax. What we call the income tax differs from a true income tax in a variety of ways – in how we treat pensions, and houses, and capital gains, to name a few. And for the most part, trying to tax these "correctly", under the logic of income taxation, is just not feasible. So let's quit pretending that we have an income tax.

What we should do is implement a progressive personal consumption tax, also called a cash flow tax. I know, when most people hear "consumption tax", they think sales tax or value added tax. But your consumption is all your spending, that is, all your income except what you save. So a personal consumption tax is an income tax that exempts savings.

Of course, that's kind of what we have now. We currently exempt some saving – savings that goes into pensions, and IRAs, and 401Ks, and the like. Fully implementing a progressive personal consumption tax would involve broadening those provisions, to allow perhaps as much as 25% of earned income to be deposited annually into IRA-type accounts, with no penalty for early withdrawal. Similarly, for businesses, cash flow taxation would allow all new capital investment to be fully deducted, immediately ("expensed" rather than "depreciated").

However, a true consumption tax would require a number of other changes. Borrowed money can finance consumption, so with a few exceptions – homes, cars and other consumer durables – the amount you borrow would need to be taxed, although your repayments would then be deductible. The same would hold for businesses. And for the consumer loans like mortgages that wouldn't be taxed, the interest would no longer be deductible.

Also, in moving to the consistent logic of a consumption tax, we would need to eliminate all the different treatments of different kinds of income that we have now. Consumption is consumption, whether you finance it with wage income, or dividends, or capital gains, or whatever. Including inheritances. If Uncle Larry leaves you a million dollars, that should be taxable, unless you save and invest it. If a Paris Hilton wants to live a lavish lifestyle, then she can afford to pay lavish taxes.

So why switch to a progressive personal consumption tax? First, because it would align with what Republicans say they want, which is a low tax on investment. With full deductibility of savings and investment, the return to investment is (on average) entirely unaffected by the tax rate. There would be no disincentive to savings or investing whatsoever.

Second though, we should switch because it would align with what Democrats say they want, which is a progressive tax that levies its burden most on those able to pay the most. Ability to pay would be measured not by what you earn, but by the lifestyle you lead.

And third, because, by changing our tax code to conform to a single, consistent logic, we would eliminate most of the abusive manipulations that make up tax shelters. Most tax shelters are constructed by using the inconsistencies within our tax code, devising strategies that take advantage of rules that might individually make sense, but don't fit logically together. A single, consistent logic would have few if any weaknesses to exploit.

A progressive, fair tax system that favors saving and investing can be done. It should be done. In fact, I can only count 535 reasons why it might not be done – all of them the members of the U.S. Congress.