

## **A conversation with Alan D. Viard on March 25th, 2014**

### **Participants**

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**Note:** This set of notes was compiled by GiveWell and gives an overview of the major points made by Dr. Viard.

### **Summary**

GiveWell spoke with Alan D. Viard, Resident Scholar at the American Enterprise Institute (AEI), about fundamental tax reform, particularly the benefits and drawbacks of various types of consumption taxes.

### **Consumption taxes**

A consumption tax is a tax on spending as opposed to income. Consumption taxation is theoretical appealing because, unlike the income tax, it does not disincentivize investment and saving. Under an income tax, both invested money and the return on invested money are taxed, meaning that income that is invested is ultimately taxed more heavily than income spent immediately. By taxing money when it is spent, a consumption tax avoids this problem and encourages greater capital growth. Dynamic simulation models suggest that a switch to a consumption tax might increase overall economic output by several percentage points in the long run.

Several types of consumption tax have been proposed. A value-added tax (VAT), somewhat like a sales tax, uses a flat tax structure. The X tax is a progressive consumption tax that taxes businesses on value-added minus wages and individuals on wages. The personal expenditure tax (PET) is a progressive tax on household expenditures which eliminates business taxes altogether.

### **Value-added tax (VAT)**

A VAT is a tax on the value added to a product at each stage of its manufacture and on its final sale to the consumer. A VAT may be viable as a partial replacement for the income tax, and it seems likely that a VAT will eventually be implemented in the U.S. The VAT has been studied extensively, so more research on it may not be necessary. 160 countries have adopted a VAT.

VATs tend to be regressive in practice because those at lower income levels spend a larger portion of their income than higher income earners on goods and services that are subject to the VAT.

### **The X tax**

The X tax, like the flat tax, is essentially a modified VAT, differing from a pure VAT in a few substantial ways. It would:

- Tax households progressively, rather than at a flat rate, on wages earned
- Allow businesses to deduct wages paid
- Tax business firms on cash flow (value-added minus wages paid) at a flat rate equal to the rate paid by the highest-paid workers
- Eliminate the import tax and export rebate associated with the VAT.

By placing the tax on wages at the household level, the X tax can be more lenient on households than a VAT by using a progressive rate structure. This avoids the regressivity problem of a pure VAT. Because national consumption equals household wages plus business cash flow, the X tax is, in the aggregate, an overall tax on consumption. Households are taxed only on wages, not on investment income, under the X tax.

In the long run, dynamic simulation modeling suggests that the X tax could have across-the-board benefits, resulting in gains to all income groups.

In the short run, without significant transition relief, equity holders (corporate stockholders and the owners of non-corporate businesses) who have already accumulated wealth would experience transitional losses under an X tax as savings earned under an income tax system would be taxed again when spent under the X tax. Because that taxation would occur through the cash flow tax at the business firm level, the transitional losses would manifest as a reduction in business equity prices. The elderly, especially those middle-income retirees who own stock, might perceive this as threatening their standard of living in retirement. The severity of this tax burden would depend on the degree of transition relief enacted.

In practice, any consumption tax will include transition relief, but this will require tradeoffs. Less generous transition relief would result in greater immediate negative impact on current equity holders. More generous transition relief would soften the tax burden on current equity holders, but would necessitate higher tax rates to meet any given revenue target, and long-term output gains would be smaller.

The X tax would also shift resources away from owner-occupied housing, which the construction industry claims would negatively impact its business. But, that effect is also likely to occur if the income tax system is reformed.

#### *Political feasibility of the X tax*

Implementation of the X tax faces several political obstacles:

1. Though the X tax functions as a consumption tax, the wage tax on households can make it look superficially like a poorly-designed income tax. Although the X tax is designed to be lenient toward wages relative to businesses, the business portion of the tax is less visible. The apparent singling out of wages may be politically problematic.

The flat tax was also commonly misperceived as an income tax when it was first developed. Supporters of the flat tax tried to market it as an income tax because of the difficulty of explaining that it is actually a consumption tax. The X tax is structurally similar to a flat tax, but with progressivity added.

2. Under the X tax, some very wealthy citizens (such as Mitt Romney and Warren Buffett) would pay no household tax, because they make their income from investments rather than wages. Dr. Viard terms this the “Romney-Buffet” problem. This may be popularly perceived as a big benefit for the wealthy, although (depending on transition relief) these citizens would actually be subject to a major tax, collected at the business firm rather than the household level, on their existing equity holdings. Currently, these citizens pay a 20% (previously 15%) tax on dividends and capital gains.

3. Many politicians favor a tax on imports and rebate on exports, which the X tax does not implement (unlike the VAT). From a welfare economics perspective, this is a benefit of the X tax, but it is politically challenging.

### *Marketing the X tax*

There is no obvious constituency for an X tax proposal. The marketing of the X tax encounters a standard political economy problem: when the anticipated benefits of a reform are diffuse, it is difficult to mobilize any particular group to support it. The long-term nature of most benefits of the X tax also makes it difficult to market. While there are some short-term gains, the biggest gains of the X tax arise from the deepening of capital over time.

There is currently no group with adequate motivation to lobby Congress in favor of the X tax. The widespread doubt that such a fundamental reform is feasible reinforces the lack of incentive to advocate for it.

The X tax’s gains in simplicity could be marketed effectively, but these gains largely result from the same source as the Romney-Buffet problem (namely, that only wages, not capital gains or dividends, would be taxed at the household level), so the Romney-Buffet problem would need to be addressed as well.

An effective movement for the X tax would need the support of the intellectual policy community to receive attention from policymakers. The business community would need to be involved as well, since a major goal of the X tax is to eliminate taxation of new business investment. Public support would be necessary later in the process.

Because there is some strong political resistance to the VAT in the U.S., it may not be politically expedient to market the X tax as a modified VAT.

### *Comparison to a wage tax*

A wage tax that maintains personal income taxes while eliminating the corporate income tax and individual taxes on investment income would essentially keep the household component of the X tax while dropping its business component. It would have some of the advantages of the X tax, but would have many additional disadvantages, in terms of both perception and economic impact. Because it would not tax business cash flow, a wage tax would fail to tax all of consumption.

The Federal Insurance Contributions Act (FICA) tax is effective as a special-case wage tax (supporting only Social Security and Medicare Part A). However, a wage tax intended to support the overall government is neither feasible nor desirable.

### **Personal expenditure tax (PET)**

The PET is an older concept than the X tax. Under a PET, households file annual tax returns, reporting income, deducting all saving, and adding back in any dissaving. This results in a bottom line calculation of the total amount that a household spends in a year. Then, total spending is taxed at progressive rates.

Two countries have implemented and subsequently abandoned a PET.

#### *Political feasibility of the PET*

A pure PET has two potential political obstacles. First, it includes no tax on businesses. Second, it taxes individuals on money they borrow.

Much like the X tax, a transition to the PET would impose losses on current wealth holders. In the case of the PET, however, the burden would be spread across all holders of wealth, rather than being concentrated on holders of business equity.

The PET taxes imports, unlike the X tax. However, the import tax is not explicit; imports are taxed because they comprise part of the consumer spending on which households end up being taxed on their individual tax returns. As a result, the PET probably won't be any more attractive than the X tax to politicians who support import taxes.

#### *Marketing the PET*

The PET may be easier to market than the X tax because it is easier to understand that it is a consumption tax.

Past attempts to advocate for the PET may have been more effective if they had emphasized positive features such as its simplicity and the efficiency of capital allocation across sectors that it allows, though the strength of these features' appeal remains uncertain.

Some people and organizations find the PET conceptually appealing but are uncertain how substantial its benefits would be and are therefore reluctant to endorse making such

fundamental changes to the current system. Some people express concern that the PET may not be implemented in as progressive a form as they would want (e.g., there is uncertainty that the rate schedule adopted would be adequately steep).

### **Benefits of the X tax and PET**

The X tax and PET are both viable forms of progressive consumption taxation, with several benefits:

- They are simpler than the current system (especially the X tax).
- They allow capital to be allocated more efficiently.
- They remove disincentives to saving in order to deepen capital and increase long-term growth.
- They would attract new foreign investment to the U.S., due to the elimination of corporate income taxes.

Additionally, a significant part of the X tax's burden on existing wealth falls on foreign holders of U.S. business equity.

Overall, Dr. Viard believes the X tax to be slightly superior to the PET.

### **The reliability of dynamic simulation models**

Dynamic simulation models indicate that replacing the income tax with some form of consumption taxation would be more effective than income tax reform at increasing long-term economic output.

It is difficult to know how confident to be in these models because there is no effective way to test their accuracy empirically. The models simulate a stylized policy experiment to compare how the economy behaves with and without a given reform. Because the models' predictions concern the long-term evolution of the economy after a reform, these predictions could not be compared to reality until several decades after a reform was implemented. At that point, however, there would be no way to know how the economy would have progressed without the reform.

While these models' accuracy cannot be tested directly, the assumptions upon which the models are built are tested frequently. Commonplace research aimed at estimating the parameters that govern people's behavior (e.g., savings behavior) are often *de facto* tests of simulation models' assumptions, though researchers rarely intend this explicitly. This process is iterative: the simulation models attempt to incorporate and calibrate themselves to statistical research that has been done.

Some of the assumptions that these models use are supported by excellent statistical evidence and are widely accepted. Others are disputed, including the critical issue of the determinants of savings behavior. For example, it is unclear how a person's current savings decisions may change upon learning that returns from savings would be higher than expected in twenty years. The determinants of people's response to savings

incentives are a key issue. Many simulation models use simplified assumptions about how people make such decisions. Some observers, including Jane Gravelle of the Congressional Research Service, criticize the structure of these assumptions, claiming that they were adopted primarily for their simplicity and may not be realistic.

Better evidence on long-term savings behavior would be beneficial but may not be obtainable. While it is unlikely that all relevant concerns can be addressed, studies of micro-data have produced some useful evidence, and ongoing studies will continue to refine this data.

### **Potential areas for philanthropy**

Assuming that effective marketing would be a major obstacle, funding could be used to research how to effectively market consumption taxation to potential supporters.

Funding could also be used for research on design issues for the X tax and the PET (e.g., how to tax financial institutions). This could accomplish three goals:

- Prepare solutions to the issues, for use in case the X tax or PET is actually adopted.
- Alleviate concerns in the intellectual community that the auxiliary design issues are insoluble (e.g., the common objection that there is “no way to tax financial institutions” under the PET or X tax). This type of research would involve statistical analysis of micro-data, in-depth discussions with various industry segments, etc., and would likely be too resource-intensive to be done by an academic working alone.
- Attract those who have latent interest in these issues to participate in research, which might eventually engage them in advocacy.

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