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Why Not Shift the Burden to Big Spenders?

By ROBERT H. FRANK

IN his memoir, Alan Greenspan joins a growing list of Republicans who now accuse President Bush of fiscal irresponsibility. As even veteran supply-siders now concede, the president’s tax cuts have added hundreds of billions of dollars to the national debt.
Mr. Greenspan, who supported those cuts in testimony before the Senate Budget Committee in 2001, when he was the Federal Reserve chairman, now says he thought the president would be more disciplined about spending. It was an unreasonable expectation. Federal spending has risen during every modern presidency, even Ronald Reagan’s.

Mr. Greenspan may have failed to convince critics that he bears no responsibility for the fiscal meltdown that is now under way, but his book has provoked long-overdue debate about what caused the crisis and what might be done about it. As all serious participants in this debate now agree, no strategy can succeed without increasing federal revenue substantially. The leading Republican presidential aspirants, advocating further tax cuts, have elected to skip this debate. Their Democratic counterparts have proposed allowing Mr. Bush’s tax cuts for top earners to expire as scheduled. That step alone, however, would not be nearly enough.

Given the political risk of proposing painful tax increases in an election year, many fear that the crisis will remain unresolved. Yet a simple remedy is at hand. By replacing federal income taxes with a steeply progressive consumption tax, the United States could erase the federal deficit, stimulate additional savings, pay for valuable public services and reduce overseas borrowing — all without requiring difficult sacrifices from taxpayers.
Under such a tax, people would report not only their income but also their annual savings, as many already do under 401(k) plans and other retirement accounts. A family’s annual consumption is simply the difference between its income and its annual savings. That amount, minus a standard deduction — say, $30,000 for a family of four — would be the family’s taxable consumption. Rates would start low, like 10 percent. A family that earned $50,000 and saved $5,000 would thus have taxable consumption of $15,000. It would pay only $1,500 in tax. Under the current system of federal income taxes, this family would pay about $3,000 a year.

As taxable consumption rises, the tax rate on additional consumption would also rise. With a progressive income tax, marginal tax rates cannot rise beyond a certain threshold without threatening incentives to save and invest. Under a progressive consumption tax, however, higher marginal tax rates actually strengthen those incentives.

Consider a family that spends $10 million a year and is deciding whether to add a $2 million wing to its mansion. If the top marginal tax rate on consumption were 100 percent, the project would cost $4 million. The additional tax payment would reduce the federal deficit by $2 million. Alternatively, the family could scale back, building only a $1 million addition. Then it would pay $1 million in additional
tax and could deposit $2 million in savings. The federal
deficit would fall by $1 million, and the additional savings
would stimulate investment, promoting growth. Either way,
the nation would come out ahead with no real sacrifice
required of the wealthy family, because when all build larger
houses, the result is merely to redefine what constitutes
acceptable housing. With a consumption tax in place, most
neighbors would also scale back the new wings on their
mansions.

A progressive consumption tax would also reduce the
growing financial pressures confronting middle-class
families. Top earners, having received not only the greatest
income gains over the last three decades but also substantial
tax cuts, have been building larger houses simply because
they have more money. Those houses have shifted the frame
of reference for people with slightly lower incomes, leading
them to build larger as well. The resulting expenditure
cascade has affected families at all income levels.

The median new house in the United States, for example,
now has over 2,300 square feet, over 40 percent more than
in 1979, even though real median family earnings have risen
little since then. The problem is not that middle-income
families are trying to “keep up with the Gateses.” Rather,
these families feel pressure to spend beyond what they can
comfortably afford because more expensive neighborhoods
tend to have better schools. A family that spends less than its peers on housing must thus send its children to lower-quality schools.

Some people worry that tax incentives for reduced consumption might throw the economy into recession. But total spending, not just consumption, determines output and employment. If a progressive consumption tax were phased in gradually, its main effect would be to shift spending from consumption to investment, causing productivity and incomes to rise faster.

Should a recession occur, a temporary cut in consumption taxes would provide a much more powerful stimulus than the traditional temporary cut in income taxes can. People would benefit from a temporary consumption tax cut only if they spent more right away. In contrast, consumers who fear that they might lose their jobs in a recession are often reluctant to spend the dollars they are no longer paying as income tax.

Failure to address the current fiscal crisis is not an attractive option. With baby boomers retiring and most voters now favoring universal health coverage, budget shortfalls will grow sharply. Annual borrowing from abroad, now more than $800 billion, will also increase, causing further declines in the slumping dollar. And the personal savings rate, which has been negative for the last two years, will fall still further,
causing future reductions in economic growth.

THE progressive consumption tax is perhaps the only instrument that can reverse these trends at acceptable political cost. It has been endorsed by a long list of distinguished economists of varying political orientations. It was proposed in the Senate in 1995 by Sam Nunn, the Georgia Democrat then serving his final term, and Pete V. Domenici, Republican of New Mexico, who called it the Unlimited Savings Allowance tax. In short, this tax is not a radical idea.

Although the Bush tax cuts for the nation’s wealthiest families threaten American economic prosperity, they have done little for their ostensible beneficiaries. When the wealthy spend millions of dollars on ever-more-elaborate coming-of-age parties for their children, they only raise the bar that defines a special occasion. Even purely in terms of self-interest, they and their families would have fared much better if the money had been spent to repair aging bridges and inspect the cargo containers that enter the nation’s ports.

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