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Just What This Downturn Demands: A Consumption Tax

By ROBERT FRANK

THE country is now in the midst of the deepest economic crisis since [the Great Depression](#). But as a new administration prepares to enter the White House, the crisis could end up being a potent ally for change. Without it, political resistance to the steps needed to address our most acute and longstanding economic problems would be almost insurmountable.

Despite broad agreement that the nation needs to increase spending in many domains — including infrastructure, health care, scientific research and clean energy development — no one has forged a legislative coalition capable of raising the necessary tax revenue. But with the country sliding into what promises to be a sharp and protracted economic downturn, it is imperative to increase spending over the short run, regardless of how we pay for it.

Even stalwart conservatives concede the point. For example, Martin Feldstein, the Harvard economist who was an adviser to the campaign of Senator [John McCain](#), recently wrote in *The Washington Post*, “The only way to prevent a deepening

recession will be a temporary program of increased government spending.” Mr. Feldstein suggested that government might need to offset a shortfall of some \$300 billion in household spending.

In the long run, though, it will be necessary to raise enough tax revenue to balance the budget. One of the most effective ways to do that is by changing what we tax. Most federal revenue now comes from the income tax. Because a family’s annual income equals the amount it spends each year plus the amount it saves, we are effectively taxing savings. And savings rates have fallen precipitously, often dipping into negative territory as families have used home equity loans and credit card debt to spend more than they earned. Because the country needs to save more, taxing savings makes no sense.

The first reform that [Barack Obama](#) should consider is replacing the progressive income tax with a progressive tax on consumption. A family would report its income to the [Internal Revenue Service](#) as it does now, and also its savings, as it now reports contributions to retirement accounts. Annual consumption would then be calculated as the family’s income minus its savings. Its taxable consumption would be that amount minus a large standard deduction — say, \$30,000 for a family of four.

A family that earned \$60,000 and saved \$10,000, for

example, would have taxable consumption of \$20,000. Initial tax rates on consumption would be low, and would then rise steadily with consumption, topping out at higher levels than the current top rates on income.

Such a tax could raise more revenue than the current system, yet would be far less burdensome for families at nearly all income levels. Because of the large standard deduction, middle-income families would pay less than they did before, and high-income consumers could limit their tax increases by saving more.

How painful would that be? Some wealthy families now spend millions of dollars on coming-of-age parties for their children. A steeply progressive consumption tax would encourage them to spend less, which would not be much of a sacrifice, since the main effect would be to lower the bar that defines an acceptable coming-of-age party for people in their tax bracket.

Other changes in what we tax could further reduce the revenue shortfall while producing positive side effects. Energy and climate specialists, for example, have long advocated taxes on carbon. The burden of these levies would be lessened by the resulting reductions in pollution and congestion.

Imposing new taxes is never easy. But recent research

suggests innovative ways of making it more palatable. Behavioral economists have shown that the pain caused by a loss is far greater than the pleasure caused by a gain of the same magnitude. This asymmetry, called loss aversion, helps explain why it is so hard to pay higher taxes. Doing so means reducing consumption now — a loss that is immediately painful.

To overcome this hurdle, Congress could vote to increase future taxes — a strategy that happily coincides with current fiscal imperatives. Tax increases are never a good idea when the economy is in the doldrums, but the current downturn will not be permanent. Higher taxes could be phased in gradually, after income growth resumes. As long as each year's tax increase is smaller than the corresponding growth in income, painful reductions in consumption will not be necessary.

Evidence supporting this strategy comes from “Save More Tomorrow,” a payroll savings program designed by the economists Richard H. Thaler and Shlomo Benartzi. Under this program, workers can allocate a portion of future salary increases to retirement savings accounts. Hundreds of corporations report that their employees began saving at sharply higher rates after the introduction of this program.

It would be quixotic to imagine that losses from the current economic meltdown won't be painful. But the crisis also

opens new doors to policymakers — providing them with options that would have seemed unthinkable just a few months ago.

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