spotlight

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The Consumed Income Tax

Efficient and Fair Tax Reform for North Carolina

KEY FACTS: **• North Carolina's state income tax penalizes people's income generating activities. In a market setting, income generating activities are those that lead to the production of goods and services and spur economic growth.**

• By reducing the rewards to all income-generating activity — work, saving, and investment — the income tax discourages those activities relative to non-income generating activities — leisure and consumption.

• Income taxation drives a "wedge" between the rewards to work effort and the rewards to non-work activities. The higher the tax rate, the greater the wedge, i.e. the greater the penalty against additional economic productivity and the more distorting the tax.

• North Carolina's income tax system enhances this tax penalty in two different ways. First, its income tax rates are high relative to the national average and are particularly high relative to other states in the Southeast.

• Adding to this anti-productivity bias is North Carolina's steeply progressive rate structure, which penalizes increased productivity by taking a greater percentage of people's incomes as they earn more.

• The NC income tax "double taxes" saving relative to consumption.

• If we apply North Carolina's top marginal rate of 7.75 percent and look at its actual impact on investment returns, we discover that, while reducing the rewards to current consumption by 7.75 percent, it reduces investment returns by about 15 percent.

• The tax that should be adopted as a replacement for the existing income tax is what is called a "flat rate consumed income tax."

• The consumed income tax would replace the state's progressive rate structure with a single flat rate. In addition, income that is saved and invested would be eliminated from the tax base until it is withdrawn from the particular saving or investment vehicle where it has been placed and used for consumption.

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A frequent truism expressed by supply side economists is that "people aren't taxed, activities are." What this means is that taxation of any kind always has the effect of penalizing some activities relative to others and it is this fact that lies at the heart of the economic analysis of taxation.

Obviously the income tax, including North Carolina's state income tax, is a tax on people's income generating activities. In a market setting, income generating activities are those that lead to the production of goods and services and spur economic growth; these include labor activities or work effort, saving, investment, and entrepreneurship.

The purpose of this Spotlight is to suggest basic reforms of North Carolina's income tax. If implemented, these proposals would help to ameliorate the bias against work effort by changing the rate structure and eliminate the bias against saving and investment by adjusting the tax base. The particular kind of tax that should be adopted as a replacement for the existing income tax is what is called a "flat rate consumed income tax." In principle, the consumed income tax would eliminate all income that is saved and invested from the tax base until it is withdrawn from the particular saving or investment vehicle where it has been placed and used for consumption. But before we look at the specifics of a consumed income tax, we need to explain why such a reform is necessary.

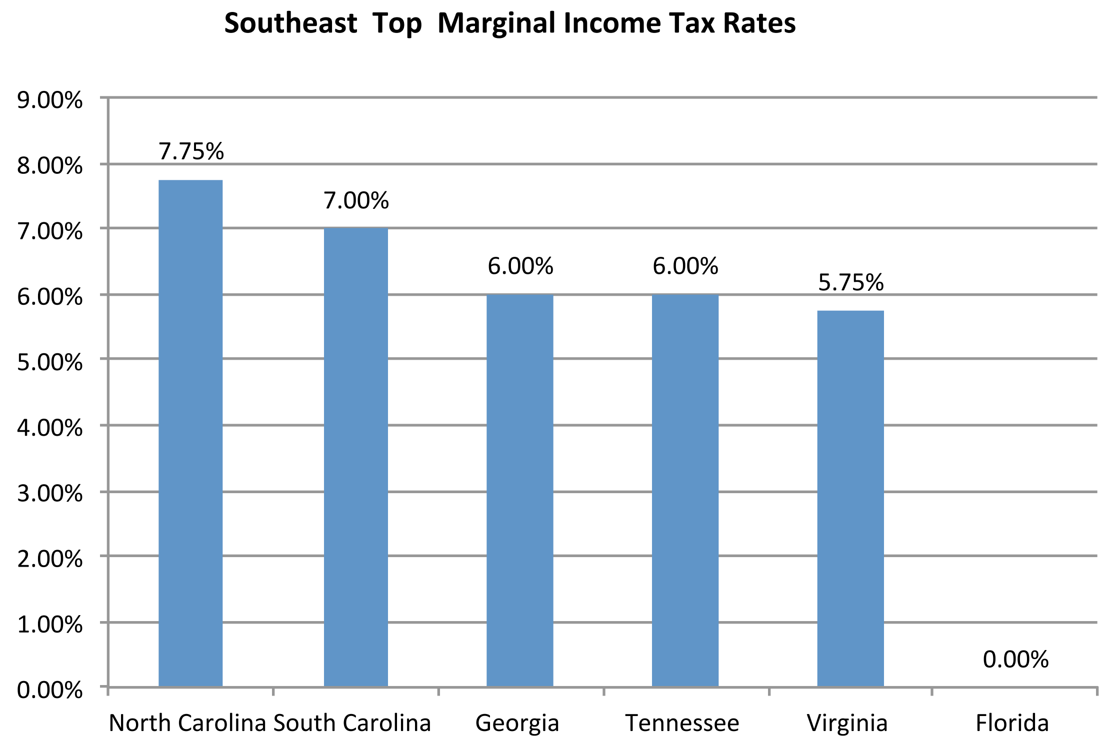
I. How North Carolina's Income Tax Penalizes Work Effort

The proposition that all income taxes penalize productivity is simple to demonstrate. As noted above, by reducing the rewards to all income-generating activity — work, saving, and investment — it discourages those activities relative to non-income generating activities — leisure and consumption. People pursue economically productive activities because of the income that they generate. The greater the rewards to these activities the more likely it is that they will be pursued.

This tax penalty is most easily demonstrated when analyzing its impact on (income-generating) work effort. In any particular instance, when deciding how much they are willing to work, people will weigh the satisfaction that they expect to receive from doing other things, what we will generically call leisure, against the income that they would receive from pursuing work-related activities. These kinds of decisions are made on a regular basis. When people are deciding whether to work overtime, to take a second job, or to go "back to school" to get higher degrees or additional training, they assess the additional income that can be gained from these additional efforts and weigh it against the other activities in their lives that they will have to give up.

Income taxation distorts this value judgment in favor of other leisure activities. It reduces the financial return to the work activity while leaving the inherently non-pecuniary rewards to leisure untouched. In the terminology of public finance, income taxation drives a "wedge" between the rewards to work effort and the rewards to non-work activities. The higher the tax rate, the greater the wedge, i.e. the greater the penalty against additional economic productivity, and the more distorting the tax.

As an extreme example, if the income tax system had one flat rate of 100 percent with no deductions (i.e., both the marginal and average rate were 100 percent) it is obvious that people, at least for public record keeping purposes, would put no effort into income-generating activity. As the tax rate fell from 100 percent, the wedge would be reduced and the mix of leisure and work related activity would shift. At a tax rate of zero the wedge would disappear. Given people's true needs and preferences, work effort and productivity would be maximized, and the mix of work and leisure that reflect these preferences would occur. This mix is guided purely by the interaction of individual preferences and the wages that employers are willing to pay (driven by the value of output produced) as compensation for services rendered.



Source: Tax Foundation, available at http://taxfoundation.org/blog/show/28002.html

North Carolina's income tax system magnifies this tax penalty, both absolutely and relative to other states, in two different ways. First, its income tax rates are high relative to the national average and are particularly high relative to other states in the Southeast with which we are economically most competitive. Not only is North Carolina's top marginal rate of 7.75 percent the highest in the region, but our bottom rate of 6 percent is, except for South Carolina, equal to or higher than the top rate in all other Southeastern states (see figure). It should also be noted that Florida and Tennessee have no income tax, which means that the anti-productivity bias does not exist. (This is equivalent to the zero percent rate scenario discussed in the previous paragraph.)

Adding to this anti-productivity bias is North Carolina's steeply progressive rate structure. As noted above, progressivity is morally inconsistent with the equal rights protections found in the North Carolina Constitution. But beyond this, it penalizes increased productivity by taking a greater percentage of people's incomes as they earn more. People climb the economic ladder, in terms of raises and job and career changes, by making themselves more productive. Progressive taxation punishes people for making productivity enhancing changes in their lives, adding an additional bias against economic growth and wealth creation.

II. How the Income Tax "Double Taxes" and Therefore Penalizes Saving and Investment

The broad choice facing an individual in choosing to allocate his or her income is to either spend it or to save and invest it. This consumption/saving choice is distorted by the income tax and biases the decision in favor of consumption. In doing so, it discourages entrepreneurship, which is fueled by saving and investment, and therefore reduces economic growth and the job creation that accompanies it.

Using the traditional terminology, the income tax "double taxes" saving relative to consumption. Unfortunately this terminology is somewhat misleading. As will be demonstrated, the tax does not explicitly double tax money that is saved or invested but reduces the returns to these activities twice, while reducing the returns to consumption just once.

The Tax Bias Against Saving and Investment: An Example

The income tax penalty on saving, investment, and entrepreneurship is analogous to the penalty against work effort. The problem can be demonstrated with a simple example. Start with an individual with $100 of pre-tax income. In the absence of taxation, this person has $100 available for either consumption, i.e. the purchases of goods and services, or saving. If the interest rate is a simple 10 percent per year, then the person can decide whether he prefers to spend $100 on, for example, dinner and a show, or save/invest the $100 and have $110 available for spending a year from now. The decision will be based on his preferences for satisfaction now relative to receiving satisfaction in the future. This is what economists call time preference.

Now assume that the individual faces a 10 percent income tax. His $100 is reduced to $90. This reduces the amount available for consumption by 10 percent. Likewise, the tax implicitly reduces his returns to saving by 10 percent. In other words, by taxing the principal the government is simultaneously reducing the entire stream of returns from the investment, in this case by 10 percent. So, if the $90 is saved his interest income is reduced from $10 to $9.00.

In the absence of further taxation, the individual's choice is between spending $90 now or waiting a year and having the opportunity to spend $99. Returns to consumption spending and returns to saving/investment have both been reduced equally by the tax. But under a standard income tax, the returns to saving get reduced again. The $9.00 in interest also gets taxed by 10 percent. The return to saving is reduced to $8.10. The tax reduces the returns to saving twice: first, from $10 to $9.00 when the initial $100 is taxed and second, from $9.00 to $8.10 when the interest is taxed. The return from consumption is only reduced once, from the level of satisfaction that could be obtained with $100 to the level that could be obtained with $90. The tax on interest or other returns to investment, including the taxation of dividends and capital gains, biases the decisions against saving, investment, entrepreneurship, and business expansion and in favor of consumption spending.

If we were to apply North Carolina's top marginal rate and look at its actual impact on investment returns, including interest, dividends, and capital gains, we discover that, while reducing the rewards to current consumption by 7.75 percent, it reduces investment returns by about 15 percent. In other words, North Carolina has an implicit top marginal rate on saving and investment of almost double its statutory rate. By taxing saving and investment, North Carolina has a strong anti-productivity bias in its tax code, which stifles entrepreneurship and ultimately job creation. This anti-growth bias does not exist in states like Florida and Tennessee, which have no income tax.

III. A Flat Rate Consumed Income Tax: Reducing the Bias

Policymakers should always strive to keep income tax rates as low as possible. The tax rate creates a "wedge" that penalizes work effort in favor of leisure and saving/investment in favor of consumption. An income tax tax rate of zero would be ideal, favoring neither leisure over work nor consumption over saving/investment.

In addition to keeping rates low, progressive taxation should be avoided. A tax system that increases marginal rates as incomes increase inherently punishes activities directed toward earning larger incomes, i.e. toward becoming more productive in one's chosen profession. It discourages people from working harder in order to improve their economic condition. It also discourages people from accumulating "human capital," i.e., more education, more work experience, more specialized technical training, etc., in an attempt to increase their future incomes. Progressive marginal tax rates, therefore, intensify the income tax system's existing bias against not only work effort but all income-earning activities.

If progressivity in some form is seen as a political necessity, it should be accomplished with a large "zero tax bracket." This would see to it that the average tax rate would increase as one's income increases, but the marginal rate would stay the same. What this means is that up to a certain income level no tax would be due. Then, a flat rate of a certain percentage would apply to all income above that level. For example, let's assume that there is a zero tax bracket for a family of four, up to $20,000 and a flat rate of 5 percent on all income above that level. Families earning less than $20,000 would face an average tax rate of zero percent. A family earning $30,000 would pay nothing on the first $20,000 and 5 percent, or $500, on $10,000 of income. This would be an average tax rate of 1.6 percent. On the other hand, a family earning $100,000 would pay nothing on the first $20,000 of income and 5 percent, or $4,000, on $80,000. This would be an average tax rate of 4 percent.

Under this approach, people aren't penalized for being more productive. A constant rate of 5 percent is taken out of each additional dollar earned, but because of the zero tax bracket, higher income earners are, on average, paying a larger overall percentage of their total income than lower income earners.

To eliminate the double taxation of saving and investment, tax reform efforts need to focus on the tax base. In particular all saved income in the current time period should be eliminated from the tax base, only taxing it when it is withdrawn for consumption purposes. This is what is known as a "consumed income tax." The idea would be to treat all saving and investment in the same way that IRA and 401K retirement investment plans are treated, except that there would be no penalties for withdrawing funds before any legally specified age.

In reference to the example above where the tax and interest rates are 10 percent, if the person decided to spend his $100 in pre-tax income, he would be subject to the 10 percent tax immediately and would have $90 available for consumption purposes. If instead, he decided to save or invest the $100 for a year, he would not be taxed on it until it was taken out of savings and used for consumption. At the end of a year, if he chose to withdraw the money from savings or to cash in his investment, the original $100 and the return of $10 would be taxed at a rate of 10 percent. This would leave him with $99 for consumption purposes, or the equivalent of a full 10 percent return on $90. Note that this is the result in the original example above before the interest is taxed for the second time.

The major point for tax reform is that only income that is used for consumption purposes is taxed directly. Consequently, the returns to consumption and saving are reduced only once and by the same percentage.

Conclusion

A word of warning is in order. It needs to be made clear that there is no such thing as a tax that does not do damage to productivity and economic growth. To invoke a term often used by economists, a "neutral tax" does not exist. At the very least, all taxation transfers the control of productive resources from a free market setting to government control. This is a transfer from an institutional setting that will generate a more efficient use of resources to an institutional setting that will generate a less efficient use of resources. What this means is that overall the economy, and therefore human welfare, always suffers as a result of taxation.

A flat rate consumed income tax would reduce tax biases against productive activities, not eliminate them. And of course, this reform should go hand in hand with reforms to other productivity- and employment-reducing taxes. These would include an overhaul of North Carolina's sales tax to eliminate its double taxation[1] of business income and the abolition of the state's corporate income tax,[2] which is a hidden tax on consumers, workers, and retirees.

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1 Roy Cordato, "Reforming the Sales Tax: Keep in mind liberty, prosperity, and sound principles of taxation" The john Locke Foundation, Spotlight #394 , July 12, 2010. Found at http://www.johnlocke.org/research/show/spotlights/245.

2 Roy Cordato, "The Corporate Income Tax: Repeal, Not Reform," The John Locke Foundation Spotlight #416, November, 2011. Found at http://www.johnlocke.org/research/show/spotlights/267