

On My Mind

A Tax Even Libertarians Can Love

It's time we replaced the income tax with a tax that favors thrift. By Robert H. Frank

SOME LIBERTARIANS DENOUNCE TAXATION as theft, but most are realistic enough to concede that we must tax something. After all, we can't field an army with voluntary contributions, and without one we'll eventually be conquered and end up paying taxes to some other government.

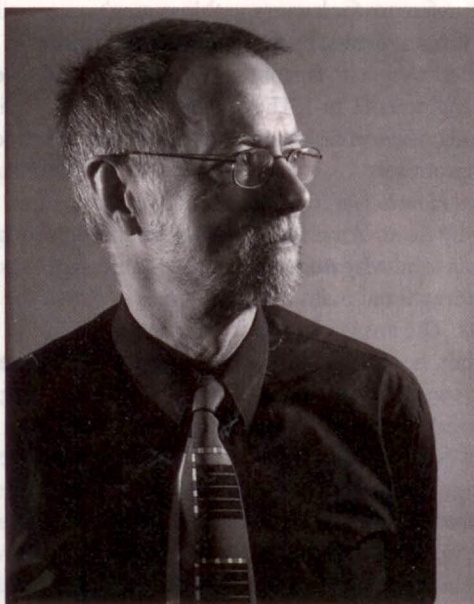
Libertarianism's patron saint, John Stuart Mill, said the only legitimate reason for the government to restrict someone's behavior is to prevent harm to others. Taxing to support an army passes muster, since not having one would harm us all. But taxes not only pay for things that prevent harm, they also discourage the activities we tax. And being discouraged from pursuing an activity you value is harmful. Some harm is inevitable, of course, but our goal should be to minimize the harm associated with any given revenue target. Mill's statement thus has clear implications for thinking about what to tax.

The income tax discourages work effort. But that doesn't prove that it causes harm. Perhaps, if the government takes half your income, you end up working twice as hard, in order to maintain a certain standard of living. Or perhaps you respond in the usual fashion, with less effort, but the net effect is still positive. If income taxation encourages people to spend more time with friends and family, that might be a good thing.

But the income tax also discourages domestic savings, low levels of which helped precipitate the current economic downturn. That's harm.

This harm could be avoided by replacing the income tax with a progressive tax on spending. Taxpayers would report their income to the Internal Revenue Service as before, and also their savings, much as we now document contributions to 401(k) accounts. A family's income minus its savings is its consumption, and that amount minus a large standard deduction—say, \$30,000 a year for a family of four—would be its taxable consumption.

Rates would start low, perhaps 10%, then rise gradually with total consumption. A family that earned \$60,000 and saved \$10,000 would have consumption of \$50,000. After subtracting the standard deduction, its taxable consumption would be \$20,000, for



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a tax bill of \$2,000, about the same as under the current income tax.

With savings tax-exempt, top marginal tax rates on consumption would have to be significantly higher than current top rates on income. But unlike high marginal tax rates on income, which discourage thrift, high rates on consumption would encourage it.

Consider, for instance, a wealthy couple approaching their 25th wedding anniversary and weighing whether to emulate friends in similar circumstances who recently spent \$2 million on their own silver anniversary gala. Under a progressive consumption tax with a top marginal rate of 100%, the aftertax cost of such a party would rise to \$4 million. Most couples would scale back, spending perhaps only half as much as they might have under an income tax. If the pretax cost of the party they chose were \$1 million, the aftertax cost would be \$2 million. The tax would generate \$1 million in additional revenue, and the couple could put aside \$2 million more for retirement than if they hadn't scaled back.

People who stage lavish parties typically have no intention of harming others. Yet the bar that defines how much one must spend to mark a special occasion is an inescapable social construct. When some spend more, others must follow suit or risk being seen as having failed to grasp the magnitude of the occasion. The rub is that when all spend more, celebrations seem no more special than before.

The real attraction of the progressive consumption tax is that it essentially creates real resources out of thin air—or, more precisely, uses smaller resources to create the same level of happiness. If everyone stages less costly parties and builds less expensive mansions, they are no less satisfied than they would have been with the more elaborate versions.

By encouraging wasteful spending patterns and discouraging private savings, the income tax causes unnecessary harm to others. For those who concede the legitimacy of preventing such harm, the progressive consumption tax is the way to go. **F**

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