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By Hyman P. Minsky

The tax package wending its way toward the president's desk is a reflection of the mishmash we nowadays call tax policy. This past week legislators spent many hours attempting to reconcile themselves to a list of tax hikes and tax decreases that often work at cross-purposes—and do little to cure our basic investment and savings problem. In fact the most promising spot on the horizon is a less noticed proposal by Sens. Sam Nunn (D., Ga.) and Pete Domenici (R., N.M.). They propose a radical change that gets to the heart of our long-term fiscal failure: replacing the income tax with a consumption tax.

Their idea is one any president will have to consider if he is to face the necessity of seriously reforming the structure and level of taxation. Government spending is now well in excess of 20% of gross national product and is likely to continue at that level. Our tax system needs to collect a like percentage of the GNP, not every year but when the economy is at a close approximation of full employment.

The genius of the consumption tax is that it can make this burden politically palatable. Under our current system, personal income tax is assessed on the market's valuation of the labor and services of assets that a household provides to the production of income. This system does not discourage consumption, and penalizes people for working and saving. A consumption tax by contrast penalizes consumption, and encourages people to save and work.

Designing a consumption tax system would not be difficult. A consumption tax does not have to be like a European value added tax — or like our states' sales taxes. In fact, the vehicle for the system already exists in the form of the Individual Retirement Account. An open-ended IRA can serve as a mechanism that transforms our present income-based direct tax into a consumption-based direct tax. Household assets, including real estate, would be considered part of a portfolio into which an unlimited share of income could be transferred.

Under the consumption tax system, the taxpayer would be allowed to withdraw whatever he wishes whenever he wishes to finance consumption. Such withdrawals would be subject to the consumption tax. To make this tax progressive, rates increase with consumption.

In fact, we already have a partial consumption tax system. With IRAs (or 401Ks) taxpayers currently defer taxation on compensation. Pension fund payments by employer and employee are exempt from taxation. In both pension funds and IRAs, withdrawals are taxed.

Now let's look at what falls into the "consumption" category under this system. A household consumes the fair rental value of a home or apartment that it owns and occupies. The equitable way to handle owner-occupied real estate is to add the fair rental value of the house to the owner-occupier's income and consumption and allow the owner-occupier to deduct mortgage payments, taxes and spending to maintain or improve the property from the taxable income. This item will face the greatest political opposition — owners of more than one home won't like the idea of being taxed on the fair rental value of their real estate. But the revenue generated here will serve to lower rates generally.

The same people will be happier about the consumption tax system for capital gains — it eliminates them as a taxable item. As long as funds remain within the portfolio, they are "investment" and are not taxed. The taxpayer is also free to rearrange his portfolio — shifting assets, say, from home ownership to financial instruments — without paying a tax on appreciation.

For libertarians, the provision for retirement is the most exciting. A consumption tax can make the provision for retirement income a personal decision, rather than a benefit or a bounty from an employer. Both corporate and employment volatility has increased markedly over the past decade. Old-style defined benefit schemes work less and less well. Defined contribution schemes, though, fit quite nicely under this alternative system. Employers and employees contribute to an IRA-type account that is usually kept in the prospective beneficiary's name. The account is portable — which is to say, it is not penalized if its bearer switches jobs. Making the contributions to an IRA-type account fully deductible and folding the employer's contribution to pension schemes into the base wage and salary of the employee liberates the employee from the employer as far as retirement planning is concerned.

Our consumption tax system does run into a dilemma with respect to health care. Medical expenses on prenatal care and child health services are arguably "investments," and medical expenses of earners during their working career can be considered to be "expenses" to maintain capital. These expenses therefore remain inside the tax-free structure. But what about medical expenses of the aged? Their working days past, their medical expenses may be considered taxable consumption. But taxing the medical expenses of the aged would be outside of society's usual notion of equity. The hard logic of the consumption tax has to compromise. All, or all but cosmetic, medical care has to be treated as a portfolio change and spared the tax.

Transforming the personal income tax into a consumption tax by revitalizing IRAs and making them open-ended is no cure for the ills of the economy. It is also true that an increase in the desire to accumulate does not automatically mean accumulation increases. That depends upon the strength of investment demand. For the full benefits of this transformation to be realized, they must be combined with programs that strengthen public and private investment demand.

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