

## Consumption tax: the most efficient way to organize redistribution of wealth.

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During the last century, in the world, three types of state management have been tried: the communist system, the capitalist system and the “European system”. The latter combines a high level of social security with free market economy. The Belgian system was once labeled as “half communist” by Luc Van Hecke, journalist of the “Tijd” and now head of research with KBC Bank, because half of the wealth created by the country goes to the State for state services and redistribution.

The communist system proved to be less economically efficient than the two others, could not offer freedom to its people but provided full employment, there was no social exclusion and very little “street” criminality.

The US capitalist system, which was adapted with some social security measures after the great depression of the thirties, had the best performance of all systems with respect to innovation and performed better than the communist system on overall wealth creation. The biggest problems of the capitalist system are its cyclic character, social exclusion and criminality. The cyclicity is well exemplified in the upswing in the stock markets during the nineties followed by a collapse since 2000.

The European model is characterized by more social exclusion than the communist system, but much less than the capitalist systems. Street criminality is largely comparable to the capitalist world.

Currently, in the world, there is a consensus that free market economy is the way to go forward in general. Even in China and India, public policy takes that view.

In Europe, in addition to the free market, there is a consensus that one of the most important role of the state is to redistribute wealth.

Currently, redistribution occurs both through the tax system and through the social security system.

People who earn a lot of money pay more taxes. People with a low income, pay less taxes and get more benefits from the social security system.

The key thesis of this paper is that redistribution of wealth can be organized efficiently using only the tax system. Moreover, the paper aims at showing that the consumption tax is the most desirable tax to organize redistribution.

Let's first look at the current redistribution of wealth.

Currently the state redistributes wealth by adapting income tax to the gross income of each individual.

So net income before social benefits is a function of gross income. It also depends on variables like number of children, marital status and other minor things.

Moreover, we currently have a system whereby social benefits are a function of income or gross income, mainly. So social benefits are (another) function of income and gross income. This function is more complex than the first one and some other variables are involved as well.

The total income is the sum of the income (most typically from labor) and the social benefits.

So the total income of an individual equals net income from labor (mainly) plus income from social benefits. The two functions, being added, become a third, combined function, whereby the total income depends on gross income (mainly) and a number of other variables of minor importance.

Of course, the following becomes obvious when you think about it: we do not need to redistribute in two subsequent phases, we can do that in just one go.

If we feel that anyone has the unconditional right to a minimum income (which is now the case in most EU countries), then we could create a tax system which allocates money to people when their income is lower than a certain level.

This approach is called the “negative income tax system”, whereby a government can redistribute wealth in one go.

Once the logic of redistribution via the income tax system is accepted, the tax system may evolve into a fully integrated “wealth redistribution system”, by gradually taking into account all parameters currently used in the social security system. In other words, one could merge those two systems, whereby “gross income” would be the main criterion for redistribution.

Another approach, which works with other redistributive taxes than income tax, is the following:

A Basic Income Grant (BIG) is given to every citizen whereby only age has an influence on the amount and the money for the children is paid to the mother until a certain age (for example 17).

But, the same amount is taken back, through the tax system, from those we think do not need it.

It is very easy to understand that somebody (an employee for example) who would get an extra amount like a basic income and at the same time has to pay the same amount through the tax system would not perceive this as a change to his personal situation.

It is also very easy to understand that to give somebody an extra amount of 500 € per month and at the same time take it away through taxes, does not constitute a net change to the State budget.

We can conclude that since we already have selective taxes, based on income, consumption and wealth, it is no problem to implement a uniform (equal, universal) social security system while *using the selectivity of the tax systems* for the redistribution of wealth. In other words: it is not necessary for *both* taxation AND social security to be selective in order to achieve overall selectivity in the redistribution of wealth.

In this sense, countries which implement selectivity both in their tax system and in the redistribution system are not efficient.

In Belgium, the cost of the selectivity of the social security system is at the very minimum 4 billion €. That is 3% of the state budget and 1,5% of GDP. This wasted money could be used to reduce state debt and tax on labor in Belgium (to reduce unemployment).

The amount of taxes to be collected is high.

Taking into account the rate of aging of the population, it seems that the cost of redistribution and health care paid by the state needs to be budgeted from less than 20% now to 25 % of GDP in “social” countries like in Western Europe, within 50 years. On the other hand, public authorities’ current spending is way too high and very inefficient, when compared to efficiency gains achieved in the private sector. Public spending (excluding redistribution) is around 30% of GDP in Belgium, a multiple of what was spent just 50 years ago, when there were no computers, no copying machines, no faxes and no internet.

It is fair to expect that governments should strive to reduce this spending to 10% of GDP, in order to prevent wealthy citizens from moving to countries with reasonable tax levels. The alternative is the collapse of the social security system.

To see the merits of consumption tax, one should look at the benefits and potential problems of the other important tax categories.

1. Is the tax important enough?

For one, taxes should be worthwhile, not only compared to the cost of collecting them but also in respect of the amount required to be collected (35% of GDP in total). Many taxes, like tax on pets, tax on terraces and the like are too insignificant in this respect. Taxes which could fulfill this first criterion are consumption tax (this includes sales tax, VAT, excise taxes) and tax on income from labour. Furthermore, theoretically, tax on capital income or on capital, tax on production and company income tax could all generate significant revenues for a government.

Taxes on capital gains and/or wealth exist in many countries. It does not generate a lot of revenues for the State as a % of GDP in most countries (not more than 2% in Belgium). This kind of tax can easily be evaded by wealthy people. Production tax is not popular at all right now. It would reduce production and would instigate companies to produce in other countries where no such tax exists. Company income tax revenues for the state rarely exceed 5% of GDP (it is around 3% of GDP in Belgium). It amounts to the difference of two big numbers, sales and costs. So it is highly variable. Critics say the money taken from the “good” companies is often used to rescue poorly managed companies.

We therefore will focus the discussion on the two most important tax options, tax on consumption versus tax on labor. For reference, today the first represents around one quarter of Belgian State revenues, tax on labor represents close to two thirds of all tax revenues in Belgium.

## 2. possibility to evade or fraud (or cost to enforce the tax).

A tax that goes unpaid by some citizens is not fair. If a tax cannot be enforced it is not a fair tax and it will deteriorate the civic sense of the population if people evade/fraud the tax.

Since overall taxation is very high, even if it would be reduced at a level of 35% of GDP, it might be good to distribute the tax burden over different tax systems. Indeed, if just one tax system is applied, the tax rate in that system will be very high, which is the typical cause for fraud or evasion. One might argue also, that it is better to concentrate all “compliance” efforts (making sure everybody pays the taxes) on one tax system. The collection cost of income tax, the effort to collect taxes from all citizens by the administration and for the citizens and their advisors to fill out the tax declaration, is more expensive (estimated at 0,4%...0,7% of GDP) than the collection cost of consumption tax, while only businesses have to be comply with consumption taxes.

Now let’s look in more detail at fraud/evasion for the main taxes.

### a 1: consumption tax on products

Currently, given computers and telecommunications, consumption tax can be fairly well enforced in most situations. One could imagine that the cash registers of the supermarket are connected with the computers of the ministry of finance trough the internet and that VAT or sales tax is paid instantly. One could oblige any organization or person selling to the public to operate in that way, even a merchant on a public market. This would be even more easy to enforce if all payments would be electronic payments, which I believe will be the case anyway at a given point in time during this century. The rationale for paper money has totally disappeared in this electronic age, just like a letter posted in a post office is being replaced by Emails. However, it will take long before the individual will accept to abandon paper money. So in the meantime we have to focus on enforcing businesses to remit their sales tax electronically to improve enforcement of consumption tax payment.

An example where high levels of consumption tax (around 70% of the value of the product) are already successfully enforced today is gasoline.

So in any B2C sale, consumption tax should not be a problem if the tax is paid instantly and electronically at the time of the sale.

In a consumer to consumer relationship, for example when people do a “garage sale” or a school organizes a “flea” market, that would be more difficult.

### a 2 consumption tax on services.

This tax is very much subject to fraud, since the sale typically occurs between two individuals. One could argue that a consumption tax on a service is not a consumption tax

but a labor tax. That is true but what matters is that any tax on services is difficult to enforce.

#### b. tax on labor

large corporations will not fraud tax on labor but rather will evade it for their middle and senior management. Even public authorities evade labor tax, setting the example.

Smaller companies will not evade such taxes nor will they fraud, unless they can get “black” money while selling their products or services. Getting black money when selling products is only possible when they can buy the products (mostly in part) in black. This does not occur very often, however.

Finally, taxes levied in conjunction with or on services, like restaurants, gardening and services like psychotherapy, legal advice and so on, whatever we call the tax, are hugely prone to fraud.

### 3. social desirability of the tax

This criterion really means: which taxes are beneficial for the people and which are deteriorating the quality of life. Are there desirable taxes at all ?? Yes, for example taxes on polluting products. Taxes on energy consumption. Taxes which induce traffic to decrease where it is too dense.

On the other hand, some taxes are undesirable. The best example is tax on labor because it makes labor more expensive and thus induces unemployment. However, this was not the case 40 years ago, when we had full employment. Then it was a desirable tax because it encouraged rationalization and productivity gains, in other words: it induced to produce more with the same number of people such that the wealth /capita did increase. The latter shows that a system analysis of our economy should be performed regularly to take into account new developments.

Since we have very high taxes on labor (including the social security charges) in Europe compared to most other countries, like China, multinational companies move their production to China, not so much because of the lower wages, but because of the lower total taxes they have to pay to produce the goods and sell them into Europe.

Today, Europe’s fiscal system induces companies to go away.

This can easily be corrected by replacing tax on labor by VAT, since in that case, products made in China would pay more taxes (in fact the same amount of taxes as products made in Europe) when sold into Europe.

Another example to illustrate a detrimental effect of labor tax is this one:

A computer scientist living in Europe with a well paid job paints his home in the week-end. Why? Because the hourly cost of a painter of 25 EUR is way higher than the net hourly revenue of the computer scientist.

The reason: tax on services rendered by the painter and tax on labor of the IT specialist.

As a conclusion, we can say that any taxes on services are socially not desirable, because it means that people are punished (pay taxes) whenever they want to work for each other.

With regard to cyclicity of the economy, one has to consider first the variation of tax revenues as a function of the economic cycle.

Taxes on consumption generate more stable revenues compared to labor taxes.

For a start the tax basis is broader for consumption tax: every citizen contributes whereas only those that work pay labor tax. Moreover, a crisis in the economy affects labor tax more than it would affect consumption tax revenues. When profits decrease, companies lay off people to improve profits again.

If every citizen has sufficient social security, for example a basic income, consumption tax revenue will be fairly stable, because consumption will be stable.

The flip side of the coin is what the taxes do to smoothen the cycles. That is in fact much more important than the continuity of the tax revenues. But most taxes do not influence the economic cycles much from a structural point of view. Specific company income tax credit schemes are successfully used to help but have a limited corrective power.

Economic cycles tend to be corrected by other means, like the interest rate and the increase or decrease of public spending (but that does not work so well).

Rather, the BIG (Basic Income Grant) system could be used as a very good way to influence the economic cycle trough *direct income injection*.

Assume a BIG is defined at 500 € per month per person at “active” age and 750€ for the elderly .

If the government is given the power to adapt the BIG to smoothen the cycles for example with plus or minus 10% (between 450 and 550), then in case of recession, it could be increased gradually up to 550 if needed, in case of overheating, it could be decreased to 450. In such case, for psychological reasons, one would have to communicate that the BIG is 450 and that there can be a “recession extra” up to 550.

Since the BIG has also an effect on employment (a higher BIG will decrease the demand for work) one might apply a different “recession extra” to the “active” age to influence on the labor market at the same time.

#### 4. Selectivity of the tax

As mentioned before, if we have a selective tax system, in the sense that it accomplishes redistribution of wealth according to the public choice of the nation, we can afford to have a uniform, non-selective social security system.

That will make a difference of approximately 2% of GDP to the overall wealth of the nation because a selective social security system is very expensive to administer and the management cost of a uniform social security system is close to zero.

It can be done using the “negative income tax system” which is based on the official gross income of the citizens.

However, there are two problems using the income tax system as an “integrated redistribution system”:

- income is not income

Many people have an “official” income which is not their real income. Many of them work “black” and have a low official income. This discrepancy would improve if services are free of taxes, but the problem would still be there in the form of those who have special arrangements to reduce labor income taxes (offshore management companies, split payroll systems...)

- selectivity is mainly limited to gross income

Redistribution based on income is fine, but is income our sole criterion for selectivity? Do we not want to reward or deter aspects of social conduct? If society feels polluting the environment is not very nice, then having taxes to deter people from buying products which damage our ozone layer makes sense. Being practical: a higher tax on gasoline would make sense today.

To assess the income selectivity of consumption tax as compared to labor income tax, one should be aware that for most people consumption equals income. Sure there is some saving, and some people take up credit, but broadly speaking income = spending. That means that if a person has to pay consumption tax on all his spending, he effectively pays tax on all of his income.

Now you could say: what if they save a lot? Normally saving is delayed spending, so it should not be a problem in the long run. What if he dies having saved a lot? Too bad for him that he did not enjoy life as much as he could have ! Maybe there is an opportunity for the State to collect taxes then. And in any case the heirs are likely to spend the rest of the money...

More taxes on fuel would effectively reduce CO2 emissions, thereby encouraging research into & adoption of alternative energy sources. Having high consumption taxes on products like TV's, computers, cars, hairdryers, kitchen appliances would induce to repair them rather than throw them away. Not having taxes on internet traffic would enhance virtual travel rather than physical travel, hence reducing pollution, traffic jams etcetera. Not having taxes on services would permit people to work for each other again without being punished, like it has always been through history of mankind until recently. Also from an income redistribution point of view, consumption taxes are by far superior to income taxes: very high taxes on luxury watches, perfumes and luxury cars would probably not even affect sales of such products and would effectively achieve real income redistribution.

And finally, absolutely the nicest thing about consumption tax is that every one of us is free to pay as much or as little tax as he wants !

Conclusion:

Today, the most desirable taxes are taxes on consumption of polluting products, energy, luxury products.

One should reduce or suppress taxes on services.

If one looks at taxation from an historical perspective, one finds that consumption tax has mostly been significant and has always been of some importance throughout history, while tax on labor is totally new: it originated less than one century ago.

Let's put back consumption tax where historically it belongs: as the most important tax category to generate revenues for the state.