

Consumption Tax vs. Production Tax

Taxation: Production vs. Consumption

- The potential tradeoff between taxing production (Income Taxation) and taxing consumption (Sales Tax) has been a topic in economics and specifically the economics of public finance for multiple generations of economists, e.g., John Stuart Mill (1806-1873).
- Fundamental advantage of a consumption base tax. (Why should policy leaders consider the consumption base issue?)
 - Indirect taxation
 - Savings are not taxed
 - Current investment is not favored over future investment
 - Simplify compliance
- The fundamental question is which tax base is the “best?”
 - Personal expenditures?
 - Personal income?
- The academic literature on this question has primarily focused on the national level.
 - Large Open Economy/Utah Small Open Economy?

General Comparisons of the Two Taxes

- **Revenue-Yield:**
- Proportional income taxes and comprehensive consumption taxes are theoretically equivalent. Revenue and yield should be similar. **But equivalence is unlikely in practice.**
- For example, the Utah Sales Tax base is not comprehensive. (Moving to a single sales tax factor on SCIT has made the SCIT equivalent to a sales tax.)
- A change to a specific tax scheme may require substantial **rate increases** on a specific base to offset the loss of revenue from the other base. Or a substantial increase in the base of the tax.

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- **Equity:**
- Without careful design and implementation a consumption-based tax can be regressive. Why? Low income individuals and families spend a greater share of their income vs. high income families. Higher income families save more, and savings are not taxed with a consumption-based tax.
- A consumption-based tax would likely be a transfer of wealth from middle income families to higher income families.

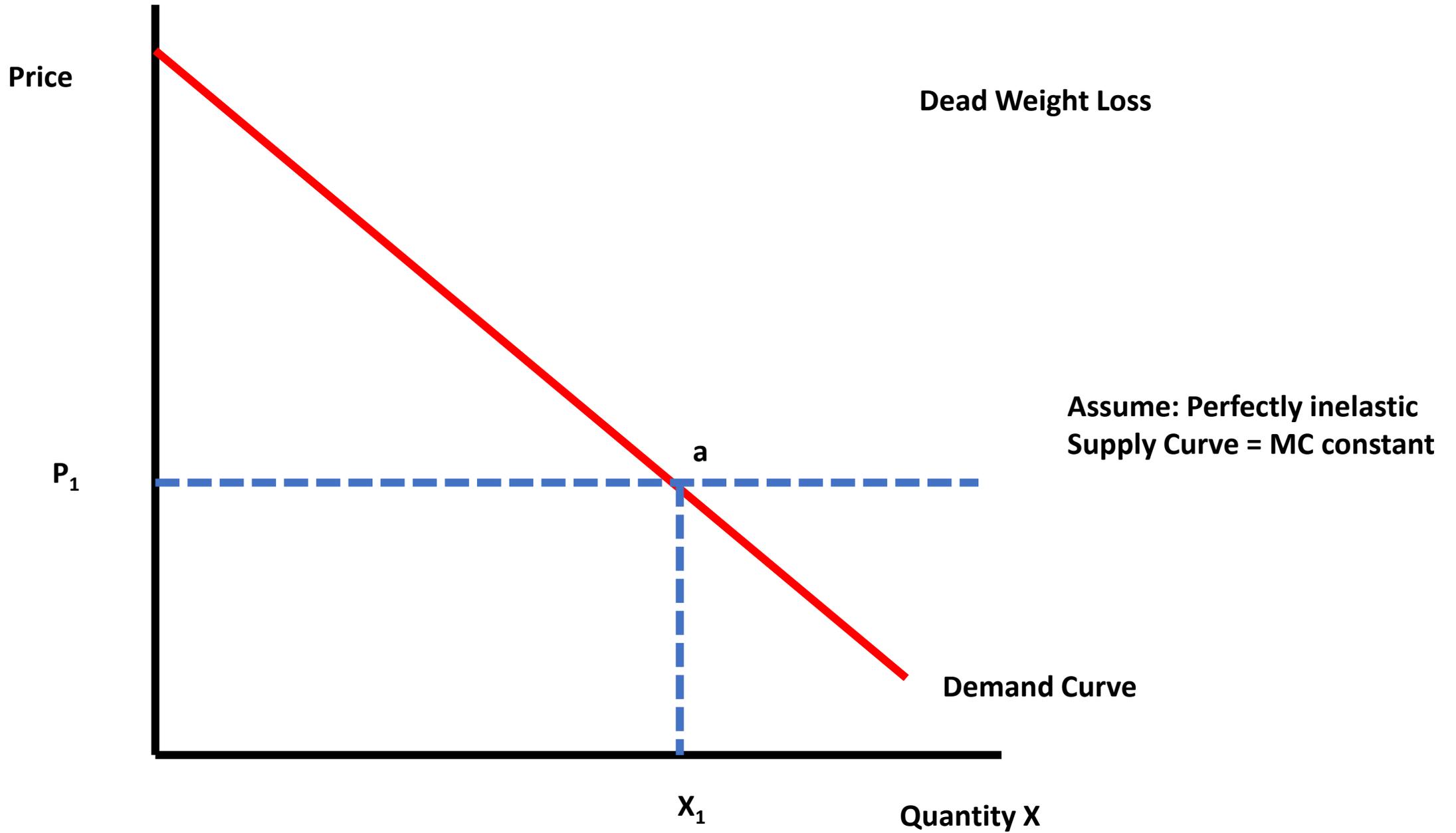
General Comparisons of the Two Taxes

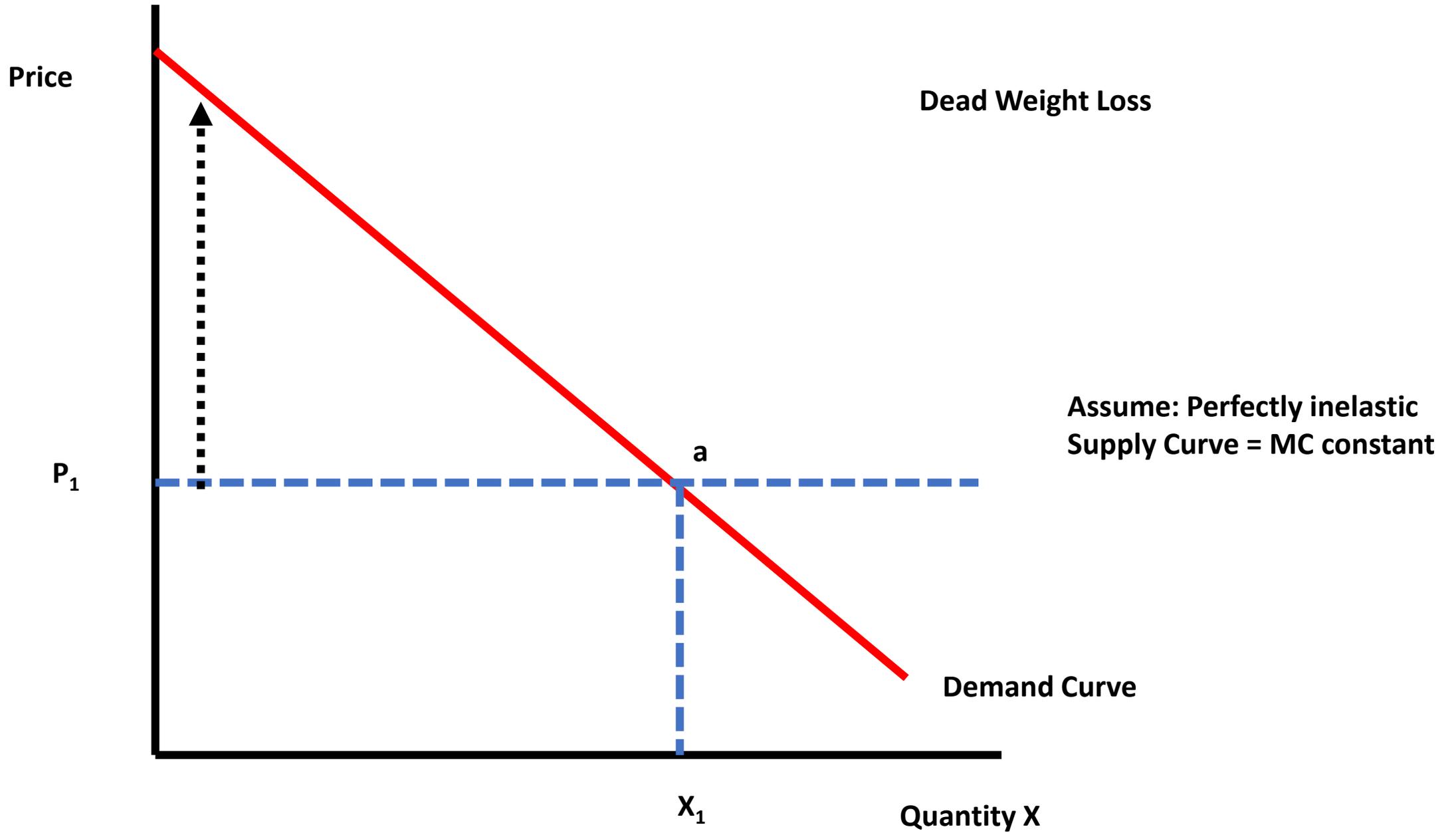
- **Simplicity:**
 - Consumption based tax less complex than income based tax.

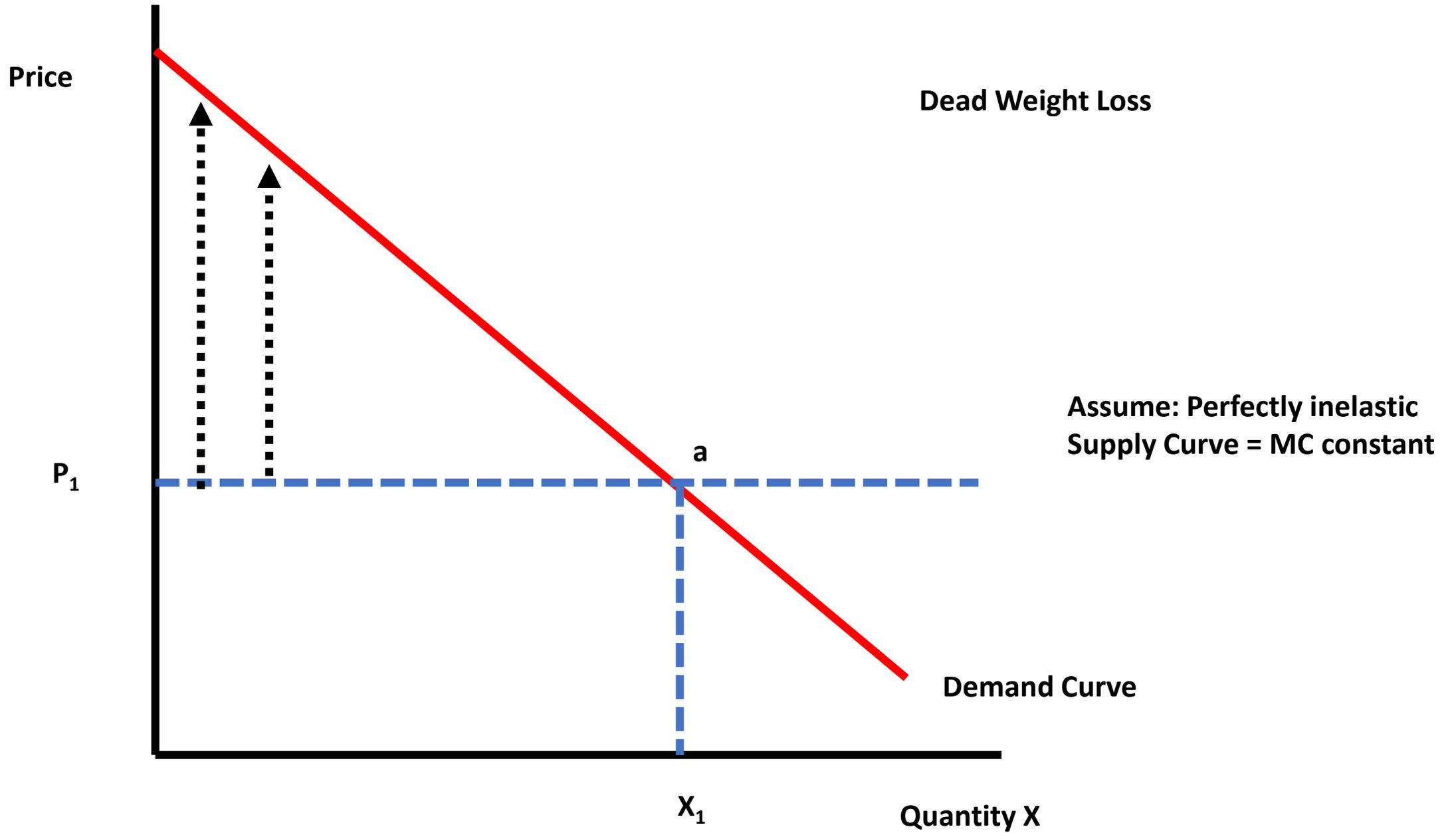
- **Transition:**
 - Older individuals that had savings taxed would now be taxed on consumption.

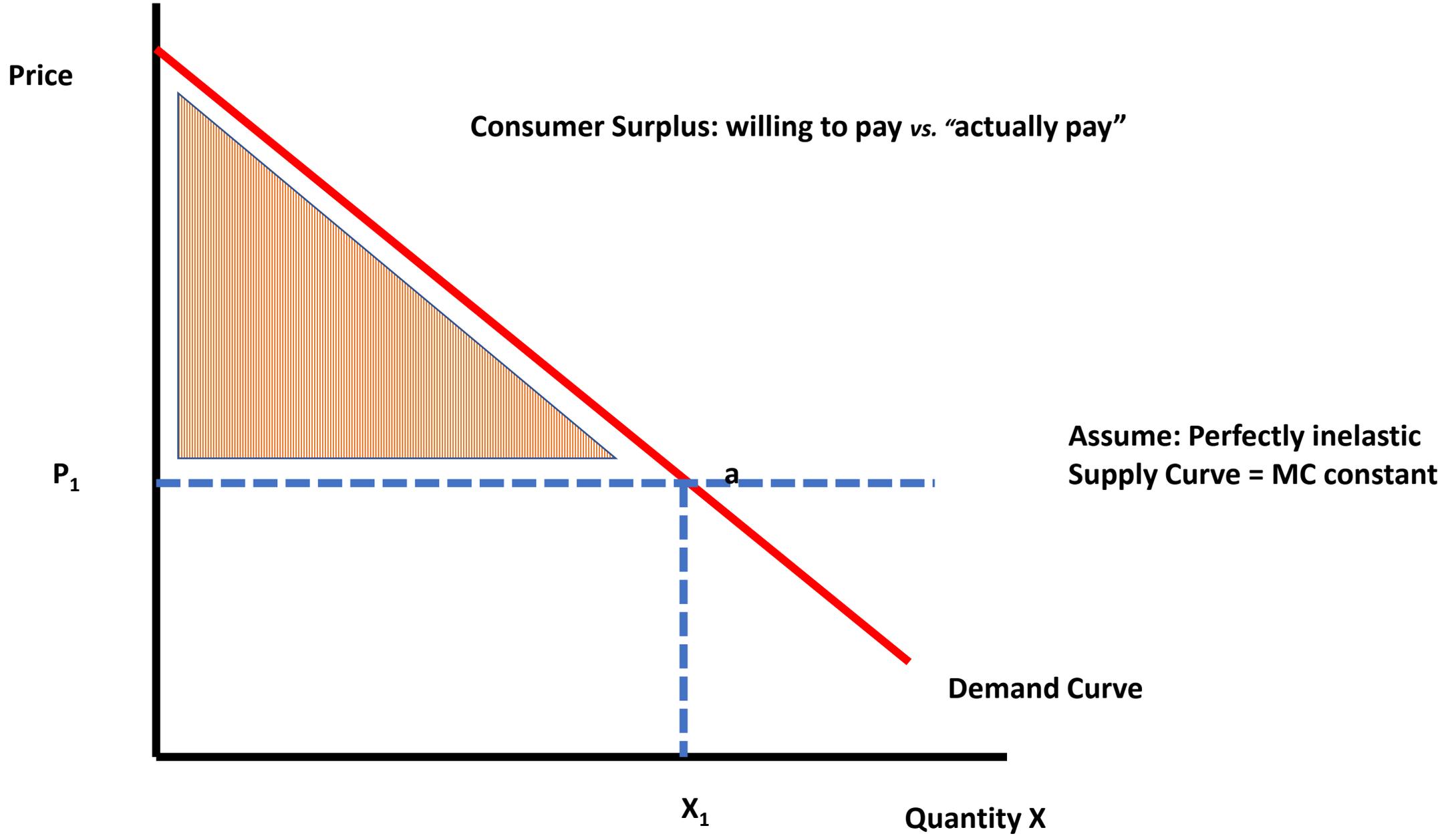
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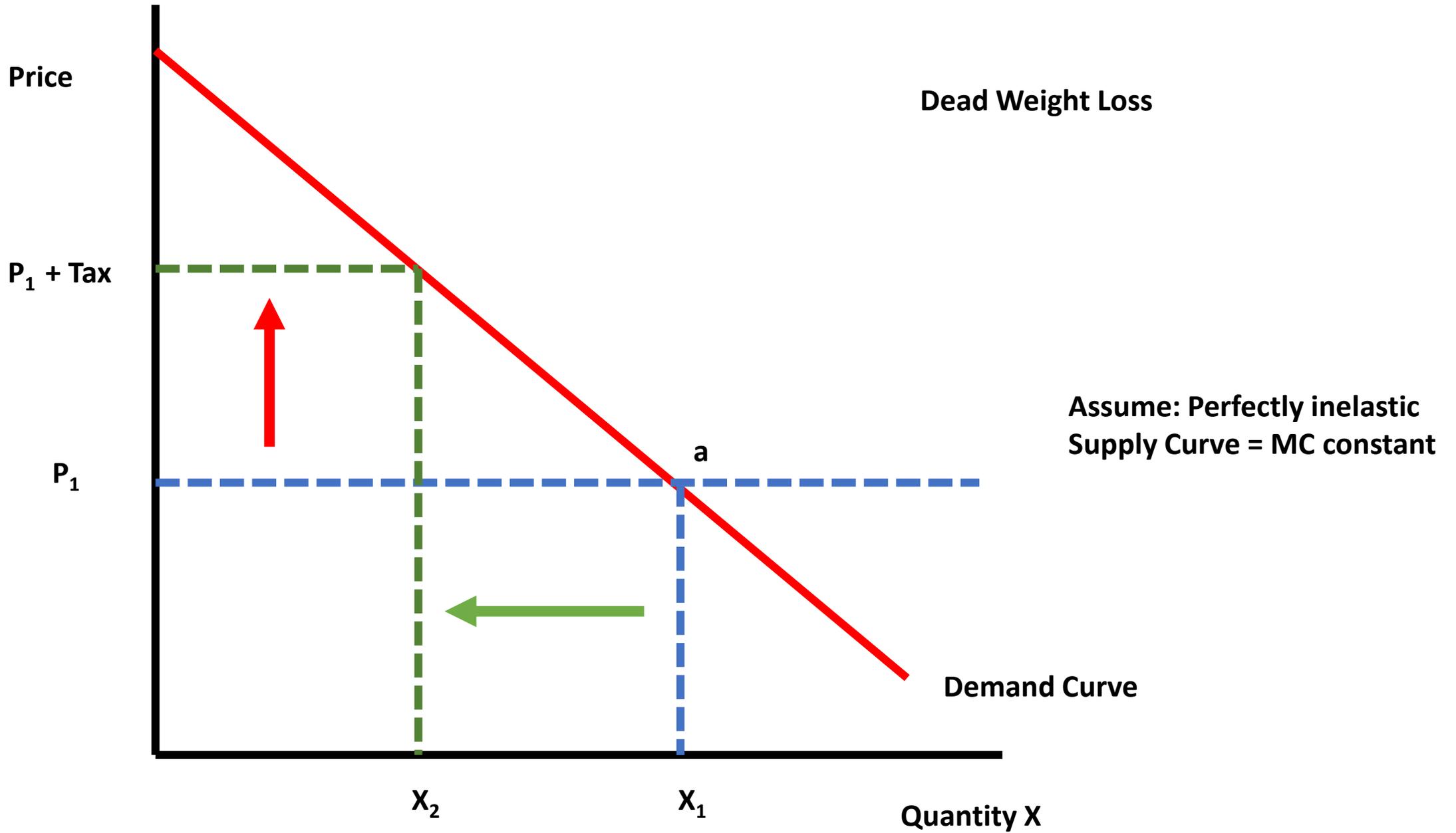
- **Efficiency Questions;**
- The primary argument in favor of a consumption tax base is the potential for an increase in economic efficiency.
- All taxes create **inefficient outcomes** (except lump sum taxes on individuals) but production based taxes are **thought** to create larger degrees of **excess burden** or **dead weight loss** in an economy.

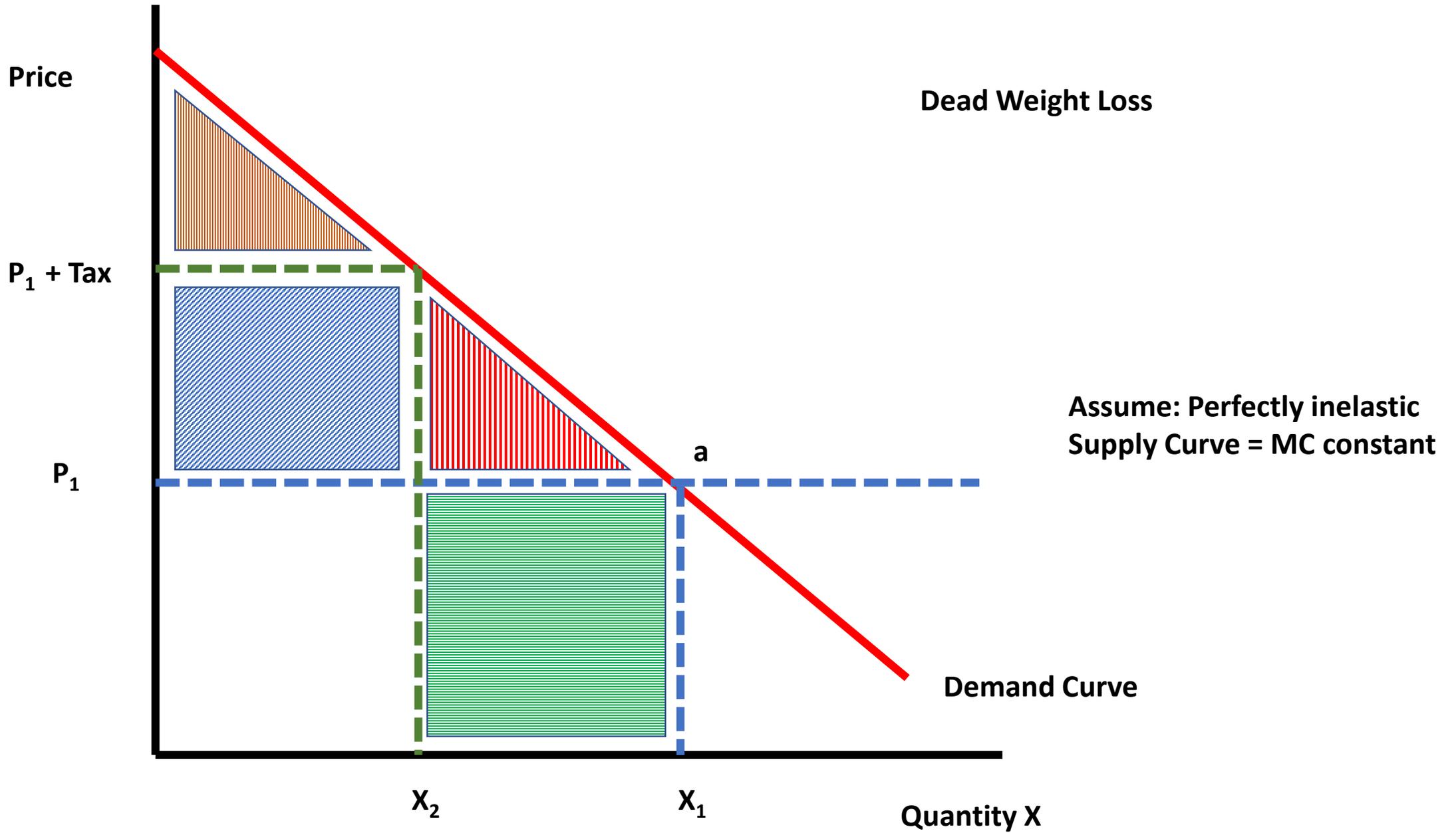


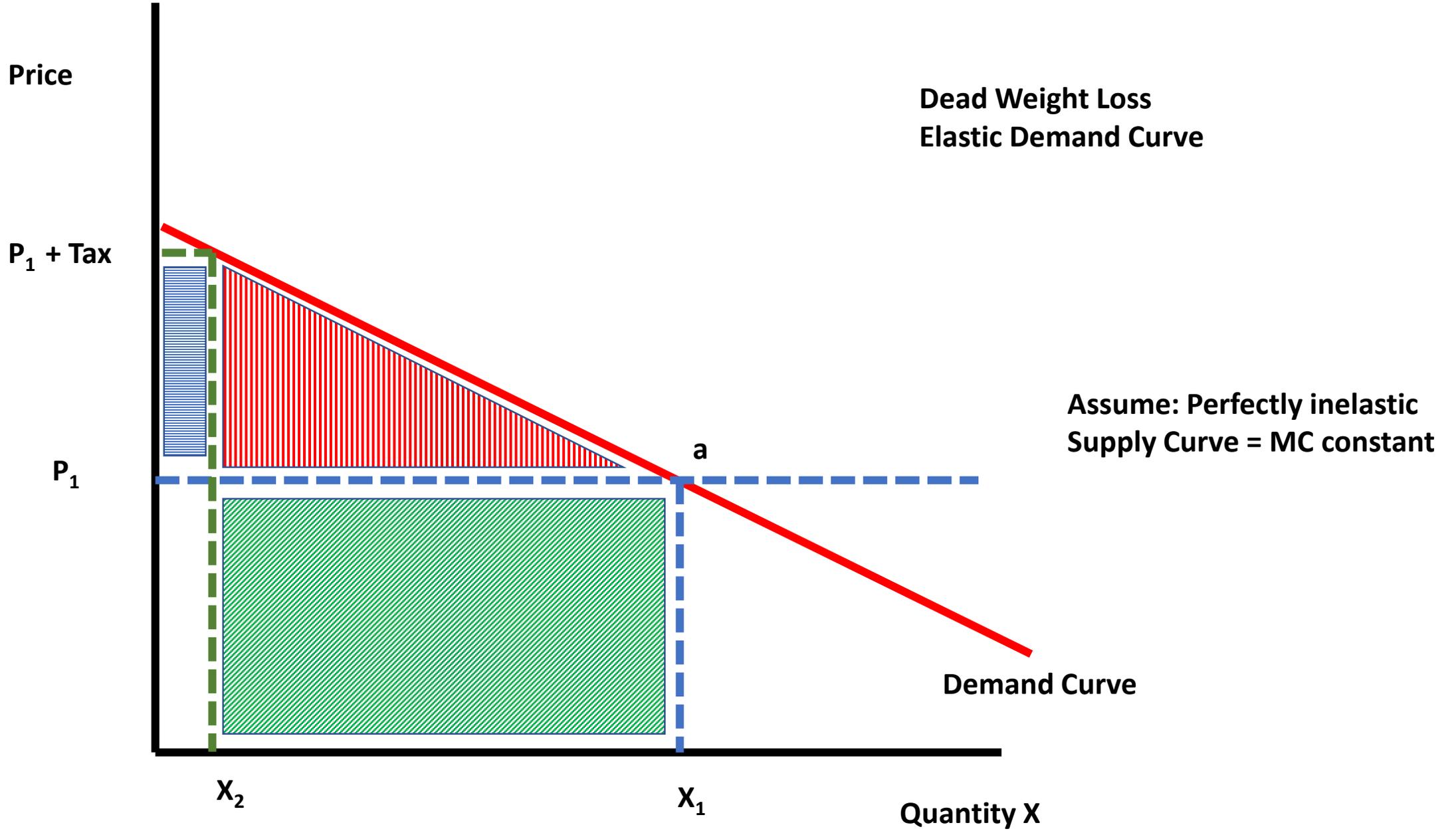


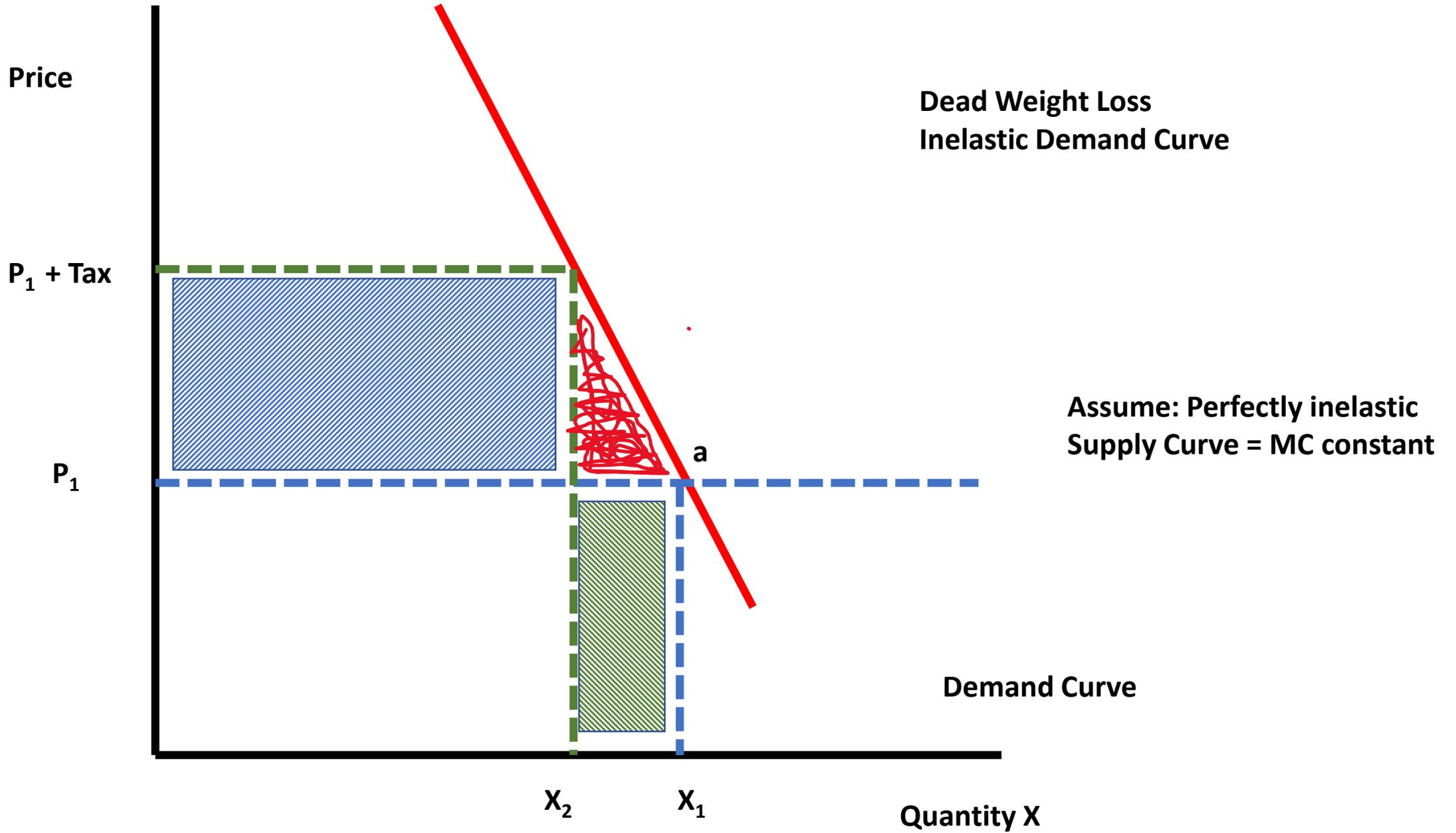












Does This Model “Explain” the Real World?

- Tariffs (Sales Tax) on Washing Machines
- 12 Percent Increase in Prices
- \$1.55 Billion Total Increase to US Consumers

- Flannen, A., Hortacsu, A., and Tintelnot, F., (2020), “The Production Relocation and Price Effects of US Trade Policy: The Case of Washing Machines.” *American Economic Review*, 110(7): 2103-2127.
- Mace, C., Patel, E., and Seegert, N., (2020), “Marijuana Taxation and Imperfect Competition.: *National Tax Journal*, 73(2): 545-592.

Summary: Production vs. Consumption Taxes

- **Revenue-Yield:** Rate issues
- **Equity-Distribution of Burden:** Tradeoffs between income groups may be large.
- **Simplicity:** Advantages of consumption base
- **Transition:** Challenges for enlarging base and distribution.
- **Economic Efficiency:** Potential for efficient gains – but at state level they are likely small.