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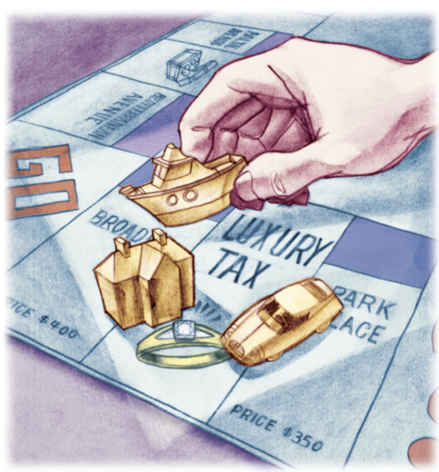
Hey, Big Spender: You Need a Surtax

By ROBERT H. FRANK

LAST year's stimulus spending is running out, yet unemployment stays stubbornly near 10 percent. And as state and local governments keep cutting their budgets, the economy desperately needs an additional spending boost. Concerned about growing federal deficits, however, many in Congress appear reluctant to act.



Their worries are misguided. Yes, deficits are bad, but protracted unemployment is far worse. Still, it seems unlikely that additional stimulus legislation can attract the supermajority now required to clear the Senate. And even without such legislation, huge budget deficits loom for years. In the long run, these deficits will impoverish our grandchildren, just as the deficit hawks assert.

But an effective remedy is at hand. A simple revision to current tax policy could spur an immediate burst of nongovernment spending that would help restore full employment without adding to the deficit. And this same revision would simultaneously create a relatively painless new revenue stream that would help balance future budgets.

What I have in mind is a surtax on extremely high levels of consumption. It would be enacted right away, but not take effect until unemployment again fell below 6 percent.

More than 99 percent of households would be exempt from this tax, which would be levied only on families earning more than $1 million who consume more than $500,000 annually.

These families would continue to report their incomes to the I.R.S., but also their annual savings, much as they now document contributions to tax-sheltered retirement accounts. Consumption would then be calculated as the difference between reported income and savings.

Once consumption topped $500,000, the families would be subject to the surtax. Rates would start low but rise as consumption grew.

(Here are a few more details: Loan repayments would be added to the savings total, thereby reducing potential tax liability. New borrowing, meanwhile, would be subtracted from savings, increasing the potential tax. For homeowners, annual housing consumption would be counted as the implicit rental value of their house, so a $500,000 purchase would not set off the tax.)

A progressive consumption surtax would produce immediate, off-budget economic stimulus by giving wealthy families powerful incentives to accelerate future spending. For example, a family that had been planning to build a new wing onto its mansion, or buy a yacht, would want to make those purchases now rather than be taxed on them later.

Stimulating a new luxury spending spree may not seem an ideal way to stimulate the economy. Far better, perhaps, would be for the government to repair dilapidated bridges and build high-speed trains. But unless someone can persuade 60 senators to support a huge new stimulus bill, this second option is foreclosed. Given our choices, it would be much better to provoke an additional burst of luxury spending than to let high unemployment linger for years.

Once it took effect, of course, a progressive consumption surtax would discourage luxury spending. Would that cause job losses down the road? No, because employment depends on total spending, not just consumption spending.

If the surtax were phased in gradually, it would shift spending from consumption toward additional savings and investment. In the long run, higher investment would increase economic growth and boost earnings across the income spectrum.

Is a progressive consumption surtax politically feasible? As we know, voters never respond warmly to any new taxes. But the looming retirements of the baby boomers will make it impossible to eliminate huge budget deficits by cutting government spending. We need more revenue.

And there is broad agreement among economists that if additional taxes are needed, consumption taxation is the way to go.

A progressive consumption surtax embodies important advantages over higher income tax rates or a national sales tax — other widely proposed sources of new revenue. Many economists warn that higher income tax rates would weaken incentives to save and invest. But because a progressive consumption tax would shelter savings from tax, it would have precisely the opposite effect. The problem with a national sales tax — or its close cousin, a value-added tax — is that it's extremely regressive because the poor save at much lower rates than the rich .

More than a decade ago, shortly after the publication of my article advocating replacement of the income tax with a progressive consumption tax, I received a warm letter from Milton Friedman, the late Nobel laureate, who was the patron saint of small-government conservatism. Mr. Friedman began by disagreeing with my contention that additional public investment would yield high returns.

He quickly added, however, that if the government did need additional revenue, a progressive consumption tax would be the best way to raise it. He enclosed a reprint of a 1943 article from the American Economic Review in which he had advocated a progressive consumption tax to pay for the war effort.

THE University of Delaware economists Larry Seidman and Ken Lewis estimate that a progressive consumption tax could generate $50 billion or more in additional revenue annually. Such a tax would not cause painful sacrifices because, beyond a certain point, additional consumption serves needs that are almost completely socially determined.

When all C.E.O.'s build bigger mansions, for example, they are simply raising the bar that defines how big of a mansion a C.E.O. needs. If a progressive consumption surtax induced all of them to postpone those additions, nothing important would be sacrificed. And if top earners spent less on mansions, so would people just below them, and so on, all the way down the earnings ladder.

If that's not creating money out of thin air, it's pretty close.

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