

The Case for a Consumed Income Tax Structure

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Abstract

This paper extends the case for a Consumed Income Tax Structure (CITS). The first five components of the case are traditional: it encourages growth, offers flexibility and simplification and introduces some much-needed rationality into the tax system. But the CITS also relates to a deeper definition of income (as final satisfaction, not the receipt of money in return for services rendered); it provides the tax system with a much-needed ethical foundation; it liberates the labor supply/leisure choice from *all* tax-based distortions, returning the surplus to those to whom it belongs (the worker and the employer); and it helps dissolve societal conflicts by providing a consensus-foundation for the mixed economy.

When CITS is embedded in a progressive system, it collects increasing units of marginal taxation from diminishing units of marginal utility (the Paradox of Flat Progressivity). Taxation ceases to be a compulsory levy on socially worthwhile activities and becomes entirely a voluntary donation.

CITS thus collects taxes through an invisible hand; it also assists the invisible hand of what Adam Smith called the “impartial spectator” to provide both privately and socially optimal levels of savings. It reduces the incentive to evade and facilitates an increase in future consumption through increased savings (the Non-Paradox of Thrift). Under CITS, Veblen’s snobs would help balance the budget.

The Introductory Caseⁱ

Agreement will never be reached about the optimal size and reach of government: at the margin, value judgments will always dominate. The young Milton Friedman’s (1948, 248-9) solution was to match taxation (T) with a consensus-derived level of government expenditures on goods and services (G^*) which should be determined “entirely on the basis of the community’s desire, need and willingness to pay for public services ... A decision to undertake additional public expenditure should be accompanied by a revenue measure increasing taxes” ($G = G^* = T$).ⁱⁱ

Friedman’s (1948, 248) scheme would eliminate discretionary fiscal policy: “No attempt should be made to vary expenditures, either directly or inversely, in response to cyclical fluctuation in business activity”. This paper examines the T side of the fiscal equation and argues that the

optimal budget-balancing tax structure already exists: the Consumed Income Tax Structure (CITS).

There is agreement about the non-sustainability of long-term government deficits; but the so-called Paradox of Thrift muddies the waters about shorter horizons. Under CITS, the Paradox of Thrift becomes a fallacy: annual budget balance can be targeted without adverse consequences.

With the Keynesians fiscal multiplier, governments can supposedly target both a balanced budget plus “benevolent” consumption (low income people with high marginal propensities to spend). But with the deficit multiplier, the government becomes a malevolent consumer of savings. A government that repeatedly borrows (from household savings in the loanable funds market) to finance temporary tax cuts which are then primarily saved (and returned to the loanable funds market) is recycling funds while expanding the budget deficit.ⁱⁱⁱ

The boost to Aggregate Demand from any increase in consumption from each round of transitory income will be crowded-out by the investment-curtailing rise in interest rates. Each rise in interest rates increases both the debt-service burden and the default risk.

A policy rule which mandated a government to respond in this way every time output fell below the “natural” rate would generate ever rising budget deficits. The sum of a geometric series is finite as long as the terms approach zero; but in this deficit multiplier, consumption not savings is the leakage, and the deficit tends to infinity. The universe may be infinite in all directions, but the gullibility of savers is not. This deficit multiplier culminates in the Junk (not to be confused with James) Bond

Governments fail when budgets remain stubbornly unbalanced. The market failure of chronically low household savings exacerbates the situation. Insufficient household savings may partly be caused by the promise or expectation of future government support; it may also partly be caused by a subjective time horizon shift.

In some countries, the forces of current consumption appear to overwhelm the forces of savings and threaten to overrun the government’s budget. The *subjective* interest rate undervalues the utility to be derived from future consumption relative to the utility derived from consumption today. Under CITS, policy makers can remove this distortion by altering the *objective* market interest rate, P_c/P_s , the price of consumption today (P_c) relative to the price of consumption in the future (financed by savings, P_s). A rate of household savings can be targeted that will eliminate the intergenerational distortions caused by these unfunded liabilities.^{iv}

The Policy Optimizing Trinity (POT) alleviates the unfunded liabilities problem (1) by removing the distortions caused by taxes on income (2) and the distortions that lead to sub-optimal levels of household savings (3).

Several piecemeal CITS components already exist. Point-of-sale taxes (Value Added, Goods and Services etc) are CITS-type arrangements (with regressive, or at least non-progressive, features) and tax-privileged savings accounts already exist. But such quasi-consumed taxes become embedded in prices: hidden and thus easier and more tempting to raise than visible taxes.

Pre-tax Individual Savings Accounts (ISA) could be voluntary - as in the U.S.A (Unlimited Savings Account) proposed by Sam Nunn (R-Georgia) and Pete Domenici (D-New Mexico) - or compulsory, as in Singapore, Australia and elsewhere. Payday default ISA deposits – or withheld savings – could replace the withholding income tax (prior to the end-of-year adjustment). Sales taxes could be retained or abolished. Saves could access their funds at any time (minus withholding tax) or with restriction. The withholding tax could diminish at 5% per year thus removing all tax on income after 20 years. CITS allows for all these permutations – plus a relatively painless method of targeting an annual balanced budget.

Singapore has perhaps gone the furthest with respect to implementing the *structure* of the consumed income tax (although debates remain about the *system* that has been chosen to operate this structure). The income tax can easily be abolished and replaced by CITS through the introduction of ISA: in Singapore, taxes are collected on income minus deposits into accounts at the Central Provident Fund (34.5% of private sector wages, for workers aged below 50).

Most economists regard CITS as ordinaly superior to the Pure Income Tax Structure (PITS). Taxes on income unambiguously distort the labor-leisure choice and there are solid reasons for concluding that taxes on consumption increase saving and wealth and are therefore are welfare improving.

Specifically, CITS has at least fifteen desirable characteristics. The first five are traditional: it encourages growth, offers flexibility and simplification and introduces some much-needed rationality into the tax system (1-5). This paper strengthens the case by adding or building upon ten further desirable characteristics.

CITS relates to a deeper definition of income: as final satisfaction, not the receipt of money in return for services rendered (6). CITS provides the tax system with a much-needed ethical foundation: it taxes what people take out of the economic system not what they put in (7).

The abolition of income tax liberates the labor supply/leisure choice from *all* tax-based distortions. Taxing income leads to welfare losses. CITS returns the surplus to those to whom it belongs: the worker and the employer (8). CITS can help dissolve societal conflicts by providing a consensus-foundation for the mixed economy (9).

When CITS is embedded in a progressive system, it collects increasing units of marginal taxation from diminishing units of marginal utility. It also provides a survey-based method of estimating utility foregone: the optimal Cardinal Utility Tax Structure (CUTS). CUTS flattens progressivity and can produce a flat progressive tax (10).

Taxation ceases to be a compulsory levy on (generally) socially worthwhile activities (such as work) and becomes entirely a voluntary donation (a consequence of the choice to consume above a certain level). CITS thus collects taxes through an invisible hand (11). It assists the invisible hand of what Adam Smith called the “impartial spectator” to provide both privately and socially optimal levels of savings (12). It reduces the incentive to evade (13). It facilitates an increase in future consumption through increased savings: the Non-Paradox of Thrift (14). Under CITS, Veblen’s snobs would help balance the budget (15).

The retreat of arbitrary taxation and the advance of democracy are linked. Taxation can expand the coercive power of the State but it also links government and the governed in a legitimizing embrace. The presence and pressures of taxation tends to increase both the transparency of government and the contestability of politics. The ever-present threat of tax revolt is a permanent reminder that taxpayer Voice can lead to political Exit for those who abuse taxpayer funds.

The State can expropriate bodily property rights through incarceration, the military draft and capital punishment. Such bodily property rights would be eliminated by the elimination of food and shelter. But we have surrendered to the State the property rights over the process by which food and shelter are provided: the income tax is a form of income punishment.^v

Since taxation is inevitable - for all except Robinson Crusoe, anarchist communities and oil sheikdoms – optimizing principles should be applied. What follows below is a “least ugly” contest. PITS – the sub-optimal Pure Income Tax Structure – is pitted against CITS – the optimal Consumed Income Tax Structure.

A tax *structure* becomes a *system* when rates are attached. CUTS – the optimal Cardinal Utility Tax Structure – is a progressive CITS with a paradoxical feature: the possibility of flat progressivity. PITS undermines the optimization process from the outset; CITS corrects this distortion.

Let the battle begin and may the optimal structure win.

Prelude: Behavioral Economics and *Homo Economicus*

CITS appeals to both neoclassical economists and their behavioral critics.^{vi} *Homo Economicus*, the work horse of neoclassical orthodoxy, began life in bondage, “under the governance of two sovereign masters, *pain* and *pleasure* ... fastened to their thrones ... *the principle of utility* recognises this subjection and assumes it for the foundation of that system” (Bentham 1907 [1823], chapter 1, para 43).

This optimizing agent maximizes lifetime utility, first, by making an optimal choice between the hours of labor supplied and “leisure”. *Homo Economicus* is also sufficiently far-sighted to

finance a smooth lifetime consumption flow by making an optimal choice between current and deferred consumption (savings).

If the choice turns out to be non-optimal – eating, not planting, the seed corn - *Homo Economicus* may be forced to revise and extend future labor supply decisions (food-feedback). Alternatively, this once mighty engine of economic analysis becomes a liability, an unfunded ward of the state, financing retirement consumption through an intergenerational begging bowl (on-the-parish-fallback).

Having optimally decided how much income to currently consume, *Homo Economicus* - in the final step of this optimization trinity - makes a utility maximizing choice between various goods and services (thus deriving demand curves).^{vii}

Consumer sovereignty provides one justification for free market capitalism. If *Homo Economicus* is victimized by persuasive marketing, this particular justification vanishes: we live, instead, in a Galbraithian world of producer sovereignty and impulsive response functions. If the same “Me, Now, credit card” forces are sufficiently seductive so as to elevate current consumption over deferred consumption, a bald *Homo Sampson*, having taken an intergenerational haircut, will end his days eyeless in Gaza.

An allegedly dieting Homer Simpson asked for “a sign” to indicate whether or not there would be divine displeasure if he consumed a forbidden donut. In some countries, household savings decisions appear to be made more by *Homo Simpson Myopicus* than by *Homo Economicus*.^{viii}

When *Homo Simpson Myopicus* fails to see his inter-temporal budget constraint, he becomes an unfunded liability for *Homo Macroeconomicus*.^{ix} Behavioral economists are currently trying to construct *Homo Behavicus* (*behavicus* is Latin for “behave yourself and save properly”).^x For example, agents with time inconsistent preferences can be embedded in a game-theoretic framework played by successive incarnations of a single decision-maker (Bernheim, Ray and Yeltekin 1999).^{xi}

Laurie Simon Bagwell and B. Douglas Bernheim (1996, 368) concluded that “an excise tax on conspicuous goods amounts to a non-distortionary tax on pure profits”. CITS is distortion-correcting and would be a major contribution to the pursuit of improved savings outcomes.^{xii}

The Traditional Case

Encouraging growth

1. CITS encourages saving and thus capital formation which can generate economic growth and higher wages (*Blueprints for Basic Tax Reform* 1977, 10). Thus CITS “gives the maximum opportunity for business enterprise and development” (*Structure and Reform of Direct Taxation* 1978, 502). A National Bureau of Economic Research study estimated that a shift to a

consumption tax could increase long run output by 11% (Altig, Auerback, Kotlikoff, Smetters and Walliser 1997; Auerback 2005).

Marginal rates: flexibility

2. It allows for flexibility: marginal rates of taxation could remain more or less as they are or could be increased at the upper end (as a “luxury” tax or tax on “luxurious” living). Raising taxes on income to try and balance the budget can be electorally hazardous and may also reduce tax revenue (via Laffer curve effects). In contrast, raising taxes on “luxury” may increase both savings and tax revenue.

Simplification and rationalization

3. The existing hybrid system treats some categories of savings in a favourable fashion while others are subject to double taxation in a “totally arbitrary manner” (*Structure and Reform of Direct Taxation* 1978, 70; Mill 1884, 179; Fisher 1939; Kaldor 1955, 80).

4. It is administratively feasible, hardly more complicated than the current system.

5. Excluding savings from the tax base further simplifies matters by eliminating many issues such as depreciation and inflation adjustments (*Blueprints for Basic Tax Reform* 1977, 9).

The Extended Case

Consumption: the optimal candidate for taxation

6. CITS relates to a deeper definition of income: as final satisfaction, not the receipt of money in return for services rendered. Maximizing lifetime utility is the fundamental behavioral postulate of neoclassical economics: since consumption generates utility it should also generate the tax revenue to pay for activities that markets do not adequately deliver.

7. All three basic forms of economic activity (production, accumulation and consumption), are transformational. With production and savings, the transformational flow runs from the private to the social sphere. With consumption, the flow runs in the opposite direction: socially produced goods and services are transformed into private utility.

For an individual worker, value-adding production transforms private resources (time) into socially available output. The private decision to save turns deferred consumption into potential future consumption. It also generates at least two social benefits. First, it transfers surplus resources to deficit resource units and is, therefore, available to be transformed into socially productive capital). Second, it reduces the future tax liabilities associated with unfunded retirement income streams.

Pigovian taxes and subsidies are designed to encourage social-value-adding and discourage social-value-subtracting activities. While most, if not all, of the benefits of consumption are

captured by the individual consumer, social costs can be generated too. At the microeconomic level, “sin” taxes on alcohol, tobacco, gambling, petrol, certain types of food etc. can discourage both social costs and self-harm. At the macroeconomic level, CITS can fund all the social activities that governments have been designed to provide. Of the three basic economic activities, consumption is the least worthy of preferential tax treatment. Therefore, on Pigovian grounds, production and savings are worthy of subsidy - or rather should be exempt from the discouragement caused by taxation.

Consumption has some social benefits – most of the benefits are privately captured. Production and accumulation are more generally socially productive and should not, therefore, be discouraged through taxation.^{xiii} In contrast, the third (consumption) uses up resources and is therefore a preferred candidate for taxation.^{xiv}

CITS thus provides the tax system with a much-needed ethical foundation. As James Meade (1978, xvi) put it, taxes should fall on “what people took out of the economic system in higher levels of consumption rather than on what they put into the system through their savings and enterprise”.^{xv}

8. The abolition of income tax liberates the labor supply/leisure choice from *all* tax-based distortions. Economists traditionally derive an individual’s labor supply curve through a choice theoretical framework: the optimal division of a 24 hour day between labor and leisure. Utility is being maximized along a labor supply curve: leisure produces utility and labor supply produces income (plus “psychic” utility) to fund current and future consumption.

The income tax generates a market labor supply curve which is removed from this utility maximizing curve. It distorts the labor supply decision by driving a wedge between the wage received by the supplier and the wage paid by the employer (the same effect as an upward shift of the supply curve). This causes a reduction in the quantity of labor demanded.

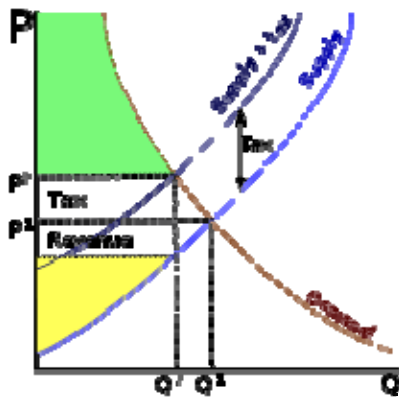
Entire macroeconomic schools are based on this optimization decision. In the basic neoclassical macroeconomic model, dysfunctions occur when the economy operates off the labor supply curve (when the real wage is above equilibrium). The economy is displaced from the “natural” rate of unemployment and output when labor suppliers are confused by unexpected inflation (monetarism) or unanticipated monetary growth (the new classical school).

But PITS thwarts the individual optimizing decision right from the outset. The income derived from the labor supply decision feeds into another optimizing decision relating to the demand curve (or functions) for goods and services. But these supposedly “optimized” demand curves are derived as a constrained optimization exercise: constrained by the sub-optimality of PITS.

With downward sloping demand curve of labor and upward sloping supply curve of labor, the free market price allows some workers to be paid more than they were prepared to work for and some employers to receive labor at a lower price than they would be prepared to pay. The

employment contract can be seen as a harmonious two-way optimization exercise: workers maximize utility, employers maximize profits, and both players receive an invisible “surplus”.

There is a third force at work: the visible hand of the tax collector expropriates part of the “surplus” that would otherwise accrue to both the worker and the employer. The tax revenue raised is less than the loss of surplus: the two Harberger Triangles are deadweight losses imposed by the tax on labor income.



Removing the tax would, ceteris paribus tend to increase the demand for labor (by moving down a labor demand curve). The price paid by employers would fall but the wage received by employees would remain unchanged. The expropriating tax collector would thus be expropriated: the surpluses would be returned to those to whom they rightfully belong (the worker and the employer). The invisible hand would no longer be impeded. Policy recommendation: tax collectors should find less distortion-inducing sources for revenue.

9. In Marxian eyes, there is no harmonious invisible hand. Exploitation is the “invisible essence”.^{xvi} In this type of exploitation theory, capital is vampire labor, which comes into the world “dripping from head to foot, from every pore, with blood and dirt” (Marx 1921 [1867], 834).

Capitalists derive profits from “surplus labour” expropriated through their co-ownership of the coercive power of the state.^{xvii} This, according to Marx, is the central driving force of capitalism. It also generates alienation.^{xviii} Marx’s policy recommendation: revolution.

Meade (1978, xvi) concluded that CITS provides a “reasonable base of political consensus for our mixed economy”. Visceral politics is driven by exploitation anxiety. The “human capital revolution” appeared to dissolve one toxic societal conflict: the owners of capital were rewarded in the same way as the owners of labor were rewarded (through mutually beneficial market exchanges). This “surplus” was not derived from the state-enforced exploitation of the proletariat. Instead, agents received compensation commensurate with their acquired skills.

As the human capital revolution undermined “working class” parties and perceptions about “wage slavery”, so CITS could undermine the suspicion that drives many self-employed people to see taxation as theft. The Tax Foundation calculated that in 2010, Tax Freedom Day fell on April 9th - the 99th day of the year.^{xix} CITS leaves all *Free to Choose* their tax bill: spending \$20,000 per annum may avoid taxation entirely, but every dollar earned over, say, \$500,000, must either be consumed at a later date (saved) or taxed at the highest marginal rate.

10. CITS collects increasing units of marginal taxation from diminishing units of marginal utility.

Because CITS is socially optimal, economists have long had an ordinal preference for it over PITS. It is also privately optimal for economists - it offers the research-enhancing prospect of measuring “utils” (or at least their close proxies).

Cardinal notions of utility pre-date Adam Smith: Francis Hutcheson (2004 [1726], section 3, 37, VIII) developed a quantity theory of happiness.^{xx} Welfare evaluations derived from cardinal perceptions can lead to extreme policy conclusions. Triage is commonly practiced on the battlefield.^{xxi} But few would argue for the redistributive cardinal superiority of ending the life of one healthy person (by extracting five organs) so that five (organ-lacking) people may live (although such decisions are effectively made by those who allocate health care expenditures).

At the other extreme, welfare evaluations derived from non-cardinal perceptions can lead to inactivity. If Robert Mugabe were to extend his dictatorship and appropriate the entire wealth of the world, it would be Pareto inefficient to remove a single dollar from him: Pareto paralysis.

The ordinalist revolutionaries (such as Lionel Robbins and John Hicks) disallowed the societal aggregation of utility because interpersonal comparisons were impossible. With ordinal utility, differences in “utils” are meaningless: we know nothing about the related strength of preferences.

It would, however, be possible to estimate the cardinal strength of dissatisfaction with current tax systems by asking taxpayers each year to attach a number (1-10) to the intensity of their dissatisfaction. Any changes over time would provide an unambiguous cardinal measure of the strength of aversion.

A progressive consumed income tax provides a numerical method of estimating utility foregone: the optimal Cardinal Utility Tax Structure (CUTS).

An individual’s income (Y) has three components: taxation (T), consumption (C) and savings (S):

$$(1) Y = T + C + S$$

Under PITS, labor income and personal income taxation (T_y) are simultaneously determined. The causality runs from income to taxation. Agents choose between labor supply and leisure: the decision to supply (paid) labor causes the tax liability. Tax is avoided by not working.

The relevant PITS behavioral equation is:

$$(2) (Y - T_y) = C + S.$$

In many countries household savings appears to be a residual, insufficiently related to future consumption needs. But savings are derived from another residual: disposable post-tax income ($Y - T_y$). Only then can the choice between consumption and savings be made. PITS thus eliminates the possibility of deriving any private utility from the tax withheld.

With CUTS, the choice between consumption and personal consumption taxation (T_c) is simultaneously determined:

$$(3) (C + T_c) = Y - S.$$

The causality runs from consumption to taxation. Tax is incurred in the choice between consumption and savings: the decision to consume is associated with the decision to pay tax. Tax is avoided by saving.

Smith (1981 [1776], book 5, chapter 2) favored a progressive tax system.^{xxii} However, the optimal CUTS *structure* is consistent with either a flat or a progressive tax *system*.^{xxiii} One advantage of a progressive system is that it minimizes the utility forgone per dollar of tax raised by attaching increasing marginal tax to diminishing marginal utility. This can lead to flat(ish) tax-induced losses in utility and in one case a progressive-flat tax.

Diminishing marginal utility suggests that the utility derived from the first \$1 of consumption (A units of utility) is less than the utility derived from the \$500,001st dollar of consumption (E units of utility). With a progressive CUTS, each intervening dollar decreases in utility as marginal consumption tax rates increase. As a hypothetical example, consider a five tier CUTS system.

In the lowest bracket (\$0-20,000) the tax rate is 0%. The dollars in this bracket are privately the most valuable, but socially (as measured by tax collected) the least valuable (the marginal rate, the tax revenue raised and the tax-induced utility forgone are all zero).

In the second bracket (\$20,000-100,000) the tax rate is 20%. The “prudent tax avoider” is free to earn whatever they can and to minimize tax by increasing their wealth (by saving to finance future consumption). Information about the goods and services purchased by this cohort could be obtained through survey evidence.

The 20,001st dollar generates B units of utility ($A > B$), but is socially more valuable. It generates \$0.20 in tax revenue (a private loss to the consumer). The tax-induced loss of utility is therefore $B/5$.

In the third bracket (\$100,000-200,000) the tax rate is 40%. The 100,001st dollar generates C units of utility ($A > B > C$) but is socially more valuable (\$0.40 tax revenue). The tax-induced loss of utility is $2C/5$.

In the fourth bracket (\$200,000-500,000) the tax rate is 60%. The 200,001st dollar generates D units of utility ($A > B > C > D$) but is socially more valuable (tax revenue: \$0.60). The tax-induced loss of utility is $3D/5$.

In the final bracket (over \$500,000) the tax rate is 80%. The “luxurious rich” high-end-cohort contribute most in terms of tax revenue. As with the “prudent tax avoider” bracket, information about the goods and services purchased by this cohort could be obtained through survey evidence.

The 500,001st dollar generates E units of utility ($A > B > C > D > E$) but is socially more valuable (\$0.80 tax revenue). The tax-induced loss of utility is $4E/5$.

Without diminishing marginal utility, each dollar would generate Z units of utility ($Z = A = B = C = D = E$). The tax-induced loss of utility for a dollar in each category would increase in exact proportion to the marginal tax rate: 0, $Z/5$, $2Z/5$, $3Z/5$ and $4Z/5$. With the progressive tax rates described above, the tax on the 500,001st dollar would cause a utility loss four times greater than the tax on the 20,001st dollar: $(4Z/5) = 4 \times (Z/5)$.

But with diminishing marginal utility, $E < B$, and therefore $(4E/5) < 4 \times (B/5)$ - the blow is softened. The tax on the 500,001st dollar causes a loss of utility *less than* four times greater than the tax on the 20,001st dollar.

Evidence about the *strength* of preferences can be elicited through survey evidence allowing greater numerical accuracy to be attached to the loss of utility associated with each tax dollar.

By comparing the consumption patterns of the “luxurious rich” with the consumption bundles of “the prudent tax avoiders” three types of consumed items would be identified: sticky, disjoint and overlapping.

The sticky set would contain items (such as salt) that are bought in exactly the same volume for approximately the same price (zero income elasticity of demand).

The disjoint set would contain items that are typically exclusive to one cohort. Inferior goods would be exclusively in the lower cohort (negative income elasticity of demand). Luxury goods (elasticity of demand, much greater than one) are purchased to signal exclusive status, income or wealth (designer clothes, yachts, large dwellings, domestic servants etc).^{xxiv} These would be found exclusively in the “luxurious rich” cohort.

The overlapping set would consist of items that fall in more than one cohort but are consumed in different quantities (seats at the opera, tickets to the baseball, holiday expenses etc). Items in the

necessity subset (for example, food and public utilities) are income inelastic. The number of items in the (income elastic) superior subset may not increase much as income increases, but expenditure per item may (for example, wine, holidays etc).

Residential housing is a unique item. In the national income accounts it is typically treated in the “investment”, not the “consumer expenditure” category. It is also typically financed through long-term debt. But for illustrative purposes it provides a perfect comparison.

Survey information could reveal a cardinal ranking of the intensity of preferences (on a scale of 1-10). A “prudent tax avoider” may live in a five bedroom dwelling; the “luxurious rich” would probably occupy more than five rooms. How much utility do the additional rooms provide in absolute terms (or alternatively, per dollar of cost)?

If the “prudent tax avoider” derived “8” reported utils from the last (and maybe only) spare bedroom, and if the “luxurious rich” derived an average of “4” reported utils from their last (maybe n^{th} spare bedroom), this would provide information about diminishing cardinal utility. If the “luxurious rich” reported only “2” utils from their last spare bedroom, ceteris paribus, this may indicate a four-fold diminution in utility.

Real estate is (more or less objectively) valued by “valuation surveyors;” carefully designed contingent evaluation surveys could also elicit information about subjective evaluations. If the “prudent tax avoider” was prepared to pay \$10,000 (plus tax) for an additional spare bedroom and the “luxurious rich” was prepared to pay \$6,666.66 (plus tax) for an identical (but n^{th}) spare bedroom, they would both face a \$12,000 cost. Alternatively, if the “prudent tax avoider” was prepared to pay 1% of income (plus tax) and the “luxurious rich” was prepared to pay 0.66% of income (plus tax) the same equivalence would hold. For those who are suspicious of contingent evaluations, *ex post* data could be used: the proportion of income that was actually spent on adding a spare bedroom by the two cohorts.

In an extreme case where, on average, the 500,001st dollar yielded one quarter of the utility than the 20,001st dollar, a powerful implication would follow. The loss of utility inflicted on the “luxurious rich” by the \$0.80 tax per consumed dollar is exactly identical to the loss of utility inflicted on the “prudent tax avoider” by the \$0.20 tax per consumed dollar (the Paradox of Flat Progressivity). Even in less extreme cases, CUTS would cut the tax-induced loss of utility by a factor that is proxy-measurable.

The invisible hand of consumption taxation

11. Taxation ceases to be a compulsory levy on (generally) socially worthwhile activities (such as work) and becomes entirely a voluntary donation (a consequence of the choice to consume above a certain level).^{xxv}

Classical and neoclassical economics were both constructed, in part, to restrain the coercive power of the State. In this tradition, market forces are generally perceived to be a superior social organizer than government coercion. Hence Milton Friedman (1999) described Adam Smith's "invisible hand" as offering "the possibility of cooperation without coercion".

Smith provides two illustrations by which economic actors are "led by an invisible hand to promote an end which was no part of his intention": the invisible hand of production and the invisible hand of consumption. The most famous reference is to the invisible hand of production.^{xxvi} But Smith's (1982 [1759] IV, i, 265) first published reference relates to the "invisible hand" of consumption. The rich are constrained in their ability to consume great quantities of "the necessaries of life" and are "led by an invisible hand" to provide employment and therefore to share "produce" with the poor and "thus without intending it, without knowing it, advance the interest of the society".^{xxvii}

CITS fits perfectly in this tradition: it is a method of removing the coercive element from tax collection. Smith (1982 [1759], IV.I.10) also described the "luxury and caprice" and "natural selfishness and rapacity" of the "proud and unfeeling" luxurious rich.^{xxviii} Through the invisible hand of consumption they unwittingly pursue social goals. By pursuing private (consumption-derived) utility, they simultaneously – through an invisible hand of consumption taxation – assist the pursuit of a balanced budget.

The invisible hand of the "impartial spectator"

12. In *The Theory of Moral Sentiments*, Smith (1982 [1759], I, i, v, 26) highlights a private, internal struggle where "passions" (short-term gratification, long-term costs) may defeat the internal "impartial spectator" (the source of "self-denial, of self-government, of that command of the passions which subjects all the movements of our nature to what our own dignity and honour, and the propriety of our own conduct, require").

There are themes in Smith's writings that resonate with behavioral economists (Ashraf, Camerer and Loewenstein 2005). Sub-optimal levels of private saving, for example, can be attributed to the victory of the "passions" over the "impartial spectator". CITS can therefore cooperate with the "impartial spectator" by providing an incentive structure to encourage savings. Thus there is "the possibility of cooperation without coercion" in situations where the invisible hand fails.

Reducing the incentive to evade

13. The voluntary nature of taxation reduces the incentive to evade. Moreover, whilst all tax systems are open to attempts at evasion, CITS provides an additional disincentive.

Current definitions of taxable income can be carried-over into CITS. Pre-tax savings vehicles account (PTSA) additions are deducted from income to derive consumed income. PTSA funds that are withdrawn are assumed to be consumed and therefore added to taxable income.

What would happen if non-PTSA assets were used to finance consumption (thus allowing a greater proportion of income to be saved)? These non-PTSA asset proceeds can be easily tracked and measured by the tax authorities and therefore would not present undue administrative difficulties or excessive exposure to evasion.^{xxix}

But what if unregistered offshore assets were liquidated and consumed? Under-reporting non-PTSA income would, of course, be a crime; electronic transfer of unregistered funds may be traceable; and carrying cash across borders is also potentially detectable. But even if such evasion were successful, the evader would still pay a price: unregistered offshore assets would gradually be eliminated.

Increasing consumption through increased savings: the non-paradox of thrift

14. Increasing savings should increase future consumption/savings opportunities. Life cycle consumption functions assume that households consider the present value of lifetime income (not just the current flow of income). Thus a stream of income received over time $\{y_0, y_1, \dots, y_T\}$ must be discounted to derive the present value (pv_y).

(4)

$$pv_y = y_0 + \frac{y_1}{(1+r)^1} + \frac{y_2}{(1+r)^2} + \dots + \frac{y_T}{(1+r)^T}$$

The consumption/savings decision is based on the (subjective) trade-off between the utility gained from consumption today c_0 and the expected utility associated with deferred consumption, $c_1 + \dots + c_T$. Whilst a dollar of current consumption generates more utility than a (purchasing power preserved) dollar of future consumption, CITS operates in the reverse direction and thus nudges current consumption towards the deferred consumption (savings) category.

In a simplified world of stable purchasing power (no inflation) and no interest (nominal or real) paid on savings, the purchasing power of dollar would be constant, regardless of when it is applied to consumption. In the absence of a tax on consumption, c_0 would be compared to c_T by (subjectively) discounting c_T .

But CITS alters this calculation. Suppose that for “the luxurious rich”, current consumption attracted a marginal tax of 80% and that this tax diminished per year of deferral (at say 5% per year of deferral or, in this example, 4 percentage points). Therefore a utility-maximizing agent would adjust the valuation of $c_0, c_1 + \dots + c_T$ by adding the tax.

Thus the choice for “the luxurious rich” lies between a dollar of current consumption (costing \$1.80) and a purchasing-power-preserved dollar of consumption (costing \$1) in 20 years time

(with intermediate calculations for the intervening years). This provides an incentive for current consumption to fall and savings (and therefore future consumption) to rise.

Consumption (C) is influenced by both (the national income accounts definition of) income (Y) and financial wealth (W):

$$(5) C = b_1Y + b_2W$$

An increase in savings will increase future consumption possibilities when funds are subsequently withdrawn from PTSA for consumption purposes (and added to income). The rise in savings will also tend to increase financial wealth. Although CITS could be expected to reduce the marginal propensity to consume out of income (b_1), the corresponding increase in financial wealth (W) would tend to offset the reduction somewhat.

The Paradox of Thrift asserts that an attempt to increase savings may be counterproductive: the corresponding fall in consumption may lower aggregate demand and income and thus lower aggregate savings. But CITS undermines whatever validity this paradox may have possessed. The Paradox of Thrift is no longer a paradox, but is instead part of Keynesian received opinion.^{xxx} It should be replaced by the Non-Paradox of Thrift.

The tax-induced rise in savings (and the tax-induced fall in consumer expenditure) should lead to a two-fold increase in investment (via quantity and price effects). The quantity effect reflects the increased flow of savings-into-investment; the price effect reflects the increase in investment caused by the associated reduction in interest rates.

CITS reduces expenditure on consumer items (some imported) whilst facilitating an increase in capital per worker, productivity, real wages and income - and thus future consumption and savings opportunities.

The budget-balancing invisible hands of Veblen's snobs

15. Twisting marginal taxes on consumed income to balance the budget produces some powerful results. The goods and services consumed by each tax cohort can be treated as a bundle with estimate-able price elasticities of demand.

If the demand for "luxurious rich" expenditures was price elastic, raising the marginal rate would, ceteris paribus, reduce aggregate expenditure and tax revenue on this tier bundle. This would increase the savings and thus – paradoxically - the wealth of the "luxurious rich". A government which undertook this tax hike would be indulging in a "taste" for discrimination: a taste that will be paid for by the "prudent tax avoider" in the form of higher taxes.

If on the other hand, such "luxurious rich" expenditures were price inelastic, aggregate expenditure and tax revenue would, ceteris paribus, rise. But the "luxurious rich" would still be on their demand curves (they would still be engaging in utility maximizing behavior).

Bagwell and Bernheim (1996, 350) noted that “members of high classes voluntarily incur costs to differentiate themselves from members of the lower class (invidious comparison), knowing that these costs must be large enough to discourage imitation (pecuniary emulation)”. If commodities in the “luxurious rich” bundle were Veblen goods (where quality is perceived to be a function of price), the tax-driven rise in price would tend to increase demand and thus tax revenue.^{xxxii} In this Veblen world there tends to be an obsession with nth hand financial instruments; but wearing 2nd hand clothes would lead to Exit. Veblen’s snobs - those who visibly display their status through the conspicuous consumption of manicured nails, diamond ringed fingers and designer wrist watches - would be led by an invisible hand to assist in the process of balancing the budget.

Concluding Case

Dysfunctional tariff policy exacerbated the Great Depression and thus contributed to the Second World War. Since then politicians have gradually surrendered the revenue and patronage of tariff walls. The dysfunctional monetary policy of the 1960s and 1970s created the Great Inflation and the pain of the subsequent Great Disinflation. Economists began to insist on politically uncontaminated monetary policy (through inflation targets and more independent for central banks). In the 1990s, politicians surrendered most if not all of their remaining power to abuse monetary policy for re-election purposes.

One economist, later Governor of the Bank of Italy (1945) and President of the Italian Republic (1948), advocated the same approach towards fiscal policy: “a system of taxation, coordinated by a single principle, immune from all the contaminations that can result from the contingencies of the moment, from class or particular interests or from that factor of such great importance in this field, the ‘fantasy’ of the lawmaker stimulated by the urgent needs of the treasury” (Einaudi 2006 [1928-9], 190). A government which phased in CITS would generate short term anxiety from those fearful of change, but long term economic and electoral benefits.

Macroeconomic outcomes are a function of macroeconomic structures. Fiscal, monetary and trade policy have, at times, been a Devil’s Triangle for macroeconomic outcomes. In the last two thirds of a century, politicians have twice embraced the public interest (bringing down tariffs walls and decontaminating monetary policy). In the next third of a century, can they also be persuaded to take the fiscal high ground?

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Notes

ⁱ This paper has been improved by comments provided by Allan Meltzer, David Laidler and seminar participants at the Reserve Bank of Australia, the University of Western Australia, the 2009 Finance, Economics, Marketing and Accounting Centre conference and Chico State University.

ⁱⁱ Friedman (1948, 248, 250) proposed three additional discretion-restraining rules (two fiscal, one monetary). First, “No attempt should be made to vary expenditures, either directly or inversely, in response to cyclical fluctuation in business activity” and second “Government would not issue interest-bearing securities to the public; the Federal Reserve System would not operate in the open market”. Eliminating bond-financed expenditure leads to Friedman’s (1948, 251) deficit-surplus-counter-cyclical monetary rule: “Deficits or surpluses in the government budget would be reflected dollar for dollar in changes in the quantity of money”. Five years previously, Friedman (1943) supported the ‘Spending Tax as a War Time Fiscal Measure’ concluding that it was “administratively feasible”; the 1948 system invoked the income tax. By the early 1950s, Friedman replaced the deficit-surplus-counter-cyclical monetary rule with the constant growth (k%) rule.

ⁱⁱⁱ Governments can also malevolently consume household savings and use these funds to bolster the capital adequacy of banks (a Basle Fawltly Accord) and lend (at low interest) to reckless banks who then buy interest-bearing government bonds (a reverse Ponzi scheme).

^{iv} CITS can be seen as a tax-based war on future poverty and future government deficits.

^v Since China exports their savings they could also export their incentive structure: capital punishment for financial criminals. A knee-jerk reaction at the other extreme seeks to initiate a lawyer-based recovery (by imposing further static regulations on the dynamic lawyer-hiring-regulation-avoiding industry). The intergenerational Okun externality tax is a compromise measure (the loss of output caused by a financial crisis is recovered by tracing the fingerprint trail and putting a lien on the future earnings of all 'Financial Mayflower' descendants).

^{vi} According to a 1940s University of Chicago graduate student skit, Rational Economic Man, when asked "How much would you charge to kill your grandmother", replied "Do I have the right to dispose of the remains?" (Arrow 1997, 760, n3).

^{vii} This paper does not discuss lifetime utility maximization through political markets.

^{viii} See also Thaler (2007). <http://www.nytimes.com/2009/07/05/business/economy/05view.html>

^{ix} One sect of *Homo Macroeconomicus* - the ISLMPC fundamentalists - add a version of the Phillips Curve to the IS/LM model. Nominal national income (Y) divided by the money supply (M) equals, by definition, the velocity of money (V); and Y, by definition, equals real income (y) multiplied by the price level (P). M and P are closely connected (most economists believe that changes in M cause changes in P). This leads to a non-existent world in which it is possible to, first, cut in half and then double P whilst holding M constant. Since $Y = MV = Py$, there are only two ways of achieving this gravity-defying feat. First, by holding Y constant and forcing real income (y) to double or to be cut in half. Or second, to compensate for the doubling of P, V must be doubled (by subsidizing every transaction?) and then be cut in half (by taxing every transaction?) when P is cut in half. Either way, the Aggregate Demand curve comes into the world dripping from head to foot with nonsense.

^x Joan Robinson (1962) famously described the Keynesian Neoclassical Synthesis as a "bastard Keynesian" species; *Homo Economicus* has been "working like a bastard" for his Neoclassical landlords. However, behavioral economists believe there is another, more legitimate, child of Adam Smith (Ashraf, Camerer and Loewenstein 2005).

^{xi} With apologies to B. □ Douglas □ Bernheim, □ Debraj □ Ray □ and □ Sevin □ Yeltekin □ (1999), □ such □ agents □ can □ be □ seen □ as □ being □ stuck □ in what might impolitely be called a "fat tail, fat ass, low asset trap".

^{xii} For example, the Save More Tomorrow (SMarT) program involved the offer of a retirement savings plan in which employees commit in advance to save a portion of future salary increases. 78 percent of those offered the plan joined; 80% of those enrolled stuck with the program through the fourth pay raise; in 40 months, the average saving rates for program participants increased from 3.5 percent to 13.6 percent (Bernartzi and Thaler 2004; see also).

^{xiii} Mill argued before a Parliamentary Committee that “what I would lay down as a perfectly unexceptional and just principle of income tax, if it were capable of being practically realized, would be to exempt all savings” (cited by Fisher and Fisher 1942, 218). Mill (1884, 179) also argued that “the proper mode of assessing an income tax would be to tax only the part of income devoted to expenditure, exempting that which is saved. For when saved and invested (and all savings, speaking generally, are invested) it thenceforth pays income tax on the interest or profit which it brings, notwithstanding that it has already been taxed on the principal. Unless, therefore, savings are exempted from income tax, the contributors are taxed twice on what they save, and only once on what they spend”. Fisher (1906; 1939) also elaborated on this double taxation argument.

^{xiv} Consumption is “a stopping place among the sequence of economic relations. Consumption is a destruction, a using-up and end” (Simons 1938, 89).

^{xv} As Thomas Hobbes (1651, 226) noted, “what reason is there, that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged, than he that living idly, getting little, and spendeth all he gets ...”.

^{xvi} “Surplus-value and the rate of surplus-value are ... the invisible essence to be investigated, whereas the rate of profit and hence the form of surplus-value as profit are visible surface phenomena” (Marx 1921 [1867], 834).

^{xvii} That is, the workers’ unpaid labor and output.

^{xviii} Through the associated antagonistic roles for employers and employees - people who would otherwise live in harmony.

^{xix} <http://www.taxfoundation.org/taxfreedomday/>

^{xx} “Virtue is as *the* Quantity of *the* Happiness, or natural Good; or that *the* Virtue is in a compound Ratio of *the* Quantity of Good, and Number of Enjoyers. In *the* same manner, *the* moral Evil, or Vice, is as *the* Degree of Misery, and Number of Sufferers; so that, that Action is best, which procures *the greatest Happiness for the greatest* Numbers; and that, worst, which, in like manner, occasions Misery” [emphases in text] (Hutcheson (2004 [1726], section 3, 37, VIII). Daniel Bernoulli (1738 [1954]) also argued that the “*utility resulting from any small increase in wealth will be inversely proportionate to the quantity of goods previously possessed* [emphases in text].”

^{xxi} Referring to the “question of sacrificing a few lives in order to serve a larger number elsewhere”, Friedrich Hayek concluded in *The Fatal Conceit: the Errors of Socialism* (1988) that “even if we do not like to face the fact, we constantly have to make such decisions ... When the army surgeon after a battle engages in ‘triage’ – when he lets one die who might be saved, because in the time he would have to devote to saving him he could save three other lives – he is acting on a calculus of lives”.

^{xxii} “The luxuries and vanities of life occasion the principal expense of the rich, and a magnificent house embellishes and sets off to the best advantage all the other luxuries and vanities which they possess. A tax upon house-rents, therefore, would in general fall heaviest upon the rich; and in this sort of inequality there would not, perhaps, be anything very unreasonable. It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in that proportion” (Smith 1981 [1776], book 5, chapter 2).

^{xxiii} For the Flat Tax argument see Hall and Rabuska 2007.

^{xxiv} If the efficient market hypothesis is correct, financial services ‘servants’ would fall into this luxury category also.

^{xxv} Tax rebels (such as Henry David Thoreau and Mahatma Gandhi) could thus legally avoid paying taxes to fund activities (such as wars) of which they disapproved.

^{xxvi} “It is not from the benevolence of the butcher, the brewer or the baker, that we expect our dinner, but from their regard to their own self interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages” (Smith 1981 [1776] I.ii.2).

^{xxvii} “They consume little more than the poor, and in spite of their natural selfishness and rapacity, though they mean only their own conveniency, though the sole end which they propose from the labours of all the thousands whom they employ, be the gratification of their own vain and insatiable desires, they divide with the poor the produce of all their improvements. They are led by an invisible hand to make nearly the same distribution of the necessaries of life, which would have been made, had the earth been divided into equal portions among all its inhabitants, and thus without intending it, without knowing it, advance the interest of the society, and afford means to the multiplication of the species” (Smith 1982 [1759]).

^{xxviii} Landlords in pre-industrial Britain.

^{xxix} Existing tax systems capture capital gains and interest payments. For example, in many countries capital gains on certain assets, when realized, are added to taxable income (sometimes discounted if the asset has been held for more than a specified period). Interest paid on bank accounts is usually taxable and the (non-declared) run-down of balances to finance consumption could also be tracked.

^{xxx} A paradox is a statement that is seemingly contradictory, opposed to common sense, or a tenet contrary to received opinion.

^{xxxi} There has been a long tradition of both scorn (e.g. Veblen 1899) and concern (e.g. Tawney 1920; Frank 2000) about top-end consumption patterns (see also Whybrow 2005; Lasch 1979). Raising CITS upper end marginal rates tackles the issue directly. Either consumption would fall (presumably benefiting the afflicted or “mania” individuals), or tax revenue would rise (a Veblen-induced trickle-down tax benefit for lower expenditure cohorts).