CHAPTER SEVEN

A CONSUMPTION-TYPE INCOME TAX

[T]he equality of imposition consists rather in the equality of that which is consumed than of the riches of the persons that consume the same. For what reason is there that he which labors much and, sparing the fruits of his labor, consumes little should be more charged than he that, living idly, gets little and spends all he gets, seeing the one has no more protection from the commonwealth than the other? But when the impositions are laid upon those things which men consume, every man pays equally for what he uses; nor is the commonwealth defrauded by the luxurious waste of private men.[a]

A. INTRODUCTION

The materials in this chapter examine two related issues. First, should the principal basis for taxation, and particularly for national taxation in this country, be consumption or income? This issue was raised in Chapter Six, but the discussion will be broadened here.

Second, what form should a broad-based consumption tax take? In comparison to the income tax, and to the forms of consumption tax discussed in this chapter, value added taxes (VATs) and retail sales taxes (RSTs) are relatively simple to administer. What, then, is the objection to VAT and similar forms of consumption taxes? *Fairness*. A hallmark of the federal income tax is progressivity. It is impossible to operate VATs and RSTs that are progressive with respect to final consumers without giving up the administrative simplicity of point-of-sale collection. If the taxpayer buys a lawn mower from a retailer, for example, the seller has no way of knowing whether the taxpayer will spend $10,000 or $250,000 during the year;[b] for that reason, the seller could not be expected to charge the correct tax unless the tax rate were the same for all purchasers of a given product.

Is it possible to levy *progressive* consumption taxes? In theory, each taxpayer could be required to keep careful records of all expenditures at the grocery store, day-care provider, barber shop, restaurant, cigarette vending machine, etc. At the end of the year, the taxpayer would pay a tax based on the total of the year's consumption, at progressive rates. It is obvious that

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a. THOMAS HOBBES, LEVIATHAN 271 (Liberal Arts Press, 1958) (1651).

b. It thus would be impossible to structure the tax so that it would be progressive with respect to its base, consumption; for similar reasons, it would also be impossible to structure a VAT or sales tax so that it would be progressive with respect to income.

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such a tax would be unworkable, and by comparison would make the present income tax seem a model of administrative simplicity. While most individuals receive income from only a few sources—frequently only one—many of those same individuals make thousands of purchases during the year. A progressive consumption tax on this model would be extremely burdensome on law-abiding taxpayers who would have to keep records of each small expenditure, and it would be impossible for the Internal Revenue Service to police.

Thus, if one is persuaded of the desirability of moving to a system of consumption taxation but without sacrificing progressivity, the challenge is to envision a consumption tax that is both progressive and administratively feasible, and that includes a system for withholding taxes. This has been done.

Most proponents of a progressive consumption tax envision a calculation that would start with income, as at present—indeed, the systems are frequently described as consumption-type income taxes. Withholding by employers and other payors of income would continue. However, certain items would be treated differently—items relating to savings and investment and/or return on savings and investment—to convert the tax base to one more closely approximating consumption than income. The resulting tax base could be taxed at progressive rates, or, even if a flat rate were employed, a considerable element of progressivity could be achieved through personal and dependency exemptions and standard deductions. (Some consumption-type proposals envision a "family allowance" sufficiently generous that many lower-middle-class individuals who are taxpayers under present law would have no liability.) Itemized deductions could be provided as desired under such a system.

In this form, the consumption tax has generated considerable academic interest. More surprising and more important, a number of proposals by political "heavy hitters" mean that there is a real chance that some form of consumption tax could actually replace the present income tax.

B. ACADEMIC EXPOSITION

As this chapter's opening quotation illustrates, utilizing the taxpayer's overall level of consumption as the principal tax base has been discussed for centuries. John Stuart Mill proposed a tax base of income minus saving—essentially the tax base of current proposals—in the Nineteenth Century. In response to the persuasive writing on Nicholas Kaldor in the middle of this century, India and Sri Lanka briefly adopted expenditure taxes.[c]

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c. Richard Goode, *The Superiority of the Income Tax*, *in* WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 49, 50 (Joseph A. Pechman ed., 1980) (citing Indian and Sri Lankan government reports attributed to Kaldor's writing). *See also* NICHOLAS KALDOR, AN EXPENDITURE TAX (1955).

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Nonetheless, Professor Andrews' 1974 article, excerpted below, is frequently and accurately described as "seminal." It has been the catalyst of extensive academic examination of the proper tax base—the Haig-Simons definition of income ("accretion"); consumption; or, as at present, some hybrid of the two.

A CONSUMPTION-TYPE OR CASH FLOW PERSONAL INCOME TAX

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87 Harvard Law Review 1113, 1113-25, 1140, 1148-54, 1156-59, 1167-69 (1974)

Serious thought about personal income tax policy has come to be dominated by an ideal in which taxable income is set equal to total personal gain or accretion, without distinctions as to source or use.[1] It will be convenient to call this ideal an accretion-type personal income tax.

Accretion is the sum of personal consumption plus accumulation.[2] This relation is the real counterpart of the accounting identity by which income equals spending plus saving, income being the source of funds whose uses are spending and saving. Computation of money income, however, does not require analysis of its spending and savings components, because income can be independently determined by reference to sources of funds, without regard to uses. Insofar as economic activity is adequately represented by monetary measures and transactions, therefore, it may seem that accretion need not be analyzed or measured in terms of its consumption and accumulation components.

But economic activity is not wholly reflected in monetary transactions. Taxable income in a true accretion-type tax would include money income (as a proxy for purchased consumption and accumulation in the form of investment purchases and money savings) plus unpurchased consumption and unpurchased accumulation. Consumption and accumulation thus serve to identify two categories of adjustments that are needed to get from money income to total real accretion. The tax falls short of the ideal in relation to consumption insofar as it fails to reflect consumption income in kind,

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1. H. SIMONS, PERSONAL INCOME TAXATION (1938), is the classic statement. For different views about the usefulness of any general prescriptive model, see B. BITTKER, C. GALVIN, R. MUSGRAVE & J. PECHMAN, A COMPREHENSIVE INCOME TAX BASE? A DEBATE (1968) (mostly reprinted from 80 HARV. L. REV. 925 (1967) and 81 HARV. L. REV. 44, 63, 1016, 1032 (1967-68)). For an argument that even the accretion ideal, properly understood, will admit some distinctions among current uses of funds but none among sources as such, see Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 375 (1972). This Article is in some respects an extension of the argument there.

2. H. SIMONS, *supra* note 1, at 50. Arguably accretion should be defined to equal consumption plus accumulation plus the tax itself, since taxable income is computed without any deduction for the income tax itself. * * * But the failure to deduct the tax itself may be viewed as just a computational shortcut, since any particular rate of tax on taxable income is the equivalent of a tax at a higher rate on disposable income—that is, taxable income minus the tax.

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whether enjoyed as an incident of employment or as imputed income from services or property, or even the direct enjoyment of leisure time and activities. Similarly, the tax falls short of the ideal in relation to accumulation insofar as it fails to reflect accumulation in kind in such forms as unrealized capital appreciation and the accrual of pension rights. As we think about the tax in real terms, consumption and accumulation emerge as two distinct components of the underlying subject matter in terms of which the tax should ultimately be understood and evaluated.

Consumption and accumulation adjustments are analytically different in several ways. For one thing, failure to tax an item of unpurchased consumption is a matter of permanent exemption; if it is not taxed now it will not be picked up later on. Accumulation, on the other hand, is essentially a matter of timing; if pension rights are not taxed as they accrue, for example, pension income will be fully taxed if and when it is paid. Moreover, accumulation may be either positive or negative. Consumption, on the other hand, is always positive. Consumption is not always less than accretion; it will be more during any period of net disaccumulation. Indeed even accretion may be negative if disaccumulation exceeds consumption.

If we think about the personal income tax in real terms, as a tax on accretion, and of accretion as consumption plus accumulation (or minus disaccumulation), reflection will show that its worst inequity, distortion, and complexity arise out of inconsistency in the treatment of accumulation. Under existing law, as we shall see, the effect is often to impair the integrity of the tax in relation to consumption as well as accumulation, so that some taxpayers with high standards of living pay limited taxes. But the underlying source of difficulty is with the accumulation component of accretion. Savings out of ordinary income are fully taxed, while accumulation of wealth in kind through appreciation in value of property already owned is not reflected in current taxable income. Further complications arise from this disparity. Some gains, though realized, are unrecognized by reason of special statutory provisions like those governing corporate reorganizations. These are among the most complex provisions in the statute, and have a substantial effect upon the structuring of financial transactions. Recognized long-term capital gains are taxed at not more than half the regular rate.[d] This discrepancy in rates means that realized capital gain income is partially permanently exempted from tax, even if and when devoted to consumption instead of accumulation. Wealth whose accumulation has already been taxed or permanently exempted is not to be taxed again, and so the statute has complex and imperfect provisions for computing and subtracting basis on sales, and for amortizing basis against ordinary income in the case of depreciable property. Distortions in the computation of

d. The historical differential between tax rates on ordinary income and capital gains was eliminated in the Tax Reform Act of 1986, and has only partially returned. Under present law, the maximum rate on ordinary income is 39.6%, compared to 28% for capital gains. (Eds.)

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depreciation and other items are sometimes grossly magnified by the way borrowing is treated in the case of leveraged investments, so that a limited passive investment may produce an artificial loss which shelters other income from tax even though that other income remains freely available for current consumption or other investments.[e]

The way out of these difficulties, according to the accretion idea, is to make taxable income provide a more comprehensive reflection of real accumulation, and therefore accretion, by including unrealized changes in the value of property in taxable income. Literal achievement of that goal would require that all assets be taken into account at current fair market value at the end of each accounting period. Although practical exigencies may prevent comprehensive inclusion of unrealized appreciation, improvement is thought to lie in that direction.

Another remedy for present difficulties lies in just the other direction. It involves putting the income tax treatment of business and investment transactions more completely on a simple cash flow basis. Investment expenditures would be deductible when made; on the other hand, all receipts from business and investment activities, including loan proceeds, would be immediately and fully includable in taxable income. This would have the effect of treating accumulation consistently by excluding it from taxable income even when it is represented by investment of realized gains or of ordinary income.

On its face this possibility may seem to be a step in the wrong direction, a step further away from fairness and equity as represented by the prevailing accretion ideal. But a cash flow income tax would correspond very closely to another ideal, that of a tax whose burdens are apportioned to current personal consumption expenditures rather than to total accretion. Net cash flow from business and investment activities is a simple and practical measure of cash flow devoted to consumption expenditure. It will be convenient to call this kind of tax a consumption-type personal income tax. Such a tax has been discussed and advocated in the economic literature,[7] and even tried, briefly, in Sri Lanka (formerly Ceylon) and India. But it has been discussed as an alternative or supplement to an income tax, not as an ideal implicit in or appropriate for the personal income tax itself.

Insofar as one thinks of economic activity as adequately represented by money transactions and historical costs, the existing personal income tax is

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e. This article was written before enactment of sections 465 (generally limiting deductible losses to amounts at risk) and 469 (limiting passive activity losses and credits). (Eds.)

7. The best and most comprehensive discussion is N. KALDOR, AN EXPENDITURE TAX (1955). Earlier advocates Include I. FISHER & H. FISHER, CONSTRUCTIVE INCOME TAXATION (1942); T. HOBBES, LEVIATHAN ch. 30 (1651); J. S. MILL, PRINCIPLES OF POLITICAL ECONOMY bk V, ch. 1, § 4 (Laughlin ed. 1884); A. PIGOU, A STUDY IN PUBLIC FINANCE, 102-133 (3d rev. ed. 1949); W. [VICKREY], AGENDA FOR PROGRESSIVE TAXATION 329-66 (1947); Marshall, *The Equitable Distribution of Taxation* (1917), *in* MEMORIALS OF ALFRED MARSHALL 340, 350-51 (A. Pigou ed. 1925).

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largely an accretion-type tax. Money income is generally taxed whether spent or saved. But in real rather than monetary terms, the existing tax is a hybrid, closer in many respects to a consumption-type than an accretion-type tax. Unrealized capital appreciation and accruals under qualified pension and profit-sharing plans are a large portion of total real accumulation, yet are not taxed. For many persons they represent most real accumulation, and for such persons the existing tax may be well represented by the model of a consumption-type tax.

A person with a moderate amount of income-producing property, for example, may live on the yield without either drawing down or adding to principal. He may take care of the future by investing in securities that will show some appreciation in value as well as current yield. Money income for him provides a close measure of consumption expenditure. Real accretion, however, would also include unrealized changes in the value of his property.

Or an employee may spend his whole salary, without saving or dissaving, if his employer is making adequate provision for his retirement and other emergencies through pension plan contributions and the like. Again, current money income will provide a measure of current consumption expenditure, not of total real accretion which would also have to include the increase in value of accrued pension rights each year.

The question whether our existing personal income tax is better represented by the accretion model or by a consumption model can be restated by asking who to take as typical, an individual whose accumulation is represented by savings bank deposits and interest or one whose accumulation takes the form of unrealized capital appreciation or pension accruals. And the question of whether to prefer the consumption model or the accretion model as an ideal can be restated by asking whose tax treatment to take as a prototype. There is clearly a discrepancy in our present treatment, which ought to be removed, but there is no a priori reason to think the way to remove the discrepancy is by taxing unrealized appreciation and pension accruals. It may well be simpler, fairer, and more efficient to provide generally for tax deferral on savings accounts and other forms of saving out of realized income, while taxing eventual disinvestment from savings accounts and capital assets alike at full, ordinary income rates.

This conclusion may be resisted by one who looks to the income tax as a device for curtailing the accumulation of wealth as well as consumption. But the existing income tax has not been fair or effective in relation to accumulation of wealth, and it would not be easy to make it so. Even if it were practical, it is not clear that we should want to tax the accumulation of fresh wealth without some corresponding imposition on existing stocks of wealth. If we are serious about reaching wealth, therefore, it would be better to strengthen and rely on estate and gift taxes for that purpose, focusing the income tax on the consumption component of accretion where it can be made to be most fair and effective.

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Prevailing patterns of thought are reflected in common vocabulary. An accretion-type personal income tax is usually simply called an ideal or comprehensive income tax, personal income being defined to mean accretion.[9] No distinction is thus maintained between practical and ideal bases (money income and real accretion); or at least no name is saved for the former. A consumption-type personal income tax, on the other hand, has been called an expenditure tax, suggesting that it is something quite different from an income tax, indeed somehow its opposite, income and expenditure being contrary notions. This terminology obscures the fact that in practice such a tax would be based on a simple cash flow computation of net yield from business and investment activities, with no more effort to keep direct track of particular consumption expenditures than under the existing income tax.[10]

In this Article, *personal income tax* means any tax whose practical computation is based on personal income transactions. *Income* thus refers primarily to the money transactions that make such a tax a practical possibility. *Consumption*, *accumulation*, and *accretion* refer to real values, accretion being the sum of consumption plus accumulation. The monetary counterparts of consumption and accumulation, which add up to money income, are called *spending* and *saving*. The prevailing prescriptive model of a personal income tax is called an *accretion-type personal income tax*, and a model in which accumulation is comprehensively excluded is called a *consumption-type personal income tax*. The latter is also called a *cash flow personal income tax* because that describes its practical computation. For shorthand it will be convenient often to refer simply to the accretion model or ideal on the one hand, and the consumption or cash flow model on the other. The existing tax is a *hybrid personal income tax* since it conforms to the accretion ideal in some respects and the consumption ideal in others, but neither with any consistency.

The difference between an accretion-type and a consumption-type personal income tax involves only accumulation, and it is in an important

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9. The most familiar instance is in H. SIMONS, *supra* note 1, at 50:

> Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question.

10. There is some tendency to think an expenditure tax base would have to be defined net of tax, since whatever is paid in tax is unavailable for expenditure. Then, to get the equivalent of income tax rates over 50% one would have to have expenditure tax rates in excess of 100%. But there is no more to that point in relation to a consumption-type tax than an accretion-type tax; if tax payments are not part of consumption, they are not part of accretion either. * * * [A]s a matter of computational convenience, it may well be better to define the practical base on a gross basis, as consumption expenditures plus the tax itself. * * * Statutory rates can then be kept on a scale of less than 100%, a scale with which we are familiar, though the effective rate in relation to what is left after tax will sometimes exceed 100% just as it does under present law. *See* note 2 *supra*.

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Throughout this Article it is assumed that in both the accretion and consumption models, as under existing law, taxable income is determined without any deduction for the tax itself.

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sense only a difference of timing. If an item of accumulation is not reflected in taxable income, the tax is not waived but only deferred. Under either kind of ideal, what is ultimately subject to tax is the same—funds or wealth available for private consumption.

This difference in timing corresponds to a difference in methods of accounting for business and investment activities. For a consumption-type tax, accounting should be on a pure and simple cash flow basis.[12] For an accretion-type tax, accounting must be put on something approximating fair-market-value accounting for business and investment assets. Our existing hybrid tax can then be defined in relation to these ideals by reference to its method of accounting, in which the cost of business and investment assets is required to be capitalized but subsequent increases in value are not generally taken into account until realization.

The difference in timing between a consumption-type and an accretion-type tax is, however, immensely important in defining the real burden of the tax. Under the accretion ideal capital accumulation and its subsequent yield are both to be taxed as they occur, and such a tax would cast a heavier burden on some taxpayers than if the tax on capital accumulation is deferred until subsequent disinvestment. Consider a farmer who plants and grows 100 fruit trees. A 30% tax on his fruit, if and when it appears for harvest, with no tax on the growth of the trees unless and until they are disposed of, would leave him with the fruit of 70 trees. But if the Government took 30% of the trees themselves as they mature, and 30% of the fruit of the remaining 70 trees, the farmer would be left with the fruit of only 49. Or, similarly, consider an individual setting aside funds for retirement. A 30% tax deferred until retirement will leave him with 70% as much to spend as he would have had in the absence of tax. A 30% accretion-type tax imposed on the funds as earned and also on the yield from investing what is left, will leave substantially less.

Nevertheless, the consumption and accretion ideals reinforce one another in important ways. Consumption is the major component of accretion for most taxpayers most of the time, and therefore under either ideal, the tax is in the long run mostly a tax on household consumption. The principal purpose of the tax, in terms of real goods and services, is to curtail private consumption so that resources will be released for public uses. What makes a personal income tax the fairest tax we have is that its burdens are generally cast in sensible relation to standards of living.

More particularly, the consumption ideal reinforces the main lesson of the accretion ideal: that distinctions should not be drawn, for personal income tax purposes, because items of income accrue from different sources.

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12. Cash receipts and disbursements accounting as authorized under the existing income tax corresponds to cash flow accounting with respect to accounts receivable and payable.

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I believe, for reasons to be developed, that the consumption model offers better solutions to the question of how to treat accumulation than does the prevailing accretion model. But even if one is not prepared to abandon the accretion model as a goal, the consumption model can help achieve a better understanding of the existing tax by providing another frame of reference for critical evaluation. Indeed, the two models together may provide a kind of binocular or stereoscopic view that will give a better sense of depth and perspective than does either model alone. Studying the model of a consumption-type personal income tax will help us to be more analytic about accretion, separating the problems and implications of taxing its consumption component from those of also including accumulation. That may enable us to see better what can and must be done to preserve the integrity of the tax in relation to the consumption component of accretion, whatever one may further decide to do about accumulation.

The main purpose of this Article is to set forth the model of a consumption-type personal income tax as an alternative for understanding the practical potential of the existing tax. * * *

This Article is only about personal taxes. It is almost entirely about the personal income tax, with some limited reference to estate and gift taxes. * * *

The Value of Deferral

It has sometimes been thought that mere deferral of income taxes was not of great importance so long as every element of accretion was eventually accounted for. Sophisticated taxpayers and their counsel, however, have realized that deferral is often of immense importance, and recent writing on matters of tax policy has come to reflect that realization. Some appreciation of the value of deferral is essential for an understanding of the argument in this Article because the difference between accretion and consumption ideals is essentially one of deferral, and because the defects in present law that make it an unacceptable hybrid arise from inconsistencies in matters of timing.

Deferral may be valuable under existing law partly because it leads to ultimate outright exemption or taxation at lower rates. Unrealized appreciation is completely exempted in the case of property held until death, because no income tax will have been imposed on such appreciation and the succeeding owner is given a stepped-up basis equal to value at or shortly after date of death. Income whose recognition is deferred until after retirement is often taxed at lower rates then than if it had been taxed during higher-income, active employment years, and not infrequently the corollary of deferral is taxation at capital gain instead of ordinary income rates.

But the important, underlying fact is that even if rates do not change and nothing is ever permanently exempted, mere deferral can be immensely important. Deferral reduces the burden of a tax because of the time value of money; it requires less than a dollar put aside today to meet a dollar of tax

liability in the future. The magnitude of the effect, which is a function of interest rates, tax rates, and length of deferral, can be illustrated by several examples.

Productive Investment

The fruit farmer in the introduction is one example. A 30% tax on the growth of his 100 trees when they reach maturity would leave 70 trees, and an annual 30% tax on the fruit thereafter would leave the taxpayer each year with the fruit from 49. On the other hand, if all tax on the trees could be deferred until the trees were disposed of, with a current tax being imposed only on the fruit harvested, the taxpayer would keep 70% of the fruit of 100 trees, which is 42.9% more than the fruit from 49.

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Retirement Income

Consider a dollar of earnings put aside for retirement. Assume this sum is invested at 9% compound interest, and that it is to be utilized 24 years later. In the absence of tax the one dollar set aside would support eight dollars of retirement consumption 24 years later.

Now consider the effect of a 33% accretion-type tax. This would take away one-third of the original dollar when earned, leaving only 67 cents to invest; and it would cut the rate of growth from 9% per annum to 6%. At 6% per annum for 24 years, 67 cents will produce a retirement fund of only \$2.67, as compared with \$8.00 in the absence of tax. On the other hand, if the tax were deferred until retirement, the taxpayer would pay only \$2.67 tax out of \$8.00, leaving \$5.33 to spend. Deferral of the tax, without any change in rate, would double what the taxpayer has left to spend.

The effect is greater for higher interest rates, higher tax rates, and longer periods. A dollar held at 12% for 36 years, for example, would produce a fund of \$64. A 70% true accretion-type tax would reduce the original dollar to 30 cents, and the rate of growth from 12% to 3.6%. At 3.6%, 30 cents will grow to about \$1.07 in 36 years, which represents a reduction from \$64.00 of about 98.3%. A 70% tax deferred until retirement would take only \$44.80 out of \$64.00, leaving \$19.80 to spend. This is more than eighteen times the amount left by a 70% tax imposed on a true accretion basis.

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The Existing Hybrid Treatment of Accumulation

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[M]any of the most intractable problems in the personal income tax arise directly out of the hybrid character of our treatment of accumulation. The complexities of corporate distributions and reorganizations, for example, at the individual taxpayer level, all have to do with matters discussed here: realization and nonrecognition, basis determination and recovery, capital gain or ordinary income treatment, and treatment of debt. Other seemingly, simpler provisions like that governing installment sales, have essentially to do with deferral or nonrecognition. The trust and partnership provisions

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involve complex problems of defining when gain will be recognized by individuals and whether it will be capital gain or ordinary income. The partnership provisions, in particular, have very complex provisions concerning the determination and recovery of basis, and the treatment of partnership borrowing. The whole matter of qualified pension and profit-sharing plans is primarily one of deferral, and other compensation schemes, like stock option plans, are designed to defer recognition of gain and to secure capital gain treatment when recognition occurs. Most of the problems that occupy most of the time of tax practitioners and administrators (not to speak of teachers, students, legislators, and taxpayers themselves) arise immediately out of our failure to take a consistent and comprehensive position with respect to inclusion or exclusion of real accumulation in taxable income.

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True Accretion Treatment of Accumulation

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A true accretion-type personal income tax would be free of many of the complexities and inequities of the existing tax. But a true accretion-type tax is hardly attainable in practice. Even a rough approximation of an accretion-type tax would require an utter transformation of the practical administration and computation of the tax from one depending mostly on cash transactions to one in which current, comprehensive property valuation would play a central role. In practical operation the tax would become largely an incremental net wealth tax as well as a tax on income transactions.

Any partial step in the direction of fuller reflection of total accretion remains a compromise in which inconsistencies are inevitable. Some compromises are undoubtedly better than others, and some of our existing problems could probably be ameliorated by fuller reflection of real accretion, but no practical solution in this direction offers anything approaching the simple practicality of a consumption-type or cash flow personal income tax.

A Consumption-Type Personal Income Tax

A consumption-type personal income tax is often assumed to involve all the practical difficulties of the existing personal income tax plus whatever new ones are involved in getting from income to consumption expenditure. The tax would, of course, be computed on personal income plus or minus net dissavings or savings, and discussion has focused on how much additional difficulty the adjustments for saving or dissaving would produce.

This discussion overlooks the fact that a consumption-type tax would avoid all the difficulties that arise from the failure of money income to provide a satisfactory reflection of real accumulation. Income, to be sure, includes savings, and savings are a partial, imperfect, monetary measure of accumulation. A consumption-type tax requires deductions and additions to eliminate savings and dissavings. But these, being based solely on money

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transactions, are incomparably simpler than either making adjustments to include unrealized appreciation under a true accretion-type tax or living with the complexity and distortion that result from the existing hybrid treatment of accumulation.

Under a consumption-type personal income tax, capital transactions are treated on a simple cash flow basis. Investments are simply deducted when made and proceeds of sales and other capital transactions are added to income when received. All that is required is to separate business and investment activities on the one hand from personal consumption activities on the other, as under present law, and then to keep track of the former on a cash flow basis. Cash flow accounting for business and investment activities automatically provides a measure of cash spent on consumption activities, which is what we are after.

Precise measurement of current consumption spending would require exact accounting for cash and loan balances which might be something of a nuisance. But in practice there is no need for precision because only short term tax deferral or acceleration and relatively small amounts are involved. Ordinary cash balances, including checking accounts and consumer loans, can therefore be left wholly out of account. In effect, both ordinary cash balances and consumer loans can be treated as falling in the consumption sector of an individual's activity rather than the business or investment sector, without any significant distortion of tax burdens.

A precise measure of current consumption would also seem to require separation of consumption from the investment element in the purchase of consumer durables. Strictly speaking it is the current use value rather than the purchase price of an automobile, for example, that constitutes consumption. But again strict precision is unnecessary. The purchase price for a durable item represents the discounted value of its future usefulness, and the tax burden will tend to be the same in the end whether one is taxed or the other. Therefore, it would be acceptable to deal with the consumer durable problem on a simple cash flow basis, although it may be desirable in some cases to give taxpayers the option of deferring taxation on part of the purchase price with interest. Because purchase price can be taken as a proxy for use value, the consumer durable problem is much more manageable under a consumption-type tax than under a true accretion-type tax. Under the latter, the money invested should be taxed when earned, and the imputed return received in the form of use value should also be taxed.

One of the general advantages of a consumption-type tax is that short-term deferral in the interest of simpler administration can be more readily tolerated than in the case of an accretion-type tax. Under a consumption-type tax the benefit of deferral is offset by a corresponding increase in the amount subject to tax at a rate equal to whatever interest rate the market charges the taxpayer for extensions of credit. No such offset occurs under an accretion-type tax where postponement has the effect of reducing the effective

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rate of taxation on income. Reverting to the example of the fruit farmer, it makes no difference whether we tax the growth of trees or the fruit under a consumption-type tax, because the ultimate burden is the same either way. Under an accretion-type tax it makes a substantial difference whether we tax the trees because we are supposed to tax the fruit, too, in any event, and a tax on both is substantially more burdensome.

These general observations are elaborated in the following discussion of how particular items would enter into the practical computation of a consumption-type personal income tax.

Ordinary Income

Ordinary income—wages, salaries, fees, dividends, interest, rent, and so on—would be treated exactly the same way under a consumption-type personal income tax as under any other personal income tax. They would be fully includable in taxable income for the period in which received and would continue to form the backbone of the tax. Withholding from salaries and wages could be continued as under the existing tax, and it could just as readily be extended to dividends and interest. Most people spend most of their ordinary income for current consumption, and to that extent a consumption-type personal income tax would be no different from the existing tax. Deductions and additions to reflect savings and dissavings would for most taxpayers be in the nature of relatively minor adjustments that would not impair the general relationship between the tax and ordinary income as its chief determinant and as the source of funds with which to pay it.

Similarly, ordinary, current deductions, business and personal, would be essentially unaffected by the shift to a pure consumption-type tax because they are addressed to the consumption rather than the accumulation component of accretion. Ordinary personal deductions for medical expenses, charitable contributions, and alimony, for example, would have the same justifications and problems as under existing law. Furthermore, personal exemptions and a standard deduction could readily be continued under a consumption-type tax.

Ordinary Investments

The most obvious difference about a consumption-type income tax would be that ordinary investments would be accounted for on a pure cash flow basis. The cost of investment assets would be deductible in the year paid, while the proceeds of sale would be fully included in taxable income in the year received. This does not necessarily mean there would be a large tax in a year when substantial sales are made, since it is likely that taxable proceeds would be largely offset by deductions for reinvestment in that year, or for extraordinary, yearend cash balances.

There is a tendency to think of this treatment of investment assets as involving at least some complication over and above the existing income tax treatment, because in a year when part of a taxpayer's income is invested a deduction must be claimed. But this is viewing the matter in too narrow a

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time frame. Under the existing income tax the cost of an investment cannot be ignored; it must be recorded for future use as a basis either for amortization or in computing gain or loss on sale or other disposition. Surely it is simpler in the long run, for taxpayer and Government alike, to have deductions based on investment costs paid during the current year rather than on costs incurred in several past periods, some quite long ago. * * * [J]ust as a matter of accurate accounting and reporting, cash flow treatment of ordinary investments would represent a vast simplification.[89]

Moreover, this treatment of ordinary investments would eliminate a whole host of complications in the existing income tax beyond the mere ascertainment of historical costs. Individual taxpayers would no longer compute depreciation or use other forms of cost amortization, since business and investment costs would be simply deducted forthwith. Furthermore, there would be no problems concerning realization and nonrecognition of gain or loss when an individual changes investments. If a taxpayer receives new investment property in exchange for old, or as an increment to old property in the case of a stock dividend or other dividend in kind, it would make no difference whether the transaction is one on which gain is realized and recognized under present law, since any gain recognized would in effect be offset by a deduction for the fresh investment. Thus, in the case of an exchange of securities there would be no need to determine whether it is pursuant to a plan of reorganization, since the deduction for reinvestment would offset any gain recognized. The whole law of corporate reorganizations as it bears on individual investors would be rendered obsolete.

Cash flow treatment of ordinary investments would also resolve present problems about when to account for compensation for services in the form of investment property such as stock bonuses or restricted property.[91] Again, cash compensation that the recipient invests would incur no tax; therefore no tax need be imposed on compensation paid in kind in investment property. Tax would properly await sale of the investment property and devotion of the proceeds to consumption expenditure in either case.

Finally, and above all, this treatment of ordinary investments would eliminate any need for special rates of tax on capital gains. The best justification for capital gain rates is to mitigate the disparity in treatment between unrealized gains and realized but reinvested gains. A cash flow treatment of ordinary investments would eliminate that disparity entirely. Proceeds from the sale of investment property would be taxed only if devoted to personal consumption, in which event there would be no reason to distinguish them from ordinary earned income also directed to consumption.

89. Immediate deductibility of capital expenditures, partly for the sake of accounting simplification, is familiar under present law.

91. *See* CODE §83 (dealing with compensation in the form of property to which restrictions are attached).

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Less persuasive justifications for capital gain rates would also be inapplicable. The argument based on inflation would be met by the fact that no tax on the accumulation represented by the initial investment would have been paid in uninflated dollars, as it would have been under an accretion-type tax. * * * Even the notion that capital gain rates are justified to offset the hardship, given progressive tax rates, of realizing in one year a gain accrued over many would be met, since only proceeds devoted to current consumption would be subject to tax.

Business and Investment Loans

Business and investment loans would be treated, just like ordinary investments, on a simple cash flow basis. Loan proceeds would be reported as income in the year received, and repayments of interest and principal would be deductible when paid. This treatment is unfamiliar, but would represent a clear net simplification for reasons similar to those favoring a cash flow accounting for ordinary investments.

Cash flow accounting for loans, as for investments, is only a matter of reporting currently events that would have to be recorded for future reference under the present tax or an accretion-type tax. While we do not tax loan proceeds as such under present law, we do tax forgiveness of indebtedness, or satisfaction of indebtedness by the conveyance of appreciated property, even when the result is a substantial tax liability in a year in which there are no cash receipts with which to pay the tax.[95] A record of money received and repaid on account of loans must be accurately kept in order to compute such gains. Cash flow accounting is only a matter of taking each receipt and payment into account in the year when it occurs.

Inclusion of loan proceeds in income would not ordinarily require large tax payments in the year of a loan, because normally such loans are to pay for capital investment that would be immediately deductible under a consumption-type tax. * * *

Consumer Credit

A strict computation of current consumption would seem to require that consumer loans and credit, like business and investment loans, be treated as income when incurred and deductible when repaid. But it is much simpler and quite acceptable just to leave ordinary consumer loans and credit arrangements out of account. The effect of that is to treat payments on account of consumer loans, rather than the use of the loan proceeds, as taxable consumption expenditures. * * *

Consumer Durables

* * *

Theoretically, under a consumption-type tax, the purchase price should be deductible like any other investment, and rental value should be imputed

95. *See* Crane v. Commissioner, 331 U.S. 1 (1947); United States v. Kirby Lumber Co., 284 U.S. 1 (1931); Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951).

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to the owner over the useful life. But in practice imputed rental value is adequately reflected, on a discounted basis, by the purchase price. * * * The practical thing to do, therefore, is to treat the purchase of [a consumer durable such as] a personal automobile like any other consumption expenditure, ignoring its investment aspect. This is accomplished by simply leaving such a purchase out of account in computing taxable income, thus making the expenditure subject to tax. * * *

When an automobile is purchased on credit, the loan should be treated as a consumer loan. In practice, therefore, neither the purchase of the automobile nor the loan would enter into the computation of taxable income, and the result would be that consumption use of the automobile would be reflected in taxable income each year in the amount of payments of principal and interest on the loan.

If consumer durable purchases in a particular year were substantial in amount, it might be appropriate to permit a taxpayer to defer them over a limited period, even if they were not financed by borrowing. The procedure would be to claim a deduction in the year of purchase but then to return the deducted amount to income with interest. * * *

Owner-Occupied Housing

Similar general conclusions apply to owner-occupied housing, which undoubtedly represents the most substantial item of consumer durable investment made by most taxpayers. Purchase price, however, is a less acceptable proxy for use value in the case of very longlife items like housing, because tax rates may change and property may go up or down in value for reasons not anticipated at the time of purchase. Nevertheless, it is still the case that the existing treatment of owner-occupied housing is more nearly consonant with a consumption-type model than with a true accretion-type model. Furthermore, whatever accommodations may be made to ease practical computation represent less of a distortion or departure from a consumption ideal than from a true accretion ideal.

A strictly correct treatment of housing would be to allow a deduction for purchase price and capital expenditures, but then to impute full rental value, with periodic changes in imputed rental to reflect market changes. This would involve the difficulties of real estate assessment and valuation on a national scale. It would also involve a duplication of the hardship that is now perceived by some to result from increasing real estate taxes in the case of elderly homeowners who do not have any corresponding increase in money income with which to pay those taxes. The fact is that home ownership during a period of rising real estate prices operates to allow older people to live in houses that are more expensive than they could afford to move into now, and that effect may be judged to be generally desirable. Furthermore, we may feel we do not want our income tax to impair that aspect of homeownership by creating a tax liability that increases over time and that can only be met by having an increasing cash income. The economics of

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homeownership allow a person to buy a home for a lifetime out of the earnings of his relatively early productive years at price levels prevailing when he makes his initial purchase. It may well be enough for the income tax law to take this economic situation as it is and be satisfied with taxing a person on the cash expenditure it takes to provide lifetime housing, as the expenditure is made.

The treatment of owner-occupied housing then would be virtually the same as under present law, except that there would be no deduction for mortgage interest, and there might be an option to deduct an initial downpayment, returning it to income over a short period of years with interest added annually to the deferred balance at a specified rate.

Proceeds on the sale of a house would present some new problems. The present rule permitting a homeowner to sell at a profit without tax if proceeds are reinvested in another principal residence should be continued.[103] This rule, for example, enables a person to move and purchase comparable housing in another location, without making the additional investment that would be required if he had to pay a tax on the heretofore unrealized appreciation on his first home. Profit on the sale of a house not reinvested in another residence would be included in taxable income, though no tax would be paid if proceeds were invested in any ordinary investment assets.[104] The new question would be whether that part of sale proceeds that represents a return of basis or costs and is not reinvested in housing should be able to be spent for other consumption on a taxfree basis on the ground that it represents a refund of money on which consumption tax has already been paid. The answer to that question should probably be yes, and again that answer is in accord with present law under which the sale proceeds from a house, to the extent they represent return of basis rather than profit, are freely available for consumption spending.[105]

Finally, it should be reemphasized that any practical solution to the problem of owner-occupied housing is more consonant with the consumption model than with the accretion model. The accretion ideal requires that the purchase price of a home come out of after-tax income because it is an item of accumulation, and then it requires that there be further additions to

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103. CODE § 1034.

104. This would avoid the problem that exists under present law of a recognized capital gain when people sell their home to move into rented quarters. It would largely obviate the need, therefore, for CODE § 121 (gain on sale of residence by a taxpayer aged 65 [now 55] or older partly excluded from taxable income).

105. The law might provide that proceeds from the sale of a house, to the extent that they represent a return of cost or basis, would not be included in taxable income. In addition, if the funds representing a return of cost were invested, the taxpayer would get a deduction for the investment itself, but would be taxed on subsequent disinvestment and consumption. Alternatively, one could grant no deduction for the investment of such funds, but instead give the taxpayer a cost basis in the assets purchased. When the investments were then later liquidated and spent for consumption, the proceeds would be excluded from income to the extent to that basis.

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taxable income to reflect both imputed rental income and unrealized appreciation. The existing treatment of housing falls short of the accretion ideal immediately upon purchase and occupation of a home, without any change in value, by reason of failure to include imputed rental income. As a house increases in value, existing treatment falls doubly short by failing to include both an increase in imputed rental income and the appreciation in value as such. By contrast, existing treatment (except for deductibility of mortgage interest) is initially consistent with the consumption ideal since taxation of the purchase price serves as a proxy for taxing imputed rental value. * * *

Fairness and Efficiency

* * *

It may nevertheless be objected that a saver is not to be viewed as a philanthropist contributing more to society than he withdraws. Accumulation is not consumption foregone; it is consumption deferred. Since a saver has not given up the claim against future output represented by his accumulated income, what reason can there be to exempt him from tax upon it?

But the issue as between an accretion-type and a consumption-type tax is not one of exemption; it, too, is only one of deferral. Under a consumption-type tax, deferred consumption is subject to deferred tax. Of course, deferral makes a difference, and in general the burden of a deferred tax is less than that of an immediate tax at the same rate. * * * But to say the burden of a deferred tax is less does not indicate which kind of tax is fairer. The most sophisticated argument in favor of a consumption-type tax is that the lesser burden of a deferred tax is more appropriate because it ultimately imposes a more uniform burden on consumption, whenever it may occur, than does an accretion-type tax. Put the other way around, a consumption-type tax is preferable because an accretion-type tax imposes an excessive burden on deferred consumption.[119] Neutrality with respect to consumption is important not only because it promotes efficiency in the allocation of income, but

119. An accretion-type tax is sometimes defended by reference to neutrality, treating saving as just one more thing a person may do with his income. A consumption-type tax, it is said, would impose a penalty on spending as compared with saving. *See* Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 46 (1967). Or, more elaborately, it is said that saving must involve some combination of satisfactions equal to what could have been derived from a little more spending at the margin; otherwise the person would have spent more and saved less. *See, e.g.*, Aaron, *What Is a Comprehensive Tax Base Anyway?*, 22 NAT'L TAX J. 543, 544 (1969).

But this line of reasoning is essentially like an argument against the deductibility of business expenses—one must get as much pleasure from a business expenditure as from a personal consumption expenditure, at the margin, or else he would make more of the latter and less of the former. What we recognize immediately, of course, with respect to a business expense is that satisfactions to be derived from it may be at least one step removed. * * * Saving, similarly, can be viewed as an instrumental expenditure, made as a means of supporting future consumption. The way to achieve neutrality between ultimate ends—future and present consumption—is, as we have seen, to exempt savings, not to tax them.

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because it keeps the tax from bearing more heavily on one person than another on account of differences in need or taste for particular goods or services, now or in the future.

Consider again the case of a working person who puts $100 aside for retirement. At 9% compound interest, in 24 years it will grow to $800. A tax of 33% imposed on a consumption basis would take 33% of $800 leaving $533 to spend. A 33% accretion-type tax would cut the $100 to $67 at the outset, and cut its rate of growth from 9% per annum to 6%. At 6%, the $67 would double only twice making $267, or just half what is left under a consumption-type tax. The effective rate of tax in relation to consumption ultimately supported by the earnings in question is thus not 33% but 67%. All this is without even taking account of graduated rates, which are likely to make the relative burden of an accretion-type tax even heavier by subjecting earnings to high-income rates even when put aside to support consumption in low-income retirement years.

The logic of a consumption-type tax is that a 33% taxpayer who would have had $800 to spend in the absence of tax should have $533 after tax whatever combination of earnings and savings may have gone to produce the $800. An accretion-type tax is discriminatory because it will leave much less for the retiree whose potential $800 is the product of work and saving than for another taxpayer with $800 of current income.

Mill called the discrimination of an accretion-type tax against deferred consumption a double tax on savings, once as they accumulate and again as they produce their own return.[121] Unfortunately, ensuing discussion has sometimes focused more on definitional than on substantive issues; the accumulation of savings and earnings of a return on the accumulation represent separate items of income or accretion, it is said, and therefore taxing both does not represent double taxation of a single item. For all the argument, no careful writer seems to have denied that an accretion-type tax imposes a heavier ultimate burden in relation to deferred consumption than to current consumption.

This discussion of neutrality has only to do with neutrality as to expenditures. A personal income tax is not neutral by any means, unfortunately, with respect to questions of productivity—how hard to work and how much, what risks to take with capital, and so on. Either a consumption-type or an accretion-type personal income tax will have substitution effects in favor of leisure over work, and, less clearly, in favor of conservative over risky investment. While both types of taxes are biased with respect to these things, a consumption-type tax is apparently less so.[123] This is an important advantage, though collateral, as it seems to me, to preserving expenditure neutrality between present and deferred consumption.

121. J.S. MILL, *supra* note 7, at 545-46.
123. *See* N. KALDOR, *supra* note 7, at 102-14.

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Insofar as accumulation is viewed as deferred consumption, a consumption-type tax seems fairer and economically more efficient than an accretion-type tax. If an accretion type tax is to be preferred over a consumption-type tax it must be because accumulation somehow represents something more than deferred consumption, something that would not be adequately captured or reflected or burdened by the deferred imposition of a consumption-type tax if and when consumption ultimately occurs.

* * *

Notes and Questions

1. Why does Professor Andrews term the measurement of income by the Haig-Simons definition an "accretion" measurement?

2. The assertion that the accretion measurement overtaxes savings is central to the proponents of consumption-type taxes. (Professor Gunn's excerpt in subchapter C challenges this assertion.) What examples of asserted overtaxation of savings does Professor Andrews offer?

3. Accretion and consumption are not the only possible models of the ideal tax base. The realization model—which present law tracks to a considerable degree—could be viewed as an ideal. See Chapter Two; see also Professor Gunn's defense of present law (and not of the accretion ideal) in subchapter C. Most scholars, however, now regard present law as a hybrid of the accretion and consumption ideals.

Mechanics of Professor Andrews' proposal

4. The ultimate tax base of the consumption-type income tax is consumption, not income (or accretion). Yet the first step in computing the tax base is quite similar to that of present law—initially including all income in the tax base, without regard to whether the income was consumed or saved. If the tax base is consumption, why start with income?

5. Most taxpayers consume the great bulk of their after-tax incomes. For such taxpayers, the tax base under either an income tax or under the proposed consumption-type tax would be almost the same. "[U]nder either ideal," Andrews observes, "the tax in the long run is mostly a tax on household consumption."

6. Does "consumption" include money paid in taxes? Consider a taxpayer who earned $50,000, but whose employer withheld $10,000 for taxes and paid only the remaining $40,000 to the employee. If the employee spent the $40,000 on consumption, should the taxpayer's consumption-tax base be $40,000 or, as under Professor Andrews' proposal, $50,000?

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7. A tax-exclusive base could lead to extremely high nominal tax rates. Suppose the consumption tax base did not include taxes. What rate of consumption taxation would be necessary to equal the effect of an income tax rate of 50 percent for a taxpayer who spent all after-tax income on consumption? What rate would be necessary to equal an income tax rate of 75 percent?

8. Professor Andrews argues that failure to tax consumption results in permanent tax avoidance, while failure to tax appreciation (or "accumulation") generally results only in moving the tax burden to a different year. Why is this generally true? Does this description hold true in all instances of accretion, such as appreciated property held until death?

9. It might be argued that an income base is to be preferred to a consumption base, because tax liability should take account of wealth as well as current living standards. Professor Jeff Strnad argues that two of the principal "norms that have motivated scholars and policymakers to favor accretion taxation" are wealth-based: "The first norm is that intangible benefits from holding wealth should be taxed. The second norm is that the tax system should address disparities in wealth as well as disparities in consumption."[f]

On what grounds does Professor Andrews reject the argument that an income tax effectively and appropriately addresses differences in wealth?

10. Do transfer taxes (estate and gift taxes) have any role to play in Andrews' proposed system?

11. Many advocates of consumption taxation, including Andrews, support transfer taxes. One reason is that the consumption-type tax will not reach income at any time during life, or at death, if the income is not consumed but is passed on to heirs. (Even then, the consumption tax is merely delayed—until consumption occurs by the heir. This delay, however, could extend indefinitely—for generations.)

The Simplification Claim

12. Why does Professor Andrews contend that his consumption tax would be less complex than either current law or the accretion ideal? (Reserve judgment on the simplification issue until you have studied subchapter E, which presents actual proposals for implementation of consumption-type taxation.)

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f. Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817, 1820 (1990).

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13. Why might such disparate provisions of current law as payments of compensation in the form of stock of the employer, corporate reorganizations, and exchanges of like-kind business or investment property be simplified under a consumption-type income tax?

14. Why would Professor Andrews count items such as cash balances and checking account balances—amounts clearly not consumed in fact—as consumption? How would you expect taxpayers to react to such a legal rule?

15. A taxpayer's expenditures for plant and equipment are usually deducted over a period of years (i.e., depreciated) under present law. How would such costs be recovered under a consumption-type tax? Why the different treatment?

16. Under present law, one source of controversy is whether a given expenditure should be viewed as an ordinary business expense such as a repair (which is "expensed," or immediately deducted), or treated as a capital expenditure (which is capitalized and deducted over time). Under the consumption-type taxing method, the expenditure would be immediately deducted either way, ending this source of controversy.

17. Under present law, neither loans nor repayments of loan principal have tax effect. Under Professor Andrews' proposal, the proceeds of many loans would be taken into the tax base, while the repayment of those loans would give rise to a deduction. What is the justification for this treatment? What would happen in the case of cancellation of indebtedness, which is generally taxable under current law?

18. Professor Andrews suggests treating consumer loans differently, giving no tax effect either to the loan or to its repayment. Why?

19. How should a consumption-type tax deal with consumer durables, such as automobiles, in theory? How would Professor Andrews deal with them? Why?

20. What is the theoretically correct treatment of housing under Professor Andrews' proposal? What, instead, does he advocate? Why?

21. What should happen under Andrews' proposal when a taxpayer sells a house?

Capital gains

22 How would capital gains taxation work under the consumption-type tax? What problems of current law would be reduced or eliminated?

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23. One of the major justifications of favorable capital gains treatment is that the gain may be illusory, the result of inflation rather than real gain. Traditionally, capital gains have been taxed much more gently than ordinary income, in part due to the inflation factor. Another suggestion is to index the basis of capital assets to adjust for inflation, but complexity, among other problems, would result. (See Chapters Fifteen and Sixteen.)

If the consumption-type tax were in place, the taxation of capital assets would seem devoid of the inflation problem. There would be no basis; at the time of purchase, a full deduction of the amount of the purchase price would be granted, so no inflation adjustment would be justified. Upon disposition, the total amount realized would be taken into account and taxed in that year, and again no inflation adjustment would be necessary.

Suppose this system had been in place for many years, and that a taxpayer who purchased stock in 1960 for $7,000 sold the stock in 1996 for $10,000, thus realizing a nominal gain of $3,000. Obviously, the "gain" would be illusory, because 7,000 1960 dollars would be much more valuable than 10,000 1996 dollars. Assuming a tax rate of ten percent, the taxpayer's "losing" investment would generate $300 tax in 1996. This is troubling under the present income tax; the nominal gain is taxed despite the fact that the transaction resulted in a "real" loss.

Under the consumption-type tax, the problem is automatically cured. Still assuming a 10 percent tax rate, the deduction of $7,000 in 1960 is worth $700 *in 1960 dollars*; when the $10,000 amount realized is taxed in 1996, it results in $1,000 tax *in 1996 dollars*. If, in fact, inflation means that the "real" value of the sales proceeds are worth less than the "real" value of the initial investment, so will the "real" tax on the proceeds be worth less than the "real" value of the deduction granted when the investment was made.

Asserted consistency of consumption-type income tax

24. Why do proponents of consumption taxation contend that unrealized appreciation is more troubling to the income tax system than to a consumption-type system?

25. Is our present federal income tax a consumption tax, or an accretion tax? In what ways does it resemble each?

26. To say that a tax system is entirely coherent and follows its "ideal" pattern at all times is not to say that it is a good system. For example, if our basic system were a head tax, requiring exactly $1,000 in annual tax from each person, there would be no inconsistency about how to handle capital gains or unrealized appreciation or any other of the thousands of perplexing questions under our tax law—the head tax would call for the same amount of tax regardless of any of these events. It does not follow that we should adopt a head tax in place of the income tax.

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27. Would a tax in the form proposed by Professor Andrews more closely resemble a point-of-sale consumption tax, such as a comprehensive sales tax or European-style value added tax, or our present income tax? Consider factors such as tax base, vertical and horizontal comparisons of tax liability, and administration.

C. THE INCOME TAX DEFENDED

While the consumption-type income tax has created considerable academic and political interest, many experts defend income as the more appropriate tax base. The excerpts in this subchapter provide a sampling of three very different types of defenses.

Professor Warren analyzes the issue from an extremely academic, and arguably socialistic, perspective. He argues that each member of society who generates income does so as part of a social system; accordingly, society should have first claim on the income produced, and society should decide what portion of that income the individual producer is to retain.

Professor Gunn counters what is perhaps the central justification for consumption taxation—the assertion that an income tax overtaxes saving vis-a-vis consumption. Addressing examples of Professor Andrews and other advocates of consumption taxation, Professor Gunn argues that saving is taxed fairly by the income tax.

Finally, we consider Treasury I, whose drafters found considerable merit in a consumption-type income tax. Ultimately, however, they rejected it for a number of theoretical and practical reasons.

WOULD A CONSUMPTION TAX BE FAIRER THAN AN INCOME TAX?

Alvin Warren*

89 Yale Law Journal 1081, 1090-93 (1980)

Using the Haig-Simons concept of income in order to compute each taxpayer's share of the annual social product, an income tax serves to deflect to the government a progressive portion of each citizen's share of the product otherwise allocated to him by transfers and the marketplace. Whether the tax proceeds are used for public goods and services or for redistribution to some persons, either in cash or in kind, those uses are funded by the output of labor and private capital during the current period. Levying the tax on income is on this view simply a logical concomitant of the proposition that society in general has a claim on its annual product that is prior to the claims of its individual citizens.

The existence of a collective claim on privately produced resources is so well-established as part of our polity that justification may seem superfluous. Nevertheless, economic theorists have formally shown that certain goods and

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services are best produced in the public sector,[31] while political theorists have argued for centuries over the nature and extent of the collective claim for redistributive purposes, a subject that has commanded renewed attention in recent years.[32] But neither the theories of public goods nor those of distributive justice have depended on the source of revenues used for the two analytically distinct governmental purposes. Discussions of redistribution generally either have considered the appropriate distribution of economic resources without identifying the best measure of such resources or have assumed that it is income (as product) that is or is not subject to a collective claim. As a result, existing theories of distributive justice and public goods have little to add to the case for the income tax beyond establishing a social claim on private resources.

Specifying that claim as on social product can be justified on the theory that a producer does not have a controlling moral claim over the product of his capital and labor, given the role of fortuity in income distribution and the dependence of producers on consumers and other producers to create value in our society—factors that create a general moral claim on all private product on behalf of the entire society.[33] This rationale would apply *a fortiori* to other increments in Haig-Simons income, such as gifts and windfalls, which come to the recipient without even the claim due to production. Such a proposition is, of course, no more demonstrable than the proposition that society has a prior moral claim on wealth or consumption rather than on product. As Professor William Andrews has stated, the ultimate choice among these alternatives is not a matter of logical proof but of exposing the assumptions and identifying the consequences of each.[34]

Given that limitation, the case for taxing income can be stated by identifying as a plausible assumption the view that, for the reasons suggested above, the distribution of social product is a matter for collective decision. The collective decisionmaking apparatus of the society is conceived of as deciding both the amount and type of public goods to be produced and the distribution of that portion of private social product that remains after diversion of resources into the public sector to produce those public goods that are not financed by service charges. Whatever after-tax distribution is

31. *See, e.g.*, Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. & STATISTICS 387, 387-89 (1954); Samuelson, *Diagrammatic Exposition of a Theory of Public Expenditure*, 37 REV. ECON. & STATISTICS 350 (1955).

32. The seminal work in rekindling interest in distributive justice is J. RAWLS, A THEORY OF JUSTICE (1971).

33. *See id.* at 72-74, 100-08, 310-15. For a recent argument that treatment of an individual's genetic endowment as an accident devoid of moral significance is inconsistent with basic concepts of individuality, see Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103, 128 (1979).

34. Andrews, *Fairness and the Choice Between a Consumption-Type and an Accretion-Type Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947, 950 (1975).

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decided upon, that decision is implemented by the income tax, which is levied on the amount of social product otherwise distributed to each taxable unit.[35]

As anticipated, this argument for the income tax does not appeal to some independently demonstrable principle but is tautological in the sense that it follows simply from the premise of the tax: given a legitimate social concern with the distribution of society's product, the income tax is justified as a means of effecting the desired after-tax distribution. The nature of the desired distribution goes to the content of the tax, rather than to its justification. Extreme egalitarianism would presumably argue for a tax characterized by progressivity, culminating in a confiscatory rate on positive income with corresponding provisions specifying a minimum after-tax income. A social decision to reduce inequality in the distribution of product, but not to the extent of eliminating incentives to work and invest, might lead to less progressivity with rates always under one hundred percent. It is a judgment of this latter type that seems to underlie much current discussion of distributive justice.[36]

Unlike the foregoing argument, the traditional case for the income tax in terms of fairness has appealed to some external standard to establish that income is an appropriate basis for taxation. Generally it has been argued that income is a superior index of an "ability to pay," and that the tax should be structured to result in "equal sacrifice" by taxpayers, the latter being especially relevant to the rate structure. Unfortunately, centuries of elucidation have failed to provide sufficient content to these concepts. For example, ability to pay has been defined as "the capacity of paying without undue hardship on the part of the person paying or an unacceptable degree of interference with objectives that are considered socially important by other members of the community."[37] Such definitions reduce to statements that society should appropriately tax what it should appropriately tax. This approach is no less tautological than the one taken here; it just appears so in that apparently, but not really, independently verifiable grounds, such as ability to pay, are said to justify the tax.

To summarize, the personal income tax follows from, and is justified by, a societal judgment as to the appropriate distribution of social product or personal income. Society's interest in the distribution of income, in turn, depends on the view that the importance of fortuity and the interrelationships of contemporary society deprive producers of a controlling

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35. This view includes the possibility of negative taxes and assumes that the desired after-tax distribution of income is a function of no personal characteristic other than pretax income. For example, if after-tax income were to be allocated on the basis of weight, intelligence, merit, or whatever, the Haig-Simons definition could be used for collection of revenue, but not for the simultaneous achievement of a given after-tax distribution.

36. *See*, *e.g.*, A. OKUN, EQUALITY AND EFFICIENCY—THE BIG TRADEOFF (1975); J. RAWLS, *supra* note 32, at 150-61.

37. R. GOODE, THE INDIVIDUAL INCOME TAX 18 (1964).

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moral claim to what would be distributed to them in the absence of a tax system.

* * *

THE CASE FOR AN INCOME TAX

Alan Gunn*

46 University of Chicago Law Review 370, 370-78 (1979)

Recent studies by the United States Treasury Department[1] and the Meade Committee[2] in England recommend a progressive tax on personal consumption as an alternative to an income tax. Neither adds anything fundamental to the expenditure-tax controversy, but each contains one intriguing feature: a discussion of the practical problems of substituting consumption for income as the tax base.[3] This development may mean that the replacement of the income tax by an expenditure tax should be taken as a serious practical possibility. And even if the possibility of so radical a change in our tax structure is remote, the arguments of the expenditure-tax theorists may encourage changes in the income tax in the form of additional relief for savers or a supplemental tax on expenditure. The time when the expenditure tax could be dismissed as lacking practical significance has long passed.

Arguments based on considerations of equity, administrative convenience, and economic efficiency play an important role in the case for an expenditure tax. I will not address the question of "efficiency" directly, although some of my "equity" arguments may bear on efficiency as well as equity. I will focus on the most important noneconomic issues in the debate between expenditure and income taxation: whether an income tax imposes "double taxation" on savings, [and] how income compares with other bases for taxation in terms of fairness.[5] * * *

The Expenditure Tax, the Income Tax, and the Double Taxation of Savings

The Basis of Expenditure-Tax Theory

The earliest proposal for an expenditure tax that is still cited today was made by Thomas Hobbes. Hobbes thought consumption to be the best tax base because it measures the benefits taxpayers receive from society; an

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1. DEPARTMENT OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977) [hereinafter cited as BLUEPRINTS]. This report presents two alternative "model tax systems"—an expenditure tax and a comprehensive income tax with rates much less progressive than the existing rates—without choosing between them.

2. INSTITUTE FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION (1978) [hereinafter cited as MEADE COMMITTEE REPORT].

3. BLUEPRINTS, *supra* note 1, at 204-12; MEADE COMMITTEE REPORT, *supra* note 2, at 187-92.

5. The tax base defended here resembles that of the existing federal income tax, tidied up somewhat, perhaps, but not fundamentally altered. I have no desire to defend an "ideal" tax based on the Haig-Simons definition.

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expenditure tax would charge individuals equally in proportion to the goods they withdraw from the common stock. Hobbes's ideas are recognizable in the position of some modern expenditure-tax theorists that the income tax is unfair to investors and wage earners because it taxes them while not taxing rich people who chose to be economically idle and live off their principal. Few people today accept Hobbes's principle that taxes should be levied in proportion to benefits received, and the idea that only those who spend receive benefits from society seems bizarre.

Modern expenditure-tax theory is closer to the position of John Stuart Mill. Mill viewed an income tax without an exemption for income saved as discriminating against savers because taxpayers would be "taxed twice on what they save, and only once on what they spend."[9] He argued that an income tax taxes savers both upon principal (the money originally earned) and the earnings from investing that principal. This, Mill argued, is unfair to the saver, because "if he has the interest, it is because he abstains from using the principal; if he spends the principal, he does not receive the interest. Yet because he can do either of the two, he is taxed as if he could do both. . . ."[10] Mill's fundamental idea, that the income tax is unfair to savers, is common today, as is the picturesque language with which he expressed this conclusion: the saver is "taxed twice" under an income tax.[11]

Some influential proponents of the expenditure tax have gone beyond Mill in important respects. Mill thought a consumption tax impractical because measuring annual personal consumption directly was impossible. Modern writers have shown, however, that consumption can be measured, perhaps even more easily than income. Irving Fisher pointed the way by demonstrating that modern accounting techniques make it no harder to compute personal savings or dissavings than business savings. He argued for an "income" tax (really an expenditure tax) under which all receipts—including gifts, inheritances, and withdrawals from savings—would enter into the definition of taxable income, but savings would be deductible, thus adding only two steps to present computations.[14] William Andrews has argued, more recently, that a spending tax would actually be easier to administer than an income tax, because the underlying computations would be simpler.[15] His claim is that an expenditure tax would not require the resolution of such troublesome problems of present law as distinguishing

9. 2 J.S. MILL, PRINCIPLES OF POLITICAL ECONOMY 407 (1874)

10. *Id.*

11. *E.g.*, M. CHIRELSTEIN, FEDERAL INCOME TAXATION 260-61 (1977) (presenting the notion that savings are doubly taxed under an income tax as fact, with no suggestion that the conclusion is open to doubt).

14. I. FISHER, THE INCOME CONCEPT IN THE LIGHT OF EXPERIENCE (n.d.) (pamphlet) 14-17, which appears to be Fisher's own translation of a paper originally published in German [in 1927] [hereinafter cited as THE INCOME CONCEPT].

15. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1148-65 (1974).

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capital gains from ordinary income, computing depreciation, and drawing a line between business expenses and capital expenditures.

Mill's "double taxation" argument, in the form in which he made it, is circular. To say, as he does, that one who invests money "abstains from using" it is to say, at least implicitly, that consumption is the only "use" of money that should be considered in devising a tax. But modern writers have rescued the "double taxation of savings" argument from circularity. They argue that an income tax discriminates against savers because it makes saving less attractive relative to spending than would be the case in a world without taxes. I will use Andrews's figures to illustrate the argument.[16]

In a world without taxes or with an expenditure tax, a person who decides to save $1.00 of income and invest it at nine percent will have eight times as much to spend after 24 years as he could have spent initially; but with an equivalent income tax he will have only four times as much to spend under the same conditions.

Tax	(1) Available after Taxes if Spent Immediately	(2) Available after Taxes if Spent In 24 Years	Ratio 2:1
No Tax	$1.00	$8.00	8:1
33 1/3% Income Tax	0.67	2.67	4:1
Equivalent Expenditure Tax	0.67	5.33	8:1

Even in this illustration, the expenditure tax does not reproduce the no-tax world in all respects, because any tax, by reducing the total amount a taxpayer has available for saving and spending, will normally affect the proportion he decides to allocate to each use. But to the extent that an individual is influenced by what a dollar saved at the margin can earn, the incentive to save appears the same under an expenditure tax as in a no-tax world and different under an income tax that contains no exemptions for saving.

This argument is convincing only if one accepts a no-tax world as a standard for judging the desirability of a tax. Economists use the model of a no-tax world as a heuristic device to measure the likely effect of different taxes on the economy and as a standard of comparison in measuring

16. *Id.* at 1125.

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"efficiency." As a starting point in making rough guesses about the effects of changes in existing arrangements, the "tax-free society" device may serve a useful purpose. But the model rests on so many assumptions about behavior under hypothetical conditions that any conclusions based on it must be problematic and tentative. As Coase has asked in another context:

> In a state of laissez faire, is there a monetary, a legal, or a political system, and if so, what are they? . . . Whatever we may have in mind as our ideal world, it is clear that we have not yet discovered how we get to it from where we are. A better approach would seem to be to start our analysis with a situation which naturally exists, to examine a proposed policy change, and to attempt to decide whether the new situation would be, in total, better or worse than the original one.[19]

Reduction to Present Value and Fairness

Even if we assume, for purposes of argument, that "no-tax society" comparisons are useful in determining economically efficient solutions to complex practical problems, it does not follow that "discrimination" against savings under an income tax (when both income and expenditure taxes are compared to a no-tax society) is unfair. The unfairness argument seems to rest on the notion that people generally prefer to consume as they earn and so must be induced by interest to defer consumption. Interest income is thus merely compensation for delaying consumption. It does not represent a true increase in value to the saver, and a tax on that interest—like a tax on a nominal profit that reflects only monetary inflation—is in reality a levy on capital, a second tax on the earnings whose consumption was delayed. The following example illustrates the thrust of this argument.[21] Two people earn $10,000 in one year. One spends all his after-tax income, while the other saves half his after-tax income the first year and spends it the second. With a flat 30 percent income tax and a 10 percent interest rate, net return after taxes is 7 percent. Ignoring their second-year salaries, we get the following results:

19. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 43 (1960).

21. The example in the text is inspired by Fisher's famous three brothers example. THE INCOME CONCEPT, *supra* note 14, at 12-13. Three brothers inherit $100,000 each. The first chooses to spend only the interest; the second allows his interest to accumulate until his money has doubled, and then spends the interest on this sum; the third buys a $20,000 a year annuity for six years, after which he has nothing left. Fisher assumes a 5 percent rate of return and a 10 percent tax. Under a conventional income tax, the first brother could take care of his future tax burden by setting aside $10,000 in the year of the inheritance, the second would have to set aside $17,140, while the third, "improvident," brother would need only $1,577,30. Under a consumption tax, each brother would have to set aside $10,000.

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	Spender	Saver
(1) Spends year 1	7,000	3,500
(2) Tax	3,000	3,000
(3) Saves	--	3,500
(4) Interest pre-tax	--	350
(5) Tax on int.	--	95
(6) Spends Year 2	--	3,745
Present Value:		
of (5) at 10%	--	95
of (6) at 7%	--	3,500
of (1) + (6)	7,000	7,000

Although the "present value" of what the saver and the spender eventually spend is the same, the saver must set aside more for taxes—not only does the saver pay more taxes in total dollars ($3,105 vs. $3,000), the present value of his taxes is greater ($3,095 vs. $3,000). Under an expenditure tax, the present value of their taxes would be the same, no matter how much or how long one saves. The argument that the net interest rate should be used to reduce future consumption and future taxes to their present value, and that, as a consequence, the saver and the spender in the illustration above "really" consumed the same amount but were taxed unequally, is the essence of the modern justification for the view that the income tax is a "double tax" on savings.

Reduction to present value is often an essential step in comparing people's well-being. If two people receive $10,000 each in a taxable transaction, the one who is allowed to pay the tax later needs to set aside less for that purpose than the one who must pay the tax immediately, because money set aside to pay a fixed sum in the future earns interest until the sum is paid. But this type of analysis, so useful for comparing the burden of taxes, cannot be used in a straightforward way as a technique for determining the present value of future consumption to a saver. If a taxpayer can obtain a secure after-tax return of ten percent, he is indifferent whether he pays $1.00 in tax now or $1.10 a year later, and this is true whether the total tax deferred is $1.00 or $1 million. But this does not mean that if a person lends $10,000 at minimum risk for one year at ten percent, he values $11,000 of consumption a year from now no more than $10,000 now.[24]

24. The differences between straightforward time-value calculations as applied to the receipt of cash and the same calculations as applied to consumption can be easily shown by a simple if somewhat extreme comparison. Suppose a taxpayer who could expect to receive a secure income of $10,000 a year for the next ten years were offered, as an alternative, a present lump-sum payment of $100,000. Ignoring any possible effects of a progressive income tax, any rational person would accept the offer, since the opportunity for an investment return makes $100,000 now worth more than $10,000 a year for ten years to anyone. But it is surely not the case that any

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The interest rate reflects the "time value of consumption," if at all, only at the margin. The interest rate at which a person lends his money measures the value to him of the last dollar he saves. If the interest rate were lower, he would probably still save, although he would probably save a different amount—less or more.[26] The money he would save with a lower rate of interest produces benefits, if invested at the higher going rate, greater than those of current consumption. Use of the after-tax rate of interest to reduce future spending to present value, when applied to measure the present value of savings, ignores that part of a person's interest income that inures to him when he is able to invest part of his savings at a higher rate than he was in fact ready to accept.

Reduction to present value is essential to the argument that the income tax involves "double taxation of savings" and is therefore unfair to savers. Fisher said that it is "unjust" to impose taxes that are different, when reduced to present value, on people whose consumption, also reduced to present value, is the same.[27] This judgment rests on at least two assumptions: first, that a tax is just only if it taxes equal benefits or enjoyments equally;[28] second, that the interest rate measures the benefits forgone by delaying consumption. If the interest rate measures these

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rational person who expected to consume $10,000 a year for the next ten years and who could give up that opportunity in exchange for $100,000 consumption this year, on condition he consume nothing for nine years, would accept the offer.

26. If consumption had a declining marginal utility for everyone, people would save more as the interest rate went up, and would save less as it went down. This analysis, however, leaves many factors out of account. For example, someone who is saving for a particular goal, such as a college education for his children or a particular level of retirement income, may reduce the proportion of his earnings that he saves as the interest rate goes up. Just as the income tax tends to encourage some people to substitute nontaxable leisure for taxable work (the "substitution effect") and encourage others to work harder to replace money taken in taxes (the "income effect"), a tax with an exemption for income saved would encourage some people to save more while encouraging others, such as those trying to accumulate a fixed sum, to save a smaller proportion of their earnings than they would under an income tax.

27. THE INCOME CONCEPT, *supra* note 14, at 12-13.

28. * * * It should be pointed out here that Fisher's view that it is fair to tax equally—and fair only to tax equally—people whose future consumption reduced to present value is the same assumes, among other things, that the only benefit people get from saving is increased future consumption. But as Guillebaud has pointed out,

> the saver has immediately a new asset in the shape of his savings as a capital sum, in terms of its present exchange value, which is valuable to him not merely, and often not principally, as a source of future income, but as a protection and reserve against emergencies which may at any time befall him. There also comes into the question the prestige value of accumulated wealth, the desire to bequeath large sums at death, the knowledge of the power that derives from the possession of wealth . . . .

Guillebaud, *Income Tax and the "Double Taxation" of Saving*, 45 ECON. J. 484, 490-91 (1935).
* * *

A person who values accumulation for its own sake will save and, under an expenditure tax, never pay tax on his accumulation, because his enjoyment comes from the possession itself. It is hard to see, on Fisher's own "benefits" approach to taxation, why it is "fair" to tax him less than a person whose benefit comes from consumption, present or future.

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benefits only at the margin, this second assumption is undermined and the argument loses much of its force. And a case can be made against reducing postponed consumption to present value, even at the margin, for the purpose of assessing the justice of a tax. As is indicated by the title of the revised (1930) edition of Irving Fisher's famous work on the rate of interest, *The Theory of Interest as Determined by Impatience to Spend Income and Opportunity to Invest It*, interest can be viewed as payment for the cost of postponing consumption—resisting impatience to spend—rather than for the supposedly lesser value of future consumption. To an economist, a forgone benefit is a cost, but not all costs are equivalent for judging the fairness of a tax.

If we view the interest rate as paying the saver for the cost to him of resisting the impulse to spend immediately, the "double taxation" argument becomes an argument for allowing taxpayers who incur the "resisting impatience" cost a tax benefit to put them on a par with current spenders, who do not incur such a cost. But to allow this cost to be taken into account in devising a tax is inconsistent with accepted principles not only of income taxation but of expenditure taxation as well. The psychological cost of deferring consumption is like any other cost of giving up lost opportunities; such costs are not, and could not be, taken into account generally under either an income or an expenditure tax. We do not say that a worker's cost in boredom, or in giving up leisure, or in physical effort should be deducted in computing either his taxable income or, under an expenditure tax, his expenditures from current earnings, even though these things are regarded as costs by economists concerned with predicting behavior. In effect, the "double taxation of savings" argument for expenditure taxation is an argument for allowing a very common kind of cost to be deducted when incurred by savers, but not by those who earn and spend, even though we know that they also incur such costs.

The foregoing discussion does not mean that an expenditure tax is necessarily less desirable than an income tax, but the case for an expenditure tax cannot rest upon the argument that the income tax subjects savings to "double taxation." The justification for abandoning income as a tax base—if indeed there be one—must derive from other considerations of tax policy.

* * *

TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH ["TREASURY I"]

United States Department of the Treasury

Vol. 1, at 30-33 (1984)

Consumption provides an alternative to income as the basis for personal taxation. A personal tax on consumption, or consumed income, would be levied by exempting all saving from tax, allowing a deduction for repayment of debt, *and* taxing all borrowing and withdrawals from savings. Consumed

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income would be reported on a form much like the present form 1040. Deductions would be allowed for deposits in "qualified accounts" similar to existing individual retirement accounts (IRAs); withdrawals from such accounts would be subject to tax.

Though a flat rate could be applied to the consumption base calculated in this way, most proposals for a consumed income tax postulate personal exemptions and graduated rate schedules. Thus, a consumed income tax could be progressive, if that were desired. Itemized deductions could also be allowed, as under the existing tax.

Administrative Advantages

The current income tax is based on the principle that income should be taxed annually as it is realized. It represents a practical compromise between administrative feasibility and the objective of taxing income as it accrues. Conceptually, accrued income can be defined as the amount a taxpayer could consume without reducing his or her net wealth, that is, as the total of what the taxpayer actually consumes plus the change in his or her net wealth. Many practical difficulties plague application of this conceptual ideal as the basis of an income tax. Compromise between achieving the ideal, on the one hand, and avoiding complexity, on the other, produces a system that departs significantly from the conceptual ideal. Examples of compromise include taxation of capital gains only when they are realized, commonly by sale of an asset, rather than as they accrue. Compromises such as this can allow tax on large amounts of income to be postponed indefinitely, or even avoided altogether, as when appreciated property is transferred at death. On the other hand, efforts to administer the tax on an accrual basis, by levying tax before realization occurs, can introduce significant complexity and hardship. For example, if tax were levied on unrealized gains on closely-held business, valuation would be difficult; payment of tax, moreover, could frequently be required even though there is no cash flow with which to pay the tax.

Because it avoids the problems inherent in accrual taxation, a tax on personal consumption is simpler in many respects than an income tax. The consumed income tax is simpler because all costs of investment are deducted immediately ("expensed"), rather than depreciated over the life of assets; because all costs of creating inventories are expensed, rather than being recognized only as goods are sold; and because capital gains are not taxed, as such. A corporate income tax is not an essential part of an ideal tax system based on consumption; if retained, it would serve only as a withholding device.

The consumed income tax has another major administrative advantage over the income tax. Under the present income tax, the measurement of income is commonly distorted by inflation. Because consumption inherently occurs in dollars of the current year, the measurement of the base of the consumed income tax cannot be distorted by inflation. Since depreciable

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assets and inventory investments are expensed, inflation cannot erode the value of future deductions because there are none. Interest is not taxed, unless spent on consumption, and thus the inflation premium is not taxed. Purely inflationary capital gains are not taxed, because there is no tax on capital gains, per se.

Economic Advantages

Advocates of a consumed income tax argue that it is preferable to the ordinary income tax on conceptual and economic grounds, as well as on administrative grounds. First, an income tax penalizes saving by inducing taxpayers to consume rather than save for future consumption. By comparison, under certain circumstances, a tax on consumption does not distort the choice between consuming now and saving for future consumption. This is a major attraction of any tax on consumption.

Second, seen from a lifetime perspective, a tax on consumed income is said to be more equitable than an income tax. A taxpayer's total tax burden on consumed income does not depend on when income is earned or spent, at least under fairly restrictive simplifying assumptions. By comparison, an income tax imposes a heavier burden on those who earn income relatively early in life or spend it relatively late.

Despite the manifest attractions of the tax on consumed income, the Treasury Department does not propose it as either a replacement for, or a supplement to, the income tax. Several defects and difficulties of a consumed income tax lead to this conclusion.

Transition Problems

First, the current existence of substantial wealth, much of which has been accumulated from after-tax income, poses difficult transition problems. Taxing all consumption financed from such wealth would constitute a cruel trick on those who did not expect it—especially those who have saved after-tax dollars for retirement. Nor would complete exemption of consumption financed from existing wealth be satisfactory. Such an exemption would either be enormously expensive in terms of lost revenue or entail extremely high tax rates during the transition period. Worse, it would allow wealthy taxpayers to escape taxation for many generations if they consumed only old wealth and saved all current income.

On equity grounds, a compromise between complete exemption and full taxation of consumption from existing wealth would be necessary. Such a compromise might allow each taxpayer above a given age to enjoy a given amount of tax-free consumption during his or her lifetime. But phasing in a consumed income tax in this way would involve transition rules that could complicate the tax system for ordinary taxpayers for a generation.

A different type of transition problem would result from the possibility of avoiding taxes by hoarding money before the effective date of the new tax. After the effective date the taxpayer could either deposit the hoarded funds in a qualified account in order to get a tax deduction for saving or use them

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to meet living expenses without paying tax. Alternatively, pre-effective date investments in foreign banks could be liquidated after the effective date and reinvested as tax-deductible saving. Even though this would be a temporary problem of transition, it would undermine both the revenue yield and fairness of the tax during that period.

Perception Problems

Even though a taxpayer's standard of living, as reflected by his level of consumption, may be considered by many to be an appropriate base for taxation, the consumed income tax suffers from an important perception problem. Taxpayers presumably would welcome the opportunity to postpone taxes on amounts saved, paying tax only when dissaving and consumption occurs; such is the tax treatment currently accorded saving in qualified pension accounts. But to be consistent, it would also be necessary to tax amounts borrowed and allow a deduction for repayment of loans. This treatment of saving and dissaving would create a pattern of tax liabilities over the lifetime of the taxpayer that might be perceived to be unfair. Relative to experience under current law, tax liability would be greater during early adulthood and during retirement—periods when financial resources are commonly strained. Tax would be relatively lower during middle age, the time when many taxpayers receive most of their income. The fairness of including amounts borrowed in taxable consumption might be questioned, and this tax treatment might even require a constitutional amendment.

Complexity for Individuals

A consumed income tax would be more complicated than the existing income tax for many individual taxpayers. Under the present income tax, amounts withheld on wages and salaries roughly offset tax liabilities for many taxpayers who have only modest amounts of income from capital. Relatively few taxpayers must worry about estimating liabilities and paying significant amounts of tax in addition to amounts withheld. Under the consumed income tax the situation could be quite different. Withholding might be required on borrowing and withdrawals from savings; if so, "reverse withholding" would be appropriate when a loan is paid off. Even then, far more taxpayers might need to file estimated returns than now, because it would be difficult to adjust withholding rates on financial transactions to the personal circumstances of taxpayers. Moreover, many young adults and retired individuals are not required to file or pay tax under an income tax, but would be required to file and pay tax under a consumed income tax.

Owner-occupied housing would not be treated as an item of consumption, to be taxed in full in the year of purchase. Rather, inclusion of the purchase price in taxable consumption would be spread over the lifetime of the home, in effect, by requiring taxpayers to pay tax as their mortgages were paid off. This could be accomplished through special treatment of mortgages outside of qualified accounts. But purchases of

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homes from amounts saved in qualified accounts could require special averaging features that would complicate compliance for taxpayers. Ironically, individual taxpayers would, in a sense, be asked to keep accounts resembling depreciation accounts at the same time that such accounts were eliminated for businesses.

The Dilemma of Gifts and Bequests

The proper treatment of gifts and bequests under a tax on consumed income is a fundamental issue. Under one view such transfers would not be taxed to the person making the gift or bequest; they would only be taxed when consumed by the recipient. Under a very different view, transfers would be taxed to the donor, as well as when consumed by the recipient. Advocates of this second approach argue that taxing gifts and bequests is necessary in order to realize fully the beneficial equity and efficiency effects of a consumption-based tax. They refer to this type of tax as a tax on lifetime income, to distinguish it from the conventional tax on annual income. The distributional differences in the two ways of treating gifts and bequests are, of course, substantial. The first approach would allow great fortunes to be passed from generation to generation without tax, whereas the second would subject transfers to tax.

International Aspects

No country has a tax on consumed income, although Sweden and the United Kingdom have considered it, and India and Sri Lanka (then Ceylon) attempted to impose the tax for a brief period following World War II. Any country imposing a consumed income tax would be very much out of step with its trading partners, all of which employ income taxes, and would face the task of renegotiating its foreign tax treaties.

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Notes and Questions

Fairness

28. Professor Warren's analysis relies on conceptions of societal structure that are not universally shared. Do you agree with "the proposition that society in general has a claim on its annual product that is prior to the claims of its individual citizens"? Should annual production in the United States be viewed as societal production ("*its* annual product"), or as the individual production of its millions of citizens (and aliens)?

29. Do you accept "the theory that a producer does not have a controlling moral claim over the product of his capital and labor, given the role of fortuity in income distribution and the dependence of producers on consumers and other producers"?

Fortuity and interdependence are important determinants of income. Professional athletes provide a good example of the dependence of producers on both consumers and other producers. How much would it be worth to

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throw a ball into a hoop if no one wanted to watch? Or if television had not been invented?

30. Professor Warren asserts that society has a legitimate interest in achieving a desired after-tax distribution of society's product. Social and legal structures are, in effect, means of allocation. An income tax "is levied on the amount of social product otherwise distributed to each taxable unit."

Note that an income tax of general application, regardless of its degree of progressivity (so long as it is less than 100 percent), will leave all taxpayers in the same rank order of after-tax income that they had with respect to pre-tax income.

31. Whether we agree with Professor Warren's position concerning the extent of society's claim against individuals, the legitimacy of any taxing system depends upon the validity of some degree of societal claim. Does Professor Warren demonstrate that this claim should be asserted against income, rather than against consumption or wealth?

32. Professor Charles O'Kelley argued that there can be debate about the relative merits of a consumption tax and an accretion tax only if we assume that the pre-tax division of income is just. If the initial distribution of income is unjust, Professor O'Kelley argued that the accretion tax is the clear choice:

> Consider * * * individual *A* who in year one earns and spends $20,000 and individual *B* who in year one earns $1,000,000, but spends only $20,000. Under a consumption-type income tax *A* and *B* would each have taxable incomes of $20,000, which taxable incomes would not reflect the relative unjustness of *B*'s pre-tax income. Therefore, a consumption-type income tax would be unable to correct an initially unjust distribution of income.[g]

33. Is ability to pay best measured by income, or by consumption? What arguments can be made for each proposition?

"Double tax" on saving

34. John Stuart Mill argued that an income tax taxes savings twice, because "if he has the interest, it is because he abstains from using the principal; if he spends the principal, he does not receive the interest. Yet because he can do either of the two, he is taxed as if he could do both." Professor Gunn labels Mill's argument as circular. What is Gunn's reasoning?

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g. Charles R. O'Kelley, Jr., *Rawls, Justice, and the Income Tax*, 16 GA. L. REV. 1, 4 (1981).

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35. Professor Gunn states that modern advocates of consumption taxation rescue the "double taxation of saving" argument from circularity by comparing the effects of an income tax and a consumption tax to a "no-tax world." While any tax leaves a taxpayer worse off, a consumption tax does not change the relative attraction of immediate consumption versus saving. Gunn illustrates this point through Professor Andrews' example of an investor whose 24-year investment (at nine percent) in a no-tax world would allow eight times as much deferred consumption as would have been available in immediate consumption. A consumption tax would reduce the absolute amount of consumption that would be possible immediately or in 24 years, but would leave the relative attractiveness of saving unchanged—eight times as much consumption would be made possible by saving and waiting. A 33 percent income tax, however, would reduce not only the absolute return on saving but the benefit of saving vis-a-vis immediate consumption—the saver would have only four times as much consumption after 24 years.

36. Does Professor Gunn agree that the best way to evaluate the impact of a tax is by comparison to a tax-free world?

37. Professor Gunn also acknowledges the argument of consumption-type tax advocates that the excessive tax burden on saving is demonstrated by reducing the tax to present value. Under a consumption tax, the present value of the tax is the same, whether the taxpayer consumes immediately or saves and later consumes both the original principal and the earnings generated by the saving. (See footnote 21 of Gunn excerpt and accompanying text.) Under an income tax, the present value of the tax is less if the taxpayer consumes immediately than if the taxpayer saves in order to consume more later.

38. In addressing the reduction of tax burdens to present value, Professor Gunn argues that such a reduction would be appropriate only if the saver actually values future consumption less than present consumption at a rate measured by prevailing interest rates—that is, only if the interest at prevailing rates does not really make the saver better off, but merely makes the future consumption equal in value to present consumption.

But, Gunn argues, the saver is actually made better off, and reduction to present value is of little relevance in this context. Indeed, sometimes future consumption is more valued than the same amount of additional present consumption. What argument is Gunn advancing in footnote 24 of his article?

39. Even if reducing future consumption to present value were appropriate, Professor Gunn argues that discounting at prevailing market interest rates would be inappropriate. Why, according to Gunn, do market

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interest rates overstate the amount that the saver loses by deferring consumption?

40. Professor Gunn argues, in sum, that additional tax on investment income is appropriate because the saver ultimately has *more* than the nonsaver. It is not the same amount reduced to present value, it is more.

41. Assuming real interest rates are positive (i.e., that interest rates exceed inflation), an individual can choose between consuming x now, or x plus interest at a future time. Professor Gunn argues that this return to investment might be viewed as a payment to the saver for resisting the impatience to consume immediately. Gunn compares the interest payment to a wage paid a worker for resisting the temptation toward leisure. Viewed in this manner, would taxing the interest be overtaxing the saver?

Treasury I

42. Although they ultimately recommended against moving to a consumption-type tax, the drafters of Treasury I acknowledged that it would create a lower, and arguably fairer, tax on saving, and, in theory, that it could be simpler than the income tax. (Simplicity is harder to achieve in concrete proposals than in theoretical proposals. See subchapter E.)

43. A major consideration in adopting a consumption-type tax would be the transition from the present system. Perhaps the most important aspect of the problem concerns accumulated wealth that has already been subjected to the income tax: Would such wealth also be subjected to the new consumption-type tax? Note that either system consistently applied would lead to only one tax—the time of wealth creation under the income tax, or the time of expenditure under the consumption-type tax. Without complicated transition rules, changing forms of tax could result in tax at both occasions. (A corresponding problem is that funds borrowed under the income tax system would have given rise to no income tax, but repayment under the new consumption regime would, absent special provision, give rise to a deduction.) Transition problems are further explored in subchapter E.

44. Treasury I also raises what might be termed the life cycle objection to the consumption-type tax. A typical life pattern is to consume more than is earned during young adulthood (for example, students have been known to take out loans); save during middle age; then consume savings during retirement. Does such a pattern suggest problems in the consumption tax system? Can these problems be met by making the consumption tax system sufficiently progressive?

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Gifts under a consumption-type tax

45. As Treasury I points out, gifts present a conceptual challenge under a consumption tax. First, the theoretical problem is whether the donor has "consumed" the money (or money's worth) given. Presenting the "utility" view, which would treat making a gift as an act of consumption, Professor Carolyn Jones observes that "[t]he utility [a donor] derives from making the gift equals or exceeds the satisfaction to be derived from any other use" of the money given.[h] (Else why would the donor have made the gift?)

The competing "preclusive use" approach favored by Professor Andrews holds that the donor has not made use of society's resources in a way that would prevent another from using them, and thus should not be regarded as having "consumed" by making a gift. Satisfaction, Andrews argues, is irrelevant for tax purposes: "Taxing income in the end does not and cannot provide an accurate reflection of either power or pleasure. It is, rather, simply the accumulation or utilization of economic resources, measured at market value, for private consumption."[i]

Which theory is to be preferred? Would the utility approach lead to double taxation?

46. If the preclusive-use theory were adopted, a high-bracket taxpayer could "give" money to a low-bracket family member or friend as part of a fraudulent arrangement (fraudulent if the money were to be spent for the benefit of the high-bracket "donor"). A similar problem exists under present law. Gifts of appreciated property give rise to no tax to the donor, and the donee takes a carryover basis. Upon sale, all gain is taxed to the donee, who may be in a lower bracket than the donor.

Is the fraudulent gift problem any greater under a consumption-type tax than under present law?

D. ANALYZING DIFFERENT TYPES OF SAVING

As Professor Andrews first observed, our income tax is a hybrid, with elements of both consumption and accretion taxation, and the difference between the two lies in the treatment of savings. As we have seen, the proper tax treatment of savings is debated on grounds of fairness and efficiency by advocates of consumption taxation and defenders of income taxation.

In the excerpt below, Professor McCaffery argues that in analyzing income and consumption tax bases we should recognize significant advantages and drawbacks to both ideals. Because the choice between the two ideals turns on the taxation of savings, it is important to realize that we

h. Carolyn Jones, *Treatment of Gratuitous Transfers: Unraveling the Case for a Consumption Tax*, 29 ST. LOUIS L.J. 1155, 1171-72 (1985).

i. William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 356 (1972).

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need not automatically assume that all savings must be given equal tax treatment. Instead, each category of savings should be analyzed, to see whether economic and equity goals point toward giving relatively favorable or relatively unfavorable tax treatment to the particular type of savings. It follows that we should be open to the possibility that the ideal tax base may be some hybrid structure that offers more favorable tax treatment to some types of savings than to others.

Professor McCaffery's article should be read not as a proposal for any particular tax structure so much as for a method of analysis. To the degree that his article points toward a particular policy, it may be less important in the income-versus-consumption debate than in the suggestion that estate taxes may undercut important societal goals.

TAX POLICY UNDER A HYBRID INCOME-CONSUMPTION TAX

Edward J. McCaffery*

70 Texas Law Review 1145, 1147-48, 1165-67, 1169-73, 1175-79, 1181-92, 1194, 1196, 1198-1213, 1216 (1992)

This Article * * * has several central themes. First, we have a hybrid income-consumption tax, the precise nature of which turns on the treatment of savings. Primarily as an illustration and following the economics literature, this Article divides savings into three categories based on the positive uses of the savings: life cycle, precautionary, and bequest savings. Second, because of the different values we place on the different types of savings, some form of a hybrid may in fact be ideal and not merely a practical necessity. These values come into relatively clear focus when we break analysis down into three broad normative categories: individual welfare, aggregate or macroeconomic welfare, and general equity concerns. Finally, this Article uses these categories to show that we may indeed support a hybrid as an ideal tax scheme. * * *

[T]his Article indicates the types of questions we ought to be asking about tax policy. * * * At the end of this undertaking, much of the work on the road to concrete policy formulation will lie ahead. * * *

The Case Against the Extremes

* * *

The Income Tax

The traditional case for an income tax rests perhaps most strongly on equitable notions of ability to pay. * * *

[A] tax based solely on income may not be ideal.

The individual efficiency concern is that the income tax distorts the choice between consumption and savings by doubly taxing the latter, thus

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causing taxpayers to consume more and to save less than they otherwise would. * * *

A second and logically distinct argument against the income tax is that its double tax discourages saving and leads to too little capital formation. * * * Indeed, a very broad consensus among political economists is that, in the long run, the world would be a better place under a consumption tax. * * *

Finally, there are also fairness arguments against an income tax and for a consumption tax. * * *

Consider the example of retirement savings. * * * Americans would be hard-pressed to understand that, while they certainly ought to save for their own retirement, those who do will be left with half as much, in present value terms, as those who do not![115] But this is exactly what an income tax does to savers. * * * It may be fairer—not just more efficient—to levy a tax based on the resources that taxpayers devote to their own needs, when and as they do so.

The Consumption Tax

* * *

In a partial equilibrium setting that considers only the consumption--savings decision, a consumption tax reduces the consumption-savings distortion and thus leads to a welfare gain and individual efficiency. Yet the partial equilibrium assumption is unrealistic; we must look beyond the consumption-savings choice alone. Given a need for constant revenue, tax rates will almost certainly go up under a consumption tax, at least in the short term. This rate increase will cause a decrease in the after-tax benefit that taxpayers receive from working, thus distorting the tradeoff between labor and leisure and producing an offsetting welfare loss. There is no a priori way of calibrating which set of distortions will be worse. * * *

Like the individual efficiency argument, the macroeconomic argument for a pure consumption tax is not completely persuasive. The inevitable rub with the argument—assuming the validity of all features leading to its basic soundness—lies in the short run, where mere mortals dwell. The argument for greater welfare in the long run is, on its own terms, predicated on reduced consumption in the present. Economists concede that there would be an instantaneous welfare loss under an immediate transition to a consumption tax. To understand what is normally presented as a graph, imagine that we are travelling along at eighty percent of our optimal capacity relative to a pure consumption tax. A change to a consumption tax promises the ultimate attainment of full capacity, but, before getting there, we will

115. The example is based on that used by Professors Andrews, Bradford, and Warren. *See* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1125 (1974). * * * It compares two workers in the 33% tax bracket with the saver saving for 24 years at 9% interest rates. As fate would have it, these numbers actually appear to be rather realistic by 1992 standards.

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have to drop down to some lesser welfare state, perhaps sixty percent of the optimum, for a while. The problem for economists is to answer what "for a while" means—that is, to ascertain the precise period during which we would all be worse off under a transitional regime. Here, the happy consensus of economists breaks down, and the estimates vary from a low of four or five years to a high of one hundred years.

* * *

Finally, although its advocates make some strong equity arguments for the consumption tax, the income tax proponents are far from defenseless in this debate. * * * A persistent thought in our society and among income tax advocates is that wealth per se matters and ought to be taxed. * * *

Framing Discussion: The Uses of Savings

The hybrid tax system turns on the treatment of savings. * * * There are also different *types* of savings, and no a priori reason why we should treat them all the same way. * * *

Life Cycle Savings

Life cycle savings are those designed solely for the saver's future, selfish needs. The standard economic models discuss this category of use mostly in terms of the young earner's savings to fund future consumption (*e.g.*, retirement savings). Life cycle savings can be generalized, however, to include any future consumption. Saving to buy a car or a house is different only in degree from saving to fund one's retirement: in all cases, one is foregoing consumption now in order to consume later. * * *

Precautionary Savings

Whereas life cycle savings are aimed at smoothing out a consumption path throughout the taxpayer's life for normal consumption purposes, precautionary savings are built up to provide for extraordinary circumstances (*i.e.*, to hedge against risk). The most commonly thought-of risk may be sickness: a taxpayer saves to have money for medical care in the event of future illness. But any risk can lead to precautionary savings, such as risks of interrupted or lessened future earnings, of general economic troubles, or of the early death of someone on whom the taxpayer depends for support. * * * [A] financial vehicle—here, insurance—can perfectly match the precautionary savings need under ideal conditions. Indeed, Medicare and Medicaid are forms of paternalistically provided precautionary savings, analogous to social security's paternalistic life cycle savings. As would be expected with precautionary savings, the economics literature indicates that government-sponsored insurance programs have tended to decrease private savings.

Bequest Savings

Bequest savings represent capital built up to be given away. * * *

Residual Uses

Life cycle, precautionary, and bequest savings may not exhaust all savings motives. Some taxpayers may attempt to accumulate capital for

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private or public power, for peace of mind, or for lack of other things to do with their money. But ultimately money will be spent in the ordinary course of events, or it will be spent under extraordinary circumstances, or it will be given away. Our mortality assures this. Sooner or later, one of the basic labels will come to fit all savings.

It may appear that a greater problem is the overlap among the uses of savings. For example, taxpayers may save for life cycle reasons while intending that any leftovers be used for bequests. Even so, it may be quite possible, depending on the outcome of our normative exploration, to tailor a system that remains agnostic regarding the classification of savings until the moment of conversion to final use. At that moment, the distinction will necessarily become apparent, and we can tax or not tax accordingly. * * *

The Case Against Identical Treatment of Savings

* * *

Neutrality Among Different Forms of Savings

Another argument for treating all savings alike is that tax laws should be neutral across different types of savings. For reasons of equity or efficiency or both, we should not relatively encourage or discourage any one type of savings. Whatever playing field the tax law creates, it should at least be level.

This argument confuses and exalts the role of neutrality as an efficiency condition. *Ceteris paribus,* tax laws ought to be as neutral as possible to avoid distortions between choices such as savings versus consumption. But all things are rarely equal, and almost never so in the byzantine world of tax. In a no-tax setting, for example, people might appear to be indifferent between apples and oranges, consuming equal amounts of each. But it does not follow that, in a taxed world, it is efficient or even "neutral" to levy the same tax rate on apples and oranges. Consumer demand for apples at the pre-tax level might be rather inelastic—perhaps because consumers place a premium on consuming enough apples to keep doctors away. At a tax rate of fifty percent on both apples and oranges, consumers might react by continuing to purchase apples and altogether eliminating oranges, for which they have a less strong preference. * * * [A] better, more efficient—and probably even more neutral—approach would have been to tax apples alone, leaving consumers to allocate their reduced after-tax dollars among all goods, including oranges, as they deemed fit.

* * * [E]fficiency does not necessarily dictate taxing all things equally. Rather, a long-standing tenet of optimal taxation has been that when lump sum (nondistortionary) taxation is unavailable, efficiency dictates taxing commodities based on their relative elasticities: the higher the elasticity, the lower the tax. We may call this technique "Ramsey pricing," after its originator. This technique would lead to a high tax on apples, which have a low elasticity, and a low (or no) tax on oranges, which have a high elasticity. It is Ramsey pricing and not a blind adherence to the principle of

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neutrality that will maximize efficiency. Neutrality becomes a mere rule of thumb to be followed when no information about the relative elasticities of different goods is available.

Of course, the efficiency norm of Ramsey pricing may yield to equity concerns. Taken to its limit, for example, Ramsey pricing would mean exorbitant excise taxes on necessities. * * *

Life Cycle Savings

This and the next two Parts examine the arguments for and against favoring each type of savings. For the most part, "favoring" will mean taxing the savings under the single, consumption tax model, and "disfavoring" will refer to the double tax, income model. * * *

The Case for Favoring

* * *

Beginning with efficiency arguments, perhaps the easiest and strongest argument for favoring life cycle savings is that the income tax distorts the choice of present versus deferred consumption by double taxing the latter. If we assume that much savings is life cycle—and the economics literature for years has supported this assumption—then the distortion of life cycle savings is particularly important. As mentioned above, a change to a consumption tax on savings leads to an unambiguous welfare gain when the savings-consumption choice alone is considered.

The second efficiency argument for life cycle savings looks to market failure. * * * [A] classic externality may be involved—a failure to provide for one's own future needs may impose costs on society as a whole in the form of increased social-welfare spending. * * *

Finally, there are at least two major equity arguments for favorable tax treatment of life cycle savings. The first is that it is fair, for one reason or another, to tax individuals on their standard of living, or what they appropriate from the common pool for their personal use. * * * The central idea is that only a consumption-type tax preserves the equality of the saver and the spender in an after-tax setting relative to their equality in a no-tax setting. * * *

The second equity argument for favoring life cycle savings is based on the belief that we should tolerate lifetime disparities in wealth because they are earned. This belief leads to a hybrid that favors life cycle and precautionary savings but not bequest savings. We can refer to this hybrid as a "consumption-*cum*-transfer tax" model. * * *

The positions of Mill, Kaldor, Rawls, Andrews, and others are rather interesting in that each favors some form of bequest or inheritance tax in addition to a personal consumption tax. Philosophically, this result is not surprising if we focus on life cycle savings. The equity notion underlying the consumption model becomes a lifetime, individualistic one. The core concept is that it is presumptively fair to allow taxpayers to decide when they should spend their own money. Yet any transfer tax is a tax on accumulation

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because what is transferred away as a gift or bequest is not consumed by the donor. Mill saw this clearly enough, but he defended a tax on inheritance because he viewed some tax on capital as acceptable and because he considered a tax on bequests as raising no adverse incentive effects: an heir who receives a 1000-pound bequest subject to a ten percent inheritance tax "considers the legacy as only 900 pounds."[200] This latter point, however, reflects an important misconception regarding the incentives for savings. Modern economic scholarship has shown that savers are motivated by a desire to leave bequests.[201] Thus, the adverse incentive effect is at the donor's level, not the beneficiary's. * * * If taxpayers are saving for intergenerational transfers, * * * hindering their ability to make such transfers may indeed reduce savings. We will return to this point when we consider bequest savings more directly.

Bequest saving accumulates income for the purpose of making gratuitous transfers. Gift and estate taxes impose a tax on the accumulated income upon transfer. To the extent that other types of saving are taxed only once under a consumption model, while bequest savings are taxed twice—both initially and on transfer—a hybrid system results. In describing a system of lifetime consumption taxes plus some form of tax on gratuitous transfers, Mill, Kaldor, Rawls, Andrews, and others advocate what is essentially a hybrid system that favors life cycle (and precautionary) savings but not bequest savings—that is, a consumption-*cum*-transfer tax system. * * *

The Case for Disfavoring

Recall that the first efficiency argument supporting consumption tax treatment of life cycle savings rests on the distorting effects of the income tax on the savings-consumption decision. This argument is very persuasive. But it is undermined somewhat by the fact that before-tax interest rates are likely to rise under an income tax, minimizing the welfare loss to individuals. There are two more significant problems with the argument. First, given a constant need for revenue, a move to a consumption tax will result in increased wage taxes in the short term, compounding the labor-leisure distortion. Second, unless we are prepared to go all the way to a pure consumption tax, the questions raised by the hybrid are relative ones—that is, do life cycle savings stand out as an efficient form of savings to tax compared to other forms of savings? Again, this depends on the compensated elasticity, or substitution effect, of the tax. There are some very good intuitive reasons to conclude that life cycle savings have a relatively low elasticity and are therefore a relatively efficient type of savings to tax. Life cycle savers may be motivated to amass a given nest egg regardless of cost.

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200. JOHN S. MILL, PRINCIPLES OF POLITICAL ECONOMY, bk. V, ch. II, §7, at 822 (W.J. Ashley ed., Logmans, Green & Co. 1909) (1848).

201. *See* Laurence J. Kotlikoff, *Intergenerational Transfers and Savings*, J. ECON. PERSP., Spring 1988, at 41 [and other sources].

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Put another way, life cycle savings may be more in the nature of necessities than luxuries.

*** [A]n expanded social security system might be a more efficient form of favoring life cycle savings than a consumption-style tax. We might even be better able to advance equity concerns through such a public system by better apportioning life cycle savings according to need.

***

[F]avoring life cycle savings, especially if we do not also favor bequests, may generate perverse incentives. *** By definition, a consumption-*cum*-transfer tax hybrid would place an added burden on accumulated capital gratuitously transferred. The flip side of this effect is that such a hybrid will favor consumption during a taxpayer's lifetime over gifts and bequests. The model would create an economic incentive to "spend down" one's resources late in life—exactly the opposite effect desired. *** Not only would such consumption undermine the macroeconomic argument, it might even be the type of excessive, conspicuous consumption that leads to inequities, both real and perceived.

This analysis brings us to the first of the two equitable arguments against favorable tax treatment of life cycle savings: that the existence of private wealth is somehow inimical to social norms. This raises the central question of what bothers us about wealth. ***

Instead of possession, however, it may be the private use of wealth that troubles us. This concern leads us to the second set of equitable arguments against consumption tax treatment of life cycle savings. We might share with Thorstein Veblen and others a concern with conspicuous consumption and its attendant problems for the allocation of resources and public morale.[234] Or we might agree with Kaldor that spending power is what matters, or with Andrews that standard of living is somehow the appropriate thing to be taxing. All of this discussion relates to Hobbes's argument and the general cultural case for saving, which favors (or at least does not disfavor) the hard-working saver over the idle consumer. If these were our concerns with wealth, we might logically be heading in quite a different direction than the consumption-*cum*-transfer tax ideal. If we were concerned mainly with the conspicuous consumption aspect of the private use of savings, we would want a persistently progressive lifetime consumption tax and a lower tax or even no tax on transfers by gift or bequest. This combination would directly and indirectly discourage excessive consumption: directly by the progressive tax and indirectly by not discouraging bequests. I will call such a system a consumption-*sans*-transfer tax hybrid.

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234. *See* THORSTEIN VEBLEN, THE THEORY OF THE LEISURE CLASS 68-101 (B.W. Huebsch ed., 1918) (1899) (discussing extensively the role an individual's consumption plays in identifying and maintaining his social class, thereby perpetuating the existence of a social hierarchy).

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This extended discussion of the possible effects of the consumption-*cum*-transfer tax hybrid has illustrated * * * equity arguments against favoring life cycle savings. * * * [P]articularly if we also had a steep bequest tax, a life cycle consumption model might lead to conspicuous consumption and other real and perceived inequities without creating the optimal incentives for long-term, private savings that might truly alleviate the long-run condition of the worst off. * * *

Precautionary Savings

Precautionary savings are a form of self-insurance. Unlike life cycle savings, which are designed to meet needs in the ordinary course of life and hence to smooth out consumption paths, precautionary savings are designed to meet extraordinary needs. * * *

The Case for Favoring

A good deal of what I have said about life cycle savings applies to precautionary savings. Indeed, the traditional tax policy literature does not separate out the two uses: both fit under what Andrews would call "consumption deferred." * * * [M]any of the equity and efficiency arguments explored above apply with equal force to precautionary savings. * * *

[F]avoring precautionary savings with consumption tax treatment might correct for market failure. Taxpayers may be likely to mis-save for their own future insurance needs either because they wrongly estimate future contingencies or because they fail to consider the social benefits that such savings generate, such as lessened welfare and emergency-care spending. * * *

Finally, the equity case for favorable tax treatment is apparent. In fact, precautionary savings is the category of uses that the law is most likely to put on the favorable no-tax model. * * * [T]axpayers suffering under a hardship may lack the relative ability to pay or the capacity of unaffected taxpayers. Professor Andrews, for example, has made clear that he does not feel that medical expenditures form part of a taxpayer's material well-being.[265]

The Case for Disfavoring

It may at first seem hard to imagine why we would not want to favor precautionary savings, given the strong equity and efficiency appeals of this use. Upon further consideration, however, we can see that there are reasons to stop short of a full-scale consumption model for precautionary accumulation.

Precautionary savings may very well be seen by taxpayers as a type of necessity and thus be a relatively efficient type of savings to tax. This application derives from the Ramsey pricing idea. * * *

265. *See* William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 335-37 (1972).

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[I]t may very well be that precautionary savers are driven by a desire to obtain a certain quantum of insurance. Tax laws that help savers attain their precautionary goals sooner rather than later might ironically free up resources for consumption. * * *

Perhaps the problems with favoring precautionary savings come into focus most clearly when we look at the choice between government-sponsored and private care. If we prefer private care, then we should encourage private precautionary savings, either through institutional or self-insurance, with consumption tax treatment. But there is no a priori reason to believe that privately funded care is better than government-sponsored care. Indeed, public care may actually be more efficient and more equitable than private care. * * *

The Once and Future Hybrid

We do generally favor precautionary savings with consumption tax treatment. Life, medical, and disability insurance are all taxed essentially under the prepayment model. In the case of life insurance, the tax laws do not allow a deduction for premium payments, but the inside build-up of cash value or whole life policies is not subject to current taxation, and the proceeds or death benefits are not usually taxed. Similarly, for medical insurance, the premium payments are not generally deductible, but the proceeds are tax free. Public care programs like Medicare are also funded with after-tax dollars and the benefits, when received, are not taxed. In certain cases, the Internal Revenue Code even allows deductions for insurance premiums (or exclusions for certain employer-paid premiums), in which case the insurance receives the most favorable, no-tax treatment.

* * *

Bequest Savings

* * * [T]his Part looks first at the case for disfavoring [bequest] savings because that side of the debate has dominated the literature. * * *

To clarify one technical matter in advance, favoring bequest savings means not imposing a tax on the transfer itself, either at the beneficiary or the donor level. The beneficiary would take the bequest with a zero basis and would be subject to the consumption tax upon consuming the wealth. We can think of this model as consumption tax treatment of bequests—we are in effect allowing the beneficiary a deduction for saving (i.e., for not spending) the inheritance. I go into this matter here because the literature itself is not consistent on how it uses the term "consumption" in the context of wealth transfers, and it is necessary to make clear a meaning from the start.

The Case for Disfavoring

As seen in Mill, among others, there is a very old case made against gifts and bequests. * * *

The principal equity theme is highly egalitarian: large inheritances create an unlevel playing field. * * *

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Consumption tax advocates similarly support gift and estate taxes to assure that wealth is taxed at least once each generation. * * *

The equitable case for favoring some type of bequest taxation is not typically thought to be undercut by economic considerations. If savings are actually motivated largely by precautionary and life cycle uses, taxing bequest savings ought to be relatively efficient. Again, this is an empirical matter of looking at the relative elasticity of bequest savings. Advocates of bequest taxation often seem to believe that such savings are mere leftovers, such that taxing them will not interfere with any important nontax incentives. * * *

In sum, wealth transfer taxes are a favorite in the literature. The most frequently articulated hybrid proposal is the consumption-*cum*-transfer tax model. * * *

The Case for Favoring

The case for disfavoring bequests is appealing and has dominated scholarly debate for centuries. It may nonetheless be wrong. The whole tenor of discussion begins to change when we consider some facts from the economics literature. A good deal, if not most, of savings may be motivated by a bequest motive,[307] and relatedly, bequest savings may be rather elastic to tax law changes.[308] Taxing bequests may indeed interfere with saving incentives at the donor's level. Bequest savings may be the best form of savings to favor * * * as the type of savings having the most elasticity to tax rules and by its nature having the longest, most beneficial time profile. One study has shown that prohibiting all bequests could reduce aggregate United States wealth by as much as fifty percent.[309] * * * Even though taxing bequests is not as onerous as prohibiting them, such a significant effect should give the transfer tax advocates pause. * * *

[Bequest] savings may be a stable source of capital. The marginal propensity to consume out of income appears to be greater than out of wealth, which means that people are more likely to spend their wages than reach into savings or a bequest. * * *

In any event, the various studies and statistics begin to cast considerable doubt on the tendency of the literature to advocate a lifetime consumption-*cum*-transfer tax. This tendency may rest on the naive assumption, evident in Mill, that because bequests represent leftover savings, taxing them would not create adverse incentives and would have little effect on capital accumulation. If people save for the purpose of transferring wealth, however, and if such savings are responsive to the effective tax rate

307. *See supra* note 201 and accompanying text.

308. The actual elasticity of bequest savings is an empirical matter that requires further study. However, compared to life cycle and precautionary savings, there are strong intuitive reasons to believe that bequest savings are relatively elastic because of their "leftover" status.

309. *See* Laurence J. Kotlikoff, *Introduction to Part I: Saving Motives*, *in* WHAT DETERMINES SAVINGS? 39, 41 (1989).

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on bequests, then quite a different story emerges. At least to the extent that we are concerned with the macroeconomic and efficiency gains promised by the consumption model, we should be reluctant to impose too high a toll on bequests.

* * *

If we are going to settle for a hybrid, a certain logic argues for choosing the consumption features most likely to achieve long-run benefits. Of all forms of savings, bequest savings may have the greatest payoff in this sense. Indeed, this logic continues to advocate a persistently progressive lifetime consumption tax combined with a reduced or eliminated transfer tax (*i.e.*, a consumption-*sans*-transfer tax hybrid)—precisely the opposite of the balance struck by Mill, Rawls, and others. This may not be simply a matter of preferring efficiency to equity. Instead, it may well be a principled view that, across generations, the best way to advance the cause of the least advantaged may be to allow and even encourage bequest savings.

* * *

The progressive lifetime consumption-*sans*-transfer tax hybrid would allow wealth to stay in private hands, but the public would effectively have a lien on the wealth: if and when savers attempted to consume their savings—that is, to appropriate their wealth for private use—the government would step in to claim its share. In the case of large amounts of savings, under the steep and persistent progressivity that would be an integral feature of this hybrid, the government's share would be generous. This solution would thus allow wealth to be private for the purposes of investment decision, but in an important sense, the law would convert much of the capital into public form.

* * * If the concern is with the private use of wealth rather than with its possession—a position arguably inherent in the logic of the consumption tax theory—then exempting bequests may lessen the offensive excess consumption at the donors' level. Once again, the point comes into sharper focus when we consider the common consumption-*cum*-transfer tax model: by disfavoring bequests relative to consumption, this model encourages private consumption. If we are concerned about accumulating and maintaining a common pool of funds, however, we should do precisely the opposite—steeply taxing conspicuous private consumption and exempting bequests. * * *

Indeed, if it is the possession of wealth and not its use that concerns us, we should confront the possibility that this concern is motivated by envy. Once we have shown that private capital is a form of public good and taken steps to hinder its private appropriation, what further reason do we have to disparage its presence? * * *

If we continue to oppose all bequests, we might have to live with a lower standard of living for all. * * *

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Notes and Questions

47. Professor McCaffery states that both efficiency and fairness arguments can be levied against the income tax. What are these?

48. The income tax is said to distort the choice between saving and consumption, but a consumption tax would, at least initially, be expected to have higher rates than an income tax. Why? These higher rates would carry their own distortion—taxpayers would inefficiently substitute leisure for labor.

49. Professor McCaffery notes that economists are in agreement that our economy would be benefitted in the long run by the change to a consumption tax. But we would be worse off "for a while." For how long would we be worse off, according to the economists?

50. Professor McCaffery's article focuses on savings, because the essential difference between the consumption tax and the accretion tax turns on how we treat savings; consumption is part of either tax base. For purposes of analysis, he then divides savings into three components. What are these? How is each described?

51. As Professor McCaffery acknowledges, people frequently save for mixed motives. "For example, taxpayers may save for life cycle reasons while intending that any leftovers be used for bequests." In such cases, which may well account for a large fraction of total savings, does McCaffery successfully explain how we can treat savings differently based upon the motivation for the saving?

52. Professor McCaffery argues that we should not necessarily tax all savings the same. We should, generally, tax more heavily forms of saving that are relatively inelastic (i.e., saving that will tend to occur even in the face of relatively heavy taxation). (Similarly, he states, we should tax apples and not oranges if the demand for apples is relatively inelastic and the demand for oranges is relatively elastic.) Why should we do this? What is meant by Ramsey pricing?

53. Professor McCaffery suggests that "life cycle savers may be motivated to amass a given nest egg regardless of cost." What is the relevance of this observation for tax policy?

54. In discussing life cycle and precautionary savings, Professor McCaffery refers to an "externality" that may lead to undersaving in preparation for old age or disability. What is this externality? In what

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direction does it point with respect to treating these forms of savings favorably in the tax system?

55. What are other arguments that suggest the tax system should favor life cycle savings?

56. Professor McCaffery points to several indications in present law that precautionary saving is favorably taxed. What are these present-law provisions?

57. Professor McCaffery suggests that the issue of whether the taxing system should treat precautionary saving favorably may come down to "the choice between government-sponsored and private care." Why might this be the case? Which should the tax system encourage?

58. The consumption tax model as applied to bequest saving would levy no tax at all on the testator who accumulated the wealth, because the testator did not consume; the heir would take a zero basis and therefore pay consumption tax when consumption occurred—which could be a long time.

Professor McCaffery notes that most supporters of consumption taxation also favor transfer taxes. Their "consumption-*cum*-transfer" model is less favorable to bequest savings than the consumption tax alone (the "consumption-*sans*-transfer" model). On the other hand, the combination of consumption and transfer taxes is more favorable to bequest savings than an accretion tax plus transfer taxes—arguably, a three-level tax.

If we imposed a consumption tax plus transfer taxes, which forms of savings—life cycle, precautionary, and bequest—would be favored and disfavored relative to the others?

59. Professor McCaffery views the imposition of estate taxes in addition to the general tax base (income or consumption) as disfavoring bequest savings. What are the traditional arguments supporting such a policy?

60. As noted above, most advocates of consumption-type taxation also favor transfer taxes. Why might the arguments favoring transfer taxes be viewed as stronger under a consumption tax regime rather than an income tax system? Do you think the case for transfer taxation would be stronger under a consumption tax than under the income tax?

61. Professor McCaffery argues that policy should take account of the likelihood that much saving is motivated by the desire to leave a bequest, and that "bequest savings may be relatively elastic to tax law changes." Do you think these propositions are correct? If they are correct, what would be the impact of heavy taxation of bequest savings on national savings?

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62. The last sentence excerpted from Professor McCaffery's article argues that opposition to bequest savings could result in "a lower standard of living for all." Why might "all" suffer if only the estates of the wealthiest one or two percent of decedents are subject to estate taxes?

63. Why might discouraging bequest savings—through high transfer taxes, for example—encourage conspicuous consumption? Would that be bad?

64. In general, adoption of a consumption-type tax rather than an income tax tends to favor saving in general.

But what practical use, if any, can we make of analysis of different types of savings? Obviously, the tax system cannot attempt to determine individual motivation in saving, so we cannot tailor a tax provision based on why an individual taxpayer engaged in a particular form of saving. If we concluded that tax law should favor life cycle savings, or precautionary savings, or bequest savings, how might those conclusions be reflected in actual tax provisions?

65. After praising the hybrid, in the end Professor McCaffery exhibits considerable sympathy for a progressive consumption tax coupled with abolition of transfer taxes. He argues that savings are good for society as a whole, and that we should encourage elderly taxpayers to pass along their savings to the next generation rather than engage in conspicuous consumption. If the heirs continue the investment, society is benefitted; if, instead, they liquidate and consume the savings, they will be subjected to a consumption tax "of steep and persistent progressivity."

Readers of the article excerpted above will not be surprised that two years after its publication, Professor McCaffery set forth a detailed proposal for a "progressive consumption-without-estate tax."[j]

66. Keep the issues raised in this subchapter in mind when studying Chapter Ten.

E. PROPOSALS IN THE POLITICAL ARENA

Thus far, this chapter has focused on the academic debate about a consumption-type tax. We turn now to a sampling of the same debate cast in a form directed at Congress and the broader public.

Professor Hall and Dr. Rabushka advocate what they describe as a single consumption tax comprised of two components—an individual tax on wages, salaries, and (when received) pensions; and a business tax. The business tax base allows for deduction of inputs from other businesses and for labor costs, but, notably, no deduction for interest. Both taxes would be

j. Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. (1994).

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imposed at the same flat rate (the authors suggest 19 percent). Considerable progressivity (more technically, degressivity) would be introduced into the individual tax by allowance of a large, untaxed "personal allowance."

The second excerpt is from an extensive and detailed "prototype" prepared by Alliance USA, a nonprofit corporation urging adoption of the Universal Savings Allowance, or USA, tax proposal. Businesses would be subjected to a flat-rate tax of about 10 percent (a subtraction-type VAT). The USA business tax would have a broader base than the Hall & Rabushka business tax, because USA would allow no deduction for employee compensation. Individuals would pay a progressive tax on income, including not only wages and salaries but income from property, but would be allowed an unlimited deduction for net savings.

Representative Richard Armey (R-TX), the House Majority Leader, has introduced a bill based on the Hall & Rabushka proposal. Senators Nunn (D-GA) and Domenici (R-NM) have offered a bill quite similar to the Alliance USA prototype. References to "the Armey bill" or to "Nunn-Domenici" can generally be understood as also referring, respectively, to the Hall & Rabushka and Alliance USA proposals.

The third excerpt is from an article written by Dr. Rudolph Penner, an economist who consulted in the crafting of the Alliance USA and Nunn-Domenici proposals. In addition to explaining the proposals, Dr. Penner's article discusses the enormous complexity—both technical and political—involved in moving beyond the model of a new tax system to deal with the multitude of issues that must be addressed in constructing an actual new system. Among the most difficult of the practical problems is the transition from present law to the proposed new system; this topic will be further explored in the Notes and Questions.

Finally, a distinguished member of the tax bar, John Nolan, compares proposed consumption-type taxes to present law. While Mr. Nolan finds favorable features in the proposals, he is generally skeptical.

THE FLAT TAX

Robert E. Hall* & Alvin Rabushka**

Pages 52-64, 71-73, 78-80, 99-100 (2d ed. 1995)

Tax forms really can fit on postcards. A cleanly designed tax system takes only a few elementary calculations, in contrast to the hopeless complexity of today's income taxes. In this chapter, we present a complete plan for a whole new tax system that puts a low tax rate on a comprehensive definition of income. Because its base is broad, the astonishingly low 19 percent tax rate raises the same revenue as does the current tax system.

*. At time of original publication, Professor of Economics and Senior Fellow at the Hoover Institution, Stanford University.

**. At time of original publication, Senior Fellow at the Hoover Institution, Stanford University.

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The tax on families is fair and progressive: the poor pay no tax at all, and the fraction of income that a family pays rises with income. The system is simple and easy to understand. And the tax operates on the consumption tax principle—families are taxed on what they take out of the economy, not what they put into it.

Our system rests on a basic administrative principle: income should be taxed exactly once as close as possible to its source. * * *

Under our plan, all income is taxed at the same rate. Equality of tax rates is a basic concept of the flat tax. Its logic is much more profound than just the simplicity of calculation with a single tax rate. Whenever different forms of income are taxed at different rates or different taxpayers face different rates, the public figures out how to take advantage of the differential.

Progressivity, Efficiency, and Simplicity

Limiting the burden of taxes on the poor is a central principle of tax reform. * * * We reject sales and value-added taxes for this reason. The current federal tax system avoids taxing the poor, and we think it should stay that way.

Exempting the poor from taxes does not require graduated tax rates rising to high levels for upper-income families. A flat rate, applied to all income above a generous personal allowance, provides progressivity without creating important differences in tax rates. * * *

Our proposal is based squarely on the principle of consumption taxation. Saving is untaxed, thus solving the problem that has perplexed the designers of the current tax system, which contains an incredible hodgepodge of savings and investment incentives. As a general matter, the current system puts substantial taxes on the earnings from savings. On that account, the economy is biased toward too little saving and too much consumption. * * * In our system, there is a single, coherent provision for taxing the return to saving. All income is taxed, but the earnings from saved income are not taxed further. * * *

An Integrated Flat Tax

Our flat tax applies to both businesses and individuals. Although our system has two separate tax forms—one for business income and the other for wages and salaries—it is an integrated system. When we speak of its virtues, such as its equal taxation of all types of income, we mean the system, not one of its two parts. As we will explain, the business tax is not just a replacement for the existing corporate income tax. It covers all businesses, not just corporations. And it covers interest income, which is currently taxed under the personal income tax.

In our system, all income is classified as either business income or wages (including salaries and retirement benefits). The system is airtight. Taxes on both types of income are equal. The wage tax has features to make the overall system progressive. Both taxes have postcard forms. The low tax

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rate of 19 percent is enough to match the revenue of the federal tax system as it existed in 1993, the last full year of data available as we write.

Here is the logic of our system, stripped to basics: We want to tax consumption. The public does one of two things with its income—spends it or invests it. We can measure consumption as income minus investment. A really simple tax would just have each firm pay tax on the total amount of income generated by the firm less that firm's investment in plant and equipment. The value-added tax works just that way. But a value-added tax is unfair because it is not progressive. That's why we break the tax in two. The firm pays tax on all the income generated at the firm except the income paid to its workers. The workers pay tax on what they earn, and the tax they pay is progressive.

To measure the total amount of income generated at a business, the best approach is to take the total receipts of the firm over the year and subtract the payments the firm has made to its workers and suppliers. This approach guarantees a comprehensive tax base. The successful value-added taxes in Europe work this way. The base for the business tax is the following:

Total revenue from sales of goods and services
less
purchases of inputs from other firms
less
wages, salaries, and pensions paid to workers
less
purchases of plant and equipment

The other piece is the wage tax. Each family pays 19 percent of its wage, salary, and pension income over a family allowance (the allowance makes the system progressive). The base for the compensation tax is total wages, salaries, and retirement benefits less the total amount of family allowances.

Table 3.1 is a calculation of flat-tax revenue based on the U.S. National Income and Product Accounts for 1993. The first line shows gross domestic product, the most comprehensive measure of income throughout the economy. The next line is indirect business taxes that are included in GDP but that would not be taxed under the flat tax, such as sales and excise taxes. Line 3, income included in GDP but not in the tax base, is mostly the value of houses owned and lived in by families; this income does not go through the market. Wages, salaries, and pensions, line 4, would be reported on the first line of the wage-tax form and would be deducted by businesses. Investment, line 5, is the amount spent by businesses purchasing new plant and equipment (each business could also deduct its purchases of used plant and equipment, but these would be included in the taxable income of the selling business and would net out in the aggregate). Line 6 shows the taxable income of all businesses after they have deducted their wages and investment. The revenue from the business tax, line 7, is 19 percent of the

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tax base on line 6. Line 8 shows the amount of family allowances that would be deducted. The wage-tax base on line 9 shows the amount of wages, salaries, and pensions left after deducting all family allowances from the amount on line 4. The wage-tax revenue on line 10 is 19 percent of the base. Total flat-tax revenue on line 11 is $627 billion. Lines 12 and 13 show the actual revenue from the personal and corporate income taxes. The total actual revenue on line 14 is also $627 billion. The flat-tax revenue and the actual revenue are the same, by design. We propose to reproduce the revenue of the actual income tax system, not to raise or lower it.

TABLE 3.1
FLAT-TAX REVENUES COMPARED WITH CURRENT REVENUES

Line	Income or Revenue	Billions of Dollars
1	Gross domestic product	$6,374
2	Indirect business tax	431
3	Income included in GDP but not in tax base	217
4	Wages, salaries, and pensions	3,100
5	Investment	723
6	Business-tax base (line 1 minus lines 2 through 5)	1,903
7	Business-tax revenue (19 percent of line 6)	362
8	Family allowances	1,705
9	Wage-tax base (line 4 less line 8)	1,395
10	Wage-tax revenue (19 percent of line 9)	265
11	Total flat-tax revenue (line 7 plus line 10)	627
12	Actual personal income tax	510
13	Actual corporate income tax	118
14	Total actual revenue (line 12 plus line 13)	627

These computations show that in 1993 the revenue from the corporate income tax, with a tax rate of 35 percent, was $118 billion. The revenue from our business tax at a rate of 19 percent would have been $362 billion, just over three times as much, even though the tax rate is not much more than half the current corporate rate.[k] There are three main reasons that the flat business tax yields more revenue than does the existing corporate tax. First, slightly more than half of business income is from noncorporate businesses—professional partnerships, proprietorships, and the like. Second, our business tax does not permit the deduction of interest paid by businesses, whereas the corporate income tax does. Third, the business tax puts a tax on fringe benefits, which escape any taxation in the current system.

* * *

k. Under present law, corporations are subjected to a progressive rate structure, which begins at 15%, for corporations earning less than $50,000, and rises to 35%. Section 11. (Eds.)

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Another limitation on our calculations is that we do not consider the way the economy would respond to tax reform. In [a portion of the book not excerpted], we discuss why the flat tax would increase national income and tax revenue. But part of that process might involve a burst of investment, which would temporarily depress flat-tax revenue because of the expensing of investment. Only a detailed analysis using data not available to us would determine whether we have over- or underestimated the revenue from the flat tax. We do not think we are far off, however.

The Individual Wage Tax

The individual wage tax has a single purpose—to tax the large fraction of income that employers pay as cash to their workers. It is not a tax system by itself but is one of the two major parts of the complete system. The base of the tax is defined narrowly and precisely as actual payments of wages, salaries, and pensions. Pension contributions and other fringe benefits paid by employers are not counted as part of wages. In other words, the tax on pension income is paid when the retired worker actually receives the pension, not when the employer sets aside the money to pay the future pension. This principle applies even if the employer pays into a completely separate pension fund, if the worker makes a voluntary contribution to a 401(k) program, or if the worker contributes to a Keogh, IRA, or SEP fund.

* * * To make the tax system progressive, only earnings over a personal or family allowance are taxed. The allowance is $25,500 for a family of four in 1995 but would rise with the cost of living in later years. All the taxpayer has to do is report total wages, salaries, and pensions at the top, compute the family allowance based on marital status and number of dependents, subtract the allowance, multiply by 19 percent to compute the tax, take account of withholding, and pay the difference or apply for a refund. For about 80 percent of the population, filling out this postcard once a year would be the only effort needed to satisfy the Internal Revenue Service. What a change from the many pages of schedules the frustrated taxpayer fills out today!

For the 80 percent of taxpayers who don't run businesses, the individual wage tax would be the only tax to worry about. Many features of current taxes would disappear, including charitable deductions, mortgage interest deductions, capital gains taxes, dividend taxes, and interest taxes. * * *

Anyone who is self-employed or pays expenses directly in connection with making a living will need to file the business tax to get the proper deduction for expenses. Fortunately, the business-tax form is even simpler than the wage-tax form.

Again, we stress that the wage tax is not a complete income tax on individuals; it taxes only wages, salaries, and pensions. The companion business tax picks up all other components of income. Together they form an airtight tax system.

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The Business Tax

It is not the purpose of the business tax to tax businesses. Fundamentally, people pay taxes, not businesses. The idea of the business tax is to collect the tax that the owners of a business owe on the income produced by the business. Collecting business income tax at the source of the income avoids one of the biggest causes of leakage in the tax system today: Interest can pass through many layers where it is invariably deducted when it is paid out but frequently not reported as income.

Airtight taxation of individual business income at the source is possible because we already know the tax rate of all of the owners of the business—it is the common flat rate paid by all taxpayers. If the tax system has graduated rates, taxation at the source becomes a problem. If each owner is to be taxed at that owner's rate, the business would have to find out the tax rate applicable to each owner and apply that rate to the income produced in the business for that owner. * * * Source taxation is only practical when a single rate is applied to all owners. Because source taxation is reliable and inexpensive, it is a powerful practical argument for using a single rate for all business income.

The business tax is a giant, comprehensive withholding tax on all types of income other than wages, salaries, and pensions. It is carefully designed to tax every bit of income outside of wages but to tax it only once. The business tax does not have deductions for interest payments, dividends, or any other type of payment to the owners of the business. As a result, all income that people receive from business activity has already been taxed. Because the tax has already been paid, the tax system does not need to worry about what happens to interest, dividends, or capital gains after these types of income leave the firm, resulting in an enormously simplified and improved tax system. Today, the IRS receives more than a billion Form 1099s, which keep track of interest and dividends, and must make an overwhelming effort to match these forms to the 1040s filed by the recipients. The only reason for a Form 1099 is to track income as it makes its way from the business where it originates to the ultimate recipient. Not a single Form 1099 would be needed under a flat tax with business income taxed at the source.

The way that we have set up the business tax is not arbitrary—on the contrary, it is dictated by the principles we set forth at the beginning of this chapter. The tax would be assessed on all the income originating in a business but not on any income that originates in other businesses or on the wages, salaries, and pensions paid to employees. The types of income taxed by the business tax would include:

* Profits from the use of plant and equipment
* Profits from ideas embodied in copyrights, patents, trade secrets, and the like
* Profits from past organization-building, marketing, and advertising efforts

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* Earnings of key executives and others who are owners as well as employees and who are paid less than they contribute to the business
* Earnings of doctors, lawyers, and other professionals who have businesses organized as proprietorships or partnerships
* Rent earned from apartments and other real estate
* Fringe benefits provided to workers

All a business's income derives from the sale of its products and services. On the top line of the business-tax form goes the gross sales of the business—its proceeds from the sale of all its products. But some of the proceeds come from the resale of inputs and parts the firm purchased; the tax has already been paid on those items because the seller also has to pay the business tax. Thus, the firm can deduct the cost of all the goods, materials, and services it purchases to make the product it sells. In addition, it can deduct its wages, salaries, and pensions, for, under our wage tax, the taxes on those will be paid by the workers receiving them. Finally, the business can deduct all its outlays for plant, equipment, and land. * * *

Everything left from this calculation is the income originating in the firm and is taxed at the flat rate of 19 percent. In most businesses, there is enough left that the prospective revenue from the business tax is the $362 billion we computed earlier. Many deductions allowed to businesses under current laws are eliminated in our plan, including interest payments and fringe benefits. But our excluding these deductions is not an arbitrary move to increase the tax base. In all cases, eliminating deductions, when combined with the other features of our system, moves toward the goal of taxing all income once at a common, low rate and achieving a broad consumption tax.

Eliminating the deduction for interest paid by businesses is a central part of our general plan to tax business income at the source. It makes sense because we propose not to tax interest received by individuals. The tax that the government now hopes (sometimes in vain) that individuals will pay will assuredly be paid by the business itself.

We sweep away the whole complicated apparatus of depreciation deductions, but we replace it with something more favorable for capital formation, an immediate 100 percent first-year tax write-off of all investment spending. Sometimes this approach is called expensing of investment; it is standard in the value-added approach to consumption taxation. In other words, we don't deny depreciation deductions; we enhance them. More on this shortly.

Fringe benefits are outside the current tax system entirely, which makes no sense. The cost of fringes is deductible by businesses, but workers are not taxed on the value of the fringes. Consequently, fringes have a big advantage over cash wages. As taxation has become heavier and heavier, fringes have become more and more important in the total package offered by employers to workers—fringes were only 1.2 percent of total compensation in 1929, when income taxes were unimportant, but reached almost 18 percent

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in 1993. The explosion of fringes is strictly an artifact of taxation and thus an economically inefficient way to pay workers. Were the tax system neutral, with equal taxes on fringes and cash, workers would rather take their income in cash and make their own decisions about health and life insurance, parking, exercise facilities, and all the other things they now get from their employers without much choice. Further, failing to tax fringes means that taxes on other types of income are all the higher. Bringing all types of income under the tax system is essential for low rates.

Under our system, each business would file a simple form. Even the largest business (General Motors Corporation in 1993, with $138 billion in sales) would fill out our simple postcard form. Every line on the form is a well defined number obtained directly from the business's accounting records.
* * *

The taxable income computed bears little resemblance to anyone's notion of profit. The business tax is not a profit tax. When a company is having an outstanding year in sales and profits but is building new factories to handle rapid growth, it may well have a low or even negative taxable income. That's fine—later, when expansion slows but sales are at a high level, the income generated will be taxed at 19 percent.

Because the business tax treats investment in plant, equipment, and land as an expense, companies in the start-up period will have negative taxable income. But the government will not write a check for the negative tax on the negative income. Whenever the government has a policy of writing checks, clever people abuse the opportunity. Instead, the negative tax would be carried forward to future years, when the business should have a positive taxable income. There is no limit to the number of years of carry forward. Moreover, balances carried forward will earn the market rate of interest (6 percent in 1995). * * *

Investment Incentives

Expensing investment eliminates the double taxation of saving, another way to express the most economically significant feature of expensing. Under an income tax, people pay tax once when they earn and save and again when the savings earn a return. With expensing, the first tax is abolished. Saving is, in effect, deducted in computing the tax. Later, the return to the saving is taxed through the business tax.

The easiest way to show that expensing investment is a consumption tax arises when someone invests directly in a personally owned business. Suppose a taxpayer receives $1,000 in earnings and turns around and buys a piece of business equipment for $1,000. Under the flat tax, there is a tax of $190 on the earnings but also a deduction worth $190 in reduced taxes for the equipment purchase. On net, there is no tax. The taxpayer has not consumed any of the original $1,000. Later the taxpayer will receive business income representing the earnings of the machine, which will be taxed at 19 percent. If the taxpayer chooses to consume rather than invest

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again, there will be a 19 percent tax on the consumption. So the overall effect is a 19 percent consumption tax.

Most people, however, don't invest by directly purchasing machines. The U.S. economy has wonderfully developed financial markets for channeling savings from individual savers to businesses who have good investment opportunities. Individuals invest by purchasing shares or bonds, and the firms then purchase plant and equipment. The tax system we propose taxes the consumption of individuals in this environment as well. Suppose the same taxpayer pays the $190 tax on the same $1,000 and puts the remaining $810 into the stock market. For simplicity, suppose that the share pays out to its owner all the after-tax earnings on equipment costing $1,000. (That assumption makes sense because the firm could buy $1,000 worth of equipment with the $810 from our taxpayer plus the tax write-off worth $190 that would come with the equipment purchase.) Our taxpayer gets the advantage of the investment write-off even though there is no deduction for purchasing the share. The market passes the incentive from the firm on to the individual investor.

Another possibility for the taxpayer is to buy a bond for $810. Again, the firm issuing the bond can buy a $1,000 machine with the $810, after taking advantage of the tax deduction. To compete with the returns available in the stock market, however, the bond must pay the same returns as a stock selling for the same price, which in turn is equal to the after-tax earnings of the machine, so it won't matter how the taxpayer invests the $810. In all cases, there is effectively no tax for saved income; the tax is payable only when the income is consumed.

In our system, any investment, in effect, would have the same economic advantage that a 401(k), IRA, or Keogh account has in the current tax system. And we achieve this desirable goal by reducing the amount of record keeping and reporting. Today, taxpayers have to deduct their Keogh-IRA contributions on their Form 1040s and then report the distributions from the funds as income when they retire. Moreover, proponents of the cash-flow consumption tax would extend these requirements to all forms of saving. Our system would accomplish the same goal without any forms or record keeping.

Capital Gains

* * *

Capital gains would be taxed exclusively at the business level, not at the personal level. In other words, our system would eliminate the double taxation of capital gains inherent in the current tax system. To see how this works, consider the common stock of a corporation. The market value of the stock is the capitalization of its future earnings. Because the owners of the stock will receive their earnings after the corporation has paid the business tax, the market capitalizes after-tax earnings. A capital gain occurs when the market perceives that prospective after-tax earnings have risen. When

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the higher earnings materialize in the future, they will be correspondingly taxed. In a tax system like the current one, with both an income tax and a capital gains tax, there is double taxation. * * *

Capital gains on owner-occupied houses are not taxed under our proposal. Few capital gains on houses are taxed under the current system—gains can be rolled over, there is an exclusion for older home sellers, and gains are never taxed at death. Excluding capital gains on houses makes sense because state and local governments put substantial property taxes on houses in relation to their values. Adding a capital gains tax on top of property taxes is double taxation in the same way that adding a capital gains tax on top of an income tax is double taxation of business income.

The Transition

* * *

Depreciation Deductions

Existing law lets businesses deduct the cost of an investment on a declining schedule over many years. From the point of view of the business, multiyear depreciation deductions are not as attractive as the first-year write-off prescribed in the flat tax. No business will complain about the flat tax as far as future investment is concerned. But businesses may well protest the unexpected elimination of the unused depreciation they thought they would be able to take on the plant and equipment they installed before the tax reform. Without special transition provisions, these deductions would simply be lost.

How much is at stake? In 1992, total depreciation deductions under the personal and corporate income taxes came to $597 billion. * * *

If Congress chose to honor all unused depreciation from investment predating tax reform, it would take about $597 billion out of the tax base for 1995. To raise the same amount of revenue as our 19 percent rate, the tax rate would have to rise to about 20.1 percent.

* * *

If Congress did opt to honor past depreciation, it should recognize that the higher tax rate needed to make up for the lost revenue is temporary. Within five years, the bulk of the existing capital would be depreciated and the tax rate should be brought back to 19 percent. From the outset, the tax rate should be committed to drop to 19 percent as soon as the transition depreciation is paid off.

Interest Deductions

* * *

Our tax reform calls for the parallel removal of interest deduction and interest taxation. If a transitional measure allows deductions for interest on outstanding debt, it should also require taxation of that interest as income of the lender. If all deductions are completely matched with taxation on the other side, then a transition provision to protect existing interest deductions

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would have no effect on revenue. In that respect, interest deductions are easier to handle in the transition than depreciation deductions.

If Congress decides that a transitional measure to protect interest deductions is needed, we suggest the following. Any borrower may choose to treat interest payments as a tax deduction. If the borrower so chooses, the lender must treat the interest as taxable income. But the borrower's deduction should be only 90 percent of the actual interest payment, while the lender's taxable income should include 100 percent of the interest receipts.

Under this transitional plan, borrowers would be protected for almost all their existing deductions. Someone whose personal finances would become untenable if the mortgage-interest deduction were suddenly eliminated can surely get through with 90 percent of the earlier deduction. But the plan builds in an incentive for renegotiating the interest payments. Suppose a family is paying $10,000 in annual mortgage interest. It could stick with this payment and deduct $9,000 per year. Its net cost, after subtracting the value of its deduction with the 19 percent tax rate, would be $8,290. The net income to the bank, after subtracting the 19 percent tax it pays on the whole $10,000, would be $8,100. Alternatively, the family could accept a deal proposed by the bank: The interest payment would be lowered to $8,200 by rewriting the mortgage. * * * The deal will be beneficial to both.

* * *

As far as revenue is concerned, this plan would actually add a bit to federal revenue in comparison to the pure flat tax. Whenever a borrower exercised the right to deduct interest, the government would collect more revenue from the lender than it would lose from the borrower. As more and more deals were rewritten to eliminate deductions and lower interest, the excess revenue would disappear and we would be left with the pure flat tax.

Charitable Contributions

Deducting contributions to worthy causes would be a thing of the past under our tax reform. Will the nation stop supporting its churches, hospitals, museums, and opera companies when the tax deduction disappears? We think not. But we should also be clear that incentives matter—the current tax system with high marginal rates and tax deductions provides inappropriately high incentives for some contributions. The immediate effect of tax reform may be a small decline in giving. Later, as the economy surges forward under the impetus of improved incentives for productive activity, giving will recover and likely exceed its current levels.

In 1991, total cash contributions to charitable causes were about $117 billion. Of this, only $61 billion was deducted on personal tax returns. Almost half of all contributions were not affected by the law permitting deduction. We confidently expect that the $56 billion in contributions being made today without any special tax benefits will continue. Further, the bulk of contributions are from people in modest tax brackets—only $28 billion in

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contributions were deducted in 1991 by families with taxable incomes of more than $75,000. In this connection, it is important to understand that well more than half of all cash contributions go to churches and that these gifts are generally from the middle of the income distribution.

Churches have nothing to fear from tax reform and, like most people and institutions, would have much to gain from better economic conditions brought about by reform. Despite their dominant position in gifts, churches are not the leaders in fighting a tax reform that denies deductions. Instead, institutions serving the absolute economic and social elite—universities, symphonies, opera companies, ballets, and museums—are protesting the loudest. No compelling case has ever been made that these worthy undertakings should be financed by anyone but their customers. * * *

Major tax cuts in 1981 and 1986 cut the top marginal tax rate from 70 percent to 50 percent and then to 28 percent. As a result, major donors shifted from spending thirty-three-cent dollars to spending fifty-cent and then seventy-two-cent dollars for tax-deductible gifts. Despite these major reductions in incentives for the rich to give, donations to charity grew robustly. * * *

UNLIMITED SAVINGS ALLOWANCE (USA) TAX SYSTEM

Alliance USA*

66 Tax Notes 1482, 1487-94, 1514-15 (1995)

The USA Tax System is designed to replace on a revenue-neutral basis the present corporate and individual income taxes in Subtitle A of the IRC of 1986. The proposed new tax system consists of two parts.

> A [10%][1] flat-rate Business Tax that applies to all organizational forms of businesses, corporate and noncorporate, and that allows a deduction for business capital investment.
>
> A graduated-rate Individual Tax that applies to individuals and that allows a deduction for personal savings.

The centerpiece of the USA Tax System is the Unlimited Savings Allowance from which the new tax system for America's future derives its name. The concept is a simple but powerful one that views Americans not as payers of taxes but as the producers of the income and the providers of the savings on which a growing economy and higher living standards depend. Everyone has a stake, a large one, in the national stock of savings whether or not they personally own any of that savings at the present time.

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*. The paper was prepared for Alliance USA by two legal consultants, Ernest S. Christian and George J. Schutzer, with advice from two economic consultants, Rudolph G. Penner and Barry K. Rogstad, at the request of the Alliance's co-chairmen, Paul H. O'Neill and Robert K. Lutz, and under the administrative supervision of its Executive Director, Barbara W. North.

1. Throughout this document, the drafters placed tax rates in brackets, apparently contemplating that their concept might be used with different tax rates. (Eds.)

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Under the USA Tax System, when people earn income, save part of it and add to the national stock of savings, they get a tax deduction. When they take their income out of savings and reduce the national stock, they pay tax on that income. For so long as people have their income invested for everyone's benefit, including their own, they do not have to pay tax on that income.

Putting aside a part of earnings in a savings account, a stock or bond or in their own small business is not the only way that Americans can invest in the future and create even more income for themselves and everyone else. They can and should also invest in human capital. Investment in their own education and training and in the education of their children will produce a large, long lasting return on investment in which everyone will share.

The USA Tax System provides a limited deduction for education expenses. This deduction works in tandem with the Unlimited Savings Allowance. Parents will be able to set aside tax-deferred income for their children's education. When they withdraw the income in the future to pay qualified tuition, the income will not be taxed to the extent offset by the deduction for education expenses.

For lower and middle-income Americans who work for salaries and wages, the existing FICA payroll tax withheld from their paychecks is a heavy burden. The USA Tax System provides a payroll tax credit that phases out as income rises and the payroll tax becomes less of a burden in proportion to income.

The USA Tax System contains important new rules related to imports and exports, and for American companies directly competing in the global marketplace. These innovations are intended to level the international playing field and let American goods, skill and know-how, including emerging new technologies and services, be more competitive.

* * *

The core principles of the USA Tax System are of overriding importance.

In order for there to be income, there must be savings but in order for there to be savings, there must be income.

Human labor and skill is the ultimate source of all income but the amount of income that people produce and enjoy will be less without sufficient savings and investment.

The existing tax system is biased against saving and, therefore, against earning income and the human dignity and well-being that go with it. By allowing people a fair opportunity to save, the USA Tax System removes the bias against earning greater incomes from human effort and skill.

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Understanding the Business Tax in the Context of the Individual Tax and Vice Versa

The Business Tax and the Individual Tax are merely two interrelated parts of a tax applied to a single tax base that happens to appear at two different points in the process by which income is created and received.

The tax base first emerges when businesses create income by producing and selling goods and services. That is when the Business Tax applies. Next, the tax base reappears when individuals actually receive that income, net of the Business Tax, in the form of wages, salaries, interest, dividends and similar distributions to the owners of a business. It is at that point where the Individual Tax applies.

Because the basic operating rules of both parts of the new two-tier tax system are largely interactive, it can best be understood by looking at both the Business Tax and the Individual Tax, separately and in relation to one another, and then by looking at detailed examples where both taxes are applied to illustrative sets of facts.

Basic Operating Rules and Principles of the Business Tax

Rules

Although supplemental rules are needed to make the Business Tax work properly and consistently in all situations, the basic operating rules are few and simple.

1. Every business, incorporated or unincorporated, that is producing and selling goods and services, and, therefore, creating income for its employees, owners and lenders, must file an annual business tax return and pay a [10%] tax on its annual "gross profit" which is a defined term under the Business Tax.

2. In calculating its gross profit tax base to which the [10%] tax is applied, the business adds only the amount it actually received from sales of goods and services and subtracts only the amount it actually paid out to other businesses for the goods and services it had to buy from them (plant, equipment, inventory, supplies, rent, utilities, telephones, fuel, legal and accounting fees, etc.). Excluded from the gross profit calculation are financial receipts and payments. For example, the business neither includes interest and dividends received nor deducts interest and dividends paid. * * * Also excluded are compensation payments to employees.

3. Amounts received from export sales of goods to a purchaser outside the United States and for services rendered outside the United States are excluded from the calculation of gross profit. Correspondingly, a [10%] import tax is imposed on the sale of goods into the United States from abroad. E.g., a foreign business that manufactures outside the United States but sells its products in the U.S. market will pay the import tax.

4. A tax credit is allowed for the 7.65% employer payroll tax (commonly called FICA or Social Security Tax) that businesses must pay on wages paid to employees.

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5. The Business Tax is territorial. U.S. businesses will not include in gross profit the proceeds from sales made or services provided outside the United States and they will not subtract amounts paid for the purchase of goods or the provision of services outside the United States. U.S. businesses will not be taxed on dividends paid by foreign subsidiaries. Foreign businesses will include in gross profit amounts received for goods sold or services provided in the United States and will subtract amounts paid for goods acquired and services provided in the United States.

Discussion of General Principles

Because of the special definition of gross profit under the Business Tax, it makes no distinction between that portion of a business's income that is produced and received by its owners and that portion produced and received by its employees. The business calculates its gross profit tax base before paying employees their share, before paying owners their share, before paying creditors their share, and before paying taxes owed by the business.

* * *

The often-drawn line between capital income and work income is, however, indistinct at best. In the case of smaller corporations and partnerships, all or most of the owners also themselves work in the business and receive their shares of the gross profit in part as salary (or "guaranteed payments" or draws) and in part as "dividends" in proportion to their investments of time and effort, as well as capital. Even in the case of large privately held corporations, many of the founders who own all or most of the stock may also work in the business. The key executives of large publicly held corporations nearly always own stock. They too will receive both salaries and dividends out of gross profit.

In the case of the many unincorporated businesses operating as "proprietorships," the owner of the business is almost by definition also the operator of the business. Proprietorships are usually small businesses, such as a farm, retail shop, pharmacy, small-town plumber or electrician, or a doctor or dentist operating as a sole practitioner. The owner-employee is usually the only one who has capital invested in the business (mostly reinvested earnings) and is sometimes the only "employee," although family members may also work full or part time in the business. Here, even for bookkeeping purposes, the distinction between a dollar of gross profit produced and received from working in the business like other employees, and a dollar produced and received for having provided the capital necessary for anyone to earn any income from the business, is as blurred and irrelevant as it is in reality.

The present income tax system makes huge distinctions in the foregoing cases depending on the form of business organization, on the size of the business, on whether income is said to be produced by labor or by capital, and on whether income is said to be received as an employee or as an owner of capital. In the process of making all these fine-spun distinctions, present

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law imposes vastly different tax liabilities on different parts of what is in fact a single tax base.

In contrast, the Business Tax is even-handed in the amount of tax it imposes on the labor and capital incomes produced by a business. After all, no one, including the Commissioner of Internal Revenue or the President or Congress of the United States, actually knows exactly how much of any business' gross profit is produced by labor instead of by capital, or vice versa, or even has a particularly realistic way of defining either one. We do know that gross profit exists, do know how to measure it in the case of any business and in total for all businesses, and do know that it is ultimately the source of everyone's income. We also know that gross profit is the result of some combination of labor and capital. * * *

The Business Tax responds to the reality of these knowns and unknowns simply by collecting [10%] of gross profit when it is produced at the business level, without distinctions as to who or what contributed more or less to its creation, and leaving to the business' owners and employees, operating within the inexorably accurate forces of the marketplace, to determine who gets and, therefore, who produced, how much of the total.

Applied in this way, the Business Tax serves as a step-one pre-collection of tax even before the respective shares of gross profit are determined, and before people actually receive their respective shares, net of the pre-collection, as wages, salaries, dividends, interest, and mixtures thereof. When people receive their income, the Individual Tax will be collected directly from them. The Business Tax plus the Individual Tax will be the total tax on their shares of what is in reality a single tax base flowing from production (business) to producers (people).

Not only does the Business Tax make no arbitrary distinctions among different dollars of income—based on presumed origins or otherwise—it proceeds from a correct definition of "income" in the first place. All businesses have some capital invested in machinery, inventories, etc. Under the gross profit calculation used in the Business Tax, that cost is subtracted so that the business is first allowed to recover capital. It is only income (not the capital itself) that is included in the business' gross profit tax base and that is ultimately, net of Business Tax, reflected in any person's share of gross profit.

Under the Individual Tax, the counterpart of the business' ability to recover capital before having taxable gross profit, is the ability of a person who receives wages, salaries, dividends, interest, etc. to defer tax on that portion which he or she saves and converts into capital. * * *

Basic Operating Rules and Principles of the Individual Tax

Rules

Although, here again, some supplementary rules are necessary, the basic operating rules of the Individual Tax are few and simple.

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1. All individuals must file an annual return and pay tax at graduated rates ranging from [X to Z%] on their taxable income for the year.

2. In calculating taxable income, the individual generally includes in gross income all amounts received from all sources other than gifts, bequests, the proceeds of loans, and certain income transfers or substitutes received from governments. Thus, gross income would generally include wages, salaries, interest, pensions, annuities, the proceeds of a life insurance contract, dividends, equivalent distributions from a partnership or other unincorporated business, and most amounts received from the sale of assets.

3. If an individual defers receipt of gross income by saving it, i.e., by investing it in a savings asset such as a stock or a bank deposit, the individual is allowed a deduction for that savings. This is called the Unlimited Savings Allowance. This deduction serves to defer tax on income the actual receipt of which the individual has deferred by recontributing it to the national stock of savings. When, later, the individual withdraws savings from the national savings pool, the amount withdrawn is at that time included in the individual's gross income.

4. The individual also deducts from gross income (i) personal and family exemptions, (ii) a Family Living Allowance deduction, and (iii) a few personal deductions generally related to home ownership, charitable contributions and education.

5. Individuals do not deduct on their personal tax returns any "trade or business" expenses such as are now reported on Schedule C of Form 1040. If an individual is self-employed and does incur such expenses, they are reported on a self-employed business tax return along with the gross sales revenues associated with that business entity. Only the net results of that self-employed business, minus the Business Tax, are reported on the individual's personal tax return and, then, only to the extent actually withdrawn from the business.

6. In general, individuals are allowed a credit for the 7.65% employee payroll tax (commonly called FICA or Social Security Tax) that their employers are required to withhold from their wages. Because this credit is phased-out as income rises, some individuals will get only a partial credit and high-income individuals will get no credit. A similar phased-out credit is allowed for self-employed individuals. In addition, employees are allowed a credit for any Individual Tax that is explicitly withheld from their wages or salaries, the same as in the case of present Form W-2 withholding of income tax. In general, W-2 type withholding will operate the same way as under present law.

Discussion of General Principles

The deduction allowed an individual for the purchase of "savings assets" illustrates the interactive combination of the Individual Tax and the Business Tax. That deduction also illustrates the goal of correctly defining income and thereby eliminating the bias under present law against an

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individual's choice and need to save income and against a business' choice and need to invest in order to create income for its owners and employees. These choices are two parts of the same thing because unless people save, businesses cannot invest and unless businesses invest, people cannot earn income.

Under the Individual Tax, "savings assets" are generally defined as financial assets such as stocks of corporations (and equivalent investments in an unincorporated business by an owner-partner or an owner-proprietor), bonds and notes, both commercial and governmental, annuity contracts, life insurance contracts, and deposits in banks and similar depository institutions.

As defined under the Individual Tax, savings assets do not include properties such as art objects, antiques, classic cars, owner-occupied housing, and land even though such properties may have long-term value in that they may frequently be sold at a later date for as much as or more than the price paid for them. Even though their purchase may be savings in a broader economic definition, there are several reasons why the Individual Tax distinguishes these admittedly valuable properties from such obvious savings assets as stock in a corporation and a bank deposit.

An art object, for example, inherently involves personal enjoyment and pleasure, and derives its value solely therefrom. The more aesthetic enjoyment a painting produces, the "better" it is, and the more valuable it is. Otherwise, it is merely $10 of canvas and paint. Except by price, and the degree and longevity of personal consumption enjoyment and service provided (which is reflected in price), it is difficult to draw the line between a 50 [cent] soft drink, a $50 bottle of wine, and a $5,000 art object. By defining a "savings asset" to include only financial assets such as stocks, bonds and deposits, the Individual Tax eliminates the need to make such distinctions.

This definition of savings assets also serves to allow people who produce and earn otherwise taxable income to defer that tax when they purchase an asset such as a stock that derives its value solely from the fact that it will in the future result in the production of additional income that will also be taxable to the owner-saver. If a person earns a $100X salary and uses current taxable income to purchase a stock that presently has a value of $100X only because it will in the future produce dividends (or the combination of dividends and liquidation or resale proceeds) that have a present value of $100X, and if that person will have to pay tax on the dividends when received (which will be the case), that person must be allowed to deduct the cost of the stock. Otherwise, the $100X of current salary will be taxed twice. In contrast, if the person uses the $100X of currently taxable salary income to purchase an asset (such as an art object, a personal automobile, or a personal residence) that will produce nontaxable income in the form of the personal service or enjoyment it provides, the

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person should not be allowed to deduct the cost of the asset. Otherwise, the $100X of salary income would not be taxed at all; not even once.

By allowing a savings deduction for the purchase of assets that will produce taxable income in the future, the Individual Tax assures that income is taxed once. If a person buys a savings bond for $25 that will mature in 10 years and pay back $50 ($25 being $50 discounted for 10 years at 7.18%), the Individual Tax allows a deduction for $25 in the year the bond is bought but includes $50 in taxable income in the year the bond matures. * * * Thus, tax is deferred, not forgiven, and all the income is taxed.

* * *

Deferring tax on deferred income is exactly the concept of the IRA (Individual Retirement Account). Prior to 1987, all individuals could defer tax on up to $2,000 of income per year by depositing it in a special IRA Account at a bank. In general, the funds in the IRA Account can only be invested in financial assets such as stocks, bonds and so forth.

The Unlimited Savings Allowance is the same in concept, although structurally different, more flexible and more efficient. In the case of the IRA, withdrawal had to occur at or during retirement. When withdrawn, the original deposit plus accumulated earnings, such as interest and dividends, were taxed. If withdrawn before retirement age, an additional penalty tax was imposed. Under the Individual Tax, there is no $2,000 limit, no special account is necessary, and the use of saved and deferred income is not restricted to retirement. Income and the earnings thereon can be withdrawn from savings at any time.

* * *

Basic Example Illustrating the Business Tax and the Individual Tax Operating in Combination—Domestic Business

* * *

[W]hat might be called "consequential rules" * * * are actually results that inevitably arise from the previously stated basic rules, although these results may not be immediately obvious. Among these, for starters, are the following.

> Compensatory stock awards (or options) to employees will not immediately result in taxable income to the employee even though they are the equivalent of cash and under present law are taxable. Reason: Stock is a deductible savings asset and receiving stock in lieu of cash salary is the same as receiving cash and then buying deductible stock.
>
> All corporations and their shareholders can have a fully flexible "dividend reinvestment" system where, when the corporation declares a common stock dividend, one common shareholder can receive taxable cash and another can elect to receive either nontaxable stock or nontaxable debt. Reason: Same as above. Even though under state corporate law the electing

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shareholder had the "right" to receive cash (which right is taxable under present law), the election to receive stock or debt provides an equal and offsetting deduction for savings.

* * *

Basic Rules That Are Illustrated

In the case of the Business Tax:

The tax rate applies only to the gross profit tax base, which is the net positive result of sales minus purchases from other businesses of goods and services.

Only cash (or the equivalent) actually received or actually paid is taken into account, i.e., the cash method of accounting is uniformly applied.

Positive or negative net cash flow from financial transactions is, however, not taken into account.

Although gross profit is computed without regard to employee payroll cost (or the employer payroll tax paid thereon), a tax credit against the Business Tax is allowed for the 7.65% employer payroll tax.

In the case of the Individual Tax:

An individual's gross income includes wages, salaries, interest and dividends.

Deductions are allowed for the costs of savings assets purchased. * * *

Why [allow deduction for] goods and services purchased from other businesses? The Business Tax is intended to be the first in a two-step process of collecting a tax on income. Therefore, the Business Tax begins with the source—Gross Domestic Product (GDP), which can for this purpose be viewed as the sum of all goods and services produced and sold by all businesses together minus, in order to avoid duplication, those that they bought from one another. * * *

Why Not Also Deduct Employee Payroll? Obviously, Widget Corporation's gross sales of $1,900,000 and gross profit of $1,000,000 were not produced solely by Mr. Founder's entrepreneurial skill and the supplies, inventory and capital equipment bought from Supplier Company in the current and prior years. * * * Widget Corporation's employees contributed a very substantial portion of Widget Corporation's gross profit—just as, by using machinery, equipment and other "tools," employees produce the major portion of total GDP every year measured by what they get paid.

Why, then, not deduct payroll cost? Answer: Employees, as such, are not a business required to file a business tax return and to pay the [10%] Business Tax. If Widget Corporation deducted its payments to them against its business tax base, there would be no corresponding inclusion of that amount in any other business' tax base, and no [10%] Business Tax would be pre-collected on that portion of income.

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* * * It is appropriate to deduct [a payment for] accounting "services" where [the payee's] CPA firm is an outside independent contractor that is itself a business subject to the [10%] Business Tax, but it is not appropriate to deduct the salary paid for similar accounting services to an inside employee-accountant who is not a business subject to the [10%] Business Tax. * * *

It is true that the employee's salary will be *included*, when received, in the employee's personal tax return under the Individual Tax but the tax rates under the Individual Tax are lower than they otherwise would be, precisely because of the pre-collection of the [10%] tax. * * *

It is, however, also the case that in addition to the [10%] Business Tax, Widget Corporation must, as under present law, pay a 7.65% payroll tax on wages up to $60,000 per year per employee; whereas in the case of the share of gross profit that goes to interest and dividends, there is only the [10%] tax. It is for this reason that the Business Tax also gives Widget Corporation a full tax credit for the 7.65% employer payroll tax.

It is by a combination of all these means—including splitting the overall tax rate between businesses and individuals—that the Business Tax and the Individual Tax achieve the intended result of correctly measuring income and being even-handed among all forms of income and the recipients thereof.

Why are financial receipts and payments excluded from the gross profit calculation? Part of the answer, at least in terms of the accounting procedure of matching deductions with income and vice versa, has already been stated in explaining that allowing no "deduction" for dividend and interest payments is the same as allowing no "deduction" for wages and salaries to employees.

There are other reasons for excluding all financial receipts and, correspondingly, all financial payments. The heart of the matter goes back to the concept of GDP which fundamentally arises from the production and sale of goods and services. GDP is not increased to a still higher number because of financial flows such as interest and dividends back and forth between businesses or between businesses and individuals. * * *

Therefore, the GDP-based Business Tax for regular, nonfinancial businesses excludes all interest, dividends and similar financial flows among businesses, except to the extent that they may be treated as implicit payments for services. * * *

Under the Business Tax, neither the lender nor the borrower takes into account the transfer or receipt of funds in loan transactions. Loans made are not deducted, repayments received are not included, loan proceeds received are not included, and loan repayments made are not deducted. * * *

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Basic Rules of the Individual Tax

* * *

Deduction for Net Amount Saved

Individuals may deduct, without any dollar limit, their additions to the national stock of savings. * * *

[A] netting calculation will be made. If the netting results in more withdrawals and sales than deposits and purchases of savings assets, the net amount will be included in the gross income line. If the netting results in a net savings deduction, it will be subtracted in the deduction line.

Determining the Net Amount Saved in the Simple Case

Most taxpayers will be able by very simple calculations to determine the net amount saved. * * *

a. When income is earned and deferred by saving, the tax on the income for that year is deferred, generally, by including the amount earned and deducting the amount saved.

b. When in a later year, the income is withdrawn from savings, the amount is included in gross income for that later year.

c. If, however, the withdrawal from savings was merely to shift the same amount of savings from one savings asset to another, the person should not be taxed on the income which, after the shift, is still in the national savings pool.

* * *

Rules to Keep the Calculations Simple

Borrowing

* * * The USA Tax System should not encourage borrowing to save, because that is not really savings. On the other hand, the Individual Tax should be as simple as possible. To balance these competing concerns, the Individual Tax contains special rules for the certain kinds of debt ordinarily incurred by individuals:

i. Mortgage debt on a person's personal residence is not taken into account in determining the net savings deduction.

ii. Debt of up to $25,000 directly related to the purchase of personal property such as furniture, appliances or a family automobile is disregarded.

iii. An additional $10,000 of debt incurred for any purpose is also disregarded in determining the net savings deduction.

* * *

Tax Basis

The simple case calculations will not work properly in cases in which an individual sells a savings asset with a tax basis. If the individual were to then save all of the proceeds, the individual would have no new savings, but if he included in gross income the excess of the proceeds of the sale of the savings asset over the basis of the asset, and deducted the full amount of the proceeds saved, he would have a net savings deduction.

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To minimize the problems caused by tax basis, the Individual Tax rules permit taxpayers who have total tax bases in savings assets of less than $50,000 to elect to assign a zero tax basis to each savings asset and to amortize and deduct their total basis in savings assets ratably over three years. * * *

The tax-basis complication cannot be fairly solved by simply disregarding tax basis in savings assets. Tax basis generally reflects the cost of the assets. Since these assets were purchased with after-tax dollars, the basis reflects amounts of gross income that were previously taxed. To avoid double taxation of income, the basis would have to be taken into account on the sale of assets. By eliminating the basis of most assets and allowing amortization deductions to offset the previously recognized income, the amortization election makes the new tax system simpler.

The amortization election is limited because taxpayer now have substantial bases in savings assets. If all taxpayers were permitted to amortize their tax bases over a short period, there would be a substantial revenue shortfall during the early years of the USA Tax System. * * *

IS RADICAL TAX REFORM IN OUR FUTURE?

Rudolph G. Penner*

21 National Tax Association Forum, Spring 1995, at 1, 2-5

At about the same time [1993], Senators Nunn and Domenici were developing a much more radical reform proposal. * * * In it, a subtraction-type VAT replaces the corporate tax and taxes on non-corporate business reflected on Schedule C, and provides a 100 percent credit for payment of employer payroll taxes. The payroll tax structure is maintained to avoid disturbing current social security arrangements.

Businesses total their sales and subtract purchases from other businesses, including investment goods, to arrive at the tax base. In the aggregate, it approximately equals consumption as defined in the national income accounts. Payroll tax payments are then credited against the tax liability. To be revenue neutral in the long run would require a tax rate of slightly less than 10 percent.

The tax is border adjustable. That is to say, it does not apply to exports, but it does apply to imports. Border adjustability has a strong appeal to many businessmen who believe that they are at a disadvantage relative to competitors producing in countries with border adjustable VATS. * * *

The business tax is territorial. That is to say, it only applies to value added generated in the United States. Foreign investments cannot be deducted and the return to them is not taxed. * * *

*. At time of original publication, Managing Director of the Barents Group, a subsidiary of KPMG Peat Marwick. Dr. Penner was a consultant to the authors of the substantially identical Nunn-Domenici and Alliance USA proposals.

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The proposed business tax is extremely simple compared to the current system. * * *

The individual tax reform is less simple. In the ideal, it would operate on a cash flow basis. Income from wages, rent, interest and dividends would be computed much as it is today. The proceeds from asset sales and borrowing would be added to purchases and asset acquisitions and the repayment of debt and interest would be subtracted. Note that the calculation is equivalent to computing income and deducting saving. It is similar to having a completely unlimited IRA.

The system can be made progressive by increasing the earned income credit and by providing generous exemptions and a large zero-tax bracket. A progressive rate structure can be applied to the remaining tax base. The Nunn-Domenici proposal allows a full credit for the payment of employee payroll taxes.

* * *

Practical and political considerations prevented Nunn and Domenici from adopting the pure cash flow system. In a pure system, the taxpayer would need to keep track of numerous credit card and accounts payable transactions and of changes in currency balances. This would involve a major effort. Some tax-free borrowing had to be allowed to reduce record keeping and for the purchase of lumpy consumer durables such as cars. The repayment of such loans is not deductible.

Owner-occupied housing represents an immense political and practical challenge to any tax reformer. It escaped the net of [the Tax Reform Act of 1986] and it largely escapes the Nunn-Domenici reform, which retains the current law treatment of the in-kind return and the mortgage and real estate tax deduction. Capital gains on housing sales, however, would be fully taxed to the extent that they are converted into consumption. * * *

Subsequent to the Nunn-Domenici proposal, House Majority Leader Armey proposed a "flat tax" that has gained a great deal of attention. The proposal is based on a design by Robert Hall and Alvin Rabushka, and David Bradford has designed what he calls an "X tax" that has a similar base, but with a tax rate structure that makes it considerably more progressive.

The Armey business tax base is similar to that used by Nunn and Domenici with the important difference that wages are deductible. That means that the tax would not be border adjustable under current GATT rules. Wages are taxed at the individual level. In the Armey proposal, generous exemptions and deductions are combined with a flat rate on what remains. The Bradford proposal would add a progressive rate structure.

These proposals have not been worked out in the same excruciating detail as has Nunn-Domenici. That gives them the appearance of being much simpler. Conceptually, the base of the Armey/Bradford tax is very similar to that used by Nunn and Domenici. It approximately equals value added in the production of consumption goods. It is only a slight

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oversimplification to say that Armey and Bradford tax income when it is earned; Nunn-Domenici taxes it when it is spent. If all income is spent over a lifetime and tax rates remain constant, the present value of the lifetime tax burden is the same.

Inherently, it may be simpler to tax earnings rather than cash flow, but it is not quite as simple as it seems in the Armey proposal. Because capital income is explicitly exempt at the individual level under the Armey proposal, there is a huge temptation to convey compensation using capital assets. For example, some technique must be designed to handle stock options which can be ignored until converted into cash under Nunn-Domenici.

Nunn and Domenici have elected to try to keep their tax reform distributionally neutral whereas the Armey proposal would result in a large redistribution of the tax burden away from the most affluent.

The rates required for distributional neutrality, however, are extremely difficult to estimate. * * *

An equally disturbing problem is that distributional neutrality cannot be defined without specifying an elaborate theory of tax incidence. Is the current corporate tax largely paid by capital owners or by wage earners because it drives investment abroad? Will the Nunn-Domenici business tax be shifted forward into prices or backward to factors? Who really knows? It is clear that the distributional tables that play such a huge role in political debates over tax policy rest on a foundation of quicksand.

Effect on Saving

Economists are generally skeptical about the use of tax policy to increase private saving and investment. After all, the decline in the saving rate continued in the 1980s in the face of increased saving and investment incentives early in the period and lower marginal rates later. * * *

The effects of a revenue neutral tax reform should, however, be very different from that of a cut in marginal rates. The average taxpayer will be no better off. The same tax will be squeezed out [of] the average person and the only impact will be a greater reward for saving. Moreover, the redistribution of the tax burden within each income class should also increase saving substantially. Those with a high inherent propensity to save will get a tax cut. They should save a relatively high share of it. Those with a high propensity to spend will face a tax increase. They will have to finance it largely by cutting spending. * * *

International Implications

[B]order adjustability is an important issue in the business community. Economists tend to argue that, all else equal, its effects will be washed out by countervailing exchange rate movements. I have never met a businessman who believes this argument.

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Transition and Other Problems

* * * Transition issues have taken more time for the designers of Nunn-Domenici to resolve than any other issues. To my knowledge, transition issues have not been confronted by the proponents of the Armey proposal and proponents of value added taxation generally manage to ignore them.

In the Nunn-Domenici proposal, the most important transition issue involving individuals concerns the treatment of savings accumulated out of after-tax income under the current tax regime. The cost basis of those old savings has already been taxed once. Should it be taxed yet again when it is consumed under the new regime? That would be particularly unfair to retirees.

Ideally, it would be nice to allow the use of old cost basis tax free, both for consuming and for investing in new deductible assets. However, there are trillions of dollars of old cost basis out there and its tax free use might deprive the government of all revenues for several years. Therefore the use of old basis must be limited. But how? * * *

People with less than $50,000 compute their old cost basis on the effective date of the new tax and simply deduct it from their tax base over a limited period, say, three years. The advantage of this approach is that it cannot be gamed. The records underlying it are the same as those now used to compute capital gains taxes.

For those who are wealthy and have complicated investments, * * * the revenue implications of allowing them to write it all off over a limited time period would be very significant since the very wealthy hold most of the nation's wealth.

The designers of Nunn-Domenici have created a fairly simple tax form that allows people to use old basis only to finance consumption in excess of income. Assets acquired by selling old basis are not deductible and the tax form tracks this old basis much as today's tax form tracks accumulated loss carryovers.

The problem with this approach is that many will never consume in excess of their income (e.g. Ross Perot), and will never be able to use old basis tax free. Others with less saving will have an incentive to concentrate the purchase of consumer durables into one year in order to facilitate the use of old basis. This is one of the few distortions in the proposed system, but any system for limiting the use of old basis is likely to inspire intense tax planning.

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THE MERIT OF AN INCOME TAX VERSUS A CONSUMPTION TAX

John S. Nolan*

12 American Journal of Tax Policy 207, 207-19 (1995)

The current political debate focuses heavily on the idea of a simple "flat tax"—accompanied by the foolish notion that it could be so simple and at such a low rate that we might even disband the IRS! The real issue lying behind the two major proposals on the table—the Armey flat tax and the Nunn-Domenici USA Tax—is, however, whether we should substitute a consumption form of taxation for our present income tax system. * * *

The most obvious forms of consumption tax are the retail sales tax and the credit-invoice type of value added tax used in Europe. The VAT has exactly the same effect as a retail sales tax; it simply is collected differently. Both forms of tax end up taxing the value of goods and services added by labor, plus "profits" or "rents" in the sense that economists use those terms, which exclude all the normal return on capital investment. Thus capital investment is clearly favored as compared to the impact of an income tax.

The business level USA Tax, and the combined business level/individual level elements of the Armey flat tax, are, in substance, simply subtraction method VAT taxes. As such, they have the same effect as a retail sales tax or a traditional credit-invoice VAT. To illustrate this equivalence, the USA business level tax allows an immediate deduction for all purchases, including the cost of plant and equipment. It allows, however, no deduction for salaries, wages, or fringe benefits. The result is that the tax base, as in a retail sales tax or traditional VAT, is the value added by labor plus profit.

The USA individual level tax then includes wages, salaries, and fringe benefits, as well as dividends, interest, capital gains, and all other forms of income in gross income for tax purposes. The resulting taxable income can, however, be completely offset by contributions to an unlimited IRA account. As a result, the combined USA business and individual taxes are levied on consumption only—that is, they tax income consumed but not income saved.

The Armey flat tax achieves exactly the same effect in a somewhat different way. Unlike the USA business level tax, the Armey business level tax allows a deduction for wages, salaries, and qualified retirement plan contributions, though not for fringe benefits. Like the USA business level tax, it also allows an immediate deduction for all purchases, including the cost of plant and equipment. The Armey individual level tax is then imposed on salaries, wages, and qualified retirement plan distributions, but not on interest, dividends, capital gains, or other investment income. The net result is to tax all forms of income only once, at either the business level or the individual level, just like the USA Tax, except that, in Armey's case, the tax is a single flat rate.

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The result in both cases is, as previously stated, to achieve the same effect as a retail sales tax or traditional VAT. The USA Tax taxes salaries and wages at the business level, while the Armey flat tax taxes salaries and wages at the individual level. While the USA Tax includes salaries and wages in the tax base for the individual tax, that tax can be avoided by saving that income, or any other form of income, by use of the unlimited IRA deduction. While the Armey flat tax taxes salaries and wages at the individual level, it does not tax investment income either at the business tax level or the individual tax level.

The key to understanding the basic equivalence of these two systems as being solely taxes on consumption is that the economic effect of not taxing an amount received, but taxing the investment returns on that amount, as in the USA Tax, is exactly the same as taxing the amount received but not taxing the investment returns, as in the Armey flat tax. As a result, both the USA Tax and the Armey flat tax end up being imposed only on income consumed. Each effectively exempts from tax income that is saved.

The political rhetoric focuses upon the flatness of the rate of tax, but that is a red herring. We could obviously achieve that result with our present income tax system, taxing all income, whether saved or consumed, at a single rate. * * *

We are finally moving toward the fiscal discipline of a balanced budget. * * * The tax base would, however, be very considerably narrower under the USA Tax because of the unlimited IRA deduction feature, or, under the Armey flat tax, because of the exclusion of all forms of investment income from the tax base. We will be taking one huge fiscal gamble that the sought-after greater inducements to savings will produce an increase in investment capital sufficient to yield larger or even equal revenues from a narrower tax base.

It is against this background that we should assess the relative merits of our income tax and these proposed forms of consumption tax.

The United States Income Tax

The U.S. income tax is not, of course, a "pure" income tax. Income set aside in qualified retirement plans, or under the limited IRA provisions of existing law, is not taxed to the employee until withdrawn. The investment returns on such savings also are not taxed until withdrawn. These provisions of existing law require a disciplined program for these savings—probably more complex and intrusive than necessary—but nonetheless valuable in a broad sense. For the most part, such savings cannot be withdrawn without penalty until the worker reaches retirement age. These provisions could be substantially simplified and improved. Even so, these provisions have resulted in a substantial volume of savings in the U.S.

Similarly, life insurance, also by its nature a disciplined pattern of saving, is favored; the investment earnings reflected in cash surrender value are not taxed, and the policy proceeds on death are not income. Individuals

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make regular premium payments every year, and there is effectively a built-in penalty for failing to continue to do so.

Owner-occupied housing, the single most important investment asset held by most Americans, is clearly favored. * * *

Our existing U.S. income tax has also been carefully crafted to serve other valuable economic goals. Employer-provided health insurance, group-term life insurance, disability insurance, and other benefits also represent, in effect, disciplined forms of savings to meet vital needs—burdens which might otherwise fall upon government.

Similarly, our existing income tax serves important social goals. The charitable contributions deduction supports an enormous range of activity that reduces the costs and burdens of government. The refundable earned income tax credit provides welfare-type benefits to low income persons who work to provide for their own needs, but for whom the economy does not provide sufficient support.

All of these other economic and social policy elements of our existing U.S. tax system could, of course, be included in a consumption tax system, but their efficacy might be drastically affected. Thus, for example, the USA Tax allows a charitable contribution deduction. But even under the USA Tax, will the same incentive to give exist in light of the unlimited IRA deduction opportunity? The wealthy can avoid tax completely by saving; the charitable contribution deduction to them loses much of its force.

* * *

The Armey flat tax allows no mortgage interest deduction and no charitable contribution deduction. The absence of a mortgage interest deduction has an important practical result. The wealthy, who can finance their own home ownership, can still acquire a home but middle class homeowners and prospective middle class homeowners would clearly be disadvantaged.

Both the USA Tax and the Armey flat tax would substantially increase the tax burdens on the middle class. Would this increased tax burden in and of itself adversely affect home ownership?

This is all untested ground.

The Armey flat tax also would repeal the earned income tax credit. Further, nonpension fringe benefits would not be deductible in determining the business level tax and would be includible in income under the individual level tax.

What would be the effect of these Armey flat tax changes? I do not find it sufficiently reassuring to hear that the economy will grow rapidly so that interest rates will fall enough to more than compensate for denying the home mortgage interest deduction. * * * Or to hear that people will give as much to charity without a deduction; major givers, induced by such tax saving opportunities as charitable remainder trusts, are very important to the support of many major charities. Even smaller givers take the tax deduction

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into account in making charitable contributions. Will employers still provide health, life, and disability insurance with no deduction for such costs? Can we really be sure that wage levels will rise sufficiently that the low income working poor will not need the help that the earned income tax credit presently provides?

* * *

The Advantage Of A Consumption Tax

The consumption tax advantage, to the extent one exists, rests on the proposition that our existing income tax system discourages savings, at least without regard to the retirement income provisions. There has been a substantial decline in U.S. household savings over the past forty years, and this has been correlated to some degree to declining U.S. business investment in real terms in plant and equipment. * * * [I]t is arguable that the decline in savings in the U.S. is caused in some substantial part by the burden of our income tax system on savings.

* * *

A consumption tax, on the other hand, while still reducing the amount available for consumption either today or in the future, eliminates this bias against current saving. Under a consumption tax, either the income saved is not taxed when saved, until it is later consumed, as in the USA Tax, or the returns on the savings are not taxed, as in the Armey flat tax. The result under either type of consumption tax is exactly the same—the present value of the future fund accumulated by saving for later consumption will be exactly the same as the income available for consumption immediately. That being so, there is no bias against saving, as there is in an income tax. As a result, the amount saved, which is available for future consumption, is substantially higher than it would be under an income tax system.

This analysis, however, overlooks an important consideration. Since the income tax is imposed on a broader base, in a perfect world the income tax would be imposed at lower rates to produce the same level of revenue for the government. But tax rates under our income tax system have not been low in modern memory, except for the brief period when the 1986 Act rates remained in effect. * * * [T]he rates under either the USA Tax or the Armey flat tax would very likely be increased after an initial period of euphoria.

* * *

Comparative Advantage

Against this background, we may evaluate the relative merit of an income tax structure versus a consumption tax structure. For this purpose, we apply the four customary criteria—economic efficiency, equity or fairness, simplicity, and administrability.

Economic Efficiency. In a theoretical world, the greatest advantage of a consumption tax is that it will increase savings as compared to an income tax. In the real world in which we live, however, this advantage is greatly moderated by the provisions of the U.S. tax system as to qualified retirement

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plans, limited IRAs, life insurance, home ownership, and income exclusions and deferrals (fringe benefits, gain on sale of a residence, and others).

A true flat rate tax would have the advantage of eliminating some bracket arbitrage—both between or among years by timing the recognition of income and deductions, and between or among taxpayers. * * * But the USA Tax has progressive rates, and in any event, tax lawyers like us will still find ways under a consumption tax to defer income and accelerate deductions.

Both of the proposed forms of consumption tax would largely eliminate the double taxation of corporate earnings, though by different means. The Armey flat tax simply exempts dividends from the individual tax base. The USA Tax would allow a shareholder to defer the tax on dividends until such income is consumed pursuant to the unlimited IRA deduction.

My greatest concern in this area is that both the USA Tax and the Armey flat tax tend to remove any incentive for employer-sponsored qualified retirement plans and the comparative advantage of permanent plan life insurance versus other forms of savings. While I believe generally in a free market, my enthusiasm for free markets is tempered by some degree of paternalism, at least to the extent of providing a tax incentive for these disciplined forms of saving. * * *

Without employer retirement plans, it is far from clear whether individual workers will maintain the same disciplined pattern of savings throughout their working years. There would be no constraints on using savings for consumption at any time prior to retirement except good judgment, which is not always uniformly exercised in making consumption versus savings decisions. Similarly, by eliminating the comparative advantage of life insurance, largely a form of retirement saving, we would eliminate or reduce the attraction of that form of disciplined saving. In all, we would be embarking upon a wholly untried experiment in free market economics. By abandoning the comparative advantages of these incentives, savings could actually decrease.

Equity. Equity or fairness, like beauty, is largely in the eyes of the beholder. Even so, most Americans instinctively consider it fairer to tax all income, including interest, dividends, and capital gains. * * * Most Americans also feel, despite the political rhetoric being now spewed out, that it is fairer to tax persons with higher incomes at somewhat higher rates pursuant to the ability to pay rationale of our existing system.

In any event, consumption taxes tend to be regressive, as compared to income taxes. Higher income individuals spend a smaller percentage of their income on consumption. Higher income individuals have a higher percentage of their income from savings. To achieve the same distribution of burden by income class, the rate structure of a consumption tax must be more progressive than that of an income tax.

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The Armey flat tax attempts to address this concern by a generous personal allowance—$21,400 for a married couple filing jointly, for example—and by a generous personal allowance—$5,000 per dependent. Even so, burden tables recently released by Treasury show disturbing effects by income class of the combined Armey business level and individual level flat taxes. Whether the 17 percent proposed flat tax rate for the business tax and for the individual tax is used, or the 20.8 percent flat tax rate Treasury says is necessary to achieve revenue neutrality, which is a must, the Treasury numbers show an extraordinary pattern of increases in tax burden compared to present law except for high income taxpayers. Persons with incomes over $200,000 would enjoy a significant decrease in tax burden. The heaviest increases in tax burden fall squarely on the middle class.

The USA Tax also addresses the regressivity concern by a substantial standard deduction-type family living allowance and personal exemptions. For a family of four, these would provide a threshold for taxation of $17,600. Unfortunately, however, the lowest nominal rate is 19 percent, rising fairly quickly to 27 percent, and then again fairly quickly to 40 percent. These rates are effectively reduced by the credit for the employee share of payroll taxes—7.65 percent—but even so the net tax rates are very substantial in the middle income range. A family of four will pay an effective rate of 32.35 percent on wage and salary income over $41,600. This 32.35 percent USA Tax tax rate is considerably higher than the 28 percent marginal rate on such income under present law. Just as in the case of the Armey flat tax, middle income families who need their income for basic consumption will pay substantially higher taxes under the USA Tax.

The Armey flat tax has been severely criticized on the ground that middle class working families save mostly by buying a home and then use much of their excess savings to assist their children in obtaining a college education. These investments in "human capital" are ignored under the Armey flat tax. The USA Tax addresses them by its home mortgage interest deduction and a token deduction for higher education expenses up to $2,000 per child per year, with a maximum of $8,000 for all children. God help the Irish and those large families like mine in the younger generation!

Finally, there is also a fundamental fairness issue in changing from an income tax-based system to a consumption tax-based system. Existing U.S. taxpayers have a massive investment in tax-paid savings even apart from qualified retirement plan savings, life insurance savings, and owner-occupied housing. There is a severe degree of unfairness in moving to a system that taxes these savings again in later life when they are consumed.

The USA Tax attempts to address this issue with exceedingly complex transition rules. Unfortunately, in their present form, they would not work and could result in manipulation by the wealthy to their advantage. Al Warren and Marty Ginsburg have demonstrated this all too well in recent

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papers they have written.[m] The Armey flat tax so far makes no effort to address this problem. It is far from clear that any workable solution can be devised to resolve this transitional unfairness.

Simplicity. The existing U.S. income tax system is inordinately complex for business taxpayers and for individual taxpayers with special circumstances. * * * For the average middle income U.S. taxpayer whose principal source of income is wages or salaries, however, the existing U.S. system is not complicated and in most respects has not fundamentally changed in the last fifty years. * * *

Although the theoretical model of a consumption tax might be simpler in some respects than an income tax, this does not mean, however, that any consumption tax actually enacted will necessarily be simpler than our current income tax system. While any income tax system presents some problems of income measurement, perhaps a greater source of the complexity of the current system is the large body of rules providing preferential treatment for certain types of income or transactions. The same political considerations that prompted Congress to adopt these rules under the income tax may lead to the adoption of similar rules under a consumption tax regime. Therefore, any consumption tax that emerges from the political process may be no simpler than the current income tax system.

In addition, knowing the abilities of this group, I am sure we will have the same arguments as to the definition of consumption, and the timing of consumption that we presently have as to the definition and timing of income.

In my view, the goal of simplification could be achieved through reform of the income tax system without replacing the current system with a consumption tax. In short, the choice between an income and consumption tax should probably be made on the basis of fairness or efficiency rather than simplicity.

Administrability. Administrability depends upon the relative underlying complexity of the system as enacted by, and frequently changed by, Congress. There is no basis for claiming that either the USA Tax or the Flat Tax—as they are likely to be enacted by Congress to serve various interstitial economic and social objectives—will be any simpler to administer than the existing U.S. income tax system.

In several respects, a consumption tax would be more difficult to administer. Withholding the appropriate amount from wages would be more challenging, because the taxpayer's ultimate tax liability would depend on whether the taxpayer uses the wages for consumption or investment. Increased information reporting might be required for transactions involving

m. Mr. Nolan is probably referring to Alvin C. Warren, Jr., *The Proposal for an "Unlimited Savings Allowance*, 68 TAX NOTES 1103 (1995), and Martin D. Ginsburg, *Life Under a Personal Consumption Tax: Some Thoughts on Working, Saving, and Consuming in Nunn-Domenici's Tax World*, 48 NAT'L TAX J. 585 (1995). (Eds.)

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loans and investment assets, because the taxability of these amounts would depend on the use of the proceeds. It might even become necessary to withhold on the proceeds of these transactions, if not reinvested.

* * *

We know what we have. It works reasonably well. We should not embark on such a massive experiment without much more assurance that it will be economically more efficient, and at least as fair, simple, and administrable as the present system.

Notes and Questions

Simplification

67. An issue of importance is whether, and to what extent, adoption of a consumption-type proposal would simplify tax law and administration. As we have seen, beginning with Professor Andrews' vision in subchapter B of taxing on "a simple cash flow basis," proponents of consumption-type tax proposals speak of simplification as a major advantage. Even many opponents of consumption-type taxation, such as the drafters of Treasury I (excerpted in subchapter C), concede that, once fully implemented, "a tax on personal consumption is simpler in many respects than an income tax."

Hall & Rabushka make perhaps the most expansive claims of simplification, asserting that every taxpayer, including General Motors, could file a postcard-sized return. Do you think this is possible?

68. Is the primary problem in achieving considerable improvements in simplicity that even an ideal system would have to be fairly complicated? For example, are you confident in the assertions of Hall & Rabushka that their system is "airtight," and that their business tax returns could be postcard-sized because "[e]very line on the form is a well-defined number obtained directly from the business's accounting records"? Or is Mr. Nolan correct that "we will have the same arguments as to the definition of consumption, and the timing of consumption that we presently have as to the definition and timing of income"?

69. Examination of the full presentation of Hall & Rabushka reveals some complications that are not apparent in the excerpted portions of their book. For example, they advise that "[b]usiness meals in restaurants would be fully deductible."[n] We have learned from decades of experience with the income tax law that "business meal" is not a self-defining term. The same complex statutory and regulatory provisions drawing the line between business and personal meals would be necessary under the consumption-type tax.

n. ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX 106 (2d ed. 1995).

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Similarly, simplicity is missing in the advice Hall & Rabushka give to a travelling saleswoman:

> All self-employed individuals will file Form 2, the business tax form, where they can deduct travel and other business expenses. To take advantage of the personal allowance, you will want to pay yourself a salary of at least $16,500 if you are married. Report this amount along with your husband's earnings on Form 1, the individual wage tax. In this way you will be able to deduct your legitimate business expenses and receive the personal allowance. You will need to keep records to document your income and expenses.[o]

The proposed tax treatment entails the artificiality—generally limited to closely held C corporations under present law—of this saleswoman paying herself a salary. She is advised that she can deduct her "legitimate" expenses—but much complexity is entailed in establishing which expenses of a traveling saleswoman are deemed "legitimate," even if there were no concern about fraud. And, of course, Hall & Rabushka recognize the danger of fraud—and thus advise the taxpayer that she is to keep complete records, even though they would not have her reveal the details of those records in her postcard tax return.

Indeed, many of the most difficult questions of current law involve distinguishing business expenses from consumption. In addition to meals and travelling expenses, this issue is raised by expenditures for entertainment, gifts, uniforms, "hobby farms," personal computers, automobile expense, education, "home offices," and club memberships, among others. The complexity of classifying these expenditures would remain. As Professor Andrews observed, "ordinary, current deductions, business and personal, would be essentially unaffected by the shift to a pure consumption-type tax."

70. It is always simpler to describe an idea in generalities than to work out all the concrete details. Dr. Penner argues that the proposals of Armey/Hall & Rabushka and others "have not been worked out in the same excruciating detail as has Nunn-Domenici. That gives them the appearance of being much simpler." The same observation could be made of academic discussion of consumption taxation.

71. Another aspect of the simplification problem is that no proposal—even one worked out in "excruciating detail"—will be enacted intact. It is almost inconceivable that sweeping tax changes of the type discussed in this chapter could be adopted without complications reflecting the input of many affected taxpayers, the political and policy judgments of

o. *Id.* at 116-17.

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many members of Congress and the Administration, and the conflicting views of many experts. Mr. Nolan and others caution against comparing the present income tax law to an idealized consumption-type proposal.

The income tax could also be made much simpler if a professor were allowed to put together a single, coherent revision. As one example, both the Hall & Rabushka and USA proposals would end the double-tax discrimination against doing business in the corporate form. This discrimination is not inherent to an income tax, however; many proposals have been advanced that would address the problem by revision of the income tax. See Chapter Fourteen.

72. The important issue of simplicity versus complexity can be viewed from different angles. Professor Boyd Kimball Dyer reminds us of the importance of administrative costs, which are not limited to the budget of the Internal Revenue Service: "By far the greater part of administrative costs is what the private sector spends to keep records, file reports, and get answers to questions about taxes. Part of these costs is the cost of keeping transactions from incurring taxes."[p] Professor Dyer concludes that "on the criterion of transaction costs, the consumption base is best because it alone treats each taxable year as sufficient to itself. There is no need for depreciation, keeping track of basis, adjustments for inflation or other concepts that tie one year to another."[q]

Mr. Nolan argues that present law "is inordinately complex for business taxpayers and for individual taxpayers with special circumstances," but is "not complicated" for most middle-income taxpayers. Is that a sufficient goal for simplicity, even if the Internal Revenue Code remains difficult to comprehend?

73. Professor Clifton Fleming devoted a 1995 article to evaluating leading consumption-type proposals in terms of simplicity, coming to the conclusion that "the devil is in the details."[r] He concluded his article with the following paragraphs, which draw an ominous parallel to the adoption of the income tax in 1913:

> A persistent theme of this article has been that the political process is quite likely to deliver a much more complicated consumption tax package than initially seems possible when one reads textbook descriptions of the VAT and the consumed income tax. Consumption tax advocates will probably view this as unduly pessimistic, and they may be correct. However, it is useful to

p. Boyd Kimball Dyer, *The Relative Fairness of the Consumption and Accretion Tax Bases*, 1978 UTAH L. REV. 457, 483.

q. *Id.*

r. J. Clifton Fleming, Jr., *Scoping Out the Uncertain Simplification (Complexification?) Effects of VATs, BATs and Consumed Income Taxes*, 2 FLA. TAX REV. 390, 441 (1995).

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recall that in 1913, when America stood optimistically poised to adopt a new tax system, the House Ways and Means Committee said:

> In view of the many valuable Governmental purposes to be subserved, those citizens required to do so can well afford to devote a brief time during some one day in each year to the making out of a personal return of income for purposes of taxation. This is done without complaint under the operation of all the general property tax laws of the States. All good citizens, it is therefore believed, will willingly and cheerfully support and sustain this, the fairest and cheapest of all taxes, in order to secure to the largest extent equality of tax burdens, an adjustable system of revenue, and in all respects a modernized fiscal system.[271]

These confident predictions of compliance burdens that would involve no more than a brief period of time on a single day and of warm public support for the income tax now seem laughable. The 1913 income tax proponents, being merely human, could not begin to foresee the complexities that would emerge over time from a system that appeared so promising at the outset. Likewise, unimagined and extensive complications may be lurking in the VAT and the consumed income tax, particularly in the latter, that will make this article's complexity speculations seem naively understated. As our experience with the income tax shows, U.S. tax systems have a way of coming to reflect thoroughly the intricacy of our society and its economy.[s]

Transition problems

74. As we have seen, there are many arguments for and against the adoption of a consumption-type tax. If we concluded that the consumption-type system were superior, we then would face the difficult question of how to get there from here.

The preceding notes have considered the issue of simplification assuming a consumption-type tax had been fully implemented. But there are many transition issues to be considered in a change so massive as moving from present law to a consumption-type system. Even if a consumption-type system might be simpler than present law once in operation, the transition problems are of daunting complexity.[t] Dr. Penner noted that the drafters of

271. H.R. Rep. No. 5, 63d Cong., 1st Sess. (1913), reprinted in 1939-1 C.B. (Part 2) 1, 3.

s. Fleming, *supra* note r, at 442-43.

t. In this connection, recall Professor McCaffery's observation in subchapter D that while economists agree we would ultimately be better off under a consumption tax, we would suffer a detriment "for a while"—which various economists estimated could last from four or five years

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Nunn-Domenici/USA had spent more time on transition issues than on any others.

75. Perhaps the most important transition issue affecting individuals is the treatment of previously-taxed assets. Consider the simple case of a taxpayer, Alex Bell, purchasing 100 shares of AT&T for $5,000, then selling in a future year for $6,000 (and using the sales proceeds for consumption).

The rules of present law or of any of the consumption-type proposals applied separately are straightforward, and give internally consistent results. Present law would give Alex no deduction and a $5,000 basis at purchase; at sale, he would have $1,000 income. The USA proposal would give Alex a $5,000 deduction and no basis at the time of purchase; when Alex sold, the USA system would tax the entire $6,000.

But suppose Alex purchased under present law—and thus got no deduction for the purchase price—and sold after adoption of the USA system—which, absent some sort of transition rule, would require tax on the entire $6,000 received. This would result in an unfair double tax—a extra tax from changing the tax system that neither system alone would have imposed.

76. The most obvious transition rule would allow taxpayers to keep their basis in assets purchased pre-transition. On post-transition sale of such assets, taxpayers would not be taxed on the entire sales proceeds, but only to the extent the sales proceeds exceeded basis. What is the problem with this approach, according to Dr. Penner?

77. Dr. Penner explains that Nunn-Domenici allows people of modest wealth ($50,000 or less) to deduct their basis in pre-transition assets over a short period, perhaps three years. Having been allowed to deduct their basis, they then would have a zero basis, and have effectively (and fairly) been converted to the new system.

78. For those with more assets, however, the revenue costs to the government of allowing an automatic write-off were deemed too great. So these taxpayers will keep their basis in pre-transition assets.

Without more, this would give the wealthy a great incentive to "churn" their assets. A wealthy taxpayer could sell old assets (with income recognized only to the extent that amount realized exceeded basis), and purchase new assets (with a full deduction under the new USA system). This would cost the government enormous revenue in the early post-transition years.

to 100 years.

Thus, Dr. Penner explained, the USA solution was to allow use of old basis, but not to taxpayers making new investments in the same year; the basis could be used "only to finance consumption in excess of income."

79. Unfortunately, the Nunn-Domenici/USA solution to the pre-transition basis problem may provide the wrong incentive. The proponents of consumption-type taxes want to give incentives to invest, but the most favorable tax treatment for wealthy owners of pre-transition property would go to taxpayers who liquidated investments in order to engage in large-scale consumption.

Another problem is that the system could be manipulated, according to Professor Martin Ginsburg: "[E]veryone decently wealthy will be a net saver in some (perhaps odd-numbered) years and a net dissaver in other years."[u] The reason for this, Professor Ginsburg explained, is that if the wealthy taxpayers show net savings in every year, they can never recoup their pre-transition basis. But by arranging their affairs to show net dissavings in some years, they will be allowed to deduct their pre-transition basis.

80. The drafters (primarily Deputy Assistant Secretary David Bradford) of *Blueprints for Basic Tax Reform*, an influential 1977 Treasury study, discussed various solutions to the transition problem should a consumption-type tax be adopted. Their recommended approach would have required, among other things, that some taxpayers compute their taxes both ways—under the income tax and the new consumption-type tax—for a 10-year period, paying the higher liability each year.[v] For these taxpayers, the promised simplicity of consumption-type taxation would be absent for at least 10 years.

81. The complexity involved in providing comprehensive transition relief to owners of pre-transition property led Professor Michael Graetz to propose very limited transitional relief for elderly taxpayers who would be promptly using pre-transition assets during retirement.[w] As is frequently the case, there seems to be a trade-off between simplicity and fairness.

82. Although less obviously, the same transition issues are presented by substituting any form of consumption tax, including a VAT, for the present income tax. Dr. Penner observed that "proponents of value added taxation generally manage to ignore" transition problems.

u. Ginsburg, *supra* note m, at 588.
v. U.S. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 209-11 (1977).
w. Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1653-58 (1979).

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Limiting the tax base to consumption

83. The proposals of both Hall & Rabushka and Alliance USA are designed to tax consumption, and thus to avoid the "double tax on savings." Alliance USA follows the route suggested by Professor Andrews in subchapter B—individuals are allowed a deduction for savings in "savings assets," and are taxed on sales proceeds of savings assets (unless the proceeds are reinvested). Interest, dividends and other returns on investment are included in the tax base. The USA approach is comparable to a fully-deductible IRA with no penalty for early withdrawal—making the IRA-like investment gives rise to a deduction, and withdrawals are taxed.

Hall & Rabushka, on the other hand, allow no deduction for investments by individuals not engaged in business, but do not tax their investment returns. The individual tax base is limited to compensation—cash wages, salaries, and pensions (when received).

Both Nolan and Penner describe these forms of taxation as economically equivalent. The form, however, is radically different. Dr. Penner states that, generally, the Armey/Hall & Rabushka proposal taxes income when earned, while the Nunn-Domenici/USA proposal taxes it when it is spent.

84. The economic equivalence of the two proposals is in terms of present value. This can be demonstrated by the two systems' methods of taxing capital gain. Assume that a taxpayer purchases a stock for $100 in Year One, and sells the stock in Year Two for $110 (and uses the sales proceeds for consumption). Assume also that this 10 percent annual appreciation exactly equals the prevailing rate of return in financial markets.

Hall & Rabushka use a very simple approach. They allow no deduction for the purchase; they levy no tax upon sale. Individuals are not taxed on income from property under the Hall & Rabushka system.

Under the USA approach, the taxpayer would be allowed a deduction of $100 in Year One, and would be taxed on the entire $110 sales proceeds in Year Two. Observe that when we apply a 10 percent discount rate, 110 Year Two dollars have a present value equal to 100 Year One dollars. Assuming a constant tax rate—say 20 percent—the $22 tax in Year Two dollars would have a discounted value equal to the $20 tax saving in Year One dollars.

Thus, in this example, the two tax systems would levy a tax that is equal in terms of present value. The USA system taxes an extra $10, but this is offset by the fact that it delays for one year taxing $100.

85. The equivalence would also be present if, in the preceding example, we substituted income produced by the property for income resulting from appreciation in value. Suppose the taxpayer purchased a $100 one-year bond in Year One, which paid the prevailing market rate of 10 percent. One year later, the taxpayer received $10 interest plus $100 principal, all of which was spent on consumption.

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Hall & Rabushka would grant no deduction, and levy no tax.

USA would grant a $100 deduction in Year One, resulting in a $20 tax saving (assuming a 20 percent tax rate). In Year Two, USA would tax $110—the interest plus the "dissaving" of using the bond redemption proceeds for consumption. Discounted at 10 percent, the resulting tax, $22, would be equal in present value to the $20 of tax savings one year earlier.

86. In the preceding two notes, it may initially appear that the taxpayer avoids any tax at all, in present value terms, despite ultimately consuming $110. When and how is the tax paid under the USA tax? Under the Hall & Rabushka proposal? (Hint: Assume the taxpayer earned $50,000 in Year One, but consumed only $49,900, and invested the remaining $100.)

87. Hall & Rabushka claim major simplicity advantages for their approach. What is the basis for their claim?

88. Do you agree that the two approaches are in fact economically equivalent? Equivalence may depend upon whether we evaluate from a macroeconomic point of view, or from the vantage point of individual taxpayers. Compare two taxpayers, Gladstone Gander and Donald Duck, each of whom earns the same amount, and each of whom, on the same day, invests $10,000 to purchase common stock. At the time of purchase, the equivalence of market value of the two stocks means that the future expected (by the market) returns of both investments, discounted to present value, equals $10,000. The two investments do not in fact provide the same returns, of course. Gladstone is more skilled, or luckier, in his stock selection. Gladstone's stock, the next Wal-Mart, earns ongoing returns greatly in excess of the expected return, and Gladstone uses these handsome dividends, and ultimately a large capital gain, to increase his standard of living. The company in which Donald invests goes bankrupt; Donald loses the principal amount of his investment, and gets no return whatever.

How would first, Hall & Rabushka, and second, USA, treat these two taxpayers? Which approach is more appropriate? (Assume that from all investors taken as a group the government gets the same overall revenue, discounted to present value, from either approach.)

Capital gains and owner-occupied housing

89. Hall & Rabushka would not tax capital gain, on the theory that doing so constitutes double taxation. They give the example of a taxpayer who purchases stock, the value of which equals "the capitalization of its future earnings." An increase in value merely reflects an increase in anticipated future earnings—hence, taxing both the earnings (dividends, in this case) and the capital gain would result in double taxation. Is this explanation satisfactory in the case of the stock purchase? Is it equally

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satisfactory in the case of non-income-producing assets (for example, works of art, precious metals, and jewels). (The important category of owner-occupied housing is discussed below.)

90. The USA proposal indirectly taxes capital gain on "savings assets"—such as stock—by allowing a deduction in the year of purchase, then taxing the entire selling price in the year of sale (unless the sales proceeds are reinvested).

But if a taxpayer invests in a painting by Picasso, expecting it to appreciate in value, the USA proposal would not allow a deduction. Why not? Upon sale of such a "nonfinancial asset," gain would be computed as under present law—amount realized less basis. Is this approach preferable to that of Hall & Rabushka?

91. Consistent with its approach on taxing the gain on sale of the Picasso painting, the USA tax would continue present law by taxing capital gain on owner-occupied housing (assuming the proceeds were not reinvested, either in a replacement residence or in "savings assets").

Hall & Rabushka would not tax an owner-occupier's gain. What is the justification offered by Hall & Rabushka for not taxing the gain on owner-occupied housing?

Which approach do you find more justifiable?

Progressivity and vertical equity

92. A major concern about any form of consumption tax is that it will be perceived as (or in fact will be) unfair to lower-income taxpayers, by comparison to our present income tax. This perceived (or real) unfairness tends to occur because lower-income people spend a larger portion of their income on consumption. How does Nunn-Domenici/USA address these concerns? Is Dr. Penner convinced that the plan achieves vertical equity?

93. The USA proposal envisions a progressive rate structure, and the system is made more progressive by its treatment of Social Security taxes. Employers are granted a full credit for Social Security taxes, and employees a credit that is phased out as income rises. In effect, Social Security taxes are folded into the proposed USA tax, except for high-income employees. Merely ending Social Security taxes would increase progressivity, because Social Security taxes, disregarding benefits, are somewhat regressive. (Looking at Social Security taxes in isolation takes a narrow view; the Social Security *system* of income and benefits combined is markedly progressive.) USA goes even further, by maintaining the tax only for high-income employees.

A simpler approach might have been simply to eliminate the separate Social Security taxes altogether, and address the desired degree of

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progressivity in the primary tax. Why, according to Dr. Penner, was this approach not taken?

94. Hall & Rabushka acknowledge that a VAT would tax consumption more simply than their proposal, but they term a VAT "unfair because it is not progressive." Assuming progressivity to be necessary to a fair tax (an issue considered at length in Chapter Four), how do Hall & Rabushka address equity concerns while employing a flat rate tax?

Effect on businesses

95. The general approach of both Armey/Hall & Rabushka and Nunn-Domenici/USA is that a business can claim a deduction for purchases from other businesses, on the assumption that the other business will be paying the business-level tax. (Under both systems, the business tax is not limited to corporations, as it is under present law.)

The two proposals take differing approaches with respect to payments of wages and salaries, with Hall & Rabushka, but not USA, allowing a deduction. (USA would allow a deduction for the services of an outside accounting firm, for example, but not for the services of an employee accountant.) What is the theory of each approach?

96. Perhaps the most striking change in business taxation is that neither proposal would allow a deduction for interest, even if paid to another business. Interest and dividends would be treated identically. .

97. Consider first the Hall & Rabushka proposal with respect to interest. What is the justification for reversing present law, which generally allows a deduction for interest paid and taxes the recipient, and moving to a no-deduction/no-inclusion model? Business interest, after all, is a business expense. Hall & Rabushka recognize that they may be taxing businesses that are not profitable, but argue that their "business tax is not a profit tax." Would businesses that borrow be hurt? How would Hall & Rabushka deal with existing debt?

98. The USA proposal does not allow the business any deduction for interest (or dividends) paid. Businesses that receive interest need not take it into income, but individual recipients of interest are taxed. What is the justification for denying an interest deduction to a business debtor if the individual creditor is taxed?

99. Dr. Penner points out that the USA business tax is designed to be border adjusted, but that under current GATT rules, the Armey/Hall & Rabushka business tax could not be border adjusted because it allows deduction of wages. As Dr. Penner notes, the economic importance of border

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adjustment is debatable, but it is desired by American business. The issues involved in border adjustment are the same under a consumption-type tax as under a European-style VAT, and are discussed extensively in Chapter Six. See Chapter Six, Notes #16-24.

Effect on saving and borrowing

100. A major objective of all consumption-type tax proposals is to stimulate saving and investment, by removing the "double tax on savings." Yet Mr. Nolan expresses concern that abandoning present law might actually undercut saving incentives. Why? Do you share his concern?

101. Alternatively, the problem might be a revenue shortfall attributable to too much saving, at least initially. Hall & Rabushka base their conclusion of revenue neutrality on figures from a past year (1993). Yet a major purpose of moving to a consumption tax is to encourage a change in taxpayer behavior, leading to increased saving and investment. Hall & Rabushka state that they anticipate "a burst of investment, which might temporarily depress flat-rate revenue because of the expensing of investment." They argue that the adverse effect on revenues would be temporary, because increased investment would result in economic growth and thus increased revenues.

Mr. Nolan, on the other hand, fears that under any consumption-type tax, "[w]e will be taking one huge fiscal gamble that the sought-after greater inducements to saving will produce an increase in investment capital sufficient to yield larger or even equal revenues from a narrower tax base."

Would you expect higher or lower revenues?

102. The theory of the USA tax should require borrowed funds to be taxed in the year of borrowing. Why? Why does Nunn-Domenici/USA not fully follow the theoretically correct approach? What approach is taken instead? What problems arise from the approach taken?

103. *Charitable contributions.* Hall & Rabushka would end the charitable contribution deduction, but suggest that any drop in contributions are unlikely to be significant in amount or permanent. They note that of $117 billion contributed in 1991, only $61 billion was deducted "on personal tax returns." (The size of corporate deductions, which also would be ended, is not mentioned.) Nunn-Domenici/USA allows a deduction, but Mr. Nolan questions the importance of the deduction under a tax system that would allow a potential donor the same deduction for simply calling a broker and buying stock.

Do you think adoption of a consumption-type tax would undermine charitable giving? Would that be a reason to oppose adoption of a consumption-type tax?

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104. In conclusion: Should the United States adopt some form of consumption-type tax to replace the income tax? If so, what form? Why?

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See also bibliography for Chapter Six.

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