

December 2000

## Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform

John K. McNulty

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# Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform

John K. McNulty†

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# Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform

John K. McNulty

*Professor McNulty suggests that one of the most interesting tax policy debates during recent decades has been that related to proposals to replace the U.S. Federal Income Tax with a consumption tax or "consumed income tax," a "cash-flow" tax or, more recently, a "Flat Tax." Conducted by public finance, legal tax-policy, and tax-theory scholars, the discussion has challenged the merits of income taxation on grounds of fairness, economic allocative efficiency, welfare, and simplicity. In this Essay, Professor McNulty examines the issues, surveys some of the literature, evaluates the arguments, and concludes that the case has not been made for replacing the income tax even with a national, broad-based, possibly personalized and progressive consumption tax. He briefly reviews the history of income taxation in the twentieth century in the United States, explains the meaning of flat-rate taxation, the taxation of consumption or consumed income, and the so-called "Flat Tax" proposals of the 1980s and 1990s, as well as Value Added Tax (VAT) and retail sales tax possibilities. Professor McNulty explains the time-value-of-money criticisms of an accretion-model income tax based on the von Schanz-Haig-Simons conception of income, and he also summarizes the arguments for replacement on the basis of fairness and economic efficiency. He considers international and federalism aspects and particularly the transitional problems associated with replacement. Professor McNulty then concludes that replacement would not be advisable, that an income tax in theory probably is preferable to a consumption tax, and that our admittedly "hybrid" income tax, while in need of improvement, has robustly withstood the twentieth-century criticisms and should remain the principal national tax. He suggests that adding a national consumption tax, such as a low rate VAT or retail sales tax, to the national tax system as so many of our industrialized trading partners have done, would somewhat reduce dependence on (or the rates of) income taxation and would seem more attractive as a major tax policy change.*

## INTRODUCTION TO INCOME TAXATION IN THE U.S.

The Federal Income Tax has served this country well for most of the twentieth century, continuously since 1913 (since 1909 for corporate taxpayers), and with roots even earlier than that. Although scholars and politicians at times have proposed switching to a consumption-based model, it was not until the last five or six years of the century that such proposals received much popular attention or support. Now, at the beginning of the twenty-first century, whether or not such a change should be made is perhaps the biggest issue within the field of U.S. national tax policy.

The original constitutional authority for Congress to impose taxes can be found in Article I, Section 8, Clause 1 of the U.S. Constitution, which states, "The Congress shall have Power to Lay and Collect Taxes, Duties, Imposts, and Excises, to pay Debts and provide for the Common Defense and General Welfare of the United States; but all Duties, Imposts, and Excises shall be uniform throughout the United States."

Early on, federal income tax legislation was held unconstitutional because it taxed income from real estate (rents and the like) and personal property and was thus considered to be a "direct tax" that was not apportioned among the states in proportion to the population of each. Therefore, the United States Supreme Court had held, the earlier federal income tax law violated Article I, Section 9, Clause 4 of the U.S. Constitution which states, "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." The apportionment requirement is recapitulated in Article I, Section 2, Clause 3 of the Constitution which states, "Representatives and direct Taxes shall be apportioned among the several States . . . according to their respective numbers. . . ." After the decision in *Pollock v. Farmers' Loan & Trust*,<sup>1</sup> proponents of an income tax were faced with the necessity of clearing constitutional barriers by amendment, which was finally accomplished eighteen years later.

From our nation's birth until the Civil War years, customs receipts or tariffs provided sufficient revenue to the Federal government, with excise taxes temporarily added during the War of 1812.<sup>2</sup> Again, during the Civil War, more revenue was needed than customs receipts could provide, so Congress enacted an income tax, as did the Confederacy. The 1864 congressional tax applied low, graduated rates and only to relatively high

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1. 158 U.S. 601 (1895).

2. There were a few other incidental taxes. The tax on distilled spirits produced the "Whiskey Rebellion" of 1794. See 1 S.E. MORISON, *THE OXFORD HISTORY OF THE UNITED STATES, 1783-1917*, at 181-82 (1927). The carriage tax, upheld in *Hylton v. United States*, 3 U.S. (3 Dall.) 171 (1796), was followed by taxes on snuff, sugar, salt, auction sales, legal documents and bonds. See MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION* 4-6 (3d ed. 1995). Real property and slaves between the ages of 12 and 50 were taxed. See *id.* An income tax was proposed in 1815, for pressing revenue needs, but was not enacted. See *id.*

incomes: 5% on income from \$600 to \$5,000, 7.5% on income from \$5,000 to \$10,000, and 10% on income over \$10,000. The income tax was repealed after the war's end and customs receipts and excise taxes (on liquor and tobacco) resumed their primary roles. Populist movements and anti-tariff thinking led to a 2% individual and corporate income tax in 1894, promptly declared unconstitutional by the Supreme Court in *Pollock*. There followed the 1909 exclusively corporate excise tax, measured by income, and later the Sixteenth Amendment and the 1913 general income tax, the foundation of present law.<sup>3</sup>

The present income tax statute is the lineal descendant of the Income Tax Act of 1913. The 1913 Act depended on and followed approval of the Sixteenth Amendment in February 1913. The Sixteenth Amendment states, "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived without apportionment among the several states, and without regard to any census or enumeration." Before this Amendment, the Income Tax Act of 1913 was a comparatively simple tax law as measured against our present Internal Revenue Code. Although it has undergone numerous changes, it established the system under which we presently operate. A steeper progressive tax structure came in with the advent of World War I.<sup>4</sup> With World War II came heavy tax rates and, because of lower exemptions, broader application of the tax. The income tax thus became a tax on most people—"the masses"—not just a tax on persons with relatively high annual incomes.<sup>5</sup> This structure, with some modifications, has survived to date.

The first Internal Revenue Code, based upon prior tax statutes, was enacted in 1939; in 1954 the present Internal Revenue Code, making substantial changes from the 1939 Code, was enacted. Comprehensive as were the modifications in 1954, the years since then have seen many important changes, some of them reflecting shifts in rather deep-seated and philosophical premises about the uses of an income tax in American society. In 1961, President Kennedy, sending a message to Congress regarding the changes embodied in the Revenue Act of 1962, promised a comprehensive revision of our income tax laws. Efforts at a major overhaul have continued since then, but as yet such significant change has not taken place. The Tax Reform Act of 1986 made substantial alterations in the Internal Revenue Code, such as base broadening, lowering rates, and other reforms, and renamed it the I.R.C. of 1986.

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3. A concise, informative history, including revenue data, appears at the beginning of Alan Schenk, *Radical Tax Reform for the 21st Century: The Role for a Consumption Tax*, 2 CHAPMAN L. REV. 133, 133-37 (1999).

4. See STUDIES IN SUBSTANTIVE TAX REFORM 3-4 (Arthur B. Willis ed., 1969).

5. For additional historical background, see generally *id.*

In the 1970s and 1980s, very significant income tax policy studies were undertaken by the U.S. Treasury Department and other institutions.<sup>6</sup> Some consideration was given to "radical" reform, such as converting the accretion-model income tax to a cash-flow, consumption-type income tax,<sup>7</sup> but the most substantial legislative work actually accomplished consisted of the 1986 base-broadening and rate lowering of the income tax in its continuing form.

The cumulative effect of eighty-seven years of accretions to the Federal Income Tax law and the studious efforts of taxpayers and their advisors to minimize taxes, followed by legislative or regulatory ripostes, is a very long<sup>8</sup> and sometimes complex Internal Revenue Code plus "Regulations" and other jurisprudence—rulings, cases, and so forth—that some commentators, scholars, and politicians think need "radical" reform.<sup>9</sup>

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6. See U.S. DEP'T. OF TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977) [hereinafter BLUEPRINTS, 1977] (calling for integration of the corporate and individual income tax, taxation of capital gains at full rates after inflation adjustments, and broadening the tax base). A second model, a cash-flow or consumption-based tax, was also put forward in the form of an income tax that excluded savings, with three tax brackets of 10-40%. See also U.S. DEP'T OF TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH (1984) (hereinafter TREASURY I); THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY (1985) (known as TREASURY II or REAGAN I) [recommending a "pure income tax," taxing capital gains at full, normal rates (with inflation adjustments in basis), and true economic depreciation allowances with inflation adjustments for receipts and inventories, partial integration of the corporate and individual income taxes by a deduction from corporate tax of one-half of dividends paid (and repeal of the pre-existing \$100/\$200 dividend exclusion), substantial broadening of the income tax base, and lower, graduated rates]. See DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 291-99 (1986) (describing TREASURY I and its broad-based accrual-income tax).

In 1984, a second revised edition of BLUEPRINTS was published as: DAVID F. BRADFORD AND THE U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM (2d ed. 1984) [hereinafter BLUEPRINTS, 1984].

7. A seminal scholarly work that drew attention to this idea was William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

8. 9833 Sections in length.

9. For more income tax history, see generally L. Hart Wright, *Carter's Projected "Zero-Based" Review of the Internal Revenue Code: Is Our Tax to Be "Born Again"?*, 75 MICH. L. REV. 1286 (1977). Wright states:

The framers of our first income tax act, and most notably Representative Cordell Hull, had no intention of creating what the President now describes as "a welfare program for the rich." Their intention was precisely the opposite. It was, in general, to apply progressive rates to an income base that, except for a *very large* exemption deduction was to include all "gains, profits, and income . . . of whatever kind and in whatever form paid . . . derived from any source whatever. . . ." In other words, as noted earlier, they intended to establish "ability-to-pay" as the criterion *and* to protect completely from this tax not only the poor but also those not at least moderately well-off. Taxable returns were expected from less than 0.5 per cent of the population.

*Id.* at 1302. Wright argues that each new Congress or presidential administration has attempted to address the social pressures of the day through the tax code. See *id.* at 1305-06. He states:

Equally important to understanding the intense criticism directed at tax preferences, and closely related to the development just discussed, is the fact that each administration and each Congress has been almost consumed by the particular societal problems *it* encountered. As a consequence, no administration or Congress has expended much effort trying to determine whether previously adopted tax preferences should be retained. Thus each such preference tended to remain a part of the Code regardless of whether the societal problem it originally

Previously conducted in the academic circles of economists and tax law professors, the debate about the virtues of taxing consumption rather than income emerged into the public for the last five or so years of the twentieth century. Prior to this time, our long experience with income taxation had overshadowed any efforts to popularize personal or direct consumption taxation. Scholars Irving Fisher of Yale and Nicholas Kaldor of Cambridge (U.K.) made some impact in the 1940s and 1950s,<sup>10</sup> relating the discussion to much earlier insights by Thomas Hobbes and John Stuart Mill.<sup>11</sup> The U.S. Treasury Department also studied such reform. In 1942, the Treasury Department proposed a federal expenditure tax, but it was rejected by the Senate Finance Committee.<sup>12</sup> The Treasury again proposed such reform in its 1977 Blueprints for Basic Tax Reform.<sup>13</sup> Others, such as David Bradford,<sup>14</sup> William Andrews,<sup>15</sup> the Meade Commission in England,<sup>16</sup> and the Carter Commission in Canada pressed on.<sup>17</sup> But it was the political excitement over proposed Congressional legislation in 1994-95 that "hit the newspapers."

House Majority Leader Dick Armey proposed "The Flat Tax," taken from the Hall-Rabushka proposals and books using that term.<sup>18</sup> Graduated personal consumption taxation was also proposed by Senators P. Domenici, S. Nunn, and R. Kerry who sponsored the U.S.A. (Unlimited Savings Allowance) Tax Bill.<sup>19</sup> Other personalized, direct

addressed was still a significant problem, and if it were, whether tax preference represented the most desirable, efficient, and feasible solution.

*Id.* at 1307. See ADRIAN A. KRAGEN & JOHN K. McNULTY, FEDERAL INCOME TAXATION (INDIVIDUALS, CORPORATIONS, PARTNERSHIPS) 2-10 (4th ed. 1985).

10. See IRVING FISHER & HERBERT W. FISHER, CONSTRUCTIVE INCOME TAXATION 3-17 (1942); IRVING FISHER, THE NATURE OF CAPITAL AND INCOME (1906) (income as satisfaction); NICHOLAS KALDOR, AN EXPENDITURE TAX (1955); Irving Fisher, *Income Theory and Income Taxation in Practice*, 5 *ECONOMETRICA* 1 (1937); see also A.C. PIGOU, A STUDY IN PUBLIC FINANCE 135-44 (1928); WILLIAM VICKREY, AGENDA FOR PROGRESSIVE TAXATION 329-61 (The Ronald Press Company 1947). Friedman and Marshall and others have supported consumption taxes. See Alvin Warren, *Would A Consumption Tax Be Fairer Than an Income Tax?*, 89 *Yale L. J.* 1081, nn.1-5 (1980); Milton Friedman, *A 1962 Flat-Tax Proposal Revisited*, *WALL ST. J.*, Feb. 9, 1996, at A14.

11. See THOMAS HOBBS, *LEVIATHAN* 226 (M. Oakeshott ed., 1960); JOHN STUART MILL, *PRINCIPLES OF POLITICAL ECONOMY*, bk. V, Ch. I, § 4, 813 ff (Sir Wm. J. Ashley ed., New Impressions ed. 1909) (1848).

12. See E. Cary Brown, *Comments, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE?* 113, 113 (Joseph Pechman ed., 1980) [hereinafter *WHAT SHOULD BE TAXED*] (discussing David Bradford's paper, *infra* note 100).

13. See BLUEPRINTS, 1977, *supra* note 6.

14. See BLUEPRINTS, 1984, *supra* note 6.

15. See Andrews, *supra* note 7.

16. See J.E. MEADE, INSTITUTE FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION (1978).

17. See REPORT OF THE ROYAL COMMISSION ON TAXATION (Ottawa 1966) (known as the Carter Commission Report).

18. See DICK ARMEY, THE FLAT TAX: A CITIZEN'S GUIDE TO THE FACTS ON WHAT IT WILL DO FOR YOU, YOUR COUNTRY, AND YOUR POCKETBOOK (1996).

19. See LAURENCE S. SEIDMAN, THE U.S.A. TAX: A PROGRESSIVE CONSUMPTION TAX (1997).



consumption-based tax reform proposals have been introduced, some of which will be described below.<sup>20</sup>

Having shown that a consumption-based tax can be designed to individualize or personalize the determination of each individual taxpayer's tax liability, including the use of graduated rates, and having offered strong arguments about the fairness and efficiency advantages of such a system, the legislative and academic proponents of consumption taxation have presented a serious challenge to the long-accepted United States national reliance on income taxation. They believe they have constructed realistic legislative consumption-based alternatives to the present Internal Revenue Code. Both theory and practicality are important in weighing these alternatives, and a rich literature has grown regarding both dimensions.

At the beginning of the new century, there seem to be three or four principal tax reform options.<sup>21</sup> One is to improve our "accretion-model" (or hybrid) income tax by broadening the base, directing major simplification efforts more toward reducing taxpayer incentives to engage in complex behavior than merely at shortening the legislation, and lowering and conforming the rates.<sup>22</sup>

A second option would be to integrate the corporate and individual income taxes. This would reduce the overburden of tax on income in the corporate sector, reduce the tax law's effect of favoring debt over equity finance and retention of corporate earnings over distribution, and alter other non-neutralities, inequalities and choice-of-form complexities in the law.<sup>23</sup>

A third option would be to add a national value-added tax (VAT) or personal consumption tax, to the federal (that is, not state and local) tax system. This plan supposedly would serve to reduce the deficit (or increase the surplus) and reduce the national debt, finance Medicare or Social Security, reduce or flatten income tax rates, and raise income tax exemption levels.

A fourth approach, one that builds upon taxpayer and legislative discontent and impatience with the current income tax regime, calls for discarding our income tax and replacing it with something called a "Flat Tax." The Flat Tax, it is sometimes said, would dispense with the Internal Revenue Service, reduce compliance to filling out a postcard-sized return, and bring heralded fairness to a system thought to be inequitable, corrupted and subject to public and private abuse.<sup>24</sup>

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20. See *infra* notes 49-58 and accompanying text.

21. See Alvin C. Warren, Jr., *Three Versions of Tax Reform*, 39 WM. & MARY L. REV. 157 (1997).

22. See *id.* at 159; see also Daniel Halperin, *Saving the Income Tax: An Agenda for Research*, 77 TAX NOTES 967 (1997).

23. See Warren, *supra* note 21, at 170.

24. See *id.* at 163.

The biggest and most interesting questions are then, what is this thing called a "Flat Tax," and can the arguments in its favor support the repeal of the Federal Income Tax? This article will consider the advisability of substituting a "Flat Tax" or other consumption-based tax for our accretion-model, national income tax on individuals and corporations. It argues that the case has not been made for substituting a consumption tax or a consumption-type income tax for the national income taxes, although it might be sound policy to add on a simple national consumption tax such as VAT.

## I

### AN OVERVIEW OF DIFFERENT SYSTEMS OF TAXATION

Tax reform has been a popular political issue over the past decade, spurring numerous reform proposals in the United States. Although these proposals are often referred to with simple names (for example, "the flat tax"), they typically combine a variety of features drawn from different taxation models. This Part attempts to give readers who may not be familiar with the basic taxation models a framework for evaluating reform proposals.

I begin by explaining the features of some of the basic systems of taxation and providing examples of proposals that draw upon each system. Part I.A discusses flat-rate taxation, Part I.B discusses consumption taxation, Part I.C discusses retail sales taxes and VAT, and Part I.D discusses the current U.S. system, which is a hybrid income tax. Part I.E provides more detailed explanations of some of the most prominent and influential consumption taxation proposals, while Part I.F highlights some of the practical implications of these and other reform proposals.

#### *A. The Flat Tax*

The name of the "flat-tax" proposals invites one to think: What is a "flat tax"? By literal definition, of course, it is any tax with a single tax rate (or, loosely, a relatively flat graduation of rates<sup>25</sup>), on any chosen tax base: income, wealth, consumption, retail sales, value added or whatever.<sup>26</sup>

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25. Recent "flat tax" proposals have employed a small number of rate steps—as many as five in Representative Gephardt's bill. See Richard Gephardt, *A Democratic Plan for America's Economy: Towards a Fairer, Simpler Tax*, Remarks Before the Center for National Policy (July 6, 1995). This is the same number as in our present Federal Income Tax—that are set at relatively low levels—14% or 17% or 20% or 25%—on a relatively broad base. See Fred B. Brown, "Complete" *Accrual Taxation*, 33 *SAN DIEGO L. REV.* 1559 (1996). And, as will be explained below, it has come often to mean a tax applied to a base that consists of "consumption" or "consumed income," rather than a tax on "gross income" or "taxable income," including accretions to wealth and all income from capital as we know it, or as defined by von Schanz-Haig-Simons.

26. See William G. Gale, *The Kemp Commission and the Future of Tax Reform*, 70 *TAX NOTES* 717 (1996).

For example, it could be an income tax rate of 25% on all “taxable income.”

Such a flat rate income tax can be made “progressive” even if it uses a single positive rate, if it also provides an exemption or exemptions. To illustrate, if the single rate were 25%, and if the tax base were taxable income and if there were a \$10,000 per capita exemption, the effective or average rates of tax on a single taxpayer would be as follows:

Table 1: Effective Average Rates of Tax

AMOUNT OF TAXABLE INCOME	EFFECTIVE RATE OF TAX
Taxpayer with \$5000 taxable income (\$0/\$5,000)	0%
Taxpayer with \$10,000 taxable income (\$0/\$10,000)	0%
Taxpayer with \$20,000 taxable income (\$2,500/\$20,000)	12.50%
Taxpayer with \$40,000 taxable income (\$7,500/\$40,000)	18.75%
Taxpayer with \$100,000 taxable income (\$22,500/\$100,000)	22.50%
Taxpayer with \$1,000,000 taxable income (\$247,500/\$1,000,000)	24.75%

### Figure A: Flat Rate but Progressive Taxation

The following figure demonstrates the actual progressivity of such a flat-rate income tax, at a tax rate of 25% with a \$10,000 exemption.

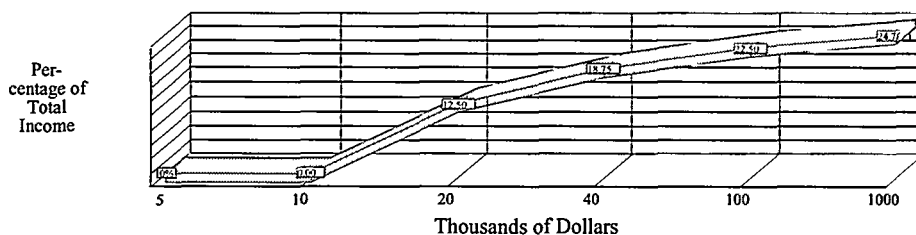


Figure A: Progressivity of a Flat-Rate Income Tax at 25 Percent with a \$10,000 Exemption

As this illustrates, a nominally “flat tax” can be a “progressive” tax even though it uses a single rate instead of graduated rates.

What is good about a single rate in an income tax? One hopeful answer is that it could provide simplification in tax-return preparation,

compliance, and administration. But this computational simplification would itself be trivial and does not alone answer the question: it could be a 99% or a 110% or a 30% rate, after all.<sup>27</sup> The primary benefit of a single-rate tax is that, by eliminating any graduation, or at least steep graduation, of rates, it tends to preclude progression to high rates and implicitly precludes differential rates on various categories of taxpayers or income, such as capital gains or “unearned,” that is, investment, income. Avoiding these two features would eliminate the distorting and complicating effects of very high or very different rates, or of a schedular system of different rates and types of income.

What is good about a low rate? One reply is that it does less harm to economic efficiency, because a low rate causes less distortion in behavior such as consumption, saving, and work, at the margin.<sup>28</sup> Both theory and common sense predict that a 90% or higher top marginal rate on taxable income, as used in the United States during World War II and the Korean War, will tend to discourage a taxpayer from working one more hour. Because his or her after-tax compensation will be reduced 90%, the taxpayer will take home only 10% of what she or he was paid for her or his last hour of work. This is a possible behavioral adjustment to a new tax or an increased rate of tax.<sup>29</sup>

Economic theory and common sense thus predict that the taxpayer, by substituting untaxed leisure for taxable work, will demonstrate what is often called a “substitution effect,” or “incentive effect” (or “price effect”).<sup>30</sup> However, economic theory also recognizes that the taxpayer’s actions may demonstrate an opposite effect, called an “income effect” (or “wealth effect”). The taxpayer may work harder or longer hours so as to have the same disposable, after-tax income as he or she would have without the 90% tax, or as he or she would have had if the marginal income were taxed at the next lower bracket.<sup>31</sup>

Whether the income or substitution effect will dominate is an empirical question. Theory alone does not predict which effect will dominate. In either case, the taxpayer will be worse off by more than the amount of the tax paid and revenue collected by the government, because he or she will

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27. See Richard A. Musgrave, *Clarifying Tax Reform*, 70 TAX NOTES 731, 736 (1996).

28. See JOEL SLEMROD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN’S GUIDE TO THE GREAT DEBATE OVER TAX REFORM 166-70* (2d ed. 2000); Joseph E. Stiglitz, *The Consumption-Expenditure Tax*, in *THE PROMISE OF TAX REFORM 107, 127* (Joseph A. Pechman ed., 1985).

29. Similarly, a 600% excise or retail sales tax on a \$2.00 pack of cigarettes probably would reduce consumption of cigarettes by raising the after-tax cost of a pack to \$14.00 (\$2.00 price plus \$12.00 tax).

30. Similarly, the smoker may substitute untaxed candy for taxed cigarettes if faced with a very high tax on tobacco products.

31. Or, if faced with a new and very high excise or sales tax on cigarettes, the taxpayer may work harder or save and invest (or eat) less in order to be able to continue his or her habitual or targeted tobacco consumption, without change.

not be working and consuming at the level, or in the ways, he or she would prefer. This distortion is part of the burden of the tax. It is a "deadweight" loss, over and above the tax paid by taxpayers to the government.

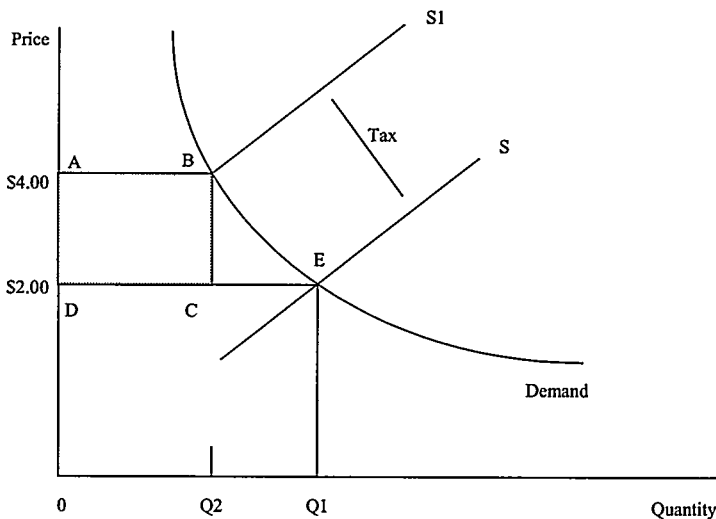


Figure B: 100 Percent Tax (Or \$2.00 Tax) on Each Sale of \$2.00 Worth of Bagels

For example, consider the market for bagels. At price \$2.00, quantity  $Q1$  of bagels is consumed. If an excise tax of 100% is imposed, the intersection of the  $S1$  and  $D$  curves shows that quantity  $Q2$  will be consumed. Area  $ABCD$  will be collected in tax. The amount described by triangle  $BEC$  is the "deadweight loss" to consumers of bagels. They do not pay that amount in tax, but they also consume fewer bagels and lose that amount of pleasure because the tax is imposed. Society loses because area  $BEC$  does not constitute tax revenue. So if a tax has a high rate, or steeply-graduated rates, the distortion of human behavior and the "deadweight loss" is likely to be greater. A flat or low rate may do less damage.

What else might be good about a low-rate tax? For one thing, it may mean that, to raise a fixed amount of revenue, the tax will be applied to a relatively broad base, such as on all income, all consumption or all retail sales. If so, that means fewer distortions and less deadweight loss to consumers (and producers) because the tax cannot be avoided easily by substituting tax-free income, such as employee fringe benefits; or untaxed consumption, such as home-grown vegetables; or untaxed sales, such as exempt necessities, services or bartered goods.<sup>32</sup> So the old public finance

32. The epitome of a tax that cannot be escaped or avoided by a behavioral change is, of course, the much-maligned "poll tax." See SLEMROD & BAKIJA, *supra* note 28, at 49, for an entertaining, brief account of British efforts in 1990 and earlier, in 1381, to impose a "poll tax," a tax of a fixed uniform

maxim states that “it is good to have a low-rate tax on a broad base.”<sup>33</sup> This maxim applies, of course, to a tax on any base, whether income, consumption or retail sales. Overall, it implies another old public finance maxim: It is better to have several low-rate taxes on various bases than one high-rate tax on one base. Also, a low rate reduces the reward and incentive for evasion or avoidance, making the tax efficient in the sense of “fiscal efficiency,” the cost of raising a given amount in revenue (as distinguished from “economic” or “allocative” efficiency).

Although many newspapers did not recognize it and most American voters still do not, in the United States in the 1990s, the phrase “flat tax” in fact had come to designate a tax on consumption or “consumed income” rather than on all income.<sup>34</sup> A most ingenious and interesting aspect of the modern flat tax proposals is their use or combination of a tax on business firms and a tax on wage earners in some way coordinated to approximate a tax on consumed income or consumption while still allowing an opportunity for the rate structure to be differential or progressive as to individuals. In general, business income or value added, perhaps apart from wages, would be taxed to business firms at perhaps a single flat rate but stepped or graduated rates would apply to individuals geared to the amount of their consumed income or consumption.<sup>35</sup> Individual exemptions or other allowances could further “personalize” the tax.<sup>36</sup>

Among the several “Flat Tax” proposals in the United States, to be described in more detail in Part I.E below, one, “The U.S.A. Tax,” amounts to a tax on consumption because it allows a deduction for current earnings that are saved, defers tax on those earnings and on their yield so long as reinvested and not consumed, and taxes the net amounts consumed and withdrawn from savings.<sup>37</sup> Another, the “Arney Flat Tax” (named for

amount on each person, not varying according to income or wealth or consumption or taxpaying ability or any other individual characteristic.

33. See *Replacing the Federal Income Tax: Hearings Before the House Comm. on Ways and Means*, 104th Cong. 123 (1996) (statement of Alan Auerbach) [hereinafter *1996 House Hearing*]; *Flat Tax Proposals, Testimony Before Senate Comm. on Fin.*, 104th Cong. 21 (1995) (statement of Alan Auerbach) [hereinafter *1995 Senate Hearing*]; A. Auerbach, *Flat Taxes: Some Economic Considerations, Testimony Before Senate Comm. on Fin.*, April 5, 1995, [hereinafter *1995 Senate Hearing II*].

34. See Marvin A. Chirelstein, *The Flat Tax Proposal—Will Voters Understand The Issues?*, 2 THE GREEN BAG 2D SER. 147 (1999).

35. On expenditure taxation generally, see the classic KALDOR, *supra* note 10. See also Advisory Commission on Intergovernmental Regulations, “The Expenditure Tax: Concept, Administration and Possible Applications” (*Information Report M-84*) (Washington, D.C., 1974); MEADE, *supra* note 16. On the two-tiered “flat taxes” and personal exemption taxes in general, see BLUEPRINTS, 1984, *supra* note 6, at 78-99.

36. This inventive conception of a two-tiered tax dates back at least to the Hall and Rabushka proposal, discussed below in Part I.E.

37. See Richard J. Joseph, *The “Consumption” and “Flat” Taxes Revisited*, 69 TAX NOTES 211 (1995). Jane Gravelle mentions that the U.S.A. tax may be more like a wage tax than a consumption tax, probably because it in effect exempts capital income. See Jane G. Gravelle, *The Flat Tax and other*

proponent Congressman Armeý), is a more extreme proposal for a tax on individuals that would use a proportional rate structure and includes in individual gross income only cash wages, retirement distributions, and unemployment compensation.<sup>38</sup> In addition, it would eliminate all itemized deductions, tax credits, and personal exemptions (but not exemptions for dependents). It would also repeal the Alternative Minimum Tax and the Federal Estate and Gift Taxes.<sup>39</sup>

There have been several other proposals for flat or proportional taxes on "income," normally defined, and for "negative income" taxes, but they have not received as much attention or support as the proposals mentioned above.<sup>40</sup>

### B. Consumption Tax

Recently in the United States, the phrase "flat tax" has come to refer to a proposal for a lower, single-rated tax imposed on consumption or consumed income; a tax to be added to, or substituted for, the Federal Income Tax on individuals and on corporations.<sup>41</sup> These consumption-based reform proposals cause us to ask: What inherently is a consumption tax?

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*Proposals: Who Will Bear the Tax Burden?*, 69 TAX NOTES 1517, 1523 (1995); see also *USA Tax System: Description and Explanation of the Unlimited Savings Allowance Income Tax System*, 66 TAX NOTES 1482 (1995). This version differs slightly from the legislative version introduced in Congress in 1995. See *infra* notes 94-95.

38. See ARMEY, *supra* note 18, at 49. Hence the tax base would not include income from investments, such as dividends, interest, rents, royalties, capital gains, and the like.

39. See *id.* at 213.

40. See, e.g., 1 ADRIAN A. KRAGEN & JOHN K. McNULTY, FEDERAL INCOME TAXATION 1201-04, 1193-2000 (3d ed. 1979); George Guttman, *The Single-Rate Income Tax: Policy Questions and Technical Issues*, 21 TAX NOTES 539 (1983); see also BLUEPRINTS, 1977, *supra* note 6, at 41. On flat and single rate income taxes, see Guttman, *supra*.

41. In contrast, the present Federal Income Tax is usually called an "accrion model" income tax (as distinguished from a cash-flow or consumption-type income tax). However, in some significant respects, it departs from a pure accretion, von Schanz-Haig-Simons model. See Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, in THE FEDERAL INCOME TAX 1, 7 (Robert Haig ed., 1921), reprinted in READINGS IN THE ECONOMICS OF TAXATION 54, 75 (1959) ("Income is the money value of the net accretion to one's economic power between two points of time." This is the "accretion" concept of income.). See also HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938) (containing the 1938 Haig-Simons "definition" of income, an equation illustrating the uses of income, namely consumption or saving). Examples of such departures include: the rule of realization (unrealized gains or accretions to wealth are not taxed), accelerated depreciation, Section 179 instant (limited) depreciation, exclusions (for example, fringe benefits, gifts and bequests, scholarships, and so forth), and "personal" deductions (medical expenses, charitable contributions and state tax payments), absence of tax on "imputed income" (from ownership of homes and cars or from services rendered for self or family), tax-preferred saving and deferred compensation (qualified pension plans, Individual Retirement Accounts (IRAs), Keogh savings accounts, stock options, and the like), and even non-recognition (deferral) rules. It is far from a cash-flow model income tax also, for example in its treatment of capitalization and depreciation, borrowing and lending, ordinary saving and investment. See also the tax expenditures listed *infra* note 154. So it is a hybrid, but one that much more is fundamentally modeled after the accretion model income tax than a cash-flow or a consumed-income tax.

In a conceptual sense, of course, it is a tax on a base that consists of "consumption" (somehow defined), regardless of the tax rate, rates, or rate system used. Its base can be computed by an additive procedure—add up all the taxpayer's expenditures for consumption (for food, wine, lodging, clothing, entertainment), not including saving nor costs of producing income and, possibly the value of all other consumption (self-services, home-grown vegetables, imputed income or consumption from home ownership or a cash bank balance that obviates a service charge for the bank's services as custodian and clearing house) during the year. Or, the consumption base can be determined by subtraction. Since, in the famous von Schanz-Haig-Simons formulation, income equals consumption plus saving ( $I = C + S$ ), if we know a taxpayer's annual income and saving, we can subtract the latter from the former and thus derive the taxpayer's consumption.<sup>42</sup> This is sometimes called the cash-flow method of taxing consumption. To the extent that all income is either consumed or saved, a consumption tax can be described as an income tax that exempts saving. So if businesses can immediately deduct the costs of all capital goods and households can deduct all new (net) saving, the base of the taxes is consumption.

The cash-flow (deduction) method is used in several fundamental reform proposals. If saved income is untaxed when earned, it (and its yield) must be fully taxed when withdrawn and consumed in a later year, so that consumption surely is taxed at that time.

In the alternative, a yield-exemption method can be used to produce a similar result, under stipulated conditions.<sup>43</sup> Under this approach, no

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The Haig-Simons definition of income seems to be derived from, or at least to resemble, that proffered by Georg von Schanz. See, e.g., von Schanz, *Der Einkommensbegriff und die Einkommensteuergesetze*, 13 FINANZ-ARCHIV 1 (1896), which in turn draws upon the work of David Davidson. See DAVID DAVIDSON, *OMBESKATTENINGNORMEN VID INKOMSTSKATTON* (Uppsala, 1889), quoted in L. MUTEN, *ZUR ENTWICKLUNG DER EINKOMMENSTEUER NACH DEM ERSTEN WELTKRIEG* 24 (1967); see also KRAGEN & McNULTY, *supra* note 9, at 88; R.A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 47 n.7 (1967).

42. See BLUEPRINTS, 1984, *supra* note 6, at 10. However, to take account of current consumption out of borrowings or prior savings, one really would have to ask what the taxpayer's net wealth was at the beginning and end of the year as well. Net saving or dissaving, in other words, is what "saving" means in the  $I = C + S$  formulation. Also, income must be very comprehensively defined or the resulting calculation of "consumption" will be much less than the actual value of rights exercised in consumption during the year. See generally RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 455-58 (1980) (discussing the determining of taxable consumption).

43. See E. Cary Brown, *Business-Income Taxation and Investment Incentives*, in *INCOME, EMPLOYMENT AND PUBLIC POLICY* 300-16 (1948); see also BLUEPRINTS, 1984, *supra* note 6, at 10.

A consumption tax is equivalent to the exemption of income from capital in a world where individuals consume all their incomes during their lifetimes and interest rates and tax rates are constant. This equivalence affords the government an alternative way of levying the tax, as a tax on wage income and not at all on the return to capital. (No deduction is allowed for saved income.) See Stiglitz, *supra* note 28, at 117.



deduction is granted for income saved, but the yield on savings (interest, dividends, rents, royalties, and so forth) is not taxed. Thus the taxpayer's yield is exempted. When the taxpayer withdraws savings and spends them, he or she is not taxed at all; the taxpayer is withdrawing previously taxed income ("capital" or after-tax dollars) plus exempt yield. This is sometimes called the "tax-prepaid method."<sup>44</sup>

An inventive and much-discussed method of calculating a personal consumption or expenditure tax is to determine the taxpayer's income, subtract any amounts saved, or spent on non-consumption, and treat the remainder plus net dissaving, even by net borrowing, as necessarily spent on consumption: a "direct" consumption tax.<sup>45</sup> This personal tax can be made progressive or regressive as well as proportional.<sup>46</sup> In its simplest

44. To show that the cash-flow method and the yield-exemption method manage to treat saved income the same and produce the same before-and after-tax rates of return to saving, consider the following example. Suppose that taxpayer *A*, with income in Year 1 of \$100,000 subject to a consumption-type income tax rate of 33%, faces a world where he or she can earn a secure rate of return of 10%, before tax. Under a cash-flow consumption tax, if Taxpayer *A* saves \$10,000 out of his \$100,000 income, his Year 1 taxable base will be \$90,000 (\$100,000 income minus \$10,000 deducted for saving). At a 33% tax rate, his tax on the \$90,000 base will equal \$29,700. In other words, no tax will be imposed on the \$10,000 saved; the taxpayer gets a deduction for that amount. This leaves \$60,300 to be consumed at once. After one year, the \$10,000 saved will have earned \$1,000 in interest or other yield. If in Year 2 Taxpayer *A* then withdraws and wants to spend the entire \$11,000 (saving and yield), he will have to pay Year 2 tax of \$3,630 (\$11,000 times 33%), and thus will have \$7,370 to spend in year 2. Overall he will have paid tax of \$33,330 on taxable "income" of \$101,000 and will have spent \$67,670 in personal consumption in the two years.

If Taxpayer *B* were instead subject to a yield-exemption consumption tax at the same rate, he or she would not have been able to deduct the \$10,000 when it was earned and saved in Year 1. So the tax on the entire \$100,000 income would amount to \$33,000 and the amount that could be saved would be reduced by the additional \$3,300 in tax. Thus the amount saved would be reduced from \$10,000 to \$6,700. (Tax = \$10,000 income times 33% or \$3,300; \$10,000 income targeted for saving, minus \$3,300 tax leaves \$6,700 after tax, to be saved. Taxpayer would have paid tax of \$33,000, not \$29,700, in Year 1.) The \$6,700 saved earns \$670 gross yield (\$6,700 times 10% = \$670), so Taxpayer *B* has a new balance of \$7,370 after one year. Since the yield is exempt, in Year 2 he can withdraw the entire \$7,370 and spend it without further payment of tax. The yield of \$670 is exempt and the original \$6,700 was previously taxed as part of the \$10,000 earnings targeted for saving and taxed in Year 1. Consequently, Taxpayer *B* has \$7,370 after taxes to spend in Year 2, just like Taxpayer *A*. So overall he will have paid a total of \$33,000 in tax on \$100,000 of income when earned and will have spent the same amount, \$67,670, on personal consumption.

In conceptual or financial terms, the present value of exempting the return to savings is equal to the present value of deducting the savings from taxable income, under certain conditions, assuming no inflation, a uniform, risk-free rate of return, and an ungraduated, unchanging tax rate. Note however, that Taxpayer *A* paid tax of \$29,700 at the outset of Year 1 and another \$3,630 in Year 2, for a total tax of \$33,330, whereas Taxpayer *B* paid tax of \$33,000 (total) at the outset of Year 1. This is explained by the fact that the present value at the outset of Year 1 of deferring payment of \$3,300 until a year later is \$330. Some of the tax on Taxpayer *B* is collected earlier than some of the tax on Taxpayer *A*; hence the difference in nominal amount of tax paid. The value or cost of the two tax burdens is arguably equivalent, much as the present value of the two taxable amounts is the same.

45. See, e.g., BLUEPRINTS, 1977, *supra* note 6; SVEN-OLOF LODIN, PROGRESSIVE EXPENDITURE TAX-AN ALTERNATIVE? (Richard Cox trans., 1978); MEADE, *supra* note 16; Andrews, *supra* note 7.

46. And its rates can be tailored to the marital status, number of dependents, age, disability or other personal characteristics of the taxpayer.

form, it assumes no consumption from gifts, pre-tax savings, post-tax savings, borrowings, or the like. Account can be taken of consumption from such other sources, of course, by appropriate reporting, calculating and verification procedures, in order to apply the tax to all consumption spending.

Consumption-based taxes can be levied in the form of "personal" (or "direct") or "impersonal" (or "indirect") taxes. Impersonal taxes (such as a retail sales tax or VAT), imposed on transactions, without regard to who the taxpayers are, generally lack the capacity to account for a taxpayer's personal circumstances, such as marital status, number of children or other dependents, or aggregate annual individual consumption.<sup>47</sup> In contrast, personal consumption taxes can take account of such individualized characteristics.<sup>48</sup>

If the United States wants to shift toward consumption taxation, there are several important models among which to choose. Generic examples of taxes on consumption include: (1) a retail sales tax (RST), like those levied by states and municipalities in the U.S.;<sup>49</sup> (2) a value added tax (VAT) levied on firms selling consumption goods to households, like the VATs in effect in the European Union, and elsewhere;<sup>50</sup> (3) a consumption-type or cash-flow income tax;<sup>51</sup> (4) a two-tiered cash-flow tax on a model such as the Hall-Rabushka "Simple Flat Tax";<sup>52</sup> (5) a pure cash-flow tax, on a

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47. The retail sales tax and VAT are examples of indirect consumption taxes. Another example is the "business transfer tax" (BTT), a version of the subtraction-method VAT utilized in Japan and proposed for the U.S. by some. See George R. Zodrow, *On The Transition To Indirect Or Direct Consumption-Based Taxation*, in TAX CONVERSATIONS: A GUIDE TO THE KEY ISSUES IN THE TAX REFORM DEBATE 187, 191-92 (Richard Krever ed., 1997) [hereinafter TAX CONVERSATIONS]; Malcolm Gillis et al., *Indirect Consumption Taxes: Common Issues and Differences Among the Alternative Approaches*, 51 TAX L. REV. 725, 727 (1996).

48. Personal consumption taxes include: the yield-exemption tax (sometimes used to modify the BTT); the Flat Tax of Hall-Rabushka; a "cash-flow" or "consumed-income" tax which taxes the proceeds of borrowing, receipt of debt repayments, and interest income, and allows deductions for interest paid, lending of funds, and repayment of debt; and possible hybrids, such as the McLure-Zodrow combination of cash-flow treatment of business and yield-exemption treatment of individuals. See Charles E. McLure, Jr. & George R. Zodrow, *A Hybrid Approach to the Direct Taxation of Consumption*, in FRONTIERS OF TAX REFORM 70, 88 (Michael J. Boskin ed., 1996).

49. Senator Richard Lugar supported replacing the corporate and personal income taxes with a 17% national retail sales tax. See SLEMRUD & BAKIJA, *supra* note 28, at 7, 196; David R. Burton & Dan R. Mastroianno, *The National Sales Tax: Moving Beyond the Idea*, 71 TAX NOTES 1237 (1996).

50. See Laurence J. Kotlikoff, *The Case for the Value Added Tax*, 39 TAX NOTES 239 (1988).

51. Perhaps of the kind proposed by Professor William Andrews in his seminal article, *A Consumption-Type or Cash Flow Personal Income Tax*. See Andrews, *supra* note 7; see also Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975); William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1975).

52. Robert Hall and Alvin Rabushka's works have been picked up by some members of Congress and are described in further detail later in this Essay. See *infra* text accompanying notes 75-91. Presidential candidate Steve Forbes advocated a 17% flat tax in 1996, the 1996 report of the Kemp Commission generally supported such a tax, and House Majority Leader Richard Arney has advocated a flat tax since 1994. See SLEMRUD & BAKIJA, *supra* note 28, at 8.

model such as the Aaron-Galper plan;<sup>53</sup> (6) the U.S. Treasury Department Blueprints models;<sup>54</sup> (7) the Treasury 1985 model (Treasury II);<sup>55</sup> (8) a graduated consumption tax imposed on top of a (flat rate) income tax, such as that proposed by Professor S.O. Lodin in Sweden;<sup>56</sup> or (9) a "personal" consumption-type income tax on a base determined for each family by determining net income, subtracting net saving, and applying (possibly graduated) rates to the difference, as in the Nunn-Domenici "Unlimited Savings Allowance" or U.S.A. tax.<sup>57</sup> All of these systems are "close relatives."<sup>58</sup>

### C. Retail Sales Tax and VAT

In considering the various proposals for taxation of "consumption" rather than "income," it is important to understand the differences between a retail sales tax or VAT, for example, and a consumption-type income tax. Most Americans are familiar with a state or city retail sales tax but far fewer are acquainted with a VAT.

The retail sales tax is an excise tax, imposed on either the retail seller or the retail buyer at the retail stage, a "point-of-sale" consumption tax.<sup>59</sup> The base of the retail sales tax is the total value or price of all sales to consumers. It is usually imposed without regard to the characteristics or tax status of the buyer, although non-profit institutions or other special categories of people sometimes are exempted from this tax. As such, it is an impersonal or indirect tax.

What is the base of a VAT? Loosely conceived, a VAT is a tax imposed on the "value added" by each taxable business firm. This amount is equal to the difference between the value of the output of the firm (gross receipts or sales) and the value or cost of its inputs (goods and services) purchased from others, calculated without a deduction for wages. In additive terms, it is the sum of the value added at each step of the production,

53. See HENRY J. AARON & HARVEY GALPER, *ASSESSING TAX REFORM* (1985).

54. See BLUEPRINTS, 1984, *supra* note 6; David F. Bradford & the U.S. Treasury Tax Policy Staff, *True Options for Tax Reform*, 24 TAX NOTES 485 (1984).

55. See TREASURY II, *supra* note 6.

56. See LODIN, *supra* note 45. Professor Michael Graetz has proposed a similar combination, but with a consumption tax as the basic tax and an income tax added on for taxpayers above some fairly high income level. See MICHAEL GRAETZ, *THE U.S. INCOME TAX: WHAT IT IS, HOW IT GOT THAT WAY, AND WHERE WE GO FROM HERE* (1999).

57. The U.S.A. tax proposal also would allow some deductions from income, a credit for Social Security taxes paid and would replace the corporate income tax with an 11.5% VAT (with no deduction for labor income). See SLEMROD & BAKIJA, *supra* note 28, at 9.

58. *Id.* at 195. See generally HEIDELBERG CONGRESS ON TAXING CONSUMPTION (Manfred Rose ed., 1989) [hereinafter HEIDELBERG CONGRESS] (describing, discussing and advocating various forms of consumption taxation); Edith Brashers, *Replacing the Federal Income Tax with a Consumption Tax*, in W. BARTLEY HILDRETH & JAMES A. RICHARDSON, *HANDBOOK ON TAXATION* (1999).

59. See Robert H. Gleason, Comment, *Reevaluating the California Sales Tax: Exemptions, Equity, Effectiveness, and the Need for a Broader Base*, 33 SAN DIEGO L. REV. 1681 (1996).

distribution, and sale process, by multiple firms or by a single, vertically integrated firm. All value added totals to the retail sales price charged to the consumer. It is not a tax on profits or gain; like a retail sales tax, it can be imposed on gross values added even if the taxpayer firm experiences no income or gain, or actually suffers a "loss" as an income or profits tax would determine it.

A VAT is imposed on firms or producers at each stage of the production process, with a credit for VAT paid by earlier factors in the chain, or upon each sale in the chain, or with a deduction for prior "value-added."<sup>60</sup>

The amount of value added can be calculated by several different methods. One method, the subtraction method, treats the retail seller, for example, as having added the value equal to the difference between his retail sales price to a consumer or household and his costs of inputs. So he deducts those costs and pays tax, say at 20%, on the difference. It uses book-accounting records or income-tax records, rather than sales and purchase invoices, to measure value added. Each firm in the chain of supply to the retailer (perhaps a farmer, processor, canner, wholesaler, distributor) would do the same thing. Each firm would pay 20% tax on the value it added, measured by the difference between its taxable sales and its taxable purchases. The total would equal 20% of the total retail sales price.

In contrast, the addition method is a mirror image of the subtraction method. It adds wages, interest and profits and applies a tax rate to this sum of inputs not purchased from other taxpayers.

Another approach, called the "invoice" (or "credit") method, is widely used in Europe. This approach requires the retailer or other final seller first to calculate VAT liability as a percentage (for example, 20%) of its total selling price to a consumer or other purchaser, and then to credit against that tentative VAT liability the VAT paid by it on its purchase from any predecessor in the chain of production, as shown by an invoice for the sale by the predecessor to it. The firm's tax liability is based on the difference between the total VAT disclosed on its sales and on its purchase invoices. The result is the same as under the subtraction or addition method; it owes VAT equal to 20% of its own value added. The ultimate consumer, of course, does not receive a credit.<sup>61</sup>

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60. See Gillis et al., *supra* note 47. Of course, sales of business inputs as distinguished from retail sales to consumers must be exempted from the tax, and this turns out to be a very difficult problem in practice, even with low-rate taxes. In addition, problems occur when high rates induce consumers to disguise their personal consumption purchases as buying raw materials or products for business use. *See id.*

61. The advantage of this invoice system over the deduction method is that each firm has an interest in ensuring that it or its predecessors paid VAT on their sales to it and that it gets proof of that fact in an invoice. So taxpayers "police" each other, and "enforce" the tax, all the way back to the farmer or other original producer in the chain. Enforcement costs are said to be lower for the government tax authorities. See CHARLES E. McLURE, *THE VALUE-ADDED TAX: KEY TO DEFICIT REDUCTION?* (1987); SLEMROD & BAKIJA, *supra* note 28, at 208-19. However, taxpayers and their

Because the retail sales tax or VAT is imposed on transactions rather than people or business entities, it is generally proportional or "single-rated," although lower rates or exemptions can be provided as incentives or for favored goods.<sup>62</sup> For example, the tax rate on food or medicine can be set lower than the rate on clothing, wristwatches or luxury goods, or on alcohol or tobacco or gasoline products. Such a tax is not, and could not easily be made, progressive with respect to the amount of consumption by each particular taxpayer or consumer.<sup>63</sup>

There are several categories of VAT. The VAT is a "consumption-type" VAT if it allows immediate expensing of capital assets; it is an "income-type" VAT if it requires capitalization and amortization of such costs. It is a "destination-based" VAT if the tax is refunded at the border on exports<sup>64</sup> and an "origin-based" VAT if sales of imports are exempt from VAT at the point of sale (but taxed, presumably, in the country of origin).

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advisors, in interviews I have conducted abroad, complain about the compliance costs this system imposes on them, as well as of complexity, planning, evasions, and other problems of any VAT system.

62. Often, in practice, some goods, services, or kinds of taxpayers in the credit-invoice method are excluded from a VAT by a "zero rating" or exemption. A zero rating allows credits for VAT paid on purchased inputs, but sales are not taxed, exempting the entire purchase price of the good, such as food, medicine or exports, from tax. An exemption, often applied to tax-exempt and small firms, simply exempts sales by (or to) exempt taxpayers; it does not allow a credit. Preferential or zero rating can relieve the value added at all stages from VAT; in contrast, "exemption" means that only the value added at the retail level is exempt from tax (unless all of the firms in the chain of production are made exempt). See SLEMROD & BAKIJA, *supra* note 28, at 315 n.4.

63. In contrast, a personal or direct consumption tax can be made progressive with respect to each taxpayer's consumption during the taxable period, or otherwise tailored to each taxpayer. A fixed or sliding amount can be credited or refunded, for example, for the tax supposedly paid on necessities. See KALDOR, *supra* note 10. Kaldor argued strongly for consumption or expenditure as a base for a direct tax. His work led to adoption of such taxes in India and Sri Lanka, for very short periods of time. See also PIGOU, *supra* note 10, at 135-44.

In practice, even a retail sales tax or a VAT reaches less than all consumption or expenditures. For example, expenditures for services, foreign travel and consumption, consumption in-kind, financial products, rental housing, owner-occupied housing and other non-market transactions may not be covered. A personal consumption or expenditure tax is, by its nature, more probably designed and likely to reach a broader notion of "consumption" than is a retail sales tax or even a VAT.

64. A destination-based VAT, one levied on the sales of imported goods but rebated on exports, may look like a subsidy for exports (especially to U.S. viewers when used by European trading partners). But it merely reproduces the way a retail sales tax works: taxation at the point of sale or consumption, no matter where produced. Furthermore, economists say that even if we effectively did try to "promote" exports by some such tax policy the effect would almost immediately disappear in the world of floating exchange rates. That is, the dollar would be strengthened, which would make our exports less attractive to foreigners and domestic prices would increase, making U.S. markets more attractive to foreign exporters as well as U.S. manufacturers. See SLEMROD & BAKIJA, *supra* note 28, at 118-19. The General Agreement on Tariffs and Trade (GATT) permits such VAT "indirect tax" border adjustments, which are a part of most existing VAT systems. Similar "direct tax" income tax border adjustments are barred by GATT. See Stephen E. Shay & Victoria P. Summers, *Selected International Aspects of Fundamental Tax Reform Proposals*, in A COMPREHENSIVE ANALYSIS OF CURRENT CONSUMPTION TAX PROPOSALS 199, 221 (ABA TAX SECTION 1997) [hereinafter COMPREHENSIVE ANALYSIS].

If no wage tax or income tax co-exists, consumers pay the VAT; their labor is not separately taxed to them so long as they are employees of a firm, rather than self-employed providers of taxable goods or services. The effect overall is a consumption tax, not an income tax. Income or wages people earn and save is not taxed to them by the VAT as it would be under an income tax, until and unless it is withdrawn and spent on taxable VAT transactions. The effect looks like a national sales tax, so much so that the late Professor Stanley Surrey wrote articles arguing that, for simplicity's sake, the U.S. should adopt, if anything, a national retail sales tax rather than a national VAT.<sup>65</sup>

One technical legal question arises in the United States as perhaps nowhere else in the world. That is the question whether a national VAT or a national sales tax would be a "direct tax" so as to be unconstitutional if not apportioned among the several states according to population.<sup>66</sup> Is either a retail sales tax or a VAT a direct tax? The income tax at one time in our history was viewed as a direct tax in some respects, particularly in the taxation of income from real property; in view of that fact, it took the Sixteenth Amendment to the U.S. Constitution in 1913 to legitimate the national income tax. Does a classic VAT so resemble an income tax that the Sixteenth Amendment might shield it, too? The usual assumption is that both a national sales tax and a national VAT are "indirect" taxes, whatever that means, or meant to the Founders, and therefore not in need of apportionment. But the question may be more difficult than is usually assumed.<sup>67</sup>

#### *D. The Hybrid Income Tax: The Current U.S. System*

Recent U.S. income tax history has shown a vacillating involvement with saving and investment incentives that sometimes increase the tendency of the income tax to resemble a consumption tax or consumption-type income tax. In 1981, the Accelerated Cost Recovery System lowered the tax on some investment income. Unfortunately, this plan overdid it. There were corrections in 1982 and 1984, and then the 1986 Tax Reform

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65. See Stanley S. Surrey, *A Value-Added Tax for the United States—A Negative View*, 21 TAX EXECUTIVE 151 (1969); Stanley S. Surrey, *Value-added Tax: The Case Against*, HARV. BUS. REV., Nov.-Dec. 1970, 86, 93-94. However the two may not be the same, in administrability, economic incidence and efficiency, compliance burden, and possibly even constitutionality.

66. See *supra* text accompanying notes 1-5.

67. The meaning of the terms "direct tax" and "indirect tax" in the United States and in its Constitution may be taken to refer to a tax imposed on a person rather than on a transaction or may be taken to differentiate between a tax (supposedly) borne by the nominal taxpayers rather than being passed forward or back, in whole or in part, to other persons. On the constitutional debate, see Bruce Ackerman, *Taxation and the Constitution*, 99 COLUM. L. REV. 1 (1999); Erik M. Jensen, *The Apportionment of "Direct Taxes": Are Consumption Taxes Constitutional?*, 97 COLUM. L. REV. 2334 (1997); Calvin H. Johnson, *Apportionment of Direct Taxes: The Foul-Up in the Case of the Constitution*, 7 WM. & MARY BILL RTS. J. 1 (1998).

Act reversed course. The tax treatment of business investment became gradually less generous than before 1981. Real estate investment, over-expanded in the early 1980s, partly crashed in the late 1980s.

Tax-favored savings account plans<sup>68</sup> and employer-provided qualified pension plans, and the late 1990s Roth IRA, give consumption tax treatment by allowing a deduction from income for amounts saved, or the equivalent in exemption of yield. Within the limits applicable to those various plans or accounts, a deduction is allowed for gross saving, not just net saving, or the yield on the savings is exempt until withdrawn (deferral) or totally exempt (exemption). Households are not asked to include in taxable income their borrowed funds on home mortgages, credit cards or open-line equity accounts. This allows tax arbitrage: Taxpayers can borrow, put borrowed money into tax-favored savings (also including investment in homes and growth stocks) while consumption remains unreduced.<sup>69</sup>

Apart from tax arbitrage, our twentieth-century incomplete hybrid income tax distorts various taxpayer decisions by its differential taxation of corporate and other business investment; capital gains and dividends or other ordinary income; home, rental property, and other durable goods ownership; present and future consumption; equipment, structure, and inventories; interest and dividends; and health insurance or other fringe benefits and wages. There are also distortions in labor supply incentives. Most of these distortions, it is argued, could be eliminated by switching to consumption taxation.<sup>70</sup>

Legislation in the 1990s saw restoration and enhancement of a capital gains rate differential,<sup>71</sup> raised rates for upper-income taxpayers,<sup>72</sup> and the introduction of more specialized credits and savings incentives,<sup>73</sup> again reemphasizing the taxation of consumed income and tax favoritism for saved income. In 1999, President Clinton proposed creation of a new "Universal Savings Account" as an alternative to the use of private savings accounts to pre-fund Social Security benefits. The account would be designed for lower-and middle-income workers, to balance the current tax-favored retirement "savings" vehicles, and high-income earners would be

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68. Such plans include the Keogh, the IRA, the § 401(k), and the § 403(b).

69. See Laurence J. Kotlikoff, *Savings and Consumption Taxation: The Federal Retail Sales Tax Example*, in *FRONTIERS OF TAX REFORM*, *supra* note 48, at 160, 169.

70. See *id.* at 169-70.

71. See I.R.C. § 1(h) as amended by Pub. L. No. 101-508, § 11101(a) (1990).

72. See I.R.C. § 1(a) as amended by Pub. L. No. 103-66, § 13202(a) (1993).

73. See, e.g., Roth IRAs, established by Pub. L. No. 105-34, § 302 (1997), codified at 26 U.S.C. § 408A; Education IRAs, established by Pub. L. No. 105-34, § 213 (1997), codified at 26 U.S.C. § 530; Medical Savings Accounts, established by Pub. L. No. 105-33, § 4001 (1997), codified at 42 U.S.C. §§ 1395w-21 - 1395w-28.

ineligible for U.S.A. participation. Some critics suggest instead revision in the Roth IRA to accomplish the same policy objectives in a simpler way.<sup>74</sup>

These enactments in the 1990s, while favoring savings (deferred consumption), do not go all the way to make the income tax a direct or personalized consumed-income tax; the so-called income tax really is a “hybrid” income tax.

### *E. Current Proposals*

This Part provides more detail on some of the more prominent taxation proposals. It begins by describing a proposal that has greatly influenced the current flat tax movement in the United States, the Hall and Rabushka “flat tax” book. This Part then discusses a few important taxation reform ideas from other countries. It concludes by describing the features of several of the taxation proposals advanced in the U.S. over the past decade.

The Hall and Rabushka flat tax book was published first in 1983 as *Low Tax, Simple Tax, Flat Tax*<sup>75</sup> and republished as *The Flat Tax* in 1985 and 1995.<sup>76</sup> Hall and Rabushka’s “Flat Tax” would provide a tax on consumption, but no retail sales tax or VAT at point of sale would be paid by the consumer.<sup>77</sup> This important proposal contains two components in an integrated system; it uses two taxes in order to be able to make the overall tax on consumption progressive. On individuals, the tax would consist of a 19% rate on wages and salaries only, including retirement benefits. All other kinds of income, such as dividends, interest, and capital gains would be exempted from tax to individuals. It would employ the yield-exemption, tax pre-payment approach. The tax would be progressive because of a family allowance, for example, \$25,500 of tax-free wages and salaries for a family of four. Like a subtraction-method VAT or a determination of consumption by subtracting savings from income, the Hall-Rabushka conception allows for a determination of an individual’s annual consumption, taxable at different rates under a progressive rate system, without requiring

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74. See Michael J. Graetz et al., *Universal Savings Accounts: The Clinton IRA*, 83 TAX NOTES 1487 (1999); Gene Steuerle, *The Administration’s USA Account Proposal*, 83 TAX NOTES 1501 (1999). The Clinton proposal was not enacted in 1999.

75. ROBERT E. HALL & ALVIN RABUSHKA, *LOW TAX, SIMPLE TAX, FLAT TAX* (1983). In 1981, Hall and Rabushka published their flat tax proposal in the *Wall Street Journal*. See Robert E. Hall & Alvin Rabushka, *A Proposal to Simplify Our Tax System*, WALL ST. J., Dec. 10, 1981, at A22; see also Robert Eisner, *Make Taxes Fair, Not Flat*, WALL ST. J., Apr. 11, 1995, at A20.

76. ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (1985). In 1992 Jerry Brown ran for the Democratic presidential nomination on some kind of a “flat tax” proposal as did Steve Forbes for the Republican nomination in 1996, both publicizing the term. See SLEMROD & BAKIJA, *supra* note 28, at 204.

77. See ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d ed. 1995); Robert E. Hall & Alvin Rabushka, *The Flat Tax: A Simple Progressive Consumption Tax*, in FRONTIERS OF TAX REFORM, *supra* note 48, at 27. Hall and Rabushka trace their plan to a suggestion by Milton Friedman. See BLUEPRINTS, 1984, *supra* note 6, at 10. Bradford concisely summarizes the plan at 76-82.



a reporting and an "adding up" of all the person's consumption expenditures made during the year. So, more generally, consumption is measured indirectly, rather than directly, by subtracting net savings from income. The tax bases are linked in such a way as to produce an outcome similar to an outright tax on consumption; in effect, an income tax can thus be converted to a consumption tax.<sup>78</sup> As such, the tax arguably would be "flat" or uniform in another sense: it would uniformly tax current and future consumption, unlike the effect of a usual income tax.<sup>79</sup>

The business side of the Hall-Rabushka Flat Tax would differ from the present corporate income tax. All businesses, regardless of form, incorporated or not, would be obliged to pay it. The base of the tax would allow capital expenditures to be deducted immediately, rather than depreciated over time. Depreciation for past investments would be stopped. Interest payments would not be deductible and interest receipts would not be subject to tax. Employer contributions to Social Security, health insurance and fringe benefits (all non-pension benefits) and state and local taxes would no longer be deductible.<sup>80</sup> And since wages, all labor income, would be taxed to individuals, whether or not fully consumed, the tax would differ in practice and to some degree from a pure consumption tax.<sup>81</sup> In essence, it would amount to a cash-flow, subtraction-method VAT, without a deduction for interest. This idea is to tax owners of a business "at the source;" that is, to tax all business income once (not to the shareholder or creditor again, nor to an employee-recipient of fringe benefits).

If the tax on wages paid to individuals were removed and if wages were not deductible by businesses, such a tax would be a subtraction-method, impersonal VAT. By taking wages out of the business tax base and taxing them to individuals, personalization is made possible. Moreover, if the business base allows a deduction for all acquisitions of

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78. See James M. Bickley, *Flat Tax: An Overview of the Hall-Rabushka Proposal*, 72 TAX NOTES 97 (1996).

79. See SLEMROD & BAKIJA, *supra* note 28, at 171. But this generalization glides over greater complexity, some of which is examined in David Weisbach, *Ironing Out the Flat Tax*, 52 STAN. L. REV. 599 (2000).

80. See SLEMROD & BAKIJA, *supra* note 28, at 206. Some other so-called "flat taxes," such as the Gramm-Buchanan 1996 version, would include interest, capital gains and other income from capital in the wage base and would not change the business tax base in the Hall-Rabushka manner, so they really become modified income taxes.

81. Compare the unlimited saving allowance (U.S.A.) approach found in derivative proposals, explained below.

While an indirect transactional consumption tax such as a VAT or retail sales tax cannot readily be personalized so as to take into account the individual taxpaying ability or other characteristics of each individual taxpayer, a direct tax on individuals' consumption can be personalized with rates graduated according to the amount of individual consumption, or with personal or family exemptions, or other allowances. An overall periodic and broad-based individual income tax with an unlimited allowance for savings, like the U.S.A. tax, can similarly be tailored to approximate an individual consumption tax, perhaps combined with a tax on capital income to firms.

capital assets, other capital expenditures and purchases of inventories, and if it eliminates depreciation deductions and deduction of the cost of goods sold (COGS) on the sale of inventory, the tax becomes a cash-flow tax. If capital income is taxed only at the level of the firm, and if interest and dividends and capital gains are not taxed to individuals, individual and corporate taxes are integrated, a little like the U.S. Treasury Department's proposed Comprehensive Business Income Tax (CBIT) of 1992.<sup>82</sup> As Jane Gravelle said of a derivative tax proposal, "The U.S.A. tax combines a VAT on firms with a direct consumption tax on individuals, which is substituted for the income tax and part of the payroll tax."<sup>83</sup>

The Hall-Rabushka Flat Tax would allow a 100% write-off for all investment spending, as in a consumption-type VAT, to avoid double taxation of investment or saving and to keep it a tax on consumption, not on all income. However, no direct deduction would be granted for income saved by an individual, because the yield would be exempted instead. Notwithstanding this, a business would get such a deduction for investment, and in a sense could pass along that benefit to the individual investor who is not taxed on the yield.<sup>84</sup> No deduction would be allowed for charitable contributions, medical expenses, alimony paid, state taxes, home mortgage interest, or any other interest. In addition, Hall and Rabushka would abolish the inheritance taxes.

The Hall-Rabushka scheme uses a subtraction-method VAT but with a deduction for labor costs plugged into it, rather than the credit-invoice VAT method that has proven most successful in other countries. This is thought necessary because of the fact that by allowing the deduction for wages, in order to personalize the tax on wages, it would not be possible to use a single fixed tax rate on all transactions between businesses.<sup>85</sup> However, perhaps some not-too-costly mechanism can be constructed to use a single rate in an invoice method VAT.<sup>86</sup> Although labeled by the authors a "progressive consumption tax," the Flat Tax by Hall-Rabushka as found in the Arney proposal takes as its base wage and salary income, not all of which need be, nor is, consumed.<sup>87</sup> And it does not include borrowed funds, which may be consumed (at least temporarily, until repayment).<sup>88</sup>

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82. See U.S. DEP'T OF TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEM—TAXING BUSINESS INCOME ONCE (1992). It would be important to ascertain at what rate capital income was taxed to firms: a rate equal to the top or single individual rate, or more or less.

83. Gravelle, *supra* note 37, at 1517-19.

84. This is because individuals would be exempt from tax on the yield from their savings, in lieu of a deduction at the outset.

85. The rate would vary with the proportions of capital and labor engaged in production of each good or service.

86. See SLEMRUD & BAKIJA, *supra* note 28, at 219, 317 n.38.

87. See Murray Weidenbaum, *The Nunn-Domenici USA Tax: Analysis and Comparisons*, in FRONTIERS OF TAX REFORM, *supra* note 48, at 54, 65.

88. Compare the unlimited saving allowance (U.S.A.) approach.

Representative Arme<sup>89</sup> and Senator Shelby's bill, the "Freedom & Fairness Restoration Act of 1994—Flat Tax,"<sup>90</sup> contains a consumption-based flat tax.<sup>91</sup> It is based on the Hall-Rabushka proposals. As to individuals, the marginal rate would be 20%, later to be reduced to 17%. The individual tax base excludes returns to investment; it is an income-based tax, but only on earned income. Therefore the tax base consists of *taxable* earned income minus a standard deduction (\$9,500-\$12,350 for a single person, plus \$5,000 for each dependent). Like Hall-Rabushka, it uses the yield exemption (tax prepayment) method; no deduction is allowed for savings. Unlike present U.S. income tax law, no deduction for charitable contributions or interest paid on home mortgages would be allowed by the Arme Bill.

As to businesses, the bill would impose the tax on any "business activity." But a business could deduct wages, the cost of tangible personal

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An ingenious and somewhat similar invention was that of Professor Sven-Olof Lodin who, in the 1970s, proposed combining a flat-rated income tax on individuals with a progressive expenditure tax on consumed income (total income minus saved or invested amounts) above a certain level. *See* LODIN, *supra* note 45. So, all income of an individual, perhaps above an exempt amount, would be taxed at a single rate, say 30%. But of that income, any expended (unsaved) amount over a specified annual level would be taxed at rates that would progress upwards. Under this model, the rich spendthrift would pay on his last dollar of consumed income an income tax rate of 30% plus an expenditure tax rate of 50%, 60%, or 70%.

Professor Michael Graetz now proposes an inverted version of a similar idea. He suggests taxing all people, including those who have incomes under some fairly high specified level (\$75,000-\$100,000), by a 10%-15% rate consumption tax (completely replacing the income tax for taxpayers below these levels) and also applying a 25% income tax (to get progressivity and redistribution) only on incomes above the high threshold. But there the tax would apply however the income was used, consumed or saved. *See* GRAETZ, *supra* note 56.

In the United Kingdom, the Meade Committee in 1978 thoughtfully studied the issues involved in choosing between taxing income or consumption. The Committee examined various forms of expenditure or consumption taxation, including an income tax form of VAT, or IVAT, as well as a regular VAT, *see* MEADE, *supra* note 16, at ch. 8, a universal expenditure tax (U.E.T.), *see id.*, at ch. 9., and a two-tier expenditure tax (T.T.E.T.), *see id.*, at ch. 10. They also worked through what it would take to perfect the income tax by making the base truly comprehensive, concluding that "it would be extremely difficult, if not impossible," to do so. *Id.* at 500; *see also* Barry Bracewell-Milnes, *The Meade Report and the Taxation of Capital*, 1979 BRITISH TAX REV. 25. Most of the members of the Commission favored moving in the direction of an expenditure tax, if the problems of transition could be solved satisfactorily. They recommended either a universal expenditure tax with a progressive rate schedule or a combination of an expenditure tax surcharge with a basic rate of income tax that would incorporate 100% capital allowances or a proportionate rate of tax on value added, and they recommended moving the corporation income tax base toward a "flow-of-funds" base (rather than a "profits" base). *See* MEADE, *supra* note 16, at 518. Neither tax proposal seems free from immediate complexity and the potential for further elaboration, planning or transaction costs, complexity and compliance burdens (record-keeping, reporting, and the like).

89. Representative Arme's own bills include: H.R. 4585, 103d Cong.; H.R. 2060, 104th Cong.; H.R. 1040, 105th Cong.; H.R. 1040, 106th Cong.

90. Rep. Arme and Sen. Shelby, *The Freedom and Fairness Restoration Act*, H.R. 2060 & S. 1050, 104th Congress, July 19, 1995. Senator Specter also introduced a similar proposal, the Flat Tax Bill, S. 488, 104th Cong. (1995).

91. The Arme "Flat Tax" bill is based on the flat tax proposal initially developed and publicized by Hall and Rabushka. *See* HALL & RABUSHKA, *supra* note 76. *See also* ARMEY, *supra* note 18.

property, and the cost of real property used in the trade or business. The same rates would apply to business firms and individuals. It therefore resembles a subtraction-method VAT, but there is also a deduction for wages paid, much like an income tax. Nevertheless, when viewed with the individual tax component, the combined tax resembles a VAT. The two taxes are integrated to form a tax on consumption, as in the Hall-Rabushka conception.

Another bill, the "U.S.A."<sup>92</sup> tax, proposed by Senators Nunn, Domenici and Kerrey,<sup>93</sup> amounts to an income tax with an unlimited deduction for net new savings. It thus uses the cash-flow method. For individuals, saved income is not taxed until consumed; the tax is a consumed-income tax, on a broader income base than the present U.S. Federal Income Tax. For individual taxpayers, it is a sort of savings-exempt income tax.<sup>94</sup> For individuals, gross income resembles gross income as presently defined under I.R.C. § 61(a) plus withdrawals from savings accounts. The U.S.A. allowance of a deduction for "net savings" would consist of the taxpayer's additions to "qualified savings" assets or accounts, less withdrawals from qualified savings accounts, during the year. Qualified savings would include financial assets and life insurance premiums, "savings assets," but not land or collectibles such as fine art or antiques. Individual taxpayers would be granted standard deductions of \$4,400 for a single person and \$2,550 for each dependent. In addition, allowable itemized deductions would include charitable contributions, home-mortgage interest, alimony, and payments for qualified higher education expenses (\$2,000 per year). No deduction would be allowed for payment of state and local taxes or for medical expenses. Borrowed money would not be included in income, but it would decrease the net savings deduction, although not below zero. So a net borrower would not pay tax on an amount greater than his income for the year. Correspondingly, repayment of a loan would not produce a deduction. No tax would be imposed on borrowing even if it produced added consumption in excess of income or savings; supposedly that additional consumption would be taxed as the loan is repaid because such repayment would not constitute deductible savings.

Three tax rates were suggested in 1995: 19%, 27%, and 40%. They supposedly would fall to 8%, 19%, and 40% in the year 2000. Some credits against tax would be allowed: the foreign tax credit, a credit for F.I.C.A. taxes (payroll Social Security taxes for an individual or a business), the "earned income credit," and a credit for any tax withheld or prepaid.

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92. Unlimited Savings Allowance Tax Act of 1995, S. 722, 104th Cong. (1995).

93. See SEIDMAN, *supra* note 19.

94. It would amount to a flat VAT on businesses. See discussion *infra*.

The U.S.A. tax for businesses would apply to any "business" (regardless of legal form of ownership) and would amount to a subtraction method VAT. The tax would base itself on gross profits from services or sales, including receipts from services, leases of property, and so forth, less costs of goods sold in the United States, not including interest, dividends, or proceeds from the sale of stock or other ownership interests. A loss carryover would be allowed. To determine the tax base, gross profits would be reduced by deductible "business purchases," that is, any amount paid out other than wages or interest, such as dividends, capital expenditures, or inventory costs.

This system is not the same as the Arney or Hall-Rabushka plan; it does not bifurcate one VAT tax system into two components coordinated to form a consumption tax overall. Instead, it is a cash-flow or savings-exempt income tax. It follows in general the proposals made in the 1970s by the U.S. Treasury Department and the U.K. Meade Commission. In general, however, a savings-exempt income tax roughly amounts to a tax on consumed income (only) and hence the U.S.A. tax involves a shift to a tax system based mainly on consumption or consumed income, with some politically desirable deductions as in an income tax and with peculiar treatment of some loans.<sup>95</sup>

A single flat rate of 11% would apply to the tax base. The tax so determined would be reduced by credits (for example, for payroll taxes paid on wages and salary payments).<sup>96</sup>

The 1995 Nunn-Domenici U.S.A. Tax employs a personal exemption and standard deduction resembling those in our income tax. It would also retain the familiar deductions for charitable donations and home-mortgage interest and would continue the exclusion for state and municipal bond interest. It would add a deduction for higher education expenses and would contain an earned-income tax credit. On the business side it would apply an 11% rate on a VAT-type base, not on profits or "net income." Both businesses and individuals would be allowed a credit each for payment of its share of Social Security payroll taxes, with a refund possible for individuals, to reduce the regressivity of the present payroll and income tax burden on wage earners. Net saving would not include home mortgage debt and some other types of borrowing. Transition rules and a limited

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95. See COMPREHENSIVE ANALYSIS, *supra* note 64, at 15. On the U.S.A. tax and the implications of a deduction for all saving, with a critical appraisal, see Alvin C. Warren, Jr., *The Proposal for an "Unlimited Savings Allowance,"* 68 TAX NOTES 1103 (1995).

96. It seems that the U.S.A. Tax Act would tax salaries and wages twice, because a business firm could not deduct compensation paid under this proposal and employees would be taxed when wage income is consumed; but, refundable credits for payroll taxes would slightly reduce the burden.

ability to withdraw from pre-conversion savings and to depreciate prior capital would make the system seem more palatable, politically.<sup>97</sup>

The U.S.A. tax would be imposed on a destination basis, while the Flat Tax, unlike most consumption taxes, would be levied on an origin basis.

Other similar consumption-based tax systems have been proposed.<sup>98</sup>

Whether the reform proposed involves a flat or relatively flat rate of tax or not, the common ingredient of these active proposals is somehow the taxation of overall consumption, not by a retail sales tax or a VAT paid "at the cash register," but by periodic, individualized, annualized taxation of each individual's (or business's, in a sense) expenditures on consumption, whether out of income, savings, inherited wealth or borrowing. The plans generally contain two elements (as perhaps invented by Hall and Rabushka): a household component that is a potentially progressive

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97. See SLEMROD & BAKIJA, *supra* note 28, at 208. For a summary of the Arney-Specter Flat Tax, the Nunn-Domenici U.S.A. Tax, and a national retail sales tax, see JOINT COMMITTEE ON TAXATION, DESCRIPTION AND ANALYSIS OF PROPOSALS TO REPLACE THE FEDERAL INCOME TAX (JCS-18-95) (June 5, 1995) (reproduced in 29 Stand. Fed. Tax Rep. (CCH), Part 2 (1995)).

98. In addition to the foregoing, during the 1990s a National Retail Sales Tax to replace the individual and corporate income taxes was proposed by Representatives Schaefer, Tanzin and Chrysler, apparently supported by Representative Archer and Senator Lugar. See National Retail Sales Tax Act, H.R. 3039, 104th Cong. (1996). Representative Gibbons has proposed a broad-based, subtraction-method VAT to replace the U.S. income taxes and payroll taxes. See Zodrow, *supra* note 47, at 195.

In the 103rd Congress, Representative Dingle (H.R. 16) and also Senator Hollings (S. 169) proposed an "input credit value added tax" (ICVAT) much along the lines of the Model VAT statute drafted by the ABA Section of Taxation Committee on VAT. Representative Gibbons introduced a subtraction method VAT (H.R. 4058). See Roger Bonney, *Restructuring the Tax System—Business Tax Design Considerations*, in COMPREHENSIVE ANALYSIS, *supra* note 64, at 133. Note that the ABA preferred the credit-method to the subtractive-type VAT.

In 1996, the National Commission on Economic Growth and Tax Reform, The Kemp Commission, endorsed a reform more or less along the lines of the flat tax proposed by Arney and Shelby, with a single rate on a tax base that would exempt income from new saving by deduction or yield-exemption. The Report would repeal the Federal Estate and Gift Taxes, allow deductibility of payroll taxes, and would phase-in a 100% inclusion of Social Security benefits. But much of the structure and details of the "single tax" on businesses and individuals was not specified. See Eric Toder, *Consumption Tax Proposals in the United States*, in TAX CONVERSATIONS, *supra* note 47, at 159, 168.

Under the Aaron-Galper approach of 1985, businesses would be taxed on a cash-flow basis with current expensing of all business-related purchases, including capital investments. Loans would be treated on a cash-flow basis, wages would be deductible by employers and taxed to the individual wage earners. Individuals would be allowed a deduction for savings and would be taxed upon the investment and its returns upon withdrawal: a consumed income tax. Transition rules would allow existing capital to be deducted from the base of the business tax, and the plan would allow deductions for basis when assets constituting "old capital" were sold and included in the tax base of individuals. Therefore, the tax would become a tax on wages, not a tax on all consumption. See AARON & GALPER, *supra* note 53. The Aaron-Galper plan differs from, and can be considered an alternative to, the Hall-Rabushka or Arney plans. The Nunn-Domenici plan includes a personal consumption tax of the kind used in Aaron-Galper combined with a BTT (a subtraction-method VAT) at the firm level. In this scheme, wages are taxed at both the firm and individual levels.

personal consumption tax, and a flat rate business component that is a consumption type, subtraction-method VAT, or something similar.<sup>99</sup>

All these new systems are said to promote saving and investment, more fairly to tax savers and consumers (both in terms of immediate and deferred consumption), and to be capable of preserving the current distribution of tax burdens among income classes (progressivity), which a retail sales tax, VAT, or other indirect consumption tax could not do.<sup>100</sup> They arguably would have the additional merits of greater simplicity, treating

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99. Joseph Isenbergh wrote an argument for separating the income tax base into two parts (consumption and saving) and combining a VAT on consumption with a tax on increases in net worth, in order to increase the neutrality of the tax system as between capital formation and consumption, and to increase the rate of saving and capital formation (and hence the allocation of resources between present and future consumption, intergenerationally) and yet still to tax "economic income" as much as at the present. See Joseph Isenbergh, *The End of Income Taxation*, 45 TAX L. REV. 283 (1990). He began by inquiring about how people respond to choices between saving and consumption, and how an income tax probably distorts choices at the margin compared to a no-tax world. See *id.* at 292. In reviewing U.S. tax history he noted that saving incentives such as the 1982-1986 fully deductible IRA were not accompanied or followed by any conspicuous increase in private saving. See *id.* at 324. He illustrates why that may have happened, emphasizing the deductibility of interest expense as a tax inducement. See *id.* at 326-37. To tax consumption more heavily, Isenbergh rejects pursuit of a truly "universal income tax base" (as a "fantasy") or a consumed-income tax or "universal saving allowance" and urges the explicit taxation of consumption. See *id.* at 331. He would replace the income tax with a very broad-based, single-rate VAT, generally not modified along the lines of the Flat Tax variety. See *id.* at 335. For progressivity reasons, he proposed a refund system to offset VAT paid by very low income taxpayers and, for higher-income taxpayers, an annual fiat tax on increases in individual net worth above an exemption level. See *id.* at 350. Thus he too, like the Flat Tax authors, uses a combination of taxes, emphasizing a consumption tax, to lighten the tax on saved income, increase the relative tax burden on consumption, and provide some progressivity vis-à-vis income.

Every person would receive a payment determined by the VAT on consumption up to the poverty level of income. The refund technique resembles, in a way, the negative income tax proposals of Lady Rhys-Williams (1953), Milton Friedman (1962), Green (1967) and even the Earned Income Credit, or President Nixon's Family Assistance Plan (1974). See sources cited in KRAGEN & McNULTY, *supra* note 9, at 743-52.

Many European countries, of course, use a combination of VAT, income tax and annual wealth tax. Isenbergh mentions the imputed value of wealth; that is, benefits that occur before savings are explicitly converted into consumption. So he views his wealth tax as a kind of surtax on the deferred material consumption, in order not to let a pure consumption tax undertax saving. It would be accompanied by elimination of the wealth transfer taxes. See Isenbergh, *supra*, at 355.

Another possibility he discusses to help solve the problems of annual valuation would be to impute appreciation to assets, perhaps at an assumed annual rate, and to tax on realization at rates designed to match annual taxes on the ratable appreciation, much as with Passive Foreign Investment Companies, and as proposed for more general use. See John McNulty, *Reform of the Individual Income Tax by Integration of the Corporate Income Tax*, 46 TAX NOTES 1445 (1990); see also Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722 (1990); Joseph Isenbergh, *Perspectives on Deferral of U.S. Taxation of the Earnings of Foreign Corporations*, 66 TAXES 1062, 1067-71 (1988).

Isenbergh briefly considers the (serious) transition problems of moving to his recommended regime and thinks them manageable. His regime taxes consumption and changes in net worth, which in primitive terms add up to "income," as he recognizes. But the emphasis is shifted toward consumption, much as the Flat Tax proposals would do.

100. See David F. Bradford, *The Case for a Personal Consumption Tax*, in WHAT SHOULD BE TAXED, *supra* note 12, at 75.

debt and equity financing alike, entailing the repeal of the estate and gift transfer taxes, eliminating the double taxation of distributed corporate earnings, and "inflation-proofing" the tax system.

If graduation of rates or other personalization of the tax were not needed, no household or personal tax would be necessary, and/or a retail sales tax or VAT or other indirect (and "simple") consumption tax or cash-flow tax could be used, probably by allowing immediate expensing of capital investment and denying a deduction for wages or interest, and possibly for taxes paid. Use of the cash method, rather than accrual accounting, would reduce complexity. A territorial principle would mean taxing only goods produced in the United States, and eliminating accounting for foreign subsidiaries. Under the destination principle, export sales would be excluded but sales of imported goods would be taxed.<sup>101</sup>

#### *F. Implications of Proposed Changes to Consumption Taxation*

The "flat tax" and other consumption tax proposals have caused American legal scholars to become increasingly concerned with the asserted and real advantages of a personal or impersonal tax on consumption compared to a tax on income.<sup>102</sup> In addition, these tax reform proposals have prompted scholars to think more about the merits and weaknesses of an ideal (or a good, realistic, and practical) income tax. Usually, a tax on consumption is claimed to be fairer and simpler, at least. Often, a tax on consumption is also said to be less distortionary of capital markets than an income tax and more neutral toward, and thus more conducive to, saving. A few years ago, growing support seemed to be emerging among many that, at least in principle, taxation on a base of consumption is preferable to a tax based on income, on grounds of equity, efficiency, and simplicity.<sup>103</sup> Some distinguished scholars have disagreed.<sup>104</sup>

This Part outlines some of the key issues surrounding the reform proposals discussed in Parts I.A through I.E. In order, this Part will address: (1) economic burden and transition issues; (2) revenue neutrality; (3) progressivity and redistribution of the tax burden; (4) corporate taxation issues; (5) the effect on savings; (6) simplicity arguments; and (7) administration and enforcement

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101. See Seidman, *supra* note 19, at 10. The "destination principle" is to be contrasted with the "origin principle," under which goods are taxed if produced within the taxing jurisdiction, whether sold there or exported.

102. See Musgrave, *supra* note 27; John S. Nolan, *The Merits of an Income Tax vs. a Consumption Tax*, 71 TAX NOTES 805 (1996).

103. See Gillis et al., *supra* note 47, at 728; Joseph J. Minarik, *Conference Discussion, in WHAT SHOULD BE TAXED*, *supra* note 12, at 297.

104. See MUSGRAVE & MUSGRAVE, *supra* note 42, at 205-06; Bradford, *supra* note 100, at 102; Richard Goode, *The Superiority of the Income Tax, in WHAT SHOULD BE TAXED*, *supra* note 12, at 49.



problems. This Part will not discuss one of the biggest issues implicated by tax reform, that of fairness, as Part II will address this topic in depth.

### *1. Economic Burden and Transition Issues*

Experts have addressed the question of who will bear the economic burden of the flat tax or other consumption taxes such as a retail sales tax or VAT, but the answer may not be wholly predictable, especially in transition.<sup>105</sup> Whether there ensues a rise in prices, as would be likely with a retail sales tax or VAT or the Flat Tax (and as predicted by Gravelle for the Arney flat tax proposal), or a parallel loss in purchasing power under a consumed-income tax can matter a great deal for such things as values of pre-existing savings and assets, redistributive effects (among income classes and between generations) and allocation of capital in the economy.<sup>106</sup> Legal commentators generally have to defer to the public-finance economists to analyze and predict the incidence and burden of a shift from a hybrid income tax to a flat-rate or other tax on consumption. The answers are, nonetheless, surely crucial to the policy debate.<sup>107</sup>

Another concern when considering substituting consumption for income taxation is how wealth transfers, gifts and bequests, and charitable contributions should or would be handled.<sup>108</sup> The issues include whether gifts and bequests should be taxed as consumption and, if so, would the tax cover consumption by the donor, the donee, or both. A family unit approach might exempt the usual parent-to-child *inter vivos* transfers, unless the parent is viewed as thereby consuming (like keeping a pet). Bequests would seem to be a form of final consumption expenditure. And the child who inherits has income or must pay tax when he or she sells the asset to purchase consumption goods. Progressivity and redistribution reasons suggest taxing all gifts and bequests, or at least those outside the family unit, at least once. Exempting them entirely might lead to undue concentration of wealth. A progressive wealth tax could attack concentrations of wealth more directly.<sup>109</sup> So taxing capital income and bequests as at present in our income tax may seem a quite acceptable approach.<sup>110</sup>

The problems of transition from an income tax to a consumption tax are formidable.<sup>111</sup> First, it is important to consider which kind of

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105. See Gravelle, *supra* note 37, at 1517.

106. See *id.*

107. See *id.*

108. See Karen Burke & Grayson McCouch, *A Consumption Tax on Gifts and Bequests?*, 17 VA. TAX REV. 657 (1998); Joseph M. Dodge, *Taxing Gratuitous Transfers Under a Consumption Tax*, 51 TAX L. REV. 529 (1996).

109. See Stiglitz, *supra* note 28, at 121-22.

110. See Burke & McCouch, *supra* note 108. But see John K. McNulty, *A Transfer Tax Alternative: Inclusion Under the Income Tax*, 4 TAX NOTES 24 (1976).

111. See Ronald A. Pearlman, *Transition Issues in Moving to a Consumption Tax*, in COMPREHENSIVE ANALYSIS, *supra* note 64, at 17.

consumption tax is to result. While a consumption tax and a "wage tax" are in many ways equivalent if originally installed, transition to a consumption tax involves imposing a tax burden on pre-existing wealth, while shifting from an income tax to a pure wage tax does not.<sup>112</sup> If the United States were suddenly to shift from its income tax system to a consumption tax of whatever type, there would be the possibility of huge consequential gains and losses.<sup>113</sup>

If the United States merely shifted to a pure wage tax, pre-existing wealth could earn its yields, in the form of rents, dividends, interest and capital gains, without tax, or could be dissaved and spent tax-free. Seemingly this would produce a benefit to holders of existing wealth, who, some analysts estimate, hold over \$25 trillion in the United States.<sup>114</sup> But, of course, these funds were accumulated after paying income tax presumably, and they could have been withdrawn and spent tax-free under the pre-transition income tax. So there probably would be no inherent benefit to wealth-holders from the changeover, except as price changes occurred in response to changed demands for assets.

In contrast, if the United States enacted a pure, transactional consumption or expenditure tax, or a cash-flow income tax, it would impose huge losses on holders of existing wealth, because consumption funded by the previously taxed wealth would be taxed again under the new form of tax. Prices probably would rise, purchasing power of both wages and savings would drop, and the effect would be comparable to substituting both a wage tax and a one-time tax on existing wealth. Even if prices did not rise, the purchasing power of existing wealth would probably drop by a percentage equal to the new consumption tax rate, applied on top of old prices. The value of previously owned securities, houses, and other capital would decline. With respect to businesses, while ending the double taxation of corporate dividends and capital gains would benefit holders of corporate shares, firms could no longer depreciate previously-purchased depreciable assets, although new assets could be expensed, leading, presumably, to a considerable demand for such new assets.

If significant transition relief were provided—for example, by allowing individuals to deduct some or all of their pre-existing wealth in the same way that new savings could be deducted—the revenue costs would be very high.<sup>115</sup> New tax rates would have to be set much higher to offset the resulting revenue loss, and the system would become more like a pure wage tax, with wage earners being hit with much of the added burden. The

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112. See SLEMROD & BAKIJA, *supra* note 28, at 174.

113. See transitional proposals in BLUEPRINTS, 1977, *supra* note 6, at 181-215; MEADE, *supra* note 16; LODIN, *supra* note 45, at 123-27; see also GRAETZ, *supra* note 56, at 261-75.

114. See SLEMROD & BAKIJA, *supra* note 28, at 177, 313 n.10.

115. See GRAETZ, *supra* note 56, at 271; Michael Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1655 (1979).

tax base of prior wealth holders would consist of something less than total consumption, of course, since they could spend that pre-transition wealth without further tax.

So, without transition relief, existing wealth-holders, particularly the elderly (whose net worth is much higher than that of the younger generations) and the very rich of the time, would be hit especially hard. Social Security and Medicare beneficiaries, and other recipients of transfer payments (or fixed incomes), without indexing for price changes, or exemption from tax, would be hurt. Other redistributive consequences, some unpredictable, involving lenders and creditors, nominal contract holders, resident aliens and non-resident citizens, and the poor receiving (unindexed) welfare, food stamps, and the like would follow.<sup>116</sup>

The Hall-Rabushka Flat Tax did not contain any transition rules, though its authors recognized that some might be needed to make the proposal politically feasible.<sup>117</sup> The U.S.A. tax provided some transition relief for property acquired in the prior income-tax years.<sup>118</sup> Property with a recovery period of less than 15 years remaining would be amortized over 10 years.<sup>119</sup> The basis of property held for use in a trade or business with a remaining recovery period of 15 years or more could be amortized over 30 years; non-depreciable property, such as land, could be amortized over 40 years.<sup>120</sup> When sold, property subject to these transition rules would entitle the buyer to amortize the pre-enactment basis, on a continuation process, for the remaining period.<sup>121</sup> But the seller would have to include the entire proceeds of sale in its gross income.<sup>122</sup> Under the U.S.A. proposal, if an individual investor sold pre-formed capital, basis recovery would depend on whether the proceeds were consumed or re-invested. If consumed, prior basis could be offset; if reinvested, the basis would be transferred to a general basis account, entitling the seller to recovery if and when he became a net saver.<sup>123</sup>

Economists conclude that the potential enhancement of economic efficiency that might well follow a change to a broad-based, low-rate national consumption tax without transition relief would not necessarily result from a more measured transition to a consumption tax, especially one with higher and steeper rates, relief for old capital, and similar necessary measures. Equity and efficiency might compromise each other in such a

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116. See SLEMROD & BAKIJA, *supra* note 28, at 179-80; Zodrow, *supra* note 47, at 212-14.

117. See HALL & RABUSHKA, *supra* note 76, at 63-64.

118. See SEIDMAN, *supra* note 19, at 96-102.

119. *See id.*

120. *See id.*

121. *See id.*

122. See S. 722, 104th Cong. §§ 301, 290, 291 (1995); Pearlman, *supra* note 111, at 17-65.

123. See S. 722, §§ 201, 57; Stefan F. Tucker, *The Impact of Federal Tax Reform Proposals on Real Estate*, in COMPREHENSIVE ANALYSIS, *supra* note 64, at 113.

wholesale tax system conversion. Consequently, it may be more advantageous to retain, but try to make some important reforms in, the income tax.<sup>124</sup>

## 2. Tax Rates and Revenue Neutrality

Commentators have made various estimates of the rate at which an entirely personal consumption tax would have to be set to replace fully the revenues from the federal corporate and personal income taxes. One figure is 14.3%, if the tax were truly comprehensive and unavoidable. More realistically, 23.6% might be necessary. But if the consumption-type tax were constructed like sales taxes of states with the broadest bases, 16.5% might do the job.

A comprehensive VAT without exemptions for food or housing might entail a 17.8% rate.<sup>125</sup> Personal or family allowances or exemptions for necessities like food or medicine would require much higher rates. Hall and Rabushka proposed a rate of 19% with an exemption of \$25,500 (in 1995) for a family of four.<sup>126</sup> The U.S. Treasury Department, in 1996, calculated that a 20.8% rate would be needed using a \$31,400 exemption (if also replacing the estate and gift taxes and eliminating the E.I.T.C.).<sup>127</sup>

One important concern is whether consumption tax rates in the 20%, 30%, or 40% range would prove to be unadministrable. European experience suggests that 20% VAT rates can work, but that much higher rates produce very troublesome levels of evasion and avoidance.

## 3. Progressivity and Redistribution of the Tax Burden

The U.S. Treasury Department has estimated that the federal tax system of the 1990s, including income, payroll, and excise taxes, is somewhat progressive. Estimates give an effective tax rate ranging from 8% to 22% for the bottom to top quintiles and 25% for the top 1%. The top quintile has 55% of the income but pays 61% of the taxes. The top 1% enjoys 14% of this income and pays 17% of taxes. The individual and corporate income

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124. See 1996 House Hearing, *supra* note 33; 1995 Senate Hearing, *supra* note 33. For transition purposes, Joel Michael has (seriously?) proposed repealing the present AMT, enacting a new AMT, and allowing taxpayers to pay the lower of it (with its new base, indexed, consumed income or even a more comprehensive income tax, or maybe even a flat tax, VAT or retail sales tax) or the preexisting and temporarily surviving regular income tax. By cleverly setting the rates and timing, the nation could shift most taxpayers to the new tax gradually and eventually repeal the regular tax without much political uproar. See Joel Michael, Letter to the Editor, *If You Hate the AMT, You'll Love This AMT*, 83 TAX NOTES 1507, 1507-08 (1999).

125. See SLEMROD & BAKIJA, *supra* note 28, at 209-12; U.S. Office of Tax Analysis, A PRELIMINARY ANALYSIS OF A FLAT RATE CONSUMPTION TAX (1995); Office of Tax Analysis, U.S. Dept. of Treasury, "New" Army-Shelby Flat Tax Would Still Lose Money, *Treasury Finds*, 70 TAX NOTES 451, 451-61 [hereinafter "New" Army].

126. See HALL & RABUSHKA, *supra* note 77, at 55-60.

127. See SLEMROD & BAKIJA, *supra* note 28, at 211-12.

taxes are much more progressive; the payroll and excise taxes are regressive.<sup>128</sup>

The U.S. Treasury Department estimated that the Armev-Shelby (July 1995) proposal would lose revenue if it used the specified rate of 17% and that a 20.8% rate would be required to be revenue neutral. At that single, nominal rate, effective tax rates would rise by fractions ranging from 10% to 81% for families in the bottom four quintiles of the population and would decline by 7% for families in the top quintile and by 36% for families in the top 1%. After-tax income would drop by 7.5% in the bottom four quintiles, but rise by 2% in the top quintile and 12% in the highest 1%.<sup>129</sup>

#### 4. Corporate Taxation Issues

So-called fiat-tax proposals have important implications for the Federal Corporate Income Tax and integration with individual taxation, because they involve shifting from taxing income to taxing consumption, or taxing consumed income only, rather than accretion income or profits. Inasmuch as a corporation, a legal construct, does not itself consume anything, full-scale consumption taxation may imply that there should be no tax imposed on the profits of a corporation, or on those of any business firm at all, or only to the extent of value added (whether the firm was profitable or not!). If the shift to a consumption regime were to take the form of a national retail sales tax or a VAT, then corporations would be taxed on their retail sales, if any, or on their value added.<sup>130</sup>

Abolishing the corporate income tax might increase foreign trade, would abolish tax preferences that lower the prices of nontradeable goods, and would remove discrimination against the use of corporate forms of business organization and against predominantly corporate sectors of the economy.<sup>131</sup>

Other current proposals for flat-rate consumption taxation would apply a tax somewhat resembling an income tax, but with crucial differences, to businesses, including corporations.<sup>132</sup> The U.S.A. plan proposed by Senators Domenici and Nunn would tax businesses at a very low flat rate of 11% on their gross profits and allow them a complete expense deduction for all capital investment (a cash-flow model tax), but would allow no

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128. See Toder, *supra* note 98, at 170-71.

129. See *id.* at 171; "New" Armev, *supra* note 125, at 451.

130. This is the approach taken by Hall and Rabushka. They would combine a VAT on all firms (including corporations) with a progressive personal consumption tax on individuals, to the extent of their consumed income. See HALL & RABUSHKA, *supra* note 77.

131. See Gillis et al., *supra* note 47, at 745.

132. See Peter L. Faber, *Tax Reform and Corporate Acquisitions*, 33 SAN DIEGO L. REV. 1541 (1996).

deduction for wages, interest, the cost of fringe benefits or local taxes.<sup>133</sup> Individuals would be taxed on wage income and other income at steeply graduated rates (8%, 19%, and 40%), and they would be allowed an unlimited deduction for net additions to saving. The plan allows no deduction for mortgage interest, charitable contributions, or state and local taxes, and fringe benefits would be included in the tax base.<sup>134</sup> The tax would be a consumed income tax.

The Armev Flat Tax plan proposes a consumption-based flat tax, because the individual tax base excludes returns to investment. It would tax all businesses at a flat 17% rate on "gross active income," allow complete expensing (a cash-flow model), with no deduction for interest, fringe benefits, or local taxes, but wages would be deductible and income from exports would be included. Individuals would be taxed on earned income only, at a flat 17% rate, capital income would be exempt from tax, no deductions would be allowed for mortgage interest, charitable contributions, or payments of state and local taxes, and there would be no tax on Social Security benefits received.<sup>135</sup>

Each of these plans retains a tax applicable to corporations and to all other firms and business activities, without regard to legal form. In each, the business tax is levied on a base very different from the present Federal Income Tax on corporations. Similarly, the proposed individual tax plans differ radically from the present Federal Income Tax on individuals, particularly in allowing a deduction for saved income or an exclusion for all income from capital (such as dividends or interest). The proposed business and individual taxes in net effect tax aggregate consumption by individuals, either to the consumers or the firms but, in theory and conception, not both. In other words, the problem of "integrating" the business and individual taxes remains, but the proposed taxes are levied on bases quite different from accretion income, and the problem of integrating them is quite different.

In final result, however, under a cash-flow consumption income tax, such as that advocated by Professor W. D. Andrews in 1974, individual shareholders who receive dividends should either receive them tax-free (because they are the yield on a prior investment of after-income tax dollars, if no deduction on investment), or should pay tax on them only if the

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133. Receipts from exports would be excluded.

134. See The U.S.A. Tax of 1995, S. 722, 104th Cong. (1995).

135. See Freedom and Fairness Restoration Act of 1994, H.R. 4585, 103d Cong. (1994) (incorporating the Armev plan and resembling a subtraction method VAT as to businesses). For more information about the Nunn-Domenici and Armev plans, see Bernstein et al., *Tax Reform 1995: Looking at Two Options*, 68 TAX NOTES 327 (1995).

investment producing them was deductible when made, and they are now consumed and not saved.<sup>136</sup>

### 5. Other Particular Problems

Commentators have identified some sector-specific implications and concerns with the consumption tax. The consumption tax proposals present problems for taxing financial institutions and financial practices because, for instance, it is difficult to identify and to measure implicit service fees for financial intermediation. A simple example is the grant of a fee-free checking account to a bank customer in return for maintaining a minimum balance, in effect constituting provision of a service in lieu of interest.<sup>137</sup> Also, some analysts have concluded that the consequences of the consumption tax proposals would be very costly, disruptive, and unfairly redistributive, primarily because of the capitalization (price) effects, and financing and transition problems.<sup>138</sup> There seem to be lots of unanswered questions about how presently tax-exempt organizations, such as charities, colleges, and the like, would be treated by the consumption tax, including whether contributions would fall off because of the lack of a tax benefit.<sup>139</sup> The impact of shifting the federal tax base so drastically might be to impose extraordinary constraints on state and local tax policy options.<sup>140</sup> Studies have analyzed the changed treatment of wages, presently untaxable fringe benefits, and deferred compensation and pension plans under some of the proposed consumption-tax systems.<sup>141</sup> Analysts have also examined effects on small businesses.<sup>142</sup> A differential impact on small and large businesses has worried, and been studied by, some.<sup>143</sup> Particularly

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136. See Andrews, *supra* note 7. The end result has been called by some a "tax (only) on wages." Warren, *supra* note 51; see generally BLUEPRINTS, 1984, *supra* note 6, at 100-29 (discussing corporate income and cash-flow taxation). If pre-existing capital is exempt from a new consumption tax, that tax would be roughly equivalent to a tax on wage (labor) income, under certain conditions.

137. See Bradford L. Ferguson, *Effect of Consumption Tax Proposals on Financial Institutions and Transactions*, in COMPREHENSIVE ANALYSIS, *supra* note 64, at 173.

138. See Tucker, *supra* note 123, at 112; J.D. Foster, *The Flat Tax and Housing Values*, 71 TAX NOTES 1795 (1996).

139. See David G. Glickman, *Tax-Exempt Organizations Under a Consumption Tax*, in COMPREHENSIVE ANALYSIS, *supra* note 64, at 257; Carol Rhee, *Gratuitous Transfers in a Consumption Tax World*, in COMPREHENSIVE ANALYSIS, *supra* note 64, at 267.

140. See Peter L. Faber, *Effect of Federal Tax Reform on State and Local Governments*, in COMPREHENSIVE ANALYSIS, *supra* note 64, at 281; Robert P. Strauss, *Federal Consumption Taxes: Implications for the State and Local Sector*, 82 TAX NOTES 1085, 1173 (1999).

141. See Thomas D. Terry, *Treatment of Wages, Deferred Compensation and Fringe Benefits Under Alternative Tax Systems*, in COMPREHENSIVE ANALYSIS, *supra* note 64, at 99.

142. See Morton A. Harris, *Impact of Alternative Tax Systems on Small Businesses*, in COMPREHENSIVE ANALYSIS, *supra* note 64, at 151.

143. See *id.* at 166 (citing THE CROSS FIRM-SIZE DISTRIBUTION OF STATE AND LOCAL TAX BURDENS UNDER FEDERAL CONSUMPTION-BASED TAXATION: IMPACT AND IMPLICATIONS; AN ADDENDUM TO THE DIFFERENTIAL IMPACT OF STATE AND LOCAL TAX INCENTIVES ON SMALL VERSUS LARGE FIRMS, Small Business Association 8138-0A-94 (April 1996)).

important might be an increased differentiation between “employees” and “independent contractors” or “owners.”<sup>144</sup>

### 6. *Effect on Saving*

Another important point made in favor of a flat or graduated rate consumption tax is that it will increase and improve saving, with good efficiency (and welfare) results. By removing the so-called double taxation (or, at least, “over-taxation”) of saving,<sup>145</sup> the consumption tax arguably should increase saving, as compared to our accrual model income tax.<sup>146</sup>

Consider the table on the following page in order to compare the tax burden on saved income imposed by a retail sales or similar tax, a consumption-type income tax including the deduction (cash-flow) type or the yield-exemption type, and the present U.S. hybrid-accretion-model income tax. Each of these regimes is compared to a hypothetical world without any tax, in effect, the starting point.

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144. See JT. COMM. ON TAXATION, IMPACT ON SMALL BUSINESS OF REPLACING THE FEDERAL INCOME TAX [JCS-3-96], April 23, 1996, 69, 76-77; see also Michael J. Calegari et al., *Flat Tax Ramifications for Self-Employed Taxpayers*, 72 TAX NOTES 641 (1996).

145. The “double taxation” criticism of the income tax is that income earned, such as \$100 of wages, is taxed once if consumed at once, but taxed “again” if saved, meaning that if the wage income (\$100) is saved and invested for a year at 10%, the yield (\$10) also will be taxed. Of course, there is no double taxation of the same income as such; the \$10 income from capital is additional income, at least nominally, and it increases the economic power of the taxpayer to consume (or save) in a world of constant prices without discounting everything to present value. Notably, there is no tax on the act of saving. If the cash is merely kept in a safe, or if it is invested and the return is zero, no tax will be imposed. The income tax applies only to any positive return on saving; a negative return or loss probably will be deductible and thus will reduce income tax on other wages or capital income. There is not really any “double taxation of saving.” There can be said to be “unequal” treatment of the two equal wage earners, the immediate consumer and the one who defers consumption and saves at a positive rate of return, the saver, if the two are viewed as “equal” in consumption power or utility on the ground that \$100 of consumption at time one is the equivalent of \$110 of consumption at time two, and the discount rate is the same as the positive yield experienced by the saver. That equivalence has been treated as true or obvious, but has not been demonstrated or analyzed adequately by the critics of the income tax.

146. The national rate of private saving in the United States in the 1980s and 1990s was about 6%, and the net national savings rate averaged 7.7% a year. See SLEMROD & BAKIJA, *supra* note 28, at 112-13. This is about one-third the rate in Japan and one-half the rate in Germany. See Kotlikoff, *supra* note 69, at 160-63. Professor Alan Auerbach says that during the early 1990s the United States as a nation saved just 2.53% of its national product in excess of that needed simply to cover depreciation of existing capital. See *U.S. Fiscal and Savings Crisis—Implications for Long-Term Growth, Hearings Before the Subcomm. on Deficits, Debt Management, and Long-Term Economic Growth of the Senate Comm. on Fin.*, 103d Cong. 16 (1994) (testimony of Alan Auerbach) (hereinafter *1994 Senate Hearings*).



Table 2: Income vs. Consumption Taxation—The Tax Burden on Saved Income

Comparison of tax burdens on income saved at a 10 % pretax rate of return for future consumption in worlds having: (1) No tax; (2) a 33 % retail sales tax; (3) 33 % cash-flow or consumption-type income tax; (4) 33 % yield-exemption consumption tax; (5) An accretion-model income tax as in the United States in 2000, but at a 33 1/3 % tax rate.

Row	Earned Income	Income Tax	If consumed in Year 1	Balance saved or invested after tax	Balance in account at end of each year (in U.S. Dollars)										Time of withdrawal for consumption		Consumed amount
					1	2	3	4	5	6	7	8	9	10	Tax rate	Cost of tax	
1	\$100	0%	\$100	\$100	110.00	121.00	133.10	146.41	161.05	177.16	194.87	214.36	235.79	259.37	0%	0.00	259.37
2	\$100	0%	\$67	\$100	110.00	121.00	133.10	146.41	161.05	177.16	194.87	214.36	235.79	259.37	33%	85.59	173.78
3	\$100	0%	\$67	\$100	110.00	121.00	133.10	146.41	161.05	177.16	194.87	214.36	235.79	259.37	33%	85.59	173.78
4	\$100	33%	\$67	\$67	73.70	81.07	89.18	98.09	107.90	118.69	130.56	143.62	157.98	173.78	0%	0.00	173.78
5	\$100	33%	\$67	\$67	71.49	76.28	81.39	86.84	92.66	98.87	105.49	112.56	120.10	128.15	0%	0.00	128.15

Note that all five horizontal lines (rows) presuppose an income earner of \$100 who lives in a fixed 10% pre-tax rate-of-return world, and lines 2-5 add some kind of tax at a 33% rate into that world. In each world, the \$100 income earner faces a choice between (a) immediately consuming everything he or she has earned (after taxes, if any) in the first year that \$100 is earned, or (b) postponing consumption and saving whatever he can for ten years, after which he will consume all saved amounts and the yield left over after payment of applicable taxes.

In Row 1, a world without any tax, the income earner can either consume \$100 at once or save all of it and have \$259.37 left at the end of ten years. Assuming no price changes, the income earner can weigh the value to him of consuming all the \$100 now or having the ability to consume 259.37% of that amount after 10 years. The taxpayer's saving funds his future consumption.

In Row 2, a consumption tax such as a retail sales tax or VAT at 33% is introduced. Here the choice is between consuming \$67 worth of good food or wine now or \$173.78 worth after ten years, the latter amount being 259.37% of the \$67 consumption power in Year 1. Even though the tax has reduced both after-tax numbers, the *ratio* between consuming now and consuming later remains the same, compared to the no-tax world. Total consumption by the taxpayer is reduced by the tax paid, but the choice is parallel to that offered in a no-tax world.

In Row 3, a cash-flow or consumption-type income tax at 33% allows a deduction for amounts saved. Thus, the \$100 of income earned and received will not be taxable until Year 10, when it and its yield are, after tax, consumed.<sup>147</sup> The ratio between future and present consumption remains 259.37%, and the Year 10 consumption power would again be 173.78% of the Year 1 income.

In contrast, the yield-exemption consumption tax in Row 4 uses a different method. It includes in income and taxes the \$100 of earnings, so (from these earnings) the saver can only put \$67 in the bank. But now the yield on this is free from tax, both when earned each year and when finally consumed. So, interestingly, after Year 10 this saver will have \$173.78 to spend tax-free on consumption, and that amount equals 259.37% of the \$67 he could have consumed in Year 1, just as with Rows 2 and 3.

Thus the consumption taxes or consumption-type income taxes in Rows 2-4 do reduce the consumption power (equally) of the income earner compared to his power in the tax-free world of Row 1. But they preserve the ratio between the choices or values of present to future consumption, values expressed in the 10% pre-tax interest rate.

Now look at Row 5. An accretion-type income tax at 33% will apply to the \$100 when it is earned and will also apply to the taxable yield on funds that are saved, that yield interest, dividends, rents, royalties, and so forth, which constitute additional income taxable under such a plan. So the income earner in Row 5 can consume only \$67 upon earning the before-tax \$100; or he or she can save the \$67, have his yield in effect reduced by about one-third each year by the 33% income tax, and then can spend the balance, \$128.15, tax-free, upon withdrawal of the funds after Year 10. But now, the ratio between the nominal value of later consumption and earlier consumption has changed. The ratio now is \$128.15:\$67.33 or about 191.27%, not the 259.37% ratio found under the first four regimes! This illustrates the effect on the saving versus consumption choice that is introduced into an otherwise similar world by an accretion-type income tax (assuming no special saving allowances) as distinguished from either a plain consumption tax or a consumed-income tax of either the cash-flow or yield-exemption variety.

In theory, the income tax thus discourages saving and, relatively, encourages present consumption. The other tax systems, which reduce total consumption compared to the no-tax world, do not change the present-to-future consumption ratio and hence are said to be "neutral" with respect to the savings versus consumption choice. Advocates offer this neutrality as the most important benefit of changing to a consumption or consumed income tax, arguing that it would lead to greater fairness, provide less

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147. The yield each year is deductible because it is saved or reinvested; hence interest compounds at 10%.

incentive for immediate consumption of income earned, and increase efficiency, simplicity, and transparency. These arguments are brought to bear on the Flat Tax proposals made in the United States in recent years.

The preceding discussion suggests that if a consumption-type income tax, or its functional equivalent, taxes income that is consumed (but not income that is saved), the substitution effect would dominate the income effect, and people would save more than if all income (whether consumed or saved) were taxed. But that outcome cannot be predicted with confidence. Some experience in the United States with tax-preferred savings incentives and other attempts at economic enhancement certainly calls into question whether this would be the result.<sup>148</sup>

In layperson's terms, people with a given propensity to save, with a given elasticity of demand for saving, would be expected to save more if the price of saving is reduced or the price of consumption is relatively increased. However, the recent U.S. empirical data show a very limited response of saving rates to income tax rate reductions or deductions for saving.<sup>149</sup> The so-called wealth effect or income effect may dominate or offset most or all of the price or substitution effect. So-called target savers may save to accomplish the same result, whether the yield is reduced by taxation or not.

Actually a switch to a consumption-based tax might have two savings-related effects. First, it might remove the income tax's supposed discouragement of saving and investment, resulting in more saving and investment. Second, it might result in more efficient allocation of resources, if the tax treatment of businesses and investment decisions would reduce misallocations across industries and asset types, thus enhancing the productivity of investment.<sup>150</sup>

As a related point, a consumption-type tax's neutrality with respect to consumption or saving is said to promote efficiency or neutrality vis-à-vis the allocation of income between saving and investment or consumption.<sup>151</sup>

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148. See 1995 Senate Hearing, *supra* note 33.

149. See 1994 Senate Hearings, *supra* note 146; Michael J. Boskin, *A Framework for the Tax Reform Debate*, in *FRONTIERS OF TAX REFORM*, *supra* note 48, at 10, 13-18; Eric Engen & William Gale, *The Effects of Fundamental Tax Reform on Saving*, in *ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM* 83, 99-102 (Henry J. Aaron & William G. Gale eds., 1996); JANE GRAVELLE, *THE ECONOMIC EFFECTS OF TAXING CAPITAL INCOME* (1994); Jane Gravelle, *The Economics of Taxing Capital Income: The Twentieth Century and Beyond*, in *TAX CONVERSATIONS*, *supra* note 47, at 223, 227; Kotlikoff, *supra* note 69, at 161-70; SLEMROD & BAKIJA, *supra* note 28, at 110-12; Jane G. Gravelle, *The Flat Tax and Other Proposals: Who Will Bear the Tax Burden?*, 69 *TAX NOTES* 1517 (1995).

150. See Gillis et al., *supra* note 47, at 728-29; SEIDMAN, *supra* note 19, at 22-34.

151. See, e.g., SLEMROD & BAKIJA, *supra* note 28; Bradford, *supra* note 100, at 109-15, 168-70; Kotlikoff, *supra* note 69, at 166-70.

Hence, by remaining neutral with respect to consumption versus savings, it promotes efficiency in the choice of form of saving by individuals.<sup>152</sup>

Why, after all, does someone who earns wages of \$100 this year save any of it? He may do so because he fears or predicts that he will not have any wages in the next year, or some later year(s), and so he saves some of his present wages to fund future consumption. But part of the reason he may save, or save an extra amount, is that someone, through the market, will pay him 10% interest per annum to “rent” his money. So, in a tax-free world, he may conclude that \$100 + \$10 consumption a year hence is preferable to \$100 consumption now. If the interest rate were 20%, he might defer more present consumption; if the rate were 4%, he might defer less.

Why would anyone pay him 10% (or 20%, or 4%) to rent his money for a year? It may be to fund necessities or desired consumption now, perhaps to flatten and even-out ability to consume over a period of years during which the borrower’s income, or other resources, will fluctuate considerably. Or the borrower may simply believe that he can invest or use the \$100 (risk free or risk adjusted) at a rate of return higher than the cost of the 10% or 20% or 4% interest rate he pays on the loan. He can profit by borrowing at, say 10%, and investing or using the money with his own labor or entrepreneurial ability to earn 40% (or at least 11%).

Because of interest rate adjustments as well, it is possible that a switch to a consumption tax would not lead to an increase in saving. If a switch to a consumption-type tax regime in fact initially does increase the rate of private saving, and if other things remain unchanged and the economy is closed,<sup>153</sup> it would seem that more capital would be available for borrowing and hence interest rates would eventually fall due to unchanged demand but increased supply. The fall in interest rates would make discretionary saving less rewarding, and thus the rate of such saving could be expected to fall. This would reduce the supply of funds available, tending to nudge up the interest rates offered until a new equilibrium would be reached, perhaps one with interest rates somewhat below comparable rates prior to the tax reform. Capital income would to some extent be freer of tax, on an exempt-yield or a cash-flow basis, but the rate of return would be somewhat lower than the pre-tax rate of return prior to the tax reform. Savers would experience some lower pre-tax return, a “shadow tax,” instead of the pre-existing income tax, though the rate reduction would not necessarily replace all of the former tax burden.

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152. Present U.S. income tax law, in contrast, distinctly favors some forms of saving, and investment, over others. *See, e.g.*, I.R.C. § 121 (gain on principal residences); § 1(h) (capital-gains rates); § 1014 (fresh-start basis at death); § 401 (qualified pension plans); § 408 (IRAs); § 408A (Roth IRAs) (2000); *see also* Kotlikoff, *supra* note 69, at 168-70.

153. *See* COMPREHENSIVE ANALYSIS, *supra* note 64, at 117.

Nevertheless, Congress and voters seem to think and act on the view that saving out of income will increase if the tax law provides income tax relief for saving or its yield.

The hybrid income tax now in place contains many characteristics that further distort savings decisions. The Presidential Tax Expenditure Budget identifies a number of large revenue losses in our present income tax, some of which are explicit or implicit subsidies and incentives for saving and investment, many in the form that a consumption tax would automatically provide.<sup>154</sup> These are departures from a pure accretion model income tax, or even a broader-based but practical "reference tax" or "normal income tax." The actual hybrid income tax fails to include unrealized appreciation in capital, accumulation of pension rights and most life insurance reserves, much gain on the sale of personal residences, much other saving, the imputed value of owner-occupied housing and other consumer durables, and the value of self-services and much human capital.<sup>155</sup> Moreover, it over-taxes distributed corporate earnings.<sup>156</sup> Therefore, a move to a consumption-based tax system would eliminate the distortions in the capital market resulting from unequal taxation of income from capital or savings.<sup>157</sup> Still, it seems a rather radical cure for these distortions to convert to a consumption tax and thereby simply exempt from tax all income from capital.

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154. See Office of Management and Budget, *The Budget of the United States Government, Fiscal Year 1996: Analytical Perspectives* 39-65 (1995); Paul R. McDaniel, *Comments*, in *WHAT SHOULD BE TAXED*, *supra* note 12, at 282, 284-88 (commenting on Michael Graetz's paper); SLEMROD & BAKIJA, *supra* note 28, at 143-46. The tax expenditures include allowances such as: immediate expensing of some capital expenditures, such as § 179 expensing, *see* I.R.C. § 179; the exclusion of interest on life insurance savings, *see* I.R.C. § 101; an exclusion or rate reduction for long-term capital gains, *see* I.R.C. §§ 1(h), 1202; an exclusion of substantial gains on the sale of owner-occupied residences, *see* I.R.C. § 121; the "fresh start basis at death" write-up, *see* I.R.C. § 1014; accelerated depreciation/cost recovery, *see* I.R.C. § 168; a home-mortgage interest deduction, *see* I.R.C. § 163(d); the (unstated) exclusion of the return received "in-kind" from owner-occupied housing and household durables (imputed income); deduction or deferral or even exemption for retirement savings and income security through exclusion of pension contributions under employer, *see* I.R.C. § 401 (k), or employee, *see* I.R.C. § 403(b), plans, IRAs, and Keoghs (deductions and/or exclusions); exclusion of state and municipal bond interest, *see* I.R.C. § 103; deferral of tax on accrued but unrealized gains; exclusion from income of gifts and bequests, *see* I.R.C. § 102; non-recognition (resulting in deferral of tax) on corporate reorganization exchanges, *see* I.R.C. § 368; and on like-kind exchanges and involuntary conversions, *see* I.R.C. §§ 1031, 1033, and other deferral opportunities.

155. See William D. Andrews, *A Supplemental Personal Expenditure Tax*, in *WHAT SHOULD BE TAXED*, *supra* note 12, at 127, 128.

156. See Michael J. Graetz & Alvin C. Warren, Jr., *Integration of Corporate and Individual Income Taxes: An Introduction*, 84 *TAX NOTES* 1767 (1999) and sources cited therein; John K. McNulty, *Corporate Income Tax Reform in the United States: Proposals for Integration of the Corporate and Individual Income Taxes, and International Aspects*, 12 *INT'L TAX & BUS. LAW* 161, 170-73 (1994).

157. In fact, perhaps most of these omissions or distortions cannot be cured in a practicable income tax. See 1996 House Hearing, *supra* note 33; 1995 Senate Hearing, *supra* note 33.

### 7. *Simplicity*

Another common argument in favor of a flat tax on consumption is that it will be simpler to comply with, to administer, and to enforce. Sometimes these arguments are exaggerated and naive (the Internal Revenue Service would be abolished, postcard-sized tax returns), especially if the new system included a direct or personal individual tax component.<sup>158</sup> To be sure, if only an indirect consumption tax, such as a retail sales tax or VAT, were employed, then periodic individual tax returns would be obviated, and the heavy tax compliance burdens of the present U.S. income tax on individuals would disappear or would be shifted to businesses.<sup>159</sup> But if an individual tax return were required, for progressive equity, personal tailoring, incentive, relief, and other reasons, it would not be so simple, and future decades might well see the compliance and administration burdens expand to something like the present burdens of income tax compliance and planning.<sup>160</sup>

Simplification resulting from a shift from an income to a consumption base probably would be greatest for taxpayers with income from capital; wage earners who spend all they earn would not be much affected. Furthermore, wage income is usually simpler to measure and report under an income tax than is income from capital, because of the complexity of reporting depreciation, capital gains, inflation, deferral, and so forth. So, if capital income were omitted from personal returns, or if value-added or gross sales rather than profits or net income were the base for the tax on business, doing one's taxes might well become simpler. Nevertheless, scholarly and professional studies have revealed some of the old and new complexities that a fiat tax would entail, in legislation, compliance, planning and enforcement.<sup>161</sup> And the mere fiatness and uniformity of the rate

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158. See, e.g., ARMEY, *supra* note 18, at 1-4 (stating that only "postcard sized tax returns" will be needed).

159. In 1913, the United States had a very short income tax return form and a very short income tax statute. See *The First 75: The Internal Revenue Code from Wilson to Reagan*, 75 *Stand. Fed. Tax Rep.* (CCH) 33-36 (1988). Some supporters of the Flat Tax ask voters to believe that a flat tax on consumption today would produce the same result, and one that would endure. Some would even claim that the Internal Revenue Service could be shrunk or abolished! See, e.g., ARMEY, *supra* note 18, at 47-48. Surely the complexities of modern society, markets, professional tax expertise and political pressures would soon re-complicate even a short, simple flat tax and its administration.

160. Shifting tax compliance obligations from individuals to businesses and other institutions possibly would reduce the national costs of enforcement and compliance. In the extreme, a retail sales tax would seem to impose very different compliance burdens (and on different taxpayers) from individualized income tax returns. A VAT on businesses (employers) with a deduction for wages, and a tax to individuals (employees) only on labor income, not capital income, and business income (if they had a sideline, or a garage sale) might reduce the overall burdens on taxpayers and government from those at present.

161. See, e.g., Graetz, *Expenditure Tax Design*, in *WHAT SHOULD BE TAXED*, *supra* note 12, at 161-295; Weisbach, *Ironing Out the Flat Tax*, 52 *STAN. L. REV.* 599 (2000); GRAETZ, *supra* note 115, *passim* and at 1659-61. See generally Arthur P. Hall, *Compliance Costs of Alternative Tax Systems*, 71

would only simplify actual taxpayer calculations on their tax returns in tiny and trivial ways.

To be sure, a single and low tax rate, or a series of rates with very little graduation, may remove some incentives taxpayers now have to gain the benefit of lower tax rates by shifting income to lower-bracket family members or others, converting ordinary income into lower-taxed income, such as long-term capital gain, or arranging to split or shift income and deductions between tax years so as to level or defer their income. But use of personalized or graduated or differential rates in a consumption tax could lead to similar efforts to shift, or convert, consumption to low-taxed persons, or to misrepresent the beneficiary of the consumption.

A very broad-based tax, perhaps using low rates as a consequence, can simplify taxpayer behavior by reducing the possibility of converting taxable consumption to tax-free consumption in the form of excluded fringe benefits, imputed income, foreign income or consumption, gifts and bequests, gains from barter, personal injury damages, casualty losses, medical expenses, charitable contributions, exempt housing, and so forth. However, even if a broad base and low, fiat rates are enacted at the outset, revenue needs (or fairness or political concerns) in the future may well cause the rates to rise or multiply or progress sharply; the new overall tax design must be robust enough to work well under those changed conditions.<sup>162</sup>

The general appeal of the consumption tax argument, of course, and its simplicity in operation, also depend on how well and how broadly consumption is defined for tax purposes.<sup>163</sup> Does it include: Gifts and bequests given? Received? Fringe benefits, financial services, foreign expenditures? Bartered goods? Imputed consumption income from ownership of homes and consumer durables? Self-services? Medical expenses, charitable contributions, state taxes? Dual-purpose expenditures (three-martini lunch, expensive artwork, and unimproved real estate)? Life insurance policies and annuity contracts? It may also turn on whether the proposed tax on consumption is destination- or origin-based, and whether it will stand alone or will serve in the company of taxes on wealth, income, and externalities or negative behavior such as pollution.

Measuring "consumption" is not free from complications if done directly. If done indirectly, by subtracting savings or investment from income, the task of determining "income" remains in place, and problems of defining and verifying savings and withdrawals from savings become even

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TAX NOTES 1081 (1996) (comparing compliance costs of current income tax with flat tax, U.S.A. tax, national retail sales tax and value added tax).

162. Recall the high income-tax rates in effect in the United States from the 1940s through the 1960s. See *The First 75*, *supra* note 159, and legislation summarized therein.

163. See GRAETZ, *supra* note 56, at 165-276.

more important. Notably, a direct consumption-expenditure tax would involve difficult balance-sheet-type calculations to measure annual increase or decrease in net worth. Falsification (by taxpayers) of prices or values of course would also be a typical compliance and administration problem. Analysts would have to consider the value of current services by people or enjoyment of capital (imputed consumption), sometimes involving net yields and depreciation of the asset.<sup>164</sup> Deviations from a comprehensive income tax often stem from difficulties of measuring income fully; people would feel parallel pressures under a consumption tax, for example, the pressure to exclude the value of services rendered for oneself, a family member, or even a bartering neighbor.

Attempts to improve horizontal equity almost surely would add special legislative allowances. Congressional efforts to reward socially desirable behavior, to provide relief for hardship, or to effect incentives through regulatory action would lead to more complexity of the kind complained about in our present income tax system. The tensions among equity, simplicity, efficiency and neutrality that we experience in our income tax would persist. Graduated tax rates, differential rates, or higher rates all would lead to tax arbitrage and complexifying taxpayer behavior and legislative and administrative responses.

Perhaps the new tax system would be, or start out to be, more transparent. In recent decades, our income tax unfortunately has gathered hidden or disguised qualities, such as phase-outs of personal exemptions and itemized deductions instead of marginal tax rate increases, or even the alternative minimum taxes (whose impact often lies hidden until after the tax year is over).

A single rate, or the nearest thing to it, probably would reduce tax arbitrage in the form of capital gain and ordinary income conversions, corporate rate versus individual rate trade-offs and planning, the use of home-equity loans, preferentially treated qualified savings vehicles (IRAs, and the like), and compensation preferred in the form of excludable fringe-benefits or qualified housing. Yet even then it seems safe to presume that inventive taxpayers would find new methods of tax reduction requiring specific anti-avoidance or evasion rules or general (and uncertain) anti-abuse principles, and certainly the continuing need for an Internal Revenue Service.

Also, legislation, regulations, rulings and decisional rule-making under a consumption-type tax would not be as easy as some of its advocates want to presume. For example, it would be necessary to define taxable consumption with great elaboration. And, if consumption is determined by subtracting savings from income, then income must be defined

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164. See Brown, *supra* note 12, at 113-17.



comprehensively to include even such items as employee fringe benefits, income-in-kind, imputed income from home ownership, consumer durables,<sup>165</sup> self-services, and other categories of problematic gains mentioned elsewhere in this Essay. Also, what constitutes eligible “saving” will become of critical importance.

Not only do advocates overstate simplicity claims, but they also lack a realistic appreciation of the nature of a plausible, personalized consumption-type tax, of political realities, and of the complicating nature of the adversarial positions of taxpayers and their advisors confronting the tax administration authorities. In addition, many dimensions of tax planning would change and impose huge transition burdens as well as continuing transaction costs.<sup>166</sup>

Fundamental reform may not produce large simplicity gains, in transition or in the long run.

#### 8. Administration and Enforcement Problems

Certainly U.S. tax policy analysts must not ignore the intergovernmental and political aspects of taxation change. A national consumption tax would invade the traditional tax bases of both state and local governments.<sup>167</sup> Also, if a federal retail sales tax or VAT were imposed at the rate of 30% or 40% and if States used the same tax base at a 10% rate, the combined rate (40% to 50% or more) would create a strong incentive to cheat, misrepresent, overplan, or hide taxable transactions.

While the retail sales tax seems to be the simplest consumption tax to administer, in fact most countries with national sales taxes have replaced them with VATs. Evidently rates of 20% or higher lead to very difficult problems of enforcement and compliance. These problems stem from trying to make sure that the retail sales tax does not tax business inputs, to prevent inefficient cascading of the tax, and from evasion at the retail-customer level, as well as the usual legal construction, interpretation and exemption problems.<sup>168</sup> Also, in contrast to a retail sales tax, a

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165. For example, cars, washing machines, televisions, and stereos.

166. Lawyers and economists can preview some of the avenues for evading a cash-flow or yield-exempt direct consumption tax, sometimes through the use of cross-border transactions. See McLure & Zodrow, *supra* note 48, at 76-79.

Professor Graetz shows how the system could be unfairly “gamed” especially if, as in *Blueprints*, taxpayers could choose between cash-deduction and yield-exemption accounts (and could maintain both kinds). See GRAETZ, *supra* note 56, at 175-82; see also Charles McLure & Greg Zodrow, *Administrative Advantages of the Individual Tax Prepayment Approach to the Direct Taxation of Consumption*, in HEIDELBERG CONGRESS, *supra* note 58, at 335-405; Christian Seidl, *Administration Problems of an Expenditure Tax* in HEIDELBERG CONGRESS, *supra* note 58, at 408-49.

167. See Michael Mazerov, et al., *Federal Tax Restructuring and State and Local Governments: An Introduction to the Issues and the Literature*, 33 SAN DIEGO L. REV. 1459 (1996); Strauss, *supra* note 140, at 1173.

168. See SLEMROD & BAKIJA, *supra* note 28, at 208-11.

credit-method VAT employs business-firm taxpayers helpfully in policing compliance by each other.

Even a VAT of the credit-invoice type presents administrative and complexity problems, as U.S. Treasury Department and General Accounting Office estimates have shown.<sup>169</sup> Exemptions for small businesses (and household yard or garage sales?), for some products (food? medicines?), and perhaps for some services (for example, financial transactions), all create problems. Nevertheless, European countries have experience dating at least from the early 1970s to inform the United States, although that history has involved somewhat narrower bases and lower tax rates than the United States would use if it tried to replace the Federal Income Tax entirely. Statistics show that the costs of raising \$1 of revenue with such a VAT might equal those imposed by the income tax, although compliance costs for individual taxpayers might be substantially reduced.<sup>170</sup>

A cash-flow income tax such as the U.S.A. Tax would involve new complexities, particularly in tracking net saving and dissaving. Individual taxpayers probably would have to submit annual wealth accounts. Retained or added tax preferences would provide new opportunities for tax arbitrage, such as borrowing at deductible interest to invest in tax-exempt yield securities.<sup>171</sup>

Finally, analysts must give more thought to the international fit and potential for international double taxation under a consumption-type tax: foreign tax credit, tax treaties, globalization of capital markets, foreign holders of U.S. assets, U.S. holders of foreign assets, U.S. citizens engaging in foreign competition, evasion, emigration and immigration, and effects on inflation and price increases.<sup>172</sup> The international legal and economic fit and effects of switching from an individual and corporate income tax to a consumption tax are exceedingly important.<sup>173</sup> Cross border and

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169. See TREASURY I, *supra* note 6, at 226; U.S. GENERAL ACCOUNTING OFFICE, VALUE-ADDED TAX: ADMINISTRATIVE COSTS VARY WITH COMPLEXITY AND NUMBER OF BUSINESSES *passim* (1993).

170. See U.S. GENERAL ACCOUNTING OFFICE, *supra* note 169, at 213-14.

171. See Toder, *supra* note 98, at 183.

172. See Gillis et al., *supra* note 47, at 740; GRAETZ, *supra* note 115, at 1643-49; Tax Reform Study Group, *Impact of the Proposed Replacement Tax Systems on the International Competitiveness of U.S. Workers and Businesses*, 13 TAX NOTES INT'L 797 (1996); Peggy Musgrave, *International Coordination Problems of Substituting Consumption for Income Taxation*, in HEIDELBERG CONGRESS, *supra* note 58, at 453-89; Gerold Krause-Junk, *Problems of International Coordination under Alternative Consumption Tax Regimes*, in HEIDELBERG CONGRESS, *supra* note 58, at 491-512; Bernd Genser, *Do International Relations Impede a Shift Towards Expenditure Taxation?*, in HEIDELBERG CONGRESS, *supra* note 58, at 513-34.

173. See LODIN, *supra* note 45; Peggy B. Musgrave, *Consumption Tax Proposals in the International Setting*, in TAX CONVERSATIONS, *supra* note 47, at 447; Reuven S. Avi-Yonah, *From Income to Consumption Tax: Some International Implications*, 33 SAN DIEGO L. REV. 1329 (1996); Michael J. Graetz, *International Aspects of Fundamental Tax Restructuring: Practice or Principle?*, 51 U. MIAMI L. REV. 1093 (1997); Steven E. Shay & Victoria P. Summers, *Selected International*

mail-order sales and underground transactions add to the jurisdictional and enforcement problems.<sup>174</sup> Border tax adjustments are a major policy problem. Internationally, the Arney Flat Tax and many of the other consumption-type taxes would require renegotiating all U.S. foreign income tax treaties. Conversion to such a tax, of course, might eventually influence similar conversions in foreign countries.

## II

### THE QUESTION OF FAIRNESS

Of all of the issues surrounding taxation and tax reform, issues of fairness are perhaps the most important and yet the hardest to analyze and evaluate. Part II.A reviews some of the recurring fairness arguments raised by academics and reform advocates. Part II.B evaluates and challenges these arguments. In particular, this Part highlights the assumptions underlying much of the fairness debate, and suggests the ways in which fairness arguments based on these assumptions may be flawed.

#### A. *The Fairness Arguments*

A consumption-type or cash-flow income tax is alleged to be fairer than an accretion model income tax, simply because it taxes consumption, not production (or receipt or realization of income or gain). Thereby, it removes the alleged over-taxation of saved income, and it supposedly taxes people equally, according to their ability or obligation to pay, regardless of time preferences, or as viewed from a lifetime perspective.<sup>175</sup>

Typically, consumption tax advocates invite us to consider two individuals who have equal education, motivation, and skills, and who work at the same jobs all their adult lives, earning exactly the same annual compensation for their labor. Hence they have identical power to consume, if viewed *ex ante*. They differ, however, in that Taxpayer *A*, the "spend-thrift," spends nearly every dollar he earns at once, while Taxpayer *B*, the "saver," defers some consumption and saves significant amounts to provide for a comfortable retirement, including travel and other recreation. So Taxpayer *A* has spent nearly everything he earned by the time he retires, and he will thus have to survive on his meager savings, Social Security, or welfare. In contrast, Taxpayer *B* has moved some funds to other assets for retirement and has been earning income on her growing capital for years,

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*Aspects of Fundamental Tax Reform Proposals*, 51 U. MIAMI L. REV. 1029 (1997); P. Mieszkowski, *Cash Flow Version of an Expenditure Tax*, O.T.A. PAPER (U.S. Dept. of the Treasury, Office of Tax Analysis 1977).

174. See Gillis et al., *supra* note 47, at 736.

175. See BLUEPRINTS, 1984, *supra* note 6; SLEMRD & BAKIJA, *supra* note 28, at 83-84; Andrews, *supra* note 7; Gillis et al., *supra* note 47, at 729.

and will have not only Social Security, but also ample savings and their yield with which to fund (and really enjoy) her retirement.<sup>176</sup>

The key question is whether these two taxpayers, viewed over their lifetimes, have or should be treated as having equal taxpaying ability or obligation. They earned the same wages or salaries (paid at the same times) and had the same capacity or opportunity to consume immediately out of earned income. But, in fact, Taxpayer *B* consumed more (though later) during her lifetime (working years and retirement) because she saved some of her wage income and thereby earned capital income in addition. If their actual streams of consumption are discounted to the same starting point, however, they each enjoyed an equal present value of lifetime consumption.

Some thoughtful observers may say that the two have equal consumption in present value terms and hence have identical ability to pay tax, and favor a consumption-type tax because it would tax them “equally.” Others, looking at the different totals of income and spending on consumption, determined by adding up annual amounts without discounting to present value, would say they had different taxpaying abilities and that an accretion-type income tax would more correctly determine their relative tax burdens.<sup>177</sup> A consumption-type income tax would either allow the saver to deduct amounts saved or, similarly, would exempt income from savings from further tax.

However, one important view is that a tax that includes capital income actually is preferable to a tax that measures only rights actually exercised in consumption. Since the latter does not take into account additions to wealth and hence to consumption power, it fails to measure important satisfactions (or, possibly, “imputed consumption”) and “ability to pay” that are measured by an income tax.<sup>178</sup> Wealth, for example from accumulated income, as well as consumption, arguably gives rise to taxable capacity. In this view, an income tax, in measuring “changes in wealth” as well as

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176. Assume both taxpayers spend all their assets by death and that neither taxpayer received or made any gifts or bequests.

177. If the income tax rate were flat and its base included labor income and capital income, Taxpayer *B* would pay more in tax every year (after the first one) than Taxpayer *A*, because although their incomes from labor would be identical, Taxpayer *B* would also have positive income from capital, growing each year, and Taxpayer *A* would have none. So the present value of lifetime income taxes paid by Taxpayer *B* would exceed that of taxes paid by Taxpayer *A*. In contrast, under a consumption tax, Taxpayer *A* would pay more taxes than Taxpayer *B* during his working years (because Taxpayer *B* is not spending all she earns), but less during retirement (when Taxpayer *B* dissaves). But it is mainly timing that differentiates the two. And if the tax base of the income tax were only labor income and did not include capital income, the two would pay equal taxes over their lifetimes. Given that a tax on total income would apply to the returns to capital, the tax burden on the saver would be greater than it would be under a pure wage tax or pure consumption tax. But perhaps it would less distort the labor market and work or leisure decisions. See, e.g., Jonathan R. Kesselman, *Base Reforms and Rate Cuts for a Revitalized Personal Tax*, 47 CAN. TAX J. 181, 210 (1999).

178. See Goode, *supra* note 104.

consumption, comes closer to measuring lifetime wealth or capacity to consume and to pay tax.<sup>179</sup>

Consumption tax advocates also criticize the income tax for its failure to tax equally two taxpayers who have equal earnings, regardless of when they choose to consume.<sup>180</sup> They assert that a consumption tax, even though applied and collected annually, would do a better job of taxing lifetime wealth, or ability to pay tax, than would an annual income tax. Events over a short period of time, a day or a week, are not an adequate basis to determine the relative obligations of two people to pay tax.<sup>181</sup> A year or, better yet, a decade would seem more reasonable, but a lifetime of information would even better enable someone to make the appropriate interpersonal comparison.<sup>182</sup> A consumption tax does this better, according to consumption tax advocates, because two taxpayers having the same initial wealth and the same present value of future non-wealth receipts (labor income) would bear the same tax burden.<sup>183</sup> An income tax is likely to

179. However, Harberger argues that the satisfactions that attach to an addition to wealth at a given time include the present value of any future benefits coming from it. *See* Arnold C. Harberger, *Comments, in WHAT SHOULD BE TAXED, supra* note 12, at 117, 118-19. An income tax, however, taxes not only the income saved (and hence taxes the present value of the satisfactions that the saving will produce in the future) but also, if the later income yield is also taxed when received or realized, it taxes these satisfactions a second time. So, he says, an income tax is substantially more inefficient than a consumption tax (if leisure and savings are substitutes). (And this could lead to a preference for a consumption tax on fairness grounds, as well as efficiency and savings grounds.)

Harberger, however, emphasizes that he would aim future tax policy at stimulating investment, not saving, because of the global capital market. If national saving is to be increased, he suggests that government reduction of its deficits would be a good approach. *See id.* To satisfy those who would want some tax on property or wealth as well as consumption, he indicates that perhaps a periodic wealth tax on individuals could be combined with a consumption tax. But then the result would be much like that of an accretion model income tax, though perhaps without need for the (disadvantageous) "rule of realization." *See* Alvin C. Warren, Jr., *Comments, in WHAT SHOULD BE TAXED, supra* note 12, at 120-122.

180. *See* Goode, *supra* note 104, at 54-55. A fairness argument for consumption taxation asserts that the natural or correct time span to use for computing tax-paying obligation is the entire lifetime of an individual taxpayer, not a month, a year or a decade. This position then goes on to observe that the present (discounted) value of an individual's lifetime income (including inheritance) is equal to the present, discounted value of his or her consumption plus bequests. So, a lifetime income tax is equivalent to a consumption tax plus a bequest tax. *See* Stiglitz, *supra* note 28, at 119. From this, it is said to be evident that a consumption tax, perhaps annualized, is fairer than an income tax, presumably because it will tax equally two taxpayers having equal present values of lifetime consumption, as if determined at birth.

181. *See* BLUEPRINTS, 1984, *supra* note 6, at 24-25; Bradford, *supra* note 100, at 107-08.

182. *See* VICKREY, AGENDA FOR PROGRESSIVE TAXATION (Augustus M. Kelley 1972) (1947) (recommending cumulative lifetime averaging).

183. *See* Bradford, *supra* note 100, at 106-09; BLUEPRINTS, 1977, *supra* note 6, at 38-40. Imagine a talented, 20-year-old basketball player who will earn \$15,000,000 during his twenties. He will not be employable past age 30 because his knees will be ruined. Therefore, suppose his lifetime earning has a present value of \$10,000,000. Now compare the basketball player with a talented pianist who also has a present value of lifetime earning equal to \$10,000,000. However, this taxpayer will earn \$25,000,000 throughout her career, but it will come mostly during her 40s, 50s and 60s. Under a consumption tax, but not an income tax, these two taxpayers would end up bearing the same tax burden.

mismeasure "lifetime wealth" by imposing an overall lighter tax burden on an individual who earns and consumes early in life and a heavier one on the individual who postpones consumption, or earns more income but later, even though both had equal consumption power measured (at birth) in present value terms.<sup>184</sup> A consumed-income or consumption tax is argued to be fairer than an income tax. Hence saved income should be deductible, or the yield excluded from an income-tax base.

Whether it would be wise to substitute a consumption-type tax system for our income-type system depends partly on public (taxpayer) perceptions of its fairness and acceptability. Whether it appears to be fair to the layperson can be as important a question as whether, under sophisticated economic or legal analysis, the proposed system is fair. There are serious appearance or transparency fairness considerations in moving in this direction toward fundamental tax reform.<sup>185</sup>

Viewed through an annual snapshot, a consumption-based tax appears to be much more regressive than does an income tax, even if the income tax has the same rate structure, because in any particular year low-income people generally consume a much higher fraction of their income, while high-income people save more (in proportion), and saving would exempt them to a greater extent from a consumption-type tax.<sup>186</sup> But viewed over a life cycle, during which people consume rather consistently even though

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184. See Joseph Bankman & Barbara H. Fried, *Winners and Losers in the Shift to a Consumption Tax*, 86 *Geo. L.J.* 539, 547-56, 568 (1998). With graduated tax rates the "taxable period" problem becomes more serious, because income bunched in a short term will be taxed at higher rates than would be the same amount spread over a longer time covering more taxable periods. See Bradford, *supra* note 100, at 106-08. Graduated rates may overtax income earned in the space of a few years (and hence taxed at high marginal rates), but spent over many more years in a relatively level or smooth consumption pattern.

185. Also, one must consider whether the public would accept a tax on wages and one that exempts most or all income from capital. A retail sales tax or anything like it has, in the U.S., a definite "regressivity" taint. See Jonathan Chait, *The Flat Tax Scam*, *NEW REPUBLIC*, Dec. 15, 1997, at 23. Addition of rate differentials, personal or family exemptions, rebates, or other devices for equity reasons will start down the complexity road (and the thruway to higher rates). However, some economists reduce the regressivity taint by emphasizing life-cycle theories of consumption and saving, rather than income-based measures of regressivity. See Gillis et al., *supra* note 47, at 739; see also text *infra*, at II.C., and accompanying notes 259-261.

186. A related issue is the redistributiveness of a consumption tax as compared to an income tax. An analysis by the U.S. Treasury Department indicates that a flat tax, even with substantial personal or family exemptions, would shift a heavy share of the tax burden currently imposed on very high income taxpayers onto other taxpayers (except for those within the exemption amounts). See SLEMROD & BAKIJA, *supra* note 28, at 222-23; U.S. DEPT. OF TREASURY, OFFICE OF TAX ANALYSIS, *A PRELIMINARY ANALYSIS OF A FLAT-RATE CONSUMPTION TAX* (1996). The top 1% or top 2%-5% would have a big increase in after-tax income if a consumption tax were instituted; all other groups would have a decrease in after-tax income. See SLEMROD & BAKIJA, *supra*, at 223. The "middle class" would suffer the most. See *id.* This might well prove politically unacceptable. Graduated rates could be used to ameliorate these effects. But, some would argue that raising progressivity by tinkering with the legislation in this way would decrease efficiency and hence undermine the welfare gains attributed to a conversion. In principle, however, the use of graduated rates could allow the United States to pursue its redistributive objectives.

their annual incomes vary, things may look different. Apart from gifts and bequests<sup>187</sup> and transfer payments, we generally consume what we earn, so that the base of a tax on consumption will add up to much the same total over a lifetime as that of a broad-based income tax.<sup>188</sup> But graduated rates applied to annual income may impose quite different tax burdens. However, an annual income tax can be constructed to minimize the differences between it and a longer-term or lifetime income tax.

Several academics who write about taxation issues have incorporated philosophical arguments about fairness into their work. For example, Professor Alvin Warren took up six fairness arguments in favor of a consumption tax in his insightful 1980 *Yale Law Journal* article.<sup>189</sup> In particular, Warren evaluated fairness issues from an ex ante and ex post perspective, and concluded that fairness in taxation "should depend on outcomes, not expectations."<sup>190</sup> Warren found the accretion-type income tax to be fair from an ex post perspective and the various consumption-type taxes to be fair only in an ex ante sense.<sup>191</sup>

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187. See 1995 Senate Hearing, *supra* note 33.

188. See SLEMROD & BAKUA, *supra* note 28, at 175-77.

189. See Warren, *supra* note 10, at 1098-99.

190. *Id.* at 1100, 1152. This is particularly relevant for his arguments concerning the discrimination against savers point, made by Irving Fisher and J.S. Mill. Warren challenges whether the comparison of present values in an income tax world with those in a no-tax or consumption-tax world is even relevant. A Haig-Simons income conception is retrospective, but Fisherian capital theory embodies expectations. Ex ante choices are what economists often pose to examine rational behavior, but fairness in taxation, Warren argues, should be evaluated from an ex post perspective.

191. However, Professor Jeff Strnad has argued that, from a general equilibrium point of view, the Haig-Simons approach is an ex ante one because the present value of an investment depends in part on anticipated future events (such as tax burdens or benefits) and calculating those effects is necessarily an ex ante exercise. See Jeff Strnad, *Taxation of Income from Capital: A Theoretical Appraisal*, 37 STAN. L. REV. 1023, 1039-40 (1985). Strnad went on to argue that a cash-flow income tax is not equivalent to a yield-exemption approach, that only a cash-flow income tax really implements the Haig-Simons principle, and that a traditional income tax does not do so. He concluded that the traditional comparisons of tax treatments and ideal tax systems are flawed even when contemplating a non-general equilibrium setting. See *id.* at 1046. This is because installation of a particular tax system may affect prices of available investments, compared to a no-tax world, and discount rates may change with a resulting difference in investment decisions. See *id.* at 1040, 1072. Overall he concluded that only the cash-flow income tax comports with the Haig-Simons ideal in a non-general equilibrium setting, and that in a general equilibrium setting none of the three tax treatments implements the Haig-Simons model in general. See *id.* at 1099.

Professors Louis Kaplow and Alvin Warren promptly replied to Strnad's article and showed that the essential argument, that only a cash-flow income tax satisfies the Haig-Simons definitions of income, was tautological, depending on his idiosyncratic interpretation of Haig-Simons. Strnad's definition of income resembled Irving Fisher's in that both equated income with consumption. Thus, they concluded that Strnad did not show successfully that cash flow is a preferable tax base, compared to a Haig-Simons income tax. They also defended persuasively the use of partial equilibrium or even "transactional" analysis, while recognizing the merits of general-equilibrium analysis when feasible. See Louis Kaplow & Alvin C. Warren, Jr., *An Income Tax by Any Other Name: A Reply to Professor Strnad*, 38 STAN. L. REV. 399, 409, 420 (1986).

The positive arguments for income, rather than consumption, taxation seem quite convincing.<sup>192</sup> Income, determined ex post, appeals most as the base for fundamental taxation. Moreover, Warren notes that an income tax, which applies to the distribution of product by collective decision, shows more respect for human liberty than a consumption tax, which, as a distributive premise, takes quantitative consumption decisions as the base for collective, not individual, judgment. Under an income tax, a person's "collective responsibilities" are completed at the time of production, whereas, under a consumption tax, they are not discharged until ultimate consumption of all of a taxpayer's resources.<sup>193</sup> According to Warren, the choice between tax bases ultimately depends on whether a social product or standard of living version of fairness is more appealing as a matter of political or moral philosophy.<sup>194</sup>

In a more recent article, Professor Barbara Fried deeply analyzed the fairness arguments for the consumption tax as a perfected income tax or a preferable "endowments tax" and found them neither sound nor convincing. More importantly, she probed the claim that a consumption tax is fair because it preserves the relative status of savers and spenders and concluded that the argument is quite unpersuasive.<sup>195</sup> First she showed that it is not clear that a tax on the income from invested capital does in fact disadvantage savers as compared to spenders, for reasons she explicated in detail. Also, she concluded that consumption tax supporters have not put forward a theory that would explain why such a differential effect is unfair, at least under entitlement-based views of fairness, the position taken here.<sup>196</sup> She acknowledged that a consumption tax exempting the return from capital might separately be argued on utilitarian or welfarist grounds (to maximize aggregate well-being), or on a theory of justice that desires to reward the virtues of thrift, abstinence, and saving, or on a retributive theory of justice that seeks to punish obscene or excessive consumption.<sup>197</sup>

Fried's work examined economic and philosophical as well as legal literature. She focused on the argument that an income tax discriminates

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192. See Warren, *supra* note 10, at 1190-93, 1121-24. Warren also successfully deals with Kaldor's arguments that the Haig-Simons income concept cannot be truly defined, even in theory, and is a defective concept. See *id.* at 1109-21. See also Richard Musgrave, On Choosing the "Correct" Tax Base—A Historical Perspective, in HEIDELBERG CONGRESS, *supra* note 58, at 29-42.

193. See Warren, *supra* note 10 at 1120-21.

194. See *id.* at 1122. Warren adds that this is at least true as long as wealth is excluded from the comparison (as it usually is). See *id.* Since an income tax reaches wealth or the return on wealth, such taxation seems superior for that reason, to some observers, even though it does so with several deficiencies. See *id.* at 1123. However, see Arthur Cockfield, *Income Taxes and Individual Liberty: A Lockean Perspective on Radical Composition Tax Reform*, 74 S.D. L. REV. (forthcoming Fall 2000), arguing that consumption taxes intrude less on an individual's personal liberty than do income taxes.

195. See Barbara Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961, 1016 (1992).

196. See *id.* at 1006.

197. See *id.* at 962, 1016-17.



against savers relative to spenders compared to their positions in a no-tax world.<sup>198</sup> While the differential may exist under one plausible set of assumptions, no one has convincingly explained why it is unfair, for example by showing that equal spenders (vs. equal earners or equal savers) should bear equal tax burdens. Attempts have been made to argue that they should do so because they face equivalent choices *ex ante*,<sup>199</sup> or to preserve the *ex post* positions they would have in a no-tax world<sup>200</sup> or because the costs of deferring consumption offset the amounts received.<sup>201</sup> She attacked and qualified even the underlying proposition that savers are disadvantaged relative to spenders by an income tax.<sup>202</sup> She separated conceptually the tax on returns to risk from the tax on risk-free return, and considered marginal savers as distinguished from infra-marginal savers who enjoy a supplier's surplus.<sup>203</sup> She also argued that the tax treatment of interest paid by the borrower (deductible or not) is important in determining whether and how much saver/lenders are worse off.<sup>204</sup> It remains uncertain whether a consumption tax would preserve the relative pre-tax positions of spenders and savers, and also it is not established that they should be entitled to do so under any articulated theory of distributive justice.<sup>205</sup>

### B. *Evaluating the Fairness Arguments*

Arguing for the greater fairness of a consumption tax over an income tax, proponents seem to invoke three closely-related "entitlement" propositions, as indicated in the foregoing text, that should be examined in more detail. The first seems to be an argument that a consumption tax is fairer than an income tax because it taxes equally consumption that is equal in present value terms. The second similar thought is that the consumption tax does not "discriminate" between equal income taxpayers with different tastes for present and future consumption ("spenders" and "savers"), while

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198. *See id.* at 964.

199. Bradford puts it:

The equity case for income taxation depends either on the acceptance of society's claim (for public goods or redistribution) to a portion of the product of capital and labor or on the acceptance of income taxation as a means of reaching the benefits of both consumption and wealth. Essentially an *ex post* view, this conclusion also requires agreement that outcomes rather than expectations are what matter for equity in taxation.

Bradford, *supra* note 100, at 125. As he says, most of the case for substituting a consumption tax depends on the opposite premise, that expectations alone are relevant, using the life-cycle hypothesis, the human-capital construct and the discounting of income streams to present value. *See id.* at 75.

200. *See* Andrews, *supra* note 7; BLUEPRINTS, 1984, *supra* note 6.

201. *See* NASSAU WILLIAM SENIOR, AN OUTLINE OF THE SCIENCE OF POLITICAL ECONOMY 58 (6th ed. 1938) (1836); Fried, *supra* note 195, at 965.

202. *See* Fried, *supra* note 195, at 966.

203. *See id.* at 982, 985.

204. *See id.* at 1002.

205. *See id.* at 1015-16.

an income tax does do so.<sup>206</sup> The third proposition, also similar, is that the consumption tax retains the same ratio of after-tax consumption power between present and future consumption as that existing in a world without tax, a point that Table Two<sup>207</sup> illustrates.

One question is whether any or all of these propositions is “true.” Even assuming all three descriptive propositions to be true, the further question arises whether it therefore follows that the consumption tax is “fairer”?<sup>208</sup>

The merits of a consumption tax seem to be argued based on the proposition that the time of consumption, rather than the time of income, is the relevant fairness criterion for judging the “horizontal equity” of each tax base.<sup>209</sup>

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206. Professor Martin Ginsburg has said that a consumption tax taxes consumption once and taxes savings once, when the savings are consumed, but that an income tax taxes consumption once and taxes savings twice. Hence it “discriminates against,” and discourages, savings and encourages consumption. Martin D. Ginsburg, *Taxing the Components of Income: A U.S. Perspective*, 86 GEO. L.J. 123, 132 (1997).

207. See *supra* table and text accompanying note 47.

208. Might not one think that an income tax is fairer because it taxes equally income that is equal in present-value terms, doesn’t discriminate between taxpayers with different capacities or tastes for present or later earning of income to support their consumption, and because it retains the same ratio between capacity to earn and to save or consume out of earnings that exist in a tax-free world? One distinguished economist said informally to me that it is like discriminating in the price of ice cream between two (equally situated) taxpayers, one of whom likes chocolate ice cream and the other of whom prefers vanilla. While it was evident to me that the chocolate-lover is the better informed and more keenly aesthetic of the two taxpayers, I have tried to accept his hypothetical on the grounds that the two ice cream buyers were equally situated in every relevant respect, and their different tastes in flavor were irrelevant to their merits, just desserts (sorry), and equal standing. I am not sure, however, about translating this irrefutably into the notion that two taxpayers of equal consumption desires or needs (but unequal income as measured by a simple income tax) are completely equal in relevant ways. Is it possible that they are unequal in a relevant way if one has a \$1,000,000 endowment at birth, which he invests and uses to produce \$4,000,000 of total consumption by his death, when the capital and income are exhausted, compared to his counterpart who has no such early endowment but who earns or is given it in increasing annual installments, finished at his death, such that he lives a rather poor childhood, a moderately comfortable youth and middle age, and an absolutely luxurious, high-consumption later life and retirement?

209. See Boyd Kimball Dyer, *The Relative Fairness of the Consumption and Accretion Tax Bases*, 1978 UTAH L. REV. 457. The consumption tax proponents repeatedly assert that if the present value of the consumption of two taxpayers is the same, the fact that their incomes occur at different times or in different ways should not cause a difference in tax burden. So they are saying that the same tax burdens should be paid by the first taxpayer, a professional basketball player who received (a signing bonus of) \$1,000,000 at age 20 and invested it to earn eventually another \$3,000,000, all spent in his lifetime, most of it early, and by the second, a concert pianist, who doesn’t save but just earns enough late in life and before death eventually to consume \$4,000,000 in total, much of it late in life.

But why not say the income tax taxes income once, when it is earned, even if saved, and taxes the additional income from those savings when *it* is earned, whether saved or consumed? (Neither tax exactly taxes “savings” itself.) The consumption tax taxes consumption, when it occurs. The income tax taxes income, when it occurs. Against that background, the policy choice merely becomes do we prefer for policy reasons a consumption tax that taxes (us) when we consume or an income tax that taxes (us) when we earn income?

One intervention might be “let’s tax ourselves only when we spend and consume income (and wealth or borrowings?)” because that is when each of us takes a share out of the common wealth and resources of the world.<sup>210</sup> What about the fairness and withdrawal from “the commons” rule? Is that somehow clearly the time when we should be taxed and on the amount that we then withdraw (perhaps under graduated rates)?<sup>211</sup> In what sense do we withdraw from a common pool when we consume? Is my corn, growing on my property, part of the common pool, until I eat it? Or allow it to rot? Or give it away? Or use it to seed my farm? Maybe so in some way. If the resource consists of a longer-lived plant, a tree for example, and I didn’t consume it, it will be there for my heirs or will escheat to the state, and somebody else will get to “consume” it. And maybe my crop in part can be attributed to the science, safety, know-how and respect of others of the population who contributed to the product.

But if I am paid the corn or the tree for the work I do, and I become thereby richer and could eat the corn or cut up the tree to make a log cabin, may not that receipt be the time when my capacity to pay is best determined, based on what compensation I received for my labor, properly valued, and the time when human intuition makes me most agreeable to pay the tax, even if I have to sell some of the corn to get the cash to pay tax on the receipt of all the corn? When I add to the world’s wealth my corn and tree (or the value of the services I rendered), and the corn and tree are given over to me and placed under my dominion and control, may that not perhaps be the fairest time to tax me or to measure my obligation to pay tax?<sup>212</sup>

So, one form of response to the fairness and “discrimination” argument against an accretion-type income tax is that the argument seems circular. If the criterion for taxation of equal taxpayers equally is

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Maybe this only pushes the question for an income tax back one step. Maybe the tax policy question for an income tax becomes do we want to tax ourselves when we receive (and save) income or only when we spend (consume) it? Which is the better time to tax each of us, and then on what amount are we to be taxed?

210. Picture a New England town three centuries ago, with all livestock owned by residents kept in a “commons” in the center of town.

211. Professor Dyer says the ethical maxim of the consumption tax is a tax on “selfishness.” See Dyer, *supra* note 209, at 459. Professor Warren dismisses the “common pool” as a source of fairness arguments, because it confuses deferral of consumption with altruistically refraining from taking out of a collectively owned group of resources and does not add anything to a “standard of living” standard of distributive justice. See Warren, *supra* note 10, at 1094-95; see also Fried, *supra* note 195, at 962-63.

212. The “income” at that time equals the right to consume the value, say \$100 (or \$75 after a 25% tax), at once. And it equals the present value of the ability to defer present consumption, save the \$100 (or \$75 after a 25% tax), earn \$10 (or \$7.50 after tax) at 10% interest over the next year, receive \$110 (or \$82.50) at year end, pay tax on the \$10 (or \$7.50) at 25%, and consume the \$107.50 (or \$75 + \$5.625 or \$80.625) a year later. That is, \$75 at Time 1 is the present value of \$80.625 a year later, in a world with a 25% income tax and a 10% secure interest rate. I can consume or save, depending on my individual preference for \$75 now or \$80.625 a year later.

“consumption” or “equality of consumption” or “time-value of consumption,” then an income tax that includes the yield on savings can be said to treat high-level consumers, who spend most of their income as soon as it is earned, differently from equal-income high-level savers, who spend more later in life, and hence to “discriminate” against the savers. But the conclusory label of “discrimination” depends on adoption of consumption as the fairness standard. The conclusion simply depends on the predicate.

The fairness argument against accretion-type income taxation should stand independent of a prior presupposition that consumption is the fairer tax base.<sup>213</sup> So far, it hasn’t done so.

The argument in favor of the income tax can be asserted in a parallel way. That is, one can assert that income rather than consumption simply is the better gauge for determining the fair distribution of tax burdens, and not measured in present-value terms. Hence one argues that the \$100-income taxpayers mentioned above, one of whom saves for ten years and the other of whom spends at once, are not in the end equal taxpayers and should not bear equal tax burdens (even in present-value terms). The saver will have more income (command over more resources) and should pay more aggregate tax. He should pay 33% on the \$100 earned in the base year as well as 33% on the interest earned each year for ten years, because his income consisted of those amounts and at those times. His behavior and income gave him choices (to consume or save more, to work while still anticipating [and worrying less about] the means to support himself during

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213. See Warren, *supra* note 51, at 935. Again, suppose we compare two taxpayers each of whom earns \$100 in a base year, but who have different preferences for present and future consumption. At 10% compound interest, using Table Two, *supra* Part I.E.6, one who saves all \$100 in a no-tax world will have \$259.37 to consume in year 10. So, \$100 foregone consumption in the base year is the cost or present value of \$259.37 consumption ten years later, in a world without tax. Imposing any of the consumption-type taxes in Rows 2, 3, or 4 will preserve that ratio, but the numbers will change (to \$67 at the present cost value of \$173.78 consumption later, a 2.59:1 ratio). In contrast, if an accretion-type income tax is in effect, \$67 will be the present cost or value of \$128.15 consumption ten years later, a 1.91:1 ratio. One can say that the taxpayer with a preference for later consumption is taxed “more heavily” than the other taxpayer or in a different proportion or ratio than under a consumption tax or a no-tax regime.

One further counterpoint is that the savings of the taxpayer preferring later consumption can be said to bring imputed consumption (or “expenditures”) in the form of security, social prestige, power, credit-worthiness and leisure. Because of these, a consumption tax discriminates in favor of that imputed form of consumption (or “expenditure”). See *id.* at 936 n.27. This implies that an income tax would not discriminate in that way.

If the financial yield on savings is accompanied by imputed income, in the form of security, social prestige, a relaxed state of mind, or other such things, then even if that imputed income is not separately measured and taxed, it is appropriate for the income tax to include the financial yield, perhaps as a proxy for (or measure of) the other income. If income is chosen as the appropriate measure of tax-paying obligations, an income tax appears to be the appropriate, non-discriminatory, and fair tax base to use. Of course, this is circular in the same way the consumption tax advocate’s criticism of income taxation can be said to be circular; from the premise of equal taxation of income as the equity standard, an income tax is fair, and fairer than a consumption tax (which discriminates in favor of later income earners, for example, those who consume soon after earning the necessary funds).

retirement, beginning in year 10, and to take pride in his thrifty lifestyle). Security, tranquillity, good credit, independence, maybe prestige, all can be associated with accumulation. The interest or financial yield is the taxable manifestation of these benefits and does add to the potential consumption, enjoyment, saving or gift-giving power each year. (Moreover, if income is viewed at least in part as "product," the saver is responsible for more of that product and should and can bear more tax.)<sup>214</sup>

So it is sometimes conceded that the income tax changes the relative positions of the two taxpayers.<sup>215</sup> But again there arises the question, what is the significance of the stipulated "no-tax world" ratio? Why is it "unfair" (or "discriminatory") to disturb the relationship between spenders and savers that supposedly would exist in a world without tax? Why is an income tax inferior to a consumption tax if it does that? To be sure, the income tax alters the relationship between the saver and spender relative to the no-tax world, by taxing the interest or yield to the saver and hence altering the base-year, present-value or cost of the saver's life-long consumption compared to that which would exist if there were no tax (and an identical interest or discount rate). But it does not alter the consumer's present value or cost.

Yet there is nothing absolutely necessary or compelling about the present-value analysis, using as a base year the year the two taxpayers each

214. See Warren, *supra* note 10, at 1090-93; see also *infra* note 258.

215. This need not be called a "double tax" on income saved, à la John Stuart Mill. See MILL, *supra* note 11, bk. V, ch. II., § 3. A simplistic answer to Mill's argument was always to say that the interest or other financial yield on the saved income was more "income" or new "income," a tax on which did not constitute a second tax on the original (saved) earnings. But, of course, this is largely terminological and does not (explicitly, at least) contemplate the time value of money. Professor Warren refers to (but dismisses) the traditional counter argument that an income tax is discriminatory, only (and circularly) if the viewer presupposes a consumption standard of fairness. See Warren, *supra* note 51, at 936; see also Strnad, *supra* note 191, at 1033 (commenting on Warren and the circularity problem, on ex ante and ex post perspectives, and on the weaknesses of transactional analysis). Warren dismisses it as not persuasive because the income tax does differentiate among taxpayers compared to their relationship in a no-tax world, as shown above, whereas a consumption tax does not. See Warren, *supra* note 51, at 936.

But what makes that test or effect determinative? If, for example, in the income-tax world a sufficiently higher rate of interest is paid (because of the tax) by borrowers who have to offer more to cause potential lenders to save and lend rather than consume (capital being in shorter supply because of the income tax burden on yields from accumulation), there may be no differentiation or discrimination between taxpayers receiving income even relative to the no-tax world, as Warren acknowledges. If the pure interest rate in the tax world had been 10%, and a 33% income tax came along, interest rates might rise to 15% so that a lender would still net \$10 out of \$15 interest received and \$5 tax paid or withheld. So a saver-taxpayer who earned \$100 in the base year, paid tax of \$33, and earned \$10 after-tax interest (15% before tax) compounded for 10 years would still have \$173.78 to consume in year 10, equal to about 191.27% of the \$67 consuming ability he had in the base year. A spender in a 33% consumption tax world where 10% was the "pure" rate of interest could spend \$67 in the base year (after paying consumption tax of \$33 on his \$100 earnings) or \$173.78 after year 10, exactly the same ratio as that facing the income-taxed earner in the 15% interest world, because of the interest rate differential. If an income tax caused the pure and pre-tax interest rate to rise higher, and reach equilibrium, the so-called discrimination would be eliminated or reduced.

earn \$100 wages, and then comparing the present values of the immediate consumption by one of them with the present value of deferred but nominally greater consumption by the other saver (the investor). Earning or receiving the income is the time when the taxpayer has effective choice and control over the increased economic resources. The income tax then does not unfairly "discriminate" at all between consumers and savers, if the reference point is not base Year 1 but the year of earning or receipt.<sup>216</sup>

Earlier earning would seem to give a taxpayer such as the youthful basketball star more choices (in some sense) than the late-earning concert pianist, or more security. If he is taxed when he earns his income during his youth, he will pay tax having a greater present value to the government (and present cost to him) than the equal nominal tax revenues collected later from the concert pianist. So in time-value of money terms, he (appropriately) will have paid "more" in taxes (measured in present value terms) on the same lifetime income.<sup>217</sup>

One way of formulating much the same issue is to ask for argumentation as to why the tax burdens of two taxpayers such as the (early earning) basketball pro and the (later earning) concert pianist should be geared to

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216. So the argument for the consumption tax reduces to an assertion that time of consumption rather than time of earning is the correct index point, and that the time of consumption, rather than of income, is what should be evaluated and reduced to present value terms.

Perhaps the unstated proposition is that income only produces one kind of satisfaction, that which we call "consumption" or spending, and that it necessarily follows that consumption, measured in time value terms, is therefore the only or the best way of viewing taxpayer obligation or capacity and utility. See FISHER & FISHER, *supra* note 10, at 3-17; FISHER, *supra* note 10, at 249-53; IRVING FISHER, *THE INCOME CONCEPT IN THE LIGHT OF EXPERIENCE* 12-13 (1927). Arguably, however, possession or receipt of income, combined with "dominion and control," provides satisfaction itself, and comprehends or includes (or incorporates) the consumption power, along with the savings/investment power and the security or prestige or other satisfactions that come with wealth. See *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). Are "satisfactions" from spending income (or in life's market transactions generally) the only measure of tax burden fairness? Of course, the actual U.S. income tax fails to cover much unrealized, imputed or non-market income, compared to a theoretically ideal, Haig-Simons accretion-type income tax.

Even if so, that does not require that "present value" or present cost be the way to approach the relation of satisfactions to tax burdens. If each taxpayer actually earns and spends (assuming no bequests, gifts, or other such transfers for the moment) \$100x during his lifetime, but the present value of each income or consumption stream would not be identical in present value measured at birth, it would seem to be fair to tax each on a base of \$100x, when earned or received, if under a flat-rate, no-exception, annual tax each would thus pay the same (Y)% of the \$100x income, promptly on receipt.

217. The late-blooming pianist, who eventually gets \$100x income, but later in life, will pay the same (Y)% in income tax, but later, so she will have paid "less" in time-value terms. Although they almost certainly didn't know it at the time, they had different time-value lifetime incomes ahead of them, with different present values, at birth. It would seem fair that their tax burdens correlate with their incomes in temporal terms, rather than with their consumption patterns. To be sure, if lifetime consumption tends to be relatively flat (over youth, middle age and old age) and incomes tend to be bunched (in middle-age working years, and somewhat during retirement, from savings) a graduated-rate income tax system will strike differently from a similarly rated consumption tax. But that is a different point, and it can be ameliorated in a real-world income tax.

expectations rather than outcomes.<sup>218</sup> Most dramatically this question applies to “winners and losers” in a yield-exemption consumption tax world (which treats equal expectations alike regardless of differences in outcome) compared to those in a cash-flow income tax (consumption tax) world (which taxes the two differently, according to outcomes and actual resources available for consumption). The question also bears on a consumption tax that applies to expectations and determines them to be equal only if they are equal in terms of consumption as measured by present value, rather than as measured by total income, whenever received, and whether saved or consumed. Whether earned early in life and largely consumed then or earned largely later in life (youth and early middle age consumption having been funded by borrowing), equal incomes are equal when received.<sup>219</sup>

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218. See Warren, *supra* note 10, at 1098. He mentions that John Rawls asserts that individuals in the “marginal position” would have no time preference.

It is unconvincing to carry over the Fisherian argument from an *ex ante* to an *ex post* perspective. The income tax is not unfair *ex post*, when outcomes are known, even if it can be said that the consumption tax is fairer *ex ante* because it does not discriminate against taxpayers with a preference for consumption in the future. Warren concludes that this is true even if investment return is certain. In a more realistic world, with risky investments and possible taxpayer behavior taken into account, an *ex ante* approach seems even less “correct” or fair. The imagined equality of treatment by a consumption tax of savers and spenders is dependent on an *ex ante* perspective, one that ignores real and relevant differences (such as real risks, actual returns, and taxpayer differences) between taxpayers in “real life” or in any realistic tax system, particularly one using graduated rates and uncertain investment returns. *See id.* at 1108.

Perhaps, Warren suggests, an income tax that exempted only the riskless return on investments would respond to the arguments of the consumption tax advocates. *See id.* at 1107. Some such advocates seemingly have proceeded as if the entire rate of return to capital is merely compensation for postponing immediate consumption of past wages. *See, e.g.,* BLUEPRINTS, 1977, *supra* note 6, at 136. Warren suggests if such “compensation” is to be exempted, as for psychic detriments, it would seem that a similar argument would be to exempt wages, because they are compensation for the unpleasantness and foregone leisure of working. *See* Warren, *supra* note 10, at 1107.

The riskless rate of return seems to be only part of the general return to capital, and a very, very small part at that. *See infra* note 221. So, exempting it by some statistical formula would not change the income tax very much. And the argument hardly supports excluding all returns to capital.

Warren criticizes the “endowments” or “capacity” approach of the attack on income taxation, and explains that the life-cycle analysis builds on the same Fisherian analysis of capital and the insistence on an “expectations” (*ex ante*) rather than an “outcomes” (*ex post*) perspective, whether one considers certain or uncertain investment return.

(The value of present consumption may be virtually incommensurable with that of future consumption, or the value of consumption and the value of saving may be incomparable, in the ways the consumption-tax advocates would ask us to compare them.)

Finally, as Warren says, an *ex ante* view of “Fisherian capital theory,” while fitting for economic analysis in general, is inapt for interpersonal measurement of tax equity, which should be measured using an *ex post* perspective. *See* Warren, *supra* note 10, at 1121. Discounting future consumption to present value is not helpful in comparing the fairness of an income tax with that of a consumption tax. *See id.*

219. If the pianist has to use later income to pay back loans with interest that she incurred to fund her early life support or higher education, that is a cost not borne by the athlete. (It will not be deductible now, unless on a home equity loan.) He will have a return on his savings for later-life

### 1. *The Use of a Tax-Free Frame of Reference*

The consumption tax advocates' argument is that it is unjust for any tax to discriminate between the current consumer of \$100 earned now and the counterpart who earns \$100 now but saves it for a year to consume \$110 a year hence. A consumption tax or consumption-type income tax imposed on both taxpayers when they each earned \$100 would not differentiate between the two, and so it is said to be fairer than an income tax that would tax the yield (at, say, 33%) and leave only \$106.70 for consumption a year later. It is said that any tax that differentiates between the two is unfair, whether it imposes a greater tax burden on the saver, as an income tax would do, or whether it imposes a lower tax burden on the saver. The present value relationship that would exist in a world with no tax, represented by the 10% interest rate, is taken as the reference point to constitute a relationship that it is "discriminatory" or "unfair" for a tax system to disturb.

Granted, in a 10% risk-free<sup>220</sup> yield world the choice would be between \$100 now and \$110 a year later. But arguably that does not matter. Contemporary taxpayers live in a world with tax, an accretion-type income tax. Admittedly the tax affects the ratio of the values of present and future consumption. In a no-tax world, \$110 is 110% of \$100, whereas in the 33% income tax world, \$106.70 is only 106.7% of \$100, so, at the margin, a person might be led to choose \$100 of consumption now over just \$106.70 a year later. Or, using entirely after-tax numbers, in the 33% income tax world, the taxpayer who earns \$100 taxable income in Year 1 can either spend \$67 after tax or save the \$67, earning 10% yield, itself taxable at 33%, and have only \$71.489 ( $\$67 + \$4.489$ ) to spend one year later, not \$73.70. Does that make the income tax "unfair" or "discriminatory"? Or just something that may discourage deferral of consumption?

Fundamentally, what is the significance of the "no-tax world" ratio? Why is it unfair to disturb the relationship between the choices facing spenders and savers that supposedly would exist in a world without tax? Why is an income tax inferior to a consumption tax solely because it does that?<sup>221</sup> If the world a taxpayer is born into is an income tax world, that is

consumption that the pianist will not receive. He should be taxable in his investment yield as income since he does not have to bear the cost paid by the pianist and has the yield for consumption to boot.

220. Interest can consist of compensation for risk or inflation as well as compensation for deferral, or lack of use of the funds. *See infra* text accompanying notes 234-237.

221. Suppose there were no interest available in the tax-free world. This evidently would mean that all taxpayers had no preference for saving or investment to fund future consumption or for borrowing to consume out of income anticipated later. If an income tax were introduced, and interest rates still remained zero, the relative ratio of the consumption power of consumers and savers would not be disturbed at all. If the interest rate became 0.001%, the relationship would be disturbed but it would not seem to matter much. There is some evidence that the inflation-free and risk-free rate of return, namely the amount paid for "deferral" is very, very, low. *See* Joseph Bankman & Thomas



the world he faces. If the prevailing pre-tax interest rate is, say, 10%, that is simply the world he faces. The taxpayer may save a little to ensure he will not starve in old age, even though a 33% income tax reduces the after-tax yield from (say) 10% to 6.7%. At the margin, he will have to choose between \$67 of consumption now or \$71.49 later, as a matter of sheer preference.<sup>222</sup>

Why, then, does the difference between treatment of taxpayers when compared to a no-tax world make the income tax unfair or less desirable? This is so only if one assumes that interest rates do not adjust to compensate for this difference, and if one accepts that the relationships between present values or costs of immediate or deferred consumption are optimal and form the only or best standard against which post-tax relationships are to be judged.<sup>223</sup>

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Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?*, 47 TAX L. REV. 377 (1992); Warren, *supra* note 51.

222. The taxpayer can even save the money under the mattress at zero percent interest, pay no tax, and have the same \$67 to spend in ten years. But he or she will have consumed later, rather than earlier, because of a taste or preference or a need to do so.

223. The distinctive nature of the capital market for dollars is the key to this argument. Other people will pay to "rent" one's money, deferred consumption, in order to fund their consumption when their income does not suffice, or to reinvest the borrowed funds in productive assets (or financial assets) that will yield a higher rate of return than the interest costs amount to. Perhaps one can imagine a capital market in bagels, too; if *A* has more than he needs, he can lend them to *B*, who will pay back more bagels later, that is, bagels indistinguishable from the borrowed ones, with interest, and so the lender will be better off. But the example of receipt and consumption of a bagel (or European trip) offers only choices between consumption of a bagel now compared to consumption of a bagel later. *See infra* note 250.

In fact, the time-value of cash may have more to do with risk and inflation than mere passage of time. *See, e.g.,* Noël Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17, 23 (1996).

A few scholars have wrestled with the time preference issue as bearing on fairness of a tax, as a potential criticism of income taxation and an argument in favor of consumption taxation. The discussion has sometimes focused on the rate of return in a no-tax world or a consumption tax world compared to the after-tax rate of return in an income tax world. *See* Mark Kelman, *Time Preferences and Tax Equity*, 35 STAN. L. REV. 649 (1983); Warren, *supra* note 10; BLUEPRINTS, 1977, *supra* note 6; Andrews, *supra* note 7.

Kelman's analysis, in particular, is very thorough. He explores some uncertain theories (about the productivity of capital, individual variations in time preferences and reasons for saving, life-cycle savings and consumption hypotheses, and so forth) and finds that the final implications for the consumption tax versus income tax debate may be themselves contingent. To simplify them, Kelman asserts that if all savers were really consumers who had to be paid to defer their consumption, then a consumption tax would appear to be fairer than an income tax. This seems to be the view implicit in the simplified "fairness" and "discrimination against savers" arguments made against income taxation. The gross interest they earn leaves them with the same value of consumption because of this time delay. But if, or to the extent that, savers save for other reasons, an income tax might be fairer. And finally, he concludes, if savers are rentiers, earning a rate of return that is independent of time preference, then their yield gives them command over more resources, or the same resources with less labor, and it would be unfair to exempt interest from taxation. *See* Kelman, *supra* at 679-80.

Evidence that the pure rate of interest charged and paid in the United States over the last sixty years has been very, very low (as low as 0.5%) or nearly zero, tends to support this last view empirically. *See text infra* at note 231. Moreover, it corresponds with an intuition about the bulk of

## 2. Temporal Choices and Present Valuation

The present value of income received in the future to fund later consumption is lower than that of income received in the present and used for immediate consumption.<sup>224</sup> The burden of a deferred tax on income amounts to less than that of an immediate tax (at the same rate) on income, and a consumption-type tax either defers both payment of the tax and determination of the taxable amount until actual consumption (as with a retail sales tax), or imposes no tax on the yield from saving and investing income (deferred consumption). Moreover, the lower burden of that deferred tax is said to be “correct” because in the end it imposes a more uniform burden (in time-value-of-money terms) on consumption, whenever it occurs, than does an accretion-type income tax, which is said to place an excessive burden on deferred consumption.<sup>225</sup>

The same neutrality, vis-à-vis consumption of a consumption-type tax, means that the tax does not fall more heavily on one taxpayer or another solely because of inter-temporal differences in need or taste for goods or services, now or later. This is put forward as a great virtue.<sup>226</sup>

saving, done for retirement security or to level one’s lifetime consumption or “for profit,” that strongly suggests it is fairer to tax interest income under an accretion income tax than to exempt it (or the equivalent) under a consumed-income or other consumption-type tax.

224. “Present value” refers to the value at time  $X$  (the “present”) of a specific amount of income, consumption, or obligation at time  $Y$  (in the future). That is, the present value (in Year 0) of \$100 earned in Year 10 to fund \$100 of consumption in Year 10 amounts to \$100 multiplied by a discount rate, presumably equal to the interest rate. The present value of \$100 in 10 years is about \$38.55, if the discount rate is 10%. It could be said that this low amount is the present cost of consumption deferred until year 10 whereas, of course, the present cost of \$100 of immediate consumption is \$100. So the future consumption seems to have a lower present value or cost. Later in this Essay further analysis of this proposition will be offered.

To spell it out, a taxpayer must earn \$100 in Year 0 to fund \$100 of consumption that year in a no-tax world. To fund \$100 of consumption in Year 10, it is sufficient to earn \$38.55 now in a no-tax world, if that income is saved, invested at 10% interest and grows to \$100 in Year 10. A consumption tax of 33% would reduce \$100 earned now to \$67 available for consumption now, and would reduce \$38.55 earned now to \$25.82, but if that \$25.82 is invested at 10% tax free, it will grow to about \$67 (\$68.97) in ten years when it will fund \$67 worth of consumption, equal to that consumption possible at the time the income was earned.

An income tax would operate differently. If \$38.55 were earned in Year 1, a 33% income tax would reduce that to \$25.82, which if invested at 10% taxable income yield would not grow to a \$67 balance in 10 years, because of the 33% tax on the interest yield each year. At 6.7% after-tax yield, \$25.82 would grow to only about \$50.00 in 10 years (actually \$49.39).

225. See discussion *supra* notes 175-179.

226. As an example, suppose a wage earner saves \$1000 for retirement. At 10% compound interest, it will grow to \$2,000 in about 7.2 years. If no tax were imposed until then, when the worker withdrew the funds to spend, a 33% consumption tax would take \$660, leaving \$1,340 to spend. In contrast, an accretion-type income tax would impose a 33% burden at the outset, reducing the amount that could be saved to \$670. The annual yield would also be taxed, so the after-tax compound interest rate would be only 6.7%. At that rate, in 7.2 years the fund would grow to only about \$1,054, or about 83% of what would be available to consume under a consumption-type income tax (\$1,340). (No further tax would apply on final withdrawal and expenditure.)

This example shows, or suggests again, that each taxpayer had an equivalent consumption power in Year 1: namely \$1,000 in a no-tax world, or \$670 in a 33% tax world (whether consumption or

Consumption tax advocates argue that a consumption or expenditure tax is more fair or rational because it treats equally two persons of equal income received at the same time regardless of when they choose to spend it on consumption. They argue that because the amount (and the present value) of income, and of an income tax, is increased if consumption is postponed,<sup>227</sup> and the funds are invested profitably, the income tax is unfair or discriminatory.

One way of concretizing this claim is to imagine again two equal wage earners in Years 1 and 2, one of whom consumes all his wages (for example, \$100) when received at the outset of Year 1, and the other who saves all his Year 1 income and consumes it at the outset of Year 2, along with the year's earnings (for example, \$10), for a total of \$110. The view is that the present value of the consumption of both is the same (\$100), but the present value of the saver's income (\$110) (and income tax) will be greater than that of the consumer's (\$100).

But it seems valid to argue that if the cumulative amount and present value<sup>228</sup> of the saver's income are greater than the cumulative amount and present value of the consumer's income, and if ability or obligation to pay tax is measured by gain, command over resources, or power to consume, it seems entirely fair to tax (as income) the enhanced power to consume more heavily than the lesser income and power. Even if the yield be partly or wholly compensation for the pain of deferring consumption, psychic deprivation, risk or some other cost or loss borne by the taxpayer, taxing the added income resembles the accepted practice of taxing the person more if he had worked longer hours, sacrificed leisure, or endured more fatigue to

income tax). One deferred his consumption and the world says it will rent his money for 10%; he decides that \$2,000 pre-tax consumption in year 7.2 (or \$1,340 after-tax consumption) is worth giving up \$1,000 (pre-tax) (or \$670 after-tax) consumption today. But the income tax takes more away: he can't consume as much measured in "present-value terms" as the person who spent all his income in Year 1. He can consume only \$1,034 in Year 7.2 compared to \$1,340: only 83% of the amount a consumption tax would allow him to consume out of savings in Year 7.2.

The logic of a consumption-type tax is that a 33% taxpayer who would have \$2,000 to spend in the absence of tax should have \$1,340 (not just \$1,034) available after tax, whatever combination of earnings and savings went into producing the \$2,000. Arguably, an accretion-type tax is "discriminatory" because it leaves much less for someone like a retiree whose potential \$2,000 pension or interest is the result of work and investment than for another taxpayer with \$2,000 of current wage income. John Stuart Mill called this discrimination a "double tax" on savings. *See* MILL, *supra* note 11, bk. V, Ch. II, § 4, 813-15. *Cf.* Bradford, *supra* note 100, at 102-09; Warren, *supra* note 10, at 1099-1100. It may well be, however, that the interest rate incorporates the tax disadvantage of an accretion-type income tax, removing much or all of its unfairness.

227. Again, "present value" refers to the value at time *X* (the "present") of a specific amount of income, consumption, or obligation at time *Y* (in the future). *See supra* note 224.

228. *See* Goode, *supra* note 104, at 55. As Goode says, an income tax curtails all opportunities for obtaining consumption power, whether by work or investment. This does not constitute a "double taxation of saving," nor an unfair treatment of persons because of when they choose to consume, or unjustified favoritism for those who consume early. *See id.* The saver pays more tax than the consumer not merely because he postpones consumption, but because he is compensated for doing so and obtains interest income, which enhances his power to consume.

generate more labor income during the year. It does not seem attractive to say that the rewards of work should be taxed but not the return from capital that has been saved and invested. It does not seem sufficient to say that the saver does not have more income or consumption power than the immediate consumer merely because his future consumption of \$110 has a present value equal to \$100, the amount consumed by the spendthrift, simply because it is true that \$100 invested can yield \$110 a year later, or even because someone would pay only \$100 now in cash to purchase a receipt of \$110 a year later in a 10% interest or discount world. Yet that seems to be the heart of the fairness criticism of the income tax by consumption tax advocates.<sup>229</sup>

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229. A rational utility-maximizing person who was planning to spend \$100 on consumption a year hence, and who lived under a 33% consumption tax regime, naturally would rather not pay the \$33 in tax now, but rather prefer to pay it a year hence. This is because the \$33 cash to be paid in tax presumably has an investment value, and if he can defer paying the tax of \$33 for a year, he can earn perhaps 10% and have an extra \$3.30 left over to consume or save. This is true merely because his cash has a "time-value" in a positive interest rate world. If he had to pay the consumption tax now, a year in advance of the spending and consuming, he would argue that to be "fair," he should have to pay only the present value of \$33 a year hence, or about \$30, at least if all immediate consumers would have to pay \$33 now if they consumed \$100 now.

But this is not the same as saying that the value of the future consumption itself is lower at a point in time that is a year in advance. If he defers his consumption, saves his \$100 now and has \$110 before tax at the end of the year to spend, he then has more consumption power to exercise than he does now, and it would seem appropriate to apply the 33% tax to a base of \$110, not just \$100 (the present value of \$110 a year later).

So, an income tax computed and paid when income is earned is "fair" and true to its principles. A consumption tax computed on a base when consumption is engaged in is fair and true to its principles. Advance or deferred collection of either one, if done uniformly for all taxpayers, merely increases or reduces the effective rate of tax above or below the nominal amount. Only a discriminatory requirement of advance payment from some taxpayers but not all would be "unfair."

Now the question becomes, if a tax is collected on income when it accretes even though that time is a year before the income will be consumed, is that itself "unfair"? Does it irrationally or wrongfully discriminate between the taxpayer who earns the \$100 now and saves it for a year at 10% interest and another taxpayer who earns the \$110 next year, the day before both taxpayers want to engage in equal consumption?

The answer seems to be "no," even if the first taxpayer has to pay more tax by virtue of the fact that his income base consists of more than the base of the second taxpayer (because it includes a tax on the yield from his saving). He is "better off" because he earned his income earlier, better off by the market yield he has received. Is he correspondingly worse off because he did not get to consume his income until a year after it was earned, so he experienced "deferred consumption," not immediate consumption? It would not appear so, unless deferral is painful, a disutility, in which event he could have chosen to consume earlier as well. (His own time preference or need for deferral of consumption is what caused the gap between time of earning and time of spending.)

Even if his saving seems to be excessive or irrational or the consequence of a neurotic compulsion stemming from childhood abuse, the fact is that he ends up having a greater spending power and benefits than the second taxpayer. Or, to put it another way, he has the same nominal spending power but it begins at an earlier time. That is advantageous because of the time-value of money. So, it is fair to make him pay more tax, if he does choose to use the earlier receipt to his advantage by saving or investing it at a positive rate yield.

Consumption itself doesn't seem to have a "time-value" that is the same as that for income. Even if one considers (or hypothesizes) a taxpayer so situated that he has no time preference for present over future consumption, time-value of money considerations do not disappear. The cost of financing \$100

The advocates for consumption taxation over income taxation assert the greater fairness (and neutrality) of a tax that applies when a person consumes (his income) rather than when he earns or receives income that will fund present or future consumption. But this argument in a way depends on its own premise, that is, the assertion that the time of receiving income (which contributes to the ability or capacity to consume)<sup>230</sup> is not the appropriate point of reference and that the time of consumption is the better reference point.

There may be arguments in favor of this predicate but one may assert the contrary, and argue it, as well. Perhaps the time a taxpayer earns or receives economic resources and becomes able to consume or save or donate (or waste) them as he chooses is the better reference point. At this point of production or receipt, society may properly assert its prior claim, prior to that of the individual recipient. Economic power, the choices it offers, and the benefits it provides perhaps do not consist solely of explicit

of consumption a year hence (in a 10% interest world) is less than the financial cost of \$100 worth of consumption today. If no tax is present, the saver can earn \$90.90 at the beginning of this year, save it, and expect to have a balance of about \$100 available to fund consumption a year later, or he can change his mind and buy \$90.90 worth of consumption today.

If there is a retail sales tax of 33%, payable at time of consumption, he can get \$67 worth of consumption now if he spends all the \$100 of his current income immediately or he can save the \$100, have \$110 a year hence, and obtain \$73.70 worth of consumption then by spending the entire \$110 on taxed goods. If he just wanted to be able to get \$67 worth of consumption a year hence, to match the \$67 worth he could get at the outset, he could save less than the full \$100, namely he could save \$90.90 which would grow to \$100 in a year and would buy goods priced at \$100 including the \$33 tax for a resulting \$67 worth of consumption. (Actually, these figures make the tax rate in some sense a 49% rate—\$33 on \$67 price [free of tax].)

In a 33% income tax world, he can earn \$100, pay tax of \$33, and buy \$67 consumption value at the outset. Or, he can save enough to buy equal consumption a year hence.

This could imply saving his \$67 (after paying 33% income tax on \$100 income), earning 10% yield, for a balance of 73.70 before tax on the yield, paying \$2.21 tax on the \$6.70 yield, and having \$71.49 to spend a year later. Or, if the saver wants only to save enough to fund \$67 consumption a year later, he could save (about) \$63, which would (at 10%) grow to \$69.30 with \$2.079 subtracted to pay income tax on the yield when received, namely \$6.30, leaving \$67.22 to spend.

If the (present) cost of future consumption in either a no-tax world or a consumption tax (retail sales tax) world or in an income tax world is less than the present cost of present consumption because of the fact that the finances (cash, for example) can be re-invested as a profit even though the items to be consumed now or later (for example, bagels) could not be profitably re-invested, does that mean a consumption tax payable at time of consumption outset or one year later is fairer than an income tax payable when the income is earned (at the outset) in the case of a saver? These examples do not show that it is inherently more fair.

In the no-tax, 10% interest world, the potential choice was to consume \$100 now or \$110 after one year, a 10:11 ratio. In the 33% consumption tax world, the choice was between \$67 worth now and \$73.70 later, a 10:11 ratio. In the income tax world, the choice was between \$67 now or \$71.49 later, a 10:10.67 ratio. But the fact that the income tax world ratio varies from the other two has not been shown to mean that it is "unfair" or "discriminatory." It may discourage saving, but that is only an efficiency or welfare point, not a fairness point. Substitution of a consumption tax would raise the after-tax rate of return on saving and investment compared to the rate of return that would be available in a world with an income tax. See Kelman, *supra* note 223, at 650.

230. See Gregory F. Jenner & Matthew P. Larvick, *A Tax Reform Primer*, in *COMPREHENSIVE ANALYSIS*, *supra* note 64, at 1, 2.

“consumption”; and the fairness comparison of “equals” may tend to beg the question.<sup>231</sup>

### 3. *Interest, Renting Money and Yield*

In a world without tax, borrowers with different resources, needs, time preferences (for consumption) and productive capacities will negotiate with borrowers or lenders to “rent” their money at some interest rate. This capital market will presumably reach an equilibrium and a positive interest rate that is determined by the time preferences, at the margin, of the various actors. Suppose that rate would be 10%, compounded annually. If an income tax distorts that rate, because the interest is taxable (and maybe not always deductible by borrowers, or is deductible at different tax rates, and so forth), then the tax may be said to have interfered with an efficient market solution. Perhaps now the rate has to be, and becomes, 12%. Less borrowing and lending (saving) will probably follow.

That distorted result will not be the efficient or optimal one, but it is not necessarily an unfair one. If the before-tax 12% rate amounts to an 8% after-tax rate for a 33 1/3% bracket lender, rather than the 10% after-tax rate we think would prevail in a world without income tax, the fact that the 8% rate differs from the 10% rate is not necessarily a fairness matter, it is an efficiency or non-neutrality issue, a distortion and a difference introduced between before and after-tax interest rates, with the probable result of less saving and investment than would be optimal. Future generations may not be as well off. But as to fairness between living taxpayers with equal initial incomes, a saver or spender can make decisions in this world about how much present consumption to defer, given the prevailing after-tax costs and rewards and his needs or preferences. An income tax that applies to the capital income of the saver is not discriminating against him in the sense of violating some horizontal equity criterion. Rather, it is constituting the world and the conditions he faces.<sup>232</sup>

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231. Suppose each of two taxpayers wants to spend about \$100 this year, the young one having just earned it, the other (older) having earned \$100 about three years ago, paid \$25 income tax, and having saved and invested the balance (\$75) and earned about \$25 in interest during the ensuing period of saving. Is it irrefutable that neither should be taxed until the present year when each spends \$100 and then be taxed equally (at, say 25%)? Perhaps it would be entirely appropriate to have taxed the older (now retired) taxpayer at 25% on the \$100 when he earned it, reducing his ability to save by \$25 to \$75, and to let him choose whether to save or spend the \$75.

If he saves it and earns \$25 interest (over about 3 years, at 10%) in order to spend now, would it also be acceptable to tax him on his earning of the interest (because he had the increased economic power and ability to spend or save) so that he has less to spend this year (\$93.17—\$24 interest less about \$6 in tax, or \$18 plus his \$75 after-tax principal) than the youngster who earned \$100 this year, was taxed at 25% on earning it, and can consume \$75 after tax? Or should his return on capital be exempt from tax for the tax to be really fair? (If the yield is taxable, he would have to wait four years or more to have \$100 clear to spend.)

232. It is not as though he is entitled to an after-tax 10% rate of return and is getting only 8% (12% less 33 1/3% rate capital income tax). He is only entitled to get what the market will give him

Actually, "interest" (investment yield on savings) can be broken down into several components important to the fairness (and efficiency) arguments against an income tax. Penetrating scholarship by tax law professors and economists, some of which will be discussed herein, goes into this breakdown, and the results undercut the fairness (and other) arguments for consumption over income taxation to a considerable degree.<sup>233</sup>

What is broadly called "interest" can consist of (at least) compensation for risk of loss or for inflation as well as compensation for deferral (lack of use of the funds). If taxpayers have an innate preference for current consumption, then they will presumably demand compensation for deferral even in the case of a risk-free loan in a non-inflationary world. If there is no investment risk and no inflation, but an inherent "disutility" from deferring consumption, interest will consist of such compensation.<sup>234</sup>

Importantly, some revealing empirical studies have shown that the real riskless rate of return in the U.S. from 1926-1989 has been very low, as low as 0.5%.<sup>235</sup> In contrast, the annual inflationary rate of return, or premium, has been about 3.1%. The annual risk premium for an investment in, for example, Standard and Poor's composite index of common stocks

after tax: 12% before tax and 8% net after tax. He can decide whether to save less and consume more presently given these facts. Of course, if he is an individual who is psychologically or situationally predisposed to save, he is less well off than he would be in the no-tax, 10% interest world. Borrowers are worse off too, having to pay 12% interest, unless deductibility at 33% means an after-tax cost of 8%, in which event they might think that they are better off. In any event, tax revenues have been generated and presumably are being used in the world with tax to fund public benefits, or to redistribute income and wealth or otherwise, and possibly both lenders and savers are benefiting from the government's programs. The burdens of taxation, Joe Pechman often emphasized, should be evaluated in light of the incidence of benefits that result. Maybe (rich?) savers are, net of everything, made worse-off and (poor?) borrowers are made better-off, or vice-versa. This is the result of raising revenues by some tax or other and using the revenues for this or that purpose. While a consumption tax that funded these government benefits might affect different taxpayers (spenders and savers) differently from an income tax, the difference does not, by itself, make one tax fair and the other unfair or discriminatory.

233. Also implicated are issues of who would be most hurt or benefited by a switch to a consumption tax, the distributional aspects, which arouse fairness concerns of their own.

234. Neither an ideal consumption nor income tax should apply to the return attributable to inflation. See Bankman & Griffith, *supra* note 221, at 391; Fried, *supra* note 195. That desirable result is almost automatically the case for a consumption tax. However, the Federal Income Tax in the United States lacks the features necessary to accomplish this, such as indexing of basis, debt, and interest. See Bankman & Fried, *supra* note 184, at 541. As a consequence, our income tax may create an undue burden on savers. See Alvin C. Warren, Jr., *How Much Capital Income Taxed Under an Income Tax Is Exempt Under a Cash Flow Tax*, 52 TAX L. REV. 1, 13 (1996) (concluding that if the difference between the cash-flow and accretion-type taxes is whether the latter taxes the riskless rate of return on capital and the former does not, then the fairness, distributional, and related consequences of shifting to cash-flow taxation could be much less important than usually believed). However, if savers can easily make portfolio adjustments to offset the tax burden, the income tax will not hurt savers very much.

Furthermore, even if deferral does involve some disutility for taxpayers, this disutility resembles the loss of utility that comes from exerting labor effort to earn income, or other parallel situations, for which an income tax does not allow an exclusion or deduction. See Bankman & Griffith, *supra* note 221, at 383, 391; Bankman & Fried, *supra* note 184, at 541.

235. See Bankman & Griffith, *supra* note 221, at 387.

was, reportedly, 6.5%. Other studies have indicated higher real, riskless rates of return, but may be flawed or unreliable.<sup>236</sup> Bankman and Griffith have computed the percentage reduction in total future values created by a 40% income tax on a 0.5% riskless rate of return and it seems almost trivial: 2% over a 10 year investment period. They conclude that, having in mind that almost all taxes distort behavior or redistribute welfare, a tax on the very low rate of riskless interest “would not appear to raise particularly serious fairness problems or to affect behavior materially.”<sup>237</sup>

As to the risk premium, an income tax may not hurt savers very much if they can easily make portfolio adjustments that will offset the tax burden. Such adjustments seem quite feasible if the applicable income tax allows full loss offsets, employs proportional rates, appropriate carryforward and carryback allowances, and so forth, and if investors can borrow readily and can choose among more- and less-risky investments with very low transaction costs. The heart of the idea is that a saver-type investor who prefers to take on some risk of loss in return for compensation in the form of the chance of greater profits can and will increase the riskiness of his or her portfolio when faced with a new or increased income tax on gains, so as to adjust fully and to obtain the pre-tax or desired position, or terminal after-tax wealth. The (proportional) income tax, having little or no impact on riskless investments, will reduce both gains and losses (after tax) on risky investments, assuming full loss offsets. Loss deductions will diminish the economic effects of a loss, much as inclusion in the tax base will reduce the profits (after-tax). The taxing government becomes a “partner” in the investment, sharing gains (up to  $X\%$ , the tax rate) and losses (also up to  $X\%$ ). By increasing the proportion of risky components of the taxpayer’s portfolio, he can obtain a position with expected outcomes equal to those sought or obtained in a no-tax world, the same “terminal wealth,” as Bankman and Griffith call it.<sup>238</sup> After taking into account the government’s share of profits or losses, a taxpayer can obtain the same net investment (probability of high gains or big losses) as in the no-tax world.<sup>239</sup>

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236. See *id.* at 388.

237. See *id.* at 389. Some critics of the income tax assume or believe that there is a positive and significant rate of interest in a no-tax world and that an income tax that reduces that rate diminishes the welfare of savers and discriminates unfairly against savers, people with comparatively high preferences for deferred consumption. (Similarly, such taxation will, it is said, reduce savings and thus produce an inefficient and sub-optimal result.) But if the riskless rate of return in a no-tax world (or a taxable world, pre-tax) is hardly above zero, the fairness (and efficiency) argument is reduced to a very minor point, at best. In effect, there is nearly a zero rate of pure “interest” or compensation for deferral. See also Fried, *supra* note 195, at 985-86.

238. See Bankman & Griffith, *supra* note 221, at 397; see also Warren, *supra* note 234, at 7-12; Fried, *supra* note 195, at 988-91.

239. To be sure, some of these necessary conditions may not be, or in fact are not, met in a realistic world, or the world as we know it. But scholars have shown that the supposed fairness (and efficiency) burdens of an income tax may be offset by portfolio adjustment or similar behavior, to such a significant degree. They also wisely counsel that *any* tax will probably reduce the surplus of some



The mere deferral of consumption may constitute a cost or a disutility to some people (or for most people some of the time), as Irving Fisher and William Andrews and the U.S. Treasury have treated it.<sup>240</sup> But even if so and even if only a net increase in utility from savings, such as that from an infra-marginal investment, ought to be taxed, deferral may not involve a significant disutility for most or many taxpayers. In any event, it resembles the loss of utility that comes from exerting labor effort to earn income, or other parallel situations, for which an income tax does not allow an exclusion or deduction.<sup>241</sup> Moreover, the empirical evidence of the very low risk-free rate of return suggests that compensation for only the "pain" of deferral is a very small part of the picture. Further, the saver usually has chosen voluntarily to postpone consumption in return for the compensation or benefits he or she gets in return. Presumably the taxpayer thereby obtains a "gain," or "income" appropriately taxable as such.

To be sure, as Bankman and Griffith point out, if the value under a von Schanz-Haig-Simons type income tax is measured *ex ante*, in present value terms, interest income would not represent income or an "accretion to wealth" because gain at whatever is the market rate of interest would be discounted to present value at presumably the same rate of interest.<sup>242</sup> But whether that approach is preferable cannot be presupposed but must be argued, and it is not somehow inherently preferable or conclusive.<sup>243</sup>

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individuals, that government actions outside the tax-sphere, in spending or regulation, will tend to alter the well-being of some persons more than others, and that surplus (for example, from infra-marginal saving) is not often thought of as something to be protected highly in tax policy. In this connection they aptly cited Professor Shaviro's article on the *Zarin* (compulsive gambler) case, Daniel Shaviro, *The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption*, 45 *Tax L. Rev.* 215 (1990). See Bankman & Griffith, *supra* note 221, at 382 n.11.

The pre-tax rate-of-return on risky investments is not necessarily a fundamental value or condition that must be preserved (or obtained) in an income tax world, especially for someone "born into" that world and facing interest rates that probably have adjusted for the tax effect. Such adjustments are likely if, for example, full loss offsets are not provided or tax rates are graduated, and so forth. And whatever compensation is received for risk (not inflation or pure deferral) would seem appropriately to be regarded (and taxed) as income, by an income tax. It is a gain resulting from saving and undertaking risk of loss, and presumably devoting assets, possibly through an intermediary such as a bank or the stock market, to productive, income-producing purposes. It would seem that, if dividends and profit shares are "income," the risk premium in interest should also be taxable as "income."

240. See FISHER, *supra* note 10; Andrews, *supra* note 7; BLUEPRINTS, 1977, *supra* note 6, at 39-40.

241. See Bankman & Fried, *supra* note 184, at 541; Bankman & Griffith, *supra* note 221, at 383; Fried, *supra* note 195, at 970-76.

242. See Bankman & Griffith, *supra* note 221, at 383.

243. There may be other arguments made to encourage (or not discourage) saving, and scholars have thoughtfully explored "paternalistic" and "altruistic" and "efficiency" arguments, but they are not the same as the fairness arguments (and also do not seem persuasive). See *id.* at 383-86. A related approach to the fairness arguments asks who would benefit and who would suffer from a shift to a consumption tax, the perspective taken by Bankman and Fried. They also dissect investment return into its various elements and analyze how an income tax treats them differently from a consumption tax. See Bankman & Fried, *supra* note 184.

In a later analysis, Professor Alvin Warren broke down the question of "how much capital income taxed under an income tax is exempt under a cash-flow tax" into four parts.<sup>244</sup> He considered the four most feasible answers to be: (a) "all"; (b) only the normal rate of return; (c) only the riskless rate of return; or (d) "none," and the applicability of each of the four possible answers depended on assumptions about surrounding market conditions or taxpayer behavior. He concluded that a cash-flow tax exempts all capital income only if the tax savings from deducting an investment can be invested at the same rate of return as that earned by the original investment. Where that is not true, for example when infra-marginal returns (above normal returns) are involved on the original investment, but the tax saving amount is invested only to receive marginal or otherwise lower returns, it will not be true that all capital income is exempted by a cash-flow tax.

He also concluded that whether only the normal rate of return is exempt under cash-flow taxation depends on whether above-normal returns are prevalent for the particular investors in question. Some infra-marginal (higher) returns to capital may actually be returns to labor or entrepreneurship, while others may be windfalls or monopoly profits, that is, returns attributable to capital. So infra-marginal (above normal) returns to capital may be taxed by a cash-flow tax system in which new investment is deductible. But if a consumption tax uses a yield-exemption method, or "tax pre-paid method," rather than the cash flow approach, it definitely will not be true, because the exemption method exempts all income from capital, whether from marginal or infra-marginal investments.

Warren then examined whether only the riskless rate of return is taxed under an income tax and exempted by cash-flow taxation (delving into the question Bankman and Griffith had explored in their 1992 article). Warren's first two analyses had put aside risk-taking and assumed that all capital income is taxed under an income tax. Bankman and Griffith had argued that an income tax does not reduce the risk return to investment, at least if taxpayers can make costless portfolio adjustments under an income tax with full offsets, proportional and unchanging rates and without inflation.<sup>245</sup> Warren concluded that the analysis reinforces the conclusion that the taxation of the riskless return under an income tax is the key difference between it and a cash-flow tax, at least under specified conditions, and not taking into account revenue effects or taxpayer borrowing.<sup>246</sup>

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244. See Warren, *supra* note 234. As he points out, the question is central because capital costs are currently deducted or "expensed" under a cash-flow tax but capitalized and later deducted, as depreciation or basis, in an accretion-type income tax.

245. Warren refers back to a seminal article by Professors Domar and Musgrave, Evsey D. Domar and Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q.J. ECON. 388 (1944).

246. He refers to Professor Cunningham's explanation that when a taxpayer borrows at a rate in excess of the riskless rate to invest in a risky asset, it is the borrowing that is taxed under an income tax

The most important conclusion is the overall observation that if the difference between the cash-flow and accretion-type taxes is that the latter taxes the riskless rate of return on capital and the former does not, then the fairness, distributional and related consequences of shifting to cash flow taxation could be much less important than usually believed.<sup>247</sup> Similarly, the positive effects on savings and investment might well be much smaller.

At the end of this third part of his analysis, Warren pointed out that it appears to be the case that above-normal returns to capital are subject to both income and cash-flow taxes. In contrast, the riskless rate of return is subject only to the income tax and hence the return to risk-taking is not subject to either tax, assuming taxpayers make portfolio shifts of the kinds discussed. Alternatively, if the riskless rate of return is characterized as the normal (marginal) rate and all other return, including the return to risk-taking, is viewed as supra-normal, one would say that the income tax reaches all capital income, including the return to risk-taking, but a cash-flow tax covers all capital income except the riskless return. In other words, the return to risk-taking would not be subject to either tax.<sup>248</sup>

This led Warren to examine whether it could be correct to say that all capital income would be taxed under a cash-flow tax, as argued by Hall and Rabushka and supporters of the U.S.A. system. He concluded that this cannot logically be deduced, when the expensing of capital costs under the cash-flow tax is understood: it simply eliminates the taxation of capital income.

Warren concluded that the amount of income that is exempt under a cash-flow tax that is in fact taxed by an income tax depends on pivotal assumptions about investor's market opportunities and their behavior, and whether infra-marginal returns are or are not taken into account in defining "normal" rate of return, and on Treasury behavior and availability of borrowing. So each of the first three answers to his question may be correct, depending on these contingencies, but the fourth ("none") cannot be correct if one recognizes the effect of expensing investments when they are made and the resulting tax savings.

Although there is not a certain theoretical answer to the central question, it seems likely that as an empirical matter, in general, while above-normal returns are taxed by both systems, only the riskless rate of return is subject to the income tax and the return to risk-taking is subject to

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and exempted by a cash-flow tax. See Cunningham, *supra* note 223. And the Treasury might adjust its portfolio, by buying or selling risky assets. Warren refers to Professor Louis Kaplow's proof that the key difference between income and cash-flow taxation remains taxation or exemption of the riskless rate of return, even after taking into account effects on government revenues and taxpayer borrowing. See Louis Kaplow, *Taxation and Risk Taking: A General Equilibrium Perspective*, 47 NAT'L TAX J. 789 (1994); Warren, *supra* note 234, at 12.

247. See Warren, *supra* note 234, at 13.

248. See *id.* at 14.

neither tax. Given that the riskless rate of return seems to have been low over a long period in the U.S., as Bankman and Griffith reported, the actual differences between an income tax and a cash-flow expenditure tax are, vis-à-vis this issue, very, very small. And so the fairness or efficiency gains from substituting a cash-flow type tax would probably be minuscule. Even if a yield-exemption method were chosen, the evaluation probably would not change because it exempts all (riskless and risky) returns to capital and thus differs from an income tax only with respect to the very low risk-free return on capital.

#### 4. Conclusions about the Time-Value of Consumption

To summarize, my position is first that there is no demonstrated inherent preference in all individuals for early consumption rather than deferred<sup>249</sup> consumption.<sup>250</sup> To say that early consumption is worth more or is

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249. Hobbes argued that accumulated income should not be taxed because it represents consumption foregone. See HOBBS, *supra* note 11. This assertion does not stand up to further analysis: Accumulated savings are usually not wasted and do not disappear, and they can fund consumption in the future. Thus, it makes more sense to say that accumulation represents consumption deferred.

250. If anything, a normal human being probably prefers a relatively level rate of annual or daily consumption over his or her lifetime. Economists have shown that we humans act that way. Generally, as children we consume more than we earn, by the support of our parents or, perhaps, in a sense borrowing against our future income. In our career years, we tend to save more and consume less than we earn, to prepare for retirement or to pay back the "loans" that funded our childhood consumption (maybe in the form of financially assisting our parents or "paying back" in other ways, and paying social security payroll taxes and income taxes that may provide benefits to us in the future). Then in old age we again consume more than we earn, and usually dissave to do it. Our most basic appetites, subsistence food, lodging, medical care, and other such things, remain fairly constant; we consume at a relatively even level. Individuals may vary, but my suggestion is that there is no uniform, immutable preference for earlier consumption. Admittedly a young child might automatically choose the earlier consumption, a kind of natural, infantile preference for pleasure "now" compared to "later." The prudence of maturity, however, leads most adults to a more deliberate analysis with a long-term perspective.

Some legal scholars have faced up to the question of the appropriateness of present value of consumption analysis. Few have objected to it or to the use of discounting to present value when consumption or utility is the dimension being valued, rather than financial income or its equivalent. See WILLIAM KLEIN, *POLICY ANALYSIS OF THE FEDERAL INCOME TAX* 38-39, 66-67 (1976) [hereinafter *POLICY*]; William A. Klein, *Timing in Personal Taxation*, 6 J. LEGAL STUD. 461, 469-70 (1977); Warren, *supra* note 51, at 946. Klein, in his 1976 book and 1977 article, seems to accept the preferability of many for current over deferred consumption, and said that he agreed with Professor William Andrews' 1974 conclusions regarding fairness, though not as to all his reasons. See *POLICY*, *supra*, at 39-43, 61-67; Klein, *supra*, at 462 n.7. In his 1976 book, Klein argues that what is desirable is no tax on the increment to consumption that is achieved by deferral of consumption. See *POLICY*, *supra*, at 43. His argument then is not even strictly in terms of unfair discrimination against savers, but seems to rely on the same difference in favoring an expenditure tax. He questions and explores whether saving is a matter simply of deferred consumption, see *id.* at 65, and the assumption (by Andrews and others) that savers are people who would prefer current consumption but who are "induced to save by the promise of greater reward later." Overall, he is persuaded by the fairness arguments discussed, going beyond just the question of "deferred consumption."

All in all, the published work does not seem to have invalidated the use of present value of consumption for gauging fairness of income tax issues. In his 1977 *Journal of Legal Studies* article,

more valuable than later consumption can best be taken to mean that in a world of capital markets with a positive interest rate, the economic cost of early consumption is greater, and the cost of equally priced later consumption is less, because assets whose consumption is deferred can be lent or

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Klein seems to accept it and uses it to criticize the income concept, although not primarily to try to demonstrate the superiority of consumption as a tax base. See Klein *supra*. Andrews concedes that logic alone does not compel acceptance of consumption rather than income as the tax base. See Andrews, *supra* note 7. Harold Groves shows that the so-called discrimination of an income tax against saving does not prove that the income tax is less fair than a consumption tax. He criticizes J.S. Mills' and Irving Fisher's arguments on the neutrality-fairness point as stemming from their initial assumptions about whether receipts or consumption should be the focus. See HAROLD M. GROVES, TAX PHILOSOPHERS 109 (Donald Curran ed., 1974).

Klein goes on to observe that the income tax treats investments in human capital more favorably than investments in other capital. See Klein, *supra*, at 475. Invoking the concept of the second best, Klein advises caution in moving from our actual income tax world to a radically different tax base (consumption) on the basis of "beguiling generalities" or models drawn from an abstract, but not real, world. See *id.* at 481.

For example, if offered a chance for a free trip, sight-seeing in Europe, at either age 18 or age 70, which would a highly rational young person choose? Are they incommensurate? Especially if we take out risk of death, infirmity or recession by the offerer, I am not sure which I would pick or which my family or friends would prefer for themselves. If a person were offered 1,000 bagels today, 1,000 three years from now, or one-a-day for three years, and if the bagels could not be sold or lent or traded and would not grow stale, would the person automatically prefer 1,000 bagels today over the one-a-day ration? Not necessarily. She might prefer either option other than the 1,000 three years from now, if bagels are the only (or a necessary or desirable) subsistence food. But if she had lots of other bagels, or good alternative nourishment, maybe the 1,000 after three years would be very or equally attractive, assuming all bagels would be equally fresh. Thus, if offered only consumption now or later, in the form of a free trip to Europe or eating a free bagel, there doesn't seem to be a time-value of consumption in kind like the time-value of money or income. Earlier is not necessarily better, apart from risk, inflation, and the like. (To be sure, if she were offered a resource that she could turn into dollars for investment or into productive property, the reasoning would be different. If she received 1,000 bagels today, ate one or two, and could sell the rest for cash and invest the proceeds to obtain interest or other positive yield, she probably would prefer to receive the 1,000 bagels today rather than after three years or over three years. By deferring "consumption" of 999 bagels and investing, she would get rent for her money and could buy more than 999 bagels later.)

One dollar today may be worth \$1.10 in one year, because the world will pay 10% interest (or perhaps only 3% without risk). But does the fact that the world will do so, which makes \$1.10 the value equivalent of \$1.00 income today, mean that consumption of 1.1 bagel a year from now is the equivalent of consumption of just one full bagel now? Unless the deferral of the consumption can produce a yield and hence greater consumption, and assuming it cannot in the bagel or European trip examples, then consumption of one bagel or trip now seems equal to consumption of one bagel or trip a year later, unless a particular individual has a time preference due to aesthetics or hunger or need. If this is so, then it is proper for the income tax to treat the consumer of one bagel now differently from the consumer of 1.1 bagel a year from now, and the argument against the income tax presupposes a standard of value purportedly based on the time-value of consumption but really based on the time-value of gain or income or the receipt of consumable (and saleable or reinvestible) resources. It is the time-value of the receipt of productive real goods or investible financial goods that matters, not the time of consumption. Early receipt of bagels is not valuable because the recipient wants to eat two today, but because there may be a risk of not being able to obtain bagels or if the bagels can be sold or loaned out to earn income. (In contrast, a consumable resource that is renewable or productive, such as seeds or nuts, may be more valuable if received early because deferred consumption of the seeds, and planting them, can yield a positive return and greater consumption over time.)

invested or put to productive use, generating yield or gain in the interim.<sup>251</sup> Hence in a 10% interest world, \$100 in cash received or spent now can be said to be more valuable than \$100 in cash received or spent one year later. It is roughly equal to \$110 received or spent a year later, in present value terms.

From this simple time-value-of-money-analysis, consumption tax advocates seem to argue that the present consumer of \$100 is equal in all relevant respects for evaluating tax-paying capacity, or the fairness of taxation, to a consumer of \$110 at a time about one year later, or a consumer of \$91.00 one year earlier.<sup>252</sup> It is as if taxpayers are entitled to this relationship. From this it is argued that an income tax is discriminatory and unfair if it taxes the \$10 yield from \$100 saved by a taxpayer who defers consumption for a year. Presumably he or she does so because he has consumed enough at the present such that, given his individual underlying preferences for present versus deferred consumption, he has reached the margin and is indifferent as between consuming \$100 now or \$110 later, or has tipped over the cross-over point and would prefer the \$110 a year later.

In opposition, my argument is that it is neither irrational nor unjust to disturb that relationship, if one thinks that the difference in time of consumption and in income is relevant to taxable capacity or fair taxation, or that the present-value identity is overcome by other relevant fairness considerations.<sup>253</sup> Since receipt of \$100 now, rather than a year hence, often

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251. A similar argument advanced by some consumption tax advocates is that it is more fair to tax ourselves only when we spend or consume income (and wealth or borrowings?) because that is the point when we take a share out of the common wealth and resources of the world. See *supra* note 250; Warren, *supra* note 10, at 1094 (citing Thomas Hobbes, Nicholas Kaldor, and Charles Fried); Warren, *supra* note 7, at 932-34; see also Dyer, *supra* note 209, at 459 (arguing that the ethical maxim of the consumption tax is a tax on "selfishness").

252. See FISHER, *supra* note 10, at 245-53; KALDOR, *supra* note 10, at 81-87; A.C. FIGOU, *THE ECONOMICS OF WELFARE* 671-72 (2d ed. 1924); Andrews, *supra* note 7, at 1167-69; Fisher, *supra* note 10, at 12-13; Richard Abel Musgrave, *A Further Note on the Double Taxation of Savings*, 29 *AMER. ECON. REV.* 549 (1939); Warren, *supra* note 51, at 946.

253. Even assuming that tax burdens should be apportioned according to consumption, it does not necessarily follow that the present value or cost of lifetime consumption must be the determinant of tax burdens. Consider two taxpayers who have the same nominal lifetime earnings and consumption, \$100x. Although they both consume throughout their lives, one earns nearly all his income early in his career and the other earns nearly all her income late in her career. It would seem to be fair to tax each on a base of \$100x, when earned or received, because earning earlier might give the first taxpayer (recall the youthful basketball star discussed *supra* note 183) more choices or security than the second taxpayer receives from her late-earned income. The first taxpayer will end up paying "more" in taxes, measured in present value terms, on the same lifetime income. It would seem fair that the two taxpayers' tax burdens correlate with their incomes in temporal terms, rather than with their consumption patterns.

If the later-earning pianist has to use later income to pay back loans with interest that she incurred to fund her early life support or higher education, that is a cost not borne by the athlete. He will have a return on his savings for later life consumption that the pianist will not receive. He should be taxable on his investment yield as income since he does not have to bear the cost paid by the pianist and has the yield for consumption to boot. See Warren, *supra* note 10, at 1098. Warren argues that fairness in

has value to an investor equal to or even over and above the \$10 yield that it can obtain in the capital market, the early earner (or late consumer) often has more utility or benefit or gain from receiving his \$100 at Time 1 rather than a year later, at Time 2, more even than the 10% interest yield. Hence it is, or may be, a relevant difference for purposes of tax equity that one taxpayer is an earlier receiver or a later consumer than the other.<sup>254</sup> A tax

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taxation "should depend on outcomes, not expectations." *Id.* at 1100, 1152. The income tax is not unfair ex post, when outcomes are known, even if it can be said that the consumption tax is fairer ex ante because it does not discriminate against taxpayers with a preference for consumption in the future. Warren concludes that this is true even if investment return is certain. *See id.* In a more realistic world, with risky investments and possible taxpayer behavior taken into account, an ex ante approach seems even less correct or fair. The imagined equality of treatment by a consumption tax of savers and spenders is dependent on an ex ante perspective, one that ignores real and relevant differences, such as real risks, actual returns, and taxpayer differences, between taxpayers in real life or in any realistic tax system, particularly one using graduated rates and uncertain investment returns. *See id.* at 1108.

If differences in wage-earning abilities or situations produce differences in wages and in income taxes on wages, and there exist similar differences in capital-investment abilities, it would seem logical and just to impose higher taxes on the higher returns of some individuals, whether using proportional or graduated tax rates. *Cf. Stiglitz, supra* note 28, at 120.

254. To put it another way, having the same nominal spending power at an earlier time is advantageous because of the time-value of money, and therefore it is fair to make the earlier earner pay more tax if he chooses to use the earlier receipt to his advantage by saving or investing it at a positive rate yield.

To distinguish further the time-value of income from the time-value of consumption, consider two sets of parents, all four having been born in the same year, say 1960, and married in the same year, say 1985. Now suppose one set bears a wonderful child in 1987, and the other parents bear a wonderful child ten years later, in 1997. Suppose each infant receives a gift from a secret donor, or a government program, worth \$10 on his third birthday. So the first child receives the gift, cash in this instance, in 1990 and the second child receives the gift in 2000.

In this case, the earlier receipt of child *A* means that by 2000, if the \$10 was saved and invested at 10%, the wealth will have grown to \$25.94 and so, comparing the wealth or consumption power of the two children in 2000 will show that the first child (at age 13) is richer, having \$25.94, not just \$10. If events continue this way, the first child will always be richer than the second child because of earlier receipt of the \$10.

However, at equivalent ages, each child will have the same wealth. When the second child reaches age 13, he too will have \$25.94, just as the first child did at that age.

Should we say that the first child is richer, better off, because he received his \$10 gift (at age 3) 10 years earlier (in 1990) than the second child did on turning 3 (in 2000)? Perhaps in some sense, but not in another sense. Each has the same disposable money at the same age and stage in life, for example when age 21 and if facing (identical) law school tuition bills.

Viewed as consumption, the \$10 value at age 3 can be similarly analyzed. If each child is given a \$10 birthday cake at age 3, one in 1990 and one in 2000, and if it is not feasible to save, sell or do anything with the cake but eat it at the birthday party, would it not seem that the two children were of equal wealth? Each was able to eat a fine cake at age 3. To be sure, the first child was able to eat his in 1990 and the second child not until 2000. But the standard for comparison now would not seem to be identical calendar years but identical ages.

In other words, earlier calendar year consumption by one individual (aged 3) does not seem more valuable than later calendar year consumption by the second also at age 3. "Earlier" consumption in this sense would seem to have no greater value than nominally later (calendar year) consumption by the later-born child.

Nevertheless, the first "family" may be thought better off in year 2000, with wealth of \$25.94, than the second family in year 2000, with wealth of \$10. So the time-value of consumption simply does not equate to the time-value of income. Earlier calendar-year receipt of income may be more valuable in

differential, particularly a heavier burden in present value on the early earner or late consumer, is not necessarily unfair or discriminatory in an unjust way. An income tax may be as fair as, or fairer than, a consumption tax.<sup>255</sup>

The relevant differences partly involve the untaxed consumption or benefit, of a psychic or of a tangible form, that saving or early receipt of income provide. Having income early and saving at least some of it often provides not just more tangible consumption later, \$110 worth in a year rather than \$100 worth now (always assuming constant prices), but real benefits that a consumption tax does not reach, such as imputed or hidden consumption or utility.<sup>256</sup> There may be a "consumer's surplus." The early earner (who then saves) can enjoy more leisure or economic security, partly at least in the form of mental relief from anxiety about an impoverished old age, than the late earner or the early consumer. He may also enjoy prestige in the community, admiration or ingratiating behavior from family or friends, more choices in forms of (taxable) consumption, pride in his actions or in his ability to provide security for himself and his dependents, freedom from guilt, more enduring, happy and nostalgic memories derived from his or her consumption or more happy and confident anticipation of future, enhanced, consumption. Above all, he has the easy freedom of choice. He or she need not depend on borrowing in an uncertain capital market to fund consumption, subsistence or luxury; the taxpayer can choose more readily, in economic and social, personal or even political ways than can the starving early consumer or later earner. These benefits are not reached by a consumption model tax; they are potentially (or crudely) reached by the existing income tax when it taxes the explicit financial yield or market gain represented in the simple example by the 10% interest earned on each \$1.00 saved.<sup>257</sup> Hence the higher tax burden imposed by an income tax is, or at least may be, fair enough and even fairer

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financial terms than later receipt of income, but the same cannot necessarily be said of consumption. (Unlike the cash, the cake if saved 10 years will be very stale!)

If each child must bear a 33 1/3% tax, losing one third of his cake at age 3, but 10 years apart, the result would seem fair; and so would taxing each \$10 cash gift at age 3, so that \$6.67 is left for each.

But the nominally earlier receipt of \$10 (in 1990) should not be taxed more heavily by an income tax than the receipt by the second child of \$10 in 2000, even though a wealth tax levied in year 2000 would find a base of \$25.94 for one taxpayer and \$10 for the other.

255. See Warren, *supra* note 51, at 936 & n.27 (arguing that a consumption tax is discriminatory in favor of imputed forms of consumption). A consciously redistributive tax system, even more so than a "fair" system, should not ignore the imputed benefits of as-yet unconsumed income. *But see* Eric Rakowski, *Can Wealth Taxes Be Justified?*, 53 TAX LAW REV. 263 (2000).

256. See Goode, *supra* note 104, at 56; cf. Harberger, *supra* note 179, at 118-19.

257. Perhaps consumption power is one of the satisfactions that, along with dominion and control, is attendant to income. See *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). Of course, the actual U.S. income tax fails to cover much unrealized, imputed, or non-market income, compared to a theoretically ideal, von-Schanz-Haig-Simons accretion income tax. See examples, *supra* notes 41 and 154.



than a consumption tax, if such values are thought to be relevant to the measure of appropriate tax burdens, or taxpaying capacity.<sup>258</sup>

Admittedly, others may find the morality of the saver's behavior, or the socially and economically beneficial consequences of the saver's actions to be relevant to the fairness of tax burdens. That argument should be evaluated, but it differs from an argument that any tax that distorts the time-value-of-money proportions that would exist in a no-tax world is therefore, automatically, in that way, unfair or unjustifiably discriminatory. Such an argument circularly depends on, and merely reasserts, its own premise—that the time value of expenditure or consumption in a no-tax world sets the standard for evaluating the equal or differential position of two taxpayers vis-à-vis fairness of their comparative tax burdens, and hence consumption or receipts of equal amounts gauged by time-value discounting make the taxpayers equal such that a heavier (income tax) burden on the saver is therefore irrational and unfair.

Nothing suggests that savers in a taxed world are "entitled" to the same ratio of present and future consumption power that they would have in an untaxed world. This remains true even if it is assumed that interest rates would be the same in both worlds.

To be sure, there would seem to be unfair "discrimination" between savers in a taxed world if some wage earners were taxed by an income tax on receipt of wages and others were not taxed until they expended their wages. The first group would bear heavier tax burdens than the second group, and if no difference between the groups justified the disparate treatment, if it were random or according to the whimsy of the law-giver, the result would be unjustified, and unfairly discriminatory. Each group would appear equally entitled to enjoy the same after-tax consumption power.

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258. A perspective that favors, or identifies part of why some analysts favor, an income tax is the view of "income as product." Mark Kelman mentions this term. See Mark Kelman, *Time Preferences and Tax Equity*, 35 STAN. L. REV. 649 *passim* (1983); see also Warren, *supra* note 10, at 1090-94. That is to say, our society produces a national product which is "gain" that is to be shared somehow among residents and perhaps by, or redistributed and transformed by, government. If the incomes of all individuals are summed, that is the distribution of that national product, allocated by the market and possibly by government or other processes (donations, inheritance, theft, and the like) and it would seem fair to tax each person on his or her share. What is produced, rather than what is consumed, during the relevant time period, appears as a tax base. If government is viewed to have (or at least to exert) a prior claim on some portion of the national product, let that claim be apportioned according to the product each person otherwise is entitled to, under some principle of equality, ability to pay, equal sacrifice, benefits received, or something similar and acceptable to all or most people. If "ability to pay" is the accepted distributional concept, it implies that command over resources, income (or wealth and consumption), should be the base. Some taxes (excise taxes?) may be imposed to discourage certain behavior or to charge beneficiaries of particularized governmental benefits (property taxes?), but as the largest and basic tax base is income, productivity, that would seem fairest to tax. An income tax may distort work and leisure choices and other household or firm behaviors, perhaps more so or in more disadvantageous ways than would a consumption tax, but that criticism is separate from the fairness argument.

But as between savers and consumers in a taxed world, or as between savers in a taxed world and savers in a (postulated) untaxed world, no such equal entitlement appears. So to tax them differently is not to violate some evident principle of equal justice and distributive equity. It can be a wise or unwise tax policy for purposes of encouraging or discouraging saving, but that is a dimension separate from a horizontal equity or other fairness dimension. Nothing entitles a person in a taxed world to the same or proportionate present versus future consumption powers or consumption/saving values that would exist if the world were otherwise the same in all respects except for the absence of taxation. Furthermore, economic analysis has shown that in reality the two worlds would not be identical in all other respects since interest rates probably would be different. Moreover, it seems that much or most of the interest yield constitutes compensation for risk or other things, not mostly for the mere cost of deferral.<sup>259</sup> And even if it were, that compensation would seem legitimately taxable by an income tax founded on normal "ability to pay" or other principles of tax-paying obligation. In effect, exempting capital income from tax would, in contrast, seem to violate those commonly accepted principles of tax equity.

### C. Appearance of Fairness

Appearance of fairness concerns also figure in considering which of the particular consumption tax models to use. Do people prefer an ex ante or an ex post approach to defining ability to pay? For example, either a cash-flow approach, which allows deduction of investment and imposes taxation on yield, or a yield-exemption tax prepayment approach, which has no deduction for investment but exempts yield from tax, could be chosen and viewed as theoretically or financially equal. But they differ in that a yield-exemption approach fails to tax big winners more heavily than small winners or losers.<sup>260</sup> An important question is whether that result is acceptable.<sup>261</sup>

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259. See Bankman & Griffith, *supra* note 221. Still further, to the extent taxpayers experience infra-marginal returns on saving, or returns on entrepreneurship, windfalls or monopoly profits, an accretion-model income tax seems even more desirable and less damaging than consumption taxation. See Warren, *supra* note 234, at 5-6; see also Kaplow, *supra* note 246. If, as Warren surmises, the difference between income and cash flow taxation is merely the taxation or exemption of the riskless rate of return on capital, then the purported advantages of shifting to cash flow taxation are likely to be quite less significant than usually claimed. See Warren, *supra* note 234, at 13.

260. To illustrate this point, consider a real world, one in which returns to investment vary and there are "winners" and "losers." Consider two taxpayers, *C* and *D*, under a cash-flow system. Each saves \$10,000 out of a \$100,000 salary. Taxpayer *C*, makes a saving or investment choice that in one year earns her a yield of 30% (\$3,000), three times what was expected and three times what the other and less lucky taxpayer, Taxpayer *D*, earned at 10% (\$1,000). Since each one got a deduction of \$10,000 when he or she saved or made the investment, the yield is taxable, at the assumed uniform rate of 33%. So Taxpayer *C* has to pay \$1,000 in tax (\$3,000 yield times 33% tax) and Taxpayer *D* has to pay \$330 in tax (\$1,000 yield times 33% tax). Each has paid a tax proportional to his or her earnings. Since Taxpayer *C* earned three times as much as did Taxpayer *D*, *C* must pay three times the tax, after

A great deal of political acceptability may depend on whether the consumption tax is personal or not, at least if voters want it to be progressive or capable of progressivity in rates, beyond what a per capita exemption or

paying which she has three times the spending power (\$2,400) of Taxpayer *D* (\$670). Fair enough to many people, especially given the flat rate of tax, which takes a proportional approach at the margin.

Now compare the treatment of identical winner-loser events in a yield-exemption world. Neither gets a deduction for saving \$10,000, so each one pays \$3,300 in "income" tax on the \$10,000 of income he or she actually saved in Year 1. In Year 2, the yield is exempt to each: Taxpayer *C* has \$3,000 yield and \$13,000 to spend; Taxpayer *D* had \$1,000 yield and \$11,000 to spend. But, earlier, each paid the same total tax, \$3,300 ( $\$10,000 \times 33\%$ ) at the same time. So *D* paid tax of \$3,300 on income of \$11,000 ( $\$10,000$  in Year 1 and \$1,000 earned on saving), for an effective rate of  $\$3,300/\$11,000$  or 30%. In contrast, Taxpayer *C* paid tax of \$3,300 on income of \$13,000 ( $\$10,000$  earned in year one and \$3,000 earned on her saving or investment), for an effective rate of  $\$3,300/\$13,000$  or only 20%.

The tax treatment was not flat, single, uniform, or, in the view of some, fair. The yield-exemption method ignored (or could not take into account) the \$2,000 difference in consumption power between the big winner and the loser or ordinary winner. The cash-flow or immediate deduction method took the difference into account in determining their tax burdens, because the tax was imposed upon withdrawal, ex post, when the amount actually available for consumption was known. The yield-exemption approach applies ex ante and irrevocably presumes the amount that can ultimately be earned and consumed, namely the amount that a normal return on saving would produce. See K. Crideon et al., *Treatment of Individual Investment and Borrowing Under Alternative Tax Systems*, in *COMPREHENSIVE ANALYSIS*, *supra* note 64, at 73; Warren, *supra* note 234.

Consequently, the method chosen may prove to be very significant, even though they are generally regarded as equivalents, as indeed they are in an abstract or mathematical sense or when applied to a restricted factual situation. As mentioned below, among the well-publicized U.S. tax-reform or "flat tax" proposals, the Arney plan and Hall-Rabushka apparently use yield-exemption and the Nunn-Domenici, see text accompanying *infra* notes 105, 112-113, plan uses the deduction or cash-flow method. The 1977 Treasury plan, see *BLUEPRINTS*, 1977, *supra* note 6, would have allowed taxpayers to choose between deducting investments (the qualified account alternative) or excluding capital income from the tax base (the prepayment alternative). See Warren, *supra* note 10, at 1102-07 (on risky investments); *BLUEPRINTS*, 1984, *supra* note 6, at 112-17. Such a choice could give taxpayers unwarranted opportunities for gaming the tax system, tax arbitrage, and the like. See, e.g., GRAETZ, *supra* note 56, at 167-84.

The preceding examples and text show that the yield-exemption method does not always appropriately distinguish between big winners and small winners or losers when the distinction is focused on the effective rate of tax each taxpayer pays as a percentage of income, or even of actual, final consumption. Consequently it differs from a cash-flow tax in some respects, especially in revenue collected from winners compared to revenue collected from losers or break-even investors. In contrast, a single-rate retail sales tax collects as tax the same proportion of all amounts spent on consumption, at the time of expenditure. So a 12% retail sales tax will collect 12% of a "big winner's" spending of \$1,000, the same percentage as the percentage it will collect from a smaller winner's spending of \$100, namely 12% in each case. It is a proportional tax on expenditure for consumption.

There is much more to be said about the purported equivalence, under conditions often left unspecified, and the actual difference between the yield-exemption method and the cash-flow (or deduction for savings) method in a consumption tax, having to do with the equivalence (or not) of the amounts saved, and the ability of taxpayers in a yield-exempt (tax up front) world to scale up their amounts invested.

The cash-flow method does what a retail sales tax would do; it taxes at a uniform rate the amount available to spend on taxable consumption, at the time of consumption. The yield-exemption method does not do that; it imposes a different (and lower) effective tax rate on the big winner than the rate on the small winner, a regressive tax effect. The government is a partner in the profitability of each taxpayer in the cash-flow world, but not in the yield-exempt world. Hence, the investor in the cash-flow world actually invests more than his equal wage-earning and saving counterpart in the yield-exempt world. If actually equal investors are compared, each having say \$100 to invest, the difference between cash-flow and yield-exempt taxpayers becomes more evident, and unacceptable.

261. The Treasury/Bradford proposal would let taxpayers choose to use either (or both) a cash-flow approach or a pre-payment, yield-exemption system. See *BLUEPRINTS*, 1977, *supra* note 6, at 119-27; Graetz, *supra* note 56, at 1599-1600. As mentioned above, in note 259, this choice would allow taxpayers to "game the system": They would try to use the prepayment method (yield-exemption method) for investments with higher-rates of return expected, and the cash-flow approach for low-rate investments. See Harberger, *supra* note 179, at 119; Warren, *supra* note 179, at 121-22.

a low-rated or zero-rated set of exceptions can do in a VAT or in a comprehensive retail sales tax.

If the tax rates in a consumption tax system ever need to be set at very high levels, the taxpaying public may find the appearance so disturbing as to reject them. For example, if income expended for consumption should be taxed at a 50% rate, the result can be stated as a 100% tax rate. This is because, of the \$100 earned to spend \$50, an equal amount (\$50) must be paid in tax, giving rise to the 100% tax rate characterization. If the tax rate were to be set at 75%, so that \$100 earned would create a \$75 tax liability, leaving only \$25 to spend on consumption, the \$75 tax amounts to three times the \$25 spent privately, amounting to a 300% tax rate on consumption: the taxpayer must pay \$75 in tax plus \$25 to get a \$25 consumption item.

So the appearance of regressivity vis-à-vis income (if a consumption tax rate is flat) and the possible appearance of unacceptably high tax rates are fairness-appearance problems that could be serious. Even more so would be a public understanding that income from capital was exempt (by yield exclusion or cash-flow deduction) or that the consumed-income tax amounted roughly to a tax on wages only, not on capital income. Moreover, the yield-exemption method's failure to differentiate big winners from small winners, or losers, would make that method objectionable.

### III

#### THOUGHTS FOR THE FUTURE OF TAX REFORM

##### *A. Overall Strengths and Weaknesses of Reform Proposals*

The most serious weaknesses of substituting a consumption-based tax for an income tax seem to be potential, actual, or perceived regressivity or lack of progressivity; equally and thus unfairly taxing winners and losers, at least if the tax-prepayment or yield-exemption method is employed; and transition issues. Also a consumption tax alone does not limit accumulation of wealth the way an income tax probably does, even though wealth provides, it should be repeated, power, prestige, security, command over resources, and untaxable consumption. Moreover, under certain assumptions, a consumption-type income tax amounts to an income tax on wages only,<sup>262</sup> or a tax on wages and on expenditure of capital accumulated after income tax before conversion to consumption taxation. Will any general taxpaying population accept a tax reform that produces that result? If conversion to a consumption tax simply meant that the very rich capitalist,

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262. See Graetz, *supra* 115, at 1579, 1598, 1602 (showing that the proposition is strictly true only if there is no initial period wealth, no unconsumed wealth at death, tax rates are not progressive, tax rates do not change, perfect capital markets exist, and all income can be classified as wage or capital income).

such as Steve Forbes (who backed a flat tax proposal in the 1996 and 2000 U.S. presidential campaigns) would not pay any tax on the receipt of huge annual dividends, interest, royalties, rents, or capital gains?<sup>263</sup> Would this be sound tax policy?<sup>264</sup>

The suggested strengths of a consumption-type tax include an improved lifetime perspective (lifetime consumption generally equals lifetime income, although the timing may be different); the base is argued to be fairer if emphasizing consumption; the timing may be thought by some to be right as to present and future consumption; and the changes could induce increased savings. In addition, there might be greater long-term simplicity. The dimensions of simplification could appear in the areas of cost recovery: cash-accrual accounting methods; similar tax treatment of all businesses, regardless of form; diminishing income-shifting advantages; abolition of the Alternative Minimum (Income) Tax; removal of the entire system of taxing long-term capital gains at special rates; and restricting the allowance of capital losses, and the attached or implicated rules and sub-systems. Inflation would probably raise fewer tax base problems.

But a host of implementation problems would remain or arise.<sup>265</sup> Among the problems remaining are those of definition, such as what is "business" versus "personal," what is "consumption," what is "saving," or "investment"? There would be significant problems of valuation of fringe benefits, barter, and compensation "in kind." Issues of imputed consumption would also pose particularly serious problems. So would loss carryovers, mixed-motive (personal and business) expenditures, treatment of non-profit institutions and government entities, financial intermediation services, and treatment of U.S. citizens living and consuming abroad. Lawyers and economists have previewed some of the avenues for evading a cash-flow or yield-exempt direct consumption tax, sometimes through the use of cross-border transactions.<sup>266</sup> And tax relief for poor individuals might be desired, but it, or its form, could be controversial.

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263. See Lincoln Arnold, Letter to the Editor, *Unanswered Flat Tax Questions*, 70 TAX NOTES 911 (1996).

264. Perhaps for redistributive reasons, a consumption tax should be accompanied by a periodic wealth tax. But then the combination of the two then resembles a broad-based income tax, particularly one that is accompanied by effective wealth-transfer taxation.

265. See David A. Weisbach, *Ironing Out the Flat Tax*, 52 STAN. L. REV. 599 (2000) (exploring the design issues presented by the Flat Tax and concluding that the regime would be complex and difficult to implement, although perhaps simpler than current law, and that the tax will be easily avoidable because it is "open" rather than "closed" in many situations, reducing its efficiency); see generally Graetz, *supra* note 115; Graetz, *supra* note 161.

266. See McLure & Zodrow, *supra* note 48, at 76-79; see also Graetz, *supra* note 264, at 1643-49; Michael J. Graetz, *Expenditure Tax Design*, in WHAT SHOULD BE TAXED, *supra* note 12, at 175-82. Whether interest expense could be handled appropriately is another tangential but important problem. See J. Clifton Fleming, Jr., *The Deceptively Disparate Treatment of Business and Investment Interest Expense Under a Cash-Flow Consumption Tax and a Schanz-Haig-Simons Income Tax*, 3 FLA. TAX REV. 544 (1997).

Some of the most significant considerations have to do with a consumption tax's supposed economic effects. Perhaps a consumption tax would produce a more efficient or optimal allocation of capital between saving and consumption and between saving and investment vehicles (e.g., no § 103 bonds versus corporate bonds or shares differential). It certainly would (and should) end the double taxation of distributed corporate earnings. Perhaps it would result in desirable effects on international trade.

The economic effects and benefits of the various consumption tax plans share as a goal the removal of the income tax's presumed disincentive to save, possibly leading to more saving and resulting employment and productivity. Not taxing various forms of investment on a uniform basis should probably lead to a more efficient allocation of capital. And "cleaning up" the consumption tax base would remove distortions among various types of consumption. Lower and flatter rates (less progressivity) might reduce some obstacles to hard work, initiative, innovation and risk taking. But economists cannot be very reassuring about the magnitude of these effects. The growth rates predicted by responsible analysts are lower than those used by some consumption tax enthusiasts.<sup>267</sup> One might fear a repeat of the supply-siders' and trickle-down economists' exaggerations of the 1980s.

What can be expected in the way of macroeconomic effects?<sup>268</sup> Would a shift from a hybrid income tax to a tax mainly on consumption actually curtail consumption? Would it increase private saving? Even if a consumption tax increases the incentive to save or, compared to an income tax, reduces the income tax disincentive to save, the change in incentive may not produce a big change in behavior: saving. Evidence from the United States suggests that private saving and work are not very responsive to the after-tax rate of return. Much may depend on Federal Reserve policies. Still, there might be productivity gains from removing distortions in the capital markets.<sup>269</sup>

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267. See SLEMROD & BAKJIA, *supra* note 28, at 227. However, some economists have argued that over a longer time period, the efficiency case for consumption taxation becomes stronger. See, e.g., Kenneth Judd, *The Welfare Cost of Factor Taxation in a Perfect-Foresight Model*, 28 J. POL. ECON. 675 (1987).

268. See Dale W. Jorgenson, *The Economic Impact of Fundamental Tax Reform*, in FRONTIERS OF TAX REFORM, *supra* note 48, at 181; SLEMROD & BAKJIA, *supra* note 28, at ch. 4. The Kemp Commission in 1996 claimed that if the U.S. replaced its progressive income tax with a flat-rate consumption tax, the long-term rate of economic growth might well double, from 2.5% to 5%. See NATIONAL COMMISSION ON ECONOMIC GROWTH AND TAX REFORM 5 (1996). These estimates may well be exaggerated. See 1996 House Hearing, *supra* note 33; 1995 Senate Hearing, *supra* note 33; 1995 Senate Hearing II, *supra* note 33.

269. See 1996 House Hearing, *supra* note 33; 1995 Senate Hearing, *supra* note 33. European experience in the 1970s with the adoption of the VAT suggests that an immediate price increase equal to the rate of tax may well occur. Would that be as likely if the new tax were substituted rather than added to the U.S. tax system? We will have to turn to the economists for help with these questions. Some intimate that much turns on the transitional methods and degree of transition relief. See 1996

Statistical studies by expert economists seem to indicate that U.S. private savings rates are hardly responsive to higher after-tax returns.<sup>270</sup> Alan Auerbach's more recent simulation indicates that a consumption tax might produce a "short run increase in national saving but not necessarily a sizeable increase in output or welfare," and he adds that if transition relief were included and progressive rates were used, there would be a marked reduction in growth of output and gains in efficiency.<sup>271</sup> Also, new distortions may be added. Investment and effort that produces or enhances exempt capital income would be favored. Lower-taxed foreign consumption might be favored. Disguising consumption as saving would save taxes as would, in some systems, disguising retail purchases as business inputs. Physical capital might benefit at the expense of investment in human capital, yet with fewer positive externalities.

What about investments in human capital, such as through education, training, health care, and other such things? Our present income tax may be seen as favoring investment in physical or financial capital over investment in ourselves and our capacity to earn income by rendering useful services.<sup>272</sup> A cash-flow type income tax or a consumption tax would do so even more, because the costs of all material investments could be deducted currently, and consequently more compensating allowances for human capital investments might be needed for neutrality and for desirable social development.<sup>273</sup>

Finally, if one regards a tax on a base of income—command over resources, ability to save or consume—to be the fairest measure of ability to pay, shifting to a consumption tax would reduce the equity of the main tax system.

### *B. Some Observations on Preferable Tax Reform*

When all is said and done, it would seem better to retain the tried-and-true income tax in the United States and somehow manage to integrate the corporate and individual taxes.<sup>274</sup> Probably the income tax base should be

*House Hearing, supra* note 33; *1995 Senate Hearing, supra* note 33; *see also* Alan J. Auerbach, *Simulating Fundamental Tax Reform in the United States*, AM. ECON. REV. (forthcoming 2001).

270. *See* ALAN J. AUERBACH & LAURENCE J. KOTLIKOFF, *DYNAMIC FISCAL POLICY* (1987).

271. Alan J. Auerbach, *Tax Reform, Capital Allocation, Efficiency, and Growth*, in *ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM*, *supra* note 149, at 29.

272. *See* John K. McNulty, *Tax Policy and Tuition Credit Legislation: Federal Income Tax Allowances for Personal Costs of Higher Education*, 61 CALIF. L. REV. 1 (1973).

273. *See* SLEMROD & BAKIJA, *supra* note 28, at 125. *See generally* Jennifer J. S. Brooks, *Taxation and Human Capital*, 13 AM. J. TAX POL'Y 189 (1996) (on the subject of taxation of human capital under income and consumption tax regimes); Louis Kaplow, *Human Capital Under an Ideal Income Tax*, 80 VA. L. REV. 1477 (1994); Louis Kaplow, *The Income Tax Versus the Consumption Tax and the Tax Treatment of Human Capital*, 51 TAX L. REV. 35 (1995); Lawrence Zelenak, *The Reification of Metaphor: Income Taxes, Consumption Taxes and Human Capital*, 51 TAX L. REV. 1 (1995).

274. *See* John K. McNulty, *Corporate Income Tax Reform In The United States: Proposals For Integration of the Corporate and Individual Income Taxes*, 12 BERKELEY J. INT'L LAW 161 (1994);

broadened, for example, to include fringe benefits, perhaps by denying deductibility of their costs by employers. In addition, some exclusions should be repealed, such as (possibly) those for gifts and bequests, municipal bond interest, gain on sale of one's principal residence, and other such exclusions (or deductions).<sup>275</sup>

Improving the income tax should also involve adding better inflation-indexing or price-level adjustments, taxing capital gains at ordinary income rates or increasing the mark-to-market (pre-realization) coverage, trying to make more uniform the taxation of income from capital, rationalizing the system (if any) of savings incentives, simplifying the law at the compliance level (repealing the A.M.T., phase-outs of exemptions and deductions) and at the "incentive/strategic" level (capital-gains relief, § 1014 stepped-up basis, marriage tax bonus/penalty, I.T.C., R.&D. credit, and so forth), even at the expense of some equity losses.<sup>276</sup> And the income tax could be improved by minimizing consumption and investment distortions (tax-free fringe benefits, various personal credits, muni-bond interest exclusion, percentage depletion, exclusion of life insurance build-up, and maybe even allowances for home mortgage interest, charitable contributions and medical expenses).<sup>277</sup>

If the United States wanted to, it could expand savings allowances such as IRAs, Keoghs, and §403(b) or §401(k) plans still further, and thereby the income tax would shift further toward a consumed-income tax base, with encouragement for higher savings rates, but without the economic and legal shock, transition costs and great uncertainties that would come from substituting a whole new consumption or cash-flow tax regime.

Perhaps the United States should repeal the estate and gift taxes and repeal the § 102 exclusion for gifts and bequests, so as to tax the donees on receiving such economic income.<sup>278</sup> Or donors could be given constructive realization treatment of gains and losses at the time of transfer.

As to excise taxes, one certainly could argue that we should tax gasoline much more heavily, at least to bring the after-tax prices closer to those

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Warren, *supra* note 21. John Fox reaches a similar conclusion in the chapter, *Flat Tax Versus Income Tax* in his book, *IF AMERICANS REALLY UNDERSTOOD THE INCOME TAX: OUR MOST EXPENSIVE IGNORANCE* (forthcoming 2001).

275. See I.R.C. §§ 102, § 103, and § 121; see also Warren, *supra* note 21.

276. See Daniel Halperin, *Saving the Income Tax: An Agenda for Research*, 77 *TAX NOTES* 967 (1997); Graetz & Warren, *supra* note 156, at 1767-77; George K. Yin, *The ALI Reporters' Study on the Taxation of Private Business Enterprises*, 85 *TAX NOTES* 91 (1999).

277. There are lots of income tax base-broadening proposals, particular and systematic. A recent model is provided by the Gephardt "10% Tax." See SLEMROD & BAKIJA, *supra* note 28, at 251-53.

278. See John K. McNulty, *Fundamental Alternatives to Present Transfer Tax Systems*, in *DEATH, TAXES AND FAMILY PROPERTY* 85 (Edward C. Halbach, Jr. ed., 1977). The Arney-Shelby proposal would repeal the federal estate and gift taxes, whereas Nunn-Domenici would retain those taxes and also re-introduce "carryover basis" for individual income tax purposes. See Harris, *supra* note 142, at 168; see also John K. McNulty, *A Transfer Tax Alternative: Inclusion Under the Income Tax*, 26 *TAX NOTES* 24 (1976).



prevailing in most other industrialized countries in Europe and Asia. Also the United States might tax more heavily certain behaviors or de-merit goods, such as consumption of cigarettes, alcohol, and activities that generate high levels of pollution.

Another approach draws from the experience of our major allies and industrialized trading partners, but it is so obvious that it may escape our attention. Perhaps the United States should add a national VAT or consumption-type tax or premium to our existing tax base as a long-term policy and reduce or reform the income and other taxes in order to spread and reduce the distortions, revenue-raising capacity, and marginal rate incentives to avoid tax.<sup>279</sup> The revenues might also be used to reduce the national debt and to support desirable public programs.

Given the uncertainties, transitional unfairness, transaction and legislative, administrative and compliance and other costs of substituting a relatively high rate, new consumption-type tax for our income taxes, with which we have great experience and know-how, the add-on rather than the replacement approach seems the much sounder policy path to follow. Even Nicholas Kaldor supported proposals to use the expenditure tax as a supplement to, rather than as a replacement for, the income tax.<sup>280</sup> Or as recommended by S.O. Lodin, Congress might retain but flatten the income tax and place a new graduated expenditure tax on top. Alternatively, or in addition, it might adopt a periodic wealth tax, as the Meade Report also recommended.<sup>281</sup> Or, some would say, wealth, or wealth transfers (and hence "wealth" itself), could be taxed more heavily.

#### IV

#### CONCLUDING THOUGHTS

The debate about substituting a consumption-type tax for our Federal Income Tax on individuals and corporations has led to a reexamination of the theoretical strengths and weaknesses of income taxation and of our actual income taxes in place. The questions have concentrated on whether a consumption-type "Flat Tax" would be simpler, fairer, or more efficient and neutral than an income tax. The policy exchanges, implicitly or

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279. See SLEMROD & BAKIJA, *supra* note 28, at 253-55; Andrews, *supra* note 155, at 127. Nicholas Kaldor agrees. See KALDOR, *supra* note 10; see also BRUCE ACKERMAN & ANNE ALSTOTT, THE STAKEHOLDER SOCIETY (1999) (proposing a new 2% annual wealth tax on all individuals in order to fund an \$80,000 cash grant to every American upon reaching age 18, for education, investment, or splurging, so long as he or she completed high school and avoided criminal activity). Ackerman and Alstott would even add on an overhaul of the Social Security system, to grant a "citizen pension" of \$670 per month (\$8,040 per year) starting at age 67, not varying with lifetime earnings. They would replace Social Security payroll taxes with an annual tax based on the degree of privilege each individual enjoyed during childhood (measured by parental earnings during the childhood of the taxpayer), a tax ranging from \$630 to \$3,465 per year from age 21 to 67. See *id.* at 16, 130-31.

280. See Minarik, *supra* note 103, at 303.

281. See MEADE, *supra* note 17.

explicitly, involve the query whether it is possible fundamentally to reform and simplify the tax structure while retaining the redistributive and other policy objectives of the present system.

The discussion has highlighted some of the weaknesses or peculiarities of our present income taxes. It has shown that considerable complexity inheres in any tax structure that distinguishes between capital and labor income, taxes both at progressive and differentiated rates and, as to income from capital, makes distinctions between return of capital and gain, ordinary income and capital gains, dividends and interest, and as to both makes exclusions, deductions and deferrals available to taxpayers. Not only complexity, but also distortions and deadweight losses result, and they are accentuated with higher marginal rates.

The consumption-type tax has been argued to offer immense simplification of the problems that result from taxing income from capital. But if or to the extent it does so by exempting all such income from tax, it seems to be a surrender and abandonment, rather than a desirable reform.

Exempting capital income from tax and, under simplifying assumptions (individuals consume all their incomes during lifetime, tax rates and interest rates are constant, and so forth), making the income tax into something like a wage tax raises serious fairness questions, and very serious "appearance of unfairness" questions. While consumption tax advocates attempt to prove that a pure consumption tax actually is fairer than a pure income tax (not to mention our imperfect hybrid) the *ex ante* (versus *ex post*) perspective and the present-value analysis are not convincing. Moreover, eliminating tax on capital income means that higher rates must be used on the remaining (labor income) base, or other taxes must be installed or raised. If a periodic wealth tax seems to be a necessary add-on to a consumption or expenditure tax, to obtain sufficient redistribution, the result is to tax both consumption and capital or capital income, which is what an income tax at least tries to do by itself. So the question becomes whether two new taxes would be better than an (improved) income tax.

As to economic distortions, economists have said that an income tax distorts both the labor and capital markets, but that a consumption tax distorts only the labor market, and doing so does less harm to overall welfare than does distortions to the market for capital, or both.<sup>282</sup> Perhaps we are accustomed to, or inobservant of, the distinction between present and future consumption made by an income tax (with its myriad of exceptions for tax-preferred savings and investment) and intuitively overemphasize the work-leisure distinction that we see in an income tax. Markets and interest

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282. See Stiglitz, *supra* note 28, at 118-19.

rates may largely compensate for the income tax on the yield from saved income.<sup>283</sup>

To be sure, there does seem to be an instinctive appeal or logic in taxing individuals on what they take from society rather than what they produce or contribute. And, perhaps a lifetime-oriented timing would be fairer as between taxpayers.<sup>284</sup> But "ability to pay tax" seems also to rest on wealth or periodic flows from capital, and it taxes income as "product," and these dimensions seem unwise to ignore. Perhaps instead we should reinstate five-year averaging or other ameliorating devices in our annual-based income tax.<sup>285</sup>

Part of the fairness issue has been misconceived or misstated, in that we automatically think desired progressivity consists of the ratio of taxes paid to income. In evaluating the substitution of a consumption tax, perhaps we must consider instead the ratio of taxes paid to consumption. But then we must compare the two progressive potential tax systems and discern which seems fairer or more correctly redistributive. And we must remember that steeply graduated or very high rates under any tax will magnify its inefficiencies and the incentives for avoidance. Low and flat rates are good for such reasons, and also because they allow taxes to be imposed at the source (as withholding taxes).<sup>286</sup> But the smaller the tax base, the higher the rates must be, for revenue reasons, apart from fairness and redistribution needs.

Comparisons sometimes are made between an ideal income tax and an ideal consumption tax, or between a hybrid and flawed income tax and a pure (or reasonably practical) consumption tax, with or without considering the transition problems. Most such comparisons spotlight how little or how much capital income is excluded from our present income tax base. Consequently it may appear that to tax some savings or yield is distortionary and unfair. Yet it must be admitted that some wage income and other similar income also goes untaxed. We do not infer that we should, as a consequence, exempt all labor income.

The transition costs and uncertainties and potential problems of shifting to a consumption-based tax are huge and important. In addition, the

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283. See *id.* at 119; A.B. Atkinson & J.E. Stiglitz, *The Design of Tax Structures: Direct Versus Indirect Taxation*, 6 J. OF PUB. ECON. 55 (1976). If a redistributive consumption tax were to be imposed, Stiglitz has suggested that an additional tax on interest income, or in contrast, maybe an interest subsidy, should also be imposed! It is argued that because capital and unskilled labor are interchangeable, an interest tax, which tends to discourage investment, would have a positive effect on income distribution.

284. A lifetime income tax is said to be equivalent to a consumption tax plus a tax on bequests. See Stiglitz, *supra* note 28, at 118-19.

285. Capital gains rate-relief, of course, can be viewed as a very crude attempt to ameliorate the effect of income bunched by the rule of realization.

286. See Stiglitz, *supra* note 28, at 125.

gains in saving or fairness or simplicity would seem to be less significant and much more uncertain than many have supposed.<sup>287</sup>

The consumption-tax, flat-tax debate has served to remind us of the robustness and appeal of income taxation. It simply has not been shown even in theory that a tax geared to a person's consumption of economic resources is fairer than, or at least as fair as, a tax geared to the person's production or command over such resources. Consequently, it would seem more prudent (and less costly and risky) to concentrate on broadening the income tax, lowering and conforming the rates, and rationalizing the tax subsidies for saving and investment.<sup>288</sup> Simplifying the law and changing it so as to disinvite complex taxpayer behavior and planning should receive strong and wise attention, in hopes that it will then seem even less necessary or desirable to convert to a (realistic) consumption-type or "flat" tax.

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287. See Toder, *supra* note 98, at 191, and sources cited therein.

288. In 1985, the Final Report of the Sixty-Ninth American Assembly noted, after extended conference and study of consumption taxation, to recommend that the federal government continue to rely on the income tax as its basic revenue source. Final Report, *in* THE PROMISE OF TAX REFORM, *supra* note 28; see also Toder, *supra* note 98, at 184.

