POINT & COUNTERPOINT:
CONSUMPTION VERSUS INCOME TAX

INTRODUCTION: The term "tax reform" has many meanings. Depending on one's viewpoint, it might imply simplification, rate reduction, or eliminating the double tax on corporate income. The President's Advisory Panel on Federal Tax Reform proposed changes to make the "code simpler, fairer, and more conducive to economic growth." One of its proposals, the Growth and Investment Tax Plan, is a "blended structure that would move the current tax system towards a consumption tax ...." Although it did not emerge as one of the two recommended systems, a Progressive Consumption Tax Plan also received Panel attention. This Point & Counterpoint addresses the consumption versus income tax debate in a unique fashion. Jack Cummings first provides pro-consumption tax quotations from writers spanning several decades. He then offers his own views in opposition to replacing the income tax with a consumption tax. Readers are encouraged to submit additional arguments, which may be published in a subsequent issue.

—Gail L. Richmond, Fort Lauderdale, FL

POINT: A POTPOURRI OF PRO-CONSUMPTION TAX VIEWS

Report of the President's Advisory Panel on Federal Tax Reform 152-153 (Nov. 2005):

The key difference between an income tax and a consumption tax is the tax burden on capital income. An income tax includes capital income in the tax base, while a consumption tax does not. Taxing capital income reduces the return to savings and raises the cost of future consumption relative to current consumption. This is likely to cause people to spend more and save less, thereby depressing the level of capital accumulation. ....

Although a consumption tax would remove the tax bias against savings and level the playing field between different types of investments, it is important to recognize that an income tax and the type of consumption tax discussed here would both tax a significant portion of the return to capital. To understand why, it is helpful to distinguish four different components of the return to capital. The first is the "normal," or risk-free, return that represents compensation for deferring consumption. This is sometimes described as the "return to waiting." The second is the expected risk premium for a project with uncertain returns—the return to risk taking. The third component is "economic profit" and represents returns due to entrepreneurial skill, a unique idea, a patent, or other factors. This component is sometimes referred to as "supernormal returns." The last component is the unexpected return from good or bad luck. This is the difference between the expected return at the start of an investment, and the after-the-fact, actual return.

Warren Rojas, *Bushonomics 101: Using Taxes as the Ultimate Disciplinary Tool,* 99 Tax Notes 1734 (Jan. 23, 2003), 2003 TNT 121-2 (Jan. 24, 2003)(both paraphrasing and quoting Grover Norquist, President, Americans for Tax Reform):

…the Republicans' virtually seamless antitax stance has helped galvanize the party and insulate any legislative efforts from being torn apart by corporate dissidents …. "We all work together against the other team," he said of today's tax-cutting gameplan. "And if yours happens to move now, mine will come later. So that has made everyone play with much less sharp elbows and a willingness to work together." ....“It sends a message of 'Calm down. ….'"

William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 Harv. L. Rev. 1113, 1120-1122 (1974) (footnotes omitted, italics in original):

The prevailing prescriptive model of a personal income tax is called an *accretion-type personal income tax,* and a model in which accumulation is comprehensively excluded is called a *consumption-type personal income tax.* The latter is also called a *cash flow personal income tax* because that describes its practical computation. …. The existing tax is a *hybrid personal income tax* since it conforms to the accretion ideal in some respects and the consumption ideal in others, but neither with any consistency.

The difference between an accretion-type and a consumption-type personal income tax involves only accumulation, and it is in an important sense only a difference of timing. If an item of accumulation is not reflected in taxable income [referring to a consumed income tax], the tax is not waived but only deferred. Under either kind of ideal, what is ultimately subject to tax is the same—funds or wealth available for private consumption. ....

Consumption is the major component of accretion for most taxpayers most of the time, and therefore under either ideal, the tax is in the

long run mostly a tax on household consumption. ….

I believe, for reasons to be developed, that the consumption model offers better solutions to the question of how to treat accumulation than does the prevailing accretion model.

U.S. Treasury, Blueprints for Basic Tax Reform 133-134 (1977) (emphasis added):

Corporations would not be taxed as entities under either the cash flow tax or the comprehensive income tax. However, under the cash flow tax, there would be no need to impute undistributed income to individuals because taxes would be assessed only on funds available for personal consumption. Consequently, a single cash flow tax applied at the household level could be accomplished without the rules for integrating corporate and household accounts that are conspicuous features of the model income tax.

The treatment of returns from corporate activity under the cash flow tax would be exactly the same as the treatment of returns from other kinds of investments. There would be no separate tax at the corporation level. Individuals would be permitted to purchase corporate stock through qualified accounts held with brokers. The initial purchase price would be deductible from the tax base at the time of purchase, and subsequent withdrawals from the account as dividends received, return of capital, or proceeds from the sale of stock would be added alike to the tax base. For stock purchased outside of a qualified account, no deduction would be allowed for purchases, and neither dividends nor proceeds of future sales would be added to the tax base. Capital gains and capital losses would, therefore, have no tax consequences.

Edward J. McCaffery, *Ten Facts about Fundamental Reform*, 101 Tax Notes 1463 (Dec. 22, 2003), 2003 TNT 246-36 (Dec. 23, 2003) (emphasis added):

….The other path laid out in *Blueprints* was to abandon the attempt to have an income tax altogether and move instead to a consistent consumption tax. This is the right path to take. ….

Liberals for their part are opposed to any such tax, both because of its flat rate, and because of the thought that a consumption tax ignores the yield to capital altogether, and that such a yield is the domain of the socially fortunate. So liberals insist on maintaining, even strengthening, a progressive income tax, with its corollaries: the gift, estate, and corporate income taxes.

But once we assume that we are going to have at least some progression in the rate structure [on wages], the traditional understanding of consumption taxes is no longer accurate. ....

An income tax falls on all labor market earnings and the yield to savings at the time they come into a household. Savers are hurt by the "double taxation" of savings, whatever the intended or actual use of the savings. Individuals, like the highly educated, who see their earnings come in relatively short, concentrated bunches, are hurt by the timing of the imposition of progressive rates. ….

A similar argument can be made against a separate corporate income tax. The problems with this tax begin with its uncertain incidence: *Since corporations are not real people, they do not really pay taxes. A corporate tax falls on workers and consumers, on capital generally, or on some combination thereof. To the extent it falls on ordinary workers and consumers, the corporate income tax's claims to fairness are questionable. But to the extent the tax does fall on capital, it does not do so in any individuated way.*

Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax,* 103 Tax Notes 91 (Apr. 5, 2004), 2004 TNT 66-48 (Apr. 6, 2004):

The first, more fundamental, issue is the significance of its being a consumption tax rather than an income tax. If the two systems are similarly progressive, is there any problem with ceasing to tax income? While noting several grounds on which one might reasonably argue for an income tax, I will aim to dispel several that I believe are misplaced. In particular, if one misunderstands the significance of exempting "capital income" and not taxing wealth until it is spent, one may erroneously conclude that a consumption tax cannot be adequately progressive after all. Consider a super-rich individual such as Bill Gates. Can a consumption tax really make him pay enough if his "capital income" is exempt and he never spends more than a small fraction of his vast wealth? In fact, exempting "capital income" has a much smaller effect than one might initially think on those such as Gates who build huge fortunes, and his wealth bears the consumption tax even before it is spent. Those criticisms therefore mean less than meets the eye, and less still if we compare a progressive consumption tax, such as the X-Tax, to a realization-based tax rather than a pure Haig-Simons income tax.

Edward P. Lazear and James M. Poterba, *Reforming Taxes to Promote Economic Growth,* 110 Tax Notes 387 (Jan. 23, 2006), 2006 TNT 15-30 (Jan. 24, 2006) (emphasis added):

Productivity growth depends on investment in human capital, physical capital, and intangible capital. Investment in human capital means acquiring skills through formal education and learning on the job. Investment in physical capital means adding to the stock of plant and equipment that makes workers more productive. Intangible capital includes the stock of research and development and other factors that make both physical and human capital more productive. Both proposals [of the President's Advisory Panel] encourage investment in skills by reducing marginal tax rates on labor supply for most earners. Both proposals encourage investment in physical and intangible capital by reducing the

tax wedge between the before-tax and the after-tax returns to new investments. Treasury estimates that moving from the current structure to the Growth and Investment Tax would lower the average tax burden on all investment from 17 percent to 6 percent. That would encourage new investment and could significantly increase productivity and wage growth.

In a global capital market, a nation's saving and its investment need not be equal, but they are linked. When a nation's saving is low, investment can remain high if the returns to investment attract foreign capital. Low tax rates on investment encourage foreign investment. But in the longer run, a nation's standard of living will grow more quickly if it owns the capital that raises its productivity, because it then benefits not only from the higher wage growth that results from using the capital, but also from the capital returns. The current U.S. tax system discourages saving. Both the proposed plans reduce the total tax burden on saving and investment, thereby promoting long-run economic growth.

COUNTERPOINT: LET'S NOT RUSH TO CHANGE THE SYSTEM

by Jasper L. Cummings, Jr., Washington, DC

The pro-consumption tax view has progressed from the theoretical to the possible in the course of the last 35 years. As George said to Coach Norman Dale in the 1986 movie *Hoosiers*: "Look, mister, there's... two kinds of dumb, uh ... guy that gets naked and runs out in the snow and barks at the moon, and, uh, guy who does the same thing in my living room. First one don't matter, the second one you're kinda forced to deal with."

Similarly, consumption tax proposals seem to have some political "legs," and we all sort of have to deal with them now. The President's Advisory Panel recently recommended a consumption tax alternative. "Common knowledge" now includes key elements of consumption taxation: (1) taxing capital discourages savings and investment, and that is bad; and (2) corporations don't pay taxes, people do, so we might as well not try to tax corporations.

The politically savvy say adoption of a consumption tax regime is highly unlikely in the near term. At most, some incremental shift toward the consumption end of the tax spectrum may occur, through things like bigger IRAs and more expensing of capital outlays. But even those changes likely will be influenced by the consumption tax arguments and by partial rejection of the theory of the income tax, which is that tax liability should relate to the current ability to pay, as measured by currently realized and recognized income. It is therefore imperative that we understand the consumption tax arguments. That can be difficult because (1) many of the arguments are "economic" in nature and somewhat unfamiliar to attorneys (and the economists seem to like it that way), and (2) some of the consumption tax proponents (other than the article authors quoted above) cannot be considered to be wholly objective.

I present my thoughts here not as an expert, but as an interested citizen who tries to be informed. This is all most of us can do, and it should be enough, because if political acceptance of consumption taxation occurs, it will be based on big picture choices. We should each see and understand those big picture choices clearly, for ourselves.

This is about who pays. "Dr. T.S. Adams … conclude[d] that 'modern taxation … is a group contest in which powerful interests vigorously endeavor to rid themselves of present or proposed tax burdens. It is, first of all, a hard game in which he who trusts wholly to economics, reason, and justice, will in the end retire beaten and disillusioned. Class politics is of the essence of taxation.'" Louis Eisenstein, THE IDEOLOGIES OF TAXATION 4-5 (Ronald Press 1961).

Not taxing capital income is not received wisdom. "The fairness of taxing more lightly incomes from wages, salaries and professional services than incomes from business or from investments is beyond question. In the first case, the income is uncertain and limited in duration; sickness or death destroys it and old age diminishes it. In the other, the source of the income continues; the income may be disposed of during a man's life and it descends to his heirs." Andrew W. Mellon, TAXATION: THE PEOPLE'S BUSINESS 56-57 (MacMillan 1924).

"Flat tax" is a stalking horse for consumption tax. Some have been enamored with the possibility of a "flat tax," presumably because the flat rate will be lower and the form will be shorter. Few realize that the term generally refers to a consumption tax at a flat rate. Admittedly, some versions of "flat taxes" are not flat (for example, the Bradford X-Tax), in that they tax wage income at progressive rates, while purportedly taxing business-level capital income at a flat rate. This would make sense to Mr. Mellon only if the wage rates scale down from the capital income rate so as to provide relief to wage earners.

Taxing capital later won't work. In the simplest version of a consumption tax, the tax is levied when the taxpayer spends money to consume. Suppose Mr. Jones earns $50,000 salary and consumes it all in the year and Mr. Big earns $500,000 in capital gains and consumes $50,000 in the year. Under a pure consumption tax, they both pay the same tax for the year. The theory is that Mr. Big will be taxed later, when he consumes the other $450,000. What if he dies with the $450,000 unspent? In theory, death should be the "final consumption" that balances the books on a consumption tax. But that concept does not appear in the models being offered, and most flat tax supporters would denounce it (although some scholars recognize its logic), just as they denounce the estate tax.

Corporations pay taxes. "Smart" folk like to amaze their friends and neighbors by smugly announcing that "corporations don't pay taxes," because they are intermediaries that can pass on their tax liabilities to employees, shareholders, customers, or some unknown combination of all three. While true, the observation does not prove that corporations should not pay taxes, or at least be a collection point for someone's taxes. It may provide support for integrating corporate and shareholder income taxation to avoid double taxation of the same income, but it does not support a shift to a consumption tax.

Corporations create wealth by using the benefits provided by the society and the various levels of government where they do business and are chartered: roads, peace, stable workforce, currency, etc. It is highly unlikely that the governments can determine which employees, customers, or owners are enjoying the benefits accorded the income producing business, much less tax them all. They may be anywhere in the world or may be tax-exempt.

Linking benefits with payment. We tend to forget that the prime basis for an income tax was the desirability of relating tax payments to the capacity of the taxpayer to pay at the time the tax is levied. A corollary is that the income tax is levied at the time the taxpayer enjoys the protection and other benefits provided by the government that presumably underwrote the production of the income to be taxed.

A consumption tax turns these connections on their heads. In some forms it focuses on divestment of funds at a time that may be far removed from the time of earning. The severance of taxing from earning and from the social conditions surrounding the time of earning could have profound effects on taxpayers' views of government. Might that be intended?

This is a moral issue. Prof. Ajay Mehrotra has written valuable studies of the work of Edwin R.A. Seligman and others in promoting the adoption of the income tax. *See* Ajay Mehrotra, *Edwin R.A.Seligman and the Beginnings of the U.S. Income Tax,* 109 TAX NOTES 933 (Nov. 14, 2005), 2005 TNT 219-43 (Nov. 15, 2005). His writings show how much public and political sentiment there was in favor of taxation on the basis of ability to pay, including the ability to pay from passive income. We should be embarrassed by the current lack of public debate about who should pay tax as a moral issue, relative to the debate at the turn of the century, particularly given the almost universal focus of the current debate on macroeconomic theory.

Savings and investment. We all must become little Greenspans. If the Fox News folk are going to say that savings and investment must be expanded at every second breath, we all need to know what that means.

Savings and investment are two different things. "Investment" refers to things such as Ford building new manufacturing plants in the U.S., and thus creating more domestic jobs and domestic economic activity. The theory is that Ford is not building those plants because there is not enough "savings" by other people, or because the "hurdle rate" that the plant must earn in profit is too high to attract debt or equity capital.

The desirability of more investment in the U.S. is real enough, but the talk about more savings gets fuzzy. The savings proponents generally want more savings by individuals. However, they conveniently ignore the second main way savings can occur in a country's economy: by the country's government avoiding dissavings. Annual deficits and the increasing national debt are forms of anti-saving that hurt Ford in the same ways as (and worse than) my not putting more cash into my 401(k) plan.

But even if we focus on 401(k) plans, the economic benefits are fuzzy. The theory is that the more individuals save, the more money is available for Ford to use to build that plant. This theory must be referring to borrowed capital, because statistics show that the vast majority of funds raised by U.S corporations is in the form of borrowing. But there is no shortage of U.S. dollars to borrow, at some price.

Therefore, the theory must be further refined to state that if Americans save more, domestic interest rates will decline, so Ford can afford to borrow more of our money and build more plants in the U.S. that otherwise would be uneconomic. These are some highly speculative assumptions on which to base a dramatic change in our tax system. We know there are all sorts of reasons why Ford may want to build plants abroad rather than here. Moreover, U.S. interest rates are not isolated from international money rates, and rates recently have been more affected by the Federal Reserve Bank's actions than by any amount of private savings or dissaving. It is not obvious how more savings by U.S. individuals is going to drive down U.S. bond rates. We should not adopt a consumption tax on such a "trust us, we know how economics works" argument.

Finally, two obvious, but little-discussed unintended consequence of increasing individual savings in the U.S. could drive interest rates up or have other bad results. First, saving individuals will buy fewer consumer goods, which will both put pressure on the profits of U.S. businesses and could cause imports to decline, thus reducing the need for foreigners to supply loans to the U.S. Conversely, if the increased "supply" of savings does make domestic interest rates fall, savers will earn less return on their savings, producing a zero sum game for them.

The truth comes out. Economists Edward Lazear and James Poterba (members of the President's Advisory Panel) have admitted the very constricted nature of the benefits of more savings, as quoted in the Point article above. They say the net gain to be had from more domestic savings comes down to this: "But in the longer run, a nation's standard of living will grow more quickly if it owns the capital that raises its productivity, because it then benefits not only from the higher wage growth that results from using the capital, but also from the capital returns." Lazear & Poterba, *supra.*

They are saying that the only net benefit to be had from more individual savings is that we individuals will own the return to the savings!!!! That is a substantial back-down from the more simplistic assertion that the additional savings will result in more domestic plant and equipment being built and bought (which they admit probably will happen anyway).

The buffalo hunt is over. An unspoken subtext of the push toward consumption taxes, is that even if the income tax has some moral claim, America can no longer "afford" the luxury of honoring it. The reason is that America faces a "perfect storm" of economic decline in (1) the end of the great 250-year buffalo hunt fostered by the rich vastness of this land, in-migration, stable government, and the relative absence of wars on our soil, etc., and (2) the end of U.S. dominance over the industrial revolution.

This is a fair point if the facts are right (U.S. is in new, dire, economic straits, and a tax change could ameliorate the problem). Are circumstances that dire? Are you that confident of the touted economic consequences? *Cf.* Jasper L. Cummings, Jr., *'Taxing Business Income Once': Where's The Beef? A Review and Critique of the Treasury Integration Study*, 54 TAX NOTES 1391 (Mar. 16, 1992). As observers begin focusing on the details, more and more of them are saying that substituting a consumption tax for an income tax, with "transition relief," produces relatively little, if any, long-term growth benefits. See Leonard E. Burman & William G. Gale, *The Tax Reform Proposals: Some Good Ideas, but Show Me the Money*, 110 TAX NOTES 397 (Jan. 23, 2006), 2006 TNT 15-33 (Jan. 24, 2006). And you can be sure that our Congress would give transition relief.

Taxing capital amounts to double taxing savings. This is a key premise of the consumption tax, because it does not tax capital income, except indirectly and partially under some models. The key cite for the premise is to John Stuart Mill's 1848 observation that a tax on income that is saved leads to a "double tax" on savings. John Stuart Mill, THE PRINCIPLES OF POLITICAL ECONOMY 317-318 (Colonial Press ed. 1899). This means that if I earn $100 and pay 3% tax and invest the $97 and pay 3% tax on annual interest received of 3% of $97, then the present value of the future taxes on the interest received in perpetuity will approximate another front-end tax of 3% on the $100 (or the $97). This results in a hypothetical approximate 6% tax on the $100.

Does that illustration intuitively make you want to not tax interest? This seems to be sort of like religion: either you believe it or you don't.

Somehow, that example has never shown me anything except an interesting mathematical truism (known as the E. Cary Brown principle): the present value of a tax on the future income to property is equivalent to a tax on the current value of the property at the same rate, holding all sorts of things constant that are never constant in the real world. See E. Cary Brown, *Business-Income Taxation and Investment Incentives, in Income, Employment and Public Policy: Essays in Honor of Alvin Hansen* (1948), *reprinted in* READINGS IN THE ECONOMICS OF TAXATION 525-37 (Richard A. Musgrave & Carl S. Shoup eds., 1959).

Conclusion. The Internal Revenue Code of 1986, as unfortunately amended since 1986, is unfair, unnecessarily hard to apply by normal folk, and not well suited to a populace that is frequently told by some of its leaders that government, taxes and tax collectors are bad. However, only a small part of that is the fault of an income tax. The blame can be widely shared by Congress, the Administrations (current and past), and the inherent greed of people (using here the Code definition of "person").

Rather than rejecting the income tax, we would do better to broaden the base and lower the rates along the lines of the Tax Reform Act of 1986, enhance our ability to collect the tax (as by withholding on various sorts of regular payments in addition to wages), and improve the people's view of government. The Bar should be at the forefront of those efforts. ■