

# **Just Taxes, & other options**

**By Robert S. McIntyre**

**Reprinted from  
*Less Taxing Alternatives*  
March 1984**

Citizens for Tax Justice

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**T**AX REFORM. “The more you get into it, the more complicated it becomes,” lamented Treasury Secretary Donald T. Regan in the spring of 1983. “But there has to be an easier way.”

Indeed, it sometimes seems that almost anything would be preferable to our current Internal Revenue mess. Our federal tax system is unnecessarily complex, widely perceived as unfair, and failing miserably to raise sufficient funds to run the government. And there’s certainly no shortage of proposals for fundamental change. Flat taxes, “Fair Taxes,” consumption taxes, value-added taxes, even no taxes—all are being pushed from various quarters as the solution to our tax discontents.

So far, the public is hedging its bets. Louis Harris’s pollsters found in 1983 that 62 percent of the Americans they talked to supported adoption of a simplified personal income tax with no deductions or credits. But by almost as large margins the same people opposed elimination of most of the specific tax breaks about which they were queried. A majority of the respondents to a 1983 Gallup poll thought a new national sales tax might be the best way to raise taxes, but they also said the main problem with the present system is that it undertaxes the rich and overtaxes the middle class and the poor.

We’re going to have to make up our minds, however, or they’ll be made up for us. Despite the fact that hardly anyone in Washington thinks the tax code will be junked all at once in favor of a streamlined system and despite all the maddening philosophical, technical and political conundrums that Secretary Regan has discovered, significant changes in the tax laws are highly likely over the next few years—if only to bring federal receipts more in line with spending. The need for major action could provide the opportunity to move toward a simpler, fairer, more acceptable tax system. It could also, however, easily lead to a tax system even worse than the current approach.

The American people, it appears, want a change in direction in tax policy. In the pages that follow, the leading tax alternatives will be scrutinized, with a particularly critical look at something called the “progressive consumption tax.” To start with, however, it makes sense to review how we got to our present sorry state.

## FROM THE CIVIL WAR TO THE TAX REVOLT

CONTRARY TO PRESIDENT REAGAN'S OFT-STATED OPINION, the progressive income tax was not the brainchild of Karl Marx. Actually, the first federal income tax act was signed into law by Ronald Reagan's premier Republican predecessor, some fourscore and six years after the American colonies declared their independence from Great Britain and 13 years before Marx endorsed the ability-to-pay principle in his *Critique of the Gotha Program*.\*

Abraham Lincoln's income tax was a graduated levy, with a \$600 personal allowance that exempted most working families and rates as high as 10 percent for incomes exceeding \$10,000. The Confederacy copied the Union approach, but with steeper rates. The Civil War income tax was only a temporary measure, however, and in 1871 it was repealed. For the next forty-two years the federal government reverted to its pre-Civil War system of raising revenues—excise taxes and, increasingly, tariffs on imports.

Popular dissatisfaction with the regressive taxes on goods, particularly the import duties, grew stronger and stronger in the latter part of the 19th century. Not only were the tariffs excessively burdensome to those with lower incomes, but they also were part of a protectionist trade policy favoring Eastern manufacturing interests at the expense of working people and farmers.

In 1913, after years of legislative and legal wrangling, Populist and Progressive forces finally succeeded in ending the government's exclusive reliance on flat-rate consumption taxes. The 16th amendment to the constitution was ratified, clarifying federal authority to impose a tax on incomes. That same year Congress approved and President Wilson signed both the individual income tax and continuation of the corporate profits tax that had been enacted in 1909. Adoption of the federal estate tax followed soon after, in 1916.

Both the defense of and the opposition to the new income tax featured strong rhetoric. Proponents, largely Democrats but also including progressive Republicans such as Theodore Roosevelt, called for reinstating Lincoln's levy as a means of taxing the "swollen fortunes" of the rich. Opponents, in attacks largely orchestrated by major business interests and later to be echoed by Ronald Reagan, decried the income tax as "confiscatory," an "assault on capital" and even "communism." The initial reality hardly deserved such

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\*Marx's 1875 *Critique* included the famous maxim: "From each according to his abilities, to each according to his needs." Of course, this was intended more as a principle of social organization than as a suggestion for a graduated income tax. And, actually, Marx didn't invent the line. Instead, he is believed to have been paraphrasing from either Louis Blanc's *Organization du Travail* (1840) or Morelly's *Le Code de la Nature* (1755). Lincoln probably hadn't read these French authors; he was more likely, however, to have been familiar with the defense of a progressive income tax in Adam Smith's *Wealth of Nations* (1776). See page 23 below.

apocalyptic pronouncements. The early individual tax rates, for example, ranged from one to seven percent, with only one American out of a hundred paying any tax at all due to generous personal exemptions. In 1913, the corporate rate was only one percent.

Concern about equity was uppermost in the minds of the income tax supporters. The 1913 House Ways and Means Committee report on the income tax bill summed up the prevailing view:

Section 2 of the bill imposes a tax upon the annual net incomes of individuals and corporations. This is in response to the general demand for justice in taxation. . . . The tax upon income is levied according to ability to pay, and it would be difficult to devise a fairer tax.

Rates zoomed up to as high as 77 percent on extremely high incomes to fund U.S. involvement in World War I, but those steep rates were quickly reduced after wartime spending needs subsided. At the outset of the Great Depression, total federal taxes amounted to less than five percent of the gross national product, with just over half of that supplied by the corporate and personal income taxes. The individual income tax totaled only 1.4 percent of personal income. Despite a number of changes over the next ten years, federal taxes in 1940 remained at five percent of the GNP, and individual income taxes at 1.3 percent of personal income.

## **A Class Tax Becomes A Mass Tax**

THE CRITICAL CHANGE CAME WITH THE ONSET OF WORLD WAR II. Exactions from the rich were insufficient to fund the enormous federal spending the war required, and the income tax was expanded to a broad-based levy affecting almost three-quarters of the population. By 1945, federal tax receipts were close to 19 percent of the GNP, with nine out of every ten dollars in federal revenues coming from personal and corporate income tax collections—which at the time were about equal. The individual income tax amounted to just under 11 percent of total personal income.

Unlike the aftermath of World War I, the German and Japanese surrenders in the mid-forties were not followed by sharp reductions in U.S. taxes. Although the Truman administration at first began cutting back military expenditures to barebones levels, President Truman's desire to reduce the national debt accumulated during the war caused him to oppose congressional efforts to cut taxes. The Republican Congress did force through some tax reduction over Truman's veto, but by 1950 federal taxes remained at 13 percent of the GNP and the individual income tax at nearly 8 percent of personal income.

Then the Korean War pushed up military spending again, and in the ensuing Cold War the decision was made to maintain a large standing army—a peacetime first for the United States. This required money—and in the fiscal thinking of the 1950s, that meant taxes. By 1955, individual income taxes were

back up to almost 10 percent of personal income, and military expenditures were consuming more than a tenth of the GNP.

As national income grew, the military's claim on the GNP gradually declined. But in the 1960s, Americans became aware of social and economic problems they thought cried out for government intervention. Domestic programs to alleviate poverty and hunger, to assist the elderly and to reduce discrimination were established or expanded, and eventually became the major focus of federal outlays. In the sixties and seventies, federal taxes averaged just over 19 percent of the GNP and never fell below 18 percent. Individual income taxes generally fluctuated between 10 and 11 percent of personal income. More significant changes, however, occurred in how the tax burden was shared, both among individuals and between personal and corporate taxpayers.

## The Business of Loopholes

EFFORTS TO AVOID THE INCOME TAX BEGAN EARLY. The 1909 corporate profits tax was defined simply as a tax on "net income," and the 1913 individual income tax law tracked the language of the 16th amendment to apply to "incomes, from whatever source derived." But loopholes were soon found and "incentives" soon adopted by Congress. Even the initial personal income tax exempted interest on state and local bonds from taxation and provided deductions for mortgage interest, property taxes and casualty losses. Charitable contributions were made deductible in 1917 as an incentive for philanthropy. By 1918, the oil industry had obtained the two major special write-offs that to this day are the keys to the low taxes of crude oil producers. The tax shelter industry got an early boost in 1921, when capital gains—profits from selling stocks, real estate and other types of property—were granted favorable treatment. Upper-income taxpayers quickly learned how to manipulate trusts and partnerships to avoid income and estate taxes.

During the 1930s, the Roosevelt administration called repeatedly for tax reform, particularly for closing the oil loopholes, but made little headway. By the fifties, when Texans Sam Rayburn and Lyndon Johnson controlled the House and Senate, it was next to impossible for a reform-oriented Representative or Senator to gain a seat on the congressional tax-writing committees.

President Kennedy came into office in 1961 with two conflicting goals in the tax area. On the one hand, he wanted to improve tax fairness, but on the other, he sought to try to use the tax system to stimulate growth with new "incentives." His small victories at the former were more than overshadowed by his dubious successes at the latter. In fact, the roots of our current tax dilemma largely can be traced to Kennedy's tax-based economic policies. Most notably, despite Republican opposition on ideological, free market grounds and labor antagonism for distributional reasons, the Kennedy administration succeeded in adding to the tax code a large tax credit for business purchases of machines and equipment. This "investment tax credit" was supposed to be temporary—a "fine-tuning" device to stimulate capital spending during a

stagnant period. A decade and a half later, however, it was to become both permanent and the single biggest loophole in the tax code.

Late in the 1960s, tax reform forces temporarily regrouped. Spurred by out-going Treasury Secretary Joseph Barr's revelation that there were 154 individuals making more than \$200,000 a year paying absolutely nothing in federal income taxes and informed by the path-breaking research of Barr's assistant secretary, Stanley S. Surrey, Congress enacted the 1969 Tax Reform Act. This bill cracked down on a number of notorious tax loopholes and repealed Kennedy's investment tax credit, which had been much criticized for being ineffective and even perverse in its impacts.

Once again, fairness was the dominant theme. The tenor of the times was aptly captured in the Senate Finance Committee's report on the 1969 bill:

Increasingly in recent years, taxpayers with substantial incomes have found ways of gaining tax advantages from the provisions that were placed in the code primarily to aid limited segments of the economy. In fact, in many cases these taxpayers have found ways to pile one advantage on top of another. The committee agrees with the House that this is an intolerable situation. It should not have been possible for 154 individuals with adjusted gross incomes of \$200,000 or more to pay no Federal income tax. Ours is primarily a self-assessment system. If taxpayers are generally to pay their taxes on a voluntary basis, they must feel that these taxes are fair. Moreover, only by sharing the tax burden on an equitable basis is it possible to keep the tax burden at a level which is tolerable for all taxpayers.

When the 1970s began, even the harshest critics of the tax system generally admitted that the U.S. federal income tax, despite its faults, was still the best, most equitable tax in the world. The American people agreed. For all the good-natured grumbling, as recently as 1972 people told pollsters they considered the federal income tax the "fairest" of all taxes. But beginning with Richard Nixon's Revenue Act of 1971, a new attitude toward the tax system emerged in Washington, an attitude that was to lead to a sharp fall-off in public support for the federal tax laws. Pressed by business lobbies and PACs, Congress gradually lost sight of the original purpose of the income tax. Concerns about fairness gave way to what might be called "loophole mania." Starting with reenactment of an expanded version of the investment tax credit and several other Nixon administration "business incentive" initiatives, Congress began throwing tax breaks at every social and economic problem that emerged.

Abandoning their free-market pretensions, Republicans found the new approach congenial, it not irresistible, since more tax breaks for corporations and the wealthy served their core constituency. Democrats were pleased to have the opportunity to emulate JFK by using the tax code to tinker with the economy. And members of both parties welcomed the campaign support that voting for loopholes invited.

The seventies provided plenty of opportunities for Congress to vote for added tax preferences. As inflation heated up, it drove individual taxpayers, particularly those at the lower end of the income scale, into higher tax brackets. Tax changes were needed simply to keep federal revenues from rising much faster than national income. It seemed easy at the time to divert some of the tax “cuts” necessary simply to offset “bracket creep” into new tax breaks for pet causes and constituencies. But as the Senate Finance Committee’s 1969 report had sagely observed, tax breaks for the privileged few inevitably meant tax increases for the unprivileged many—increases that would not be long tolerated. By the end of the 1970s, as tax burdens on average citizens grew, the public was becoming increasingly dissatisfied with the federal tax system. The same polls that had found widespread public approval for the income tax in 1972 now found the opposite. Since 1979 the federal income tax has been annually cited as the “least fair tax” by more people than any other tax.

Congress did not quickly get the message, however. In 1980, Ways and Means Republican Richard Schulze of Pennsylvania was not far from the congressional mainstream when declared:

I would like to comment, first, on all this talk about “equity.” I hear so much in this room about “equity” and “our search for equity,” and quite frankly, I don’t think that should be the role of this Committee. Maybe it could be a second-level or a third-level role, but our primary role should be to create incentives through the tax code.

## **The Reagan Ravagement**

WITH A SUBSTANTIAL ASSIST FROM PRESIDENT REAGAN’S 1981 TAX ACT and despite some retrenchment the following year, Representative Schulze’s wish has come true. The dominant role of the current income tax is to implement a hodgepodge of government “incentive” policies. In fact, the total amount of revenues the Treasury now forgoes through officially-designated “tax expenditures” is almost as large as the amount actually collected in income taxes. The explosion in loopholes has been most dramatic on the corporate side—up from \$7 billion on the government’s official list in 1970 to an expected \$87 billion by 1985. Fiscal 1983 saw \$1.67 lost through corporate loopholes for every dollar paid in corporate income taxes. On the individual side, there now are about 83 cents in “tax expenditures” for every dollar collected in personal income taxes. Even not counting individual relief measures that are not intended to change behavior, one still finds close to 60 cents in individual tax “incentives” for every dollar paid in personal taxes.

What have all these “incentives” done for us?

Well, the most obvious result has been a rather dramatic shift in the way the tax burden is shared. Since 1978, inflation-driven “bracket creep” has raised the effective income tax rate on the bottom half of the population by more than 50 percent. Counting higher Social Security taxes, the federal tax burden on a poverty level family has quintupled. The income tax rate paid by

the next 30 percent of taxpayers is up by 14 percent or more and Social Security tax rates on these middle-income families are up by close to 30 percent. At the same time, mainly due to added loopholes, the effective tax rate paid by the wealthiest individuals—those making more than \$200,000 a year—has been slashed by more than a third.

Meanwhile, our major corporations are barely contributing at all. According to a recent congressional study, the effective federal income tax rate in 1982 on 213 Fortune-500 companies surveyed was only 16 percent. Telecommunications firms paid less than 2 percent; railroads chipped in only 4 percent (after paying nothing the previous year); large banks, insurance companies, aerospace firms and chemical companies got outright tax *rebates*. Among the well-known, highly profitable businesses getting tax money back from the government in 1982 were DuPont, RCA, Texaco, and General Electric. GE's total rebates in 1981 and 1982 of \$250 million were garnered despite reported profits in those years totaling \$3.5 billion. In fiscal 1983, the corporate share of the tax burden amounted to a mere 6 percent—and with the swelling federal budget deficit, corporate taxes paid for only 4½ percent of federal spending.

As a result of this huge tax shift, average taxpayers are paying more in taxes but getting no more or even less in government services. To ordinary taxpayers, who see only what *they* are paying, not what others are *not*, it may plausibly look like the government is suddenly wasting a great deal of their money. But the reality is that they are paying the taxes that have been avoided by the politically powerful.

But what of the silver lining? Are the new “incentives” at least helping achieve important economic goals? Apparently not. The huge depreciation tax breaks enacted in 1981, for example, were supposed to increase corporate capital spending. Instead, plant and equipment investment declined in 1983 for the second year in a row—the first time that's happened in the entire postwar era. The new “savings incentives” enacted in 1981 were supposed to be a boost to private saving. Instead, they simply attracted funds away from other kinds of savings, and the personal saving rate reached a 33-year record low of 4 percent of disposable income in the second quarter of 1983.

In fact, although the explosion in loopholes over the past decade has been relentlessly defended by Washington lobbyists as beneficial to the economy, the actual results have been just the opposite. Not only have the costly giveaways failed to lead to increased investment, not only have they helped send federal deficits and real interest rates soaring, but they also have seriously distorted economic decisionmaking. Tax sheltering, rather than the market etplace, has become the driving force behind many investment choices. Bad investments, entered into only for their tax advantages, have crowded out good ones.

What tax loopholes—both corporate and individual—have given us in the way of “investment” is lots and lots of paper shuffling. Take, for example, a \$485 million tax shelter engineered in the fall of 1982, in which 534 wealthy investors bought Metromedia, Inc.'s entire stock of 45,000 used billboards with

the expectation that they'd sell them back in five years after milking the tax write-offs. Or the rampant trading in used office buildings under way in cities across the country, as investors seek "newly-acquired property" to get the enhanced depreciation deductions available since 1981. Or the quadrupling in syndicated tax shelters since 1979 involving, among other things, such highly productive assets as llamas, foreign stamps and used shopping centers. Or the tidal wave of corporate mergers over the past three years, totaling a staggering \$209 billion—with new records predicted for 1984.

Although heralded by backers as the start of a new era in tax policy, President Reagan's 1981 tax victories were simply the continuation of an old one—and they may turn out to have been its zenith. The failure of "trickle-down" policies to boost the economy (and instead the experience of a deep recession followed after much pain by a consumer-led recovery), the news of how the 1981 loopholes virtually wiped out the corporate income tax, the spectacle of profitable companies buying and selling tax breaks and most important, the realization by most people that their own taxes have gone up despite the so-called Reagan tax cuts have brought public discontent with the tax system to a critical mass.

One bemused congressional tax staffer may have been speaking for many other taxpayers when he summed up his dissatisfaction with the tax laws this way: "Last year Occidental Petroleum made \$720 million and got \$25 million back from the government. I made about \$50,000 or so and paid something like \$10,000 or \$15,000 in taxes. Now, the way I figure it, with a little rounding off, I made \$720 million less than Occidental—but I paid \$25 million more in taxes. I'm no dope, but for the life of me, I can't figure out how that can be fair."

Belatedly, many members of Congress also are becoming unhappy with their handiwork. Liberal Democrats are discovering that they can't fund social programs without revenues and that middle-class support for the government—and for Democrats—has plummeted as the tax burden has shifted. On the other side of the aisle, principled conservatives look at the wreckage of the free market that tax preferences have given us—and many are aghast.

## ESCAPING THE LABYRINTH

**S**O WHERE DO WE GO FROM HERE? What kind of tax system do we want? And how do we get there?

The original income tax had low rates and few loopholes. Seventy years later, we have a system that verges on being more loophole than tax. Because so much income is sheltered in one way or another, we've ended up with much higher tax rates on what's left—primarily wages. And even with those high statutory rates, the tax system falls far short of raising sufficient revenues to fund the government. Moreover, there is widespread agreement that the

loopholes and special breaks are causing serious and harmful distortions in the economy.

The obvious answer—you might say—is to close the loopholes and restore fairness, simplicity and economic common sense to our tax laws. Indeed, there are numerous politicians talking about doing exactly that. But while all the suggestions call for a simpler tax system, they differ radically in their definitions of equity and economic efficiency.

At a fundamental level, the current tax debate raises the same kinds of issues that were threshed out prior to adoption of the original income tax way back in 1913. Now as then, there are those who want to establish a simple income tax system with relatively low, but progressive tax rates. Raising their voices against this approach now as then are those who contend that consumption rather than income should be the target of taxation. And now as then, quite a lot rides on which direction we choose to take.

## **The Fair Tax**

THE LEADING CURRENT PROPOSAL FOR A SIMPLIFIED PROGRESSIVE INCOME TAX comes from two Democratic members of the congressional tax-writing committees. Senator Bill Bradley of New Jersey and Representative Richard Gephardt of Missouri. Their “Fair Tax” would reverse the direction tax policy has taken for the past decade or so by wiping out most special tax breaks on both the personal and corporate sides of the tax ledger. It would also increase standard deductions and personal exemptions so that taxes no longer apply to poverty-level incomes, and would cut statutory tax rates. For four out of five American families, the tax rate would be 14 percent of income in excess of the standard deduction and exemptions (which would total \$11,200 for a family of four). The top tax rate—applicable to corporations and to families earning more than \$65,000—would be 30 percent.

The Fair Tax would retain a handful of popular tax deductions—mortgage interest, property taxes, state-and-local income taxes and a few others—but they would be limited to saving taxpayers 14 cents for each dollar deducted (unlike the current system, where the more you make, the more your deductions are worth). And because of the significantly larger standard deduction, far fewer taxpayers would utilize the option to itemize.

The Bradley-Gephardt plan offers a radically simplified tax system that basically gets the government out of the business of trying to influence investment decisions through tax “incentives.” Gone would be tax breaks for speculating in gold or collectibles, tax shelters in used shopping centers and billboards, and tax subsidies for companies to move their factories overseas. No longer would loopholes rather than real profit opportunities dominate so many private sector choices. Thus, the Fair Tax is responsive both to complaints about the tax code’s complexity and to criticisms that most of the current “incentives” have proven either ineffective or counterproductive in achieving their putative economic goals.

What about winners and losers? Well, because rate reductions are combined with a general crackdown on loopholes, most taxpayers will not be indifferent to the Fair Tax in terms of their actual tax bills. For example, under the Fair Tax, a couple with two children earning \$15,200 would pay a 14 percent tax rate on \$4,000 in taxable income. That family's tax bill would be \$560—about a \$250 cut from present law. A typical family of four making \$30,200 would pay taxes on \$19,000, and have a tax bill of \$2,660—about \$200 less than currently (even though the family no longer would itemize deductions).

Overall, Bradley and Gephardt estimate that about 30 percent of individual taxpayers—those making exceptional use of tax breaks under present law—would pay higher taxes under the Fair Tax. The remaining 70 percent of us would pay somewhat less.

Similarly, on the corporate side, despite the proposed drop in the corporate rate from 46 percent to 30 percent, many companies would pay significantly more in taxes than they do now. This isn't surprising, of course. As noted earlier, the average 1982 tax bill for 213 Fortune-500 companies studied by the staff of the congressional Joint Committee on Taxation was only 16 percent—and about a quarter of the industries paid less than 10 percent. But companies that now pay high taxes would get tax cuts under the Fair Tax. It has been suggested, for example, that many high-tech firms might benefit.

Although Bradley and Gephardt can rightfully claim that their program would enhance both tax equity and economic efficiency, they admit that they do not solve two critical and related problems with our current law. The first is the federal government's urgent need for added revenues to narrow the deficit. The second is what many believe to be the equally important imperative to reverse the radical shift in tax burdens that has taken place over the past several years. Although the Fair Tax does rearrange tax burdens within income classes, the authors say that it roughly reproduces both the current amount of revenues and the current average distribution of taxes across different income levels (with the notable exception that the poor no longer would be taxed).

Bradley and Gephardt may well be too modest about the impact of their program on revenues and tax progressivity, however. In the longer run, their restructuring of business taxes seems almost certain to lead to an increase in corporate tax payments and to a larger decrease in upper-income tax shelters than their estimating model is capable of measuring. And at least some improvement in compliance with the tax laws also would be likely. Studies have shown that cheating declines when taxpayers believe in the equity of the tax laws. And the Fair Tax's basic principle—as Senator Bradley puts it, that “if you manage to do well in this society and to benefit economically, then you should pay a somewhat higher tax rate than those individuals who find themselves struggling from paycheck to paycheck”—fits in well with popular notions of what tax fairness is all about.

Whether the Fair Tax is politically feasible in its entirety remains to be seen, but it's certainly possible to move toward its goals in stages through the kind of loophole-closing programs that Senator Bob Dole, Republican Chairman of the Senate Finance Committee, among others, has been promoting. So the Fair Tax is an action agenda, not an excuse to do nothing until the millennium arrives and all loopholes are closed at once. And by making some rather modest changes in tax rates and by attacking some of the tax preferences, particularly on the business side, that the Bradley-Gephardt plan leaves intact, the program's problems of insufficient progressivity and revenue shortfall could plausibly be resolved. (Such is illustrated by an adaptation of the Bradley-Gephardt plan proposed by the International Association of Machinists and Aerospace Workers as part of their "Rebuilding America" program).

## **Flat Rates**

COMPETING WITH BRADLEY-GEPHARDT-STYLE INCOME TAX REFORMS for popular support are a variety of proposals for "flat-rate taxes." As the label suggests, these programs would abandon graduated tax rates in favor of a single rate. In addition, most of them would replace the income tax with a tax solely on personal consumption.

One version of the flat-rate approach is the "value-added tax" or "VAT," a complicated national version of the familiar retail sales tax collected in almost every state. Like a regular sales tax, the VAT would be paid in full by retail consumers when they purchase goods. In addition, the tax would be collected, and then rebated, at various stages of production—a device widely used in Europe to combat tax evasion at the retail level. Unlike a sales tax, however, the VAT typically is included in the price of goods rather than added on at the time of purchase, so that its impact can be largely hidden—a feature that some see as politically advantageous.

Closely related to the VAT are most of the so-called "flat-rate income tax" proposals that have received so much recent attention. Through one means or another, a majority of these "income tax" plans would exempt from tax money saved or invested—and therefore tax only spending, as under a sales tax. These flat-rate proposals differ functionally from a VAT primarily in that they would provide an exemption for the very poor.

Supporters of the various flat-rate proposals, including VAT, tout their systems as being loophole-free. Such claims, however, are highly misleading. Yes, these programs would curb tax breaks for homeowners and end the partial tax exemption for Social Security benefits. But they also would retain and expand the most significant tax "incentives" enjoyed by people wealthy enough to save and invest large sums. In fact, by exempting all saved income—including all undistributed corporate profits—these plans simply would consolidate the current array of "savings and investment incentives" into a single sweeping loophole.

In effect, the flat-rate plans, directly or indirectly, would generalize the system of excise taxes and customs duties that prevailed as the federal government's main revenue source prior to adoption of the 16th amendment. As might be expected, such a radical step would have a major impact on the distribution of tax burdens.

In an attempt to hide that impact, many of the flat raters engage in some rather outrageous political demagoguery. For example, Senator Jesse Helms of North Carolina, Representative Phil Crane of Illinois and, before he became President, Ronald Reagan all have said they favor replacing the current tax system with a flat 10-percent consumption tax. (As a concession to the truly needy, families with incomes substantially below the poverty level would be exempt.) These gentlemen have traced their choice of a 10-percent tax rate to the old Christian practice of tithing. Crane says the approach would cut taxes for virtually all Americans. He's not quite right—many lower-income people would pay considerably more due to reduced exemption levels. But the 10-percent tax these men have proposed would indeed be a considerable tax cut overall—in fact, it would add as much as \$175 billion a year to the federal deficit.

More carefully thought out from a revenue point of view, although still very sketchy in other respects, is a flat-rate consumption tax introduced in Congress by Senator Dennis DeConcini of Arizona. Authored by Robert Hall and Alvin Rabushka of Stanford's Hoover Institution, this plan would tax all unsaved income at a 19 percent rate (with exemption levels roughly similar to those in current law).

Hall and Rabushka admit that their program—like any serious flat-rate plan—would dramatically slash taxes on the rich and the corporate sector and raise taxes on almost everyone else. That is, a flat tax would accentuate the tax shift onto middle- and lower-income taxpayers that has been going on for the past decade. The theory, which Hall and Rabushka state bluntly in their book, *Low Tax, Simple Tax, Flat Tax* (1983), is a depressingly familiar one:

Now for some bad news. [Our] simple tax does not make everybody better off straight away. . . . Until a response to improved incentives takes place, it is an obvious mathematical law that lower taxes on successful people will have to be made up by higher taxes on average people. . . . If incomes remain exactly the same after tax reform, then the poor and the middle class subsidize the rich. . . . But quickly everyone will benefit from the increased economic activity that will accompany a dramatic improvement in the incentives facing the most critical participants in our economy.

Now, note that Hall and Rabushka are not talking here about the economic benefits which almost surely could be gained from closing loopholes that foster tax shelters and thereby divert capital and effort into less productive areas. Nor are they touting the supposed added savings that switching to a consumption tax might produce (discussed below). Elsewhere in their book, they do make arguments for these intended elements of their program, but on

behalf of abandoning graduated tax rates their economic case is nothing but a restatement of Andrew Mellon's famous "trickle-down" dictum that "the prosperity of the lower and middle classes depends upon the good fortune and light taxes of the rich."

Why do the flat raters subscribe to this theory? Aside from repeated references to the rich as "the most critical participants in our economy," as "the most productive and highly paid . . . part of our population" and as "bright people," Hall and Rabushka don't tell us. They certainly offer no explanation for the disappointing results from our most recent experiment with "trickle-down" policies—the 1981 Reagan tax act. And while they point to Hong Kong and the Isle of Guernsey as evidence that a flat rate works, they ignore a much larger body of experience that shows economic growth and inequity are inversely correlated.

In its 1982 annual report for example, the congressional Joint Economic Committee investigated whether there was any connection between inequality and prosperity in the economies of America's major trading partners. It found the truth to be "just the opposite. Those countries with above average inequality have grown less rapidly than the more nearly equal countries." Writing in the March 1982 issue of *The Atlantic*, conservative American Enterprise Institute scholar Michael Novak reached a similar conclusion. It's no coincidence, he found, that the United States historically has combined exceptional economic growth with continued improvements in economic fairness. Looking back over 400 years of economic history, in fact, countries with "relative equality" of income, wealth and political power have had by far the most economic success. Conversely, "a narrow concentration of wealth has negative effects" that are "quite visible" in countries and regions whose economies have not performed well.

Likewise, a number of analyses of Japan's economic success have pointed to that country's relatively equal distribution of incomes as a major factor in encouraging both work er-management cooperation and entrepreneurship. According to *Time*, for example, the highest paid individual in Japan was recently disclosed to be a baseball player making \$740,000. In contrast, the highest paid American corporate e xecutive in 1982, Frederick W. Smith, chairman of Federal Express, pulled down more than \$51 million (and the second and third place finishers in the e xecutive-pay derby received \$44 million and \$15 million, respectively). In its special issue on Japan, *Time* also cited several examples of successful, relatively highly paid Japanese who, while complaining about high taxes, said they had redoubled their efforts in response.

Whatever their views on "trickle-down" theory, most members of Congress are usually—and understandably—reluctant to support large tax increases on most of their constituents, at least if the increases are so visible that the voters will almost certainly notice them and know whom to blame. Thus, after the outrageously regressive and impolitic distributional consequences of the various flat-rate-tax schemes were pointed out by numerous

witnesses at Senate Finance Committee hearings in 1982, most members of the Committee were quick to disavow any interest in the idea.

Leading the retreat was former (and perhaps future) Finance Committee Chairman Russell Long, who took to the op-ed page of *The Washington Post* to denounce the Hall-Rabushka flat tax. “If you’re rich, you’ll love it,” said the Louisiana Democrat. “If you’re not, then look out.” Long’s spirited defense of graduated tax rates was ironic, in light of the fact that only two years earlier he had joined then House Ways and Means Committee Chairman Al Ullman (D-Ore.) in proposing a federal value-added tax as a partial substitute for the income tax. Since the main difference between the Long-Ullman VAT and the Hall-Rabushka plan is that the two Stanford professors at least find it seemly to exempt the very poor from tax, Long seems to be reading the political tea leaves differently than he did in 1980. His thinking may have been influenced by the fact that Ullman was retired in 1980 by the voters of Oregon, one of the few states still without a retail sales tax. The fact that a VAT is a hidden tax, while the Hall-Rabushka flat tax is not, may also have colored Long’s opinion.

## The Progressive Consumption Tax

ALTHOUGH ABANDONING GRADUATED TAX RATES SEEMS to be at least temporarily out of vogue, the idea of switching from an income tax to a tax solely on spending may be gaining ground. Over the past decade, a great deal of academic effort has been expended to try to demonstrate that such a switch need not be based on “trickle-down” principles. Instead, it is argued, it’s possible to have a consumption tax that is progressive.

A progressive consumption tax? How do you do that? Well actually, the theoretical mechanism is pretty clever. In order to retain graduated tax rates, advocates of a progressive consumption tax would eschew direct taxes on spending, such as a sales tax or value-added tax. Instead, they would retain the trappings of the income tax, but allow a tax deduction for money saved or invested (an approach similar to that followed by some of the flat-rate plans discussed earlier). Moreover, and this is critical, “negative savings”—money either borrowed or taken out of savings—would be added to income in computing taxable consumption. Since by definition people must either save or spend their earnings (ignoring gifts), a tax deduction for savings and an add-back for “negative savings” is a slick way to measure an individual’s actual consumption expenditures in a given year.

The idea of a “progressive consumption tax” has caught the fancy of a wide range of pundits whose views normally span the political spectrum. Liberal economics writers Lester Thurow and Robert Reich endorse the approach. So do the Reagan administration’s conservative chief economist Martin Feldstein and the Treasury Department’s assistant secretary for tax policy John Chapoton (although these two officials intimate that they might prefer a flat-rate consumption tax were its distributional consequences not so

impolitic). It sometimes seems that every economist under 40 has jumped on the progressive-consumption-tax bandwagon, too.

Progressive consumption taxers believe their system's technical cleverness allows them to achieve a number of seemingly inconsistent goals simultaneously. The supposed need for "investment incentives" that provided the rationale for the loophole-poking tax approach of the past decade would be met by carving out one giant loophole for all funds saved or invested. Fairness allegedly would be retained, or even enhanced, by properly setting the tax rates and, perhaps, by beefing up inheritance taxes. The political process that produced the current hodgepodge of tax breaks and all the investment distortions they entail would be short-circuited by putting all savings and investment on an equal footing—that is, tax-exempt. Knotty problems involving inflation and several other capital-income issues would be defined away. In fact, many proponents of the progressive consumption tax believe that the only real difficulty with their proposal involves overcoming public misconceptions about it.

That perceived political problem is certainly real. In fact, up till now, most elected officials have been wary of giving any kind of consumption tax—progressive or flat-rate—a straightforward endorsement, figuring that the voters would react negatively to the idea. Al Ullman's unhappy experience with the citizens of Oregon after he proposed a VAT in 1980 offers one illustration that this political assessment probably is correct. Another example was provided in the spring of 1983, when President Reagan suggested he might favor outright repeal of the corporate income tax—one of the key elements of the consumption tax package its supporters often fail to mention. "I'll probably kick myself in the morning for saying this," Mr. Reagan predicted, and he was right. The President's off-the-cuff remark was greeted with an uproar of popular indignation and was quickly followed by official denials that the administration was planning to pursue the President's idea.

Senator Gary Hart has bravely promoted the progressive consumption tax for several years as one of his "new ideas." But this Democratic presidential candidate now is hedging his bets by supporting a reformed progressive *income* tax as well. Hart has found that merely the term "consumption tax" is politically frightening. "If anyone can think of a better title for this than 'expenditure tax' or 'consumption tax,'" he complained in 1982, "I would certainly welcome it." To try to deal with the problem Hart identifies, assistant Treasury secretary Chapoton calls his favored plan a "tax on consumed income." His predecessor under President Ford preferred the name "cash-flow tax," while corporate lobbyist Charles E. Walker is trying out "tax on business transactions" as a euphemism for his (flat-rate) value-added tax proposal.

From the other side of Sierra Nevadas, Robert Hall and Alvin Rabushka came up with the most innovative—and for a time successful—approach to the nomenclature problem, on behalf of their so-called "flat-rate income tax." The following exchange between Senator Bill Bradley and Robert Hall at a 1982 Senate Finance Committee hearing illustrates that novel approach, and shows

how it eventually runs afoul of Abraham Lincoln's famous aphorism about fooling people:

SENATOR BRADLEY. I would like to get a little better understanding of what your plan really is. . . . When you say you tax *income* only once, what does that mean? . . . [W]hat I am getting at is that we had a couple of witnesses earlier in these hearings say that what they were for was a tax where if you spent the money, you paid a tax on that. But if you didn't spend it, if you saved it or reinvested it or whatever, you wouldn't pay a tax on that. Now we call that a consumption tax.

MR. HALL. Right.

SENATOR BRADLEY. What is the difference between that tax and the one you have advocated?

MR. Hall. None at all.

SENATOR BRADLEY. None. So you are advocating a consumption tax?

MR. HALL. That's right, but we are careful not to label it as a consumption tax.

Of course, in a country in which people will pay good money for pet rocks, packaging difficulties may not be insurmountable. Moreover, even impractical ideas can influence policymaking . So, whether or not the progressive consumption-tax advocates have any realistic prospects of getting over their marketing hurdle, the substantive merits of their idea still need to be scrutinized.

#### ANSWERING THE WRONG ECONOMIC QUESTION BADLY

In his popular 1983 book , *The Next American Frontier*, Robert Reich repeats the most commonly stated argument for abandoning the income tax in favor of a graduated tax on spending. "The progressive consumption tax," he asserts flatly, "would encourage more savings." Reich does not belabor the issue of whether more saving would be desirable—in fact, he never discusses it. Nor do most economists who agree with Reich's conclusion. Instead, they are content to construct mathematical models that purport to show an inherent bias in the income tax against saving and investment. This is a serious distortion, they contend, whereas exempting money saved or invested from tax would be "neutral."

Neutral compared to what? you may ask . Compared to no taxes at all, retort the consumption taxers. On its face at least, this comparison seems unusual. Would the economists who push the consumption tax favor steep taxes on apples and no taxes on oranges because that would leave the incentive to buy oranges the same as if there were taxes at all? Of course not. They would quickly recognize that such a system would create a bias in favor of oranges and against apples, hardly a "neutral" result. But unless we are to abandon all taxes and fund the government entirely on debt (as one former top-level Reagan administration Treasury official has suggested), a tax system

that exempts capital must necessarily impose steeper taxes on something else—say, wages. And this, one might argue, could hurt the economy by discouraging work in favor of goofing off.

The old-fashioned view was that the tax laws ought to be more concerned about deterring toil than about stifling the incentive for thrift. Savers, it was thought, are primarily motivated by their desire for economic security and sometimes power, with the after-tax interest they earn a far less important factor. Indeed, it used to be pointed out, some people put their saving in a sock or under a mattress. In contrast, after-tax wages were considered to be the key force driving workers to forgo leisure, expend effort and put up with the other inconveniences of holding a job, such as getting up the morning. Thus, quite the opposite from the thinking of the modern consumption taxers, it was once a popular notion that capital income should be taxed *more* heavily than wages. The original 1913 income tax law, for example, set generous personal exemptions that intentionally exempted almost all wage-earners from taxation, so that the tax fell primarily on capital income—the “swollen fortunes of the rich.” In 1969, Congress concluded that wage-earners have to make more sacrifices than savers to turn a penny and set the maximum tax rate on wages at 50 percent, compared to 70 percent on “unearned” investment income. (This rule remained on the books until it was repealed in 1981.)

As economic analysis goes, however, all the above is pretty simpleminded. Mere theorizing, it has been shown, produces “indeterminate” answers about the incentive effects of a consumption tax versus an income tax. A serious economic evaluation ought to examine the various incentives and disincentives to work or not to work, to save or not to save, and then try to measure the impact of various tax rules on those incentives based on real evidence. Thus, for example, the conclusion that people will save more if the after-tax rate of return is higher—the underlying theme of the consumption taxers’ case—may be true some of the time. But it is equally clear that many people will save more if the rate of return is *lower*. If I’m saving to put my little girl through college and interest rates go down, you can be sure that I’ll increase my savings rate if I can, to assure that my daughter’s education will be paid for. Likewise, if you’re trying to save enough to fund your retirement, a lower interest rate may persuade you to set aside more.

Similarly, higher wages may cause some people to work longer hours. But the history of this century is that higher wages have gone together with *shorter* work weeks. People found they could live reasonably comfortable lives with less effort—and they did so.

Most empirical evidence simply fails to support—in fact, undermines—the consumption taxers’ case about the impact of taxes on saving. Enactment of a variety of tax breaks for capital income over the years has had no clear impact on the saving or investment rate. Tens of billions of dollars in new corporate investment “incentives” were adopted in the 1970s, but the overall national investment rate stayed at the same 16 percent of the GNP it had averaged since the end of World War II. Tax breaks for Individual Retirement

Accounts were greatly expanded in 1981—and in the second quarter of 1983, when the new “incentives” were fully effective, money did indeed flood into IRAs. But all of that and more flowed out of other savings, so that the personal saving rate hit a 33-year low (as did the overall national saving rate, which subtracts the government’s deficits as negative saving). A 1983 Congressional Research Service study of various countries found that the ones with the highest taxes on capital also enjoyed the highest rates of savings and investment—the most notable example being Japan.

Faced with this kind of real-world data, the best and most honest of the consumption tax advocates, such as William Andrews of Harvard and Rudolph Penner, director of the Congressional Budget Office, carefully avoid making grandiose economic claims for their position. Penner, for example, has cautioned: “I don’t think the consumption tax would have large effects on either saving or work effort.”

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Even if we could, would we want to install a tax system that would lead to a higher level of savings and investment? Do we need to divert a larger share of our resources away from buying the goods and services we’ll otherwise be capable of producing and into expanding our capacity to create still more? Despite the forceful assertions of self-interested lobbies, a “yes” answer to these questions is not self-evident nor is it supported by the actual evidence.

Looking at the big picture, the Federal Reserve Board in a 1981 study titled *Public Policy and Capital Formation*, concluded that America’s overall level of saving and investment was probably “optimal” from the point of view of a healthy, productive economy (and that our main capital problem was misallocation, due largely to tax loopholes). Likewise, a 1983 report by the President’s Commission on Productivity determined that insufficient investment was not the cause of the decline in American productivity growth. Focusing more narrowly on the automobile industry, production experts Kim Clark, Alan Kantrow and the late William J. Abernathy, in their 1983 book, *Industrial Renaissance*, found that our problem with Japanese competition had no apparent connection with levels of capital spending—in fact, our capital investment per worker in the auto industry is double that of Japanese companies. When California business consultants and part-time Stanford professors Thomas Peters and Robert Waterman, Jr., of McKinsey & Co. looked for lessons from “excellent companies” in their best-selling 1983 treatise, *In Search of Excellence*, capital investment levels were discounted and tax breaks never mentioned. In short, the oft-repeated contention that inadequate capital spending is the root of our economic problems is rapidly being discredited.

On the other hand, the opposite problem, an oversupply of capital, coupled with insufficient demand, is not a danger to be lightly dismissed. Historically, it has been the chronic dilemma of market-based economies and is precisely the problem the federal government’s economic policies have

concentrated on trying to avert since the Great Depression. Although “demand management” fell out of favor in the seventies, it has made a remarkable comeback recently. The policies of President Reagan and his Federal Reserve Board Chairman Paul Volcker have shown that deep recession and extremely high unemployment will indeed curb inflation and that huge budget deficits will indeed spark a consumer-led recovery.

Of course, there can be situations in which government policy is too pro-spending and too anti-investment. While short-term deficit spending usually stimulates the economy, today’s looming specter of huge federal deficits for the foreseeable future creates a real danger that long-term public and private investment will be insufficient unless the government gets its fiscal house in order. But this is a problem of macroeconomic policy—not a problem of incentives.

In recent years, it has become politically fashionable to promote tax changes as magic solutions to all our economic woes. Speaking unkindly of his former supply-side compatriots, Budget Director David Stockman told reporter William Greider in 1981 that “[w]henver there are great strains or changes in the economic system, it tends to generate crackpot theories which then find their way into the legislative channels.” Stockman hasn’t intimated where he stands with regard to a consumption tax. But among experts with no axe to grind, there is very limited support for the idea that switching to a consumption tax would be an economic panacea—or that it would even be economically beneficial at all. At a 1979 Brookings conference titled *What Should be Taxed: Income or Expenditure?*, the consensus of the assembled highly reputed tax analysts was that the supposed economic advantages of a consumption tax are either non-existent or unproven.

#### AVERAGING FAIRNESS OUT OF THE SYSTEM

However little or much they credit the economic claims for taxing only spending, most advocates of the progressive consumption tax believe that by assuming complete freedom to set tax rates, they have defined away the issue of tax fairness. If you are the average middle-income taxpayer, they say, we can keep your tax bill exactly where it is now. Moreover, they continue, we can do the same for the average poor family and for the average rich person. Or we can change the average distribution to take more or less in taxes from any group, depending on society’s preferences about redistribution. And therefore, they conclude, a progressive consumption tax could be just as distributionally fair—if not more so—than the current income tax.

Mathematically, the claim that a consumption tax can be as progressive on average as an income tax seems irrefutable. If we decide, for example, that people earning \$30,000 a year should pay 10 percent of their income in taxes, and the average person with that income saves \$3,000 a year, then a tax rate of 11.1 percent on those people’s spending will give the same average result as a 10 percent income tax. But what about people taking in, say, \$50 million a

year? Under the Bradley-Gephardt income tax, such people would pay about \$15 million in taxes. (That's a hefty sum—but they can afford it. After all, they'll still have \$35 million left after-tax.) How could a consumption tax approximate this result? Someone making \$50 million probably has time to spend only a million or two of it. For a consumption tax to assess a \$15 million tax on \$2 million in spending, the rate would have to be 750 percent. This works arithmetically, but it's hardly a likely political outcome.

Even if we accept the cockeyed assumption that there is no built-in bias in the consumption tax toward a less progressive tax system, however, the progressive-consumption-tax supporters who believe they have defined away the fairness issue are correct only if tax fairness involves nothing but the *average* distribution of tax burdens.

To be sure, average distribution is a key fairness concern, probably the most critical. By asserting that they can achieve any average distribution of tax burdens that is desirable, the consumption taxers may have narrowed the fairness debate between taxing spending and taxing income. But is average distribution all there is to fairness?

Consider who it is that supporters of the progressive consumption tax feel should be paying more in taxes. People who save a lot would do well under a spending tax, of course, but people who save less than average would fare poorly. Particularly hard hit would be those who spend more than their incomes. Who might we expect to find in this last group? Some examples that come to mind include students borrowing to fund their educational expenses; elderly people drawing down their savings to pay their living costs; unemployed individuals forced to deplete their bank accounts or borrow in order to put food on the table; and families taking out loans for major purchases, such as a car or a home.

Perhaps some of these hardship cases could be dealt with by special rules. Consumption-tax advocates have suggested, for instance, that auto loans and mortgages could be treated differently from other kinds of borrowing. And adequate exemption levels could mitigate problems for the truly down-and-out. But is a tax system that starts with the premise that the best time to tax people is when they most need to borrow or to spend their savings appealing on fairness grounds? Certainly, the mere assertion that, on average, things will work out is not a sufficient answer.

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Despite the apparent problems, some consumption tax supporters do try to make a fairness case for taxing income only when it is spent. Typically they begin by quoting or paraphrasing Thomas Hobbes. Three hundred years ago, in *Leviathan*, Hobbes wrote:

To equal justice, appertaineth also the equal imposition of taxes. . . .  
[T]he equality of imposition consisteth rather in the equality of that which is consumed, than of the riches of the persons that consume the same. For what reason is there, that he which laboureth much, and

sparing the fruits of his labour, consumeth little, should be more charged, than be that living idly, getteth little, and spendeth all he gets; seeing the one hath no more protection from the commonwealth, than the other? But when the impositions, are laid upon those things which men consume, every man payeth equally for what he useth . . . ?

What Hobbes seems to be suggesting in the passage is that taxes ought to be a charge for the benefits a person gets from society—and that consumption is a better measure of those social benefits than is wealth. (Hobbes didn't discuss the possibility of an income tax, a concept that probably never occurred to him. The tax debate in England at the time was solely between property taxes, on the one hand, and tariffs and excises, on the other.)

The idea that taxes ought to be based on benefits received from government is not without intuitive appeal. In fact, we apply such a benefit principle in a number of areas: gasoline and tire taxes are used to build and maintain highways; water and sewers are largely financed through "user fees"; Social Security benefits are very roughly related to payroll taxes paid in the past. But as a general principle of taxation, the benefit approach quickly breaks down. It suggests, for example, that welfare recipients should pay a tax equal to their welfare check plus their pro-rated share of common benefits such as national defense, space exploration, aid to the arts and so forth. Moreover, what clear relationship is there between someone's spending and his or her share of the services provided by the government? Does a person who spends \$100,000 enjoy a greater benefit from, say, the Defense Department than someone who spends \$50,000? What if the latter person has greater wealth to be protected or a larger family?

The benefit theory of tax fairness is a dead end on its own. But it can be reformulated as an appealing slogan: "People should be taxed on what they take out of society [that is consumption], rather than on what they put in [that is, savings]." With this slogan in mind, consumption-tax advocates turn to the ideas of John Stuart Mill.

One hundred years ago, Mill put forth the proposition that the income tax was unfair to savers because people are "taxed twice on what they save, and only once on what they spend." If a saver earns interest, Mill argued, "it is because he abstains from using the principal; if he spends the principal, he does not receive the interest. Yet because he can do either of the two, he is taxed as if he could do both."

Why spending is the only use of money that should be relevant to taxation is a question Mill left unanswered. But his modern followers have tried to bring meaning to his "double taxation" rhetoric by making the following argument. Interest, they say, is a fee paid by lenders to borrowers to encourage the latter to defer immediate consumption. In order to equalize the situation of people who spend now and those who spend later, the value of the savers' deferred consumption should be equal to the value of the spenders' satisfaction from consuming immediately. Or put another way, savers should be allowed a deduction for their "cost" of deferring their spending—that "cost" by definition

being exactly equal to the interest they were paid. In other words, interest should be tax-exempt—a result whose mathematical equivalent in this simple example can be achieved by allowing a tax deduction for savings, and taxing income only when it is spent.\*

Possessed of two attractive slogans—“Tax People On What They Take Out Of Society, Not On What They Put In” and “End The Double Taxation Of Savings”—most consumption taxers who have gotten this far rest their fairness case.

But if these slogans prove anything, they prove far too much. If savers are allowed to deduct their psychological “costs” of deferring gratification, why shouldn’t workers be allowed to deduct their “costs” in effort and foregone leisure in computing their wage income? If savers are “putting resources into society rather than taking resources out,” does not the same apply to workers whose efforts create the goods and services society desires? Is not a consumption tax a “double tax” on wages, taxing workers on their consumption but giving them no credit for the resources their work has created?

The “double tax” slogan is a logical trap, as some consumption tax advocates admit. Assistant Treasury secretary John Chapoton, for example, concedes that the income tax “is *not* a double tax on savings as some have asserted; it is a single tax on capital income.” Moreover, Chapoton acknowledges, a “uniform income tax would be consistent with most people’s conception of equity,” while a consumption tax could raise a significant “concern” about excessive wealth accumulation. Chapoton offers no fairness argument for favoring savers, but instead opposes even a “single tax” on capital income based on the kind of dubious economic reasoning discussed earlier.

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Chapoton’s discreet refusal to pursue the “double tax” argument may have been the better part of valor, for those consumption tax proponents who do trudge ahead end up revealing a profound distaste for ordinary notions of tax fairness.

It’s a truism among most American tax analysts that the tax laws should avoid unnecessary interferences in the operations of the marketplace. In the early seventies, tax theorists began exploring how far we would need to go to achieve a tax system with absolutely *no* effects on economic behavior. Their answer, put forward almost satirically, was modestly labeled the “optimal tax.”

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\*The numbers run as follows: If someone who’s in, say, the 30% tax bracket earns \$100, he will keep \$70 after-tax. If he puts that \$70 in a savings account paying 10% interest, after a year he will have \$77 available to spend if interest is tax-exempt. Alternatively, if he’s allowed a deduction for the amount he saves, he can put \$100 in the bank at the outset. After a year, that will grow to \$110. If he then takes the money out of the bank, he will owe \$33 in tax, leaving him again with \$77 to spend. (Similarly, if the money is left in the bank for, say, five years, it will grow to \$112.74 under the interest-exemption approach, while under the savings-deductibility system it will grow to \$161.05 before-tax and, again, will allow \$112.74 in after-tax spending.)

Simply put, the “optimal tax” would be a lump-sum tax imposed on everyone without regard to income, consumption or any other personal characteristic whatsoever. Since no particular activity would be taxed, worries about deductions for psychological costs and “double taxation” could be dispensed with. In its “ideal” form, the optimal tax would be imposed on a one-shot, surprise basis without debate by Congress, thereby eliminating opportunities for taxpayers to evade the tax by leaving the country. At current budget levels, a one-time, lump-sum tax of roughly \$40,000 per capita—or \$160,000 for a family of four—would be about right to provide the federal government with a perpetual endowment so that no further taxes ever would be required. The economic beauty of the lump-sum optimal tax, we are told, is that no matter what people do, they still have to pay it. Workers pay, savers pay, goof-offs pay, spendthrifts pay. Unfortunately, its designers admit, unless one assumes that everyone starts off with the same wealth, ability and opportunities, the optimal tax is an absurdity from a fairness point of view.

By itself, the optimal tax is merely an amusing, somewhat instructive exercise in social theory. But the optimal tax perspective of looking at where individuals are at the starting line, rather than at how the race actually turns out, has proven seductive to many consumption tax proponents. They regularly defend their program as “consistent with optimal tax principles,” except that instead of assuming everyone starts off equal, the consumption tax supposedly results in “taxing people with equal endowments equally.” Thus, for example, Harvard professor William Andrews, one of the giants of consumption tax advocacy, has written that “a consumption-type personal tax can be usefully regarded as the equivalent of a lump-sum tax on wealth,” with “wealth being defined to include the present discounted value of all future earnings as well as material wealth.”

Based on this putative equivalence, most versions of a progressive consumption tax would grant taxpayers the option of forgoing a tax deduction for their investments in favor of a tax exemption for the income the investments generate. Thus, if Mr. Smith and Mrs. Jones each invest \$10,000 and the lucky Mr. Smith becomes a millionaire while Mrs. Jones loses her shirt, each could be taxed the same. The fairness of this approach is self-evident to its proponents, since Mr. Smith and Mrs. Jones started with equal opportunities.

Those consumption tax advocates who find no fairness problem in allowing taxpayers to choose an exemption for their investment income in lieu of a deduction for their investments usually note that *on average*, availability of the alternative approach should be no more beneficial to taxpayers, nor should it entail any added revenue loss to the government—since rates of return on various types of investments tend to average out. But on average *any* tax system is fair, including even the pure lump-sum optimal tax. No matter what that tax code provides, the average taxpayer always will pay the average tax. True fairness, however, is supposed to deal with specifics, not averages.

Suppose the IRS were to announce that henceforth it would flip a coin over every tax return it received. If the coin came up heads, whatever tax had been paid on the return would be refunded. But if the coin came up tails, the unlucky taxpayer would have to pay double. This game of chance wouldn't affect the average distribution of tax burdens or, for that matter, government revenues. But it clearly would raise some serious fairness questions. A few consumption taxers, notably Professor Andrews, recognize the problem in the Mr. Smith/Mrs. Jones situation (which is quite similar conceptually to the coin-flipping example), and would not allow such results to occur under their systems. But the optimal-tax perspective of looking at opportunities rather than actual outcomes permeates the reasoning about equity underlying all versions of the consumption tax.

If you and your neighbor each earn the same income, but for one reason or another, your neighbor saves a good deal more than you do, he would find a tax on spending advantageous. Consumption tax advocates defend this result by arguing that since you and your neighbor had equal opportunities to save, you each should pay the same tax on your "endowments." But for consumption taxes, the "same tax" means that the total taxes paid by your neighbor on both his savings and the interest he earns on those savings in the future should be exactly equal in value to the taxes you pay on your consumed income. One way to achieve this "equality" would be to tax both of you on your full incomes this year, but allow your neighbor a permanent tax exemption for the interest he earns (whether he spends it or not). Another approach—the more normal consumption-tax treatment—would be to allow your neighbor a deduction for the money he saved, and to tax it only when (and if) he spends it. The "present discounted value" of each approach is mathematically the same.

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Now contrast the consumption tax's "equal endowment" reasoning to the fairness case for the income tax—a tax that focuses on actual outcomes and that eschews averages in favor of specifics. As reflected in the committee report on the 1913 income tax bill quoted earlier, the most often cited theory behind taxing income is that taxes ought to be based on a person's ability to pay them. And income, perhaps with adjustments for large medical expenses, different levels of state-and-local taxation or catastrophic personal losses due to fire, storm or other calamity, seems clearly to be a better measure of taxpaying ability than the amount a person happens to spend out of income in a given year. Someone earning \$100,000 and spending only \$20,000 certainly has greater taxpaying capacity than someone making \$20,000 and spending it all. Should they be taxed the same? Yes, say consumption taxers; no, say proponents of the income tax.

Just as the consumption taxers quote Hobbes and Mill for historical endorsements, so do those who favor taxing income claim a distinguished lineage for their approach. Most notably, the first apostle of modern capitalism, Adam Smith, wrote in 1776:

The subjects of every state ought to contribute toward the support of government as nearly as possible in proportion to their respective abilities, that is in proportion to the revenue which they respectively enjoy under the protection of the state.

Stanley Surrey recalls how, when he helped design a new Japanese tax system after World War II, the guiding principle was “tax equity, tax fairness—that each strata of society would pay what it was capable of paying.” How did Surrey and the other American members of the tax-writing commission determine the “ability to pay” of different “strata” in Japan? They went out and talked to people:

[W]e simply went up and down the street, asking the Japanese such questions as: How high do you think your taxes should be? Is the amount of taxes you have to pay now fair? Are they correctly handled? Do you have any suggestions on how to improve the tax system?

Those conversations with shopkeepers, farmers, miners and fisherman led to adoption of a Japanese tax system remarkably similar to the Bradley-Gephardt Fair Tax proposal. Surrey and his cohorts found that “ability to pay” seemed to be a popular and understandable notion to the Japanese people—as it has been to the American public as well. In fact, it is exactly that public appeal that most justifies—and that also limits—the “ability to pay” rule. As it turns out, the case for taxing income is inextricably wound together with public support for using the tax system for at least some amount of income redistribution. Professor Alvin Warren, after examining “centuries of elucidation” on ability to pay and the income tax, concluded:

The argument for the income tax does not appeal to some independently demonstrable principle but is tautological in the sense that it follows simply from the premise of the tax: given a legitimate social concern with the distribution of a society’s product, the income tax is justified as a means of effecting the desired after-tax distribution. . . . Society’s interest in the distribution of income, in turn, depends on the view that the importance of fortuity and the interrelationships of contemporary society deprive producers of a controlling moral claim to what would be distributed to them in the absence of a tax system.

In essence, Warren’s argument is simply a sophisticated restatement of Senator Bill Bradley’s folksy defense of the Fair Tax’s operating principle quoted earlier—“if you manage to do well in this society and to benefit economically, then you should pay a somewhat higher tax rate than those individuals who find themselves struggling from paycheck to paycheck . . .” Warren might have added that the importance of luck and the efforts of others in helping generate the earnings of the big winners under our system is not the only reason for society’s interest in redistributing income. That interest also is directly related to the need to reinforce the economic and political structures

we have chosen. Neither capitalism nor democracy works well if economic power is too concentrated. And income is almost always a better measure of economic and political power than is consumption, particularly since the income tax reaches corporate earnings while the consumption tax exempts them. (A wealth tax seems to fit this theory as well, and the fact that the estate tax was enacted at about the same time as the income tax reflects this view.)

Under income tax theory, therefore, you, the spender, and your neighbor, the saver, should be treated equally on your equal incomes because you each have the same ability to pay taxes and enjoy similar control over economic resources. A year later, when your neighbor's income is higher than yours due to the interest he earns on his savings, an income tax would ask him to pay more in taxes than you, since his control over economic resources has increased and his ability to pay taxes has become higher than yours. Whether your neighbor is paying a "single tax" or a "double tax," this result seems to square best with what assistant secretary Chapoton forthrightly concedes to be "most people's conception of equity."

#### DEFINING PROBLEMS AWAY

For many progressive-consumption-tax advocates, neither economic arguments nor "optimal tax"-style fairness theories are the fundamental source of their discontent with the income tax. Instead, the attractiveness of taxing only spending stems from frustration—both with the political process by which tax laws are made and with the serious difficulties the income tax has faced in curbing tax-shelter manipulations by upper-income Americans.

Frustration with income tax politics is not limited, of course, to those who favor a consumption tax. Reformers of many stripes have long bemoaned the seeming inability of the political process to withstand pressure for more and more loopholes. Sometimes it seems that tax policymakers have no vision of a good tax system in mind at all when they make tax policy decisions. Instead, tax changes are often made on a completely ad hoc basis.

Unemployment is too high? Let's try a jobs tax credit. We'd like more business investment? Let's install faster tax write-offs and an investment tax credit. The personal savings rate seems too low? Let's create tax-free "All-Savers Certificates." The public is grumbling about tax unfairness? Let's impose a token minimum tax. And on and on the process has gone.

This ad hoc approach to tax and economic policy has made the tax code an easy prey for special interests seeking backdoor government subsidies, especially those interests that can back up their arguments with campaign assistance. Ways and Means Committee Democrat Andrew Jacobs of Indiana has described the process this way: "If you evade your taxes, you go to the penitentiary. If you want to avoid taxes, you go to the U.S. Congress—and see what they can do for you."

Some consumption taxers believe that by explicitly establishing a new tax paradigm, Congress would become more aware of the dangers of deviating from

consistent and “correct” tax rules. Moreover, many consumption tax advocates seem to think that since their proposal concedes so much to the business lobbying groups that provide most of the pressure for junking up the tax laws, the greed of these lobbies will be satiated.

Realistically, however, this idea—or hope—that a consumption tax would be more immune to loopholes than the income tax seems frivolous. It’s hard to imagine that homeowners would gratefully give up their tax advantages merely because we tax spending rather than income. Or that Social Security recipients would cheerfully agree to pay taxes on half their stipends. Or that charities would be sanguine at losing the benefits of tax-deductible contributions. Or much more important, that oil companies, timber growers, real estate investors or any of the other currently favored business interests that often now enjoy outright tax subsidies—or “negative tax rates”—would be content simply to pay at the consumption tax’s zero rate on capital income.

Why is it reasonable to assume that merely by a change in the paradigm for taxation, Congress would lose its zeal to tinker with the economy or favor particular campaign contributors with tax concessions? No currently extant consumption tax proposal includes a Wizard of Oz capable of providing political courage. An exchange between consumption tax proponent Gary Hart and Senator Russell Long in the fall of 1982 illustrates that the consumption tax offers no yellow brick road to ending pressures for special tax treatment:

SENATOR LONG. [Senator Hart,] I think you raised an interesting point there that . . . we ought to consider a uniform type deduction . . . when people make investments . . . Senator Hart, if a person makes a lot of money and does invest it but merely invests in buying real estate, which just tends to bid up the price, without putting that real estate to use—he buys land and attempts to move up the land prices that someone else who would like to use it would have to pay—he is not serving society. If he buys the same land and puts it to very active use, he is serving society—creating jobs, providing opportunities. In that case I think we would be well advised to try to make deduction uniform. . . . But if he is not investing that money in ways that are going to benefit the Nation or its people and is only going to benefit himself, offhand I don’t see why he ought to have any tax advantage, do you?

SENATOR HART. Senator Long, . . . this [consumption tax] proposal [of mine] says that you only get the tax break if you in fact invest it and invest it productively. Now, the definition of what is “a productive investment” would in my judgment be one of the few possibly lengthy or complicated provisions in the reformed tax code, because clearly you would have to have some technical definition of what was productive investment. Racehorses, Persian rugs, diamonds and Krugerrands probably wouldn’t qualify. . . . [Y]ou couldn’t just say “savings or investments in anything” because, as you indicated, there are some investments that don’t increase productivity at all.

SENATOR LONG. To a large extent we already have that [approach].

Years of experience obviously have given Senator Long a keen nose for the possibility of “special” tax rules. And his intuition that political life under a progressive consumption tax might not be much different than affairs under the current system has been confirmed in several valuable articles by tax attorneys. Those sharp lawyers found sufficient technical shortcomings and enough areas where the consumption tax’s inherent resistance to loopholes is likely to be weak to keep the tax lobbying bar occupied in perpetuity. Thus, consumption taxers who compare a “perfect” progressive consumption tax to the present Internal Revenue Code and conclude that a consumption tax is therefore intrinsically more loophole-resistant than an income tax are indulging in a silly logical error. A day-old banana may be in better shape than a year-old apple, but that doesn’t mean bananas are less prone to rot.

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Many progressive-consumption-tax advocates admit that expecting a congressionally-enacted consumption tax to be free from problems is naive. But they remain persuaded that a progressive consumption tax would be practically superior to the income tax in avoiding the worst kinds of tax-shelter abuses. In fact, for a large number of progressive-consumption-tax supporters, this supposed feature of the program is its chief attraction.

Tax shelters are essentially investments that pay a higher return after-tax than before-tax. A typical current real-estate shelter, for example, may generate virtually nothing in cash flow for its investors, yet pay them a huge return consisting almost exclusively of tax benefits.

In one or many ways, tax shelters always involve mismatching of profits with tax deductions. One usual type of mismatching involves timing: in the early years of a shelter investment, participants get big write-offs that more than offset the investment’s real profits and thereby provide the investors with deductions for artificial “losses” that can be used against their other income. Later, when the deductions are exhausted, the taxable profits from the investment may in turn be artificially inflated, and the investors may be liable to “pay back” the tax benefits they obtained earlier. The effect is similar to an interest-free loan from the government—and the value of such “loans” should not be underestimated. If you could borrow \$1 million for five years at no interest, for example, you could pay back the loan at the end of the period and end up with more than \$600,000 in your pocket (assuming you could earn 10 percent a year while you hold the money). Or you might ask for an extension of the loan term, as tax-shelter investors in effect routinely do when they roll a “burned-out” old shelter into a fresh new one.

Another type of mismatching common to tax shelters involves using the deductions an investment generates to offset income that would otherwise be taxed at a high rate, while paying tax at a lower rate on the cash flow the investment throws off. A \$10 million real-estate shelter, for example will provide its 50-percent bracket investors with \$5 million in tax savings from depreciation write-offs over 15 years. If the building or shopping center is then

sold for \$10 million, the special 20-percent capital gains tax on the proceeds will be only \$2 million. This mismatching of tax rates will by itself net the investors \$3 million.

A final key element in tax shelters is that they almost always are financed with borrowed money. The investors in a typical \$10 million real-estate deal, for example, will put up only \$1 or \$2 million in cash. By borrowing the rest, they both magnify their other tax shelter advantages and benefit from still another kind of mismatching: they can deduct the interest they pay on their loan even though the profits from their investment are sheltered from tax. A simple way to understand this “arbitrage” process is to look at what happens if someone takes out a loan to invest in tax-exempt securities. A 50-percent bracket taxpayer who borrows \$100,000 at a 14-percent interest rate and invests the \$100,000 in tax-free municipal bonds paying 10 percent may seem imprudent, since he will lose \$4,000 a year before-tax. *After-tax*, however, he will make a *profit* of \$3,000. The \$14,000 a year he pays in interest will be deductible, so that his net interest expense will be \$7,000, while the \$10,000 a year he earns on the municipal bond will not be taxed.

The bottom line is that the current income tax, by allowing hugely excessive write-offs (and sometimes credits as well) for investments, by granting enormously preferential treatment to capital gains and by largely ignoring the interaction between these “incentives” and debt-financing, ends up actually subsidizing, rather than taxing, the profits from many types of transactions. Are there viable solutions to these tax-shelter problems under an income tax? The technical answer probably is yes, but implementing those solutions, as the consumption taxers point out, has proven politically and practically difficult.

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Take, for example, the issues that arise with regard to the tax treatment of capital gains. Under a theoretically perfect income tax, inflation-adjusted increases in the value of stocks, bonds, real estate or other property would be taxed each year, whether or not the assets are sold. And conversely, real declines in asset values would be deductible annually. Given the overwhelming practical difficulties in assessing such unrealized gains and losses (except, perhaps, in the case of publicly-traded stocks), however, the taxation of capital gains and the deductibility of losses is deferred until assets are sold, when gains and losses are measurable with certainty.

This “realization” system creates numerous problems. Not only is the deferral of tax on unrealized gains a substantial loophole in and itself , but taxpayers can even spend their capital gains without paying any tax—by borrowing against appreciated assets rather than selling them, with the interest paid, of course, being deductible. Moreover, when taxpayers do choose to sell assets and realize capital gains, they can often offset much of their tax by taking advantage of their freedom to realize losses on other investments at the same time.

On top of these advantages. Congress has added two more breaks for capital gains. First of all, 60 percent of realized capital gains are tax-exempt. And second, when property is inherited, taxes on all previously accrued gains are permanently forgiven.

Somewhat ironically, the first of these loopholes—the 60-percent exclusion—is often defended as an incentive for people to realize their gains and pay at least some tax, rather than borrowing against their assets and passing them on to their heirs tax-free (or waiting to sell until they have losses to offset against gains). Some people even earnestly argue that the 60-percent exclusion actually raises money for the government, despite the huge tax benefits it appears to provide to upper-income taxpayers.

Whatever one thinks of this argument in isolation, however, it clearly fails to take into account the incentives the capital-gains exclusion creates for tax shelter gambits whose main purpose is to recharacterize what would otherwise be fully taxable income as “capital gains.” The wealthiest Americans—those making more than \$200,000 annually—year in and year out manage to have 35 to 40 percent of their incomes treated as lightly taxed capital gains. The key to real-estate shelters, as well as many other tax-avoidance devices, is their alchemic ability to turn ordinary-income lead into capital-gains gold.

In light of these tax-shelter problems, income-tax reformers usually put ending the several loopholes for capital gains at the top of their list of needed changes. Eliminating the 60-percent exclusion is the most common proposal, but suggestions have also been made to delay interest deductions for debt used to finance capital assets and even to impose some kind of surcharge on realizations to take account of past deferral benefits. The singular lack of success reformers have had with these proposals is illustrated by the last major change in capital gains treatment—which increased the exemption level from 50 percent to 60 percent.

Despite past failures, however, curbing the tax benefits for capital gains is an essential part of any comprehensive income tax reform program. The Bradley-Gephardt Fair Tax, which would repeal the capital gains exclusion, attempts to get around the usual objection that this would discourage asset sales by cutting the top tax rate to 30 percent (and the rate for the vast majority of people to only 14 percent) at the same time.

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Attempts to crack down on capital gains tax breaks and most of the other “investment incentives” provisions in the tax laws are complicated by the fact that many of those “incentives” were adopted in part to try to mitigate serious problems the income tax faces due to inflation. Indeed, inflation has been the Achilles heel of the income tax—the source of its worst troubles, both real and perceived. As noted earlier, inflation-driven “bracket creep” was the chief catalyst for most of the regressive tax changes that have taken place over the past decade. But bracket creep at least always has been amenable to easy resolution, technically if not politically. The proper measurement of earnings

from capital during periods of significant inflation, however, has proven less tractable.

Suppose, for example, that someone has \$100 in a savings account that earns \$10 in interest in a year. But over the same period, inflation is 6 percent. The saver's "real" income is only \$4, since the other \$6 merely keeps the original investment even with rising prices. Yet under current income tax rules, the saver will be taxed on the full \$10. For a 30-percent bracket taxpayer, the \$3 tax amounts to 75 percent of the "real" interest. For a 50-percent bracket taxpayer, the \$5 tax would be a 125 percent "real" rate.

The same problem can exist with regard to capital gains. If someone buys stock for \$100 and it goes up in value to \$150 over a period in which prices generally rise by 30 percent the "real" gain is only \$20, and it doesn't seem very fair to tax the whole \$50 "profit." Moreover, if someone buys for \$100 and sells for \$120 after 30 percent inflation, even the 60-percent capital gains exclusion of current law is insufficient to prevent taxation of what really amounts to a \$10 loss.

Similarly, if a business invests in equipment that wears out over time, it should be entitled to depreciation allowances that reflect that decline in value. If those allowances are set without regard to inflation, however, they may be insufficient to compensate the business for its true costs.

Now, on average the inflation problem is less serious than it may appear. For every lender that is overtaxed on interest income, there is a borrower that is undertaxed by being able to deduct nominal rather than only "real" interest paid. Since the majority of people (and businesses) are borrowing and lending at the same time, the gains and losses from inflation tend to be roughly offsetting in most cases. Indeed, by and large, current law with its plethora of loopholes hardly taxes "real" capital income at all, despite the overtaxation that inflation sometimes produces in particular cases. The title of a 1980 study by Eugene Steuerle of Treasury's tax policy staff, for example, asked: *Is Income From Capital Subject To Individual Income Taxation?* In the aggregate, Steuerle concluded, the answer to this question is "no"; the various tax preferences for investment income have effectively wiped out most net taxes on non-wage income.

But inflation does create winners and losers. Richard Musgrave, America's leading public finance economist for the past several decades and an ardent advocate of a fair income tax, has concluded that, "[a]s to inflation, there can be no doubt about what the principles of equitable taxation demand. . . . Tax reform calls for inflation adjustment to the largest possible degree."

Unfortunately, adjusting capital income for inflation is not easy. Technically correct rules tend to seem—and sometimes are—quite complicated, and Congress has resisted adoption of such approaches. Ad hoc solutions, such as the 60-percent capital-gains exclusion and accelerated depreciation write-offs for machinery and buildings, turn out not only to be too generous in most cases but also to create further, even worse problems, as taxpayers manipulate them to create shelters.

In part because of the technical difficulties in trying to deal with inflationary distortions and especially because of Congress's proclivity to add a new loophole every time the issue is raised, income tax reformers have traditionally disregarded Musgrave's advice on the need for some system of accurate inflation adjustments. The Bradley-Gephardt Fair Tax proposals, for example, addresses the issue only in the area of depreciation, and even there only indirectly. As in the case of capital gains, the Fair Tax's main response to the inflation problem is to reduce statutory tax rates very substantially—a step which really does, however, make the problem far less significant.

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Advocates of a progressive consumption tax argue that the partial answers to the income tax's capital-gains and inflation dilemmas offered by Bradley-Gephardt-style reform measures are insufficient both philosophically and politically. Instead, they maintain, only a radical change in the tax treatment of investment income is capable of truly resolving these issues—and thereby truly ending the ability of tax-shelter investors to make a mockery of the tax laws.

Back in the late sixties, Vermont Senator George Aiken suggested a novel way out of the Vietnam War quagmire: declare victory and withdraw. The progressive consumption taxers' self-proclaimed proudest achievement—finding a cure-all for the problems of capital gains, inflation and tax shelters—is similar. They declare victory by defining the problems away—or more precisely, by abandoning the long-time reform goal of taxing capital income fairly.

Inflationary distortions in measuring capital income are not a problem under the progressive consumption tax because it does not tax income. It taxes spending—and spending, by definition, is always current, always in the dollars of the moment. Likewise, under a consumption tax it would no longer be necessary to define capital gains and losses. Taxpayers would get a write-off for the full cost of capital investments, but if a taxpayer sells an asset and spends the proceeds, the entire amount will be taxable—whatever the gain (and even if there were a loss). Attempts to avoid tax by borrowing against appreciated capital assets and schemes to magnify the tax benefits for investments by “leveraging” would be futile. Borrowed money would be added to income in computing taxable consumption. Thus, while a debt-financed investment would be nominally deductible under the consumption tax, that deduction would be offset by an add-back for the amount of the loan.

The seeming elegance of the consumption tax's definitional answer to tax shelters is intriguing (and the fact that totally exempting capital from tax might be tougher on tax shelters than current law says quite a lot about the present system). But serious concerns remain. For one thing, the consumption tax's solution is not as technically slick as first appears. How, for example, do we deal with capital gains in things such as vacant land, Persian rugs and Krugerrands, for which Senator Hart and others don't want to provide

consumption tax treatment? What about gamblers—will they be allowed an option either to deduct their bets or to treat their winnings as tax-exempt? Or will we need to run an income tax system alongside the consumption tax to deal with what Congress concludes are unproductive investments? Then there's the sixty-four dollar question of how to handle capital gains and debt during the transition from an income tax to a consumption tax (an issue discussed generally below). And finally, there's the most fundamental issue:

Is defining savings and investment out of the tax system—whatever the simplification gains—fundamentally fair? Despite all the theoretical arguments discussed earlier, few progressive -consumption-tax advocates really seem to think so. Typically, progressive consumption taxers continue to use income, rather than spending, as their benchmark for measuring tax progressivity, and they say they would impose steep tax rates on high levels of spending in hopes of indirectly taxing high earners on their incomes. Moreover, most progressive-consumption-tax supporters also recommend beefing up inheritance taxes to deal with the huge individual accumulations of untaxed income that a consumption tax would likely foster.

But if taxing income is what we want to do, trying to do so through a spending tax seems perverse, especially given the political unlikelihood of the high tax rates and tough inheritance taxes such a system would need to approximate fairness even on its own terms.

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The weakness of the progressive consumption taxers' sleight -of-hand solution to capital income taxation problems is most evident when it comes to the corporate income tax, which under a progressive consumption tax would be eliminated entirely.

Under any reasonably fair *income* tax, a tax on corporate profits is essential. For one thing, exempting corporate earnings from tax would be a windfall for shareholders, who are disproportionately well-off, since they would pay no tax at all until profits are paid out as dividends or they cash in their stock for a capital gain. In addition, corporations would gain a great advantage over sole proprietorships and partnerships. Of course, these latter kinds of businesses could always incorporate to share in the tax advantages that would exist in the absence of a corporate tax. But that result simply would increase the unfairness to wage earners. (Remember, somebody has to pay the taxes.) In fact, the lack of a tax on corporate earnings could allow virtually any kind of capital income to be indefinitely tax-exempt, since it would be hard to stop people from holding their savings and brokerage accounts within personally-owned corporations. The only unincorporated investments that would exist under such a bizarre system would be those designed to generate artificial tax losses to offset their owners' personal tax liabilities (for example, real-estate tax-shelter partnerships).

Just as fundamental is the role the corporate income tax should play in achieving one of the basic purposes of a progressive income tax—the

redistribution of wealth and economic power. An income tax that exempted the largest and most significant accumulations of profits from its ambit would be properly derided as a hoax.

Some income tax reformers, however, have seen a problem in the theory of a separate tax on corporate earnings. While agreeing that taxation of corporate income is appropriate and necessary, they argue that a “double tax,” whereby corporate profits are taxed as earned by the company and again when paid out as dividends, is overly burdensome. Under this view, the proper approach would be to treat corporate earnings as the income of stockholders and to tax a company’s owners directly on their share of the corporation’s income, whether paid out in dividends or not. In other words, it is said, theoretically corporations should be treated as giant partnerships.

If the idea of treating AT&T as a 3-million-member partnership is not insufficiently mind-boggling in and of itself, however, consider the problems that would arise when shareholders sell their stock during the year . The 3 million people who own AT&T on January 1 may be a quite different bunch from the 3 million who end up owning the company on December 31. Moreover, what happens when after a corporation reports its income to its shareholders, the IRS determines that the company’s accountants made a serious mistake? That’s an awful lot of Form 1040X amended tax returns to have to deal with.

Could this problem be solved simply by allowing corporations to deduct their dividend payments? Then the corporate tax would apply only to retained earnings, while shareholders would pay individually on their dividend receipts. Under this approach, however, charities, pension funds and other tax-exempt holders of corporate stock would receive an enormous windfall. Not only would the revenue cost to the Treasury be very large, but such a rule would allow tax-exempt organizations to run businesses tax-free, so long as they were incorporated. Such an enormous expansion of the benefits of tax-free status could create significant competitive problems for taxable businesses, and would be in sharp conflict with long -standing rules that, directly or indirectly, generally subject charities and other tax-exempt groups to taxation on their “unrelated business income.”

Still another approach to “integrating” the corporate and personal income taxes would be to grant shareholders a tax credit for the taxes their companies are deemed to have paid “on their behalf.” This system would avoid giving away anything to tax-exempt shareholders, who presumably couldn’t use the tax credits (unless they are allowed to sell them to taxable investors), but tax lawyers have discovered it reopens the same kinds of knotty technical issues that are involved in “partnership” treatment of big companies.

Of course, in the current context, worrying about “double taxation” of corporate profits at all is pretty zany. One leading past advocate of “integration,” assistant Treasury secretary Charles McLure, recently noted ruefully that his book defending integration had become “instantly irrelevant”—since soon

after it was published Congress passed the 1981 Reagan tax act, wiping out most of the corporate tax.

Would we need to worry about integration under a reformed income tax? The Bradley-Gephardt Fair Tax, which would reinstate an honest corporate tax, does not. But the Fair Tax's relatively low rates on both corporate and personal income would substantially mitigate any "double tax" problem. Moreover, it should be noted, adoption of the Fair Tax would be a substantial short-term windfall to companies that had made large investments under the generous rules of the old tax system, with the expectation that future profits might be taxable at relatively high rates (a factor that caused the International Association of Machinists and Aerospace Workers to propose only a gradual reduction in the statutory corporate tax rate in its adaptation of the Bradley-Gephardt program). Were the Fair Tax actually to be adopted, "integration" possibilities might be worth exploring at some point, but it's also reasonable to conclude that the small "double tax" Bradley and Gephardt would retain not only would be tolerable in the interest of simplicity, but also would be beneficial to tax progressivity and to the furtherance of redistributive goals.

The progressive consumption taxers' assertion that they can define savings and investment out of the tax system, yet still achieve fairness goals—at least in the distributional sense—by personal rate adjustments, may have some theoretical appeal with regard to individual tax shelters. But that argument is completely unpersuasive in the case of the corporate income tax. It may be true in some sense, as consumption tax advocates are fond of noting, that "corporations don't pay taxes, people do." The corporate tax may indeed ultimately be passed back to shareholders in reduced dividends or smaller capital gains. But it's equally true, and rather more important, that corporate profits generate economic and political power—power that is not merely the sum of the individual ownership rights of stockholders, but that is unique to the corporate entities themselves. In fact, it's quite obvious that America's largest concentrations of economic and political power are in corporate form. A tax system that purports to maintain some checks on that power merely through adjustments in individual tax rates simply fails to comprehend a fundamental purpose of progressive tax policy.

#### **WE CAN'T GET THERE, BUT IT HURTS TO TRY**

Despite all the learned treatises that have been written about the progressive consumption tax, its advocates have yet to hit upon a solution to an overwhelming practical predicament. Even if such a tax system otherwise made sense, no one has a clue as to how it could be implemented fairly.

Defining taxable consumption as income minus savings is a clever way to measure an individual's actual spending. But when it comes to trying to get from where we are to the academic version of a "perfect" progressive consumption tax, it's not clever enough. The transition problem, in a nutshell, involves dealing with old money.

Suppose that a progressive consumption tax really were to be adopted, and on the day its goes into effect Mr. Jones has \$10,000 in the bank. How do we treat that \$10,000?

1. Do we allow Mr. Jones an immediate \$10,000 tax deduction for his existing savings?
2. Or do we ignore the savings for the time being, but tax the \$10,000 when and if Mr. Jones withdraws it?
3. Or do we ignore the \$10,000 now *and* when it is withdrawn?

Total indifference to existing savings—as under Rule 3—may be the most intuitively appealing approach, since it seems to continue the old income-tax rules under which Mr. Jones originally made his deposit. But Rule 3 turns out in practice to be merely a restatement of Rule 1, which would make all existing savings deductible. Under rule 3's indifference approach, Mr. Jones could simply withdraw his \$10,000 from his bank account and then redeposit it to get the desired deduction. And following the Rule 1 system of making all existing savings deductible would not be a very happy result. It could lead to long-term tax exemption for the very wealthy. Someone with \$1 million in savings who is living off the interest, for example, could end up owing nothing in taxes for 10 years (with carryovers of unused deductions), even though he or she consumes \$100,000 a year.

To allow no deductions for existing savings, while taxing all withdrawals, as under Rule 2, seems to create the opposite problem. Suppose, for example, that Mr. Jones had put the \$10,000 in his savings account out of his after-tax income in years prior to adoption of the consumption tax. This means that the \$10,000 has in effect already been taxed. Taxing it again seems punitive, and would be an ironic result of a tax system supposedly designed to favor savers. How would you feel, for example, if you were told that the IRS now claims a right to take 30 percent or so of the \$5,000 nest egg you have been building to finance a new car or your child's education?

A sales tax—that is, a direct, flat tax on consumption—implicitly adopts the seemingly harsh Rule 2. And, it could be argued, such an approach might not be so bad under a progressive consumption tax as well. Given the current income tax's many preferences for capital income, on average the supposition that Mr. Jones made his savings deposit out of after-tax dollars is probably at least partially wrong.

But even if one were cavalierly to dismiss the fairness arguments against taxing all withdrawals from existing savings, in practice it would be difficult to avoid ending up making all existing savings deductible anyway, as under Rule 1. Were a progressive consumption tax about to be enacted, everyone in the country with substantial wealth would be advised by their lawyers to amass as large as possible a store of cash outside of bank accounts or other places where records are kept. Then, when the law took effect, these people would deposit their money back into the bank and take big tax deductions. Such shenanigans could be outlawed, of course, but the prohibition would be very difficult to

enforce. Theoretically, the IRS could try to monitor individual consumption and crack down on flagrant discrepancies it detected between actual spending and the taxable consumption reported by taxpayers. But no one thinks that such an approach is workable. Alternatively, the law could require taxpayers to file balance sheets listing their assets and liabilities as of the day the tax was enacted. Expecting a balance sheet requirement to be politically feasible in a country as concerned about privacy as ours, however, is wishful thinking. Expecting such balance sheets to be honest seems downright Pollyannaish.

Even taxpayers without much in the way of wealth could manipulate the transition rules that would have to accompany a consumption tax. Suppose, for example, you were to borrow \$50,000 the day before the consumption tax took effect. The next day, you pay off your loan. Since loan repayments are deductible under the consumption tax (borrowing is taxable as dissavings, repayments are deductible as *dis*-dissavings), you would have generated a tax deduction from a meaningless transaction. In fact, why stop at \$50,000? On a one-day loan, the sky's the limit.

Now this result, too, could be prohibited, by denying deductions for paying off loans incurred prior to the effective date of the consumption tax. Such a prohibition creates its own problems, however. Suppose that the day before the consumption tax goes into effect, Mrs. Smith has debts totaling \$50,000. Suppose that after the tax takes effect, she decides to refinance her loans, say to take advantage of a lower interest rate. Will we tax her on the proceeds of her new loan and give her no deduction for paying off her old debts? The cries of unfairness would be justifiably loud. But how do we distinguish “new” borrowing from refinancing? It looks like we’re back to the impractical “solution” of balance sheets.

The above discussion only touches on the horrendous transition problems of moving to a progressive consumption tax—problems that undercut the “simple” solutions the consumption tax purports to offer for hard issues such as capital-gains taxation and inflation adjustments. And to these dilemmas, in turn, the consumption taxers suggest only ridiculously complex answers. A leading transition proposal, for example, would require everyone to fill out his or her tax return under both the old income tax rules and the new consumption tax rules for 10 years—and pay whichever amount was higher! Try selling that to the average taxpayer—or to the average congressman up for reelection every two years.

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Given the political and practical unworkability of the progressive consumption tax why should we worry about it? Why has this essay devoted so much space to discussing the idea?

The reason is that the unfeasibility of the progressive consumption tax does not make the concept of only academic interest. Hearing (ad nauseam) the consumption taxers’ thesis that the income tax is hurting the economy by discriminating against saving and that there is no inherent conflict between

fairness and a tax only on spending, Congress has felt intellectually justified in adding loophole after loophole to the income tax in the name of “incentives” for saving and investment. Over the past year and a half, the Reagan Treasury Department has repeatedly defended various corporate tax breaks as “consistent with consumption tax principles” (based on the apparent theory that *anything* that reduces corporate taxes meets this test). Moreover, academic support for the consumption tax has helped keep the flat-rate value-added tax—the only tax on spending that does not present insurmountable transition problems—on the table as a dangerous, although still remote, political possibility. (As noted earlier, the hidden nature of the VAT helps mitigate its political disadvantages.)

Now, of course, Congress doesn’t take its marching orders from academicians and economists, and many—perhaps most—of the problems we currently face in tax policy would exist in the absence of academic support for the progressive consumption tax. Moreover, it’s fair to note that most advocates of the progressive consumption tax have loudly decried both congressional loophole fever and the value-added tax as perversions of their beliefs. But ideas do matter in Washington, and the progressive consumption taxers’ protests do not absolve them of blame for the predictable political consequences of their actions. They should not lightly shrug off Harvard professor Stanley S. Surrey’s charge that “the academic focus on taxes on consumption is both a false route out of our troubled tax picture and itself a cause of that troubled state.”

The bottom line view from the Washington tax reform movement is that it’s time for academicians and economists who are concerned about tax fairness to stop touting the progressive consumption tax as a viable alternative to reform of the income tax. So long as well-intentioned people argue that a consumption tax—supposedly by stimulating saving and investment—will help the economy, they are playing into the hands of self-interested corporate lobbyists who claim that inadequate investment is the source of our economic problems and that added loopholes in the income tax are the solution. They are playing into the hands of those who propose a value-added tax or national sales tax as a substitute for progressive taxes. They are playing into the hands of flat-raters and supply-siders who want to abandon fairness as a goal of the tax system. In short, as Stanley Surrey puts it, “they are playing a dangerous political game.”

## CONCLUSION: INSTITUTIONALIZING TAX REFORM

IS IT REALLY POSSIBLE TO THROW OUT THE ENTIRE TAX CODE and make a new start? Most people who have worked on tax policy for any length of time think not. They point to technical problems, transition issues and political reality. These experts are not necessarily right but they may well be.

This makes it of critical importance that the vision of a fair tax system we set for ourselves be one susceptible to incremental achievement, as well as all-at-once adoption. Such a criterion enhances the attractiveness of schemes such as the Bradley-Gephardt Fair Tax—which in essence is a program of closing loopholes and lowering rates. Senator Bradley points out that the Senate Finance Committee may in fact try to take some steps toward a Fair-Tax-type system over the next several years. In contrast, an idea like the progressive consumption tax, even if it were desirable in the ideal, fails miserably to meet the step-by-step guideline. The consumption tax essentially involves expanding income tax loopholes for investment, balanced by a sharp crackdown on the tax treatment of borrowed funds. Until the latter step is taken—and it probably never will be—incremental steps toward a consumption tax actually move away from *any* ideal, providing the well-advised and the well-off with more opportunities to shelter both their income *and* their consumption.

When all is said and done, the problems with our current tax code are not philosophical or technical. Most people know generally what a fair tax system should look like and technicians know how to craft the rules to implement such a system. Ultimately, the problems in our tax laws are political, and the solutions to those problems also must be political. In particular, we need to address the institutional imbalance of power between those who benefit from tax loopholes and those who pay for them.

Astute analysts have written persuasively about the problems created by our system of private financing of election campaigns. Those problems are pervasive and solving them could do much to improve the making of tax policy. But there are other institutional problems that need to be confronted as well.

There are few loopholes in the Social Security payroll tax because the public clearly sees the link between payroll taxes and Social Security benefits. There is therefore a huge and deeply interested constituency of senior citizens—and to a large degree their children—who will fight tenaciously to maintain an adequate Social Security tax. But when an income tax break of enormous value to a particular company or industry is debated, the constituency against granting the preference is diffused and its stake is tenuous. If a technical amendment can give a single corporation \$14 billion over ten years, as was true for AT&T in 1981, the company obviously will expend enormous effort to obtain that change. But who will oppose it? Will ordinary taxpayers view the \$14 billion loophole as costing them \$200 each over the decade and rise up in protest? Will food stamp recipients fear a six or seven percent cut in their

allotments and take to the streets? Will the Pentagon be energized into action at the thought that the tax break may cost it the cruise missile? Will potential homebuyers make known their concerns about added deficits and the resulting impact on interest rates? Or will everyone assume that someone else will bear the cost?

Public interest groups can try to dramatize the connection between loopholes for some and lost governmental benefits or higher taxes for others, and sometimes they will be successful. They can appeal to Congress's sense of justice and sometimes prevail. When faced with equal pressures to do good or to do evil, Congress almost always will choose to do good. But more often than not, the pressures will not be equal.

So perhaps we should be exploring institutional ways to link taxes more directly to government programs or to connect narrow tax breaks more directly to higher taxes generally. To some degree, the congressional budget process is supposed to create these kinds of link ages. And to some degree, it has been successful. The 1982 tax reform act, for example, was largely a product of that budget process. Faced with a mandated revenue increase target, Congress had to face up to the question of who would be asked to pay higher taxes, and in general it focused on raising taxes on those who were paying too little. But the budget process was co-opted in 1981, when a popular President pushed through his irresponsible tax cut and defense increase package, and it was ignored in 1983, when that same President successfully fought all attempts to narrow his deficits by either spending cuts or tax hikes.

Imagine, however, that the corporate income tax was earmarked to defense spending. Its erosion would have powerful enemies. If the cost of tax shelters in used shopping centers were offset against HUD's budget for subsidized housing, those tax preferences would attract serious opposition. If tax forms included a line assessing a "loophole surcharge," middle -income Americans might complain a bit louder.

Some tentative steps in this direction already have been taken. The Navy now is required to count in its budget the tax losses involved in leasing rather than purchasing certain ships. For the past few years, cleaning up chemical pollution has been financed through a "Superfund" tax on chemical companies. And presidential candidate John Glenn has suggested what he calls a "pay-as-you-go" plan for federal budgeting , under which proponents of new spending initiatives would have to specify which existing programs would be cut or whose taxes would be raised to offset the cost of the new spending . Presumably, Senator Glenn wouldn't mind extending the pay-as-you-go principle to proposals for new tax loopholes as well.

Earmarking specific taxes to particular programs enjoys little favor among public finance economists. In practice, it may be a technically poor idea. But highlighting the connection between low taxes for some and higher taxes and lost government services for others is not a demagogic trick. Facing up to that linkage is exactly what making good tax policy is all about. ●

# Citizens for Tax Justice

**C**ITIZENS FOR TAX JUSTICE was formed in 1979 to give ordinary people a greater voice in the development of the tax laws at the national, state and local levels. Against the armies of special-interest lobbyists for corporations and the wealthy, CTJ fights for a fair shake for middle- and low-income families, based on the idea that people should pay taxes according to their ability to pay them. Dan Rostenkowski, chairman of the House Ways and Means Committee, has called CTJ “the average taxpayer’s voice in Washington.” *The Washington Monthly* ranked CTJ at the top of its 1988 list of the “best public interest groups.”

CTJ’s studies on corporate tax avoidance, including *130 Reasons Why We Need Tax Reform* (1986), *Corporate Taxpayers & Corporate Freeloaders* (1985) and *Money for Nothing: The Failure of Corporate Tax Incentives, 1981-84* (1986), have been widely cited for their central role in the enactment of the Tax Reform Act of 1986—path-breaking federal legislation that curbed tax shelters for corporations and the rich and cut taxes for poor and middle-income families. Indeed, *The Washington Post* called CTJ’s reports a “key turning point” in the tax reform debate that “had the effect of touching a spark to kindling” and “helped to raise public ire against corporate tax evaders.” *The Wall Street Journal* said that CTJ “helped propel the tax-overhaul effort,” and the Associated Press reported that CTJ’s studies “assured that something would be done . . . to make profitable companies pay their share.”

Other recent CTJ reports include: *Inequality & the Federal Budget Deficit* (1990), *It’s Working, but . . .* (1989), *The Corporate Tax Comeback: Corporate Income Taxes After Tax Reform* (1988), *Nickels & Dimes: How Sales & Excise Taxes Add Up in the 50 States* (1988) & *The Sorry State of State Taxes* (1987).

Articles written by CTJ staff members frequently appear in *The New York Times*, *The Washington Post*, *The Los Angeles Times*, *The New Republic* and other publications—big and small—across the country. Through press, television and radio coverage, CTJ’s message gets out—to the public and policymakers alike. Working with a growing network of labor, community and church groups from every part of the country, CTJ’s goal is to make taxes a better deal for middle- and low-income American families.

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