The Erwin N. Griswold Lecture

The Merit of an Income Tax Versus a Consumption Tax

John S. Nolan

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

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

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

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

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

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

The key to understanding the basic equivalence of these two systems as being solely taxes on consumption is that the economic effect of not taxing an amount received, but taxing the investment returns on that amount, as in the USA Tax, is exactly the same as taxing the amount received but not

taxing the investment returns, as in the Armey flat tax. As a result, both the USA Tax and the Armey flat tax end up being imposed only on income consumed. Each effectively exempts from tax income that is saved.

The political rhetoric focuses upon the flatness of the rate of tax, but that is a red herring. We could obviously achieve that result with our present income tax system, taxing all income, whether saved or consumed, at a single rate. Indeed, we came close to that very result in the Tax Reform Act of 1986. To me, given the revenue constraints of our federal government, the 1986 Act is about as close to tax nirvana as we have ever come--low rates on a much broader base.

The 1986 Act rates did not last long because the politicians needed to increase revenues to fund increased expenditure programs. They covered their tracks by asserting that the flattened, mildly progressive rate structure under the 1986 Act was not "fair" because higher income taxpayers should pay more. Tax rates except for the poor and the lower middle class were substantially increased. This history obviously has ominous overtones for any relatively low-rate flat tax on a narrower tax base, as would occur under the Armey flat tax or the USA tax.

In judging these proposals, we must face the realities of our political history. We are finally moving toward the fiscal discipline of a balanced budget. Under that regime, expenditures cannot exceed revenues, but there will be constant political pressure for new economic and social spending programs. The party in power will change from time to time. The tax base would, however, be very considerably narrower under the USA Tax because of the unlimited IRA deduction feature, or, under the Armey flat tax, because of the exclusion of all forms of investment income from the tax base. We will be taking one huge fiscal gamble that the sought after greater inducements to savings will produce an increase in investment capital sufficient to yield larger or even equal revenues from a narrower tax base.

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

THE UNITED STATES INCOME TAX

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

Similarly, life insurance, also by its nature a disciplined pattern of saving, is favored; the investment earnings reflected in cash surrender value are not taxed, and the policy proceeds on death are not income. Individuals make regular premium payments every year, and there is effectively a built-in penalty for failing to continue to do so.

Owner-occupied housing, the single most important investment asset held by most Americans, is clearly favored. The allowance of a deduction for interest on mortgage debt and for real estate taxes, plus the capital gain rollover and the capital gain exclusion as to a principal residence, plus the exclusion of gains at death, provide a broad-based permanent, substantial exemption from U.S. income tax for this largest class of investment assets in the U.S.

These variations from the classic income tax model are more like elements of a consumption tax than an income tax. Other consumption tax elements are found in our accelerated depreciation provisions, our special tax rates for long-term capital gains, and other provisions in existing law to defer or forgive tax on certain types of investment income.

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

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

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

The USA individual level tax also provides a mortgage interest deduction for interest on mortgage debt up to $1 million, but that deduction would not affect the 11 percent business activities tax to the extent the burden of that tax is passed through to the consumer in prices.

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

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

This is all untested ground.

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

What would be the effect of these Armey flat tax changes? I do not find it sufficiently reassuring to hear that the economy will grow rapidly so that interest rates will fall enough to more than compensate for denying the home mortgage interest deduction. What about long-term, fixed rate mortgages? Or to hear that people will give as much to charity without a deduction; major givers, induced by such tax saving opportunities as charitable remainder trusts, are very important to the support of many major charities. Even smaller givers take the tax deduction into account in making charitable contributions. Will employers still provide health, life, and disability insurance with no deduction for such costs? Can we really be sure that wage levels will rise sufficiently that the low income working poor will not need the help that the earned income tax credit presently provides?

Having raised these issues as to the USA Tax and the Armey flat tax, I readily acknowledge what is obvious to all tax lawyers--our existing income tax system itself has fundamental faults. Income earned

by corporations, except S corporations, is taxed more than once--to the corporation and then again to the shareholders when distributed. This double tax burden is compounded where a corporation owns less than 80 percent of the stock of another corporation. Nearly all foreign countries with an income tax system have provisions to eliminate or moderate these effects.

There is much that could be done to improve our existing system. Furthermore, our existing income tax system has obviously become extremely complex, probably far more than really necessary. But I hardly need elaborate on that issue for this audience.

THE ADVANTAGE OF A CONSUMPTION TAX

The consumption tax advantage, to the extent one exists, rests on the proposition that our existing income tax system discourages savings, at least without regard to the retirement income provisions. There has been a substantial decline in U.S. household savings over the past forty years, and this has been correlated to some degree to declining U.S. business investment in real terms in plant and equipment. Foreign investors through global capital markets have taken up some of the slack. The majority of these foreign investors are in countries with which the U.S. has tax treaties which, in accord with accepted international tax policies, provide for low U.S. tax withholding on interest and dividends. Accordingly, the country of residence of such investors has the primary right to tax these investment flows. Many such foreign countries rely in substantial part on a consumption tax, and as a result these foreign investors may be subject to lower tax burdens than U.S. investors. Accordingly, it is arguable that the decline in savings in the U.S. is caused in some substantial part by the burden of our income tax system on savings.

The proponents of a consumption tax seek, as I have described, to eliminate tax either on saved income or on the investment returns on saved income. The basic argument by these proponents is that the U.S. income tax system actually encourages current consumption, and thereby discourages the saving of income. This rests on the simple economic proposition that in the absence of any tax, a wage earner would be indifferent whether to use his or her wages for consumption now or to save such income now, investing the saving, and using the increased amount for later consumption. The wage earner can make either choice with equal economic effect because, in the absence of taxation, the present value of such increased future consumption will be the same as using the wages for current consumption.

An income tax, however, changes this equation. The after-tax income available for consumption today is significantly higher than the present value of future consumption because the investment earnings on the saved income will be taxed. Thus, there is a bias to consume the income immediately, as it is earned.

While this may sound unduly theoretical, and while most wage earners do not think in these terms, it is nonetheless quite possible that these economic effects influence conduct under our income tax system.

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

This analysis, however, overlooks an important consideration. Since the income tax is imposed on a broader base, in a perfect world the income tax would be imposed at lower rates to produce the same level of revenue for the government. But tax rates under our income tax system have not been low in modern

memory, except for the brief period when the 1986 Act rates remained in effect. This in and of itself raises the ominous political overtones I previously mentioned; our government cannot seem to operate on a low rate tax system, and the rates under either the USA Tax or the Armey flat tax would very likely be increased after an initial period of euphoria.

In any event, the real issue is whether we can increase personal savings by eliminating this theoretical bias in an income tax system to consume income as earned, rather than to save it. In doing so, we must take into account the consumption tax features of our existing income tax structure, which I listed earlier. The flatness of the rate is a political diversion.

On the real issue whether a consumption tax will increase savings, economists so far have reached no consensus as to the elasticity of household savings to changes in tax rates. Some argue with almost religious fervor that savings will be dramatically increased. Others argue with equal force from available data that savings will be barely affected. We need more light on this fundamental issue.

COMPARATIVE ADVANTAGE

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

Economic Efficiency. In a theoretical world, the greatest advantage of a consumption tax is that it will increase savings as compared to an income tax. In the real world in which we live, however, this advantage is greatly moderated by the provisions of the U.S. tax system as to qualified retirement plans, limited IRAs, life insurance, home ownership, and income exclusions and deferrals (fringe benefits, gain on sale of a residence, and others).

A true flat rate tax would have the advantage of eliminating some bracket arbitrage--both between or among years by timing the recognition of income and deductions, and between or among taxpayers. The kiddie tax, which taxes the unearned income of children at their parents' rate, is a perfect example of the complexity required to solve this problem. Similarly, noninterest bearing loans between related parties have required complex anti-avoidance rules. But the USA Tax has progressive rates, and in any event, tax lawyers like us will still find ways under a consumption tax to defer income and accelerate deductions.

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

My greatest concern in this area is that both the USA Tax and the Armey flat tax tend to remove any incentive for employer-sponsored qualified retirement plans and the comparative advantage of permanent plan life insurance versus other forms of savings. While I believe generally in a free market, my enthusiasm for free markets is tempered by some degree of paternalism, at least to the extent of providing a tax incentive for these disciplined forms of saving. It is regrettable that we have made the rules governing defined benefit pension plans so onerous and complex that employers and employees have already moved heavily toward defined contribution plans. Even so, defined contribution plans also induce regular, disciplined saving.

Without employer retirement plans, it is far from clear whether individual workers will maintain the same disciplined pattern of savings throughout their working years. There would be no constraints on using savings for consumption at any time prior to retirement except good judgment, which is not always

uniformly exercised in making consumption versus savings decisions. Similarly, by eliminating the comparative advantage of life insurance, largely a form of retirement saving, we would eliminate or reduce the attraction of that form of disciplined saving. In all, we would be embarking upon a wholly untried experiment in free market economics. By abandoning the comparative advantages of these incentives, savings could actually decrease.

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

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

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

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

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

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

The USA Tax attempts to address this issue with exceedingly complex transition rules. Unfortunately, in their present form, they would not work and could result in manipulation by the wealthy to their advantage. Al Warren and Marty Ginsburg have demonstrated this all too well in recent papers they have written. The Armey flat tax so far makes no effort to address this problem. It is far from clear that any workable solution can be devised to resolve this transitional unfairness.

Simplicity. The existing U.S. income tax system is inordinately complex for business taxpayers and for individual taxpayers with special circumstances--including taxpayers incurring foreign income tax burdens. For the average middle income U.S. taxpayer whose principal source of income is wages or salaries, however, the existing U.S. system is not complicated and in most respects has not fundamentally changed in the last fifty years. Deductions for home mortgage interest, real estate taxes, and charitable contributions, the major deductions for those who itemize, are relatively simple and unchanged for an average middle income taxpayer. Tax credits for household and dependent care expenses, for the elderly and permanently disabled, and for interest on certain home mortgages unnecessarily complicate the existing U.S. income tax. Some of the objectives could be substantially achieved more simply by straightforward deductions if the progressivity of the rates were moderated, as they were under the 1986 Act until they were changed.

While there are complexities for very low income taxpayers claiming the earned income tax credit, and for high income taxpayers with investment interest expense and complex financial transactions, these represent a minority of the individual income tax returns filed. The application of the earned income tax credit could be greatly simplified by providing some inducement for employers to implement it by reduced withholding on salaries or wages of low income workers.

In theory, however, I concede that adoption of a consumption tax could allow for greater simplicity. Much of the current tax law focuses on the identification and measurement of realized income. The provisions that address this goal would be far less important under a consumption tax. Expenditures for assets would be fully deductible under a consumption tax, while amounts received from the disposition of assets would be fully taxable. It would be unnecessary to identify and require capitalization of those expenditures that produce value beyond the close of the current taxable year. Accordingly, the concepts of tax basis, depreciation, and uniform capitalization would be relevant, if at all, only for transitional purposes.

The income tax has often provided special treatment to capital gains, to ameliorate the effects of taxing in a single year a gain on an investment asset that may have accrued over many years. Under a consumption tax, the proceeds from the sale of a long-term investment would be taxed only to the extent used for current consumption. Therefore, special treatment of capital assets would be unnecessary. Moreover, transactions such as like-kind exchanges or corporate reorganizations that change the form of an investment without liquidating the investment would by definition not be subject to tax. No special rules would be necessary to provide nonrecognition treatment to these transactions.

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

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

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

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

In several respects, a consumption tax would be more difficult to administer. Withholding the appropriate amount from wages would be more challenging, because the taxpayer's ultimate tax liability would depend on whether the taxpayer uses the wages for consumption or investment. Increased information reporting might be required for transactions involving loans and investment assets, because the taxability of these amounts would depend on the use of the proceeds. It might even become necessary to withhold on the proceeds of these transactions, if not reinvested.

CONCLUSION

It is far too early in the process of developing any of the new proposed tax systems to conclude that any of them would be superior in concept or application to the existing U.S. income tax system. Much could be done to improve the economic efficiency, fairness, simplicity, and administrability of the existing U.S. tax system without wasting the time and effort that may be involved in seeking a fundamental change in the nature of that system.

Furthermore, given the insatiable appetite of Congress and the Administration, Republican or Democratic, constantly to experiment with, amend, and tinker with the tax system to achieve economic goals, social goals, or differing concepts of fairness, it could be a very dangerous step. What if it should prove to raise less revenue than expected? That will mean added tax burdens on business and individuals. What if it proves less fair than expected? That will mean more tinkering and more burdens.

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

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