

# THE DEBATE OVER REPLACING THE PRESENT INCOME TAX WITH AN ALTERNATIVE TAX STRUCTURE

EDWARD B. HYMSON\*

## I. INTRODUCTION

There is an ongoing debate about whether the United States should switch from its present progressive income tax structure to a consumption tax or a hybrid income tax, and whether the tax structure chosen should be a flat tax (all taxpayers pay the same percentage) or a progressive tax. The debate turns on disputes over the economic efficiency of the alternative structures, social welfare, and transition problems inherent in any attempt to change the present tax structure. The following discussion identifies mainstream proposals to replace or modify the present income tax structure as well as identifying the theoretical and practical reasons for and against proposing changes.

Whether a pure income tax, a pure consumption tax, or a hybrid tax structure is preferable depends largely on whether it is desirable to always, sometimes, or never tax the return to earnings from savings and investments (income invested in savings accounts, stocks and bonds, real property, or a business).<sup>1</sup> Consumption tax supporters argue that their preferred structure maintains the parity of present value between consumption and savings decisions, prevents over consumption and under-saving, and moves toward a more efficient tax structure.<sup>2</sup> Hybrid income tax supporters argue that their structure can achieve most of the benefits of converting to a consumption tax without having to deal with the major problems associated with managing the transition.<sup>3</sup>

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\* J.D., Ph.D., Research Fellow, State Bar of New Mexico. The views expressed in this paper represent those of the author only, and not necessarily those of the State Bar of New Mexico. No legal advice is provided in this paper.

<sup>1</sup> See e.g. William D. Andrews, *A Consumption-Type or Cash-flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006); Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961 (1992); Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283 (1994); and Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash-flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975).

<sup>2</sup> Fried, *supra* note 1.

<sup>3</sup> In fact, the current income tax is already a hybrid income tax that contains some elements of a consumption tax. See e.g., I.R.C. §§ 401(a) (2011) (qualified deferred pension plans, 401(k)

Both income tax and consumption tax structures can be designed to be either flat (a constant tax rate regardless of the level of income or consumption), or progressive (a tax rate that increases as income or consumption increases). Whether a flat tax rate or a progressive tax rate is preferable depends on both the effect of progressive taxes on work and investment incentives and on differing definitions of social welfare posited by the advocates of the two alternatives.

## II. DEFINITION OF INCOME, CONSUMPTION, AND HYBRID TAXES

### A. *Income and Consumption*

The Haig-Simons definition of income is “the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.”<sup>4</sup> Consumption is the using up of goods and services<sup>5</sup> and a consumption tax is imposed on the portion of income that is consumed either immediately (for example by eating food or going to a movie) or over time (for example by purchasing a consumer durable good that wears out over time such as a personal residence, washing machine, or automobile).<sup>6</sup>

### B. *Income Tax, Consumption Tax, and Hybrid Tax*

An income tax is a tax imposed during the year as either a flat percentage of income or as a percentage that progressively increases as annual income increases, less whatever exemptions from taxable income (tax

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individual saving accounts, 408 Roth IRA (taxing contributions but not withdrawal of principal or earnings)). Proponents would stop taxing more savings intended for retirement as well as expenditures for education.

<sup>4</sup> Henry C. Simons, PERSONAL INCOME TAXATION 50 (1938); Robert M. Haig, *The Concept of Income--Economic and Legal Aspects*, THE FEDERAL INCOME TAX 1, 7 (Robert M. Haig ed. 1921) (reprinted in AM. ECON. ASSN. READINGS IN THE ECONOMICS OF TAXATION 54 (Richard A. Musgrave & Carl Shoup eds., 1959)). The Internal Revenue Code (I.R.C. or Code) defines gross income as all income, from all sources, (including, but not limited to compensation for services, business income, partnership income, interest, rents, dividends and gains from the sale of property) other than items specifically exempted by other sections of the Code. I.R.C. § 61(a) (2011). Items specifically included in income in the Code are found at I.R.C. §§ 71-90 (2011). Items specifically excluded from gross income are found at I.R.C. §§ 101-149 (2011). See also § 61(b) (2011).

<sup>5</sup> RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE UNABRIDGED, 437 (1987) (hereinafter RANDOM HOUSE DICTIONARY). Consumer goods are goods ready for consumption for the satisfaction of human wants. RANDOM HOUSE DICTIONARY at 437.

<sup>6</sup> *Id.*

expenditures) are mandated by statute. A pure income tax taxes all income earned from any source.

A consumption tax is a tax on the market value of all goods and services consumed during the year imposed as either a flat percentage of consumption or as a percentage that progressively increases as annual consumption increases, less whatever tax expenditures are mandated by statute.<sup>7</sup> It is imposed on consumption financed from income, funds removed from saving/investment (as either income or principal), as well as funds that are borrowed. A consumption tax does not tax income used to repay prior borrowings. It can be imposed on either the increase in the value of goods and services at each stage of production, a value added tax (VAT), as a tax on the value of the final sale of goods and services, a retail sales tax, or as a flat or progressive tax on each individual's annual aggregate consumption. VAT and retail sales tax are usually a flat tax ultimately paid by the consumer on all goods and services consumed.<sup>8</sup>

A hybrid income tax has some characteristics of an income tax and some of a consumption tax. It puts off taxation of some saving/investment such as income placed in an individual retirement account (IRA) or a qualified pension plan until account balances are withdrawn and consumed; however, it imposes tax on income placed in other forms of saving/investment, such as income invested in a regular savings account or in a business.

### C. *Work and Leisure*

Work is the means of earning one's livelihood; any activity undertaken to earn income.<sup>9</sup> Leisure is time spent free from the demands of work or duty. It is any activity undertaken for purposes other than to earn income.<sup>10</sup> Staying home to care for children, cook, clean, play baseball, or watch television is leisure. Time taken for vacation is leisure as is time sleeping. Taking care of others for pay is work; taking care of one's friends, spouse, or children without compensation is leisure.<sup>11</sup>

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<sup>7</sup> Joel Slemrod & Jon Bakija, *TAXING OURSELVES* 195 (4th ed. 2008).

<sup>8</sup> Lawrence Zelenak, *Debt-Financed Consumption and a Hybrid Income-Consumption Tax*, 64 *TAX L. REV.* 1 (2010).

<sup>9</sup> *RANDOM HOUSE DICTIONARY* at 2188-9.

<sup>10</sup> *Id.* at 1100.

<sup>11</sup> *Id.*

### III. TAXES PROPOSED AS ALTERNATIVES TO THE CURRENT INCOME TAX

#### A. Taxes that Are Neither Income Taxes nor Consumption Taxes

Imposing taxes on goods or services for which demand is perfectly inelastic produces no distortion and therefore no deviation from an optimal distribution of goods and services.<sup>12</sup> Both an income tax and a consumption tax create deviations from an optimal economic structure. The issue is which creates the smallest deviation.

The most efficient tax from the perspective of not altering market allocation of resources is a lump sum tax, a tax imposed annually for the right to exist. Since it is imposed independent of both saving/investment and the marginal rate of earnings it leaves the choice between both work and leisure and between consumption and saving/investment unaffected. The practical problem is that measuring annual ability to pay prospectively is impossible because lump sum taxes would have to reflect expected annual and lifetime earnings.<sup>13</sup>

The second efficient alternative is an annual tax imposed on all land called a land tax (not to be confused with a property tax on both land and structures or other improvements). Land is neither created nor destroyed (with the exception of a few recoveries of land from the sea or swamps) so taxing land does not alter the supply of land.<sup>14</sup> Each landowner either pays the annual land tax or sells the property to a buyer who becomes obligated to pay the tax. However, as a practical matter, property owners, banks, and builders oppose land taxes. Raising land tax by enough to offset revenue lost by eliminating the income tax would probably unite enough interest groups in opposition to make such a change a political impossibility.

#### B. Consumption Tax Alternatives to the Current Income Tax

A consumption tax can be collected directly from consumers as a tax on consumed-income (income less saving plus dissaving) sometimes referred to as a wage tax or a consumed income tax. The tax is assessed on all wages earned less saving/investment plus the amount that is borrowed and the amount withdrawn from saving/investment and consumed.<sup>15</sup> All tax

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<sup>12</sup> Frank Ramsey, *A Contribution to the Theory of Taxation*, 37 ECON. J. 47 (1927).

<sup>13</sup> Gregory Mankiw, Matthew Weinzierl, and Danny Yagan, *Optimal Taxation in Theory and Practice*, 23 J. OF ECON. PERSP. 147 (2009).

<sup>14</sup> Henry George, PROGRESS AND POVERTY CH. 3, ¶¶ 1-39 (Centenary ed. 1979), <http://schalkenbach.org/library/henry-george/p+p/ppcont.html> (last visited May. 2, 2013).

<sup>15</sup> Robert E. Hall and Alvin Rabushka, *THE FLAT TAX* (Hoover Institution Press, 2d ed. 1995).

expenditures now provided to business disappear because under a consumed income tax business is no longer taxed.<sup>16</sup> Capital purchases are normally expensed at the time of purchase rather than depreciated.<sup>17</sup> The consumed income tax can be a flat tax, a progressive tax, or flat tax with a demogrant (a negative tax paid to low income taxpayers). Consumption tax proposals do not include tax expenditures for home mortgage interest, state and local taxes, charitable deductions or other deductions or credits.<sup>18</sup> The structure could, however, include such tax expenditures.

A cash flow consumed income tax is a tax on income, plus borrowing less taxpayer increase in saving/investment, less repayment of prior borrowing. It is collected both from each individual consumer and on unreinvested business profits, which are treated as being passed through to the business' owners. Former Senators Sam Nunn and Pete Domenici proposed The USA Tax. It includes a modified subtraction VAT imposed on business sales income less capital, material, and wage cost, and a graduated wage tax (consumed income tax) imposed on wages with a top rate equal to the VAT rate. Retirement saving/investment is treated as deferred wages taxed when spent on consumption. The proposal does not tax consumption financed with prior savings and does not address borrowing and repayment.

A yield exemption tax taxes all income from labor and business; however, returns from saving/investment are exempt from tax. Business debt and interest remain deductible and gains on business investment are not included in business tax base. Under this structure, to the extent business investment yields a rate above the risk free rate of return, the yield exemption tax provides a greater benefit to capital than does expensing capital investment.

### *C. VAT and Retail Sales Tax Imposed on the Value of Consumer Goods*

There are two forms of consumption tax applied as a percentage markup on goods and services. A VAT is a tax on the value each firm adds to a product, imposed on the difference between a firm's sales and its purchases

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<sup>16</sup> Joel Slemrod and Jon Bakija, *TAXING OURSELVES: A CITIZEN'S GUIDE TO THE GREAT DEBATE OVER TAX REFORM*, 233-271 (MIT Press, 3rd ed. 2004).

<sup>17</sup> James M. Bickley, *CRS Examines Revenue-Raising Possibilities of U.S. VAT*, CONG. RES. SERVICE, R41602 (Jan. 21, 2011) (reprinted in *TAX NOTES TODAY*, 16-41, Jan. 25, 2011).

<sup>18</sup> I.R.C. §§ 163(h)(2)(d), (h)(3) (2011) (home mortgage interest deduction); I.R.C. § 164(a) (2011) (state and local tax deduction); I.R.C. § 170(a) (2011); and Treas. Reg. § 1.170A-1(a) (2008) (charitable deductions).

of inputs. Ultimately it is collected from the consumer.<sup>19</sup> A retail sales tax is a percentage of the retail sales price collected by retail sellers from purchasers of consumption goods.<sup>20</sup> It can either be added to the pre-tax price at sale (tax exclusive computation) or included as part of the final retail sales tax (tax inclusive method). Both VAT and retail sales taxes can be imposed in addition to or as a substitute for an income tax. Both are normally imposed as a flat percentage of purchases; they can also vary depending on the good or service.

### 1. Computing the VAT

Twenty eight of the twenty nine countries in the Organization for Economic Cooperation and Development (OECD) use the credit-invoice method under which each firm in the production chain computes the gross VAT on its sales less the VAT it paid for inputs.<sup>21</sup> Each firm shows separately on every invoice the VAT it paid directly and the VAT paid by intermediate suppliers.<sup>22</sup> Under the subtraction method each firm subtracts its cost of taxed inputs from its taxable sales and multiplies the result by the tax rate to compute its tax liability. The subtraction method is incompatible with tax structures where some goods are exempt or where different tax rates are levied on different products or services. Under the addition method each firm identifies the value it has added by adding all payments for untaxed inputs (generally wages and profits). That amount is multiplied by the VAT tax rate to determine the firm's VAT.<sup>23</sup> While the subtraction method and addition method require less record keeping than the credit-invoice method, they create incentives to cheat because they are not as easily auditable as the credit-invoice method.<sup>24</sup>

European credit-invoice method VAT structures include exempt and zero rated businesses. An exempt business does not collect VAT on its sales, does not receive credit for VAT paid on purchases, and is not registered with the tax collector. A zero-rated business does not collect VAT on sales and

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<sup>19</sup> See generally, James M. Bickley, *CRS Analyzes Replacing Current Tax System with Flat Tax*, CONG. RES. SERVICE, 98-529 (Jan. 28, 2011) (reprinted in TAX NOTES TODAY, 21-24 Feb. 1, 2011).

<sup>20</sup> California's retail sales definitions and tax rules are typical. California imposes sales tax on retail sales (including leases and rentals) of tangible personal property, CAL. REV. TAX. CODE §§ 6003, 6203 (2011); use tax on the use, storage or other consumption of taxable tangible personal property that is complementary to the sales tax, and sales tax on the rendition of designated services, CAL. REV. TAX. CODE §§ 6604, 62241, 6246 (2011); Retailers are responsible for collecting the tax from consumers, CAL. REV. TAX. CODE § 6452 (2011).

<sup>21</sup> Only Japan uses the subtraction method. Bickley, *supra* note 17.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

receives credit for VAT paid on inputs.<sup>25</sup> Exempt businesses typically provide basic health services, professional services of doctors and dentists, prescription drugs, and financial services.<sup>26</sup> Most countries with VAT structures use what is referred to as the destination principle to make the tax border adjustable, that is, to zero-rate goods exported from the country and impose VAT on imports to the country. This causes imported goods to have the same taxes imposed on them as competing domestically produced goods<sup>27</sup> (The subtraction method is not border adjustable).<sup>28</sup>

The percentage of revenue lost through evasion in Belgium is 8%, in France 3%, in Netherlands 6%, and in the United Kingdom 2-4%, while Italy has an estimated 40% evasion rate.<sup>29</sup> The European countries generally appear to apply VAT to broader tax bases than the tax base to which most U.S. states apply sales tax.<sup>30</sup> Even then, European countries apply VAT to only about 38-48% of gross domestic product, far less than the 80% coverage proposed for the FairTax discussed *infra*.<sup>31</sup> The Tax Policy Center at the Urban Institute and Brookings Institution estimates that a broad based U.S. VAT would generate \$55.44 billion for each 1% VAT imposed.<sup>32</sup>

## 2. Computing the Retail Sales Tax

Like a VAT, a retail sales tax is a consumption tax; however, it is only levied at final sale of a good or service to the consumer,<sup>33</sup> not at each stage of production as is a credit-invoice method VAT.<sup>34</sup> The advantage of a retail sales tax is that it does not require extensive recordkeeping throughout the production process as does a VAT. If collection rates were the same, a retail sales tax would generate the same revenue as a VAT at lower cost to both the

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<sup>25</sup> *Id.*

<sup>26</sup> Liam Ebrill, Michael Keen, Jean-Paul Bodin, and Victoria Summers, *The Modern VAT*, 93-94, International Monetary Fund, Washington, D.C. (2001).

<sup>27</sup> Bickley, *supra* note 17. See also, Henry J. Aaron, *The Political Economy of a Value-Added Tax in the United States*, 38 TAX NOTES 10, 1113 (Mar. 17, 1988) (arguing that a challenge under World Trade Organization rules could arise under the subtraction method; however, no such challenge has arisen).

<sup>28</sup> Bickley, *supra* note 17.

<sup>29</sup> Ali Agha and Jonathan Haughton, *Designing VAT Systems: Some Efficiency Considerations*, 78 REV. OF ECON. AND STAT. 304-5 (1996).

<sup>30</sup> Sijbren Cnossen, *VAT and RST: A Comparison*, 35 CANADIAN TAX J. 559-615 (1987).

<sup>31</sup> Joint Committee on Tax, U.S. Congress, *Description and Analysis of Proposals to Replace the Federal Income Tax*, 49, Joint Committee Print, Washington: U.S. Government Printing Office (1995).

<sup>32</sup> Tax Policy Center, Urban Institute and Brookings Institution, *5 Percent Broad Based Value Added Tax (VAT) Impact on Tax Revenues 2010-19*, 1, Table T 09-0442 (Nov. 12, 2009).

<sup>33</sup> James M. Bickley, *A Value-Added Tax Contrasted With a National Sales Tax*, Cong. Res. Service, RL3348, (Jan. 28, 2011) ((reprinted in TAX NOTES TODAY, 21-25, Jan.. 25, 2011)).

<sup>34</sup> *Id.*

tax collector and the businesses collecting it.<sup>35</sup> However, a credit-invoice method VAT is much harder to evade than is a retail sales tax because both seller and buyer at each stage in the chain both must have records of tax paid and collected.<sup>36</sup>

The FairTax is a retail sales tax first proposed in Congress in 1999<sup>37</sup> and reintroduced in the 112<sup>th</sup> Congress as the FairTax Act of 2011.<sup>38</sup> The legislation proposes to 1) impose a single rate national sales tax on new goods and services,<sup>39</sup> 2) repeal the income tax, social security tax, health insurance taxes, and the estate tax,<sup>40</sup> 3) abolish the Internal Revenue Service (IRS),<sup>41</sup> 4) impose a 23% tax inclusive (30% tax exclusive) sales tax on new goods and services (collected for the federal government by those states willing to collect it),<sup>42</sup> and 5) repeal the 16<sup>th</sup> Amendment to the U.S. Constitution (legalizing the federal income tax).<sup>43</sup> The legislation couples the retail sales tax with a monthly cash demogrant for each family that registers

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<sup>35</sup> Organization for Economic Co-Operation and Development, VAT/GST AND EXCISE RATES, TRENDS AND ADMINISTRATION ISSUES (2008); Sijbren Cnossen, *Evaluating the National Retail Sales Tax from a VAT Perspective*, UNITED STATES TAX REFORM IN THE 21ST CENTURY 215 (New York: Cambridge University Press, George Zodrow and Peter Mieszkowski, eds. 2002). This is not to suggest that there are not problems collecting VAT; there are. *See A Tax Net Full of Holes*, ECONOMIST, Dec. 12, 2005, at 87; Bertrand Benoit, *Germany and Austria Take Steps to Combat VAT Fraud*, FIN. TIMES, Dec. 12, 2005, available at <http://www.ft.com/intl/cms/s/0/75fd6a50-6ab3-11da-ba41-0000779e2340.html#axzz2SH9w0bLt>.

<sup>36</sup> Office of Tax Analysis, Cited in President's ADVISORY PANEL ON FEDERAL TAX REFORM, *Simple, Fair, and Pro-Growth: Proposals to Fix American's Tax System*, 70 FR 232370, 2005 (Nov. 2005), available at <http://govinfo.library.unt.edu/taxreformpanel/final-report/index.html>.

<sup>37</sup> Paul Bachman et al., *Taxing Sales under the Fair Tax: What Rate Works?*, 113 TAX NOTES 663 (Nov. 13, 2006). Arguments against the approach were presented by Bruce Bartlett, *Why the FairTax Won't Work*, 117 TAX NOTES 1241 (Dec. 21 2007).

<sup>38</sup> H. R. 25, S.13, 112th Cong. (2011), <http://thomas.loc.gov/cgi-bin/bdquery/z?d112:h.r.25> (hereinafter FairTax Act of 2011). For arguments supporting the approach to taxation and defending the rate chosen see Bachman, *supra* note 37; Bartlett attacks the approach, *supra* note 37. Opponents of Bartlett's chosen rates include David G. Tuerck, *Memo to Bruce Bartlett: Just do the Math*, 118 TAX NOTES 639 (Feb. 3, 2008). *See also*, William G. Gale, *The National Retail Sales Tax: What Would the Rate Have to Be?*, 889-911 TAX NOTES (May 16, 2005).

<sup>39</sup> FairTax Act of 2011, *supra* note 38.

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.* The act imposes a 23% tax computed based on the total price including the tax, the tax inclusive rate. This is equivalent to a 30% tax added to the pre-tax price of the good or service, the tax exclusive rate. *Id.* at § 101(b)(1). *See also* Peter R. Matejcek, *Framing the FairTax for the American Consumer: Tax-Inclusive? Tax-Exclusive?*, 22 LOY. CONSUMER L. REV. 391, 397 (2010).

<sup>43</sup> FairTax Act 2011, *supra* note 38, at §§ 2(f), 401.



to receive it to reduce the regressivity of the sales tax.<sup>44</sup> Congress may change the tax rate after the first year.<sup>45</sup>

Under the FairTax tuition and job training expenses are treated as an investment in human capital rather than consumption and are not subject to sales tax.<sup>46</sup> The FairTax proposal treats new rental properties purchased as not subject to tax while new properties purchased for residential use are.<sup>47</sup> Purchase of an existing home from another, whether tax had previously been paid on it or not, is not subject to tax; purchase of a new home is.<sup>48</sup> Rents paid to landlords are subject to sales tax; however, the value received by the residential owner who resides in his property is not.<sup>49</sup> Financial management costs including brokerage fees and the fees normally rolled into a personal loan (which would have to be disaggregated from the cost of the loan), but not the interest expense, are subject to tax.<sup>50</sup> Purchases by both federal and state governments are also subject to sales tax.<sup>51</sup> The FairTax Act relies on states to collect the tax for the federal government in most instances in order to save collection costs.<sup>52</sup> A similar effort at cooperation, permitting states to adopt the federal individual income tax base (as many have with minor exceptions) and have the federal government collect state income taxes as well as federal income tax was passed in 1972. It remained in effect until 1990; however, no state availed itself of the opportunity.<sup>53</sup>

William Gale and the President's Advisory Panel on Federal Tax Reform have both argued that the tax rate would have to be higher to replace the revenue lost by repeal of the income tax.<sup>54</sup> Gale argues that if one accepts

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<sup>44</sup> *Id.* at §§ 301, 304.

<sup>45</sup> *Id.* at § 101.

<sup>46</sup> *Id.* at §§ 1(8)(D), 14(B)(ii)(IV).

<sup>47</sup> Purchase of properties for purposes of renting them are not subject to tax. FairTax Act of 2011, *supra* note 38, at § 101(a)(2). Purchase of a personal residence is subject to tax. *Id.*

<sup>48</sup> Purchase of newly constructed residence subject to tax. *Id.* at § 101(a). Purchase of used residence not subject to tax. *Id.* at §§ 2 (14)(A)(i)(II), 2(16).

<sup>49</sup> Rents paid for real property are subject to the tax. FairTax Act of 2011, *supra* note 38, at §§2(14)(A)(i), 405(g)(1). The FairTax Act of 2011 contains no provision to impute rent on owner occupied residences and therefore no provision to tax occupancy of residences purchased before passage of the act or purchase of used residences.

<sup>50</sup> *Id.* at §§ 101, 803 .

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* at §§ 401 (Authority for states to collect tax), 402 (Federal administrative support for states), 404 (Federal administration in certain states).

<sup>53</sup> U.S. Congress, Joint Committee on Internal Revenue Taxation, *State and Local Fiscal Assistance Act and the Federal-State Tax Collection Act of 1972*, H.R. 14370, 92nd Cong., Pub. L. No. 51-72, 92-512, JCS-1-73 (1973). The provision of the Federal-State Tax Collection Act of 1972 (which became I.R.C. §§ 6361- 6365) were repealed by the Omnibus Budget Reconciliation Act of 1990, P.L. 101-508, § 11801(a)(45) (1990).

<sup>54</sup> President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth* (Nov. 2005); Leonard E. Burman and William G. Gale, *A Preliminary Evaluation of the Tax Reform Panel's Report*, TAX NOTES (Dec. 5, 2005).

the premises on which the FairTax Act is based, no avoidance, evasion, or legislative erosion of taxed consumption (through tax expenditures), the required tax rate would be 31% tax inclusive or 44% tax exclusive.<sup>55</sup> The Joint Tax Committee argues that the sales tax rate required to replace the revenue produced by the present taxes would be 36% tax inclusive, 57% tax exclusive.<sup>56</sup> Further, Gale argues that the assumption prices would rise by the full amount of the sales tax while spending is assumed to remain constant causes nominal revenue to be overstated, nominal spending to be understated, or both.<sup>57</sup>

Bartlett, opposing the FairTax, argues the FairTax will cause an increase in prices; however, David Tuerck, a FairTax supporter, argues that Bartlett neglects the effect of eliminating the income tax; which offsets the decrease in real disposable income by increasing disposable income by the amount of the eliminated income tax.<sup>58</sup> However, since those who receive extra money are different from those who pay additional taxes some taxpayers will have more disposable real income and others less causing price adjustments.<sup>59</sup> Bull and Lindsey explain:

[F]or the consumer prices to stay constant [when a sales tax is imposed], the producer price must fall by the amount of the tax. And because a drop in the producer price means that the business revenue produced by hiring another worker drops, the before-tax wage must drop by a corresponding amount.<sup>60</sup>

Following this reasoning, workers must accept a reduction in wages comparable to the percentage of tax charged or the Federal Reserve must expand the money supply to raise price levels.<sup>61</sup> The argument is supported by evidence accompanying past sales tax increases.<sup>62</sup>

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<sup>55</sup> Gale, *supra* note 38.

<sup>56</sup> Joint Committee on Tax, *Budget Neutral Tax Rate for H.R.2525*, Memorandum from Lindy Pall to John Buckley (Apr. 7, 2000) (reprinted in TAX NOTES, 917 (Nov. 15, 2004)).

<sup>57</sup> Gale, *supra* note 38, at 889-90.

<sup>58</sup> Tuerck, *supra* note 38, at 639.

<sup>59</sup> See, e.g. Don Fullerton and Gilbert E. Metcalf, *Tax Incidence*, HANDBOOK OF PUBLIC ECONOMICS, vol. 4, 1963 (New York: Elsevier, Alan J. Auerbach and Martin Feldstein, eds. (2002)); Edgar K. Browning, *Tax Incidence Analysis for Policy Makers*, DISTRIBUTIONAL ANALYSIS OF TAX POLICY, 169 (Washington: American Enterprise Institute, David F Bradford, ed. 1995).

<sup>60</sup> Nicholas Bull and Lawrence B. Lindsey, *Monetary Implications of Tax Reforms*, NAT'L T. J., 362 (Sept. 1996).

<sup>61</sup> Bartlett, *supra* note 38.

<sup>62</sup> Henry J. Aaron, *THE VALUE-ADDED TAX: LESSONS FROM EUROPE*, (Washington: Brookings Institution, 1981); George N. Carlson, *Value-Added Tax: European Experience and Lessons for the United States*, 65, Washington: Office of Tax Analysis, U.S. Treasury Department

### D. *Progressive Consumption Tax, VAT, and Retail Sales Tax*

A progressive consumption tax could be imposed on individual income less saving/investment plus dissaving and borrowing each year. Alternatively, a progressive VAT or retail sales tax type spending tax could be imposed on each purchase of a consumption good or service at a rate that varies with the degree of necessity or luxury of the item consumed.<sup>63</sup> Professor McCaffery has argued for imposing a progressive spending tax on individuals.<sup>64</sup> He argues:

A spending tax, as opposed to an income or wage tax ... [could generate] significantly more progressive marginal tax rates than obtain today. ...[H]igh marginal rates under a spending tax fall on and hence deter high-end spending, which is arguably a social bad, and do not necessarily deter the social goods of work and saving; indeed, a progressive spending tax may increase saving. A spending tax can bear more steeply progressive rates with less cost in efficiency or social wealth than an income or wage tax. Progressive spending taxes also fall on consumption financed by windfall gains, doing so with diminished adverse incentive effects.<sup>65</sup>

McCaffery's spending tax would be collected from individuals directly.<sup>66</sup> Alternatively, Professor Graetz would impose one tax rate on spending that is normal for an individual or family over a lifetime, dissaving when young and old, saving in mid-life to the extent it is to be used to finance retirement. He would impose a higher tax rate on spending that is above normal levels.<sup>67</sup>

### E. *The Hall Rabushka Flat Consumption Tax*

The Hoover Institution's Hall and Rabushka have proposed collecting a flat consumed income tax on consumption from individuals in place of the current income tax administered as an individual tax on wages and pension

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(1980); U.S. Treasury Department, *TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH*, vol. 3, 20 (Washington: U.S. Government Printing Office, 1984).

<sup>63</sup> Sean Raft, *Imagining a Progressive and Comprehensive Consumption Tax*, 86 OR. L. REV. 161, 166-68 (2007).

<sup>64</sup> Edward J. McCaffery and James R. Hines, Jr., *The Last Best Hope for Progressivity in Tax*, 83 S. CAL. L. REV. 1031, 1041, 1046 (2010).

<sup>65</sup> *Id.* at 1037-8.

<sup>66</sup> *Id.* at 1047.

<sup>67</sup> Michael J. Graetz, *Tax Policy Challenges*, 35 OHIO N.U.L. REV. 1 (2009).

receipts less saving/investment. The wage tax would include a demogrant for each low income family to eliminate the tax for low income families; however, there would be no tax deductions. Social security payments would not be deductible, and Social Security benefits would not be taxed.<sup>68</sup> There would also be a business tax component consisting of a modified subtraction method VAT on each firm's value added by other than wages, salaries, and pension contributions but including all other fringe benefits including employer social security contributions.<sup>69</sup> The value of government employees' fringe benefits would be imputed and taxed. Purchases of plant and equipment would be expensed rather than depreciated; however, sale of inventory would not be deductible. A business's negative VAT resulting from losses would be carried forward with interest to offset the next positive VAT. The cost of real estate for rental would be deducted when purchased, and the sale price would be taxed when sold.<sup>70</sup> Hall and Rabushka would tax charges for intermediation, which are the services of collecting deposits, making loans, selling insurance (as opposed to interest charged or paid or insurance benefits paid).<sup>71</sup> (However, identifying and separating the charges for intermediation from interest paid or received and life insurance dividends and benefits payouts proved too difficult for Europeans to identify and make subject to VAT.<sup>72</sup>) Present tax preferences associated with employer deductibility and employee non-taxability of employee health insurance and deductibility of health care expenses would be eliminated.<sup>73</sup>

The proposal was championed in the 1990s by then Congressperson Dick Armey and has been suggested in subsequent years.<sup>74</sup> According to proponents, replacing the current tax structure with a flat tax would result in a simpler tax system that is also more efficient because it is a consumption

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<sup>68</sup> Hall and Rabushka *supra* note 15, at 59, 77.

<sup>69</sup> *Id.* at 77.

<sup>70</sup> *Id.* at 72.

<sup>71</sup> *Id.* at 74-75.

<sup>72</sup> *Id.* Hall and Rabushka claim it would be easy to measure; however, that unsupported assertion is rebutted by Charles E. McLure, Jr., *THE VALUE-ADDED TAX, KEY TO DEFICIT REDUCTION?* 135, (Washington: American Enterprise Institute, 1987).

<sup>73</sup> See generally, Internal Revenue Service, *Medical and Dental Expenses* (2010), Publication 502.

<sup>74</sup> Bickley, *supra* note 33. Representative Michael C. Burgess introduced *Freedom Flat Tax Act*, H.R. 1040, 110th Cong. (2009); Senator Lamar Alexander introduced the companion *Optional One Page Flat Tax Act*, S. 963 (2009); Senator Arlen Specter introduced *Flat Tax Act of 2009*, S. 741, 110th Cong. (2009); Senator Richard C. Shelby introduced the *Simplified, Manageable, and Responsible Tax Act*, S. 741 and S. 932, 110th Cong. (2009); Representative Michael C. Burgess introduced *Freedom Flat Tax Act*, H.R. 1040, 110th Cong. (2009); Senator Lamar Alexander introduced the companion *Optional One Page Flat Tax Act*, S. 963 (2009); Senator Arlen Specter introduced *Flat Tax Act of 2009*, S. 741, 110th Cong. (2009); and Senator Richard C. Shelby introduced the *Simplified, Manageable, and Responsible Tax Act*, S. 741 and S. 932, 110th Cong. (2009).

tax rather than an income tax.<sup>75</sup> (Like McCaffery's tax on spending, a consumed income tax need not be a flat tax. It may be a progressive tax, rising with increases in consumption.)<sup>76</sup>

Like all shifts to a consumption tax, under Hall and Rabushka, interest and capital income is free of tax when earned and is only taxed when it is spent on consumption. Thus, municipal bond interest would lose its benefits as a source of income that is free of both income and consumption tax, causing the market value of municipal bonds to fall.<sup>77</sup> Similarly, the benefit states receive when taxpayers deduct state income or sales tax from federal income would disappear. Finally, the state sales tax is also a consumption tax.

### F. *The Hybrid Income Tax*

The current U.S. income tax already contains some aspects of a consumption tax; however, it is made inefficient by the many tax expenditures (credits, deductions, and exceptions) that most economists agree create significant departures from an optimal tax structure. A consumption tax with the same tax expenditures included would generate the same inefficiencies. Major tax expenditures include preferential capital gains rates,<sup>78</sup> carried interest,<sup>79</sup> and dividend tax rates;<sup>80</sup> as well as deductions for charitable contributions,<sup>81</sup> home mortgage interest,<sup>82</sup> and state and local tax deductions.<sup>83</sup> The inefficiencies created by tax expenditures can be eliminated by repealing the tax expenditures to broaden the tax base. Once the two tax bases are comparable, proponents of a hybrid income tax argue that the primary benefit of replacing the current income tax structure with a

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<sup>75</sup> Hall and Rabushka, *supra* note 15.

<sup>76</sup> Bickley, *supra* note 17. See also Edward J. McCaffery and Hall, *supra* note 64.

<sup>77</sup> Dennis Zimmerman, *Consumption Taxes and State-Local Tax Systems*, CRS Report 95-1150, 1995; Robert P. Strauss, ADMINISTRATIVE AND REVENUE IMPLICATIONS OF ALTERNATIVE FEDERAL CONSUMPTION TAXES FOR THE STATE AND LOCAL SECTOR (American Tax Policy Institute, 1997).

<sup>78</sup> I.R.C. § 1(h)(1)(c) (2011).

<sup>79</sup> Treas. Reg. § 1.731-2 (1996) (describing carried interest and making gain subject to capital gains rates).

<sup>80</sup> I.R.C. § 1(h)(11) (2011). The top 400 taxpayers account for over 10% of capital gains and nearly 5% of dividend income reported by individual taxpayers. N.Y. TIMES, Mar. 24, 2012, at B1.

<sup>81</sup> Treas. Reg. § 1.170A-1 (2008) (charitable gift deductions).

<sup>82</sup> I.R.C. § 163(h)(3) (2011).

<sup>83</sup> I.R.C. § 164(a) (2011).

consumption tax structure, not taxing savings/investment,<sup>84</sup> can largely be accomplished through modifications to the current income tax structure.

Many savings intended for use at retirement are already taxed when consumed rather than when earned.<sup>85</sup> Expanding the existing tax deferral on savings for retirement until spent to all savings not intended for bequests or luxury good consumer expenditures prior to retirement would provide many of the benefits consumption tax theorists allege for their structure.<sup>86</sup> Middle class saving already occurs primarily through retirement plans and home ownership (the return on which is not taxed until retirement and liquidation).<sup>87</sup> Many remaining savings in society are either savings intended to be passed on to another generation as bequest savings, or to be used by the rich to purchase luxury goods.

Consumption theorists fail to distinguish between life cycle savings and consumption for intergenerational transfers.<sup>88</sup> Hybrid income tax advocates argue that the case for consumption taxes only applies over the course of an individual's life.<sup>89</sup> Thus, Shenk, for example, suggests that consumption tax treatment should be applied to savings/investment taxpayer plans to use for future consumption while income tax treatment should apply to savings/investment to be used for bequests.<sup>90</sup> Schenk has pointed out, "[it is] not that we should attempt to tax power [and other intangible benefits of wealth] directly, but that savers enjoy more than deferred [consumption] . . .

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<sup>84</sup> Bankman and Weisbach, *supra* note 1; Zelenak, *supra* note 8, at 9-10; Zelenak elaborates on the point in Lawrence Zelenak, *The Income Tax and the Costs of Earning a Living*, 56 TAX L. REV. 39, 54 (2002). Gratz has argued for a VAT imposed on all consumption and an income tax only imposed on incomes above \$100,000. Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L.J. 261 (2002). The Graetz proposal includes taxation of debt financing. From Zelenak's point of view the income tax could include debt financing in the tax base to produce the same result. See also Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 TAX L. REV. 423 (2000).

<sup>85</sup> See, e.g. I.R.C. §§ 401(a), 401(k), 408 (2011).

<sup>86</sup> Zelenak, *supra* note 8, at 2.

<sup>87</sup> On the consumption tax components in the present income tax, see generally UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX (Henry J. Aaron, Harvey Galper & Joseph A. Pechman eds. 1988); Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145 (1992); David F. Bradford, BLUEPRINTS FOR BASIC TAX REFORM 112-13 (Tax Analysts, 2d ed. 1984); Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 878-80 (2005). Employment related retirement accounts are addressed at I.R.C. §§ 401-407 (2011); individual retirement accounts are addressed in I.R.C. § 408 (2011); Roth individual retirement accounts are addressed at I.R.C. § 408A (2011); taxation of assets only on realization sale or exchange is addressed in I.R.C. § 1001 (2011).

<sup>88</sup> Alvin C. Warren, Jr., *Would a Consumption Tax Be Fairer than an Income Tax?*, 89 YALE L.J. 1081, 1094-95 (1980) (cited as an argument by Zelenak, *supra* note 8, at 6). See also, Alan Gunn, *The Case for an Income Tax*, 46 U. CHI. L. REV. 370, 378-88 (1979).

<sup>89</sup> Zelenak, *supra*, note 8, at 16 (relying on Schenk, *supra* note 84, at 462).

<sup>90</sup> *Id.* at 463.

and therefore need not be taxed the same as current consumers.”<sup>91</sup> Zelenak argues that the current income tax laws already approximate that result.<sup>92</sup> However, Bankman and Weisbach have critiqued the proposition by arguing that a consumption tax that taxes goods purchased with savings already taxes Shenk’s intangible benefits.<sup>93</sup>

A consumption tax structure taxes loan proceeds used to purchase consumption goods when borrowed, but not principal and interest payments on the loan.<sup>94</sup> The elimination of deductibility of personal interest in 1986<sup>95</sup> effectively produces the same result under the income tax as would be produced under a wage tax.<sup>96</sup> If borrowing is taxed as income when borrowed, and repayment of principal and interest is deductible when paid, the taxation of borrowing under a consumption tax is replicated under a hybrid income tax. The advantage of such a structure is that it avoids significant transition problems inherent in converting to a consumption tax. However, Zelenak points out, “[w]hen relevant tax rates differ in different years, however, the denial of a deduction for personal interest expense (that is, wage tax treatment) will be a poor substitute for cash-flow taxation.”<sup>97</sup> To address the problem Zelenak would allow taxpayers to elect either cash flow taxation or wage taxation with respect to debt-financed consumption to deal with expected tax rate differences.<sup>98</sup>

Consumer durables (personal residences, automobiles, refrigerators, washing machines) are consumed over multiple tax years. The tax on consumption of consumer durables should reflect the multi-year pattern of consumption; however, consumption tax proposals have ignored the issue on grounds of impracticality, substituting taxation at the time of purchase as a form of tax prepayment.<sup>99</sup> Rather, borrowing for consumer durables should be handled by not including loan proceeds in income when the consumer durable was purchased, and allowing no deductions for repayment of principal or payment of interest.<sup>100</sup> Having no tax consequences in the year of purchase of a consumer durable with debt, and no deduction from income for

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<sup>91</sup> *Id.* at 465. See also Stanley A. Koppelman, *Personal Deductions under an Ideal Income Tax*, 43 TAX L. REV. 679, 724 (1988).

<sup>92</sup> Zelenak, *supra* note 8, at 16.

<sup>93</sup> Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413, 1449 (2006).

<sup>94</sup> Zelenak, *supra* note 8, at 4.

<sup>95</sup> I.R.C. § 163(h) (2011). However, I.R.C. § 163(h)(2) (2011) provides that interest on qualified home mortgages continues to be deductible even if the borrowed money is used for consumption.

<sup>96</sup> I.R.C. §§ 163(h)(2)(d), (h)(3) (2011); Zelenak, *supra* note 8, at 21.

<sup>97</sup> *Id.* at 22.

<sup>98</sup> Bradford, *supra* note 87, at 112. (

<sup>99</sup> Zelenak, *supra* note 8, at 28; Bradford, *supra* note 87, at 108-9.

<sup>100</sup> Zelenak, *supra* note 8, at 29.

principal and interest payments would spread out the tax liability to match the loan duration, if not the life of the consumer durable.<sup>101</sup> This is the same result that already occurs under I.R.C. § 163(h) for other than personal residence secured debt.

With respect to personal residence purchases, the current structure partially follows wage tax treatment. No tax is imposed in the year the home is debt-financed, the same as under wage tax treatment of home mortgage debt; however, under the current tax structure, interest is deducted from the tax base.<sup>102</sup> Under the wage tax approach, such interest would not be deductible unless political necessity imposed such a requirement on the theoretically preferred structure.<sup>103</sup> If interest deductions were eliminated, the current tax treatment of purchase of a personal residence would replicate the result under wage tax treatment of the purchase.

If investment in education was treated as a human capital investment, it would not be taxable under a consumption tax.<sup>104</sup> The current income tax structure could easily be modified to produce the same result.<sup>105</sup> As with other loans, a student could also elect cash flow tax treatment, including tuition loans in the tax base, offset by tuition investment, and deducting later payments of principal and interest. Alternatively, a student could elect wage tax treatment in the year of borrowing, with a tuition deduction permitted and in later years, fully taxable wages with no deduction for repayment of loan principal or interest.

#### IV. ECONOMISTS' ARGUMENTS FOR AND AGAINST COMPETING TAX STRUCTURES

Economists' arguments for and against each of the alternate tax structures are tied to disputes over what constitutes economic efficiency. Structural economic efficiency analysis identifies how tax structures shift the mix of goods and services, consumption and savings/investment, and work

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<sup>101</sup> *Id.* at 30; Bradford, *supra* note 87, at 112-13.

<sup>102</sup> I.R.C. § 163(h)(2)(d) (2011).

<sup>103</sup> Zelenak, *supra* note 8, at 30-31; Commentators have argued that the home mortgage deduction should not be continued, Joel Slemrod & Jon Bakija, *TAXING OURSELVES* 218-222 (4th ed. 2008); President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* 70-75 (2005), <http://www.taxpolicycenter.org/taxtopics/upload/tax-panel-2.pdf>.

<sup>104</sup> Richard Goode suggests that the expenses should be amortized over the taxpayer's earning years rather than being deducted immediately. Richard Goode, *INDIVIDUAL INCOME TAX*, 83-87 (1976).

<sup>105</sup> *Id.*



and leisure away from the most efficient mix.<sup>106</sup> Social welfare efficiency identifies how competing tax structures affect the aggregate welfare of the society. There is a credible structural economic efficiency argument for a consumption tax structure. The problems with a consumption tax arise because of major problems inherent in shifting from the present income tax to a consumption tax. The dispute over whether tax structures should be flat or progressive is more contentious because of conflicting opinions about what constitutes social welfare maximization. That conflict leads to disputes about the measure of social welfare efficiency.<sup>107</sup> If the marginal utility of additional income or consumption for top bracket tax filers is small relative to that of the average taxpayer, social welfare is maximized by installing a progressive tax structure.<sup>108</sup> If one cannot measure the rate of increase or decline in the marginal utility of an individual's additional income or consumption, then social welfare is not necessarily maximized by income redistribution, a progressive tax structure cannot be shown to result in social welfare maximization, and a flat tax becomes preferable on structural economic efficiency grounds.<sup>109</sup>

### *A. Pareto Optimality and Structural Economic Efficiency*

A policy is Pareto efficient if it makes at least one party better off without making others worse off.<sup>110</sup> Pareto optimality occurs if resources are used such that there is no possibility they could be used in an alternative manner that would leave one or more persons better off without leaving anyone worse off.<sup>111</sup> Three conditions must be met for Pareto optimality:

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<sup>106</sup> Richard A. Musgrave and Peggy B. Musgrave, PUBLIC FINANCE IN THEORY AND PRACTICE, 444 (McGraw Hill, 1973).

<sup>107</sup> Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 STAN. L. REV. 745 (2007) (providing a litany of reasons why a progressive income tax may be preferable to a consumption tax though the author mildly supports a shift to a consumption tax).

<sup>108</sup> Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, 25 J. ECON. PERSP. 165-70 (2011).

<sup>109</sup> *Id.*

<sup>110</sup> Joseph E. Stiglitz, *Pareto Efficient and Optimal Taxation and the New Welfare Economics*, HANDBOOK OF PUBLIC ECONOMICS 991-1042 (North Holland: Elsevier Science Publishers, Alan Auerbach and Martin Feldstein eds., 1987).

<sup>111</sup> Musgrave and Musgrave, *supra* note 106, at 444.

1. The marginal rate of substitution (MRS) of any two products in consumption should be equal to their marginal rate of transformation (MRT) in production.<sup>112</sup>
2. The marginal rate of substitution of leisure for goods should be equal to the marginal rate of transformation of leisure into goods.
3. The marginal rate of substitution of future for present consumption should be equal to the marginal rate of transformation of present into future goods in production with both equal to  $1/(1 + i)$  where  $i$  is the rate of interest.<sup>113</sup>

Saez, Slemrod, and Gieritz conclude that the ability of the very wealthy to utilize tax expenditures to reduce their tax liability translates into higher estimates of elasticity than were tax expenditures eliminated.<sup>114</sup> Tax expenditures interfere with condition 1; thus, broad based tax structures are preferable to those containing tax expenditures.<sup>115</sup> Neither a broad based income tax nor a broad based consumption tax alters relative prices of one good or service for another.<sup>116</sup> A general consumption tax interferes with condition 2, (by causing a shift from work to leisure) and a general income tax interferes with conditions 2 and 3.<sup>117</sup> Both an income tax and a consumption tax insert a wedge between the gross wage rate as seen by the employer and the net wage rate as seen by the worker; thus, both a consumption tax and an income tax alter the choice between work and leisure.<sup>118</sup>

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<sup>112</sup> The MRS of X for Z is defined as the amount of Z which the consumer is willing to surrender for an additional amount of X. The MRT of X for Z is the amount by which the output of Z must be cut to produce an additional unit of X. *Id.* at 444-5.

<sup>113</sup> *Id.* at 445.

<sup>114</sup> *Id.* See also Bagehot, *The Notting Hill Budget*, *ECONOMIST*, Mar. 24, 2012, at 80 (finding that a reduction of the top British income tax rate from 50% to 45% in exchange for closing some loopholes was a reasonable political compromise).

<sup>115</sup> Emmanuel Saez, Joel Slemrod, and Seth H. Gieritz, *The Elasticity of Taxable Income with Respect to Marginal Tax Rules: A Critical Review*, 50 J. OF ECON. LITERATURE 3, 42 (2012).

<sup>116</sup> Neil Bruce, *PUBLIC FINANCE AND THE AMERICAN ECONOMY* 363-5 (Addison-Wesley Longman, 2001). Musgrave and Musgrave, *supra* note 106, at 447. If a general consumption tax, applicable alike to  $C_p$  and  $C_f$  and is imposed, relative prices are unchanged and therefore no excess burden results. "Since both  $C_p$  and  $C_f$  are reduced at the same rate relative prices are unchanged, the MRT and MRS of present for future consumption and future consumption remain equal and no excess burden results." *Id.* 449. Note; however, a selective tax on some consumption does. *Id.* 447.

<sup>117</sup> Musgrave and Musgrave, *supra* note 106, at 445-46.

<sup>118</sup> Musgrave and Musgrave, *supra* note 106, at 449. The distortion could be removed by valuing leisure and taxing it as income or a consumption good; however, such a practice is

## B. *The Structural Efficiency Argument for a Consumption Tax*

The argument for a consumption tax instead of an income tax is based on the structural economic efficiency argument that the Pareto optimal level of saving is not achieved under an income tax. Professor Zelenak, among others, has explained:

...Spender and Saver both have \$100 of wages in the current period (period one)... . Spender chooses \$100 of period-one consumption, while *Saver* opts for \$110 of consumption in period two. Each has chosen a consumption package with a present value (from the perspective of period one) of \$100. Now suppose a cash-flow consumption tax with a flat rate of 20 percent is introduced. After paying a \$20 tax in period one, Spender will be able to consume \$80 in that period. ... Saver will owe no tax in that period. She will invest her entire \$100 of wages, which will grow to \$110 by period two. Her consumption tax in period two will be \$22 (20 percent of \$110), leaving her with \$88 of consumption. The new tax decreases the consumption power of both Spender and Saver, but it does not disrupt the present value equivalence of their consumption packages. Using a 10 percent discount rate, the present value (in period one) of Saver's \$88 consumption in period two is \$80, which is exactly the amount of Spender's period-one consumption.

Assuming (as before) a tax with a flat rate of 20 percent, Spender will still pay a \$20 tax on his wages and consume \$80 in period one. Saver will also pay \$20 tax in period one on her wages, and will invest the remaining \$80 at a pretax rate of return of 10 percent. In period two, Saver will pay income tax of \$1.60 on her \$8 of investment income, leaving her with \$86.40 of period-two consumption. From the perspective of period one, applying a 10 percent discount rate results in a present value of \$78.54 for Saver's period-two consumption--which is less, of course, than the \$80 value of Spender's year one consumption.<sup>119</sup>

Thus, because an income tax causes individuals to over consume and under save, it causes a shift away from the Pareto optimal levels of saving/investment.<sup>120</sup>

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impractical in the extreme. ABBA P. LERNER, *THE ECONOMICS OF CONTROL* 231-238 (New York: Macmillan, 1944).

<sup>119</sup> Zelenak, *supra* note 8, at 11.

<sup>120</sup> Fried, *supra* note 1.

### C. *The Inverse Elasticity Rule as a Measure of Structural Economic Efficiency*

Economists generally agree that the greater the elasticity of labor supply to reductions in wages resulting from imposition of tax, the lower is the optimal tax rate.<sup>121</sup> Imposing taxes on goods or services for which demand is perfectly inelastic produces no distortion and therefore no deviation from Pareto optimal prices.<sup>122</sup> The greater the elasticity of demand the greater the decline in the quantity of that taxed for a given increase in the tax rate relative to that which is not taxed and; therefore, the greater the deviation from the Pareto optimal distribution of goods, services, consumption, saving/investment, and/or work and leisure.<sup>123</sup>

Saez, Slemrod, and Giertz, in a study published in 2012, contend that the range of estimates for elasticity of demand is between 0.12 and 0.40.<sup>124</sup> Most recently Romer and Romer analyzed total elasticity of response to tax changes from the end of World War I to the beginning of World War II. During the period they studied only the wealthy paid significant income taxes and there were relatively few tax expenditures. They concluded that the elasticity overall was approximately 0.2.<sup>125</sup> The confidence interval for the analysis was extremely high (the *t*-statistic was over 6).<sup>126</sup> After reviewing the literature professor Keane has concluded:

At least for men, it is fair to say that the majority of studies find rather small elasticities with respect to after-tax wage rates. This, in turn, implies that efficiency costs of distortionary income taxation are small. But, as we will see, a sizable minority of studies makes a strong case for larger elasticities.... For women, in contrast, most studies have found rather large labor supply elasticities, especially on the participation margin [i.e. whether women choose to work or not].<sup>127</sup>

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<sup>121</sup> James A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. OF ECON. STUD. 174 (1971).

<sup>122</sup> Ramsey, *supra* note 12.

<sup>123</sup> Bruce, *supra* note 116, at 303, 305.

<sup>124</sup> Saez, Slemrod, and Giertz, *supra* note 115, at 42.

<sup>125</sup> Christina D. Romer and David H. Romer, *The Incentive Effects of Marginal Tax Rates: Evidence from the Interwar Era*, 2012, 15-6, working paper, <http://elsa.berkeley.edu/~dromer/papers/The%20Incentive%20Effects%20of%20Marginal%20Tax%20Rates%20Feb%202012.pdf> (Last visited Mar. 23, 2012).

<sup>126</sup> *Id.*

<sup>127</sup> Michael P. Keane, *Labor Supply and Taxes, a Survey*, 49 J. OF ECON. LIT. 961, 962 (2011). Keane argues that the better studies support higher elasticities; however, his paper makes clear that support for such a conclusion is, at best, weak. *Id.*

Marshallian labor supply elasticity (also referred to as the uncompensated elasticity or total elasticity) is a function of consumption and leisure only and does not consider borrowing and saving, human capital accumulation, or lifetime income.<sup>128</sup> Hicks elasticity (or compensated labor elasticity) disaggregates total elasticity into elasticity of substitution and income elasticity resulting from imposition of the tax.<sup>129</sup> It accounts for both reduced consumption caused by imposition of the tax due to substitution of other goods or leisure as well as reduced consumption occurring because of the reduction in net income when the tax is imposed.<sup>130</sup> Keane suggests, “Hicks elasticity is the correct concept to use in evaluating the labor supply effects of such a policy change.”<sup>131</sup>

#### D. *The Mankiw-Diamond Debate over Optimal Tax Structure*

The debate between flat tax supporters and progressive tax supporters revolves around a tradeoff between structural economic efficiency and social welfare efficiency.<sup>132</sup> Mankiw et al. ignore social welfare efficiency on grounds that interpersonal social welfare maximization cannot be measured accurately, then argue for flat taxes and a low marginal rate on high income taxpayers on grounds that progressive taxes discourage entrepreneurship.<sup>133</sup> Diamond and Saez’s believe that as income increases the marginal utility of additional income increases at a declining rate and model their social welfare function accordingly. Their argument that marginal tax rates should rise as income increases is based both on low measures of elasticity and on the benefits they claim are the result of maximizing social welfare efficiency based on their social welfare function.<sup>134</sup>

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<sup>128</sup> *Id.* at 966-7.

<sup>129</sup> *Id.* at 967.

<sup>130</sup> *Id.* at 968.

<sup>131</sup> *Id.* at 969. A third, *Frisch elasticity*, measures elasticity in life cycle models. *Id.* at 969-70, 977.

<sup>132</sup> Mirrlees, *supra* note 121.

<sup>133</sup> MATTI TUOMALA, OPTIMAL INCOME TAX AND REDISTRIBUTION, 95 (New York: Oxford University Press, 1990).

<sup>134</sup> Diamond and Saez, *supra* note 108, at 168-173; Romer and Romer, *supra* note 125, at 11, 25. Romer’s estimates of the elasticity of extremely high income taxpayers with respect to increases in tax rates show elasticity is low, 0.19 to 0.2 for high and very high income taxpayers. *Id.* at 11, 27; Emmanuel Saez, *Using Elasticities to Derive Optimal Income Tax Rates*, 68 REV. OF ECON. STUD., 205, 109 (2001).

# 1. The Mankiw et al. Arguments for a Flat Tax

The Mankiw et al. argument for a flat consumption tax over an income tax reflects the views of a number of classical liberal economists.<sup>135</sup> Their position is contested by many other economists.<sup>136</sup> Mankiw et al. claim that the shape of the social welfare function is based on conjecture and should be ignored when forming tax policy. They conclude that the optimal tax structure should be derived by looking to structural economic efficiency to minimize deviations from Pareto Optimality.<sup>137</sup> On the basis of their log normal simulations measuring elasticity Mankiw et al. conclude that a Pareto efficient distribution for higher wages up to \$300,000 should be a flat tax rate schedule:

[W]e have calculated a wage distribution that yields optimal marginal tax rates between 48 and 50 percent for all but the lowest and highest skilled workers and that lies between the lognormal and lognormal-Pareto distributions except at low wage levels (where fewer disabled and more low-skilled workers are required to lower the optimal marginal rate ... and a few intermediate wage levels (where it slightly exceeds both distributions). This nearly flat optimal tax policy provides a lump-sum grant to the lowest-ability worker equal to just over 67 percent of average income per worker in the economy.<sup>138</sup>

While accepting a flat tax as a practical approximation of the optimal structure Mankiw et al. claim, “[i]n particular, tax schedules ought to vary systematically, the theory tells us, with gender, height, skin color, physical attractiveness, health, parents’ education, and so on.”<sup>139</sup> Since they do not claim that their proposed tax structure should be based on these factors, there is little point in discussing the assertion further.<sup>140</sup>

Mankiw et al. argue that taxes should be zero on intermediate goods (capital assets and inputs to the productive process) as a matter of structural

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<sup>135</sup> Mankiw et al., *supra* note 23, at 165, 167.

<sup>136</sup> Shaviro, *supra* note 107, at 745 (providing a litany of reasons why an income tax may be preferable to a consumption tax though the author mildly supports a shift to a consumption tax). Diamond and Saez, *supra* note 108 (responding to Mankiw’s claims).

<sup>137</sup> Mankiw et al., *supra* note 13, at 152, 158.

<sup>138</sup> *Id.* at 158.

<sup>139</sup> He reassures us that no modern tax system has such variation with the exception of several countries that reduce the burden on older individuals. *Id.* at 163.

<sup>140</sup> *Id.* at 155-6.

economic efficiency.<sup>141</sup> They argue both that a capital tax is a tax on future rather than current consumption and taxing capital distorts the relative prices of saving/investment and consumption.<sup>142</sup> Taxes may be imposed on intermediate goods producers only as Pigovian taxes that internalize costs imposed on society by the firms, such as pollution, that would otherwise not appear in the firm's cost structure.<sup>143</sup> Subject to that exception, the argument goes, taxes should be equal across final consumption goods and they cannot be if intermediate and capital goods are taxed.<sup>144</sup> Both a universally applied VAT and a consumed income tax address this concern by imposing a flat tax on all consumption without taxing intermediate goods.<sup>145</sup>

While opposing taxation of intermediate goods production and capital Mankiw et al. admit that some take legitimate exception to the conclusion that capital and intermediate goods ought not to be taxed: "[o]ne can find reasons to question the optimality of zero capital taxes. If all individuals have relatively short planning horizons, as in overlapping generations models, then capital taxation can provide redistribution without the dramatic effects on capital accumulation identified in the Ramsey literature."<sup>146</sup> Proposals by Zelenak,<sup>147</sup> and Graetz<sup>148</sup> to tax capital gains are based on such reasoning.

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<sup>141</sup> *Id.* at 164. The position has a long history; see, e.g. Peter A. Diamond and James A. Mirrlees, *Optimal Taxation and Public Production: Production Efficiency*, 61 AM. ECON. REV. 8, 27 (1971); Mankiw et al., *supra* note 13, at 164; Kenneth I. Judd, *Redistributive Taxation in a Simple Perfect Foresight Model*, 28 J. OF PUB. ECON. 59, 83 (1985); Christophe Chamley, *Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives*, 54 ECONOMETRICA 601(1986).

<sup>142</sup> Mankiw et al., *supra* note 13, at 167.

<sup>143</sup> A. C. Pigou, *THE ECONOMICS OF WELFARE* (Macmillan, London, 1920); 62 William J. Baumol, *On Taxation and the Control of Externalities*, 62 American Econ. R. 307, 319-20 (1972).

<sup>144</sup> Mankiw et al., *supra* note 13; see also Anthony Atkinson and Joseph E. Stiglitz, *The Design of Tax Structure: Direct Versus Indirect Taxation*, 6 J. OF PUB. ECON., 55, 75 (1976); Louis Kaplow, *THE THEORY OF TAXATION AND PUBLIC ECONOMICS* (Princeton University Press, 2008); Gregory N. Mankiw, *The Savers-Spenders Theory of Fiscal Policy*, 90 AM. ECON. REV., 120, 125 (2000).

<sup>145</sup> The VAT is imposed at each stage of production; however, it is refunded to each producer from the ultimate payment made by the end consumer. Mankiw et al., *supra* note 13, at 165.

<sup>146</sup> Mankiw et al., *supra* note 13, at 167-68; Juan Carlos Conesa, Sagiri Kitao, and Dirk Krueger, *Taxing Capital? Not a Bad Idea after All!*, 99 AM. ECON. REV. 25 (2009).

<sup>147</sup> Zelenak, *supra* note 8.

<sup>148</sup> Graetz, *supra* note 84.

## 2. Diamond and Saez Dispute Mankiw's Measures of Efficient Taxation

The Diamond and Saez analysis considers both structural economic efficiency and social welfare efficiency.<sup>149</sup> They define a social welfare function, then identify a tax function reflecting their measures of both elasticity and their social welfare function.<sup>150</sup> Their analysis takes into account the social value of marginal compensation to top earners as compared with the social value of marginal compensation to middle income earners.<sup>151</sup>

Models in optimal tax theory typically posit that the tax system should maximize a social welfare function subject to a government budget constraint, taking into account that individuals respond to taxes and transfers. Social welfare is larger when resources are more equally distributed, but redistributive taxes and transfers can negatively affect incentives to work, save, and earn income in the first place.<sup>152</sup>

Diamond and Saez conclude that the social marginal utility of an increase in consumption of the top 1% (average income in 2007 of \$1,364,000) is only 3.9% of the social marginal utility of those with a median family income in the same year (average income of \$52,700).<sup>153</sup> Setting the marginal tax rate for the top 1% that maximizes revenue from those taxpayers Diamond and Saez argue is Pareto optimal.<sup>154</sup> Using an empirically derived elasticity of top incomes with respect to the net-of-tax rate of 0.25, they conclude that the Pareto optimal tax rate is 73%, which is far higher than the 2011 top U.S. federal, state, FICA, and FUTA combined tax rate of 42.5%.<sup>155</sup> They argue not only that tax rates should be progressive; they also argue that capital income should be taxed because such a structure maximizes social welfare.<sup>156</sup>

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<sup>149</sup> They are the latest in a long line of economists making similar arguments. See e.g. Diamond and Saez, *supra* note 108; Saez, Slemrod, and Giertz, *supra* note 115. But see also Keane, *supra* note 127 (arguing that taxes should be flat rather than progressive because a minority of empirical studies found high rates of substitution of leisure for labor). The empirical results on elasticity being low and justifying high marginal tax rates were supported most recently by Romer and Romer. Romer and Romer, *supra* note 125.

<sup>150</sup> Diamond and Saez, *supra* note 108, at 165-70.

<sup>151</sup> *Id.* at 169-70.

<sup>152</sup> *Id.* at 165-70.

<sup>153</sup> *Id.* at 169.

<sup>154</sup> *Id.* at 170-71.

<sup>155</sup> *Id.* at 171.

<sup>156</sup> *Id.* at 166. The position is contrary to analyses such as those of Anthony B. Atkinson and Joseph E. Stiglitz, *The Design of Tax Structure: Direct Versus Indirect Taxation*, 6 J. OF PUB.



Because income elasticity is reduced by broadening the tax base and eliminating tax expenditures,<sup>157</sup> they claim that the higher measures of income elasticity reported in some studies are the result of unaccounted for tax expenditures (government funded give backs) and such tax expenditures should be excluded in a proper analysis of the optimal tax rate.<sup>158</sup>

...[U]sing the different elasticity estimates of Gruber and Saez for high-income earners...the optimal top tax rate using the current taxable income base (and ignoring tax externalities) would be ... 54 percent, while the optimal top tax rate using the broader income base with no deductions would be ... 80 percent. Taking as fixed state and payroll tax rates, such rates correspond to top federal income tax rates equal to 48 and 76 percent, respectively. Although considerable uncertainty remains in the estimation of the long-run behavioral responses to top tax rates ... , the case for higher rates at the top [up to 54 percent] appears robust... ”<sup>159</sup>

Diamond and Saez conclude that the argument that marginal tax rates should decline at the top is contrary to the weight of empirical economic analysis.<sup>160</sup> They also conclude that some savings/investment (which they refer to as capital income) should be taxed.<sup>161</sup> Diamond and Saez propose that distinctions should be made between savings of lower income taxpayers and higher income taxpayers. They would impose no (or lower) taxation on savings intended for retirement and tax intergenerational discretionary saving and savings for other than retirement, (on grounds such saving is primarily the province of the rich).<sup>162</sup> Diamond and Saez conclude, “[t]he bottom line is that uncertain future earnings opportunities argue against zero taxation of

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ECON. 55 (1976); Chamley, *supra* note 141; and Judd, *supra* note 141, at 59-83. Diamond and Saez argue that contrary conclusions are based on findings that are “not robust enough to be policy relevant.” Diamond and Saez, *supra* note 108, at 167.

<sup>157</sup> Joel B. Slemrod and Wojciech Kopczuk, *The Optimal Elasticity of Taxable Income*, 84 J. OF PUB. ECON. 91 (2002); Wojciech Kopczuk, *Tax Bases, Tax Rates and the Elasticity of Reported Income*, 89 J. OF PUB. ECON. 2093 (2005).

<sup>158</sup> Saez, Slemrod, and Giertz, *supra* note 115.

<sup>159</sup> Diamond and Saez, *supra* note 108, at 172-3.

<sup>160</sup> *Id.* at 173-4 (citing in support Peter A. Diamond, “Optimal Income Taxation: An Example with a U-Shaped Pattern of Optimal Marginal Tax Rates, 88 AM. ECON. REV. 83 (1998)); Emmanuel Saez, *supra* note 134; Mankiw et al., *supra* note 13, at 147-74.

<sup>161</sup> Chamley, *supra* note 141; Judd, *supra* note 141; Diamond and Saez, *supra* note 108, at 178; James Banks, Peter Diamond, *The Base for Direct Taxation*, DIMENSIONS OF TAX DESIGN: THE MIRRLEES REVIEW 548-68 (Institute for Fiscal Studies, Stuart Adam et al. eds. 2010 ). For an opposing view see Judd, *supra* note 141.

<sup>162</sup> Emmanuel Farhi and Ivan Werning, *Progressive Estate Taxation*, 125 Q. J. OF ECON. 635, 637-38 (2010); Diamond and Saez, *supra* note 108, at 179.

capital income, as do savings preference heterogeneity, limited distinctions between capital and labor incomes, and borrowing constraints.”<sup>163</sup>

## V. PRACTICAL PROBLEMS OF CONVERSION FROM INCOME TAX TO CONSUMPTION TAX

Conversion from the present tax structure to a consumption tax opens up the entire tax structure for review. In particular, all of the existing tax expenditures and proposed new tax expenditures will have to be voted on. Some consider repeal of any tax expenditure an impermissible tax increase while others believe that at least some should be repealed.<sup>164</sup> The determinations will be contentious. For example, do home owner interest and tax deductions promote home ownership and home improvement, or do mortgage deductions and property tax deductions primarily benefit higher income families and have little effect on the rate of home ownership? The change is likely to be opposed by builders, lenders, and homeowners.<sup>165</sup> However, the bipartisan Competitive Policy Council claimed that Americans were hurting their competitiveness “by overinvesting in their houses and underinvesting in the kinds of new products and technologies that generate higher wages and salaries.” Their analysis has had little effect on eliminating the homeownership interest and tax deductions to date.<sup>166</sup> The political process is likely to generate innumerable compromises in the form of including existing tax expenditures and creating new tax expenditures in any consumption tax adopted.<sup>167</sup> The resulting negotiations virtually assure that at least some tax expenditures migrate to any consumption tax approved; however, which will be retained or added is impossible to say—the deliberative process is simply too unpredictable.<sup>168</sup>

The change in tax structure, whatever the tax expenditures retained after conversion, will make some taxpayers better off and others worse off. This has macroeconomic implications that the government must address to minimize unwanted economic contraction.<sup>169</sup> Thus, getting from the present tax structure to any consumption tax is a major undertaking that will put

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<sup>163</sup> Diamond and Saez, *supra* note 18, at 183.

<sup>164</sup> Floyd Norris, *Tax Policy: Much Talk, Few Details*, N.Y. TIMES, March 23, 2012, at B1; James B. Stewart, *Taking Aim at Loopholes in Theory*, N.Y. TIMES, March 24, 2012, at B1.

<sup>165</sup> Hall and Rabushka, *supra* note 15., at 94.

<sup>166</sup> Steven Pearlstein, *Americans' Investing Focus Faulted*, WASH. POST, Sept. 15, 1995, at F3.

<sup>167</sup> In this respect, see the unsuccessful negotiations for tax reform and deficit reduction attempted at the end of 2011 by the Democrats and Republicans for a description of how negotiations are likely to proceed and compromises struck.

<sup>168</sup> Matt Bai, *The Game is Called Chicken*, N.Y. TIMES MAG., April 1, 2012, at 22.

<sup>169</sup> See, e.g. David H. Romer, *The New Keynesian Synthesis*, 7 J. OF ECON. PERSP. 5 (1993).

substantial strain on the fiscal structure of the country.<sup>170</sup> One of the unavoidable problems will be a shift in the relative cost of consumption goods and saving causing a change in the mix and, consequently, a change in relative prices. For example, adopting a consumed income tax in the absence of transition relief will subject cash and saving/investment on which income tax was already paid to consumption tax.<sup>171</sup> A VAT could cause spending to decline as the tax is added to the price of the goods, reducing purchasing power.<sup>172</sup> Adding either a value added tax or a retail sales tax to the existing income tax will alter price levels. A shift to a consumption tax effectively increases tax on those who are borrowing or dipping into savings, typically the young and the old, and lowers tax on those who are saving as well as those who plan to bequeath investments to the next generation.<sup>173</sup> Further, since the consumption tax base is smaller than the income tax base by the amount of saving/investment, the average tax rate must be higher unless tax expenditures are eliminated. Thus, imposition of a consumption tax structure will launch a series of adjustments to price levels, debt, asset values, interest rates, and wages that will create upheaval in all of those markets.<sup>174</sup> Macroeconomic disturbances may cause economic downturns.<sup>175</sup>

Consumption tax advocates have ignored the macroeconomic effect of such relative price changes in the face of price rigidity.<sup>176</sup> When the Federal Reserve contracted the money supply in 1929-32, contemporary economists thought it would lead to general deflation—a decline in both prices of goods, services, and wages—with employment continuing at prior levels. However, prices and wages did not decline to restore equilibrium.<sup>177</sup> Instead, producers faced with falling sales reduced output and laid off employees, causing the economy to contract.<sup>178</sup> To avoid such an outcome, successful conversion

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<sup>170</sup> Daniel S. Goldberg, *The Aches and Pains of Transition to a Consumption Tax: Can We Get There from Here?*, 26 VA. TAX REV. 447 (2007).

<sup>171</sup> *Id.* at 455, 459.

<sup>172</sup> *Id.*

<sup>173</sup> Americans for Fair Taxation, *Thumbnail Sketch of the FairTax, a Comprehensive Plan to Replace Income and Payroll Taxes*, 5-6, 2007, <http://www.fairtax.org/site/PageServer?pagename=about-basica-thumbnail> (last visited May 15, 2011).

<sup>174</sup> Goldberg, *supra* note 170, at 465.

<sup>175</sup> Christina D. Romer and David H. Romer, *The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks*, 100 AM. ECON. R. 763 (2010); Romer, *supra* note 169; MILTON FRIEDMAN AND ANNA JACOBSON SCHWARTZ, *A MONETARY HISTORY OF THE UNITED STATES, 1867-1960*, 299 (Princeton University Press, 1963).

<sup>176</sup> Goldberg, *supra* note 170, at 467-9.

<sup>177</sup> See, Friedman and Schwartz, *supra* note 175, at 299-315.

<sup>178</sup> Dennis Carlton, *The Rigidity of Prices*, AM. ECON. REV. 637 (1986); Michael D. Bordo, Christopher J. Erceg, and Charles L. Evans, *Money, Sticky Wages and the Great Depression*, 1447 AM. ECON. REV. (2000); LIONEL ROBBINS, *THE GREAT DEPRESSION*, 185 (London: Macmillan, 1934).

depends on the Federal Reserve using monetary policy to keep the overall price level constant during a conversion to a consumption tax. Even then, changes in relative prices within the economy may result in some prices and consumer disposable income rising and other prices and consumer disposable income falling, causing potentially adverse effects on the economy.<sup>179</sup>

If a flat tax is imposed, tax rates rise on 80% of the population whose income is below \$200,000 and fall on the other 20% whose income is above that level.<sup>180</sup> Thus, any flat tax VAT, retail sales tax, or flat consumed income tax shifts the tax burden to the lowest 80% of the population who receive a tax increase and away from the highest 20% whose tax burden drops (from 84.2% of the total tax bill to 65.1%).<sup>181</sup> Conversion to a flat consumption tax would cause different impacts, some beneficial, some adverse, on businesses, charitable organizations, housing, financial services, health care, and state and local governments. Bickley points out:

A flat consumption tax would be shifted backwards onto owners of equities (old capital) and wage earners. The flat consumption tax would reduce the tax burden on the young to the extent they saved but increase it on the old to the extent they dissaved in retirement. There is no conclusive theoretical or empirical evidence that the flat consumption tax proposal would significantly affect savings, work effort, investment, or growth.<sup>182</sup>

A flat tax, such as the Hall Rabushka tax, will alter the relative prices of present consumption and future consumption.<sup>183</sup> Further, because income saved is not taxed the base for a consumption tax must be smaller than the base for an income tax. To maintain revenue neutrality the average consumption tax rate will either have to be higher than the average income tax rate was or the tax base will have to be broadened by eliminating tax expenditures present in the income tax base.<sup>184</sup>

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<sup>179</sup> Romer, *supra* note 169.

<sup>180</sup> James M. Bickley, *Flat Tax: An Overview of the Hall-Rabushka Proposal*, Congressional Research Service 98-529 (Jan. 28, 2011), reprinted in 2011 TAX NOTES TODAY 21-24 (Feb. 1, 2011).

<sup>181</sup> Office of Tax Analysis, cited in President's Advisory Panel on Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, 70 FR 232370, 212 (Nov. 2005), <http://govinfo.library.unt.edu/taxreformpanel/final-report/index.html> (last visited May 17, 2011). For a summary of the analysis see Bartlett, *supra* note 37.

<sup>182</sup> Bickley, *supra* note 19.

<sup>183</sup> See *infra*.

<sup>184</sup> Jane G. Gravelle, *Income, Consumption, and Wage Taxation in a Life-Cycle Model: Separating Efficiency from Redistribution*, 81 AM. ECON. R. 985 (1991).

## VI. CONCLUSION

The Congressional Research Service has recently concluded, “[t]here appears to be insufficient theoretical or empirical evidence to conclude that a consumption-based tax is inherently superior to an income-based tax or vice versa.”<sup>185</sup> In light of the problems associated with conversion, one has to ask whether the risk and uncertainty that will arise during the potentially long transition period is worth the risk. A hybrid income tax can produce many consumption tax benefits without the political and transition problems inherent in converting to a consumption tax structure.

Unlike proposals to shift to a consumption tax, modification of the income tax to incorporate more consumption tax features can occur incrementally without requiring reconsideration of the entire tax structure. This means that both changes in income distribution and macroeconomic effects of change can more easily be managed. Further, the change to a hybrid income tax does not depend on broadening the tax base (though such broadening would be desirable). Such broadening of the tax base by eliminating tax expenditures is essential for successful implementation of consumption tax proposals if tax rates are not to rise. All of this suggests that it is unrealistic to expect that any consumption tax will be passed. As Zelenak concludes:

Consumption tax proponents should consider adoption of the proposed hybrid to be a move in the right direction. Income tax proponents have never objected to the treatment of debt-financed consumption under consumption tax proposals (directing all their attacks, instead, at the consumption tax treatment of savings). And cash-flow taxation of consumer borrowing would present no major technical or administrative difficulties. It is not easy to find common ground between income tax advocates and consumption tax advocates in the great tax base debate, but there should be common ground here.<sup>186</sup>

Many of the benefits of converting to a consumption tax structure can be secured by modifying the present income tax structure. Securing those benefits by shifting to a hybrid tax within the present income tax structure offers the path of least resistance.

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<sup>185</sup> Bickley, *supra* note 19.

<sup>186</sup> Zelenak, *supra* note 8, at 1, 11.