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Reuven S. Avi-Yonah

University of Michigan Law School, aviyonah@umich.edu

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The Three Goals of Taxation

REUVEN S. AVI-YONAH*

I. INTRODUCTION

The current debate in the United States about whether the income tax should be replaced with a consumption tax has been waged on the traditional grounds for evaluating tax policy: efficiency, equity, and administrability. For example, Joseph Bankman and David Weisbach recently argued for the superiority of an ideal consumption tax over an ideal income tax on three grounds: First, that the consumption tax is more efficient because it does not discriminate between current and future consumption,1 while both income and consumption taxes have identical effect on work effort. Second, that the consumption tax is at least as good at redistribution as the income tax, and thus can equally satisfy vertical equity.2 Third, that the consumption tax is easier to administer than the income tax because it makes no attempt to tax income from capital and thus can omit many of the vexing complications that arise from such an attempt, like accounting for basis.3

One can agree or disagree with Bankman and Weisbach, and this debate will no doubt go on.4 For the sake of the argument, however,

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2 Id. at 1428-30.

3 Id. at 1418.

4 Part II addresses the argument in regard to redistribution. In regard to efficiency, Bankman and Weisbach rely on a 1976 paper by Atkinson and Stiglitz to argue that it is incorrect to claim that there is a trade-off between reducing the disincentive to save by adopting a consumption tax, and reducing the incentive to work by increasing taxes on wages (to replace revenue lost as a result of exempting income from savings). Id. at 1414, 1420, 1422-28; A.B. Atkinson & J.E. Stiglitz, The Design of Tax Structure: Direct Versus Indirect Taxation, 6 J. Pub. Econ. 55 (1976). For an example of the argument for the trade-off theory, see Jane Gravelle, The Economic Effects of Taxing Capital Income 11-50 (1994). Bankman and Weisbach argue that the trade-off theory is untrue because the tax on income from savings also reduces work effort. Bankman & Weisbach, note 1, at 1422. But it is quite plausible to assume that people systematically value future taxes less than current taxes by more than the time value of money, and, if so, the current tax on wages

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assume that an ideal consumption tax is indeed superior to an ideal income tax on all three fronts. Given this outcome, two puzzles present themselves, which have not received much attention in the current debate: First, why do most developed countries employ both income and consumption taxes, and more specifically, the value-added tax (VAT)?5 And second, after having employed only consumption taxes at the federal level for over a century spanning the Jefferson to the Taft administrations, with the exception of the short-lived Civil War income tax,6 why did the United States switch to taxing primarily income for most of the past century?

Both of these questions are puzzling if the consumption tax is clearly superior to the income tax on traditional policy grounds. One could argue that this superiority was not clearly understood when the United States switched from taxing consumption to income in 1913. It would still be interesting, however, to consider what the framers of the Sixteenth Amendment thought they were achieving by its adoption. Why would anyone ever consider replacing a well-functioning consumption tax, which was bringing in adequate revenue, with an untested income tax?

The action of other OECD member countries is even more puzzling in this regard. After all, some of them, including Canada, Australia, and Japan, have adopted VATs quite recently,7 after the economic case for the consumption tax had become established and even after it

will reduce work effort by more than the present value of the future tax on savings. Bankman and Weisbach seem to acknowledge this concept ("[p]erhaps one can offer various psychological theories for why people misperceive the effect of various taxes"), but dismiss it (because "the trade-off theory purports to apply standard economics"). Id. at 1424 n.22. The debate, however, is about the effects in the real world of replacing the income tax with a consumption tax, not in some ideal realm of classical economics. Similarly, the argument in regard to administrability depends crucially on the actual consumption tax that will be adopted. The experience of other countries with the VAT indicates it has significant problems of complexity and administrability. See, e.g., Peggy B. Musgrave, Consumption Tax Proposals in an International Setting, 54 Tax L. Rev. 77 (2000) (discussing the international aspects of use of broad-based consumption taxes as alternatives to income taxes in the United States). For replies to some of Bankman and Weisbach's other arguments (for example, about taxation of risky investments), see Reuven S. Avi-Yonah, Risk, Rents and Regressivity: Why the United States Needs Both an Income Tax and a VAT, 105 Tax Notes 1651 (Dec. 20, 2004).


had made its way into the legal literature. And yet, instead of substituting a consumption tax in lieu of their existing income tax, these countries all followed the lead of other OECD members and adopted a consumption tax in addition to their income tax.

To answer these puzzles, it is necessary to resurrect a question that has not been considered recently in the tax policy literature: What are taxes for?

The obvious answer is that taxes are needed to raise revenue for necessary governmental functions, such as the provision of public goods. And, indeed, all taxes have to fulfill this function to be effective; as the Russian government discovered in the 1990’s (following many others in history), a government that cannot tax cannot survive. And there is widespread ideological agreement that this function is needed, even while people vehemently disagree about what functions of government are truly necessary, and what size of government is required.

But taxation also has two other functions, which are more controversial, but which modern states also widely employ. Taxation can have a redistributive function, aimed at reducing the unequal distribution of income and wealth that results from the normal operation of a market-based economy. This function of taxation has been hotly debated over time, and different theories of distributive justice can be used to affirm or deny its legitimacy. What cannot be denied, however, is that many developed nations in fact have sought to use taxation for redistributive purposes, although it also is debated how effective taxation was (or can be) in redistribution.

Taxation also has a regulatory component: It can be used to steer private sector activity in the directions desired by governments. This function is also controversial, as shown by the debate around tax expenditures.

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10 Meltdown in Russia, Economist, Aug. 29, 1998, at 47.


13 See, e.g., Boris I. Bittker, Accounting for Federal “Tax Subsidies” in the National Budget, 22 Nat’l Tax J. 244, 260 (1969) (discussing the view that tax expenditures should not be included in the national budget based on the inability to accurately quantify the associated costs for lack of an agreed conceptual model of federal income tax); Stanley S. Surrey & Paul R. McDaniel, Tax Expenditures (1985) (discussing the historical develop-
used widely for this purpose, as shown inter alia by the spread of the tax expenditure budget around the world following its introduction in the United States in the 1970's.14

These three functions can even be discerned in the current effort to reform the U.S. tax system. The two guidelines that President Bush gave to the Tax Reform Panel were revenue neutrality (any reform has to preserve the current stream of federal revenues) and preserving certain tax expenditures (specifically, the mortgage interest deduction and the charitable deduction, both of which have clear regulatory goals).15 The Tax Reform Panel Report explains in great length the distributive impact of its proposals.16

This Article argues that the answer to the two puzzles of widespread use of both income and consumption taxes globally, and of the historical shift in the United States toward the income tax, is based on these three functions of taxation. Specifically, to achieve the goals of raising adequate revenue in an effective way, reducing unequal distributions of wealth, and regulating market activity, a pure consumption tax is not sufficient. Instead, an income or wealth tax is needed, but because of the well-known problems of taxing income or wealth, a consumption tax is needed as well. Thus, the ideal tax system will include both income and consumption taxes, and it is thus not surprising that every single OECD member country except the United States, and most developing countries, rely on both types of tax.

Thus, there is a mistaken premise underlying the current tax reform debate in the United States: that we need to choose between having an income tax and having a consumption tax. This is the premise underlying most of the voluminous tax reform literature.17 Instead, I would argue that (like most countries) the United States needs both types of tax, and therefore the correct path to tax reform is not to

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14 Surrey & McDaniel, note 13, at 177-81.
substitute a consumption tax in lieu of the income tax, but to adopt a consumption tax (and specifically, a VAT) in addition to the income tax.\(^{18}\)

The rest of this Article advances the above argument in detail. Part II explains why as a matter of raising revenue the combination of income and consumption taxes is superior to either of them standing alone. Part III lays out why both income and consumption taxes can play a major role in redistribution. Part IV delineates how both income and consumption taxes can fulfill regulatory functions. Part V concludes by drawing implications for U.S. tax policy.

II. Revenue

"Taxes are what we pay for a civilized society . . . ."

Oliver Wendell Holmes\(^{19}\)

From a pure revenue-raising perspective, it is reasonably clear that in the current U.S. context, a consumption tax can be devised that will raise as much revenue as the existing income tax does. While some of the current proposals for a federal consumption tax, such as a national sales tax to be administered by the states, are likely to fall far short of this goal, other proposals (like the flat tax or the cash flow tax) are more likely to fulfill any mandate of revenue neutrality.\(^{20}\)

In fact, consumption taxes have a very good track record in terms of raising revenue. The VAT, specifically, is second only to the individual income tax in its ability to raise revenue in most OECD member countries, and in some it raises more revenue than the income tax. In Western European countries, for example, the individual income tax accounted in 1996-2002 for 32% of total tax revenue, compared with 30% for the VAT.\(^{21}\) If one adds excises and the corporate income tax, total income taxes account for 44% of all government revenues in the same period, while consumption taxes account for 49%.\(^{22}\) In North America, on the other hand, income taxes accounted for 82% of all

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\(^{18}\) For a similar recent proposal by a bipartisan group, see Committee for Economic Development, A New Tax Framework: A Blueprint for Averting a Fiscal Crisis 25 (2005) (advocating a 10% VAT in addition to the income tax). The Tax Reform Panel Report, however, rejected a proposal for a “partial replacement VAT,” primarily because it might lead to a higher share of government in GDP. See Tax Reform Panel Report, note 15, at 203.

\(^{19}\) Compania Gen. de Tobacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

\(^{20}\) For an analysis of these proposals, see Avi-Yonah, note 4, at 1660-62.

\(^{21}\) Bird & Zolt, note 12, at 1655 tbl.A.

\(^{22}\) Id.
revenue for the same period, and only 15% came from consumption taxes (including state level sales taxes).\textsuperscript{23}

Moreover, the VAT has been successful in raising revenue even in developing countries with weak tax administrations, which are largely unable to collect the personal income tax from the majority of the population. In Latin America, for example, consumption taxes accounted for 52% of total revenue in 1996-2002, compared to only 27% for (mostly corporate) income taxes; in Africa the figures for the same period were 35% for consumption taxes, 32% for taxes on international trade (which are equivalent to consumption taxes), and 30% for income taxes.\textsuperscript{24} For all developing countries in 1999-2001, income taxes accounted for only 24.3% of total tax revenue, compared to 38.6% for all developed countries; the remaining revenue was mostly based on consumption taxes.\textsuperscript{25}

Given this track record, it is not surprising that every OECD member country other than the United States, and the vast majority of developing countries, use consumption taxes (primarily the VAT) as a major revenue raising tool.\textsuperscript{26} In fact, one could argue that the most important tax policy development in the second half of the twentieth century was the triumphant march of the VAT from a tentative experiment in the 1950's to virtual global adoption.\textsuperscript{27}

What is surprising, however, is the resilience of the income tax in developed countries (and to some extent, in developing countries as well). Why is it that all of these countries, including sophisticated economies with tax policy analysts who were well aware of the arguments for the superiority of consumption taxes on all the traditional tax policy domains, rejected precisely the tax reform that currently is being debated in the United States, namely replacing the income tax with a consumption tax?

The answer lies in another development of the second half of the twentieth century: the rise of the welfare state. In the same period that governments were considering whether to adopt a consumption tax, the overall size of the public sector as a percentage of GDP in

\textsuperscript{23} Id. These numbers do not include payroll taxes (such as the Social Security tax in the United States). As a political matter revenues from such taxes need to be devoted to funding social insurance programs, and they cannot be raised significantly, so they are ignored in the rest of this Article.

\textsuperscript{24} Id.

\textsuperscript{25} Id. at 1657 fig.2.


\textsuperscript{27} Id.
OECD member countries rose from 27% in 1960 to 48% in 1996.\(^{28}\) The principal reason for this rise is the adoption and expansion of universal pension and health insurance programs by OECD countries in the years immediately following World War II.\(^{29}\) During the war, governments in all developed countries used the crisis to greatly expand their income tax collections, converting what was a "class tax" on the rich to a "mass tax" enforced by withholding on the majority of the population.\(^{30}\) After the war ended, instead of reducing rates to pre-war levels (as happened to some extent after World War I),\(^{31}\) governments used the expanded revenue base to offer universal entitlement programs (the "cradle to grave" social insurance safety net).\(^{32}\)

These programs proved highly popular with voters, but also very expensive, especially as the post-war baby boomers began to age.\(^{33}\) Already in the 1970's, governments in Europe began feeling the demographic crunch that currently is reaching its peak, and it became clear that to maintain the programs adopted in the flush post-war years, additional revenue would be needed.\(^{34}\) In the 1980's, the pressures of globalization were added as governments liberalized and opened their economies.

Theoretically, governments could have responded by trying to raise more revenue from the existing income tax. At the same time, however, various economic studies were documenting the negative incentive effects of high income tax rates.\(^{35}\) Following the U.K. and U.S. tax reforms in the 1980's, it became widely accepted economic orthodoxy that very high income tax rates like those that prevailed in all OECD countries before 1980 were too costly in terms of their impact on economic performance.\(^{36}\) Moreover, experience with high rates had shown that they lead to increased tax evasion and avoidance efforts.\(^{37}\) Thus, in the period between 1976 and 1997, most OECD member countries reduced marginal income tax rates (by an average

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\(^{29}\) See Sven Steinmo, Taxes and Democracy (1993).


\(^{31}\) Id. at 210.

\(^{32}\) Steinmo, note 29, at 120.

\(^{33}\) Id.

\(^{34}\) Id.

\(^{35}\) See, e.g., Michael J. Graetz, To Praise the Estate Tax, Not to Bury It, 93 Yale L.J. 259, 273 (1983) (discussing incentive effects of increasing income tax rates).

\(^{36}\) See Steinmo, note 29.

\(^{37}\) See Graetz, note 35.
of 21%), while preserving revenue neutrality by expanding the income tax base.\footnote{Steinmo, note 30, at 222 tbl.3.}

Given these developments, especially in conjunction with the pressure of tax competition and globalization in the period after 1980, it was clear to most OECD governments that an additional revenue base other than the income tax needed to be exploited if the social welfare safety net that originally was constructed with income tax revenues was to be maintained in the face of an aging population and the insecurities of globalization. The VAT, which originally was adopted as a minor tax to finance the European Economic Community,\footnote{Schenk & Oldman, note 26, at 26.} proved to be the ideal tax for this purpose. Hence the widespread adoption of VATs, and gradual increase of VAT rates, first in Europe, and then in non-European OECD countries and in developing countries.\footnote{On the origins and spread of VAT, see Liam Ebril, Michael Keen, Jean-Paul Bodin & Victoria Summers, The Modern VAT 4-8 (2001); Alan A. Tait, Value Added Tax: International Practice and Problems 19-30 (1988); Adrian Ogley, Principles of Value Added Tax 27-41 (1998); Alan Schenk, Value Added Tax: A Model Statute and Commentary 1 (1989); Schenk & Oldman, note 26, at 26-27.}

This, therefore, is a partial answer to the first puzzle: A principal reason why most OECD economies adopted both income and consumption taxes is their fundamental commitment to the principle of ensuring a social safety net for all their citizens. The tax policy implications of this fundamental commitment flow from its budgetary consequences and from the efficiency and administrability constraints on raising too much revenue from either income or consumption taxes. If the rates are too high, this will both discourage economic activity and lead to increased avoidance and evasion efforts, resulting in slower growth and more wasted resources, but not necessarily higher revenues. This holds true for consumption taxes as well as for income taxes. Experience in Europe has shown that very high VAT rates can have similar negative consequences to very high income tax rates.\footnote{See Tait, note 40, at 39-48.} Hence, both income and consumption taxes are needed to fund the social safety net.\footnote{Payroll taxes (a form of wage tax, and hence equivalent to a consumption tax) also have been widely used in OECD countries to fund social welfare programs. Jonathan R. Kesselman, Payroll Taxes and Social Security, 22 Canadian Pub. Pol’y 162, 166 (1996).} The main reason for that is administrability. Experience from all the other OECD countries has shown that more revenue can be raised from a combination of an income tax and a consumption tax than either alone, even though there is some overlap in the base of the tax.
One could argue that this line of analysis is irrelevant to the current U.S. debate. After all, our federal public sector is currently funded almost entirely from income taxation (or, more precisely, a hybrid income/consumption tax). As stated above, it is reasonably clear that a properly constructed consumption tax can raise the same revenue as the current income tax, so that we could substitute one for the other at no significant cost. If we later need more revenue, we could then add an income tax to the existing consumption tax (since relying on either income or consumption taxes alone would not be sufficient, as the European and worldwide experience has shown).

This argument, however, ignores the political reality of tax reform. The United States currently has a hybrid income/consumption tax. If we now proceed to replace it with a pure consumption tax, it seems highly unlikely that in the future we will be able to easily reinstate the income tax, especially given that the most feasible current consumption tax proposals are deliberately camouflaged to look like an income tax. (The reason for this is discussed in the conclusion).

Thus, I would argue that the reason that some conservative Republicans want to replace the income tax with a consumption tax, and are opposed to proposals (like the one advanced by Michael Graetz) to adopt both, is precisely that they want to foreclose the possibility that the U.S. government sector will expand. Our government sector was only 31.7% of GDP in 2004, which is among the lowest in the OECD and significantly below the OECD average. We can indeed fund our current public sector by either an income or a consumption tax, so that under current conditions replacing one with the other seems a plausible alternative.

As has been widely noted, however, current conditions are not sustainable in the longer run: In part, as a result of existing mandated but unfunded entitlement programs, the federal government faces an actuarial deficit of about $1.8 trillion in the next 10 years. This order of magnitude cannot be funded with either the existing income tax or by a consumption tax standing alone, because the incentive effects of raising rates high enough to fund the deficit are unacceptable. As the other OECD countries have discovered, to fund this type of social safety net, both the income tax and a consumption tax are needed.

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44 See Graetz, note 17, at 282-84.
To a conservative Republican, of course, this argument is completely unpersuasive, because she is not interested in maintaining the existing U.S. social safety net, and would certainly reject proposals to expand it. Indeed, she probably would prefer shrinking it further, and believes the solution to the actuarial deficits problem is cutting the entitlement programs.

But for a Democrat, the revenue argument is an important reason to reject the current tax reform proposals. If the United States replaces the income tax with a consumption tax, this would make it politically much more difficult to readopt the income tax in the future. And both an income tax and a consumption tax will be needed to fund the existing social safety net in the United States, which has near universal support among Democrats. Hence, the revenue argument is a strong reason for Democrats to reject proposals to replace the income tax with a consumption tax.

III. Redistribution

"The case for drastic progression in taxation must be rested on the case against inequality."47

Henry Simons

The revenue goal of taxation thus explains why all other OECD members, and most other countries, have both an income tax and a consumption tax as their principal sources of revenue. But this still leaves the second puzzle—why would any country change from relying primarily on consumption taxes to relying primarily on income taxes? This is what the United States did when it adopted the Sixteenth Amendment in 1913. Throughout the nineteenth century, with the brief exception of the Civil War and its immediate aftermath (1862-1872),48 the federal government was funded entirely by tariffs (that is, taxes on consumption).49 Following the passage of the Sixteenth Amendment (authorizing the federal government to levy taxes on income without apportionment), the United States began levying an income tax, and from World War II onward this became the principal source of revenue of the U.S. federal government.50 Even when taking the state level sales taxes into account, income taxes currently account for over 80% of total U.S. tax revenue.51

49 Id. at 32.
50 Id. at 41-42 & tbl.2.1, 44.
51 See Bird & Zolt, note 12.
Historically, the answer to the question of why the change to an income tax occurs is clear: The income tax was substituted for the tariffs because of its redistributive impact. The post-Civil War industrialization and urbanization had led to a shift from a mostly agrarian society to one dominated by large industrial corporations and a sharp rise in inequality, as measured by the distribution of income or wealth.\textsuperscript{52} Lawmakers of both parties viewed this state of affairs as inequitable,\textsuperscript{53} and the existing tax system was considered ineffective in remedying the situation because it relied completely on consumption taxes, which were regarded as regressive because the poor consume a higher proportion of their income than the rich.\textsuperscript{54} In addition, state level personal property taxes were seen as ineffective in reaching intangible forms of property such as stocks and bonds,\textsuperscript{55} which formed the bulk of the new wealth in the hands of the industrialists.\textsuperscript{56}

The result was a focused and sustained effort to enact a federal income tax on both individuals and corporations, as well as an estate tax. In 1895 the Supreme Court blocked the first attempt to do so,\textsuperscript{57} but Congress ultimately enacted the corporate tax in 1909,\textsuperscript{58} the modern estate tax in 1916,\textsuperscript{59} and the individual income tax in 1913\textsuperscript{60} after the adoption of the Sixteenth Amendment abated concerns regarding its constitutionality.\textsuperscript{61}

Significantly, until World War II, the income tax applied only to the richest Americans, because the exemption levels were set high enough to leave the bottom 90% of the population outside the reach of the income tax.\textsuperscript{62} Redistribution was considered to require only taxing the rich, and beginning in World War I, the rich were subject to income tax at very high rates.\textsuperscript{63} After a period of rate reductions in the 1920's,\textsuperscript{64} Elliott Brownlee shows that by World War II, this "soak the rich"\textsuperscript{65} tax policy resulted in quite high effective tax rates on the top
1% of earners (the effective tax rate in 1944 was 58.6%, with a top marginal rate of 94%). These high rates on the top earners persisted through the late 1970's and early 1980's (70% top marginal rate), although the effective rate by then had declined to 28.9%.67

Thus, a primary goal of the income tax historically was seen as redistributing wealth from the rich to everyone else. This explains why it was first adopted in the United States, and it also explains why the income tax is persistently maintained today in developing countries that could satisfy their entire revenue needs by the VAT. Even though the personal income tax in these countries has a spotty record, they insist on maintaining it because of its symbolic potential in achieving redistribution (although, as I argue below, redistribution in these countries can be achieved through consumption taxes as well68).

This narrative is of course familiar, but it is useful to revisit it because of a central claim of modern proponents of consumption taxes like Bankman and Weisbach, that an ideal consumption tax is as good, if not superior, at achieving redistributive goals as an ideal income tax.69 Given that the rich consume a much smaller proportion of their total income (on average) than the poor,70 and that a consumption tax by definition does not reach income that is not consumed, how can this claim be asserted as a true reflection of reality?

The answer lies in the welfarist perspective adopted by Bankman and Weisbach, as well as other proponents of the consumption tax.71 From a welfarist perspective, all that matters is increasing the overall welfare or utility of the individual members of a given society, which can be measured by using a social welfare function. Under a utilitarian social welfare function, the ultimate goal is simply to increase the sum total of the welfare of members of society.72 Under other social welfare functions (for example, a Rawlsian one), the welfare of the poor weighs more heavily than that of the rich.73 But all welfarist perspectives share the view that social policies must be measured from the perspective of changes in individual welfare.

From a welfarist perspective, it then is argued, wealth can have value only when it is consumed—otherwise, as Daniel Shaviro has stated (and as Bankman and Weisbach repeat), it is merely the same

66 Id. at 60 tbl.2.5.
67 Id. at 61 tbl.2.6.
68 See text accompanying notes 105-06.
69 Bankman & Weisbach, note 1, at 1414.
70 Bankman and Weisbach note this. Id. at 1440.
73 Id. at 51-52.
as Monopoly money, and of no real value.\textsuperscript{74} Once this premise is established, it becomes easy to “prove” mathematically that a consumption tax is just as good at redistribution as an income tax (although this is only true for those types of consumption tax that are imposed on all consumption; prepaid consumption taxes like the flat tax do not reach economic rents, and therefore do not tax all consumption).\textsuperscript{75}

Opponents of the consumption tax sometimes have argued (following the lead of Henry Simons) that unconsumed wealth is an independent source of welfare to the individuals who possess it because it confers security, political power, or social standing.\textsuperscript{76} Bankman and Weisbach argue that these types of intangible benefits also flow ultimately from consumption value and are reduced by taxing consumption.\textsuperscript{77} I am not persuaded, since the super-rich will never consume most of their wealth, so it is hard to see what motivates them to accumulate it if the only value of wealth is in consumption.\textsuperscript{78} This debate within the welfarist tradition will doubtless go on.

Bankman and Weisbach, however, also mention in passing another argument for the income tax—the redistributive argument as seen from the perspective of society as a whole, rather than its individual members: One version of this argument is that failure to tax returns to saving leaves enormous pools of wealth untaxed, creating vast inequalities in our society.\textsuperscript{79} Much of that wealth is created because of general societal conditions such as property rights, an effective government, the legal system, educated workers, natural resources, and protection from invasions, conditions that have nothing to do with the fortunate (although skilled and hard-working) individual who earns great wealth as a result. Society has a right to distribute that wealth as it sees fit and it is just and fair to use [the income tax] to reduce inequality.\textsuperscript{80}

Bankman and Weisbach then proceed by stating that “[t]he more technical version of this argument is that transferring a dollar from the

\textsuperscript{74} Shaviro, note 71, at 106; Bankman & Weisbach, note 1, at 1449.
\textsuperscript{75} See Bankman & Weisbach, note 1, at 1418-19; Avi-Yonah, note 4, at 1660-61 (discussing the flat tax).
\textsuperscript{76} Anne L. Alstott, The Uneasy Liberal Case Against Income and Wealth Transfer Taxation: A Response to Professor McCaffery, 51 Tax L. Rev. 363, 371 (1996); Schenk, note 17, at 463-67.
\textsuperscript{77} Bankman & Weisbach, note 1, at 55-56.
\textsuperscript{79} Bankman & Weisbach, note 1, at 1421 n.12 (citing Liam Murphy & Thomas Nagel, The Myth of Ownership: Taxes and Justice (2002); Stephen Holmes & Cass Sunstein, The Cost of Rights (1999); Alvin C. Warren, Would a Consumption Tax Be Fairer Than an Income Tax, 89 Yale L.J. 1081 (1980)).
\textsuperscript{80} Bankman & Weisbach, note 1, at 13.
wealthy to the poor increases welfare because the marginal utility of money for a wealthy person is likely to be lower than it is for a poor person." But this is a completely different argument than the one given above, not a "more technical" version of it. The second argument is welfarist, and looks at the utility individual members of society get from their wealth. The first argument is nonwelfarist: It looks at the desirable shape of society as a whole, which has nothing to do with the feelings of individual members. "[E]normous pools of wealth" are from this perspective bad regardless of how much utility their posseors derive from owning them.

The assumption of the nonwelfarist argument is that any human society is more than just the sum of its individual members: It has a distinct character that distinguishes it from other societies, which are not interchangeable with it. One of its characteristics is the degree of inequality of distribution of wealth within it. Other characteristics are its language, culture, and history. None of these characteristics of human societies can be reduced to the measurement of individual utilities or a social welfare function, since these essentially regard all people, and hence all human societies, as interchangeable.

One good measure of the difference between welfarist and nonwelfarist views of redistribution is the importance of the Gini coefficient, which measures the level of inequality within a given society. Louis Kaplow, writing from a welfarist perspective, has stated that "there is little need to measure inequality per se. Although inequality is an aspect of overall social welfare, it is best to measure welfare directly; measuring inequality requires additional effort and yields no return." But from a nonwelfarist perspective that is interested in the overall character of a given society, measuring inequality can be very important, and changes in the Gini coefficient can be a direct measure of the desirability of various policies. In other words, if the goal of a tax policy is to reduce the unequal distribution of wealth within a society per se, then measuring this distribution becomes essential.

But why would one want to reduce inequality? The argument that "private" wealth is in part a creature of social conditions and therefore society can redistribute it "as it sees fit" is not an answer to this question, because it only legitimizes redistribution, but does not explain why redistribution is desirable. The answer to this question is ultimately political: In a democratic society, the majority can legitimately (because of the argument from social conditions given above)

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81 Id.
82 Id.
decide to redistribute wealth from the rich to the poor, even if their only reason is that inequalities are "unfair" or aesthetically offensive (as they were, for example, to Blum and Kalven).85

Let me suggest, however, three other arguments that contend for the desirability of redistribution from a societal perspective. The first two are based on the observation that private concentrations of wealth confer social and political power. Here, power is considered from the perspective of the relationship of the rich to the rest of society, regardless of whether or not they derive utility from it (when consumed or otherwise). And it is primarily the power to invest, not to consume, which is at stake—that is, the kind of power that a consumption tax cannot reach.

There are two principal arguments why a democratic state should curb excessive accumulations of private power.86 The first is the argument from democracy: In a democracy, all power ultimately should be accountable to the people. Private accumulations of power are by definition unaccountable, since the holders of power are neither elected by the people nor have their power delegated from the people's representatives. In fact, the American Revolution was founded on the conception that while people have natural, Lockean liberal rights to their property, undue concentrations of private power and wealth should be discouraged.87 This view found its expression in the republican creed of civic humanism, which emphasized public virtue as a balance to private rights. A virtuous republic, the Founders believed, was to be free from concentrations of economic power such as characterized England in the eighteenth century.88 Therefore, from the beginning of the republic, federal and state legislators used taxation to restrict privilege and to "affirm communal responsibilities, deepen citizenship, and demonstrate the fiscal virtues of a republican citizenry."89 As Dennis Ventry has written, "[t]he ideal of civic virtue created a unique form of ability-to-pay taxation that was hostile to excess accumulation and to citizens who asserted entitlement through birth . . . Inherited wealth, as well as gross concentrations of wealth (inherited or not), characterized an aristocratic society, not a free and virtuous republic."90

87 Ventry, note 11.
88 Id.
89 Id. at 28.
90 Id.
The other principal argument against excessive private power is based on a liberal conception of equality. Michael Walzer has explained that when liberals talk about equality, they are not concerned with “simple equality”, that is, equalizing everyone’s initial means.\textsuperscript{91} Instead, they are advocating “complex equality,” by which Walzer means that every social “sphere” should have its own appropriate distributive principles and that possession of goods relevant to one sphere should not automatically translate into dominance in other spheres as well. “In formal terms, complex equality means that no citizen’s standing in one sphere or with regard to one social good can be undercut by his standing in some other sphere, with regard to some other good.”\textsuperscript{92} In our capitalist society, money is the “dominant good,” and the people who possess it are the most likely to accumulate illegitimate power in other spheres, such as politics. “This dominant good is more or less systematically converted into all sorts of other things—opportunities, power, and reputation.”\textsuperscript{93} Walzer goes on to explain the insidious effects of money and why it needs to be curbed by redistribution, including redistributive taxation:

Market imperialism requires another sort of redistribution, which is not so much a matter of drawing a line as of redrawing it. What is at issue now is the dominance of money outside its sphere, the ability of wealthy men and women to trade in indulgences, purchase state offices, corrupt the courts, exercise political power . . . The exercise of power belongs to the sphere of politics, while what goes on in the market should at least approximate an exchange between equals (a free exchange). . . When money carries with it the control, not of things only but of people, too, it ceases to be a private resource.\textsuperscript{94}

Nor, as noted above, is the power of money limited to direct political power:

It would be a mistake to imagine, however, that money has political effects only when it “talks” to candidates and officials. . . It also has political effects closer to home, in the market itself and in its firms and enterprises . . . Even within the adversary relation of owners and workers, with unions and grievance procedures in place, owners may still exercise

\textsuperscript{91} Michael Walzer, Spheres of Justice: A Defense of Pluralism and Equality 18 (1983).
\textsuperscript{92} Id. at 19.
\textsuperscript{93} Id. at 12.
\textsuperscript{94} Id. at 120-21.
an illegitimate kind of power. They make all sorts of decisions that severely constrain and shape the lives of their employees (and their fellow citizens, too). Might not the enormous capital investment represented by plants, furnaces, machines, and assembly lines be better regarded as a political than an economic good? To say this doesn’t mean that it can’t be shared among individuals in a variety of ways, but only that it shouldn’t carry the conventional entailments of ownership. Beyond a certain scale, the means of production are not properly called commodities . . . for they generate a kind of power that lifts them out of the economic sphere.\(^9\)

Walzer thus advocates taxation as one means (along with trade unions and limiting property rights) of restricting the market to its proper sphere.\(^{96}\) But he also recognizes the inherent limitations of all redistribution, since his aim is not to abolish the market:

All three redistributions redraw the line between politics and economics, and they do so in ways that strengthen the sphere of politics—the hand of citizens, that is, not necessarily the power of the state. . . But however strong their hand, citizens can’t make just any decisions they please. The sphere of politics has its own boundaries. . . Hence redistribution can never produce simple equality, not so long as money and commodities still exist, and there is some legitimate social space within which they can be exchanged.\(^{97}\)

The third argument in favor of redistribution from a societal, nonwelfarist perspective is based on the observation of the negative effects of extreme inequalities. In particular, as Ted Gurr has shown, revolutions are most likely to occur in societies that have experienced a period of economic growth that lifts the standard of living and expectations of all members of a given society, followed by an external or internal shock that reduces the standard of living of the majority while leaving the rich unaffected.\(^{98}\) This “J-curve” theory of revolutions suggests that rising inequality, even when accompanied by an improved standard of living for the entire society, poses significant hazards. Any contemplation of the twentieth century history of countries like Argentina can show the risks a society runs by ignoring rising inequality. As Richard Bird and Eric Zolt recently observed: “Sus-

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\(^{95}\) Id. at 121-22.
\(^{96}\) Id. at 122-23.
\(^{97}\) Id.
tained excessive inequality in a country, whether generated by the market or from governmental policy, may not be sustainable over time." Or as Aristotle noted long before them, "when there is no middle class, and the poor greatly exceed in number, troubles arise, and the state soon comes to an end."

As I have argued at length elsewhere, all three of these considerations underlay the thinking of the Progressive lawmakers who enacted the corporate and individual income taxes (and the estate tax) in the early twentieth century. They were opposed to allowing vast concentrations of wealth on both democratic and egalitarian grounds, and they were acutely aware of the hazards of permitting inequality to grow unchecked even against the background of generally rising living standards, as illustrated by contemporary events in Russia and elsewhere in Europe.

Moreover, it is abundantly clear that what concerned the Progressives was increasing inequality of wealth, not consumption. They would have rejected as absurd the contention that a consumption tax can be as redistributive as an income tax, precisely because their goal was to alter the distribution of unconsumed wealth in the United States. The existing tax instruments, a federal-level consumption tax and a state-level personal property tax, could not achieve significant redistribution of wealth, the first because it failed to reach unconsumed wealth, and the second because of administrative limitations on taxing intangible wealth. Hence they adopted the estate tax and the corporate and individual income taxes, which together were expected to reach most sources of wealth (that is, inheritances plus wealth earned during one's lifetime).

I would argue that the same arguments can support redistributive taxation in the twenty-first century as well. We are again living in an era of sharply rising inequality of wealth, fueled primarily by globalization and technological progress. But globalization and its benefits are threatened by a backlash driven by the very inequalities it has produced. This backlash currently can be seen both in rising protectionism in the United States and in the rejection of the EU constitu-

99 Bird & Zolt, note 12, at 1660.
102 Id. at 16-29.
103 Id. at 16-22.
If globalization is to be maintained, and to avoid a retreat like the 1920's, it is essential to deal with the problem of inequality, and to adequately fund a social safety net.

Even if one agrees, however, that redistribution of wealth is desirable as a goal of tax policy, it is not clear that the income tax is the best policy instrument to achieve this. Richard Bird and Eric Zolt recently have written a compelling article arguing that in developing countries, redistribution can be achieved more effectively by using consumption taxes and spending policies in redistributive fashion, rather than by relying on income taxation (although they do not advocate repeal of the existing income taxes in developing countries, primarily because of their symbolic value).

Redistribution through income taxation certainly has limits. The U.S. experience in particular has shown that extremely high rates imposed on the rich lead to increased avoidance and evasion. Moreover, the use of the income tax for regulatory purposes frequently has clashed with its redistributive goals. Thus, Joseph Pechman and Benjamin Okner found in 1966 (when the top income tax rate was 70%) that the U.S. tax system did not exert any major influence on the distribution of income, and a follow-up study by Pechman found the same result for the period between 1966 and 1985.

So should we only use consumption taxes to fund government activities, and rely entirely on the spending side to reduce inequality? The answer is no, for three reasons. First, it is politically dangerous to rely entirely on spending decisions for redistribution. Second, experience in other countries has shown that the income tax can have significant redistributive effect. And finally, the use of income and wealth taxation has important symbolic value.

The first argument is that to rely entirely on spending programs for redistribution, and therefore accept repeal of the income tax, is dangerous in the current U.S. political climate. The income tax today is significantly progressive: According to 2001 IRS data, the top 1% of the U.S. population by adjusted gross income paid 33.89% of federal personal income taxes, and the top 5% paid 53.25%. (By comparison, the bottom 50% of the AGI distribution paid less than 4% of total

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105 Bird & Zolt, note 12, at 1694-95.
income taxes collected).\textsuperscript{108} This is a significant increase from 1994, when the top 1% of taxpayers only paid 28.9% of federal personal income taxes.\textsuperscript{109} In 2004, even after President Bush’s tax cuts, the top 1% still paid 32.3% of federal individual income taxes and the top 5% paid 53.7%.\textsuperscript{110} Any consumption tax is likely to be significantly more regressive than these figures indicate. Relying on spending programs to redress the redistributive imbalance is politically risky because spending programs that are means tested (and thus benefit the poor the most) are politically unpopular.

Second, there is considerable evidence that in developed countries, the income tax can play an important role in redistribution. For example, a 2000 study by the International Monetary Fund showed that while income inequality before tax and transfer programs was actually higher in developed countries than in developing countries, developed countries (but not developing countries) were successful in using tax and transfer programs to reduce inequality.\textsuperscript{111} There is no suggestion in the study that this reduction of inequality resulted only from the transfer programs. A 2003 study of the Canadian tax and transfer system showed that it is significantly redistributive, and that while two-thirds of the redistribution is achieved via the transfer system, the remaining third is due to the income tax.\textsuperscript{112} As Bird and Zolt write: “Despite the many qualifications we have noted, the income tax, and particularly the personal income tax, is probably the only significantly progressive element found in most tax systems.”\textsuperscript{113} Given that no consumption tax by definition can achieve the same level of redistribution of unconsumed wealth as the income tax, and that redistribution of unconsumed wealth continues to be an important policy goal, the income tax should be retained.

Finally, income taxation has an important symbolic value. To a large extent, current U.S. dissatisfaction with the income tax stems from the perception that it is not progressive enough—that is, that the rich can avoid paying their “fair share.”\textsuperscript{114} The result of this dissatisfaction has

\textsuperscript{109} Id.
\textsuperscript{113} Bird & Zolt, note 12, at 1682-83.
\textsuperscript{114} See John Braithwaite, Markets in Vice Markets in Virtue (2005).
been attempts to ensure that the rich pay their "fair share" (like the AMT), and attempts to reduce opportunities and incentives for avoidance by broadening the tax base while reducing the top rate (the 1986 tax reform). Both of these may have failed, but the solution is not to abandon the effort to tax the rich by adopting a consumption tax. It is always hard to persuade the majority to pay their taxes when it is perceived that the wealthy minority do not pay theirs. A commitment to progressivity in taxation is an important symbolic bulwark for the legitimacy of the tax system as a whole.

Nevertheless, I do agree that the time has come to abandon the century-old attempt to achieve redistribution of wealth in the United States entirely through the income and estate taxes. We know more now about the inherent limitations of these taxes in achieving redistribution than the Progressives knew 100 years ago. We cannot go back to the pre-1980 rate structure, and we will not abandon the use of the tax system as a regulatory tool, which underlies most avoidance techniques, or "loopholes." Nor are we any closer to solving the practical problems inherent in taxing income, such as the realization requirement. Globalization and tax competition for capital also introduce their own limitations on taxing capital too highly, although it is important to note that their effects have not been significant so far in developed countries.\textsuperscript{115}

Thus, a different kind of tax is needed in addition to the income tax. A wealth tax is an obvious candidate to achieve wealth redistribution, but it is problematic politically (as shown by the revolt against local property taxes and unpopularity of the estate tax), constitutionally (a federal direct wealth tax without apportionment is probably unconstitutional) and administratively (because of liquidity and valuation issues).

Thus, I believe the solution is a federal level consumption tax—specifically, a VAT similar to the ones used successfully in all other OECD countries. If this tax is enacted in addition to, and not as a replacement of, the income tax, the revenues under current political conditions are likely to be used for universal entitlement programs like Social Security and Medicare. These programs are far more politically resilient than programs aimed solely at the poor, and are inherently redistributive. Thus, there is little risk that the revenues from the new (progressive) additional consumption tax would not be spent in a progressive fashion—which is not the case if the consumption tax replaced the income tax, because then it would fund the same federal programs as the income tax does now, with no increase in progressiv-

ity and no solution for the actuarial deficit of the entitlement programs, other than cutting benefits.

IV. REGULATION

"[T]he power to tax involves the power to destroy..."\textsuperscript{116}

John Marshall

The previous two Parts have shown that a combination of revenue and redistributive goals explains the two puzzles I posed in the beginning: Why most countries have both income and consumption taxes, and why the United States switched from taxing consumption to taxing income a century ago. But there is a third puzzle I have not yet addressed, which is the surprising political resiliency of both the individual and corporate income taxes in the past twenty-five years. Since the 1980's, there has been a growing consensus among academics that the consumption tax is superior to the income tax, at least on efficiency and administrability grounds. And yet, there has not been much response among politicians in the United States (or elsewhere) to the call for substituting the income tax with a consumption tax.\textsuperscript{117}

Part of the explanation no doubt lies in the revenue and redistribution arguments outlined above—politicians tend to like tax revenues, and redistribution still has strong support among voters (a point I return to later). But I would suggest that a stronger reason for the political resistance exists, and that is the third function of the income tax—as a regulatory tool.

The income tax, and in particular the corporate income tax, had been seen as a potential regulatory tool from the beginning. President Taft, in proposing the corporate tax in 1909, had emphasized its regulatory potential: By adopting the tax, he said, the government can achieve "supervisory control of corporations which may prevent a further abuse of power."\textsuperscript{118} And in adopting and developing the reorganization provisions from 1918 onward,\textsuperscript{119} the United States began a long series of measures designed to reward some forms of corporate activity and deter others.

The heyday, however, of using the income tax as a regulatory tool was in the post World War II period. This was part of a general tendency to entrust regulatory powers to the state—the so-called "golden

\textsuperscript{116} McCulloch v. Maryland, 17 U.S. 316, 431 (1819).
\textsuperscript{118} 44 Cong. Rec. 3, 3344 (1909) (statement of President Taft).
\textsuperscript{119} Revenue Act of 1918, 40 Stat. 1060.
period of the nation state." In the 1960's and 1970's, in particular, hundreds of provisions were added to the Code to influence investment and spending decisions by both individuals and corporations.

The problem, of course, was that these regulatory provisions ("tax expenditures") clashed with the other goals of taxation—they made the income tax less effective in both raising revenue and as a redistributive tool, since most of the tax expenditures were aimed at the rich. In addition, the tax expenditures made the Code far more complex. The result was a backlash led by academics like Stanley Surrey, who wanted to restore the tax law to its "pure" functions of revenue raising and redistribution and achieve regulatory aims directly by subsidies and direct regulation. The movement began in the adoption of the AMT in 1969 (designed to reduce the ability of the rich to use tax expenditures to avoid taxation below a certain minimum) and culminated in the adoption of the tax expenditure budget in 1974, and in the Tax Reform Act of 1986, which closed hundreds of "loopholes."

As we now know, these achievements of the anti-tax expenditure movement were transitory. The AMT has become a burden on the middle class; the tax expenditure budget had no discernible effect on the willingness of Congress to adopt and expand tax expenditures; and the 1986 compromise unraveled in the 1990's, which saw a plethora of new targeted tax incentives. The trend shows no sign of abating, as exemplified by the American Jobs Creation Act of 2004 and the Energy Policy Act of 2005.

Tax expenditure purists bewail this trend, but I believe they are mistaken. As Weisbach and Nussim have shown, there is no particular a priori reason why tax expenditures are better or worse than direct subsidies. And as other students of regulation have noted, deterring harmful activities via taxation sometimes can be more effective than direct regulation (consider, for example, Prohibition vs. taxes on

120 See Peter B. Evans, Dietrich Ruschmeyer & Theda Skocpol, Bringing the State Back In (1985); Bo Rothstein & Sven Steinmo, Restructuring the Welfare State: Political Institutions and Policy Change (2002).
alcohol consumption).\textsuperscript{128} Even if these arguments are rejected, as Boris Bittker and others have argued,\textsuperscript{129} the choice of what is and is not a tax expenditure lies very much in the eye of the beholder. Thus, we are unlikely to ever have a pure income (or a pure consumption) tax.

Moreover, the political appeal of regulating via the Code is immense. It gives significant power to the tax writing committees, and enhances the role of lobbyists (who are frequently former members of the tax writing committees). This political reality means that efforts to eliminate regulation via taxation probably are doomed. Even President Bush conceded this reality when he instructed the Tax Reform Commission to refrain from touching two of the most popular tax expenditures (the home mortgage interest and charitable deduction),\textsuperscript{130} even though this severely limited the tax reform options they could consider (for example, it eliminated the option of a national sales tax).

This, then, is the third goal of taxation: regulation of private sector activity by rewarding activities that are considered desirable (via deductions or credits) and deterring activities that are considered undesirable (via increased taxation). A major portion of the current Code can only be understood as fulfilling this regulatory function.

What are the implications for tax reform? Some private activities can best be regulated by consumption taxes—consumption activities. In fact, if the goal of the government is to deter consumption of certain items (for example, tobacco, alcohol or gasoline), excise taxes on these items are the most effective way of achieving this aim—far better than denying an income tax deduction. General consumption taxes are also widely used (although this use is more controversial) to impose extra taxes on some items (luxuries) and lower taxes on others (food and medicine). (It should be noted, however, that the aim of these provisions frequently is to abate regressivity, which can be achieved better by spending programs.)

But most of the regulatory function of taxation relates not to consumption, but to investment and saving behavior. The biggest tax expenditures in all countries tend to be those that encourage individuals to invest for certain goals (for example, retirement, housing or education).\textsuperscript{131} Other important ones are designed to encourage corporate

\textsuperscript{128} See Ian Ayres & John Braithwaite, Responsive Regulation: Transcending the Deregulation Debate (1992); Braithwaite, note 114.


\textsuperscript{130} Exec. Order No. 13,369, 3 C.F.R. 2323 (2005) (ordering that the panel's recommendations should "recogniz[e] the importance of homeownership and charity in American society").

investments (for example, accelerated depreciation, investment tax credits). These types of regulation can be achieved only in the context of a system that taxes individual and corporate income, not consumption.

In a cash flow type consumption tax, all individual savings are deductible, and all corporate capital expenditures are expensed. This encourages savings and investment in general. But it does nothing to draw these distinctions that are at the heart of regulatory uses of the Code: to encourage individuals and corporations to save and invest in some purposes but not in others. There can be no preference for saving for retirement or for college tuition for individuals, no accelerated depreciation for some types of corporate investment but not others.

Some, of course, would say that it is a good thing for government to get out of the way and just support savings and investment in general via a consumption tax, without trying to influence particular savings or investment decisions. But others would support a role for the government, especially where it is shown that a market failure exists or when individuals behave in a systematically irrational way. For those who believe in a continued regulatory role in taxation, the maintenance of both an individual and corporate income tax is essential, since a consumption tax by definition cannot be used to regulate savings and investment decisions.

Regardless of one's position on the desirability of regulation via taxation, the inescapable reality is that politicians are unlikely to give up on this tool. The 1986 tax reform after all was widely conceded to be an aberration, and it unraveled over time (in part, because it carried the seeds of its own destruction, like the mechanism for a capital gains preference). But even the 1986 Act involved far less regulatory abstinence than a complete repeal of taxation of savings. This, I believe, is the principal reason the current effort to replace the income tax with a consumption tax will fail.

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132 Id.
133 See, e.g., Treasury Dep't, Blueprints for Basic Tax Reform 9 (1977).
134 In theory, one could imagine tax preferences being given for investment activities within the context of a consumption tax by granting more generous treatment than expensing to certain activities but not to others. See, e.g., IRC § 168(f)(8) (before repeal in 1982) (treatment of finance leases in 1981-1982). But it is hard to imagine such a system raising sufficient revenue.
136 Strikingly, the Tax Reform Panel Report rejected any proposal for a pure consumption tax, proposing instead either a streamlined income tax (the "Simplified Income Tax", or SIT) or a partial consumption tax with an added tax on income from capital (the "Growth and Investment Tax", or GIT). Tax Reform Panel Report, note 15, at 59. If even a panel designed to advance consumption tax proposals failed to reach consensus, it seems
V. Conclusion: Why the United States Should Tax Both Income and Consumption

I began by conceding, for argument's sake, the superiority of the consumption tax to the income tax on the three traditional policy grounds of efficiency, equity, and administrability. I then said that this result poses two puzzles: Why do most countries use both income and consumption taxes, and why the United States chose to switch from taxing consumption to taxing income. The answer, I argued, lies in the three functions of taxation: revenue, redistribution, and regulation. The revenue function explains why for most countries (although not yet for the United States), both income and consumption taxes are needed to support the social safety net.\textsuperscript{137} The redistributive function, properly seen as redistributing unconsumed wealth, explains why the United States adopted the income tax and why even developing countries insist on retaining an income tax.\textsuperscript{138} The regulatory function explains the political resiliency of the income tax, since only by taxing savings can politicians regulate savings and investment behavior.

And yet, consumption taxes are needed for all three functions. A consumption tax is needed to raise revenue whenever the public sector requires more revenue than can be raised by the income tax.\textsuperscript{139} Redistribution to a large extent can be achieved more effectively by taxing consumption broadly and using the spending side of the budget to achieve progressivity.\textsuperscript{140} And consumption itself is more easily regulated by consumption taxes than by an income tax.

What are the policy implications of this argument? Two major implications can be drawn. First, it is unlikely that the United States will in fact substitute a pure consumption tax for the income tax, although it is possible that some movement will be made to expand the consumption tax features of the current income tax. Second, I believe the United States should follow the rest of the world and adopt a consumption tax (specifically, a VAT) in addition to the income tax.

The unlikelihood of radical tax reform in the United States stems directly from the role of the income tax in all three of the above functions, and from the observation that in the last decade, consumption...
The three goals of taxation

Tax proposals have gained political traction only to the extent they resembled an income tax. Since the 1990’s, three major tax reform proposals have been made repeatedly in one form or another: the national sales tax, the flat tax, and the cash flow tax. Of these, only the cash flow tax has had any political success, precisely because it comes closer than the other two to achieving the three goals of taxation outlined above; that is, it more closely resembles an income tax.

The national sales tax is the most obvious form of consumption tax. It achieves consumption tax treatment directly by taxing only consumption transactions, and enables Congress to abolish both the Code and the hated IRS. But this proposal has gone nowhere: It does not bring in adequate revenue (because of inherent administrability constraints on a single stage sales tax); it is purely regressive; and it eliminates any regulatory potential at the federal level. Despite the enthusiasm of prominent Republicans, this proposal has no future.

The flat tax (or its cousin the X tax) has had more appeal. It brings in adequate revenue, and because corporations still are taxed (albeit on a cash flow basis), it has some regulatory potential at the corporate level. Moreover, it has the potential to maintain a progressive tax on wages. But the complete exclusion of interest, dividends, and capital gains from the tax base probably dooms it on redistributive grounds. If even President Bush’s proposal to exempt dividends (with the double tax argument behind it) could not get enacted in a Republican Congress, and if the President’s own tax reform panel rejected a pure flat tax and added a 15% tax on income from capital, it is hard to believe an all-out exemption for all investment income (even rents used for consumption) can get enacted.

The only proposal that has had some traction is thus the cash flow proposal: to tax both individuals and corporations on a cash flow basis, allowing the expensing of capital expenditures at the corporate level and a full deduction of savings at the individual level. This proposal maintains adequate revenue and some potential for regulation. As far as redistribution is concerned, it taxes rents and maintains the graduated rate structure.

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And yet, I do not believe even this proposal can get enacted. Fundamentally, it comes down to the question whether the American public believes in the version of redistribution proposed by Bankman and Weisbach, that is, redistribution only from an individual perspective, based on welfarist premises, in which individuals only value consumption; or whether it still believes the version of redistribution laid out above, namely redistribution of unconsumed wealth as a legitimate goal of tax policy. If it is the latter, it is highly unlikely that Congress will accept the distributive tables showing the impact of a tax reform proposal that allows the rich an unlimited savings deduction. It is more likely that some compromise will be struck, expanding the range of deductible savings for the middle class but with limits on the rich. This will result in moving the current income tax more in the direction of a consumption tax, but without abandoning income taxation of the rich. It is similar in this regard to current compromise proposals that keep the estate tax for the ultra rich.

But in the longer run, the current situation is not tenable. Once the baby boomers reach retirement age in large numbers, the costs of Social Security and in particular Medicare will become so high that the need for either cutting benefits or additional revenues will be inescapable. At that point, I believe the political dynamic from other OECD countries will repeat itself, and we will end up with a VAT in addition to the income tax.

As stated above, consumption taxes have many advantages. Although I am not truly willing to concede their superiority on the traditional measures of efficiency, equity, and administrability (a point I have addressed elsewhere), I believe they—and in particular the VAT—have a lot to offer in fulfilling the three goals of taxation set out above. Because of this, I support adopting a VAT in addition to the income tax in the United States. As other countries have learned from experience, the VAT is an important tool for revenue, redistribution, and regulation. Its details, and how to get there from here, I leave for another day.

146 See Part II.
147 See, e.g., Nonna A. Noto, Cong. Research Serv., Estate Tax Legislation in the 108th Congress CRS 4-12 (May 14, 2004) (discussing recent congressional proposals to raise the estate tax exclusion amount).
149 Avi-Yonah, note 4.
150 For a preliminary discussion, see generally id.