2004

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Reuven S. Avi-Yonah
University of Michigan Law School, aviyonah@umich.edu

Recommended Citation

Avi-Yonah, Reuven S. "Risk, Rents, and Regressivity: Why the United States Needs Both an Income Tax and a VAT." Tax Notes 105, no. 13 (2004): 1651-66.

tax analysts special report

RISK, RENTS, AND REGRESSIVITY: WHY THE UNITED STATES NEEDS BOTH AN INCOME TAX AND A VAT

By Reuven S. Avi-Yonah

Reuven S. Avi-Yonah is the Irwin I. Cohn Professor of Law at the University of Michigan.

In this article, Prof. Avi-Yonah argues that the legal academic debate about fundamental tax reform from 1974 onward has been skewed by the assumption that a consumption tax must replace the income tax. He addresses three of the major issue in recent writings on the income/consumption tax debate, and shows how none of the arguments in favor of the consumption tax are conclusive. Avi-Yonah also addresses the various consumption tax proposals that have been made and shows that they are all deficient in comparison with a VAT, as well as failing to achieve the goals of an income tax. Finally, he develops the proposal that the United States should adopt a VAT in addition to the existing income tax, and addresses some of its implications (for example, for the state and local sales tax). He then distinguishes the proposal from one made by Prof. Michael Graetz to substitute a VAT for the income tax on middle-class taxpayers, and argues that while the Graetz proposal is sensible, we cannot afford it.

The author would like to thank David Bradford, David Hasen, Kyle Logue, Charles McLure, Oliver Oldman, and Alan Schenk for their helpful comments on earlier versions of this article.

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When the people are weary of any one sort of Tax, presently some Projector propounds another, and gets himself Audience, by affirming he can propound a way how all the Publick Charge may be born without the way that is.[1]

Fundamental tax reform has once again moved to the center of political discussions. Speaker of the House Dennis Hastert, R-Ill., and House Majority Leader Tom DeLay, R-Texas, have proposed replacing the income tax with a national sales tax. Other radical tax reform proposals like the flat tax and a cash flow tax have also been introduced in Congress. Meanwhile, President Bush has proposed a dramatic expansion of tax-exempt savings accounts, which together with his proposed zero tax on dividends represent major steps toward exempting all income from capital from taxation, and has said he would focus on the tax reform issue in his second term. Given the results of the 2004 election, the wide support for some kind of tax reform, and the broad unpopularity of the existing income tax, more developments in the same vein are likely in the near future.

For more than 30 years, the tax reform debate in the United States has focused on whether the proper base for taxation should be income or consumption. Arguments based on both fairness and efficiency have been made in favor of replacing the income tax with a consumption tax. Counterarguments in favor of the income tax have also been made, primarily on fairness grounds.

However, the debate is misplaced because of its focus on the consumption tax as a replacement for the income tax. In every other member country of the OECD, a consumption tax — or a VAT — exists *in addition to* the income tax. Each tax has its advantages and disadvantages: The income tax is less regressive and better geared to taxing the rich, while the VAT is easier to administer and better geared to taxing the majority of the population

[1]Sir William Petty, *A Treatise of Taxes and Contributions* 60 (1679). The author would like to thank Alan Schenk for highlighting this wonderful example of déjà vu all over again; *see* Alan Schenk, ''Value Added Tax: Does This Consumption Tax Have a Place in the Federal Tax System?'' 7 *Va. Tax Rev.* 207 (1987).

who consume most of their income. The VAT is also less prone to evasion, less dependent on cyclical economic fluctuations, and less subject to the pressures of globalization and capital flight than the income tax. That is why the VAT has been adopted in more than 100 countries as an addition to the income tax.

The reason why a VAT is used in addition to the income tax in every other OECD member country is simple: The revenue is needed to support the social insurance safety net for the elderly. As developed countries face the retirement of the baby boom generation, even long-time opponents of the VAT like Japan, Canada, and Australia have recently adopted it.

The United States faces the same problem: An unfunded gap of $70 trillion between expected revenues and projected outlays for Social Security and Medicare. The gap leaves the United States with two options: drastically cutting benefits for the baby boom generation, or raising more revenue. Cutting benefits would threaten the unraveling of the social compact between young and old that has enabled this country to achieve a dramatic reduction in poverty among the elderly in the last generation, and would further increase the gap between the haves and have-nots. To avoid that outcome, at some point in the near future we will need to raise significant revenues. This article argues that that a VAT enacted *in addition to (and not as a replacement of)* the income tax is the best option for raising those revenues.

The article is divided into four parts. Part I briefly surveys the legal academic debate about fundamental tax reform from 1974 onward, and shows how that debate has been skewed by the assumption that a consumption tax must replace the income tax. Part II addresses three of the major issues in recent writings on the income/consumption tax debate, and shows how none of the arguments in favor of the consumption tax are conclusive. Part III addresses the various consumption tax proposals that have been made and shows that they are all deficient in comparison with a VAT, as well as failing to achieve the goals of an income tax. Finally, Part IV develops the proposal made above, that the United States should adopt a VAT in addition to the existing income tax, and addresses some of its implications (for example, for the state and local sales tax). It then distinguishes the proposal from one made by Prof. Michael Graetz to substitute a VAT for the income tax on middle-income taxpayers, and argues that while the Graetz proposal is sensible, we cannot afford it.

I. Introduction: The Great Tax Base Debate

The U.S. individual income tax was enacted in 1913 to replace existing consumption taxes (tariffs) on the ground that they were regressive. Until World War II, it was imposed mainly on upper-income taxpayers and was imposed at low rates, compared with the current individual income tax rates. Even after the war, with rates soaring to 91 percent, the income tax enjoyed considerable popularity as the fairest tax. However, beginning with California's tax revolt in the early 1970s, an increasing barrage of criticism has been leveled at the income tax on grounds of inefficiency and complexity. At the same time, perceptions of the income tax's fairness have been undermined by the increasing use of sophisticated tax shelters by the rich to reduce or eliminate their income tax liability. While the Tax Reform Act of 1986 achieved considerable simplification of the income tax by reducing its rates and expanding its base, subsequent enactments (especially in the late 1990s) have eroded the gains of the 1986 act and have once again prepared the ground for the advocates of radical tax reform to press for replacing the income tax with a consumption tax.

In the legal academic literature, the recent debate on the appropriate tax base began with Prof. William Andrews's seminal 1974 article in the *Harvard Law Review*, published just as the decline of the income tax was beginning.[2] Before Andrews, legal tax scholars assumed that a consumption tax had to be regressive because it is based on sales and therefore cannot take into account the personal characteristics of the buyer. Andrews, building on earlier economics literature (for example, by Nicholas Kaldor), showed that in principle it is possible to achieve a consumption tax with a progressive rate structure built in. He did this by showing that on the basis of certain assumptions (to be explored below), allowing taxpayers to deduct all of their savings and applying graduated rates to them when they consume those savings is equivalent to not taxing the income from those savings at all. Thus, under the Haig-Simons definition of income as consumption plus the increase in savings, exempting the income from savings is equivalent to only taxing consumption.

Prof. Alvin Warren replied to Andrews by arguing that a cash flow consumption tax, as proposed by Andrews, is equivalent to an exemption of the returns to saving, and therefore only labor income would be taxed, which he considered unfair.[3] Prof. Barbara Fried added that the supposed unfairness of taxing income "twice" (once when earned and again when it produces interest) is illusory, since it depends on using subjective utility rather than wealth as a measure of income.[4]

In the voluminous literature that followed, proponents of the consumption tax have advanced three main arguments in its favor.[5] First, they argued that it promotes efficiency by eliminating the deadweight loss from a tax on saving. Second, they argued that a consumption tax would boost national productivity by increasing national savings. Third, they argued that the consumption tax is considerably simpler than an income tax.[6]

Opponents of the consumption tax have replied that the supposed efficiency gains of the consumption tax are

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[2] *See* William D. Andrews, "A Consumption-Type or Cash Flow Personal Income Tax," 87 *Harv. L. Rev.* 1113 (1974).

[3] *See* Alvin C. Warren, "Fairness and a Consumption-Type or Cash Flow Personal Income Tax," 88 *Harv. L. Rev.* 931 (1975); William D. Andrews, "Fairness and the Personal Income Tax: A Reply to Warren," 88 *Harv. L. Rev.* 947 (1975).

[4] Barbara H. Fried, "Fairness and the Consumption Tax," 44 *Stan. L. Rev.* 961 (1992).

[5] For these arguments see generally Joseph Pechman (ed.), *What Should be Taxed, Income or Expenditure?* (1980).

[6] *See, e.g.*, David F. Bradford, *Blueprints for Basic Tax Reform* (1984); David F. Bradford, *Untangling the Income Tax* (1986); David F. Bradford, "The Choice Between Income and Consumption Taxes," *Tax Notes*, Aug. 23, 1982, p. 715.

exaggerated and depend crucially on imposing a one-time tax on accumulated wealth at the time of the transition from the income to the consumption tax, which is politically highly unlikely to happen. Moreover, the added incentive to save under a consumption tax depends on the crucial assumption that people do not have a set savings goal, because if they do, they would decrease, rather than increase, their savings rate in response to a reduction of tax on savings. Moreover, the empirical evidence is ambiguous at best on whether tax decreases boost savings. Finally, the administrative advantages of the consumption tax depend crucially on its structure and may be lost if Congress builds in exemptions like it did in the income tax.[7]

In recent years, the debate has shifted to three other issues, which will be discussed more extensively below. First, proponents of the consumption tax (beginning with Profs. Joseph Bankman and Thomas Griffith in 1992 and continuing more recently with Prof. David Weisbach) have argued that the actual difference between it and the income tax is minimal because neither can reach risky returns, and risk-free returns on capital have historically been very low.[8] Second, Prof. Ed McCaffery has recently emphasized another point of similarity between a cash flow consumption tax and an income tax, in that they both reach inframarginal returns (rents), and therefore they can both be used to tax the rich, but the consumption tax is fairer because it taxes people only when they use their savings to enhance their lifestyle (and not when they use them to smooth their lifetime income patterns).[9] Finally, Prof. Dan Shaviro has recently argued that a consumption tax can achieve the same degree of progressivity as the income tax, even though it does not appear to tax unconsumed income.[10] Thus, proponents of the consumption tax argue that because the difference between an income tax and a properly structured consumption tax is minimal, but the consumption tax is administratively simpler than the income tax, it should be preferred.

One notable feature in this entire discussion is the near-universal assumption that a consumption tax must replace the income tax, rather than be imposed concurrently. And yet, every other OECD member country has both a consumption tax (the VAT in its various guises) and both a personal and a corporate income tax. Some OECD members have only added the consumption tax recently (Canada, Japan, Australia, Finland, and Switzerland are the most recent ones), but none have abolished their existing income tax on doing so.[11]

The reason for this phenomenon is simple: The income tax is needed to tax the rich. As I will argue below, no consumption tax can tax unconsumed wealth, and unconsumed wealth needs to be taxed in a democratic polity to enable government to achieve some degree of control over the economic, social, and political power of the rich. Thus, both a personal income tax and a corporate income tax are necessary tools of regulation of private power in a modern society.

However, the income tax by itself is not enough. It is necessarily complex, and its revenue-raising potential is inherently limited both by administrability concerns and by the incentive effects of high tax rates. In addition, the income tax is limited by tax competition and the increasing ability of the rich (including large corporations) to shift their capital to other countries with lower tax rates, and its revenues are highly cyclical. Thus, to fund the social safety net, the government needs another tax instrument that can produce high levels of revenue at low administrative costs, and that is less dependent on cyclical shifts in economic activity. All over the world, in both developed and developing countries, the VAT has proven over the last 50 years to be ideally suited to this role. In fact, the rise and spread of VAT in the period since 1960 was the most important tax policy development in the 20th century. As argued below, it is time for the United States to follow the rest of the world and adopt a VAT *in addition to* the corporate and personal income taxes.

II. Should the Income Tax Be Replaced?

In this part of the article, I address three recent arguments in favor of replacing the income tax with a consumption tax. Fundamentally, the arguments boil down to one assertion: The consumption tax is not meaningfully different from the income tax in terms of its progressivity or ability to tax the rich. Therefore, not much would be lost if the consumption tax is adopted, and the relative administrative simplicity of the consumption tax favors its adoption.

The three arguments in favor of equating the consumption and the income tax are (a) that neither can reach the returns on risky investments; (b) that both can reach inframarginal returns; and (c) that both can achieve identical progressivity. I will address each in turn. However, before turning to those arguments, it is necessary to reexamine the fundamental rationale for having an income tax in the first place.

A. Why Tax Income?

The individual income tax was adopted in 1913, when the 16th Amendment empowered Congress to tax incomes and overturned the Supreme Court's *Pollock* decision of 1895, which held a previous attempt to tax

[7]Joseph Pechman, ed., *What Should Be Taxed: Income or Expenditure?* (Brookings Institute Press 1980).

[8]Joseph Bankman and Thomas Griffith, "Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?" 47 *Tax L. Rev.* 377 (1992); David Weisbach, "The (Non-) Taxation of Risk," 58 *Tax L. Rev.* (forthcoming 2004).

[9]Edward McCaffery, "The Fair Timing of Tax," 102 *Mich. L. Rev.* (forthcoming 2004).

[10]Daniel Shaviro, "Replacing the Income Tax With a Progressive Consumption Tax," *Tax Notes*, Apr. 5, 2004, p. 91.

[11]For an excellent discussion of the VAT in the U.S. context, see Charles E. McLure, *The Value Added Tax: Key to Deficit Reduction* (1987). *See also* Liam Ebril, Michael Keen, Jean-Paul Bodin, and Victoria Summers, *The Modern VAT* (2001); Alan A. Tait, *Value Added Tax: International Practice and Problems* (1988); Adrian Ogley, *Principles of Value Added Tax* (1998); Alan Schenk, *Value Added Tax: A Model Statute and Commentary* (1989); Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach in Theory and Practice* (2001).

incomes unconstitutional as a direct tax lacking apportionment. Before the 16th Amendment was adopted, the federal government relied primarily on tariffs and excises for revenues, which served to protect American industry from competition and were imposed on consumption goods.

The principal argument in favor of replacing the consumption-based tariff system with a personal income tax was that the tariffs were regressive. Because the poor consume a higher percentage of their income than the rich, a consumption tax is generally more regressive than an income tax. Economic developments in the late 19th and early 20th century significantly increased the gap between rich and poor, and supporters of the income tax (primarily from the more agricultural states in the South and West) felt that the industrialists of the Northeast had grown rich behind protective tariffs and should bear a greater part of the burden of financing the government. In addition, state personal property taxes had notoriously failed to reach intangible types of property like stock and bonds, further reducing the tax burden on the newly rich railroad, steel, and oil magnates.

I have argued elsewhere that the principal reason for taxing the rich today is similar to one of the major reasons why the personal and corporate income taxes were enacted in the early 20th century: Both were perceived as having the potential of curbing excessive accumulations of political, economic, and social power by the rich.[12]

There are two principal arguments why a liberal democratic state should curb excessive accumulations of private power. The first is the argument from *democracy*: In a democracy, all power should ultimately be accountable to the people. Private accumulations of power are by definition unaccountable, because 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. That 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 Founding Fathers believed, was to be free from concentrations of economic power such as characterized England in the 18th century. 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." 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."[13] In the 20th century, the same view was best expressed in the corporate context by Berle, who wrote that in a democracy like the United States "it becomes necessary to present a system (none has been presented) of law or government, or both, by which responsibility for control of national wealth and income is so apportioned and enforced that the community as a whole, or at least the great bulk of it, is properly taken care of. Otherwise the economic power now mobilized and massed under the corporate form . . . is simply handed over, weakly, to the present administrators with a pious wish that something nice will come of it all."[14]

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.[15] 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."[16] 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."[17] 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.[18]

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

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[12]The following is based on Reuven S. Avi-Yonah, "Corporations, Society and the State: A Defense of the Corporate Tax," 90 *Va. L. Rev.* 1193 (2004); *see also* Reuven S. Avi-Yonah, "Why Tax the Rich? Efficiency, Equity, and Progressive Taxation "(review of Joel Slemrod (ed.), *Does Atlas Shrug? The Economic Consequences of Taxing the Rich*, 2001), 111 *Yale L.J.* 1391 (2002).

[13]Dennis J. Ventry, "Equity Versus Efficiency and the U.S. Tax System in Historical Perspective," in *Tax Justice: The Ongoing Debate* (Thorndike and Ventry, eds., 2002), p. 28.

[14]A.A. Berle, "For Whom Corporate Managers Are Trustees," 45 *Harv. L. Rev.* 1365, 1368 (1932).

[15]Michael Walzer, *Spheres of Justice: A Defense of Pluralism and Equality* (1983).

[16]*Id.* at 19.

[17]*Id.* at 12.

[18]*Id.* at 120-121.

> 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 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.[19]

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

> All these 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 just make 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.[20]

The personal income tax is one means by which the state can regulate the accumulation of private power. As I have argued elsewhere, the tax achieves that function in two ways: by directly limiting the rate of private wealth accumulation (the *limiting function*), and by providing incentives and disincentives to particular activities by the rich (the *regulatory function*). For reasons explained below, both functions are necessary and related to each other, in the same way that both a brake and a steering wheel are necessary for driving a car.[21]

First, the limiting function: Imagine a 100 percent tax imposed on profits. Over time, that tax would eliminate all sources of the power of the rich, since it would force them to use their existing resources to pay politicians and employees, and it would remove any incentive to accumulate further wealth. The power to tax is indeed potentially the power to destroy.

But a 100 percent tax is inconceivable. Taxation faces an inherent limit that was well expressed by Justice Oliver Holmes when he stated that "the power to tax is not the power to destroy while this court sits." The Constitution places limits on the power to tax, limits that are implicit already in *Dartmouth College*: The public sector may not use taxation to completely eliminate the private one. This is both a matter of constitutional law (a tax may be a taking if the rate exceeds any reasonable estimate of the state's contribution to private wealth creation) and a matter of practicality: We do not want to kill the goose that lays the golden eggs by imposing taxation at rates that create huge deadweight losses to the economy at large (the deadweight loss is approximately a square function of the tax rate). The precise limit of desirable taxation thus becomes the quintessential political question of our time, to be refought every four years at the ballot box.

Given that we cannot tax at 100 percent, what is the effect on private power of a lower tax rate, such as the current 35 percent? Even at that historically low rate, the income tax does significantly slow down the accumulation of private resources, which are the foundation of private power. For example, imposing a tax at 35 percent on assets invested at a 10 percent yield (compounded annually) over 10 years results in approximately 27 percent less assets being available at the end of the period than would be available in the absence of the tax. Thus, taxation at lower rates can meaningfully restrict the buildup of assets that forms the base of the power of the rich, even when it does not destroy it. But since that power would continue to exist and grow at any reasonable rate of taxation, we also need the tax to perform a regulatory function.

Second, the regulatory function: The use of assets by the rich (that is, their use of its power) may be impacted by the threat that the tax rate would be raised if it is perceived that the assets are not used for the betterment of society. That can be seen by the imposition of higher effective rates on certain forms of behavior Congress disapproved of, like bribes paid to foreign officials and participation in international boycotts. In both cases, empirical research has suggested the tax penalties had a significant impact. More recently, the threat of increased tax rates applied to U.S. corporations that moved their nominal place of incorporation to Bermuda seems to have sufficed to block one such "inversion" transaction and stop other corporations from adopting the same strategy. Thus, it seems that taxation even at rates much less than 100 percent can suffice to regulate private power. But the rates cannot be set too low, because then the rich would not care sufficiently to avoid the tax. That is why we need the limiting function (that is, set rates at sufficiently high levels for management to notice) for the regulatory function to work properly.

Finally, in addition to providing disincentives, the tax can be used to provide incentives as well. For example, investment incentives are provided as a way of bolstering the economy. Another example is research and development, which has been shown by economists to produce significant positive externalities for society, which justify the government in providing a subsidy via the tax code. Now, it is of course true that the government could

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[19] *Id.* at 121-122.
[20] *Id.* at 122-123.
[21] *See* Avi-Yonah, "Corporations, Society and the State," *supra* note 12 at 1246-1249.

subsidize those functions directly, rather than use tax expenditures, so this cannot strictly be an argument for taxing the rich. However, that would require setting up an IRS-like agency to monitor the use of the subsidies, so that any simplification advantage from abolishing the income tax is diminished. And once the income tax is in place, it seems like an obvious and convenient vehicle to deliver the desired subsidies at little additional cost.

Is the income tax the best vehicle for curbing excessive private power accumulation? An obvious alternative vehicle would be a direct wealth tax. However, in addition to concerns on its constitutionality, it is questionable whether a wealth tax is administrable. Intangible forms of property proved difficult to tax in the 19th century, and are probably even harder to tax today, since the valuation of nonpublicly traded property is a very difficult enterprise. In particular, the rise of financial derivatives makes it hard even for sophisticated financial institutions to value their assets for financial reporting purposes. In addition, political experience since 1972 has shown that the American people are very averse to paying taxes on property, as indicated by the wave of property tax limitations and the impending demise of even the estate tax. Thus, the income tax remains the best way of reaching the sources of power of the rich, assuming that it can do so.

B. Risk: Is There a Meaningful Difference?

Can the income tax in fact tax the rich, or to put it another way, can it tax income from capital? If it cannot, then a strong argument can be made for replacing it with a consumption tax on administrative grounds, because if income from capital cannot be taxed, an income tax has the same base as a consumption tax but is immensely more complicated (for example, because it needs to account for basis).

Beginning with Bankman and Griffith in 1992, a significant body of legal literature has argued that the difference between income and consumption taxes is minimal, and therefore the consumption tax should be preferred on administrative grounds. Most recently, David Weisbach has argued that ''a Haig-Simons tax is basically the same as a consumption tax (which imposes a zero tax on capital), and the debate between the two tax bases is not particularly meaningful. The decision might best be made on administrative grounds rather than on deep philosophical arguments about the proper distribution of the tax burden.''[22]

The argument relied on by Bankman, Griffith, and Weisbach is based on an observation made by Domar and Musgrave in 1944, and expanded by many economists since then. Domar and Musgrave pointed out that if an individual is subject to (say) a 50 percent income tax on risky returns, he can eliminate that tax by increasing the amount invested, because the government shares equally in both his gains and his losses. Thus, suppose the individual makes a bet of $100 with an equal chance of winning and losing (for example, a coin flip). Before tax, the individual would receive $100 if he wins and would pay $100 if he loses. If the government imposes a 50 percent Haig-Simons income tax, the individual would only receive $50 if he wins (since he pays $50 in tax to the government) but would only lose $50 if he loses (since the government would in effect pay him $50 by allowing him to deduct the $100 loss at a 50 percent tax rate). But if he could double the bet to $200, he would get $100 if he wins and pay $100 if he loses, putting him in the same position he was in if the tax was not imposed at all.

Bankman, Griffith, and Weisbach expand this proposition to argue that a Haig-Simons income tax cannot be imposed on risky returns. They then go on to demonstrate that if the income tax can be imposed only on risk-free returns, since those have historically been very low (around 0.5 percent), the difference between an income tax and a consumption tax is so minuscule that it is not worth the argument.

Various commentators have recently taken issue with this line of argument. Prof. Reed Shuldiner argues that the model is misleading for several reasons.[23] First, in the case of investments rather than bets, grossing-up the investment is not costless: it involves both transaction costs and credit risk, since even rich individuals cannot borrow at the risk-free rate of return. Second, he argues that the risk-free rate used by Bankman and Griffith is too low, because they used the period 1945-1972, in which unexpected inflation was high; from 1972 to 1999 the risk-free rate was 1.5 percent and from 1802 to 1997 it was 2.9 percent. Moreover, the term of the rate is important: It should match the term of the investment, and the real risk-free rate for 1972-1999 on 10-year investments was 3.3 percent. Thus, the difference between the income and consumption tax, even on the assumptions underlying the Domar-Musgrave model, is more significant than previous commentators have assumed.

In addition, both Prof. Shuldiner and Prof. Larry Zelenak point out that the key assumptions underlying the model may not be accurate.[24] First, individuals do not always behave with the kind of perfect rationality assumed by the Domar-Musgrave analysis. Second, we do not have a Haig-Simons income tax, as assumed in the model, because there are various loss limitations imposed by the income tax.

First, individual behavior: Various empirical studies have attempted to examine whether individuals adjust their portfolios in the ways required for the Domar-Musgrave analysis to be correct. Weisbach surveys the literature and concludes that ''the empirical evidence is insufficient to sway us one way or another.''[25] More broadly, economists have studied generally how sensitive the behavior of the rich is to taxes and concluded that, in many cases, that sensitivity is surprisingly low. For

[22]Weisbach, *supra* note 8; *see* Bankman and Griffith, *supra* note 8.

[23]Reed Shuldiner, *Taxation of Risky Investments*, unpublished manuscript on file with author.

[24]*Id.*; Larry Zelenak, *The Sometimes-Taxation of the Returns to Risk-Bearing Under a Progressive Income Tax*, unpublished manuscript on file with author.

[25]Weisbach, *supra* note 8.

example, in most of the empirical studies in Joel Slemrod's book on taxation and the rich, the expected tax avoidance behavior either did not materialize or was lower than expected.[26] There are many considerations that influence individual behavior beyond taxes, and transaction costs make a difference as well. Because the consumption tax advocates are using the Domar-Musgrave result to advocate a radical change in our tax law, it seems to me that the burden should be on them to show that the risky returns are in fact not reached by the income tax, rather than (as Weisbach suggests) on the advocates of the income tax to show that the Domar-Musgrave model is incorrect.

Second, loss limitations: The existing income tax imposes various limitations on losses, such as the at-risk, passive activity, and capital loss limitations. In addition, it imposes graduated (progressive) tax rates, so that losses can sometimes be deducted at different rates than the rates applied to income. All of these limitations violate the Domar-Musgrave assumptions and result in a positive tax rate being imposed on the return to risk under the existing income tax.

Various critics have rejected the argument on the ground that it is hard to find a normative justification for the particular pattern of taxing risk imposed by those limitations, except perhaps for progressive rates. In addition, Weisbach argues that this issue is irrelevant because the debate is about comparing Haig-Simons taxation to a consumption tax, not about the current income tax.

However, the key question in the debate is not whether we do or do not have a perfect income tax. The key issue is whether the existing income tax succeeds in taxing the rich in ways that a real consumption tax would not. A tax is just a means to an end, not an end by itself. If the purpose of having an income tax like the one we have is to tax the rich, as argued above, the key issue is whether it succeeds in doing so.

There is abundant empirical evidence that the income tax does in fact tax the rich. First, according to 2001 IRS data, the top 1 percent of the U.S. population by adjusted gross income paid 33.89 percent of federal personal income tax, and the top 5 percent paid 53.25 percent (by comparison, the bottom 50 percent of the AGI distribution paid less than 4 percent of total income taxes collected). That is a significant increase from 1994 when the top 1 percent of taxpayers only paid 28.7 percent of federal personal income tax.[27] In 2004, even after President Bush's tax cuts, the top 1 percent still paid 32.3 percent of federal individual income taxes and the top 5 percent paid 53.7 percent.[28] Because (as indicated below) a very large portion of the income of the rich consists of risky returns, it is hard to explain those patterns if risky returns are in fact exempt from tax.

Second, it appears likely that those significant payments by the rich are in large part the result of taxing risky returns to capital, not labor income or nonrisky returns. There is a strong correlation between wealth and the percentage of an investor's portfolio allocated to risky assets, so that it is likely that a significant portion of the rich's income derives from risky assets. Specifically, the percentage of income from equity investments (dividends and capital gains), which are the most common type of risky asset, increases from 4 percent for taxpayers with incomes of $100,000 or less, to 11.5 percent for taxpayers with incomes from $100,000 to $500,000, 24.7 percent for incomes between $500,000 and $1 million, 37.6 percent for incomes between $1 and $10 million, and an impressive 61.4 percent for taxpayers whose incomes exceeds $10 million.[29] Another indication that the income tax does reach risky returns is that total revenues from the federal personal income tax rose dramatically in the Internet bubble of the late 1990s and fell dramatically as the bubble burst in 2000. Most of that rise and fall is attributable to realizations of risky assets in the bubble years.

It is not entirely clear *why* the return to risky assets is taxed under the existing income tax. A combination of loss limitations and limitations on investor behavior (such as transaction costs, credit risk, and myopia) may explain the observed pattern. However, the key issue is not why this result occurs but that it does, in fact, occur. The burden should be on the advocates of radical tax reform to show that the existing income tax (and not some theoretical construct like Haig-Simons) fails to tax the rich on risky returns. It is, after all, the existing income tax that they seek to replace, not some ideal tax. If they can show that the top 1 percent by AGI would continue to bear over a third of the total burden of a consumption tax, then the reform would be more acceptable to those who believe in taxing the rich for the reasons stated above (or any other reasons).

Moreover, it seems to me that this distribution of the burden makes the existing income tax normatively attractive even if its particular rules operate in sometimes erratic ways. Thus, I disagree with Profs. Deborah Schenk and Larry Zelenak, who argue that the existing tax on capital is too unpredictable to be normatively attractive.[30] We should look at the tax burden and its meaning from an aggregate, not from an individual perspective. A tax that is as progressive *in its overall outcome* as the existing income tax is worth defending even if its rules lead to strange results in individual cases. The key issue is the ultimate burden imposed on the rich, not the particular rules of the tax (progressivity, loss limitations, and the like).

Finally, a word of caution is in order. The risk argument advanced by Bankman, Griffith, and Weisbach bears a lot of similarity to the argument used (for example, by Weisbach) to justify the adoption of the check-the-box rule in 1997 for classifying foreign entities

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[26]*See* Joel Slemrod (ed.), *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* (2001).

[27]Joint Economic Committee, *New IRS Data on Income and Tax Shares* (2001).

[28]Congressional Budget Office (2004).

[29]Tax Policy Center (2004).

[30]*See* Zelenak, *supra* note 24; Deborah H. Schenk, "Saving the Income Tax With a Wealth Tax," 53 *Tax L. Rev.* 423 (2000).

as branches, partnerships, or corporations. Weisbach and others argued that taxpayers can in fact achieve any result they want under the existing classification rules, so that it would save administrative costs to replace those rules with a simple election.[31] The results of that radical reform were catastrophic: It turns out that a vastly higher number of taxpayers made check-the-box elections and used classification to avoid the international tax rules. Apparently, there were significant transaction costs imposed under the pre-1997 regime that prevented taxpayers from achieving like results. That episode should lead us to be very cautious in relying on theoretical constructs like the Domar-Musgrave model to advocate replacing the income tax with a consumption tax because they are ''just the same.'' For whatever reasons, the current income tax succeeds in taxing the rich. It is highly doubtful that any consumption tax would achieve the same outcome (although as we will see below, some are better than others).

C. Rents: Prepaid vs. Postpaid Taxes

Much of the consumption tax literature relies on the familiar Cary Brown theorem, which is studied in every basic tax class. The Cary Brown theorem demonstrates the theoretical equivalence, under certain assumptions, of prepaid and postpaid consumption taxes in exempting the return to capital from tax. In a prepaid tax, the tax is paid when the income is earned, just as in an income tax, but investment returns are exempt from tax. In a postpaid tax, a deduction is available for savings, so that income that is saved is not taxed, but investment returns are taxed when they are consumed.

To take a common example, suppose a taxpayer earns $100 subject to a tax of 50 percent and can invest it in a bond earning 10 percent per year. Under an income tax, the $100 of earnings are subject to a tax of $50, and the remaining $50 are invested in the bond, yielding $55 after 1 year; the $5 of interest is subject to income tax (Mill's ''double tax'') leaving the taxpayer with only $52.5.

In a prepaid consumption tax, the $100 of income is subject to tax of $50 when earned. The remaining $50 are invested in the bond, but when the additional $5 of interest is earned, they are exempt from tax, so that the taxpayer is left with $55.

In a postpaid consumption tax, the $100 of income are saved, and the resulting deduction eliminates the tax on the $100, so that the taxpayer can invest the entire $100 in the bond. However, when the bond is sold for $110 a year later and the $110 are consumed, they are subject to tax at 50 percent, leaving the taxpayer with the same $55 as in the previous example.

Hence, the Cary Brown theorem demonstrates that pre- and postpaid consumption taxes are equivalent, and both exempt the $5 return on the bond from tax. Since income from capital is exempt, under the Haig-Simons definition of income, both pre- and postpaid consumption taxes are also theoretically equivalent to a direct tax on consumption like the retail sales tax (RST).

The Cary Brown theorem makes two important assumptions. The first is that tax rates do not change between the time the income is saved and the time it is consumed. If the tax rate changes, the equivalence of pre- and postpaid consumption taxes does not hold, because a prepaid tax applies the rate at the beginning of the year and a postpaid tax applies the rate at the end of the year. However, that assumption may not matter too much because rates can either increase or decrease over time, so that it is unclear which form of the tax is more beneficial to the taxpayer.

The other assumption, however, has clear implications. That is the assumption that the taxpayer can invest the savings from taking the tax deduction in a postpaid tax at the same rate as the underlying investment. That holds true when the investment is a commonly available one like a bond, yielding what the economists call marginal (normal) returns. However, suppose the underlying investment is in a unique business opportunity, yielding what the economists call inframarginal (extraordinary) returns, or rents. In that case, the investor may not be able to invest the tax savings at the same rate as the underlying investment because the size of the unique investment opportunity is limited, and the Cary Brown equivalence does not hold.

For example, suppose in the example above the underlying investment yields a 50 percent return but the tax savings can only be invested in a bond earning 10 percent. In a prepaid tax, the taxpayer earns $100, pays $50 in tax, and invests the other $50 in the high-yielding opportunity, resulting after a year in a $25 return that is exempt from tax, for a net after-tax of $75. In a postpaid tax, the investor earns $100 and does not pay tax because of the deduction for savings; however, of the $100, only $50 can be invested at a return of 50 percent, and the other $50 (the tax savings) are invested at 10 percent. The result is a yield after a year of $75 from the underlying investment and $55 from the tax saving, for a total of $130, and when those are consumed and are subject to tax at 50 percent, the taxpayer nets only $65. To put it another way, in a postpaid tax, only the normal yield is exempt from tax; the extraordinary yield is fully taxable.

Ed McCaffery uses that result to argue for a postpaid consumption tax.[32] In his view, such a tax is superior to an income tax because it does not tax the normal return to savings, but it is also superior to a prepaid consumption tax because it does reach extraordinary returns to savings when they are consumed. Or to put it another way, the tax is deferred when savings are used to smooth income over a lifetime, but imposed when the savings are consumed above the return necessary for that smoothing.

While I disagree with McCaffery about taxing unconsumed earnings, for the reasons explained above (and elaborated further below), I agree with him regarding the superiority of postpaid over prepaid consumption taxes because of their ability to reach rents. Rents should be subject to high taxation in part because they are hard to replicate (and thus the deadweight loss from taxing them is small) and in part because they depend on luck (such

[31] *See* David Weisbach, ''Line Drawing, Doctrine, and Efficiency in the Tax Law,'' 84 *Cornell L. Rev.* 1627 (1999).

[32] McCaffery, *supra* note 9.

as the distribution of various talents). The key issue is how common are those rents. There is abundant literature that suggests that rents are common for corporations, and that may be why most serious consumption tax proposals (but not some of them) support a postpaid (cash flow) consumption tax for corporations.

However, there is also evidence that in a ''winner take all'' society, rents are commonly earned by individuals as well. Consumption tax advocates sometimes argue that those rents are a form of labor income, not income from capital. Thus, the extraordinary returns earned by Bill Gates or Warren Buffett presumably result from their skill and luck and not primarily from capital invested (which in the case of Gates was minimal). However, it seems to me immaterial whether those rents earned by individuals are capital or labor income. The key issue is to ensure that they are taxed, and while the current income tax does not do a very good job in taxing them (primarily due to the realization requirement), it does a better job than a prepaid consumption tax that exempts those rents altogether. Whether a postpaid consumption tax can reach them depends on whether they are in fact consumed, which I will discuss below. For now, it is important to remember that only postpaid consumption taxes can reach rents, because that is a key issue in differentiating among the various tax reform proposals currently advanced.

D. Can a Consumption Tax Be Progressive?

Many consumption tax advocates argue that a properly structured consumption tax can be just as progressive as the income tax. The most promising candidate from this perspective is a postpaid consumption tax, because as we have seen it can impose progressive rates on both labor income and on rents when those are consumed. On the other hand, transactional consumption taxes like the RST cannot generally be progressive because they are imposed at a uniform rate and because the poor consume a higher proportion of their income than the rich. Nor can prepaid consumption taxes be as progressive because they exempt rents even when those are consumed.

The key issue regarding regressivity is whether any consumption tax, even a postpaid one, can be as progressive as an income tax given that it does not by definition reach income that is not consumed. The super-rich do not consume a significant portion of their income during their lifetime, and an income tax can in principle tax those earnings (or at least the risk-free portion of them) whereas even a postpaid consumption tax does not.[33]

Dan Shaviro argues that that perception is mistaken because a consumption tax will always tax income whose consumption is deferred, even if it is deferred for a long time. He gives an example of taxpayers A and B who both consume \$100,000 in a given year, but A has spent everything she earned whereas B has saved \$1 million in the bank. Assuming a 50 percent consumption tax rate and a 10 percent interest rate, A presumably earned \$200,000 and B earned \$1.2 million, and each paid \$100,000 in tax. B's remaining \$1 million grows to \$1.1 million and when it is consumed B pays \$550,000 in tax. Shaviro points out that this is the same additional \$500,000 in tax liability B would have had had she consumed everything in year 1, increased by the interest rate of 10 percent to take into account the one-year deferral. Thus, A and B are in fact treated the same.

More generally, Shaviro argues that any income is only worth what it can buy; ''otherwise, it might as well be play money from the board games Monopoly or Life.'' Thus, it is wrong to argue that a consumption tax fails to reach the indirect benefits of wealth-holding, such as security, political power, or social standing; this non-sequitur ''appears to rest on money illusion, or the mistaken belief that a dollar has inherent value, rather than being worth what it can buy.''[34]

However, the argument ignores the fact that money can be used for other things than consumption. Most importantly, it can be used to acquire investments — both financial and real, such as manufacturing plants. And the key point made above is that the power of the rich, which is (in my view) the principal target of the income tax, rests primarily on their ability to invest, not to consume. For example, it is the ability of corporations to choose which locations to open plants and create jobs that makes politicians so solicitous of their welfare — more, in fact, than their direct political contributions. But even in the case of political contributions, it is unclear whether those would be reached by a consumption tax, because it can persuasively be argued that those are a form of investment rather than consumption. Thus, a consumption tax would only reach the small percentage of the power of the rich that depends directly on their ability to consume, such as their personal employees or businesses that provide consumer goods to them. It would not reach the much larger percentage of their power that depends on their ability to invest.

Theoretically, therefore, no consumption tax can achieve the goals of progressivity, which I have argued above are to curb the power of the rich, as well as an income tax. That does not mean that the current income tax does a very good job, although it appears from the data cited above to be quite progressive. Perhaps a consumption tax that taxes labor income at sharply graduated rates and also reaches actual consumption of saved income can be as progressive as the current income tax.[35] However, the burden should be on consumption tax advocates to show that this is indeed the case; the distributive tables of President Bush's steps toward a consumption tax suggest otherwise. In addition, the income tax, because it reaches unconsumed income, can be made more progressive in ways that a consumption tax cannot, because it can reach the main source of the power of the rich — their unconsumed wealth.

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[33]Theoretically, leaving accumulated wealth to one's heirs can be defined as a form of consumption, but none of the current consumption tax proposals do so.

[34]Shaviro, *supra* note 10.

[35]One should note, however, that the sharply graduated rates of such a tax come at a price, namely increased pressure on the labor/leisure tradeoff.

III. What Kind of Consumption Tax?

There are three major proposals currently advanced for replacing the income tax with a consumption tax. They are: a proposal to enact a federal RST (a transactional consumption tax), the flat tax and its variant the X tax (prepaid consumption taxes), and the cash flow tax (a postpaid consumption tax). I will discuss each in turn, comparing each with the existing income tax and with a VAT, and also consider some of the international implications of adopting those proposals.

A. A Federal RST

The RST proposal (for example, H.R. 25, introduced by Rep. John Linder, R-Ga.) would abolish all federal taxes and replace them with a uniform 23 percent RST to be administered by the states. Unlike the state RSTs, however, the federal tax would apply to services as well as goods, would apply only to final sales to consumers, and would apply regardless of whether the selling entity has a physical presence in the state in which the consumer lives. Thus, the federal RST is designed to address the major flaws of the current state RSTs (discussed in more detail below): they generally apply only to goods, not to services; they apply in many cases to business-to-business transactions; and they cannot be collected on sales by remote vendors (via catalogs or e-commerce).

Nevertheless, the federal RST proposal is badly flawed. First, in comparison with the income tax, it is highly regressive. As a transactional tax, it cannot take into account the personal characteristics of the buyer or have a progressive rate schedule. While it may be possible to build in exemptions for some necessities like food or clothing, as the states do, the effect would make the tax much more complicated, would require much higher rates on the remaining items, and would still be regressive. This proposal is a step back to 19th century federal finance, based entirely on regressive tariffs and excises. The result is acceptable only if one believes that ultimately wealth is valuable only as deferred consumption, which I have argued above is not the case.

Second, the tax is unadministrable. No country in the world has tried, much less succeeded, to collect a single stage sales tax with rates exceeding 20 percent. The reason is that with only one point of collection, evasion opportunities are rampant. Moreover, enforcement would be entirely up to the states, some of whom do not currently have an RST. It is likely that states would compete with each other in lax enforcement, given that the revenue would flow to the federal government (as they do, for example, in Germany where the states collect the federal VAT).

The VAT, in contrast, has a much better enforcement record. Many countries, including developing countries with weak tax administrations, have succeeded in collecting VATs at rates well over 20 percent. The reason is that in an invoice-credit VAT, the taxpayers are recruited to and have an interest in helping the tax administration collect the tax. An invoice-credit VAT works by collecting tax at each intermediate transaction, as in the following example assuming a 10 percent (tax-exclusive) VAT:

Manufacturer sells widget to wholesaler for $100, pays tax of $10 (output tax).

Wholesaler sells widget to retailer for $200, pays tax of $20, receives credit of $10 for tax paid by manufacturer (input credit).

Retailer sells widget to consumer for $500, pays tax of $50, receives credit of $20 for tax paid by wholesaler.

The net result is that the government imposes tax of $80 ($10 + $20 + $50) but gives out credits of $30, for a net collection of $50, just as if the tax was an RST imposed only on the final sale from retailer to consumer. However, because the tax is collected in three stages rather than in one, the chances for evasion are much smaller: If the wholesaler fails to pay the tax on the purchase from the manufacturer, the retailer would not get a credit, and therefore the retailer has an interest in ensuring that the wholesaler pays his share of the tax. Similarly, if the manufacturer does not pay tax, the wholesaler would not get a credit. The only transaction to which this monitoring does not apply is the final sale from the retailer to the consumer, and indeed it is in that stage that evasion takes place in a VAT. But the revenue at stake if evasion takes place successfully is only $30, not the full $50, as in an RST. In a VAT, there is an incentive to be "in the system" and not make exempt sales, since no input credits are available for those sales.

If we are serious about abolishing the federal income tax and replacing it with a transactional consumption tax, the only plausible candidate would be a VAT, not an RST, administered by the federal government, not by the states. But that is not a plausible option given the regressivity of the proposal.

B. The Flat Tax and the X Tax

These two proposals are quite similar but differ in one important way: The flat tax (for example, H.R. 3060, introduced by Rep. Nick Smith, R-Mich., and others), as its name implies, has only one rate, while the X tax (proposed by Prof. David Bradford) has progressive rates on wage income.

In both cases, the tax includes a cash flow tax on businesses, which is the same as a subtraction method VAT except that wages are deductible.[36] Thus, a business deducts all expenses (including capital expenditures) and includes all income from sales. Financial transactions are ignored, so that interest is neither includable nor deductible, and margins go untaxed.

At the individual level, wages (including deferred compensation in the form of retirement benefits) are taxed as income either at a flat rate with an exemption or at graduated rates. Interest, dividends, and capital gains are not taxed. The combination is a consumption tax at the business level because of the current deduction for capital expenses (so that normal income from capital is exempt under the Cary Brown theorem). At the individual level, the tax is a prepaid consumption tax because income from capital is exempt.

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[36] A VAT can be collected either by the invoice-credit method (described above and used primarily in Europe) or by the subtraction method (used in Japan), in which a business includes all sales and deducts all purchases.

In comparison with the income tax, the flat tax and X tax may be acceptable at the business level, because only the normal return to capital is exempt under the cash flow tax (although that may have adverse international implications, discussed below). However, at the individual level, even rents are exempt, because (as explained above) they are not reached by prepaid consumption taxes. Thus, the tax is acceptable only if we believe that the existing income tax fails to reach most returns to capital and even returns to labor in the form of rents (such as the returns of Bill Gates or Warren Buffett). As argued above, the best evidence is that this is not true, and therefore even the X tax with its progressive rates on labor income would tax the rich less than the existing income tax.

In comparison with a VAT, those proposals are deficient for two reasons. First, they are less easy to administer at the business level than an invoice-credit VAT because they require the administrative mechanism of an income tax to police deductions. That is why the vast majority of countries have opted for an invoice-credit VAT. Second, because of the deduction for wages, the flat tax and X tax do not qualify as an indirect tax for World Trade Organization purposes. As a result, the rebate of this tax embedded in export prices (if it could be calculated with precision) likely would constitute a prohibited subsidy under the WTO rules. To comply with the WTO rules they must be origin- rather than destination-based. I will discuss the relative advantages of each system below, but for now it suffices that origin-based taxes suffer from the same transfer pricing issue as an income tax. Under an origin-based tax, imports are deducted and exports are included in the tax base, which means that transfer pricing is a problem when either imports or exports are from or to a related party. If the flat tax were destination-based, on the other hand, exports would be excluded from the base and imports would not be deductible, so the problem would not arise. That is one reason why every country that has adopted a VAT has opted for the destination principle, which is also superior for other reasons (explained below).

C. Cash Flow Taxes

A cash flow tax is the best form of consumption tax proposal (for example, H.R. 269, introduced by Rep. Phil English, R-Pa.). It includes a cash flow, destination-based VAT at the business level, which exempts only the normal return to capital. At the individual level, it is a postpaid consumption tax, with a deduction allowed for savings but all cash flows included in the base, and progressive rates. Thus, rents are taxed for the reasons explained above at both the business and individual levels.

In comparison with the income tax, the only problem is the nontaxation of savings until they are consumed. As argued above, that is a problem if one believes, as I do, that the main purpose of an income tax is to curb the power of the rich, and that power is expressed primarily through investing unconsumed income.

In comparison with the VAT, the cash flow proposals include a normal destination-based, consumption VAT at the business level. The only issue is the choice of a subtraction method rather than a credit invoice method to make the tax resemble an income tax. I believe the credit invoice method is superior from an administrative perspective, but reasonable people can disagree on this point.

D. International Implications

One of the major reasons to reject any tax reform that replaces the income tax with a consumption tax is the international implications of such a move. I have argued elsewhere that a situation in which the United States does not levy taxes on the normal return to capital, while the rest of the world has a normal corporate income tax, is untenable. It would result in massive shifts of capital to the United States, the unraveling of the income tax treaty network, and either the end of the income tax in other countries (the better result, but one not likely to please our trading partners) or a ''tax war'' in which those countries try to capture the revenue we have foregone to tax.[37] None of those problems arise if the United States adopts an invoice-credit, destination-based VAT in addition to the existing income and corporate taxes. In that case, we would be following the rest of the world. The lack of a VAT in the United States is a glaring anomaly in our tax policy, and it is time for it to be corrected.

However, not everybody agrees with the critique of the international aspects of consumption tax proposals set out above. In his article ''Ironing Out the Flat Tax,'' Prof. David Weisbach mounts a trenchant critique of all aspects of the flat tax proposal.[38] All, that is, except one — the international dimension. In its international aspects, Weisbach writes, ''most of the implementation issues . . . are not that serious, which is important given that some have claimed that these issues are significant.''[39] Because the only person he cites as those ''some'' is myself, and because his observations apply to all the consumption tax proposals discussed above, I would like to take this opportunity to respond to some of his critique.

The first point Weisbach raises as a potential issue is transfer pricing. Because the flat tax is an origin-based system, Weisbach acknowledges that transfer pricing would be an issue, for the reasons stated above. However, he states, ''[i]t is likely that the transfer pricing regime in the Flat Tax would be similar to current law in both scope and complexity.''[40] Therefore, it is not a reason not to adopt the flat tax.

The argument is wrong for two reasons. First, because the flat tax is territorial, transfer pricing applies to both inbound transactions (sales by foreign corporations to related domestic corporations) and outbound transactions (sales by domestic corporations to related foreign corporations). Our current system, however, is in principle global, so that the transfer pricing issue applies primarily to inbound transactions. For outbound transactions, it is true (as Weisbach notes) that transfer pricing is an issue under current law because we grant deferral to

[37]*See* Reuven S. Avi-Yonah, ''From Income to Consumption Tax: Some International Implications,'' 33 *San Diego L. Rev.* 1329 (1996).

[38]David A. Weisbach, ''Ironing Out the Flat Tax,'' 52 *Stan. L. Rev.* 599 (2000).

[39]*Id.* at 641.

[40]*Id.* at 642.

most forms of active income earned by subsidiaries of U.S. corporations. But crucially, we do not grant deferral to those outbound transactions that raise the most important transfer pricing concerns, that is, base company transactions (in which goods are sold from the United States to a tax haven subsidiary and then resold at a hefty markup to non-tax haven subsidiaries or to consumers in high-tax countries). Those rules were enacted in 1962 in response to the *Dupont* case, which took the IRS 20 years to litigate. Adopting a territorial system (either as part of the flat tax or otherwise) would invite massive shifting of profits to overseas subsidiaries in tax havens, which would dwarf the significant shifting that takes place currently. Thus, it is not accurate to say that ''[a]t most, more enforcement or a slightly stronger set of regulations might be needed.''[41] A territorial system like the flat tax would require much more transfer pricing enforcement (as well as more enforcement of sourcing rules) than our current system. In addition, our current regime could be improved dramatically from that perspective by eliminating deferral altogether, which would leave transfer pricing as a problem only for inbound transactions.

Second, Weisbach is wrong here because he ignores the existence of a much better alternative — the one proposed below, namely a destination-based consumption tax, like all current VATs. A destination-based tax does not give rise to transfer pricing issues. Even David Bradford, who otherwise favors the flat tax (or a variant thereof, the X tax), has recently come out in favor of modifying the origin-based system to address transfer pricing concerns.[42] In evaluating the flat tax, it should not only be compared with the current income tax; it should also be compared with other consumption tax alternatives (like a VAT or the USA tax, both of which are destination-based), as well as to possible reforms of the income tax (like abolishing deferral).

The second point Weisbach raises concerns whether the flat tax would be creditable under income tax treaties. I have argued that it likely would not be because it is a consumption tax, and because the IRS has ruled that a similar cash flow tax proposed by Bolivia was not creditable. Weisbach disagrees, but he also does not believe the creditability of the flat tax is a ''very serious'' issue. For marginal (risk-free) returns to capital, he argues, noncreditability is not an issue because on a present value basis the flat tax rate is zero, so the fact that other countries may not credit it is irrelevant. For inframarginal (above normal) returns, he argues that if they are specific to the United States, the foreign investor has to be in the United States in any case, and therefore the lack of a credit would not affect the decision where to invest. Thus, the issue arises only if there are inframarginal returns not specific to the United States, and that ''is unlikely to be a large category.''[43]

Weisbach is clearly right to say that to the extent the flat tax imposes a zero rate on marginal returns to capital income, the fact that it is not creditable should not matter. In that case, there is no double taxation; instead, the foreign country may just step into the vacuum and levy its own tax on the return the United States refrains from taxing. The net result is a transfer of revenue from the United States to the foreign Treasury, which I am not sure is what the supporters of the flat tax have in mind.

Weisbach is also correct in pointing out that if inframarginal returns can be earned only in the United States, the investor is likely to earn them here even if they are subject to full double taxation. It should be noted, however, that unless it has a monopoly, the foreign investor may have to compete with U.S. investors that bear the burden of U.S. taxation only on the same inframarginal returns. It has recently been argued that that situation could lead to the foreign investor being forced out of the U.S. market.[44]

Where I disagree with Weisbach on this point is in his assessment of the frequency with which foreign investors are likely to earn inframarginal returns that are not specific to the United States. There exists a huge literature on why multinational enterprises exist, and most of it suggests that they exist because they can earn inframarginal returns by internalizing costs that would have to be borne in arm's-length transactions.[45] Moreover, most of these inframarginal returns are *not* specific to any country; they result from the multinational possessing, for example, intangible assets that can be utilized in many places. That is the key to the existence of tax competition in which multinationals conduct an auction among several countries that are otherwise equivalent to see which one will grant them the biggest tax breaks. The whole point of the competition is that the multinational can earn inframarginal returns in more than one country.[46] Thus, if those returns are subject to double taxation in the United States but to single or no taxation elsewhere, the multinational will not invest in the United States. Contrary to Weisbach's assessment, that is likely to be a frequent occurrence.

Weisbach further argues that I am wrong in concluding that existing U.S. treaties would not apply to the flat tax, because ''income taxes are not defined in treaties. While the flat tax would tax consumption, not income, it is not labeled a consumption tax, which seems to be the key factor.''[47] He points out that there were periods in U.S. history in which accelerated depreciation led to the effective rate on capital income being zero (for example, 1981-1982), and that other countries did not abrogate their treaties.

While it is true that treaties were not abrogated in the early 1980s, the Reagan administration did not label the adoption of accelerated depreciation as fundamental tax reform, and it retreated from the zero rate within one

[41]*Id.* at 642.

[42]David Bradford, *The X Tax in the World Economy* (2004).

[43]Weisbach, ''Ironing,'' *supra* note 38 at 643.

[44]*See* Mihir Desai and James Hines, ''Evaluating International Tax Reform,'' 56 *Nat'l Tax J.* 487 (2003).

[45]*See, e.g.*, Pitelis and Sugden, *The Nature of the Transnational Firm* (1998), ch. 2.

[46]*See* Reuven S. Avi-Yonah, ''Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State,'' 114 *Harv. L. Rev.* 1573 (2000).

[47]Weisbach, ''Ironing,'' *supra* note 38 at 643.

year because of its dire budgetary consequences. If the flat tax were adopted, it would be intended as a permanent measure, and everyone would be aware that the United States has explicitly abandoned the income tax in favor of a consumption tax. It seems highly unlikely that this would not lead other countries to reconsider their income tax treaties with the United States, especially if (as argued above) the U.S. reform leads to a significant capital outflow from those countries to the United States. There are no tax treaties for VATs, and there is no reason to maintain treaties for the flat tax, which is (as everyone, including Weisbach, acknowledges) a form of VAT. Moreover, as Weisbach also acknowledges, countries would have no reason to renegotiate their treaties because the flat tax unilaterally abolishes our main negotiating leverage, the withholding tax.

Weisbach also argues that my prediction that the United States would become a tax haven is "simply incorrect" because "[t]he United States previously has had a very low, even negative, tax on capital income, and problems with foreign investors sheltering income in the United States were not sufficient to cause serious international concerns."[48] This ignores three facts: First, the previous period of zero or negative rates on capital income in the United States was very short (1981-1982). Second, capital mobility now is much higher than it was in the early 1980s. And finally, European economists have documented that the Reagan tax cuts of 1981 did in fact have very serious negative consequences for Europe and the world economy, including rising European unemployment and a sharp rise in the value of the dollar that forced a concentrated intervention to bring it down in 1987.[49] I believe those negative consequences would be dwarfed if the United States were to permanently adopt a zero tax on marginal returns to capital. It is hard to imagine that any country could continue to tax capital income, just like the unilateral abolition of withholding on portfolio interest by the United States in 1984 forced all other countries to do the same. Some, of course, would welcome the end of the income tax, but I do not share their enthusiasm, and neither do some other thoughtful observers.[50]

Weisbach argues correctly that adoption of the flat tax could lead to dramatic simplification of the international tax rules, because both the antideferral and foreign tax credit rules could be eliminated.[51] The same degree of simplification can be achieved by adopting a territorial income tax, so this is not just a feature of the flat tax. The price to be paid, however, is significantly increased avoidance potential, as U.S. multinationals shift their income overseas through transfer pricing and similar planning techniques. Simplification, as many observers have noted, is not the only criterion for a well functioning tax system. Efficiency and equity are also relevant, and both are decreased under a territorial system.

Weisbach concludes by stating that "[d]espite the complexity of the economic issues, the design considerations for international taxation under the flat tax are mostly good news."[52] For the reasons given above, I respectfully disagree.

IV. Should the U.S. Reinvent the Wheel?

In this section, I will develop a proposal to adopt a federal VAT in addition to the existing income tax. I will first discuss some of the structural issues that need to be addressed in designing a federal VAT. Next, I will address the relationship of the proposed tax to state and local RSTs. Finally, I will distinguish this proposal from the proposal advanced by Michael Graetz to adopt a federal VAT but exempt the first $100,000 of income from the income tax.

A. A Federal VAT

In general, a VAT is superior to the income tax for several reasons. First, it is much simpler to administer, as evidenced by the ability of developing countries with weak tax administrations to collect significant revenue from it (while failing to collect the personal income tax). Second, it is less subject to cyclical fluctuations in the economy. Third, it is less subject to tax competition, because consumers are less mobile than capital. Fourth, it can reach sectors that are hard to tax otherwise (such as the informal sector, the criminal sector, and the nonprofit sector). Its main drawback is its regressivity, but that can be addressed by using other, more progressive taxes to tax the rich, and by using the revenues in progressive fashion. Thus, it is not surprising that most countries in the world use the VAT as their primary tax, and even in OECD member countries it is approaching the income tax in importance as the main source of government revenues.[53]

Any VAT proposal has to address several issues: Will it be a consumption or income VAT; will tax liability be determined by the invoice-credit, subtraction, or addition method; will the tax be destination- or origin-based; and what exemptions will be allowed?[54]

1. Consumption vs. income VAT. A VAT can be either a consumption- or an income-type VAT. A consumption-type VAT allows for expensing of all business expenditures, including the purchase of capital goods and inventories. An income-type VAT, on the other hand, allows only capital expenses to be depreciated, like the income tax. In a consumption-type VAT, but not in the income-type, the normal return to capital is exempt under the Cary Brown theorem.

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[48] *Id. at 644.*

[49] Hans Werner Sinn, "U.S. Tax Reform 1981 and 1986: Impact on International Capital Markets and Capital Flows," 41 *Nat'l Tax J.* 327 (1988).

[50] *See, e.g.,* Michael J. Graetz, *The Decline (and Fall?) of the Income Tax* (2001).

[51] Weisbach, "Ironing," *supra* note 38 at 644.

[52] *Id.* at 645.

[53] Countries with VAT use it to raise an average of 27 percent of total revenues and 5 percent of gross domestic product. *See* Ebrill *et al.*, *The Modern VAT,* p. 8 (2001). In 2001 taxes on goods and services accounted for 31.3 percent and corporate and personal income taxes accounted for 36 percent of total revenue. OECD Revenue Statistics 1965-2002, Table 3 (2003).

[54] Some countries use multiple rates as well, but they are not discussed in this article.

Almost all countries follow a consumption-type VAT, although some restrict the deductibility of large capital expenditures for revenue reasons. The United States should adopt a consumption-type VAT because it is much simpler to administer than an income-type VAT. In fact, one of the major simplification advantages of a consumption tax is to get rid of accounting for basis for both inventory and capital goods, which is the source of significant complexity in the income tax. Moreover, the concerns that arise because of the exemption of the normal return to capital from tax, primarily in the international context (described above), do not apply in the context of this proposal because the corporate income tax will be retained.

2. Invoice-credit, subtraction, or addition VAT. In theory, a VAT can reach the same result either by using an invoice-credit method, a subtraction method, or an addition method. Under the invoice-credit method (a tax against a tax calculation), input credits are granted against tax on taxable sales on showing an invoice indicating that output tax has been paid. Under the subtraction method, a business deducts its taxable purchases from other registered firms from its taxable sales to arrive at the tax base, to which the tax rate is applied. Under the addition method, the various factors of production (wages, rent, interest expense, and profit) are added up as the tax base.

The vast majority of countries using the VAT use the transaction-based invoice-credit method. Japan uses a modified form of the subtraction method, but has recently come to rely more on invoices to audit the tax. Israel uses a form of the addition method for financial institutions and insurance companies (and so do Michigan and New Hampshire for all companies).

One could argue that using the subtraction method is preferable for the United States because it is more familiar and "feels" more like an income tax. It is based on accounts for taxable periods, not on transactions, and involves the subtraction of deductions from taxable sales (and is thus much more vulnerable to base erosion). In addition, it is less obviously competitive with the state RST, and some commentators have expressed concern about two taxes (the federal VAT and state RST) being stated on the same invoice.

However, I believe that the better choice for the United States would be to adopt an invoice-credit VAT like the majority of other countries. First, because in my proposal the income tax is retained, I think it is better to sharply distinguish the VAT from the income tax by making it a transparent transactional tax that is stated on invoices. Otherwise, businesses are likely to face the confusing burden of filing periodic returns for both income and VAT liability with different sets of inclusions and deductions for each. Many of the design problems with some of the current consumption tax proposals in the United States (for example, the problems with WTO, discussed above) result from the attempt to make them look more like an income tax. If we adopt a consumption tax we should be clear about what we are doing and distinguish it as much as possible from the income tax.

Second, the invoice-credit VAT is difficult to evade, because it most clearly invokes the interest of business purchasers in ensuring that tax was paid by their suppliers. That is why even Japan relies more on invoices than it did previously.

Third, I do not think the concern about the state RST is well taken. For reasons explained below, I think the federal government should not accommodate the state RST in any way, but should instead put pressure on the states to adopt the VAT.

3. Destination or origin VAT. A VAT can be either destination-based, that is, imposed on imports and zero rated on exports, or origin-based, that is, with imports deductible and exports includable. Economists have argued for a long time that border adjustability (that is, a destination-based VAT) does not boost exports because exchange rate adjustments would ensure that in the long run the relative prices in the exporting and importing country would be the same as before the imposition of the tax. That is, even if country A uses the destination principle and country B the origin principle, so that it seems as if exports from A to B are not taxed at all and from B to A double-taxed, the exchange rate would adjust to eliminate country A's apparent advantage.

There are some grounds to doubt whether that theoretical construct holds in the real world. Exchange rates are notoriously imperfect, and may take a while to adjust. In addition, while there is only one exchange rate, imports and exports may have different balances in different sectors of the economy. Thus, it is not surprising that politicians are convinced that border adjustability boosts exports, at least in the short run. Nevertheless, under the WTO rules, the United States can adopt a border-adjustable VAT, as long as it clearly qualifies as a VAT, which an invoice-credit VAT of the type proposed certainly does.

Moreover, the destination principle is far superior as an administrative matter. It means that all countries in the world use the same principle without the need for an elaborate tax treaty network, as in the income tax. Moreover, the destination principle eliminates the need for transfer pricing enforcement, which is a major issue in the income tax and in origin-based VATs because imports from related parties are deductible and exports to related parties includable in the base.

Thus, I believe the United States should follow the rest of the world and adopt a destination-based VAT. It also makes sense to have a consumption tax apply when goods are consumed and not where they are produced. There is a temptation in destination-based VAT to travel abroad to consume goods and services in low VAT countries, but this "tourism problem" is hardly a sufficient reason not to adopt the destination principle. Moreover, the United States does not have the problem of open borders that the EU and the states face: If goods are purchased in low VAT countries abroad and imported, they can be taxed at the border at the higher domestic VAT rate.

4. Exemptions. Most of the administrative problems associated with VATs abroad result from exemptions. Those fall into three broad categories: item exemptions for some products, like food, clothing, or housing, to alleviate regressivity; entity exemptions for small business regardless of the kind of products sold, to lighten the administrative burden; and exemptions for sectors that are hard to tax, like financial services.

In general, the fewer exemptions allowed, the better, and we should follow the example of countries like New Zealand and South Africa that have VATs with a very broad base (even local government services are taxed in New Zealand). Exemptions to alleviate regressivity are misplaced because the VAT revenues can be used in nonregressive ways. If necessary, a rebate check would even be issued to low-income families, and that would be easier if the income tax mechanism is left in place. That would prevent the endless debate, familiar from the state RST, about which items are and are not exempt.

A threshold for small business is also a bad idea, because it inevitably leads to attempts to disaggregate businesses to put each below the threshold, provides an incentive to omit sales when approaching the threshold, and is contrary to the experience of states in collecting retail sales taxes from small firms. Instead, the federal government should pay small businesses a small subsidy to help cover the costs of compliance with the VAT, such as printing tax invoices or purchasing automated cash registers.

Finally, an exemption for the financial services industry is the worst of all, because it leads to a cascading tax in services rendered to business: If a bank is exempt, it cannot get input credits for its own purchases, nor can businesses that receive services from the bank get credits for those taxes paid by the bank's supplier. The reason the financial services sector is exempt in some countries (primarily in Europe) is because it was mistakenly believed that it would be impossible to unbundle fee-based services (which should be taxable) from intermediation services buried in interest rates (which should be exempt until an administrable way is found to tax those services). But South Africa has shown that bundling does not happen in practice if interest rate competition is strong enough, as is certainly the case in the United States. Thus, both fee-based financial services and casualty and similar insurance (other than life insurance) should be covered.

B. The State and Local Retail Sales Tax

Some of the complexity of consumption tax proposals in the United States results from the attempt to accommodate the state and local RST. However, I believe that the tax is hopelessly broken and should not be accommodated.

The state and local RST in the United States is an old tax, adopted in the 1930s by most states to alleviate the cyclicality of the income tax during the Depression. From today's perspective, it suffers from four major problems that make it hopelessly obsolete.

First, the tax is overinclusive: A very large portion (some estimates are as high as 40 percent) of the RST falls on sales from business to business, because most RSTs only contain exemptions for items that are themselves resold or that are physically incorporated into items that are resold. That means that the tax has a cascading effect (the tax on the final retail sales falls in part on the tax on a previous sale).

Second, the tax is underinclusive: Most services are exempt from the tax. Attempts by Florida and Massachusetts to tax services failed as service businesses threatened to move out of state. Other states tax some services, but the list of which services are taxable is arbitrary and varies greatly by state. Debates and litigation on classifying items as goods or services abound.

Third, state taxes are extremely complex, and needlessly so. That is true of the taxes of individual states and is especially true when the taxes of all states and localities are considered together.

Fourth, because of that complexity the Supreme Court decided in *Quill* that states cannot force vendors to collect use tax on items sold via catalogue or e-commerce from out-of-state locations, because to do so would impose an unconstitutional burden on interstate commerce. Attempts by the states to get Congress to accept their efforts to harmonize the sales tax base and overrule *Quill* have failed.

I believe the last problem offers an opportunity: When adopting a VAT, Congress should overrule *Quill* (and the moratorium on taxation of Internet services) for every state and locality that adopts an identical VAT to the federal one, with only the rate to be determined by the state. Hopefully, the rise of e-commerce should prompt most states to abandon their obsolete RSTs in favor of VATs, which could even be collected by the federal government as a "piggyback" on the federal tax (as is done in several other federal countries).[55]

C. Conclusion: The Graetz Proposal

I am not the first to propose that the United States adopt a destination-based, invoice-credit VAT in addition to the income tax. That proposal has been made over a decade ago, and elaborated more recently, by Prof. Michael Graetz.[56]

However, there is a major difference between my proposal and the Graetz proposal: Graetz proposes using the revenue from the VAT to exempt any U.S. resident with AGI of $100,000 or less from the income tax. Thus, Graetz argues, we will eliminate "100 million unnecessary returns" and return the income tax to its pre-World War II function of taxing the rich.

The Graetz proposal is sensible. As argued above, the main function of the income tax is to tax the rich, so that from this perspective it makes no sense to impose it on middle-income and poor taxpayers. In addition, those taxpayers consume most of their income, so that they can be taxed with a VAT without the complexities of the

[55]*See, e.g.*, the harmonized sales tax of the Canadian Atlantic provinces. In general, there are many different models of accommodating subnational VATs in a system that has a national VAT; Canada has six of them, Brazil yet another. The main point here is that the national VAT should not attempt to accommodate the state RST.

[56]*See* Michael J. Graetz, "100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System," 112 *Yale L.J.* 261 (2002). *See also* Rep. Gibbons's proposal (H.R. 4050, Revenue Restructuring Act of 1996, 104th Cong. 2nd Sess.) to replace the corporate tax, much of the individual tax (for incomes up to $75,000), and the payroll taxes with a sales-subtraction VAT. *See* William H. Morris, "A 'National Debate' on VAT: The Gibbons Proposal," *Tax Notes*, Aug. 30, 1993, p. 1259.

income tax. And to the extent they save, we should be encouraging saving by the middle class, given our abysmal national savings rate.

However, I believe the Graetz proposal is the wrong way to go, at least for now. First, Graetz exaggerates the complexity of the income tax for middle-income taxpayers. Many of them file Form 1040EZ, and take the standard deduction. For those taxpayers, the income tax is not complex at all. We should, however, consider simplifying it further by adopting a pay-as-you-earn (PAYE), return-less system based on employer withholding for taxpayers with only wage income, as is done by many other countries.

Second, and more importantly, we cannot afford the Graetz proposal at present, because it is designed to be revenue-neutral. To finance the retirement and health needs of the baby boom generation, not to speak about other urgent needs like extending health insurance to all Americans, we face a budgetary gap of $70 trillion dollars. There is simply no way to raise that kind of revenue with the existing income tax. Raising income tax rates to the levels of the 1970s or earlier is counterproductive because it imposes too high burdens on the decision to work, and because it drives away investors in the face of global tax competition. Thus, if we do not want to unravel the social compact of the New Deal by drastically cutting benefits, we need to adopt a VAT in addition to the existing income tax.[57]

[57]We could, of course, raise the payroll tax instead, but this seems highly unlikely to be politically acceptable.

The adoption of a VAT on top of the income tax is likely to be opposed by both conservatives and liberals. Conservatives will argue that increasing the overall share of the government in GDP from about 30 percent to about 40 percent, the average level in the OECD, will slow economic growth. They may be right, but the level of economic growth in other OECD member countries has been acceptable, and in some cases (for example, Europe) has been hindered by other factors we do not face, like low labor mobility. I believe that a slightly lower growth rate is an acceptable price to pay for ensuring a decent retirement and healthcare package for the baby boom generation.

Liberals are likely to oppose the VAT because it is regressive. That is true, but as explained above, the regressivity of the VAT can be offset by using the revenue in progressive ways. Both Social Security and Medicare are progressive, and if needed, some of the revenue can be rebated to lower-income families to ensure further progressivity.

In 2003 the United States joined most of the OECD in enacting a form of corporate-shareholder income tax integration. While I have misgivings about that reform, it was a step to eliminate one of the basic ways in which our tax structure differed from that of other OECD member countries. The time has come to eliminate the other, more glaring abnormality of our tax system by adopting a VAT in addition to the existing income tax. The political prospects for this reform may be dim at present; but every year that brings the baby boomers closer to retirement will make those prospects brighter.