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Risks, Rents and Regressivity Revisited

Reuven S. Avi-Yonah

University of Michigan Law School, aviyonah@umich.edu

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Risk, rents and regressivity revisited†

Reuven S Avi-Yonah*

Abstract

This article seeks to survey the debate in the United States about whether the tax base should be income or consumption, and then focus on some recent arguments that have been made in favour of a consumption tax. In the author’s opinion, none of these arguments are convincing, and he would favour adopting a consumption tax in addition to, and not in lieu of, the existing income tax.

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* Irwin I Cohn Professor of Law and Director, International Tax LLM, the University of Michigan; Senior Fellow, Taxation Law and Policy Research Institute, Monash University.

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I. Introduction: the great tax base debate, 1974-2008

The US 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 per cent, 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 1986 Tax Reform Act 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 Professor William Andrews' seminal 1974 article in the *Harvard Law Review*, published just as the decline of the income tax was beginning. 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 (e.g. 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 these 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.

Professor 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 labour income will be taxed, which he considered unfair. Professor 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.

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In the voluminous literature that followed, proponents of the consumption tax have advanced three main arguments in its favour. 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.

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

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 Professors Bankman and Griffith in 1992 and continuing more recently with Professor David Weisbush) 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. Second, Professor Ed McCaffery has emphasised another point of similarity between a cash flow consumption tax and an income tax, in that they both reach infra-marginal 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). Finally, Professor Dan Shaviro has 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. Thus, proponents of the consumption tax argue that since the difference between an income

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4 For these arguments see generally Joseph Pechman (ed.), What Should be Taxed, Income or Expenditure? (1980).
6 See Joseph Pechman, above n 4.
II. Should the income tax be replaced by a consumption tax?

In this Part of the article, I propose to address three recent arguments in favour of replacing the income tax with a consumption tax. Fundamentally, these arguments boil down to one assertion: the consumption tax is not meaningfully different than the income tax in terms of its progressivity or ability to tax the rich. Therefore, not much will be lost if the consumption tax is adopted, and the relative administrative simplicity of the consumption tax favours 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 these arguments, it is necessary to re-examine the fundamental rationale for having an income tax in the first place.

A. Why tax income?

The individual income tax was adopted in the US in 1913, when the Sixteenth Amendment empowered Congress to tax incomes and overturned the Supreme Court’s Pollock decision of 1895, which held a previous attempt to tax incomes unconstitutional as a direct tax lacking apportionment. Before the Sixteenth Amendment was adopted, the federal government relied for revenues primarily on tariffs and excises, which served to protect American industry from competition and were imposed on consumption goods.

The principal argument in favour of replacing the consumption-based tariff system with a personal income tax was that the tariffs were regressive. Since 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 Southern and Western, more agricultural states) felt that the industrialists of the North-East 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 of 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.\footnote{The following is based on Reuven S Avi-Yonah, “Corporations, Society and the State: A Defense of the Corporate Tax” (2004) 90 Virginia Law Review 1193; 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), (2002) 111 Yale Law Journal 1391.}

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, since the holders of power are neither elected by the people nor have their power delegated from the people’s representatives. In fact, the American Revolution was founded on the conception that while people have natural, Lockean liberal rights to their property, undue concentrations of private power and wealth should be discouraged. This view found its expression in the republican creed of civic humanism, which emphasized public virtue as a balance to private rights. A virtuous republic, the Founders believed, was to be free from concentrations of economic power such as characterized England in the 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.”\footnote{Dennis J Ventry, “Equity Versus Efficiency and the US Tax System in Historical Perspective”, in Joseph J Thornhike and Dennis J Ventry (eds) Tax Justice: The Ongoing Debate (2002) at 28.} 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.”\footnote{A A Berle, “For Whom Corporate Managers Are Trustees” (1932) 45 Harvard Law Review 1365 at 1368.}
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”, i.e. equalising everyone’s initial means.¹⁴ 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.”¹⁵ 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.”¹⁶ 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.¹⁷

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

> It would be a mistake to imagine, however, that money has political effects only when it "talks" to candidates and officials...It also has political effects closer to home, in the market itself and in its firms and enterprises...Even within the adversary relation of owners and workers, with unions and grievance procedures in place, owners may still exercise 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.¹⁸

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¹⁵ Michael Walzer, above n 14 at 19.
¹⁶ Michael Walzer, above n 14 at 12.
¹⁷ Michael Walzer, above n 14 at 120-121.
¹⁸ Michael Walzer, above n 14 at 121-122.
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 recognises the inherent limitations of all redistribution, since 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.19

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 this 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.20

First, the limiting function: imagine first a 100 per cent tax imposed on profits. Over time, such a 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 per cent tax is inconceivable. Taxation faces an inherent limit that was well expressed by 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 per cent, what is the effect on private power of a lower tax rate, such as the current 35 per cent? 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 per cent on assets invested at a 10 per cent yield (compounded annually) over ten years results in approximately 27 per cent less assets being available at the end of the

19 Michael Walzer, above n 14 at 122-123.
20 See R Avi-Yonah, above n 11 at 1246-1249.
period than would be available in the absence of the tax. Thus, taxation at lower rates can meaningfully restrict the build-up of assets that forms the base of the power of the rich, even when it does not destroy it. But since that power will 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 (ie their use of its power) may be impacted by the threat that the tax rate will be raised if it is perceived that the assets are not used for the betterment of society. This can be seen by the imposition of higher effective rates on certain forms of behaviour 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 US 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 per cent 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. This is why we need the limiting function (ie 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 government in providing a subsidy via the tax code. Now it is of course true that the government could subsidise these functions directly, rather than use tax expenditures, so that 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.21

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 non-publicly 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.

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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, since if income from capital cannot be taxed an income tax has the same base as a consumption tax but is immensely more complicated (eg because it needs to account for basis).

Beginning with Bankman and Griffith in 1992, a significant body of legal literature has argued that in fact 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.”

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 per cent income tax on risky returns, he can eliminate that tax by increasing the amount invested, since 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 (eg 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 per cent 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 per cent 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 only be imposed on risk-free returns, since these have historically been very low (around 0.5 per cent), the difference between an income tax and a consumption tax is so minuscule as to not be worth the argument.

Various commentators have recently taken issue with this line of argument. Thus, Professor Reed Shuldiner argues that the model is misleading for several reasons. 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

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22 David Weisbach, above n 9; see Joseph Bankman and Thomas Griffith, above n 7.
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 per cent and from 1802 to 1997 it was 2.9 per cent. 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 ten year investments was 3.3 per cent. 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 Shuldiner and Professor Larry Zelenak point out that the key assumptions underlying the model may not be accurate. 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 behaviour: 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 this literature and concludes that "the empirical evidence is insufficient to sway us one way or another." More broadly, economists have studied generally how sensitive the behaviour of the rich is to taxes and concluded that in many cases that sensitivity is surprisingly low. For example, in most of the empirical studies in Joel Slemrod’s book on taxation and the rich, the expected tax avoidance behaviour either did not materialise or was lower than expected. There are many considerations that influence individual behaviour beyond taxes, and transactions costs make a difference as well. Since 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 this argument on the ground that it is hard to find a normative justification for the particular pattern of taxing risk imposed by these 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.

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25 David Weisbach, above n 7. See also the recent empirical study by Terrence R Chorvat, The Effect of Taxation of Risky Income on Investment Behavior (2005) (finding no confirmation of Domar/Musgrave model in pilot experiment using law students).

However, the key question in this 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 per cent of the US population by adjusted gross income paid 33.89 per cent of federal personal income tax, and the top five per cent paid 53.25 per cent (by comparison, the bottom 50 per cent of the AGI distribution paid less than 4 per cent of total income taxes collected). This is a significant increase from 1994, when the top 1 per cent of taxpayers only paid 28.7 per cent of federal personal income tax. In 2004, even after President Bush’s tax cuts, the top 1 per cent still paid 32.3 per cent of federal individual income taxes and the top 5 per cent paid 53.7 per cent. Since (as indicated below) a very large portion of the income of the rich consists of risky returns, it is hard to explain these patterns if risky returns are in fact exempt from tax.

Second, it appears likely that these significant payments by the rich are in large part the result of taxing risky returns to capital, not labour income or non-risky 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 per cent for taxpayers with income of $100,000 or less, to 11.5 per cent for taxpayers with income from $100,000 to $500,000, 24.7 per cent for income between $500,000 and $1 million, 37.6 per cent for income between $1 and $10 million, and an impressive 61.4 per cent for taxpayers whose income exceeds $10 million. 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 realisations 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 behaviour (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 in fact it occurs. 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) in fact 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 per cent by AGI will continue to bear 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 Professors 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 (eg by Weisbach) to justify the adoption of the "check the box" rule in 1997 for classifying foreign entities 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 these rules with a simple election.31 The results of this 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. This 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: pre-paid v post-paid 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 pre-paid and post-paid consumption taxes in exempting the return to capital from tax. In a pre-paid 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 post-paid 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 taxpayer earns 100 subject to a tax of 50 per cent and can invest it in a bond earning 10 per cent per year. Under an

income tax, the 100 of earnings are subject to tax of 50, and the remaining 50 are invested in the bond, yielding 55 after one year; the five of interest is subject to income tax (Mill’s “double tax”) leaving the taxpayer with only 52.5.

In a pre-paid 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 five of interest is earned, they are exempt from tax, so that the taxpayer is left with 55.

In a post-paid 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 per cent, leaving the taxpayer with the same 55 as in the previous example.

Hence, the Cary Brown theorem demonstrates that pre – and post-paid consumption taxes are equivalent, and both exempt the five return on the bond from tax. Since income from capital is exempt, under the Haig-Simons definition of income, both pre – and post-paid consumption taxes are also theoretically equivalent to a direct tax on consumption like the Retail Sales Tax.

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 post-paid consumption taxes does not hold, since a pre-paid tax applies the rate at the beginning of the year and a post-paid tax the rate at the end. However, this assumption may not matter too much since 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 post-paid tax at the same rate as the underlying investment. This 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 infra-marginal (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 per cent return but the tax savings can only be invested in a bond earning 10 per cent. In a pre-paid 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 exempt from tax, for a net after-tax of 75. In a post-paid 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 per cent, and the other 50 (the tax savings) are invested at 10 per cent. 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 these are consumed and are subject to tax at 50 per cent, the taxpayer nets only 65. To put it another way, in a post-paid tax, only the normal yield is exempt from tax; the extraordinary yield is fully taxable.
Ed McCaffery uses this result to argue for a post-paid consumption tax. 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 pre-paid consumption tax because it does reach extraordinary returns to savings when they are consumed. Or to put it in other terms, 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 such 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 post-paid over pre-paid 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 as the distribution of various talents). The key issue is how common are such rents. There is an 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 post-paid (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 such rents are a form of labour 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 such rents earned by individuals are capital or labour income. They 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 realisation requirement), it does a better job than a pre-paid consumption tax that exempts such rents altogether. Whether a post-paid 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 post-paid consumption taxes can reach rents, because that is a key issue in differentiating among the various tax reform proposals currently advanced.

D. Regressivity: can a consumption tax achieve the same progressivity as an income tax?

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 post-paid consumption tax, because as we have seen it can impose progressive rates on both labour income and on rents when those are consumed. On the other hand, transactional consumption taxes like the RST cannot generally

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32 Edward McCaffery, above n 8.
33 Of course, it might be a good idea to improve the existing income tax by marking to market publicly traded securities and derivatives whose value is easy to ascertain, like the assets held by Gates and Buffett. See David Miller, A “Progressive” Mark-to-Market System of Taxation (2005).
be progressive since they are imposed at a uniform rate and since the poor consume a higher proportion of their income than the rich. Nor can pre-paid 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 post-paid 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 these earnings (or at least the risk-free portion of them) whereas even a post-paid consumption tax does not.34

Dan Shaviro argues that this 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 per cent consumption tax rate and 10 per cent 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 one, increased by the interest rate of 10 per cent 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.”35

However, this 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 will be reached by a consumption tax, since it can persuasively be argued that these are a form of investment rather than consumption. Thus, a consumption tax will 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 will not reach the much larger percentage of their power that depends on their ability to invest.

34 Theoretically, leaving accumulated wealth to one’s heirs can be defined as a form of consumption, but none of the current consumption tax proposals does so.
35 Daniel Shaviro, above n 9.
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. This 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 labour income at sharply graduated rates and also reaches actual consumption of saved income can be as progressive as the current income tax. 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.

E. **Is an ideal consumption tax superior to an income tax?**

Professors Bankman and Weisbach have recently argued for the superiority of an ideal consumption tax over an ideal income tax on three grounds: first, that the consumption tax is more efficient because it does not discriminate between current and future consumption, while both income and consumption taxes have identical effect on work effort. Second, that the consumption tax is at least as good at redistribution as the income tax, and thus can equally satisfy vertical equity. Third, that the consumption tax is easier to administer than the income tax because it makes no attempt to tax income from capital and thus can omit many of the vexing complications that arise from such an attempt, like accounting for basis.

The argument in regard to redistribution is addressed above. In regard to efficiency, Bankman and Weisbach rely on a 1976 paper by Atkinson and Stiglitz, to argue that it is incorrect to claim (as Jane Gravelle does, for example, in *The Taxation of Capital Income* (1994)) that there is a trade-off between reducing the disincentive to save by adopting a consumption tax, and reducing the incentive to work by increasing taxes on wages (to replace revenue lost as a result of exempting income from savings). Bankman and Weisbach argue that this is untrue because the tax on income from savings also reduces work effort. But it is quite plausible to assume that people systematically value future taxes less than current taxes by more than the time value of money, and if so, the current tax on wages will reduce work effort more than the present value of the future tax on savings. Bankman and Weisbach seem to acknowledge this (“perhaps one can offer various psychological theories for why people misperceive the effect of various taxes”), but dismiss it because “the trade-off

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

37 On ways to do this see David Miller, above n 33.


theory purports to apply classical economics."40 However, the debate is about effects in the real world of replacing the income tax with a consumption tax, not in some ideal realm of classical economics.

Similarly, the argument in regard to administrability depends crucially on the actual consumption tax that will be adopted – the experience of other countries with the VAT indicates it has significant problems of complexity and administrability. David Gamage has recently pointed out that if one assumes that the transaction costs of avoiding taxes increase with the amount of tax to be avoided, then having two taxes with lower rates (income tax and VAT, for example) is superior to having only one tax at a higher rate, because taxpayers will then have an incentive to incur those higher transaction costs.41

III. Conclusion

The “consensus” in favour on replacing the income tax with a consumption tax is based on arguments that seem patently flawed when examined closely. Nor is this reform likely to be enacted in practice. Instead, it is much more likely that the US will follow all the other members of the OECD and enact a consumption tax (the VAT) in addition to, and not as a replacement of, the income tax.

40 Joseph Bankman and David Weisbach, above n 10; see also Daniel Shaviro, above n 10.