Alternatives to the Current Individual Income Tax

By Glenn H. Miller, Jr.

The personal income tax is the cornerstone of the federal government's revenue-raising structure. Now entering its eighth decade of existence, the modern income tax came into being after the ratification of the Sixteenth Amendment to the Constitution in 1913. About 350,000 returns were filed in 1913 compared with over 95 million in 1982. In 1914, its first full year of operation, income tax receipts were $41 million. In 1982, individual income taxes brought in nearly $300 billion, almost half of total federal budget receipts.

Despite its potency as a revenue raiser, there has been increasing dissatisfaction with the income tax in recent years and mounting concern over some of its effects. As a result, fundamental changes in the tax system are being discussed, with the focus primarily on the income tax. Some observers believe that concern about very large projected federal budget deficits may be the catalyst for a fundamental change in the income tax.[1]

Tax reform, the label often applied to fundamental changes in the tax system, is thus on the national economic policy agenda. The President, in his budget message to Congress in January 1984, stressed the need for a simpler and fairer tax system that would also increase savings, investment, and work incentives. To that end, he directed the Treasury Department to complete a study of the tax system and recommend changes by the end of the year. Substantial alteration of the tax system is also being discussed in Congress, the media, the economics profession, and among the general public.

This article briefly examines several alternatives to the current individual income tax and some of the issues surrounding them. Emphasis is on the basic concepts of those alternatives, although some indication is also given

Glenn H. Miller, Jr. is a Vice President and Economic Adviser in the Economic Research Department at the Federal Reserve Bank of Kansas City.

[1] "Mounting Deficits Could Spur Total Overhaul of the Tax System," *Congressional Quarterly Weekly Report*, December 24, 1983, pp. 2731-37.

of the effects of using them as substitutes for the income tax or complements to it. The two broad alternatives discussed here are (1) income base broadening and rate reduction culminating in a flat rate tax on a comprehensive income base and (2) the substitution of consumption spending for income as the tax base through either a personal expenditure tax or an indirect consumption tax such as a value-added tax (VAT) or a retail sales tax.

Objectives of a tax system and the current income tax

The main purpose of a tax system is to raise revenue by transferring resources from the private sector to the public sector so as to satisfy such socially determined public wants and needs as national defense, public education, and income security and health care for certain groups. A good tax system is expected to be fair, neutral, and simple.[2] Revenue should be raised so that the tax burden is distributed as fairly as possible, in terms of both horizontal equity (seeing that people in similar situations are treated similarly) and vertical equity (seeing that people in different situations are treated differently).[3] Ideally, taxes would be as neutral as possible in terms of minimizing their interference with economic decisions and behavior. The effect of the tax system on choices between working more or taking more leisure time, for example, or on choices between saving or consuming from income, would be minimized.[4] Administration of the system by the tax collector and compliance with the law by the taxpayer would be as simple and efficient as possible.

The following brief description of how tax liability is determined under the current income tax shows how it is believed to fall short of the goals of a good tax system. This description also provides a starting place for examining alternatives to the current income tax.

Joseph A. Pechman has listed the factors necessary for determining income tax liability.

> The personal income tax is determined by the definition of income, allowable deductions, personal exemptions, tax rates, and tax credits. These elements can be combined in various ways to produce a given amount of revenue.[5]

The taxation of income, therefore, requires that an income tax base first be established. In the current personal income tax, total income is computed by adding up income from such sources as wages and salaries, interest, dividends, capital gains, rents, and royalties. Exclusions are then applied. In 1983, for example, interest on obligations of state and local governments was not taxable, the first $200 of dividend income on a joint return was excluded, 60 percent of net long-run capital

[2] Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice*, Second Edition, McGraw-Hill Book Co., New York, 1976, pp. 210-11; Joseph A. Pechman, *Federal Tax Policy*, Fourth Edition, Brookings Institution, Washington, 1983, pp. 5-7.

[3] The current federal income tax is moderately progressive—that is, those in higher income classes pay a larger share of their income in income tax than do those in lower income classes. But it is estimated that the total U.S. tax system (federal, state, and local) is much less progressive, perhaps roughly proportional over most of the income range—that is, people in nearly all income classes pay about the same share of their income in taxes.

[4] The tax system may, of course, be consciously used to influence economic behavior, such as by giving an investment tax credit to stimulate capital formation. Often, however, the impact of the tax system on economic decisions and behavior may not be explicit or even recognized, leading in many instances to distortion in the allocation of resources or to restrictions on the growth of output or productivity.

[5] Joseph A. Pechman, *Federal Tax Policy*, Fourth Edition, p. 74.

gains was excluded, and royalties income could be reduced by the appropriate depletion allowance. Total income so computed is then adjusted to give adjusted gross income. For example, payments into Individual Retirement Accounts (IRA's) or Keough retirement plans can be deducted. Taxable income is then computed by subtracting from adjusted gross income the dollar value of personal exemptions claimed for taxpayer status, dependency, age and blindness, and the dollar value of allowable deductions. Deductions now include extraordinary medical expenses, interest paid on home mortgages and taxes paid on owner-occupied houses, charitable contributions, income and sales taxes paid to state and local governments, and certain expenses of earning income.

The appropriate tax rates are then applied to taxable income to determine income tax liability before various tax credits. Rates for 1984 for married people filing joint returns are shown in Table 1. The range of taxable income is divided by brackets, and the income in each bracket is taxed at the percentage rate shown. These bracket rates, also known as marginal rates, apply only to the slice of income in a particular bracket and not to all income. The graduated increases in rates from one bracket to the next as income increases are primarily responsible for the progressivity of the current income tax system.[6] Subtraction of the value of various tax credits, such as for the costs of home energy conservation or for political contributions, gives income tax liability after credits.

Dissatisfaction with the current income tax arises from concerns that it falls short of the goals of a good tax system. First, income tax law and the filing of returns are seen as having become exceedingly complex, thus making taxpayer compliance difficult, time-consuming, and expensive.[7] Second, the fairness of the distribution of the tax burden is questioned, both in terms of horizontal equity and in terms of vertical equity. The principles of simplicity and fairness have suffered from a tendency over the years to try to do too much with the income tax. Special provisions such as tax credits to stimulate capital formation or to promote energy saving, exclusion from the tax base of certain types of income like capital gains, deductions of mortgage interest payments and property taxes on houses, and similar tax preferences make the current income tax more complex and narrow the tax base.

Narrowing of the taxable income base leads to perceived violation of the principle of horizontal equity by making it possible for people with the same incomes to have different tax liabilities. There is also concern that the current income tax does not meet the principle of vertical equity.

Specifically, there is a concern whether a progressive tax structure best meets the ability-to-pay criterion for distributing the tax burden. For instance, some argue that the range in marginal rates is too large and that the marginal rates are too high at the upper end of the income scale.

---

[6] A couple with taxable income of $25,000 would pay a marginal rate of 25 percent on $400, 22 percent on $4,400, and so on. Their average rate on $25,000 of taxable income would be about 14 percent. A couple with taxable income of $16,000 would pay an average rate of about 11 percent. Tax paid as a percent of a broader income base concept gives the effective tax rate. A schedule of such rates by income class is considered to be a more meaningful indicator of the distribution of tax burden. The broader income base used may be adjusted gross income (income before the subtraction of personal exemptions and allowable deductions) or, even more broadly, total income (before the exclusion of various forms of income).

[7] It has been estimated that about 300 million hours are spent every year filling out personal income tax forms and that about 40 percent of taxpayers use professional help in preparing their returns. *Revising the Individual Income Tax*, Congressional Budget Office, Washington, 1983, p. 2.

Lastly, the current income tax is believed to have too much influence on economic decisions and behavior. This concern reflects the belief that the current income tax leads to choices that reduce work effort, saving, and investment, with deleterious effects on the growth of output and productivity.

The federal individual income tax has not been a static system. Many changes have been made over the past 40 years.[8] The biggest changes in recent years were the Economic Recovery Tax Act of 1981 (ERTA), which sharply reduced individual income tax rates, and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which recaptured some of the revenue loss to ERTA while keeping ERTA's rate reductions intact. Even including these changes, alterations in the tax code have stopped far short of the large-scale overhaul now being discussed.

Not everyone is convinced that a sweeping overhaul of the tax system is inevitable in the near future—or even necessary.[9] But, the coming together at this time of a recognition of the budget deficit problem, a perception of need for more fairness and simplicity in personal taxation, and a belief that the current tax system inhibits necessary growth in work effort, savings, and investment makes the issue of substantial alteration of the tax system worthy of attention. This article now examines various alternatives to the current income tax.

TABLE 1
Federal individual income tax rates, 1984
(Married persons filing joint returns)

Taxable income (dollars)	Tax rates (percent)
Up to $ 3,400	0
3,400-5,500	11
5,500-7,600	12
7,600-11,900	14
11,900-16,000	16
16,000-20,200	18
20,200-24,600	22
24,600-29,900	25
29,900-35,200	28
35,200-45,800	33
45,800-60,000	38
60,000-85,600	42
85,600-109,400	45
109,400-162,400	49
$162,400 and over	50%

Source: Internal Revenue Code.

Tax base broadening

One approach to income tax reform that has received considerable support in recent years is base broadening with associated reductions in rates. The larger the tax base established by the definition of taxable income, the lower the tax rates necessary for a given amount of revenue. Many economists and other tax experts contend that the erosion of the income tax base through the application of various exclusions and deductions has created problems of fairness in distributing the tax burden and higher tax rates than would otherwise be needed. As a result, many commentators recommend a broadening of the income tax base by removing most, if not all, the exclusions

[8] For a chronology of changes, see David Paris and Cecelia Hilgert, "70th Year of Individual Income and Tax Statistics, 1913-1982," U.S. Department of the Treasury, *Statistics of Income Bulletin*, Winter 1983-84, pp. 2-3.

[9] "[There is no] reason to make radical changes in the federal tax system in the expectation that they will produce miracles. Notwithstanding its defects, the U.S. federal tax system is probably the best in the world. It produces a large amount of revenue, but it is less burdensome than most systems, it is moderately progressive, and compliance is high." Joseph A. Pechman, "Tax Policies for the 1980s," p. 169, in Pechman and N. J. Simler, eds., *Economics in the Public Service*, W. W. Norton & Co., New York, 1982.

and deductions.[10]

Comprehensive broadening of the tax base could ease some of the dissatisfactions with the current income tax.[11] Simplification of tax law by removing the current exclusions from taxable income, allowable deductions, and tax credits would make compliance and administration easier. Horizontal equity could also be improved by not taxing different kinds of income differently, and taxpayers with similar incomes before taxes would thus be more likely to be taxed at similar rates. Broadening the base would also allow the same revenue to be raised with significantly lower marginal tax rates, reducing the influence of high marginal rates on economic decisions and behavior. The structure of the new lower rates would be open to consideration. A graduated rate structure could be retained with whatever degree of progressivity was wanted. Rate brackets might also be widened, reducing the number of steps in the progressivity ladder.

One illustrative design for a comprehensive income tax is provided in a recent study by Pechman and Scholz. The design includes in the tax base a number of sources of income currently excluded, restricts the use of itemized deductions, and increases both the zero bracket amount (standard deduction) and the size of personal exemptions. The result is a larger estimated taxable income in 1984 than under the current income tax, and one that would yield about 25 percent more revenue at current tax rates. Tax liabilities would change substantially for some income classes. Both taxable income and tax liability would be less than under current law for taxpayers with incomes under $20,000 and more for taxpayers with incomes over $20,000.[12]

The same illustrative broader base would also allow for a reduction of tax rates by an average of 22 percent while still providing the same total revenue given by the current income tax base and rates. If all of the increase in the tax base were used for general rate reductions so that the same total revenue was raised, the present distribution of tax burden across income classes could be preserved with a marginal rate structure containing seven taxable income brackets with rates ranging from 9 percent to 28 percent of the comprehensive income base.[13] That structure would be compared with 14 taxable brackets for the current income tax with rates ranging from 11 percent to 50 percent. Rate reductions would not be spread evenly across taxpayers, however. Those now benefiting from tax preferences would owe more taxes when their particular exclusions, deductions, exemptions, or credits were returned to the tax base. Those

---

[10] Such a movement toward a comprehensive income tax base is in the direction of what is recognized in much of the public finance literature as the ideal income tax base—the Haig-Simons definition of income. This definition, also known as the accretion concept, defines income as the sum of consumption and accumulation (or savings) in a given period. For Simons, personal income for tax purposes "is merely the result obtained by adding consumption during the period to 'wealth' at the end of the period and then subtracting 'wealth' at the beginning." Haig emphasized the power to satisfy economic wants conferred by the acquisition of income, whether spent or saved. "Income is the *money value of the net accretion to one's economic power between two points in time*." Both quoted in Richard Goode, "The Economic Definition of Income," in Joseph A. Pechman, ed., *Comprehensive Income Taxation*, The Brookings Institution, Washington, 1977, p. 8.

[11] One difficulty with comprehensive base broadening is that every income exclusion, allowable deduction, and personal exemption exists under current law because it benefits some group, and those groups would be reluctant to give up their benefits. Public opinion polls have shown that a solid majority of Americans favor a broad based, low-rate tax structure, but far more people oppose the repeal of specific major deductions, such as home mortgage interest payments and medical expenses. *Revising the Individual Income Tax*, p. 33.

[12] For details and further discussion and analysis, see Joseph A. Pechman and John Karl Scholz, "Comprehensive Income Taxation and Rate Reduction," *Tax Notes*, October 11, 1982, pp. 83-93. Other designs are also presented in the article.

not now benefiting from such preferences would owe less.

In summary, if this particular broad base concept were adopted without changing current tax rates, substantially more revenue would be raised and the tax burden would be reduced for those with incomes less than $20,000 and increased for those with incomes more than $20,000. Tax liabilities would increase substantially for those with incomes over $50,000. On the other hand, using this broad base concept to raise the same revenue as the current income tax without changing the distribution of the tax burden, marginal tax rates could be reduced for nearly all income classes and tax brackets could be widened. In the extreme case of bracket widening, a single flat tax rate could be adopted so that all taxpayers would pay the same marginal tax rate on increases in their incomes.

Flat rate income tax

The flat rate income tax has received considerable attention and support in recent discussions of tax reform. Instead of a graduated rate schedule, such as is used in the current income tax, a flat rate income tax applies a single rate to the income base. The definition of income used as a base for a flat rate tax is open to choice, and affects the level of the flat rate needed to raise the desired revenue. To produce the same revenue from a flat rate tax as from the current income tax, for example, a much higher flat rate would be required if no changes were made in the current tax base than if a more comprehensive tax base were adopted. Flat rate tax proposals usually call for some base broadening both to simplify compliance and administration and to allow a lower tax rate.[14]

Consideration of the substitution of a flat rate tax for the current income tax also involves the effect a reduction of high marginal tax rates might have on work effort, savings, and investment. Though considerable uncertainty remains, it is widely believed that high marginal tax rates paid by upper income groups tend to restrict labor supply and work effort and to reduce savings. Research shows generally that, at best, relatively small increases in labor supply and saving result from reductions in marginal tax rates.[15]

One appeal of the flat rate tax is that proponents believe that it would distribute the income tax burden more equitably than a progressive income tax. Both the flat rate tax and the progressive income tax are said to be based on the notion of ability to pay. The difference is that the progressive tax presumes that the ability to pay criterion is met when those with higher incomes pay a larger share of their income in taxes. With a flat rate tax

[13] Tax Rate Schedule, 1984,
For Illustrative Broad Base Concept*

Taxable income (dollars)	Rate (percent)
Up to $4,000	0
4,000-9,000	9
9,000-14,000	15
14,000-24,000	18
24,000-34,000	21
34,000-54,000	24
54,000-74,000	26
$74,000 and over	28%

*One rate schedule for all taxpayers. Two-earner married couples receive a deduction of 25 percent of lower earner's earned income.
Source: Pechman & Scholz, p. 88.

[14] For further discussion of the potential for greater simplicity and ease of administration of a flat rate tax, see *Revising the Individual Income Tax*, pp. 39-41, 44.

[15] For a brief review of these issues, see *Revising the Individual Income Tax*, pp. 32-38.

the ability to pay criterion is presumably met when higher income taxpayers pay a higher dollar amount in taxes even though the share of income paid is the same for all taxpayers. Flat rate tax proposals often include a personal exemption that, by leaving some income untaxed, would provide a measure of relief for low-income taxpayers.

Questions of equity in taxation are especially difficult. They involve problems of interpersonal comparisons regarding both ability to pay and the appropriate distribution of the tax burden among taxpayers. Thus part of the argument for or against a flat rate tax rests on the public's attitude toward the equitable distribution of tax burden, and substitution of a flat rate tax for the current income tax would involve significant changes in that distribution.

Together, the flat tax rate, the taxable base adopted, and the extent (if any) of low-income relief determine the distribution of tax liability by income class and by individual tax returns. Table 2 shows estimates of the flat tax rate needed to generate the same revenue as the current income tax for various tax bases, and how such different tax structures would affect the distribution of tax liabilities by income classes.[16] These estimates indicate that if the tax base were broadened by including all capital gains and eliminating all personal exemptions and deductions (System 1), a flat rate of 11.8 percent would generate the same revenue as 1984 tax law.[17] With no changes in the current tax base, a flat tax rate of 18.5 percent would be needed to raise the same revenue (System 2).

Given the progressivity of the current income tax structure, some redistribution of the tax burden would result from adoption of a flat rate tax. Table 2 shows estimates of the redistribution by income class for various flat rates. Under Systems 1 and 2, taxpayers in the lowest income groups would receive large tax increases, and high-income taxpayers would receive large tax reductions. A flat rate of 11.8 percent applied to a broad base as in System 1 would increase taxes for all income classes below $30,000. Taxpayers in the $15,000 to $20,000 income class would pay an average of about $470 more than under 1984 law. Every income class above $30,000 would pay lower taxes, and those with incomes above $100,000 would pay about 50 percent less than under 1984 law.

With no change in the current tax base (System 2), the flat rate—here, 18.5 percent to generate the same revenue—is obviously a reduction in tax rates for high-income taxpayers and an increase for low-income taxpayers. There would be some differences in outcomes from System 1, because current exclusions and deductions would still be used. Tax payments would be higher than under the current law for lower income groups, including those in the $30,000 to $50,000 range, and lower for groups with incomes above $50,000.

Because of the increase in tax payments for low-income groups under flat tax rate plans such as Systems 1 and 2 of Table 2, most flat tax rate proposals include some form of low-income relief. System 3 of Table 2 shows a flat rate plan with low-income relief, both direct and indirect. Indirect low-income relief is achieved by broadening the tax base to include some of the currently excluded income of higher income groups. The base is broadened by adding all long-term capital gains to the System 2 base (1984 law taxable income)

[16] From Joseph J. Minarik, "The Future of the Individual Income Tax," *National Tax Journal*, September 1982, p. 237.

[17] Income levels in 1981 were used in making the estimates. The earned income credit, the two-earner couple deduction, and the IRA and Keough provisions were excluded from the 1984 law and from the flat rate systems to facilitate comparisons.

TABLE 2

Distribution of tax liabilities under alternative flat rate tax systems Compared with 1984 Tax Law at 1981 Income Levels

			System 1			System 2			System 3		
Income (thousands)	Number of taxable returns (thousands)	Tax liability 1984 law (millions)	Tax liability (millions)	Change (percent)	Change (dollars per return)	Tax liability (millions)	Change (percent)	Change (dollars per return)	Tax liability (millions)	Change (percent)	Change (dollars per return)
Up to $5	6,482	$403	$5,479	1,260%	$783	$1,574	291%	$181	$1,996	395%	$246
5-10	15,057	5,772	14,280	147	565	8,752	52	198	5,345	-7	-28
10-15	13,092	12,526	19,700	57	548	17,610	41	388	12,698	1	13
15-20	10,737	17,462	22,496	29	469	22,665	30	485	18,802	8	125
20-30	16,800	44,080	49,701	13	335	52,871	20	523	48,170	9	243
30-50	13,568	63,833	60,579	-5	-240	66,419	4	191	68,804	8	366
50-100	3,580	38,687	27,389	-29	-3,156	30,486	-21	-2,291	36,104	-7	-722
100-200	631	18,656	9,872	-47	-13,921	10,743	-42	-12,540	14,344	-23	-6,834
Over $200	164	16,385	7,675	-53	-53,107	7,129	-56	-56,438	11,843	-28	-27,692
TOTAL	80,110	$217,803	$217,172	-0.3%	$-8	$218,249	0.2%	$6	$218,106	0.1%	$4

Source: Joseph J. Minarik, "The Future of the Individual Income Tax," *National Tax Journal*, September 1982, p. 237.

System 1: 11.8 percent tax on adjusted gross income with long-term capital gains included in full.
System 2: 18.5 percent tax on 1984 law taxable income less zero bracket amount.
System 3: 18.7 percent tax on 1984 law taxable income less zero bracket amount, with long-term capital gains included in full, and no itemized deductions, with increased exemption and zero bracket amount.

and allowing no itemized deductions. Direct low-income relief is achieved with an increase in the personal exemption from $1,000 under current law to $1,500, and an increase of the zero-bracket amount from $3,400 to $6,000 for joint returns. With these changes, the flat rate needed for the same revenue under System 3 is 18.7 percent. The rate is little more than under System 2, but the low-income relief of System 3 shifts the burden away from low-income groups toward those with higher incomes. Compared with Systems 1 and 2, the tax increases are smaller with System 3 for groups with incomes below $30,000 and tax reductions are smaller for those with incomes above $50,000.

The illustrative flat tax rate structures in Table 2 show that, in order to raise the same revenue as under the current law, lower income groups would pay more tax and higher income groups would pay less with a flat rate tax even if the tax base were broadened and direct low-income relief were added. Taxpayers in the middle-income ranges would also pay more tax following a switch to a flat rate tax. Furthermore, the illustrations indicate only what would happen on average; some taxpayers would be affected more than others. Those now benefiting from tax preferences that would be lost with base broadening would be worse off following a change to a flat rate tax than those without such preferences. For example, homeowners no longer able to deduct mortgage interest payments and local real estate taxes would have greater tax increases than renters with the same incomes. While it might be argued that these tax preferences for homeowners were not equitable in the first place, the change would be drastic, probably affecting the net worth of homeowners as well as their disposable incomes.

An expenditure tax

An expenditure tax is a way of taxing consumption instead of income. Most simply put, under an expenditure tax system an individual would be taxed on his income less his savings. He would count his income as cash receipts from all sources—including wages and salaries; interest, dividends, and rent; proceeds from the sale of assets; and funds borrowed. From this total, he would subtract his savings—such as additions to financial accounts, purchases of real or financial assets, and debt repayments. The difference would be his expenditure tax base. Presented in this simple form, a comprehensive tax base is used for computing expenditure tax liability.

Support for taxing consumption can be traced from Thomas Hobbes in the seventeenth century to John Stuart Mill in the nineteenth century and to Irving Fisher in the first half of this century. Recent discussion of an expenditure tax began with the publication of Nicholas Kaldor's book in 1955 and picked up momentum in the 1970s.[18] Much of this discussion addresses whether, in terms of fairness, income or consumption is the appropriate base for personal taxation. Recently, however, taxation of consumption expenditures has been proposed as a replacement for the income tax on grounds that tax system disincentives for saving and investment could be removed or greatly reduced by excluding savings from taxation.

The main reason for changing from an income tax to an expenditure tax would be to remove the inhibitions to saving under the current income tax. While there are some forms of preferential treatment for saving in the current income tax system, such as the deductibility of IRA's, the expenditure tax approaches the matter directly and comprehensively by exempting all current period savings from taxation in that period. The expenditure tax, therefore, is expected to increase the incentive to save by increasing the after-tax rate of return. The important question is the magnitude of the increase. As Pechman has said:

> The expenditure tax would encourage saving more than an equal-yield income tax distributed in the same proportions by income classes. However, since the elasticity of saving with respect to the rate of return is not known, there is no way to predict how much saving would increase if the income tax was replaced by an expenditure tax.[19]

Advocates of the expenditure tax believe that consumption is a fairer base for taxation than income. Exercising the power to consume marketable output, they maintain, is a better measure of ability to pay than income, which is the sum of consumption plus the accretion of power to consume. Furthermore, in a line of reasoning descended from Hobbes, they argue that "consumption, a measure of what people take *out* of the economic system, is a more appropriate basis for taxation than income, a measure of what they contribute to the economic system in productive perform-

---

[18] Nicholas Kaldor, *An Expenditure Tax*, George Allen and Unwin Ltd., London, 1955; William D. Andrews, "A Consumption-Type or Cash Flow Personal Income Tax," *Harvard Law Review*, April 1974, pp. 1113-88; U.S. Department of the Treasury, *Blueprints for Basic Tax Reform*, 1977; Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation* (the Meade Committee Report), Allen & Unwin, London, 1978; and Joseph A. Pechman, ed., *What Should Be Taxed: Income or Expenditure?* The Brookings Institution, Washington, 1980.

[19] Pechman, "Tax Policies for the 1980s," p. 158.

ance."[20]

Not all tax experts, however, are persuaded of the greater fairness of taxing consumption. Some hold that ability to pay is better measured by income, which is the means of controlling resources for both consumption and investment. In a practical sense, an expenditure tax would tend to make taxes higher during the years of youth and old age and lower during the middle years of life.

As with an income tax, the broader the base of an expenditure tax, the lower the rates needed to provide the same revenue. The argument that an expenditure tax would be simpler than the current income tax rests largely on the use of a comprehensive tax base. In practice, however, such deductions as state and local income taxes, charitable contributions, and health care costs could be applied to an expenditure base just as they are now to an income base. An expenditure tax base could be subject to the same eroding pressures as the income tax base, with the result that it might lose some of its attraction as a cleaner and simpler approach to personal taxation.

Recent discussion of an expenditure tax has assumed a graduated rate structure, with the degree of progressivity open to choice. In fact, adoption of an expenditure tax implies progressivity, for if roughly proportional taxation of consumption were wanted, an indirect consumption tax, such as a value-added tax or a federal retail sales tax, could be used.[21]

The Congressional Budget Office, using estimates of saving rates by income class, has designed illustrative graduated rate schedules for two expenditure tax bases.[22] Both schedules are designed for the same revenue yield and for the same overall distribution of tax burden by income class as estimated for the current income tax in 1984 (Table 3).

For the broad based consumption tax shown in Table 3, taxable consumption equals adjusted gross income under current law (that is, no itemized deductions are allowed) less personal exemptions and the zero bracket amount, less estimated net saving, plus currently excluded long-term capital gains. To produce the same revenue and distribution of the tax burden as under 1984 income tax law, tax rates on consumption would range from 10 percent to 35 percent in five brackets. The table also shows that removing certain elements from the expenditure tax base would require higher rates to give the same revenue yield. The narrow base of Table 3 is simply taxable income under current law with all savings deductible. Rates required to produce 1984 income tax law revenue on that consumption base would range from 10 percent to 60 percent in seven brackets. Obviously, other revenue yields and distributions of the burden of the expenditure tax could be achieved with other rate schedules.

Questions about the desirability of an expenditure tax include the treatment of gifts and bequests, the potential for increasing the concentration of wealth, and the transition from an income tax system to an expenditure tax system.

The questions of the treatment of gifts and bequests, and of potential increases in the concentration of wealth, are related. Savers can give gifts in their lifetimes or make bequests at their deaths. Both gifts and bequests could be treated as consumption by the givers and

---

20 David F. Bradford, "The Case for a Personal Consumption Tax," in Pechman, ed., *What Should be Taxed: Income or Expenditure?* p. 102.

21 Michael J. Graetz, "Expenditure Tax Design," in Joseph A. Pechman, ed., *What Should Be Taxed: Income or Expenditure?* pp. 162-63.

22 *Revising the Individual Income Tax*, pp. 127-29.

TABLE 3
Marginal consumption tax rates and taxes due by taxable consumption class

Taxable consumption (in dollars)	Broad based consumption tax*: Marginal tax rate (in percent)	Broad based consumption tax*: Tax due at bracket bottom (in dollars)	Narrow based consumption tax†: Marginal tax rate (in percent)	Narrow based consumption tax†: Tax due at bracket bottom (in dollars)
Up to $2,100	10%	0	10%	0
2,100-4,200	10	210	10	210
4,200-8,500	10	420	10	420
8,500-12,600	15	850	25	850
12,600-16,800	25	1,465	30	1,875
16,800-21,200	30	2,515	40	3,135
21,200-26,500	30	3,835	40	4,895
26,500-31,800	30	5,425	50	7,015
31,800-42,400	30	7,015	50	9,665
42,400-56,600	30	10,195	50	14,965
56,600-82,200	35	14,455	50	22,065
82,200-106,000	35	23,415	50	34,865
106,000-159,000	35	31,745	55	46,765
159,000-212,000	35	50,295	60	75,915
$212,000 and over	35%	$68,845	60%	$107,715

Source: Congressional Budget Office.

* Taxable consumption equals adjusted gross income under current law less personal exemptions and zero bracket amount, less estimated net saving, plus excluded portion of nominal long-term capital gains.

† Taxable consumption equals taxable income under current law, less zero bracket amount, less estimated net saving.

thus included in their tax bases. Or, they could be taxed when used for consumption by the receivers. Taxing both seems unfair, and the logic of the expenditure tax suggests that taxing the receivers when they use the gifts or bequests for consumption would be more appropriate. But this approach would make possible the accumulation of untaxed wealth that could be passed on to further untaxed accumulation, leading to greater concentration of wealth. While this problem might be handled through gift and estate taxes, or even some form of wealth tax, proponents of an expenditure tax argue that such taxes would offset some of the stimulus to saving that the expenditure tax is intended to create.

Problems would also likely characterize the transition from the current income tax system to an expenditure tax system. These problems include the taxation of consumption from wealth accumulated before the changeover and already taxed as income. (Wealth not taxed when acquired under current law, such as IRA's, would present no problem.) One solution would be to require that all taxpayers declare their accumulated wealth at the time of changeover and include this wealth in receipts for the first year of the expenditure tax. Consumption from that wealth would then be fully taxed. Such an approach, however, would give incentive to conceal wealth at the time of declaration. And it would also impose special difficulties on taxpayers in or near their retirement years, who were depending on their already-taxed savings to support their consumption spending. In these cases, some kind of relief would probably be needed.

It appears that a drastic change from the current income tax to an expenditure tax would allow, at best, mixed gains in simplicity and fairness, and limited and uncertain gains in the stimulation of saving.

An indirect consumption tax

A progressive expenditure tax is only one way of moving the tax system away from an income base toward a consumption base. Consumption taxes also can be indirect taxes levied on commodities or transactions as well as direct taxes levied on people according to their consumption expenditures. Some indirect consumption taxes, such as excise taxes on specific commodities, are narrow based. A broad based indirect tax is viewed as a preferable means of taxing consumption, because narrow based taxes tend to distort consumption decisions as well as to produce less revenue. Selection of a broad based indirect consumption tax can be reduced to a choice between the value-added tax and the retail sales tax—both of which are essentially flat rate consumption taxes.

The value-added tax is collected from firms at every stage of production throughout the economy. In its consumption-type form, which exempts investment goods from taxation, the tax is levied on the difference between a firm's sales and the value of its purchased inputs, including capital goods. This is the "value added" to output by the firm.[23] Tax liability can be computed by applying the tax rate to total sales and deducting the tax paid on total purchases of intermediate and capital goods. This is called the tax credit method. Alternatively, the tax rate could simply be applied to the firm's net sales (sales less input purchases). Though both methods give the same tax outcome, the tax credit method is believed to give better compliance because one firm's tax liabilities become another's credits.

With taxes being passed on at every stage of production, the final consumer bears the burden of the VAT, making it a general consumption tax. The VAT is, therefore, essentially equivalent in base and outcome to a general retail sales tax—both are indirect, broad based consumption taxes. While the VAT is now widely used in western Europe, the retail sales tax is better known in the United States where it is levied in nearly all states and by many local governments. Although both the VAT and the retail sales tax are collected from sellers, the latter is a single-stage tax collected only at the retail level.

Some tax experts find little reason for choosing between the VAT and the retail sales tax, with regard to either equity or efficiency.[24] A federal retail sales tax might be preferred over a VAT because it could be eas-

---

[23] Other types of VAT's may extend the tax to net investment and to gross investment. See Dieter Pohmer, "Value-Added Tax After Ten Years: The European Experience," in Sijbren Cnossen, ed., *Comparative Tax Studies: Essays in Honor of Richard Goode*, North Holland Publishing Co., Amsterdam, 1983, pp. 247-48.

[24] For example, Pechman, *Federal Tax Policy*, Fourth Edition, p. 199; and John G. Head and Richard M. Bird, "Tax Policy Options in the 1980's," in Cnossen, ed., *Comparative Tax Studies*, p. 20.

ier to administer. Consumers and businesses are already familiar with retail sales taxes, fewer taxpaying firms would be involved, and determination of tax liability would be simpler.

As consumption taxes, both the VAT and a federal retail sales tax have received support as contributing to increased saving and investment when compared with the current income tax.[25] At the same time, both taxes are seen as sharing a number of problems. In terms of effective tax rates on income, both the retail sales tax and the VAT are regressive, that is, low-income taxpayers who spend more of their income on consumption would bear a heavier tax burden relative to high-income taxpayers. Substitution of such consumption taxes for some or all of the current income tax would make the total tax structure more regressive. Proponents of the VAT or the retail sales tax have suggested that some of the regressivity of these taxes could be mitigated by exempting from taxation certain classes of consumer spending, such as for food, medical care, clothing, and housing.

Other criticisms of a VAT or federal retail sales tax also have been raised. Prices of consumer goods would rise with the imposition of a VAT or a sales tax, giving at least a one-time boost to the overall price level. Inflationary effects could follow, for example, through the impact of such a price level increase on indexed wage contracts. Adoption of a federal broad based consumption tax such as a VAT or a retail sales tax would also put the federal government in a field of taxation that has historically been reserved to state and local governments. Those governments could very well argue that their capacity to raise revenue was being impaired.

Despite such criticisms, a broad based consumption tax such as a VAT or a federal retail sales tax continues to attract support as a replacement or complement to the current income tax. The attractiveness of such a tax comes both from its presumed stimulus to saving and from its potential revenue yield. Even with exemptions for low-income relief, a national broad based consumption tax would be a powerful producer of revenue. The Congressional Budget Office estimates that, after exempting some forms of consumption, such as housing, food, and medical care, a national consumption tax base of about $1.2 trillion would remain in 1985. Applied to that tax base, a rate as low as 5 percent would yield $60 billion in revenues.[26] With the same tax base, a rate of over 25 percent would be required for a broad based consumption tax to replace all of the $340 billion in revenue now projected to be received from individual income taxes in fiscal year 1985.

Summary

Recent years have brought increasing concern about the current federal income tax. Questions have been raised about its fairness and complexity and about its effects on incentives to work, save, and invest. One result of such concerns is active discussion of alternatives to the current income tax, among them a flat rate income tax and taxation of consumption instead of income. While some of the alternatives could be structured more simply than the current system, especially through base broadening, the realities of pressure from taxpayers might prevent such simplification.

[25] See "The New Focus on Consumption Taxes," *The Morgan Guaranty Survey*, April 1983, pp. 1-6.

[26] Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, Washington, February 1984, p. 196.

Significant shifting of the tax burden toward lower income groups would result from use of a simple flat rate tax on income. Use of an expenditure tax raises questions of equity, and of difficulties in compliance and administration, that have to be weighed against potential benefits in reducing tax disincentives for saving. While sales taxes, whether of the retail sales type or the VAT type, have great potentials for raising revenue they also have drawbacks, such as a regressive distribution of the tax burden, that have to be set against their benefits.

It appears, therefore, that the substantial changes in the tax system represented by these alternatives bring difficulties of their own. Careful consideration of such difficulties must be a part of the expected debate over fundamental changes in the federal tax system. The best solution may not be the jettisoning of the current income tax, but serious efforts to improve its fairness and simplicity, along with some complementary and perhaps temporary revenue enhancement actions.