Three Views of Tax

Edward J. McCaffery

I. Introduction: The Traditional View of Tax

Traditional tax policy for decades, if not centuries, has been locked in a seemingly all-or-nothing debate between two apparent extremes, income and consumption taxation.[1] In this ongoing war, income tax advocates have carried the banner for liberal egalitarian redistribution[2]—for the cause of taking from the rich and giving to the not-so-rich—virtually uncontested.[3]

Critical reflection reveals that there are two connected reasons for this intellectual hegemony of the income tax. These reasons relate to the two basic features of any broad-based tax system: its base, or the *what* question of taxation, and its rate structure, or the *how much* question of taxation.[4] In the traditional view of tax, liberals believe that the income tax has the superior base because it, alone, includes savings or the yield to capital in it, and also that consumption taxes are inferior because they tend to feature flat or flatter rates than income taxes.[5] Thus a liberal egalitarian conception of justice requires fighting the barbarian consumption tax advocates at the gate.

This traditional view of tax has matters wrong, analytically, and thus normatively as well. Hope for liberal egalitarian justice in tax rests not on the income tax and its traditional adjutants, namely, the corporate income and wealth transfer

---

Thanks to Alex Baskin and Greg Barchie for their excellent research assistance.

1. For some representative perspectives on point, see Joseph A. Pechman, ed., *What Should be Taxed, Income or Expenditure?* (Washington, D.C.: Brookings Institute Press, 1980). The income versus consumption debate has its historic roots in the writings of Thomas Hobbes, Adam Smith and, most importantly, perhaps, John Stuart Mill. The British economist Nicholas Kaldor wrote an important volume, *An Expenditure Tax*, in 1955 (reprinted in the *Routledge Library Editions—Economics, 91* (London: Routledge, 2003)). The American law professors William Andrews and Alvin Warren famously revived the debate in a series of law review articles beginning in 1974. It rages on to this day, as any basic tax policy book readily demonstrates. For much more thorough discussion of the debate, with fuller citations to the literature, see Edward J. McCaffery, "A New Understanding of Tax" Mich. L. Rev. [forthcoming, 2005]. This present essay is a shortened version of that much longer piece.
2. See Kirk J. Stark, "Enslaving the Beachcomber: Some Thoughts on the Liberty Objections to Endowment Taxation," in this volume of *CJLJ*, for a discussion of the term "liberal egalitarian," which, broadly speaking, characterizes the political philosophy of John Rawls, Ronald Dworkin and other contemporary liberal political theorists.
3. For some representative criticisms of alternatives to the income tax along broadly liberal egalitarian lines, see Anne L. Alstott, "The Uneasy Liberal Case Against Income and Wealth Transfer Taxation: A Response to Professor McCaffery" (1996) 51 Tax L. Rev. 363; Eric Rakowski, "Can Wealth Taxes Be Justified?" (2000) 53 Tax L. Rev. 263; Reuven S. Avi-Yonah, "Risks, Rents, and Regressivity: Why the United States Needs Both an Income Tax and a VAT" (December 20, 2004) 105 Tax Notes 1651.
4. For an overview of the basic analytics, see Edward J. McCaffery, *Fair Not Flat: How to Make the Tax System Better and Simpler* (Chicago, IL: University of Chicago Press, 2002).
5. For an excellent statement of the popular understanding of tax policy, see John Cassidy, "Tax Code" *The New Yorker* (6 September 2004) 70 (discussing inter alia President Bush's below-the-radar efforts to shift to a flat tax).

HeinOnline -- 18 Can. J. L. & Jurisprudence 153 2005

tax systems, but rather on a particular form of consumption tax. This essay explains and defends this claim, which many may find surprising.

Ironically, when we better integrate the questions of the base and rate structures, we can see that there are three choices of a comprehensive tax system, not two. This is because, under progressive rates, the two possible types of consumption tax are not equivalent, as the traditional view of tax would have them be. Adding in a distinct third view of tax makes clear that the best system for effecting liberal redistribution is not an income tax at all but a specific form of a consumption tax, a consistent progressive postpaid one. And this is, in large part, because such a consumption tax best gets at the yield to capital, in just the way ordinary moral intuitions want to get at it.[6]

To set tasks from the outset, this essay mainly assumes that a progressive, redistributive tax system of some sort is desired. This is, I believe, reasonable: the cause of progressivity is supported by independent political moral theory, and also meets with widespread popular support, across peoples and times.[7] A commitment to progressivity is normative, supported by a wide range of traditions, including liberal egalitarian ones. At the same time, there is an analytic dimension to the assumption. Should some degree of redistribution *not* be desired within tax, many far simpler alternatives to the status quo exist: the third view of tax is not needed, because the traditional view suffices.[8]

Take it, then, that the question for this essay is what form of comprehensive tax system best effects a redistribution of material resources or, better put, what system best effects progressivity. So understood, it is clear that the system must be an individuated one;[9] taxes on entities such as corporations get passed on and so cannot, in the first instance, add to individual justice in tax.[10] We must examine what—and, more important, *when*—decisions about individuals' fair tax burdens ought be made.

II. The Usual Arguments

We start with a clearer view of the usual arguments, in the cause of liberal egalitarian redistribution, for income over consumption taxes.

Reduced to its essence, any tax consists of the product of a base (what is being

6. I present a much extended version of this argument in "A New Understanding of Tax," *supra* note 1.
7. See for some discussion of the historical support for progressivity, Peggy A. Hite & Michael L. Roberts, "An Experimental Investigation of Taxpayer Judgments on Rate Structure in the Individual Income Tax System" (1991) 13 J. Am. Taxation Ass'n 47; Jonathon Baron & Edward J. McCaffery, "Masking Distribution (or Its Absence)" in Edward J. McCaffery & Joel Slemrod, eds., *Behavioral Public Finance* (New York: Russell Sage Press) [forthcoming]. Gene Steuerle considers some progressivity in tax to be essentially a requirement of natural law. C. Eugene Steuerle, *Contemporary U.S. Tax Policy* (Washington D.C.: Urban Institute Press 2004) at 11.
8. See below the discussion of Ant and Grasshopper, under constant tax rates, in section III "The Traditional View, and Beyond".
9. See William Vickrey, *Agenda for Progressive Taxation* (New York: The Ronald Press, 1947).
10. See the discussion below on corporate taxes.

taxed) times a rate structure (how much it is being taxed). The two parts lead to two liberal egalitarian arguments for income taxation.

One, the traditional view of matters is that a consumption tax does not include the yield to capital, or savings, in its base, whereas the income tax does.[11] This follows from the celebrated Haig-Simons definition of "income:" that Income equals Consumption plus Savings (I = C + S), in simplified form.[12] Equivalent ways to put this definition are to see that sources must equal uses, inputs must equal outputs, or that all wealth or income is either spent (consumption) or not (savings)[13]. Rearranging terms, it appears that Consumption equals Income minus Savings (C = I – S) or that, as it is often put, the only difference between an Income and a Consumption tax base is that the former does, and the latter does not, include Savings.[14] Since consumption is, by definition, non-savings, this truism can be reached in other semantic ways as well.[15] These analytic matters seem to support a normative case for income taxation: because only the rich or socially fortunate have any savings at all to worry about—since, that is, in equivalent terms, the not-so-rich consume a higher percentage of their income than do the rich—the income tax is presumed to be fairer than a consumption tax. Call this the "base argument" for income taxation.

Two, it is presumed that consumption taxes feature flat or flatter rates than income taxes do. Thus, even apart from the base effect just noted, income taxes are thought to be more redistributive than consumption ones. There are two reasons for this assumption. In the more or less popular understanding, the "rate argument" follows from the presumed regressivity of the consumption base: if a consumption tax falls more on the not-so-rich, it is assumed that it cannot also feature steeply progressive rates, lest the unfairness be compounded. Tax policy scholars, who can see beyond this argument, have a deeper and more abstract reason to make a connection between rates and bases. Because the best reason for a consumption tax has been, or has been presumed to be, the principled non-taxation of savings, consumption

11. See, e.g., Noël B. Cunningham, "The Taxation of Capital Income and the Choice of Tax Base" (1996) 52 Tax L. Rev. 17 ("Both bases include consumption; the difference is that an income tax also includes changes in wealth, or savings. Whether or not it is appropriate or desirable to tax savings has been at the core of the debate." (footnote omitted)); Barbara H. Fried, "Fairness and the Consumption Tax" (1992) 44 Stan. L. Rev. 961 ("Under a plausible set of assumptions, the two forms of consumption tax—a tax on consumption only and a tax on wages only—impose an equivalent tax burden in present value terms" (footnote omitted)); Liam Murphy & Thomas Nagel, *The Myth of Ownership: Taxes and Justice* (Oxford: Oxford University Press, 2002) at 101 ("This equivalence allows us to say, furthermore, that any consumption tax scheme, in taxing not accretions to wealth as such, but rather only consumption, exempts from taxation the normal returns to investment."). See also Joel Slemrod & Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate Over Tax Reform*, 3rd ed. (Cambridge, MA: MIT Press, 2004).

12. See Henry C. Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago, IL: University of Chicago Press, 1980 (1938)) at 50; Robert M. Haig, "The Concept of Income—Economic and Legal Aspects" in Robert M. Haig, ed., *The Federal Income Tax* (New York: Columbia University Press, 1921) at 7; McCaffery, *supra* note 4 at 11-12.

13. See McCaffery, *supra* note 4 at 11-13.

14. See, for example, the sources cited in *supra* note 11.

15. See McCaffery, *supra* note 4 at 15.

taxes have been thought to be ideally flat.[16] For either or both reasons, the rate argument for income taxation arose and persists: the income tax, and perhaps only the income tax, can go hand-in-hand with progressive rates.

The base and the rate arguments, each apparently sufficient, combine to make a powerful case that income taxation, alone, advances a liberal conception of equity in taxation, of distribution or redistribution[17] of material resources to effect a more egalitarian distribution. Proponents of consumption taxation are left to argue for the greater efficiency or administrability of their preferred tax plan, and/or to take on the case for liberal redistribution itself.

But all this is mistaken. The confusion arises in part for analytic reasons but also in considerable part because the case for consumption tax has been plagued by the wrong argument structure, at least since Mill.[18]

III. The Traditional View, and Beyond

There are in fact three major choices of broad-based tax systems in ideal theory: the income, prepaid and postpaid consumption taxes.[19] We get to the three-view perspective when we see that the two broad types of consumption taxes are not created equal under progressive rates. In one model of consumption taxation, the tax is imposed up-front, and never again: a wage tax, like social security, or a so-called pre-paid or yield-exempt consumption tax. "Roth" IRA's in the United States work on this model (pay tax now, never again).[20] The second form of consumption tax imposes its single tax on the back-end: this is a sales tax, a postpaid, cash-flow or "qualified account model" consumption tax. Traditional IRAs in the United States work this way (no tax now, only later).[21]

Under flat or constant tax rates, the two principal forms of a consumption tax are indeed largely equivalent, and this equivalence has led to a confusion in the traditional view of tax. Both taxes are single taxes on individual flows of wealth that effectively exempt the normal yield to capital from tax.

To see this equivalence and also to consider the celebrated "double tax" argument against the income tax, owing most famously to Mill, and central to the

---

16. William D. Andrews, "A Consumption-Type or Cash Flow Personal Income Tax" (1974) 87 Harv. L. Rev. 1113 at 1167-68 [hereinafter Andrews 74]. ("Neutrality with respect to consumption is important not only because it promotes efficiency in the allocation of income, but because it keeps the tax from bearing more heavily on one person than another on account of differences in need or taste for particular goods or services, now or in the future."). Alvin C. Warren, Jr., "Fairness and a Consumption-Type or Cash Flow Personal Income Tax" (1975) 88 Harv. L. Rev. 931.

17. For the idea that it is the initial distribution of material resources, and not their "redistribution," that is at stake—that, in other words, the pretax distribution of material resources is not a normatively compelling baseline—see e.g., Murphy & Nagel, *supra* note 11. See also, Andrei Marmor in this Taxation issue of CJLJ.

18. John Stuart Mill, *Principles of Political Economy* (orig. 1848), ed. by W.J. Ashley (Logmans, Green & Co., 1909) Book V., ch. II, § 4 at 814.

19. This is before bringing transaction costs into the story, which push the income tax to an income-with-realization tax, and generate other types of "hybrid" taxes. Edward J. McCaffery, "Tax Policy Under a Hybrid Income-Consumption Tax" (1992) 70 Tex. L. Rev. 1149.

20. *Internal Revenue Code* ("I.R.C."), 26 U.S.C. § 408A.

21. *Ibid.* § 408.

HeinOnline -- 18 Can. J. L. & Jurisprudence 156 2005

traditional view of tax, a simple numeric example proves illustrative:

Suppose that Ant and Grasshopper each earns $200 in wages, the tax rate is 50 percent, and the interest rate on savings is 10 percent. Grasshopper, as is his way, spends all of his available money at once. Under any tax—income, prepaid or postpaid consumption—the government takes its 50 percent cut, or $100, and Grasshopper consumes the remaining $100. This demonstrates an important point: a good deal of the whole discussion has no direct impact on most taxpayers, for the simple reason that they do not save. *Income equals consumption for those who do not save*, a matter of definition one can see in the Haig-Simons formulation.

Ant, in contrast, does save, and so the choice of tax does matter to her. Suppose Ant saves for two years, at the conclusion of which she consumes all that she has amassed. How do the three different taxes treat her?

An income tax reduces Ant's $200 to $100 right away, which she puts in the bank. Ant earns 10 percent on her savings, or $10, in Year 1, but the income tax hits this, too—Mill's double tax—taking away $5, leaving her with $105 at the end of Year 1. In Year 2, this $105 again earns 10 percent, or $10.50; again the income tax strikes, taking $5.25; this leaves Ant with $110.25 to consume at the end of Year 2. If the 10 percent interest rate simply compensated Ant for inflation—if the cost of goods were rising at 10 percent per year—Ant would be losing real value, actual purchasing power, over time under the income tax: $110.25 at the end of two periods of 10 percent inflation is worth—has the same real purchasing power as—$91.12 at the start of the two periods.[22]

Consider next the two forms of consumption tax. First, the prepaid model: Ant is taxed on initial receipt under this system, reducing her $200 to $100. But she is not taxed again: consumption taxes are *single* taxes, escaping Mill's double-tax label. The $100 grows by the full 10 percent interest rate, to $110, after Year 1. In Year 2, the $110 earns another 10 percent, or $11, to $121, and Ant is left to consume this much at the end of Year 2. Unlike the case with the income tax, this end of Year 2 consumption is worth the same as $100 at the start of Year 1, under a 10 percent inflation or discount rate.

Under the postpaid consumption tax model, Ant pays no tax up-front and so can save her entire $200. This grows by 10 percent, or $20, in Year 1, to $220. The $220 grows by another 10 percent, or $22, to $242 in Year 2. When Ant goes to consume this, the government collects its 50 percent share, leaving Ant with $121 to consume. This is just as under the prepaid model. And it is more than the income tax. There is no smoke and mirrors here. There are only two critical assumptions needed to make out the equivalence of prepaid and postpaid consumption taxes: that the interest and tax rates have stayed constant in the two periods.[23]

Table 1 summarizes the example. Grasshopper's consumption from the start of Year 1, set out in the first column, is constant at $100. Ant's consumption at the end of Year 2, set out in the middle column, is $110.50 under an income tax and $121 under either form of consumption tax. The final column converts these values

---

22. 110.25/1.21, that is, the future value divided by 1 plus the discount rate, squared.
23. For fuller discussion, see McCaffery, *supra* note 1 at Part II.

back into constant starting Year 1 dollars, at a 10 percent discount/interest rate. This conversion makes clear that, under constant rates, savers lose real value under a true income tax, whereas a constant-rate consumption tax is "neutral" as between savers and spenders, present and deferred consumption.[24]

	Grasshopper	Ant	
Tax	Year 1 $	Year 2 $	Year 1 $
Income	$100	$110.50	$91
Prepaid Consumption	$100	$121	$100
Postpaid Consumption	$100	$121	$100

Table 1: Income, prepaid and postpaid consumption taxes compared

The Ant-Grasshopper example, or something rather like it, stands at the center of the traditional view of tax. The income tax is a double tax on value that is not immediately consumed, which has led many conservatives to oppose it as an unfair burden on the noble Ant, but liberals to support it as a necessary means of capturing some of the return to capital, the nearly exclusive domain of the wealthy. Both forms of consumption tax get put on the other side of a divide, as not reaching the yield to capital at all. It becomes a matter of either indifference or administrative convenience which of the two forms is chosen.[25]

IV. A New Understanding of Tax

The equivalence of prepaid and postpaid consumption taxes does not hold under non-constant or progressive rates.[26] Once we assume at least some progression in the rate structure, the traditional understanding of consumption taxes is no longer accurate.

Progressive rates under most comprehensive tax systems work through a series of marginal rate brackets, which form, in mathematical terms, a step-function. To have a simple and illustrative structure in mind, suppose that no tax is paid on the first $10,000; followed by a 15% marginal rate on the next $40,000; a 30% rate on the next $50,000, and so on. Such a system effects progressivity in average or effective tax rates. A taxpayer who has $100,000 subject to such a tax, for example, will pay total taxes of $21,000 ($6,000, or 15% of $40,000, plus $15,000, or 30% of $50,000), for an average tax rate of 21%; this is a higher average tax rate than someone who makes $50,000, who pays $6,000, or 12%, in average tax.[27]

The two forms of consumption taxes differ in their effects under progressive

24. See further discussion of "neutrality" as a norm in section IV below.
25. Like many elements in the traditional view, Andrews was among the first, best spokespersons for this idea. See Andrews 74, *supra* note 16. See also Slemrod & Bakija, *supra* note 11; David E. Bradford & US Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform*, 2nd rev. ed. (Arlington, VA: Tax Analysts, 1984).
26. See William D. Andrews, "Fairness and the Personal Income Tax: A Reply to Professor Warren" (1975) 88 Harv. L. Rev. 947 [hereinafter Andrews 75].
27. For more detail on how tax rates work, see McCaffery, *supra* note 4 at ch. 5.

HeinOnline -- 18 Can. J. L. & Jurisprudence 158 2005

rates. Now there are three—not two—alternatives for the tax policymaker to choose. The differences come in when the tax falls, and how this impacts choices of work, savings, education, and so on, and, most important, in how the tax redistributes material resources. Consider each in turn.

One, an income tax falls on all labor market earnings and the yield to savings, at the time they come into a household. Savers are hurt by the "double taxation" of savings, whatever their intended or actual use. Individuals, like the highly educated, who see their earnings come in relatively short concentrated bunches, are also hurt by the timing of the imposition of progressive rates.

Two, a prepaid consumption tax falls on labor market earnings alone, again at the time they come into a household. Once more, people whose earnings profiles are uneven throughout their lifetimes are hurt by the timing of the imposition of the progressive rate structure. But—and here is the rub for most liberals and even moderates—those who live off the yield to capital are never taxed.

Three, a post-paid consumption tax does not come due at the time of initial inflows, but rather at the time of outflows, when money is spent in consumption. This means that a progressive postpaid consumption tax stands between an income tax, which double taxes all savings, and a prepaid consumption tax, which ignores all savings. A consistently progressive postpaid consumption tax treats savings differently depending on their use.

Now we can think of two broad uses of savings. One is to *smooth* out consumption profiles, within lifetimes or across individuals—to translate uneven labor market earnings into even consumption flows. We do this by borrowing in youth and saving for retirement (and/or other times of special need, such as health and education demands) in mid-life. A second use of savings is to *shift* consumption profiles, up or down. An upward shift occurs when the fruits of our own or another's savings allow us to live a "better" lifestyle than we could on the basis of our own labor market earnings, alone, smoothed out over time. A downward shift occurs when our beneficence or bad fortune means that we will live at a lower lifestyle than we otherwise could, again on the basis of our smoothed out labor market earnings profile alone.

A simple example helps to make points clearer. One taxpayer, Steady Earner, makes and consumes $50,000 a year for the relevant years of comparison, say beginning in her 20's. A second taxpayer, Lumpy Earner, stays in school until he is 30, and then makes $100,000 a year. But Lumpy Earner spends $50,000 a year, using prudent borrowing and saving to effect this result.[28] Finally, Trust Fund Baby lives off his parents' fortune, getting and spending $50,000 a year. How do the three taxes affect these three individuals, under the simple progressive rate structure posited above?

An ideal progressive income tax burdens all three taxpayers, but falls most heavily on Lumpy Earner, because of the timing of the imposition of the progressive rates. In the simple rate structure posited above, Lumpy pays 21% of his earnings

28. My simple example ignores interest, which I discuss at greater length in McCaffery, *supra* note 1.

in income tax, whereas Steady and Trust Fund Baby each pays 12%. (In reality, Trust Fund Baby will pay far less under the actual income tax, as we shall note below.) A progressive prepaid consumption tax also burdens Lumpy Earner most heavily, at a 21% level given the same rate structure, continues to tax Steady Earner at the 12% level, but *altogether ignores* Trust Fund Baby—taxing him at 0%, thereby accepting the tax, if any, in some *prior* generation of labor earnings as sufficient for his contribution to society. A progressive postpaid consumption tax, in contrast, falls equally on all three taxpayers, at the 12% level.

In sum, whereas an ideal income tax double taxes all savings, whatever their use, and a prepaid consumption tax ignores all savings, again whatever the use, a consistent progressive postpaid consumption tax splits the difference, in a principled way, and by design. It allows taxpayers to lower their taxes by smoothing, but it falls on the yield to capital when used to enhance lifestyles, as for Trust Fund Baby. This reflects simple, commonsensical attitudes about life, income, and savings. These attitudes are reflected imperfectly under the status quo in the United States and other advanced Western democracies, with a nominal income tax rife with pro-savings provisions for retirement, health, and education.

This discussion also illustrates that each of the three types of tax have a claim to "neutrality" of some sort. The challenge for tax policymakers is to choose the right sort. Ideal income taxes fall on all inflows, at the time of their receipt into a household. Prepaid consumption taxes apply to all and only wages, at the time of their receipt. Postpaid consumption taxes fall on all consumption, or "private preclusive use," as the American law professor William Andrews put the matter,[29] whatever their source.[30] If we consider the three main sources of financing a lifestyle—labor, capital, or beneficence (someone else's labor or capital)—a consistent progressive postpaid consumption tax falls on each equally, without marking the distinctions, which can be hard to make out in practice.

V. A New Look at Tax Reform

A better understanding of the analytics of tax can lead to a dramatically simpler tax system that is at the same time far fairer, one that perfectly incorporates the ordinary moral intuitions about savings—namely that savings for some purposes, which we can broadly call smoothing, should not be burdened twice over, but that savings that enables a higher material lifestyle can and should be subject to tax. The new, three-tax understanding of tax leads to a richer understanding of what we have in tax today, and what a better tomorrow might look like.

Specifically, this new understanding plus a consideration of a near century of actual tax policy in the United States and elsewhere shows that the real, pressingly practical choice in tax policy should not be over income versus consumption taxes, as it has been for centuries, but over which type of consumption tax to have, prepaid or postpaid.

29. Andrews 74, *supra* note 16.
30. See Andrews 75, *supra* note 26.

HeinOnline -- 18 Can. J. L. & Jurisprudence 160 2005

Simply put, we do not have, have never had, and will never have an ideal income tax.[31] When we observe the status quo closely in the United States—with parallel findings to be had in other jurisdictions—we see a slow but steady movement toward a flat or flattened *prepaid* consumption tax. Second taxes on capital have long been fairly easily avoided.[32] Recent legal changes, such as the lowering of the capital gains rate and the exclusion of corporate dividends from income, and more recent proposals, such as those for more expansive Roth-style savings accounts, continue and confirm the trend. These changes are moving and will move the United States ever farther toward a wage tax, in which the yield to capital is never taxed. Discussions among conservative tax policy reformers are increasingly explicit on point.[33]

This is the wrong place to go, in the name of fairness. Prepaid consumption taxes fall only on labor earnings, as we have seen, and, for this reason, are capped in their practical capacity for progressivity: the base and rate arguments do apply to them. Most liberal egalitarians today, laboring under the traditional understanding of tax, feel that they can only counter the trend towards a particular type of consumption tax—a flat prepaid one—by insisting on retaining the status quo and resisting all attempts at change. A better understanding of tax shows that another type of consumption tax—a consistent progressive postpaid one—is the most attractive option, for just the reasons liberals oppose consumption taxes: because such a tax does, whereas a prepaid consumption tax does not, reach the yield to capital, and can maintain and even increase the progressivity of the tax system's rates.

Further, crude practicalities need not impede this compelling reform: far from it. Implementation of a consistent, progressive, postpaid consumption tax is practical. The basic analytics of tax, specifically the rearrangement of the Haig-Simons definition to show that Consumption equals Income minus Savings ($C = I - S$), helps to show this fact. A consistent postpaid consumption tax looks much like what we do now in tax, except that it can support considerable simplification.

Specifically, there are two broad ways to implement a consistent, progressive, postpaid consumption tax.

One path is to keep the basic income tax system in place, but repeal the limits on savings accounts: adopting unlimited IRA or savings account treatment, as in the Nunn-Domenici USA tax plan. These savings accounts must be on the postpaid model. Debt that is used to finance personal consumption (as negative savings) must be included as a taxable input.[34]

---

31. See Edward J. McCaffery, "A Voluntary Tax? Revisited" (2001) Nat'l Tax J. 268. 93rd Annual National Tax Association Proceedings.

32. *Ibid.*

33. The highly influential Grover Norquist, for example, notes of the four tax cuts in President George W. Bush's first term that "[p]eople looked at those and thought they were just catch as catch can. But every one of those tax cuts moved us toward a single-rate tax system that taxes income just one time." Stephen Moore, president of the powerful Club for Growth, foresees not "a big grandiose plan, but rather incremental steps." Moore regards the flat tax as the "Garden of Eden [that requires] that every change we make with tax policy is moving us in that direction." Reported in Warren Veith, "U.S. Tax Code May Be Facing a Full Rewrite" *L.A. Times* (7 November 2004) A27.

34. For more discussion of debt, see McCaffery, *supra* note 4 at 19-20, 132-34. This inclusion of debt-financed consumption, plus the repeal of any special preference of capital gains under a

HeinOnline -- 18 Can. J. L. & Jurisprudence 161 2005

A second path is to take advantage of the analytic equivalence of sales taxes and postpaid consumption ones, and replace the income tax with a three-part plan, consisting of:

- A national sales or value-added tax at a modest, sustainable rate, say 10 to 15 percent;
- A system of rebates to effect a "zero bracket" under the national sales tax, say $500 per person, which would offset $5,000 of taxable consumption (at a 10 percent rate);
- A supplemental "consumed income tax" for the wealthiest Americans, modeled along the lines of the existing income tax with unlimited deductions for savings, as above. This tax could apply to households consuming say $100,000 a year or more, and would simply subtract out the national sales tax rate.[35]

The net result of this three-step plan would be to have a zero bracket of $20,000 for a family of four; followed by a 10 or 15 percent bracket extending to $100,000 of consumption; followed by a 20 or 30 percent bracket, and so on, but effected by a consumed income tax with rates starting in again at 10 or 15 percent (to add to the national sales tax).

The choice of which mechanism to choose comes down to administrative and political concerns, including the wisdom of having two taxes rather than one. But the simple analytic fact of the matter is that the two broad practical choices lead to the same theoretical place: a consistent, progressive, postpaid consumption tax.[36]

Under either means for getting to a consistent progressive postpaid consumption tax, and consistent with the principled basis of such a tax, we could and should repeal:

- All capital gains taxes under the income tax;
- All rules for "basis" of investment assets;
- All rules about maximum contributions to and minimum distributions from the savings accounts;
- The corporate income tax; and the
- Gift and estate tax.

A word or two is in order on the last two items. The current system aims to "backstop" the income tax, which tax is (in ideal theory) supposed to burden savings,

---

consistent postpaid consumption tax model, happen to be two base-*broadening* features of such a plan, compared to the status quo. It is not simply true that rates will have to rise in any conversion from the status quo to a consistent postpaid consumption tax; the base broadening features must be set against the base-constriction of allowing additional deductions for savings, bearing in mind that the current tax has many such features already. These are, of course, empirical questions to be studied. See Edward J. McCaffery, "Ten Facts about Fundamental Tax Reform" (22 December 2003) Tax Notes 1463.

35. Michael J. Graetz, on his proposal to reform the current American tax system with a value added tax plus a continued *income* tax for the wealthy, uses a $100,000 cut off. See Michael J. Graetz, "100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System" (2002) 112 Yale L. J. 261; "To the Point of No Returns" *New York Times* (15 November 2004) A23. I compare and contrast Graetz's plan to my preferred one in McCaffery, *supra* note 4 at 102-03.

36. McCaffery, *supra* note 4 at 100-02.

HeinOnline -- 18 Can. J. L. & Jurisprudence 162 2005

by levying a hefty tax on those decedents who die with large estates. This tax is obviously desired as a matter of fairness. But its very existence encourages the rich to consume more, and die broke, whether they spend on themselves or their heirs.[37] In contrast, a consistent progressive postpaid consumption tax never taxes savings directly. Saved assets thus have a zero "basis" in technical tax terms.[38] These assets can therefore be passed on to heirs on life or at death, without the moment of transfer itself triggering tax. On the other hand, and at a different time, *spending* by the heirs will generate tax, and under a progressive rate structure. A consistent progressive postpaid consumption tax does not need, in principle, a separate gift and estate tax, because the very design of the tax entails an accessions or inheritance tax.

In Canada, there is no wealth transfer tax, but there is a capital gains tax imposed on death; death becomes a "realization event," in technical tax parlance.[39] A consistent progressive postpaid consumption tax can get rid of this bit of unpleasantness, too. Once again, because savings are not initially taxed, assets have a zero "basis" for tax purposes. A consistent postpaid consumption tax can keep operating consistently, through transfers including death. The heirs take the assets with no basis, and these heirs pay tax when, if, and to the extent they consume from their inheritance. It is all a matter of time.

Parallel arguments can be made against a separate corporate income tax. The problems with this tax begin with its uncertain incidence: since corporations are not real people, they do not really pay taxes. A corporate tax falls on workers and consumers, on capital generally, or on some combination thereof. To the extent it falls on ordinary workers and consumers, a corporate income tax's claims to fairness are questionable. But to the extent such a tax falls on capital, it cannot do so in any *individuated* way. Savers bear the burden of the corporate income tax whether they are rich or not, saving for lifetime needs or emergencies or to support a high-end lifestyle. Once again, under a consistent, progressive, postpaid consumption tax—which falls on the yield to capital as a source of personal consumption—such a tax is not needed. It is a matter of time, again.

The elimination of these other taxes follows from the principle of a consistent progressive postpaid consumption tax: to tax individuals as they spend, not as they work, save, give, or die. Simplicity, transparency, and efficiency can be enhanced; fairness need not be abandoned. Such a tax system would apply to the yield to capital, when but only when it is appropriate to do so. The rich would not be let off the social hook; their tax would come due when, as, and if they spent wealth on themselves. Progressivity could be maintained, even strengthened.

---

37. See Stephen M. Pollan & Mark Levine, *Die Broke* (New York: Harper-Collins, 1997). For my own thoughts on estate or wealth transfer taxation, see Edward J. McCaffery, "The Uneasy Case for Wealth Transfer Taxes" (1994) 104 Yale L. J. 283; Edward J. McCaffery, "The Political Liberal Case against the Estate Tax" (1994) 23 Phil. & Pub. Affairs 281; McCaffery, *supra* note 4 at ch. 4, 62-77.

38. I.R.C. § 1011 (basis); I define 'basis' in McCaffery, *supra* note 4 at 161, as after-tax dollars.

39. *Income Tax Act*, R.S.C. 1985 (5th Supp.), c.1, s. 70(5), (5.1).

HeinOnline -- 18 Can. J. L. & Jurisprudence 163 2005

VI. Last Words

The traditional understanding of tax has liberal egalitarians worldwide stuck, defending unpopular and ineffective taxes—individual income, corporate income, and wealth transfer ones. Conservative and libertarian opponents of any and all redistribution meanwhile march happily onward, pressing tax systems ever closer toward flat prepaid consumption taxes—wage taxes, in short.

A new and better understanding of tax promises a way out of this gloomy predicament.

A consistent progressive postpaid consumption tax is not equivalent to a wage tax; it does not foreswear the taxation of any and all of the yield to capital. Such a tax instead sits sensibly between an income tax, which double taxes all savings, willy-nilly, and a prepaid consumption tax, which avoids ever taxing the yield to capital, come what may. Instead, a consistent progressive postpaid consumption tax allows individuals to lower their burden of taxation when they use capital transactions (borrowing, saving, investing) simply to move uneven labor earnings evenly through time, smoothing out their spending. It increases the burden of taxation, in contrast, when the yield to capital—or any other source of enhanced spending power, such as another's beneficence—allows one to live a "better" or enhanced lifestyle. Simply and by design, the consistent progressive postpaid consumption tax captures attractive ordinary moral intuitions about the taxation of capital and its yield: that savings which simply prudently provide for a consistent lifestyle should not be double-taxed, but that those capital (and other) transactions that bring greater material pleasures ought to be taxed.

The current tax system, in the United States at least, taxes people when they work, save, marry, give, and die. These are bad times to tax. We can tax people when and only when they spend, on simple annual returns that maintain and indeed strengthen and make more enduring a historical and independently attractive commitment to progressivity in tax burdens. It is time to get the understanding of tax down right: Tax is too important not to do so.

HeinOnline -- 18 Can. J. L. & Jurisprudence 164 2005