

1979

# The Case for an Income Tax

Alan Gunn

*Notre Dame Law School*, alan.gunn.1@nd.edu

Follow this and additional works at: [https://scholarship.law.nd.edu/law\\_faculty\\_scholarship](https://scholarship.law.nd.edu/law_faculty_scholarship)



Part of the [Tax Law Commons](#)

---

## Recommended Citation

Alan Gunn, *The Case for an Income Tax*, 46 U. Chi. L. Rev. 370 (1978-1979).

Available at: [https://scholarship.law.nd.edu/law\\_faculty\\_scholarship/326](https://scholarship.law.nd.edu/law_faculty_scholarship/326)

This Article is brought to you for free and open access by the Publications at NDLScholarship. It has been accepted for inclusion in Journal Articles by an authorized administrator of NDLScholarship. For more information, please contact [lawdr@nd.edu](mailto:lawdr@nd.edu).

# The Case for an Income Tax

Alan Gunn†

*There are some enterprises in which a careful disorderliness is the true method.*

Herman Melville, *Moby Dick*

Recent studies by the United States Treasury Department<sup>1</sup> and the Meade Committee<sup>2</sup> in England recommend a progressive tax on personal consumption as an alternative to an income tax. Neither adds anything fundamental to the expenditure-tax controversy, but each contains one intriguing feature: a discussion of the practical problems of substituting consumption for income as the tax base.<sup>3</sup> This development may mean that the replacement of the income tax by an expenditure tax should be taken as a serious practical possibility. And even if the possibility of so radical a change in our tax structure is remote, the arguments of the expenditure-tax theorists may encourage changes in the income tax in the form of additional relief for savers or a supplemental tax on expenditure. The time when the expenditure tax could be dismissed as lacking practical significance has long passed.

Arguments based on considerations of equity, administrative convenience, and economic efficiency play an important role in the case for an expenditure tax.<sup>4</sup> I will not address the question of

---

† Professor of Law, Cornell University.

<sup>1</sup> DEPARTMENT OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977) [hereinafter cited as BLUEPRINTS]. This report presents two alternative "model tax systems"—an expenditure tax and a comprehensive income tax with rates much less progressive than the existing rates—without choosing between them.

<sup>2</sup> INSTITUTE FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION (1978) [hereinafter cited as MEADE COMMITTEE REPORT].

<sup>3</sup> BLUEPRINTS, *supra* note 1, at 204-12; MEADE COMMITTEE REPORT, *supra* note 2, at 187-92.

<sup>4</sup> The most important recent defense of an expenditure tax is Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974). Among older proponents of an expenditure tax, Irving Fisher was especially influential. The most concise and forceful expression of his views is I. FISHER, *THE INCOME CONCEPT IN THE LIGHT OF EXPERIENCE* (n.d.) (pamphlet) [hereinafter cited as *THE INCOME CONCEPT*], which appears to be Fisher's own translation of a paper originally published in German in 3 *DIE WIRTSCHAFTSTHEORIE [sic] DER GEGENWART* (1927). See also I. FISHER, *THE NATURE OF CAPITAL AND INCOME* (1906); I. FISHER & H. FISHER, *CONSTRUCTIVE INCOME TAXATION* (1942); N. KALDOR, *AN EXPENDITURE TAX* (1955); A. PIGOU, *A STUDY IN PUBLIC FINANCE* 118-26 (3d ed. 1951). For defenses of the income tax, see generally H. SIMONS, *PERSONAL INCOME TAXATION* (1938), and Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975). Professor Andrews responded to Professor Warren's criticism in Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1975).

“efficiency” directly, although some of my “equity” arguments may bear on efficiency as well as equity. I will focus on the most important noneconomic issues in the debate between expenditure and income taxation: whether an income tax imposes “double taxation” on savings, how income compares with other bases for taxation in terms of fairness, whether “ability to pay” is a meaningful test of fairness in a tax base, and whether an expenditure tax will be easier than an income tax for the government to administer and more convenient for most taxpayers to pay.<sup>5</sup> Finally, in the last section, I will touch on some collateral policy issues and suggest that attempts to reform the income tax may be more fruitful than the radical strategy of changing our tax base.

## I. THE EXPENDITURE TAX, THE INCOME TAX, AND THE DOUBLE TAXATION OF SAVINGS

### A. The Basis of Expenditure-Tax Theory

The earliest proposal for an expenditure tax that is still cited today was made by Thomas Hobbes. Hobbes thought consumption to be the best tax base because it measures the benefits taxpayers receive from society: an expenditure tax would charge individuals equally in proportion to the goods they withdraw from the common stock.<sup>6</sup> Hobbes’s ideas are recognizable in the position of some mod-

<sup>5</sup> The tax base defended here resembles that of the existing federal income tax, tidied up somewhat, perhaps, but not fundamentally altered. I have no desire to defend an “ideal” tax based on the Haig-Simons definition of income:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it 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.

H. SIMONS, *supra* note 4, at 50. Haig’s earlier formulation was: “Income is the *money-value of the net accretion to economic power between two points in time.*” Haig, *The Concept of Income—Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX 7* (R. Haig ed. 1921), reprinted in *AMERICAN ECONOMIC ASSOCIATION, READINGS IN THE ECONOMICS OF TAXATION 54*, 59 (R. Musgrave & C. Shoup eds. 1959).

Nor do I mean to defend a progressive income tax. Indeed, I shall argue that one advantage of income over expenditure as a base for taxation is that an income tax need not be progressive to be fair. See Part IV(C) *infra*.

<sup>6</sup> T. HOBBS, *LEVIATHAN* 298 (A. Lindsay ed. 1959):

To equal justice, appertaineth also the equal imposition of taxes; the equality whereof dependeth not on the equality of riches, but on the equality of the debt that every man oweth the commonwealth for his defence . . . [T]he equality of imposition, consisteth rather in the equality of that which is consumed, than of the riches of the persons that consume the same. For what reason is there, that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged, than he that living idly, getteth little, and spendeth all he gets; seeing the one hath no more protection from the commonwealth, than the other? But when the impositions, are laid upon those things

ern expenditure-tax theorists that the income tax is unfair to investors and wage earners because it taxes them while not taxing rich people who choose to be economically idle and live off their principal.<sup>7</sup> Few people today accept Hobbes's principle that taxes should be levied in proportion to benefits received, and the idea that only those who spend receive benefits from society seems bizarre.

Modern expenditure-tax theory is closer to the position of John Stuart Mill.<sup>8</sup> Mill viewed an income tax without an exemption for income saved as discriminating against savers because taxpayers would be "taxed twice on what they save, and only once on what they spend."<sup>9</sup> He argued that an income tax taxes savers both upon principal (the money originally earned) and the earnings from investing that principal. This, Mill argued, is unfair to the saver, because "if he has the interest, it is because he abstains from using the principal; if he spends the principal, he does not receive the interest. Yet because he can do either of the two, he is taxed as if he could do both . . . ."<sup>10</sup> Mill's fundamental idea, that the income tax is unfair to savers, is common today, as is the picturesque language with which he expressed this conclusion: the saver is "taxed twice" under an income tax.<sup>11</sup>

Some influential proponents of the expenditure tax have gone beyond Mill in important respects. Mill thought a consumption tax impractical because measuring annual personal consumption directly was impossible.<sup>12</sup> Modern writers have shown, however, that consumption can be measured, perhaps even more easily than income. Irving Fisher pointed the way by demonstrating that modern accounting techniques make it no harder to compute personal savings or dissavings than business savings.<sup>13</sup> He argued for an "income" tax (really an expenditure tax) under which all receipts—including gifts, inheritances, and withdrawals from savings—would enter into the definition of taxable income, but savings would be deductible, thus adding only two steps to present computations.<sup>14</sup> William Andrews has argued, more recently, that a spend-

---

which men consume, every man payeth equally for what he useth; nor is the commonwealth defrauded by the luxurious waste of private men.

<sup>7</sup> See, e.g., N. KALDOR, *supra* note 4, at 14, 53.

<sup>8</sup> 2 J.S. MILL, *PRINCIPLES OF POLITICAL ECONOMY* 406-09 (1874).

<sup>9</sup> *Id.* at 407.

<sup>10</sup> *Id.*

<sup>11</sup> E.g., M. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 260-61 (1977) (presenting the notion that savings are doubly taxed under an income tax as fact, with no suggestion that the conclusion is open to doubt).

<sup>12</sup> 2 J.S. MILL, *supra* note 8, at 428.

<sup>13</sup> THE INCOME CONCEPT, *supra* note 4, at 14-17.

<sup>14</sup> *Id.*

ings tax would actually be easier to administer than an income tax, because the underlying computations would be simpler.<sup>15</sup> His claim is that an expenditure tax would not require the resolution of such troublesome problems of present law as distinguishing capital gains from ordinary income, computing depreciation, and drawing a line between business expenses and capital expenditures.

Mill's "double taxation" argument, in the form in which he made it, is circular. To say, as he does, that one who invests money "abstains from using" it is to say, at least implicitly, that consumption is the only "use" of money that should be considered in devising a tax. But modern writers have rescued the "double taxation of savings" argument from circularity. They argue that an income tax discriminates against savers because it makes saving less attractive relative to spending than would be the case in a world without taxes. I will use Andrews's figures to illustrate the argument.<sup>16</sup>

In a world without taxes or with an expenditure tax, a person who decides to save \$1.00 of income and invest it at nine percent will have eight times as much to spend after 24 years as he could have spent initially; but with an equivalent<sup>17</sup> income tax he will have only four times as much to spend under the same conditions.

Tax	(1) Available after Taxes if Spent Immediately	(2) Available after Taxes if Spent In 24 Years	Ratio (2) : (1)
No Tax	\$1.00	\$8.00	8:1
33½% Income Tax	\$0.67	\$2.67	4:1
Equivalent Expenditure Tax	\$0.67	\$5.33	8:1

Even in this illustration, the expenditure tax does not reproduce the no-tax world in all respects, because any tax, by reducing the total amount a taxpayer has available for saving and spending, will normally affect the proportion he decides to allocate to each use.<sup>18</sup> But

<sup>15</sup> Andrews, *supra* note 4, at 1148-65.

<sup>16</sup> *Id.*, at 1125.

<sup>17</sup> For purposes of this example, an equivalent tax is one that takes the same proportion of nonexempt earnings. To do this, the nominal rate would have to be higher under an expenditure tax than under an income tax, if the income tax base is pretax income, and the expenditure tax base is what a person spends after setting aside what he will need for taxes (assuming no savings). This should not be confused with the problem of whether the aggregate tax base would be greater or smaller under an expenditure tax than it is today. The extent, if any, to which rates might have to be raised overall if the income tax were replaced by an expenditure tax is uncertain and cannot be calculated without knowing how people's savings would respond to changes in the rate of return on investment. For a discussion of the problems in this area, see R. GOODE, *THE INDIVIDUAL INCOME TAX* 37-57, 312-16 (rev. ed. 1976).

<sup>18</sup> The reason an income tax appears to "discriminate" against savers is that it seems to "take" not only money that would have been saved (but for the tax) but also the money that would have been earned by the money used to pay the tax. But any tax, even an expenditure

to the extent that an individual is influenced by what a dollar saved at the margin can earn, the incentive to save appears the same under an expenditure tax as in a no-tax world and different under an income tax that contains no exemptions for saving.

This argument is convincing only if one accepts a no-tax world as a standard for judging the desirability of a tax. Economists use the model of a no-tax world as a heuristic device to measure the likely effect of different taxes on the economy and as a standard of comparison in measuring "efficiency." As a starting point in making rough guesses about the effects of changes in existing arrangements, the "tax-free society" device may serve a useful purpose. But the model rests on so many assumptions about behavior under hypothetical conditions that any conclusions based on it must be problematic and tentative. As Coase has asked in another context:

In a state of laissez faire, is there a monetary, a legal, or a political system, and if so, what are they? . . . Whatever we may have in mind as our ideal world, it is clear that we have not yet discovered how we get to it from where we are. A better approach would seem to be to start our analysis with a situation which naturally exists, to examine a proposed policy change, and to attempt to decide whether the new situation would be, in total, better or worse than the original one.<sup>19</sup>

## B. Reduction to Present Value and Fairness

Even if we assume, for purposes of argument, that "no-tax society" comparisons are useful in determining economically efficient solutions to complex practical problems, it does not follow that "discrimination" against savings under an income tax (when both income and expenditure taxes are compared to a no-tax society) is unfair. The unfairness argument seems to rest on the notion that people generally prefer to consume as they earn and so must be induced by interest to defer consumption.<sup>20</sup> Interest income is thus merely compensation for delaying consumption. It does not represent a true increase in value to the saver, and a tax on that interest—like a tax on a nominal profit that reflects only monetary inflation—is in reality a levy on capital, a second tax on the earnings whose consumption was delayed. The following example illustrates

---

tax, can "discriminate against savers" in this way. The "double taxation" examples assume that the portion of the taxpayer's income that is saved is unaffected by the kind of tax in force. See, e.g., Macgregor, *Taxation of Savings*, 3 *ECONOMICA* (New Series) 387 (1936).

<sup>19</sup> Coase, *The Problem of Social Cost*, 3 *J.L. & ECON.* 1, 43 (1960).

<sup>20</sup> See note 28 *infra*.

the thrust of this argument.<sup>21</sup> Two people earn \$10,000 in one year. One spends all his after-tax income, while the other saves half his after-tax income the first year and spends it the second. With a flat 30 percent income tax and a 10 percent interest rate, net return after taxes is 7 percent. Ignoring their second-year salaries, we get the following results:

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	Spends Year 1	Tax	Saves	Interest pre-tax	Tax on Int.	Spends Year 2	Present Value of (5) at 10%	Present Value of (6) at 7%	of (1)+(6)
Spender	7,000	3,000	—	—	—	—	—	—	7,000
Saver	3,500	3,000	3,500	350	105	3,745	95	3,500	7,000

Although the "present value" of what the saver and the spender eventually spend is the same, the saver must set aside more for taxes—not only does the saver pay more taxes in total dollars (\$3,105 vs. \$3,000), the present value of his taxes is greater (\$3,095 vs \$3,000). Under an expenditure tax, the present value of their taxes would be the same, no matter how much or how long one saves. The argument that the net interest rate should be used to reduce future consumption and future taxes to their present value, and that, as a consequence, the saver and the spender in the illustration above "really" consumed the same amount but were taxed unequally, is the essence of the modern justification for the view that the income tax is a "double tax" on savings.<sup>22</sup>

Reduction to present value is often an essential step in comparing people's well-being. If two people receive \$10,000 each in a taxable transaction, the one who is allowed to pay the tax later needs to set aside less for that purpose than the one who must pay the tax immediately, because money set aside to pay a fixed sum in the future earns interest until the sum is paid. But this type of analysis, so useful for comparing the burden of taxes, cannot be used in a

<sup>21</sup> The example in the text is inspired by Fisher's famous three brothers example. THE INCOME CONCEPT, *supra* note 4, at 12-13. Three brothers inherit \$100,000 each. The first chooses to spend only the interest; the second allows his interest to accumulate until his money has doubled, and then spends the interest on this sum; the third buys a \$20,000 a year annuity for six years, after which he has nothing left. Fisher assumes a 5 percent rate of return and a 10 percent tax. Under a conventional income tax, the first brother could take care of his future tax burden by setting aside \$10,000 in the year of the inheritance, the second would have to set aside \$17,140, while the third, "improvident," brother would need only \$1,577.30. Under a consumption tax, each brother would have to set aside \$10,000.

<sup>22</sup> *Id.* See also N. KALDOR, *supra* note 4, which is more explicit on this point than Fisher. Kaldor's discrimination argument is put in terms of "a comparison between the present capitalized value of a man's future prospect and the present capitalized value of his future tax liabilities." *Id.* at 84-85. Pigou, *Taxation of Savings: A Reply*, 4 *ECONOMICA* (New Series) 204 (1937) and BLUEPRINTS, *supra* note 1, at 39-40, make similar points.

straightforward way as a technique for determining the present value of future consumption to a saver.<sup>23</sup> If a taxpayer can obtain a secure after-tax return of ten percent, he is indifferent whether he pays \$1.00 in tax now or \$1.10 a year later, and this is true whether the total tax deferred is \$1.00 or \$1 million. But this does not mean that if a person lends \$10,000 at minimum risk for one year at ten percent, he values \$11,000 of consumption a year from now no more than \$10,000 now.<sup>24</sup>

The interest rate reflects the "time value of consumption," if at all, only at the margin. The interest rate at which a person lends his money measures the value to him of the last dollar he saves.<sup>25</sup> If the interest rate were lower, he would probably still save, although he would probably save a different amount—less or more.<sup>26</sup> The

---

<sup>23</sup> This criticism seems to be implicit in Simons's response to Fisher, although Simons emphasized Fisher's inconsistent use of the term "income." H. SIMONS, *supra* note 4, at 90:

It seems not unfair to say that Fisher is guilty of no little verbal legerdemain in his double usage of the income concept. Part of the time he is talking about income in the sense of values realized in consumption; but, whenever he is dealing with the valuation of capital goods, he uses income in exactly what we have defined as the yield, rent, or productivity sense . . . . What is discounted in the valuation of property is future yield (*Ertrag*), which may or may not be consumed. What are discounted are yields, not "consumptions."

See also H. GROVES, *TAX PHILOSOPHERS* 109 (1974).

<sup>24</sup> The differences between straightforward time-value calculations as applied to the receipt of cash and the same calculations as applied to consumption can be easily shown by a simple if somewhat extreme comparison. Suppose a taxpayer who could expect to receive a secure income of \$10,000 a year for the next ten years were offered, as an alternative, a present lump-sum payment of \$100,000. Ignoring any possible effects of a progressive income tax, any rational person would accept the offer, since the opportunity for an investment return makes \$100,000 now worth more than \$10,000 a year for ten years to anyone. But it is surely not the case that any rational person who expected to consume \$10,000 a year for the next ten years and who could give up that opportunity in exchange for \$100,000 consumption this year, on condition he consume nothing for nine years, would accept the offer.

It is also worth noting that whatever conclusions can be drawn about someone's preference for present over deferred consumption, even at the margin, from that person's decision to save at a given rate of interest are conclusions about *expected* enjoyment of consumption, not about actual enjoyment as determined (if, indeed, it could be determined) after the fact. See A. Warren, *Income and Consumption Taxes—The Issue of Fairness* (1979) (unpublished manuscript on file with author).

<sup>25</sup> If interest income compensates a person for postponing consumption, and if, as is likely, consumption has a declining marginal utility—that is, as more is consumed, each additional unit of consumption is valued less—a person will save only if the interest rate compensates him for the last unit of consumption he is to forego by saving. If the interest rate does not compensate him for postponing that unit of consumption, he will consume it immediately instead of saving it. If it overcompensates, he will save more until it no longer "pays" him to save. *But see* note 26 *infra*.

<sup>26</sup> If consumption had a declining marginal utility for everyone, people would save more as the interest rate went up, and would save less as it went down. This analysis, however, leaves many factors out of account. For example, someone who is saving for a particular goal, such as a college education for his children or a particular level of retirement income, may

money he would save even with a lower rate of interest produces benefits, if invested at the higher going rate, greater than those of current consumption. Use of the after-tax rate of interest to reduce future spending to present value, when applied to measure the present value of savings, ignores that part of a person's interest income that inures to him when he is able to invest part of his savings at a higher rate than he was in fact ready to accept.

Reduction to present value is essential to the argument that the income tax involves "double taxation of savings" and is therefore unfair to savers. Fisher said that it is "unjust" to impose taxes that are different, when reduced to present value, on people whose consumption, also reduced to present value, is the same.<sup>27</sup> This judgment rests on at least two assumptions: first, that a tax is just only if it taxes equal benefits or enjoyments equally;<sup>28</sup> second, that the interest rate measures the benefits forgone by delaying consumption. If the interest rate measures these benefits only at the margin, this second assumption is undermined and the argument loses much of its force. And a case can be made against reducing postponed consumption to present value, even at the margin, for the purpose of assessing the justice of a tax. As is indicated by the title of the revised (1930) edition of Irving Fisher's famous work on the rate of interest. *The Theory of Interest as Determined by Impatience to*

---

reduce the proportion of his earnings that he saves as the interest rate goes up. Just as the income tax tends to encourage some people to substitute nontaxable leisure for taxable work (the "substitution effect") and encourage others to work harder to replace money taken in taxes (the "income effect"), a tax with an exemption for income saved would encourage some people to save more while encouraging others, such as those trying to accumulate a fixed sum, to save a smaller proportion of their earnings than they would under an income tax. For a discussion of these effects, see R. GOODE, *supra* note 17, at 52-57.

<sup>27</sup> THE INCOME CONCEPT, *supra* note 4, at 12-13.

<sup>28</sup> This is discussed at notes 42-47 *infra*. It should be pointed out here that Fisher's view that it is fair to tax equally—and fair only to tax equally—people whose future consumption reduced to present value is the same assumes, among other things, that the only benefit people get from saving is increased future consumption. But as Guillebaud has pointed out, the saver has immediately a new asset in the shape of his savings as a capital sum, in terms of its present exchange value, which is valuable to him not merely, and often not principally, as a source of future income, but as a protection and reserve against emergencies which may at any time befall him. There also comes into the question the prestige value of accumulated wealth, the desire to bequeath large sums at death, the knowledge of the power that derives from the possession of wealth . . . .

Guillebaud, *Income Tax and the "Double Taxation" of Saving*, 45 *ECON. J.* 484, 490-91 (1935). A similar argument is made in H. SIMONS, *supra* note 4, at 95-96 ("Time-preference theories are also interesting for their emphasis upon consumption as the unique end of all economic behavior.").

A person who values accumulation for its own sake will save and, under an expenditure tax, never pay tax on his accumulation, because his enjoyment comes from the possession itself. It is hard to see, on Fisher's own "benefits" approach to taxation, why it is "fair" to tax him less than a person whose benefit comes from consumption, present or future.

*Spend Income and Opportunity to Invest It*, interest can be viewed as payment for the cost of postponing consumption—resisting impatience to spend—rather than for the supposedly lesser value of future consumption. To an economist, a forgone benefit is a cost, but not all costs are equivalent for judging the fairness of a tax.

If we view the interest rate as paying the saver for the cost to him of resisting the impulse to spend immediately, the “double taxation” argument becomes an argument for allowing taxpayers who incur the “resisting impatience” cost a tax benefit to put them on a par with current spenders, who do not incur such a cost. But to allow this cost to be taken into account in devising a tax is inconsistent with accepted principles not only of income taxation but of expenditure taxation as well. The psychological cost of deferring consumption is like any other cost of giving up lost opportunities; such costs are not, and could not be, taken into account generally under either an income or an expenditure tax. We do not say that a worker’s cost in boredom, or in giving up leisure, or in physical effort should be deducted in computing either his taxable income or, under an expenditure tax, his expenditures from current earnings, even though these things are regarded as costs by economists concerned with predicting behavior. In effect, the “double taxation of savings” argument for expenditure taxation is an argument for allowing a very common kind of cost to be deducted when incurred by savers, but not by those who earn and spend, even though we know that they also incur such costs.

The foregoing discussion does not mean that an expenditure tax is necessarily less desirable than an income tax, but the case for an expenditure tax cannot rest upon the argument that the income tax subjects savings to “double taxation.” The justification for abandoning income as a tax base—if indeed there be one—must derive from other considerations of tax policy.

## II. TAX POLICY AND “ABILITY TO PAY”

The tax treatment of participants in qualified pension and profit-sharing plans<sup>29</sup> is virtually identical to that which everyone would receive under an expenditure tax:<sup>30</sup> contributions to such

---

<sup>29</sup> I.R.C. §§ 401-415.

<sup>30</sup> Except that many of the restrictions regarding limitations on contributions, vesting, discrimination against low-paid employees, and responsibilities of fiduciaries would be unnecessary (in principle) under an expenditure tax. One suspects, however, that the legislature’s paternalistic leanings might lead to the adoption of at least some restrictions along these lines in connection with any expenditure tax actually enacted. If so, the expenditure-tax advocates’ dream of a simplified tax system would be transformed into a nightmare of

plans (savings) are not taxed; income earned by the contributions is not taxed as it accrues; and participants are taxed in full when they withdraw their contributions and accumulated earnings. The deficiencies of qualified plans, writ large, are the deficiencies of the expenditure tax. And the principal flaw in the tax-subsidized pension system is its utter disregard of the principle that taxes should have a close connection with the taxpayer's ability to pay. Consider a self-employed taxpayer seeking advice about whether to incorporate his business and put large sums otherwise taxable into a qualified plan. The first advice his lawyer will give him is this: "You can save a great deal in taxes, but only if you don't need the money to live on." Such a system stands the ability-to-pay principle on its head. An expenditure tax would enable someone of vast and increasing wealth to pay little tax, merely by living frugally, while imposing heavy tax burdens on those who prefer to spend their earnings, or who have to spend them.

Nearly everyone would accept some version of ability to pay as an important aspect of fairness in taxation. A tax that required someone to pay more money than he had or could easily get would be unacceptably harsh, and no system that consistently taxed the poor more heavily than the rich would attract many supporters. The expenditure tax does meet these minimal standards of ability to pay, as its supporters are fond of pointing out.<sup>31</sup> On the average, a progressive expenditure tax could well be progressive with respect to income, since those with high incomes tend to consume more than those with low incomes and would most likely continue to do so under an expenditure tax. In order for the income tax to be shown to be superior to a consumption tax on grounds of fairness, the concept of ability to pay must be given a specific enough meaning to justify its use in comparing individual taxpayers.

#### A. Wealth, Human Capital, and Ability to Pay

Anyone would agree that, if all else is equal, someone with a large income has more "ability" to pay taxes than someone with a smaller income. The problem is that other things never are equal, and the threshold difficulty in justifying income as a tax base is explaining why potential sources of tax payments other than income should be disregarded. Those using ability-to-pay concepts for purposes other than measuring taxable capacity do not limit their attention to income. No sensible college would award a scholarship based on "need" to a millionaire who happened to have no current

---

complexity. The details of the qualified plan provisions are incomprehensible; their extension to every taxpayer's investment activities would be a disaster.

<sup>31</sup> *E.g.*, N. KALDOR, *supra* note 4, at 48-53.

income. The applicant's wealth would surely be taken as representing ability to pay tuition. Why, then, do we not simply tax people on the basis of their wealth plus their income?<sup>32</sup> In what sense can a tax be fair that takes more from someone with modest current earnings but no savings than from someone with no current earnings who also has a fortune in the bank?

The Carter Commission Report<sup>33</sup> dealt with the question of wealth taxation by invoking the difficulties of measuring wealth in the form of "human capital." Since those with valuable skills could not, as a practical matter, be taxed on the value of those skills, people with valuable income-producing assets like bank accounts should not have to pay tax because of those assets.<sup>34</sup> This argument is not convincing. In the first place, the "human capital" argument can be used against an income tax as easily as against a wealth tax. An income tax does not tax a low-paid hospital resident on the process of accumulating valuable skills, but it does tax someone accumulating valuable bank accounts. Furthermore, the "human capital" argument ignores the very ability-to-pay notions that suggest taxing wealth. Human capital resembles a bank account in the sense that each is a source of future wealth, but it differs greatly in terms of present ability to pay. One with a bank account or stock portfolio can pay by withdrawing money or selling stocks, but one with only human capital would be hard pressed to convert that capital into the cash with which taxes must be paid.

One good reason for not taxing wealth is that a wealth tax would bring about drastic and undesirable<sup>35</sup> changes in society. A tax on wealth as such, at rates more than trivial, would bring about changes more rapid and extreme than those that any reasonable income tax could effect. No income tax with moderate rates could make the rich as poor as the poor; a wealth tax could easily do so. As long as taxes are regarded as a tool for enabling society to func-

---

<sup>32</sup> Some countries do impose annual wealth taxes, but in no case is the rate of the wealth tax even close to the rate of the income tax. This difference in rates, as well as the exemption provided under some wealth taxes for non-income-producing wealth like household furnishings, suggests that these taxes should probably be regarded as supplementary income taxes on income from property. The kind of wealth tax considered in the text is one that treats wealth accumulated in the past the same as wealth being currently accumulated. The question might be put this way: Why is a dollar that comes in this year a better measure of taxable capacity than a dollar the taxpayer has had for a long time?

For a description of existing wealth taxes, see generally C. SANDFORD, J. WILLIS & D. IRONSIDE, *AN ANNUAL WEALTH TAX* (1975).

<sup>33</sup> 3 REPORT OF THE ROYAL COMMISSION ON TAXATION (1966) (Canada).

<sup>34</sup> *Id.* at 27.

<sup>35</sup> Undesirable, that is, in the opinion of those who have an important voice in making the laws. A wealth tax might be seen as highly desirable by those who favor a major redistribution of wealth, though recent history teaches us that such extreme change, when it occurs, does not usually rely on devices as gentle as taxation.

tion, rather than a device for effecting drastic social change, we are unlikely to see wealth taxed at rates even close to those applied to income.

Another reason for objecting to wealth taxes is that they can be seen as taking something to which people have a stronger social claim than they have to the money they receive as income. A stock figure in most popular denunciations of one common form of wealth tax—the tax on real property—is the person of limited income who is forced to sell the family home because of ever-increasing property taxes. An income tax can also affect one's housing, of course, but it normally does so by preventing the taxpayer from saving enough money to acquire a house in the first place. From an economist's point of view, there may be little difference between a tax that forces *A* to sell his house and one that prevents *B* from buying an identical house, but socially they are vastly different. Our society, for reasons that are not at all clear, has always regarded taking property as harsher than preventing one from acquiring property; the constitutional barriers to the government's taking property have no strong counterparts preventing government actions that keep people from acquiring new property. The distinction here may not be coldly "logical" but it is real and pervasive. Consider the laws allowing people to acquire rights by prescription<sup>36</sup> and the "grandfather clauses" featured in most provisions drastically changing the law. A failure to gain is not truly a loss in the strongest sense of the term, and so an income tax, which takes money almost as it is earned, may be seen by most people as less oppressive than a tax on wealth, which may take that which the taxpayer has come to regard as "his own."<sup>37</sup>

Another source of ability to pay is unexercised earning capacity. Suppose an entertainer who can earn \$10,000 a week decides to quit work and live on roots and berries. In a sense, he has more ability to pay than someone working as hard as possible to earn ten

---

<sup>36</sup> Holmes's explanation of prescription is a nice illustration of my point:

I should suggest that the foundation of the acquisition of rights by lapse of time is to be looked for in the position of the person who gains them, not in that of the loser. Sir Henry Maine has made it fashionable to connect the archaic notion of property with prescription. But the connection is further back than the first recorded history. It is in the nature of man's mind. A thing which you have enjoyed and used as your own for a long time, whether property or an opinion, takes root in your being and cannot be torn away without your resenting the act and trying to defend yourself, however you came by it. The law can ask no better justification than the deepest instincts of man.

Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 477 (1897).

<sup>37</sup> This part of my argument is not essential to a criticism of an expenditure tax. Those who insist that a true measure of taxable capacity should take wealth into account can have that result by supplementing an income tax with an annual wealth tax.

thousand dollars a year, for a ten-thousand dollar annual poll tax would devastate the worker while causing the retired entertainer a relatively minor inconvenience. In some cases we do consider this kind of ability to pay. A New York Court of Appeals case holding that alimony can be based on the amount a spouse is capable of earning<sup>38</sup> and welfare programs denying benefits to those capable of working are examples. But the tax system ignores this kind of capacity, for the excellent reasons that measuring working capacity on a large scale would be impossible and that forcing people to choose work over leisure solely to pay a tax would be an unacceptable restriction on freedom.

### B. Equal Sacrifice and Equal Contribution

Having eliminated wealth and unexercised earning potential as sources of ability to pay in the context of choosing a tax base, we are left with income, almost by default.<sup>39</sup> Even here there are serious problems. The use of income as a measure of ability to pay has long been identified with the "equal sacrifice" theory of taxation.<sup>40</sup> If "sacrifice" notions really are central to a concept of "ability," that concept is indeed useless. We surely cannot say that a twenty percent tax on the identical incomes of *A* and *B* causes each an "equal sacrifice" or leaves each in the same position, relative to the other, as if there were no tax.<sup>41</sup> *A* may care little about money. He may derive great nonpecuniary satisfactions (not available to *B*) from leisure, or watching sunsets, or attending free concerts or museum exhibits. *A* may even be employed by an organization that determines his salary on an "after-tax" basis, so that the tax "on" his income is actually borne by his employer. Or he may have planned

---

<sup>38</sup> *Hickland v. Hickland*, 39 N.Y.2d 1, 346 N.E.2d 243, 382 N.Y.S.2d 475 (1976) (husband capable of earning a "reasonable" income obliged to support wife despite husband's status as a "subsistence farmer" when reasons for taking up a farming career went "beyond the needs of a reasonable occupational choice").

<sup>39</sup> Default is as good a way as any of dealing with questions like this. Eliminate all oppressive or otherwise unfair alternatives and what remains must be at least reasonably satisfactory.

<sup>40</sup> The "sacrifice" theory goes back to Mill, who said, following Adam Smith, that people should pay taxes "in proportion to their respective abilities." Mill justified this principle on the utilitarian ground that as government action should "make no distinction of persons or classes in the strength of their claims on it, whatever sacrifices it requires of them should be made to bear as nearly as possible with the same pressure upon all, which, it must be observed, is the mode by which least sacrifice is occasioned on the whole." 2 J. S. MILL, *supra* note 8, at 394, 396.

<sup>41</sup> For criticisms of the "sacrifice" theory in the context of discussions of progressive taxation, see generally W. BLUM & H. KALVEN, *THE UNEASY CASE FOR PROGRESSIVE TAXATION* 39-70 (2d ed. 1963); Fagan, *Recent and Contemporary Theories of Progressive Taxation*, 46 J. POLITICAL ECON. 457 (1938).

to give most of his income to his relatives, in which case they are hurt by the tax more than he. If "equal sacrifice" is the only possible foundation for trying to tax people fairly we may as well abandon the attempt at fairness and tax whatever can be most easily policed, such as sales.

The "sacrifice" theory of taxation is not only unnecessary in devising a tax proportional to ability to pay, it is in some ways inconsistent with the ability-to-pay principle. Some of the more extravagant attempts at broad definitions of "income" illustrate the point. The "sacrifice" theory is a product of the erroneous idea that income measures one's annual "satisfactions."<sup>42</sup> We might say, pursuing this line, that a "true" measure of income would include all forms of imputed income from owning property or performing services, and all nonpecuniary "windfalls" like pleasant sunsets.<sup>43</sup> Those who take this position concede its impracticality, and so are willing to fall back on the more conventional notions of income as a rough measure of the real thing. But this will not do. If "income" is truly measured by all of someone's satisfactions, the pecuniary aspects of income are so trivial in relation to the whole that taxing

---

<sup>42</sup> As Blum and Kalven put it, "the doctrine ultimately refers to the pleasures of having money and the pains of paying taxes." W. BLUM & H. KALVEN, *supra* note 41, at 40. See also *id.* at 43-44 ("Any theory of equalizing the sacrifice of taxpayers implicitly assumes that the taxes are a necessary evil falling upon a distribution of money, and therefore upon a distribution of satisfactions." (emphasis added)).

<sup>43</sup> An ambitious effort along these lines is Aaron, *What Is a Comprehensive Tax Base Anyway?*, 22 NAT'L TAX J. 543 (1969), suggesting a "comprehensive" income definition that would include "all goods and services provided by federal, state, and local governments, . . . [and] services . . . of non-profit institutions." *Id.* at 544. Aaron suggests that some of these benefits, such as "education in subsidized public colleges and universities," can "directly add to the household's ability to pay." *Id.* The "ability to pay" aspect of this argument is unpersuasive. Consider a taxpayer who has very little income and who attends a free public college, and suppose that the taxpayer would not go to college if it were not free. The services he receives give him nothing with which he could pay taxes. The taxpayer's "ability to pay," in the broadest sense, could include his wealth, his income, and his unexercised earning capacity. Suppose these total \$20,000 for a given period, in the sense that by living at a subsistence level and working as hard as possible he could pay that much in taxes and survive. The availability of a tuition-free college cannot possibly change this figure. The ability-to-pay argument seems to be that a taxpayer who, without free public education, would spend \$5000 per year in tuition at a private school is \$5000 per year "better off" because the tuition-free school is available. But this argument involves a double counting of the \$5000 the taxpayer would have spent (out of income, say) on tuition. In measuring his income, we include this \$5000 whether it is spent on college or on riotous living. The availability of a tuition-free school enables the taxpayer to spend this \$5000 on something other than education, but it does not give him \$5000 more to spend. We surely would not say that someone with no interest in attending college has more "ability to pay" than someone who wants an education merely because the former is freer to spend for items other than education. To be sure, one who wants to go to school and who has the opportunity to do so for nothing is "better off" than someone else who must pay; but well-being is not the same thing as ability to pay.

"measurable" income as a substitute for taxing "true" income would no more be acceptable than taxing people's earnings in January as a substitute for taxing their annual incomes.

Those who try to define "income," in principle, as annual satisfaction, have wandered far from "ability to pay." Should A, whose skills are such that he can earn nothing, but whose sensitivity to the pleasures of the world gives him great satisfaction, pay more than B, who earns \$100,000 a year but does not enjoy it? The idea is absurd: A has no ability to pay whatever, no matter how much he enjoys his life, and B, however miserable he is, has a great deal of ability to pay. A tax on "satisfactions," if they could be measured, might fall most heavily on young children.<sup>44</sup>

Although the notion that the ability-to-pay principle is a principle based on "equal sacrifice" and the associated idea that income is a good tax base because it measures "satisfactions" have long been in vogue in the academic literature, they have played a surprisingly small role in our tax system. Congress and the courts seem to have paid little attention to "sacrifice" or "satisfaction" in devising basic principles of taxation. Income is not, for the most part, taxed to the person who "owns" or "benefits" from it but rather to the person who earns it.<sup>45</sup> Departures from this principle are generally viewed as mistakes,<sup>46</sup> and attempts to deduce specific tax rules from "benefit" notions of income tend to produce systems bearing little resemblance to the law as it actually has developed.<sup>47</sup> The only real role played by "sacrifice" and "satisfaction" has been in devising narrow exceptions to the general rules of taxation for hardship cases

---

<sup>44</sup> Cf. de Jouvenel, *Efficiency and Amenity*, in MICROECONOMICS 452, 459 (2d ed. E. Mansfield 1975):

In an economic policy-making committee I recently happened to suggest that the Parthenon was an addition to the wealth of Athenians, and its enjoyment an element of their standard of life. This statement was regarded as whimsical. When I had made it clear that it was seriously meant, I was told that standard of life is expressed by per capita Private Consumption of goods and services acquired on the market. Meekly accepting this correction I asked my colleague whether when he drove out to the country on weekends, his satisfaction was derived from the costly consumption of gasoline, or from the free sight of trees and possibly the free visit of some cathedral.

<sup>45</sup> E.g., *Lucas v. Earl*, 281 U.S. 111 (1930).

<sup>46</sup> E.g., *Poe v. Seaborn*, 282 U.S. 101 (1930). See also the Supreme Court's notorious footnote 37 in its *Crane* opinion, *Crane v. Comm'r*, 331 U.S. 1, 14 n.37 (1947), and Professor Bittker's criticism of the "benefit" notion of income that led to footnote 37, Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 TAX L. REV. 277 (1978). The chaos caused by "benefit" theories of income in the area of the income tax treatment of alimony trusts is discussed in Gunn, *Douglas v. Willcuts Today: The Income Tax Problems of Using Alimony Trusts*, 63 CORNELL L. REV. 1022 (1978).

<sup>47</sup> An example is McIntyre & Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 HARV. L. REV. 1573, 1583 (1977) (proposing a "benefit" theory of income that would, among other things, eliminate the assignment-of-income doctrine).

such as extraordinary medical expenses, where the reasons for rejecting sacrifice principles are weak.

Once "sacrifice" notions are set aside, the standard objections to the ability-to-pay principle disappear. The equality achieved by an income tax is not an equality of sacrifice, but of contribution. An income tax is fair in the sense in which a compulsory uniform military service requirement is fair.<sup>48</sup> Each taxpayer is required to devote an equal (under a *proportional* income tax) amount of each year's income-producing efforts to the government. This concept is sometimes better captured in popular descriptions of the income tax than in the academic literature. When we read, for example, that the average taxpayer "works for the government" for so many months per year we see not only a vivid description of the size of our tax burden, but an insight into the nature of an income tax.

It would be foolish to suggest that the "equal contribution" version of ability to pay, without more, generates a set of specific tax rules. If contributions are in fact to be "equal," account must be taken not only of taxpayers' measurable consumption and increases in wealth but of the inconvenience that would attend an across-the-board application of a "pure" accretion-type income tax such as a tax on income measured by the Haig-Simons definition. Although sacrifice is not a reason for choosing income as a tax base, it cannot be ignored altogether. In a purely mathematical sense someone who discovers an oil deposit worth \$50,000 in his back yard has been enriched as much as someone who finds \$50,000 in cash, but the taxpayer with the cash can more easily contribute part of his find to the government. Thus the government's share of the finding of an oil deposit consists of a claim to a portion of the proceeds when it is sold. There is nothing unfair about this. Indeed, since the taxpayer with the cash can put his money in the bank and earn interest immediately, while the taxpayer with the oil cannot (except by selling the property), it seems proper to tax the taxpayer with the cash earlier to reflect the time value of his money.<sup>49</sup> But

---

<sup>48</sup> Such a draft would not, except in cases of extreme hardship, take into account the "sacrifice" entailed by compulsory service, for much the same reasons as were given above for rejecting "sacrifice" theories of taxation. As a result, some people would have to sacrifice a great deal more than others to meet their obligations.

The uniform military service analogy is not perfect, of course; if it were, it would be more than an analogy. One difference is that a uniform draft would not exempt idlers capable of work, while an income tax would.

<sup>49</sup> One problem with this argument is the possibility that the taxpayer's decision not to sell the oil deposit might be based on his belief that it would increase in value faster than anything he could buy with the sales proceeds. To the extent this is the case, the time-value argument fails, although the argument based on the disruption in the taxpayer's affairs caused by a forced sale to pay taxes still holds.

this is an easy case, and such problems as the proper treatment of appreciated assets that can be sold without inconvenience cannot be solved by saying that "everyone should contribute equally."

### C. Expenditure Tax and Ability to Pay

Advocates of the expenditure tax tend to ignore the ability-to-pay argument or to deny that ability to pay is a useful concept. To the extent that the "ability" argument they are criticizing is actually the "sacrifice" argument, their criticisms are sound but misdirected. And some of the criticisms fail because they demand of ability to pay more specificity than can reasonably be asked of any useful general principle. I shall take Kaldor's treatment of ability to pay as my target, for his is by far the most extensive criticism of the ability concept in the expenditure-tax literature.

Kaldor seems sympathetic to the argument that a tax imposed according to "taxable capacity," defined as "spending power," is just. He devotes a long and thoughtful chapter to the subject,<sup>50</sup> which itself suggests that he does not view the taxable-capacity argument as unworthy of discussion. He notes that "income," either as measured in practice or as it might be more comprehensively defined, cannot measure spending power perfectly. Wealth itself confers a power to spend,<sup>51</sup> and different kinds of income give rise to different spending power. Those with earned incomes, for example, must save for sickness and retirement,<sup>52</sup> and those whose receipts are not expected to recur regularly may not feel as free to spend them as those in possession of a steady income stream.<sup>53</sup> We depart even further from spending power when we introduce such features as special treatment of capital gains into a tax system.<sup>54</sup> Kaldor concludes that there is no objective way, even in principle, to find in the various sources of ability to pay "a common unit of spending power."<sup>55</sup> "[A]ny system which sets out to tax Consumption plus Savings is bound to fall long or short of its objective, with

---

<sup>50</sup> N. KALDOR, *supra* note 4, at 21-78.

<sup>51</sup> *Id.* at 30-34. Kaldor's treatment of wealth as a source of spending power is the best response I have seen to the common error of supposing that because wealth is a source of future income wealth is future income, and nothing else.

<sup>52</sup> *Id.* at 29. The necessity any prudent worker feels of saving for retirement supports the present treatment of qualified pension and profit-sharing plans, but only to the extent of saving enough to provide for a reasonably comfortable retirement. Under present law, some people can accumulate millions of dollars tax-free by using qualified plans.

<sup>53</sup> *Id.* at 34-35.

<sup>54</sup> *Id.* at 41-46.

<sup>55</sup> *Id.* at 47.

serious consequences for equity as between persons.”<sup>56</sup>

Everything Kaldor has said about the impossibility of finding objective measures of spending power is true, although much of the argument has little to do with an equal-contribution theory of ability to pay. But to say that because there is no perfect measure of ability to pay we should stop trying to do the best we can is to impose an unnecessarily strict standard. There is no “objective” measure of justice, or of “equal protection of the laws,” or of “due process,” but we do not stop trying to achieve these goals; why should we behave differently in designing a tax system? Kaldor’s objection to ability to pay is nothing more than an example of the anything-imperfect-is-useless fallacy.

In one respect an expenditure tax might come closer to taxation according to ability to pay than the present income tax. Gifts and inheritances plainly give their recipients spending power, yet they are not includible in income under current law. This omission may have resulted from an unthinking application of economic concepts of “income,” which exclude transfer payments because they do not measure productive activity, to the definition of income for tax purposes.<sup>57</sup> Although some expenditure tax supporters have made much of the ability of their tax to extract money from people squandering inherited fortunes,<sup>58</sup> the gifts and inheritances argument, if valid, establishes no more than the superiority of an expenditure tax over the existing income tax as applied to a few people. The problem of gifts and inheritances can be as easily solved by tinkering with the income tax as by adopting a consumption tax. It is a separate issue, which is irrelevant in deciding whether income or consumption is the better tax base.

Every expenditure tax supporter implicitly acknowledges the importance of tying taxes to ability to pay and using income as its measure simply by supporting a tax on expenditure rather than a sales tax. If preventing “double taxation of savings” and achieving administrative convenience are really the only important goals of a tax system, why not replace income taxes with sales taxes? The answer, of course, is that sales taxes are regressive, while a progressive expenditure tax could also be progressive, on the average, with

---

<sup>56</sup> *Id.* at 46.

<sup>57</sup> H. SIMONS, *supra* note 4, at 56-59. I do not mean to argue here that gifts and inheritances necessarily should be treated as income. Indeed, an “equal contribution” approach to ability to pay suggests that they should not. My point is only that they could be so treated, and so their exclusion under the present income tax gives no reason to reject income as a tax base on the ground that it leaves out an important source of spending power.

<sup>58</sup> *E.g.*, N. KALDOR, *supra* note 4, at 53; Feldstein, *Taxing Consumption*, 174 *NEW REPUBLIC* 14, 16-17 (1976).

respect to income. By insisting that their proposed tax is not regressive, those who favor an expenditure tax admit that income cannot be ignored.

### III. ADMINISTRATIVE CONVENIENCE<sup>59</sup>

As the Internal Revenue Code has grown longer and more complex, simplification of the income tax has come to be viewed as an important social goal. The expenditure tax was once viewed as so plainly incapable of being administered as to be unworthy of serious consideration by the legislature.<sup>60</sup> But today, due mainly to Professor Andrews's article *A Consumption-Type or Cash Flow Personal Income Tax*,<sup>61</sup> many see a spendings-tax system as simpler to run than the present income-tax system or any feasible alternative income tax.

Andrews argues that "much of the law concerning business and investment transactions could be vastly simplified by a shift to a pure consumption-type personal income tax,"<sup>62</sup> and he is right. Nearly all of the Code's nonrecognition provisions, including the almost unbelievably complex provisions governing corporate-shareholder transactions, could be eliminated under an expenditure tax, as could the partnership provisions, the capital gain and loss provisions, and many other sources of complexity. Adopting a spendings tax would almost surely make the tax code shorter. If that were the same thing as making the tax system easier to administer, the case for adopting the expenditure base on convenience grounds alone would be strong.

Convenience for taxpayers and administrators is not a necessary consequence of simplifying the tax laws. Even more important, an expenditure tax would have complexities of its own, and, unlike most of the inherent complexities of an income tax, they would make compliance by average taxpayers more difficult than it is today. Simplifying the law applicable to those few taxpayers who are partners, shareholders of closely-held corporations, or sole proprietors of businesses would not lead to an overall decrease in the costs of administering a tax system if the tax computations of ordinary taxpayers—those with incomes from salaries, pensions, bank accounts, and investments in mutual funds and publicly-held cor-

---

<sup>59</sup> See generally Kelley, *Is an Expenditure Tax Feasible?*, 23 NAT'L TAX J. 237 (1970); Sliitor, *Administrative Aspects of Expenditures Taxation*, in BROAD-BASED TAXES: NEW OPTIONS AND SOURCES 227 (R. Musgrave ed. 1973).

<sup>60</sup> See text and notes at notes 12-15 *supra*.

<sup>61</sup> See note 4 *supra*.

<sup>62</sup> Andrews, *supra* note 4, at 1165.

porations—were made harder. Proponents of an expenditure tax are troubled by the complexities in our present tax system, as thoughtful people must be. Not unnaturally, they focus on present problems—which, as experts and problem-solvers, is what they are most familiar with—and propose reforms to eliminate or reduce these problems. In the process, however, they overlook the many ways in which our tax system functions smoothly for tens of millions of taxpayers, and they fail to consider fully the effects the changes they propose will have in the areas that are now problem-free.

One of the most difficult problems of tax administration involves capitalization and depreciation of expenditures on long-lived assets. Questions of capitalization and depreciation<sup>63</sup> are not so much legal as factual, which is why their resolution requires expensive and time-consuming case-by-case negotiation and litigation. Under an expenditure tax, these problems would not have to be resolved for businesses, as all business capital expenditures would be immediately deductible. But complexity would increase for many individual nonbusiness taxpayers, since large and nonrecurring personal expenditures would almost surely have to be capitalized and depreciated. Housing is one example. Political pressures alone would surely prevent taxing someone on three or four times annual income in the year a house was purchased. A theoretically correct solution under an expenditure tax would require taxpayers to capitalize the costs of houses, “improvements,” and other significant consumer durables and to depreciate them over the assets’ expected period of use.<sup>64</sup> Only by departing significantly from a consumption base, or by requiring depreciation at arbitrary rates, could these problems be alleviated.

The problem of large expenditures under an expenditure tax

---

<sup>63</sup> The Code provisions concerning capitalization and depreciation are fairly brief, as tax provisions go, and could be briefer still were it not for Congress’s unhappy tendency to subsidize a vast range of worthwhile activities by allowing immediate deduction of some capital expenditures and accelerated depreciation for others.

<sup>64</sup> See N. KALDOR, *supra* note 4, at 195-201; Andrews, *supra* note 4, at 1153 n.94, 1157-59. Professor Andrews suggests, as “a fairly workable alternative treatment of housing . . . an immediate deduction for purchase price and capital expenditures” and an imputation of “income at a specified rate on the deducted amount.” *Id.* at 1158 n.102. A defender of the income tax should not quibble over the theoretical shortcomings of such an approximation, since the existing tax treatment of owner-occupied housing is itself far from ideal. See, e.g., Epstein, *The Consumption and Loss of Personal Property Under the Internal Revenue Code*, 23 STAN. L. REV. 454 (1971). But the income tax treatment of housing is at least well-established and familiar; under an expenditure tax we would be starting from scratch. Professor Andrews’s proposal resembles taxation of imputed income from home ownership, which has not always proved practical where it has been attempted. C. KAHN, PERSONAL DEDUCTIONS IN THE FEDERAL INCOME TAX 119 (1960).

would not be limited to expenditures for assets. It is highly unlikely that our society would tolerate taxing people heavily in the years in which they are incurring pressing financial burdens, perhaps even going into debt, to send themselves or their children to school.<sup>65</sup> The expenditure tax that appears in the literature is one without "tax expenditures." That is one of the reasons why it looks so appealing in comparison with an income tax. It is certain, however, that any politically feasible expenditure tax would have to include some sort of relief for heavy spending on "worthwhile" consumption, such as schooling, with attendant administrative complexities.

The borderline between consumption and investment would present another source of serious difficulty under an expenditure tax.<sup>66</sup> Has a taxpayer who has purchased a diamond, a painting, or a stamp collection made an investment, entitling him to deduct the purchase price from "gross spending," or has he spent for consumption, giving him either no deduction or a capital expenditure to be treated like the purchase of a house?<sup>67</sup> These problems arise from time to time under an income tax, but mainly in the case of losses,<sup>68</sup> which are fairly infrequent for such investments. Under an expenditure tax, either some arbitrary compromise solution would be required or there would be a significant expansion of the class of problems that must be resolved on a case-by-case "primary purpose" basis.<sup>69</sup>

Under an income tax, the taxable person is the earner of income; under an expenditure tax, the person who consumes out of income (or consumes out of any other source) would be taxable. This

---

<sup>65</sup> See Slitor, *supra* note 59, at 248 ("For social reasons, there would be considerable pressure for the exemption of tuition and possibly other educational expenses. Apart from the social aspects, it might be essential from the standpoint of relief for parents who have expanded personal budgets because of heavy college, university, or other educational costs.").

<sup>66</sup> This problem is not merely administrative. See note 36 *supra*. The line between "consumption" and "investment" is as arbitrary as any of the lines that have to be drawn in devising a practical income tax.

<sup>67</sup> Kaldor's solution is to treat all such purchases as consumption, acknowledging that this proposal "would be likely to arouse fierce opposition from art dealers and stamp dealers." N. KALDOR, *supra* note 4, at 198-99. The original version of India's expenditure tax exempted expenditures for books and art works. Kelley, *supra* note 59, at 249 n.32.

<sup>68</sup> I.R.C. § 165(c)(1)-(2).

<sup>69</sup> To be sure, the problem discussed here can arise under an income tax, but the income tax stakes are usually low because only the amount of a loss (rather than the entire amount of the expenditure) can be in issue, and because income tax rates are almost certain to be lower and less steeply progressive than those of any substitute spendings tax. As Groves pointed out, "[t]he effect of a 300 percent marginal rate on administration is something about which we have no experience. It would mean that on the doubtful classification of a single dollar of expense, three dollars for taxpayer or government would be at stake. H. GROVES, *supra* note 23, at 118.

raises a problem of whether gifts should be deductible from gross spending by the donor and taxable (if spent) to the donee. No solution to this question consistent with the expenditure-tax principle could be easily administered. If gifts were nondeductible by the donor on the theory that a gift is "consumption"<sup>70</sup> and if spending out of gifts were taxable to the donee, both donor and donee would have an incentive to conceal gifts. Even if gifts were reported (which could be encouraged by making them deductible by the donor), we would have no easy way to tell whether consumption "by the donee" was really disguised consumption by the donor.<sup>71</sup> Was the money spent by a low-bracket child on a Rolls Royce really his spending, or was it spent for the benefit of a parent, and if so, which one? Under an expenditure tax, we would surely see attempts by high-bracket taxpayers to arrange for more lightly taxed people to do their spending for them, and I am not at all confident that the taxing authorities could police such transactions effectively. As with most of the problems discussed here, a similar problem arises under an income tax—in this case, the "assignment of income" tangle. But much less administrative prying is usually required to tell who has earned income than who has spent it.

An expenditure tax would attach important tax consequences to transactions that average taxpayers can ignore under an income tax. Every deposit of money in a bank account, every purchase of life insurance, every borrowing and repayment, and every withdrawal of funds from a bank account or from life insurance would have tax effects. Some of these transactions might be ignored for reasons of convenience, but not all would be.<sup>72</sup> Again, the problem is not so much that the tax law would be made complex, as that

---

<sup>70</sup> Andrews, *supra* note 4, at 1162-64, recommends that gifts be nontaxable to the donor, and that consumption out of gifts be taxable to the donee, except for small cash gifts that, for administrative reasons, would be treated as consumption by the donor. Kaldor, *supra* note 4, at 201-05, finds this treatment correct in principle but "well-nigh impossible to administer" (because of the possibility of evasion), and recommends that most gifts be disallowed as a deduction to the donor, and that spending out of gifts be taxable to the donee (with an exception for small gifts).

<sup>71</sup> N. KALDOR, *supra* note 4, at 201. This problem would be less serious if the donor could not deduct gifts, but an almost equally difficult administrative problem of disguising gifts as loans would arise under that approach. *Id.* at 203 n.4.

<sup>72</sup> For example, Andrews, *supra* note 4, at 1161-62, proposes ignoring year-end cash balances for administrative reasons, with an exception for "unusually large closing cash balances." *Id.* at 1161. Savings account deposits would ordinarily be deductible, but deposits made in the last month of a year would not be if the taxpayer withdrew the money within thirty days. *Id.* at 1161-62. Policing these requirements in the case of taxpayers with many investments would seem to me to be quite difficult, and even voluntary compliance might be impeded by the unfamiliarity and apparent arbitrariness of these rules.

compliance by ordinary taxpayers would be made more difficult.

Most of the administrative drawbacks of the income tax, on the other hand, result from the problems of business taxpayers, who are more likely than others to have access to expert advice and to be accustomed to record-keeping. Those problems faced by low-income taxpayers in nonbusiness contexts—the tax problems of divorce and separation, for example—would persist under an expenditure tax. The administrative burden of a tax depends not only on the difficulty of the problems raised by the tax, but on the number and sophistication of the taxpayers who must face these problems. An expenditure tax is likely to prove more complicated than an income tax for the vast majority of taxpayers who cannot afford to pay for competent expert advice. The apparent ability of the expenditure-tax advocates to devise a tax with fewer theoretical shortcomings than an income tax is not a strong argument for change; intellectual coherence is not the same thing as administrative convenience.

#### IV. EXPENDITURE TAXATION VS. REFORM OF THE INCOME TAX

Since it will take enormous effort to convince the public and its lawmakers to change the tax base from income to expenditure, and still more effort to translate the legislative decision into administrative practice, the case for such a change must rest not only on the alleged superiority of an expenditure tax to the present income tax, but on its superiority to the income tax as it might be reformed with comparable effort. In this regard, it is particularly important to note that a change to an expenditure base will, as a by-product, decide a number of other questions of tax policy, such as whether “paper gains” due to inflation should be tax-exempt or whether corporations should be subject to taxation. As long as everyone considered an expenditure tax impracticable on administrative grounds, people could support it as a purely theoretical construct, an image of Utopia that made one aware of the flaws in the real tax systems of modern societies. The question of the political and administrative costs of such a change did not arise. Now, however, expenditure tax supporters must face the issue whether, given all the ramifications of a change to expenditure taxation, it would be wiser and easier to reform the income tax in a less drastic manner.

##### A. Inflation

One supposed advantage of a consumption tax is its ability to adjust the tax base automatically for inflation. By taxing people only as they spend, an expenditure tax appears not to tax

“imaginary” gains from inflation. Kaldor puts the case of a doubling of price levels, and of wages, which causes someone who formerly had £100,000 worth of assets, producing £5,000 per year in income, to have £200,000 worth of assets and £10,000 yearly income.<sup>73</sup> Either in absolute terms or in comparison with another taxpayer who had earned income of £5,000 per year before the inflation and £10,000 per year afterward, this taxpayer is no better off than before the inflation. Yet an accretion-type income tax would tax the property owner on the “imaginary” gain represented by the doubling of the “value” in pounds of his capital. And the income tax in force in the United States today would tax him on this gain if and when he sold these assets. An expenditure tax, on the other hand, would reach only actual, exercised spending power. A change in price levels would change the amount of tax payable in any year by those who consume a given quantity of goods,<sup>74</sup> but the change would not discriminate among those spending equal amounts in the same year.

If adjusting the tax base to eliminate the distortions of inflation were a sound goal for a society to pursue, the inflation argument would be strong. An income tax in an inflationary period does tax some people on “gains” that represent no increase in spending power, and the problem would be corrected automatically by changing to a spendings tax. But adjustment of taxes to eliminate inflationary gains from the tax base is not a worthwhile goal. The inflation-adjustment case for an expenditure tax fails not because the tax would not adjust perfectly for inflation but because there is no reason to think that such adjustments should be made.

The argument for adjusting taxes for inflation proceeds from a tacit premise that basing the tax system on something that accurately measures ability to pay, or consumption, or whatever else it is we want to measure would be worthwhile. And so it would, if the explicit tax system were the only tax system. But inflation itself is a tax, in the sense that it results from the deliberate pursuit of governmental policies that will take spending power from those who suffer from inflation and give spending power to those who benefit. The real tax people pay is the sum of what they pay expressly in taxes and what they pay by losing purchasing power through inflation. Correcting the explicit tax system for inflation would make that system, viewed in isolation, fairer. But to look at the explicit tax system alone is to look at only part of the whole.

---

<sup>73</sup> N. KALDOR, *supra* note 4, at 42.

<sup>74</sup> This change is essentially an automatic increase in tax rates; if thought to be undesirable it could easily be dealt with by adjusting the rates automatically.

Kaldor's example is misleading because it involves people whose relative positions would have been unchanged by inflation if there were no explicit taxes. His change in price levels and wages, by itself, leaves each taxpayer with the same purchasing power as before the change. But suppose that inflation doubles prices and increases the income (all of which is spent) of *A* from \$10,000 to \$20,000, while leaving *B*'s income (all spent) at \$10,000. A proportional expenditure or income tax would take twice as much from *A* as from *B* after the change, which seems fair enough at first glance, since *A* has earned and spent twice as much as *B*. But *B*, unable to avoid the effect of the inflation, has in fact been subjected to an additional tax of 50 percent of his income simply because of the inflation. The tax system as a whole (*i.e.*, with inflationary losses regarded as a part of the tax, rather than as merely a reduction of the tax base) is arbitrary and unfair, even though the explicit part of the tax system seems perfect.

We will not get a fair tax system by combining a fair explicit tax with the capricious tax consisting of the inflation itself. If anything, adjusting the explicit tax base for inflation would have the undesirable effect of camouflaging the harm done by inflation. The only sound way to adjust the tax system for inflation is to eliminate inflation.

## B. The Corporate Income Tax

Replacing the income tax with an expenditure tax would bring another fundamental change in its train: corporations would pay nothing under an expenditure tax system, since nothing a corporation does can be viewed as "consumption." Many would favor this: even under an income tax a respectable case can be made for not taxing corporations. But the matter is not clear-cut, and there are good arguments for taxing corporations, particularly where they have been taxed in the past.<sup>75</sup>

The usual argument against taxing corporations is that they exist only to make money for their shareholders; therefore, their earnings "belong" to the shareholders, and should be taxed to the shareholders at their individual rates when earned or when paid in

---

<sup>75</sup> Since those who have bought and sold stock in the past have done so with the knowledge that corporate earnings are taxed, and have set the price on that basis, elimination of the "double taxation" of corporate income would give a huge windfall to those holding stock at the time the change came to be expected. Significant changes in tax systems often produce such effects, which is why it is said that "an old tax is a good tax."

dividends.<sup>76</sup> This line of reasoning is circular. If corporate income "belongs" to the shareholders in a sense appropriate for taxation, of course it should be taxed to them. But the question is precisely whether the income of corporations should be treated as the income of their shareholders for tax purposes. The earnings of General Motors are plainly not the earnings of its shareholders for many other purposes: unless General Motors declares a dividend the shareholders may not even be enriched by them, for gloomy future prospects may depress the value of General Motors stock even as the corporation earns income; and the people who eventually get the money General Motors earns this year will include many who are not now General Motors shareholders. For these and many other reasons, the underlying premise that a corporation is a mere fiction cannot be taken seriously today. Once we discard "sacrifice" notions of ability to pay and recognize that it is the earners of income, not those who "benefit" from income, who pay income tax, taxing corporations seems no more absurd and no more unjust than taxing anyone else.<sup>77</sup>

---

<sup>76</sup> *E.g.*, Thurow, *Abolish the Corporate Income Tax*, Wall St. J., July 6, 1977, at 16, col. 4. Another question-begging "reason" sometimes given for abolishing the corporate income tax is that corporations are not people because they do not have certain human features like hands. Supporters of taxes on corporations are accused of forgetting this obvious fact and so of "personifying" corporations. What the possession of hands has to do with taxable capacity eludes me.

Thurow also makes the familiar argument that corporations do not "pay" taxes, but simply "collect" them, since the money corporations use to pay taxes is obtained from someone else: shareholders, employees, or customers. The "collection" argument logically leads to the elimination of all taxes, since human beings, like corporations, must get the money they pay in taxes from others.

The enormous amount of attention paid to the question "who pays the corporate income tax" seems astonishing in view of the utter lack of attention in the literature to the question "who pays the income tax of associate professors?" The answer to the latter question is, of course, "students and donors," if one accepts the "collection" argument.

The strongest reason for retaining taxes on corporations may be the emptiness of the arguments used to oppose them. The eagerness with which reasons for change that are not reasons at all are accepted may suggest that there are no real reasons, or that the real reasons might be politically unacceptable.

<sup>77</sup> The argument for treating corporations as taxpayers is weakest in the case of closely held corporations. A one-physician medical corporation, for example, is so closely identified in all practical respects with its shareholder-employee that its treatment as a separate entity is absurd. But "double taxation" is no problem for such arrangements, at least if the taxpayer is well advised.

Perhaps the clearest case for treating an organization as a taxpayer is that of the organization without shareholders. If a university, for example, were to lose its tax exemption, it, rather than any of its employees or trustees, would surely provide the best candidate for taxation, if it had any income in whatever sense the income of a school should be measured. Corporations whose shares are widely traded are a less attractive target, since the success of their income-producing efforts affects the price of their shares. Such a corporation is less "separate" from its shareholders than a university is from its employees, but more "separate" than a closely held corporation, a partnership, or a trust. *See generally* Klein, *Income Taxa-*

It is not necessary, for present purposes, to establish conclusively that corporations should be taxpayers, and I certainly would not defend every detail of corporate-shareholder taxation.<sup>78</sup> But serious doubts can be raised about the wisdom of a tax base whose adoption would ipso facto remove the question of the corporate income tax from the area of debate.

### C. Expenditure Taxation vs. A Proportional Income Tax

If the expenditure tax is compared with a proportional, rather than a progressive, income tax, its supposed administrative superiority disappears completely. True, few of the problems of the income tax result directly from progression; even a proportional income tax must deal with questions of the choice of the taxable person and the timing of income and deductions. But many of the hardest questions of current law arise because the progressive rate structure gives high-income taxpayers, and taxpayers whose income is bunched, a strong incentive to devise ingenious schemes for avoiding taxes. A proportional income tax would exert much less pressure of this sort. Furthermore, it could take from corporate incomes at the same rate as from individual incomes, thus relieving much of the pressure in the corporate-shareholder area. If the tax rate under a proportional tax were sufficiently low, the only respectable argument for special treatment of capital gains—the “locking-in” problem<sup>79</sup>—would lose much of its force. Without reduced taxes for capi-

---

*tion and Legal Entities*, 20 U.C.L.A. L. Rev. 13, 13 (1972) (listing fifteen “legal devices for the control and use of income and wealth by individuals and groups of individuals . . . in order of their increasing tendency to be associated with an attenuation of the relationship between income and the individual”). The devices range from direct ownership to public service governmental agencies like the Forest Service. Corporations are listed eleventh, non-profit organizations thirteenth. Professor Klein does not favor taxing corporations, except as a step in imposing a tax on someone else, because corporations lack “the capacity to bear the burden of the tax.” *Id.* at 53. This argument seems to me to assume that the importance of income consists only of the “benefits” one gets from it. But this criticism is unimportant. What matters here is that questions of who or what should count as a taxpayer should be probed, and not assumed out of the way. By treating consumption as the only significant product of income, the expenditure-tax advocates assume that only people can properly be taxpayers. In this they may or may not be right.

<sup>78</sup> Certainly the “earnings and profits” component of the dividend definition is absurd. Blum, *The Earnings and Profits Limitation on Dividend Income: A Reappraisal*, 53 TAXES 68 (1975); Andrews, “*Out of Its Earnings and Profits*”: *Some Reflections on the Taxation of Dividends*, 69 HARV. L. REV. 1403 (1956). The great distinction the tax law draws between debt and equity, to give another example, also seems unsatisfactory in principle and, perhaps, in some of its economic effects. Warren, *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585 (1974). For proposed reforms, see AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, (Tent. Draft No. 2, 1979) (Subchapter C).

<sup>79</sup> Andrews, *supra* note 4, at 1133-34.

tal gains, administration of the Internal Revenue Code could be greatly simplified.

Abandoning progression would appear to mean abandoning the redistributive goal, which has been the most respectable defense for the progressive features in the income tax.<sup>80</sup> This, it might be argued, is politically unrealistic.<sup>81</sup> If redistribution of wealth or income is to be a major goal of our tax system, the case for expenditure taxation is not much stronger than the case for a proportionate income tax. An income tax at least makes the enlargement of existing fortunes or accumulation of new ones more difficult. The expenditure tax will not even do that.<sup>82</sup> Some expenditure tax supporters have made much of the ability of that tax to reach someone who is dissipating a large fortune, but from the viewpoint of redistribution this effect is of marginal significance, since the spendthrift is already engaged in a process of distributing his wealth to others. In theory, it would be possible to make consumption tax rates steeply progressive and high enough to force wealthy people to dip into capital for taxes if they wished to maintain a high standard of living. But such rates would be politically unacceptable, particularly since they would also force the many people in our society with high incomes but little wealth to reduce their standard of living apprecia-

---

<sup>80</sup> See generally W. BLUM & H. KALVEN, *supra* note 41. See also H. SIMONS, *supra* note 4, at 18-19. By "redistribution" I mean taking wealth from the rich as an end in itself, not necessarily giving that wealth to the poor. There are so few rich people, and so many poor people, that taking from the rich and giving to the poor would surely not enrich the poor in any significant absolute sense (even apart from whatever undesirable economic effects such a program would have). But a redistribution program need not enrich the poor to reduce inequality; impoverishing the rich will do as well.

I am not arguing here for a program of redistribution. I will argue only that the redistributive goal is not well served by expenditure taxation, and that a reform of the income tax to make it proportional is compatible with other changes—in particular, meaningful death taxes—that will serve the redistributive goal better than it is served either by the progressive income tax or by a progressive expenditure tax.

<sup>81</sup> One answer is that much of the change would be formal, since few people actually pay 70 percent of any of their income in taxes. A change to proportionality that was accompanied by the elimination of tax preferences would make the tax system both simpler and fairer. Such a change would be no harder to explain to the public than a change to an expenditure tax.

<sup>82</sup> The sort of person who would become wealthier under an expenditure tax than under an income tax is not the entrepreneur, whose gains today tend to be lightly taxed capital gains and untaxed unrealized appreciation, but the person who works hard and spends little, accumulating through restraining his tendency to enjoy wealth. Those who see spending as "luxurious waste," T. HOBBS, *supra* note 6, quoted in N. KALDOR, *supra* note 4, at 53, and who view the self-denying saver as a paragon, may tend to favor a consumption tax. But it is as hard to find virtue in compulsive accumulation as in extravagant spending, and the accumulation of fortunes to be passed on to the next generation raises distributional and incentive problems that would be magnified by exempting income saved from taxation. See Stigler, *The Goals of Economic Policy*, 18 J.L. & Econ. 283, 291-92 (1975).

bly. More moderate rates, on the other hand, would not prevent rich people from accumulating still larger fortunes from their tax-free unspent incomes, especially with the corporate income tax eliminated. As a practical matter, therefore, Kaldor is wrong in saying that "[b]y making the [expenditure] tax sufficiently progressive, it would always be possible to prevent the rich from saving too much."<sup>83</sup>

Any serious attempt at redistribution of wealth must rely on death taxes, and here the adoption of an expenditure tax base might prove counterproductive. Although the question of death taxes is in principle entirely separate from the question whether income or expenditure provides a better tax base, in practice, as Henry Simons has observed, "[t]here would surely be grounds for complaint if we taxed inheritances heavily and then levied again on the beneficiaries when they consumed the inherited capital."<sup>84</sup> Congress has shown little enthusiasm for imposing estate taxes not so easily avoidable as to hint that their purpose is largely symbolic, and none at all for introducing inheritance taxes, which could be far more effective than estate taxes in changing wealth distribution. A moderate—but meaningful—estate or inheritance tax, however, might be more acceptable politically if combined with a reform of the income tax to make it proportional and to eliminate tax preferences. Such a package would respond to most of the justifiable criticisms of the present system. It would involve less drastic change—and less "hidden" and unpredictable change—than moving to an expenditure tax. And although it may sound utopian to those familiar with the problems of getting tax reform through Congress, it is highly unlikely to encounter more opposition than changing to an expenditure tax.

#### D. An Expenditure Surtax

The more cautious advocates of consumption taxes recommend, at least as an initial step, the introduction of such a tax as a surtax.<sup>85</sup> Against this proposal as an end in itself (though not, as its proponents urge, as a step in the direction of replacing the income tax with an expenditure tax) the arguments I have advanced have little force. A combination of a general, proportional, income tax and a progressive expenditure tax with a large enough exemption to exclude most taxpayers would probably be little worse and might

---

<sup>83</sup> N. KALDOR, *supra* note 4, at 97.

<sup>84</sup> H. SIMONS, *supra* note 4, at 229.

<sup>85</sup> N. KALDOR, *supra* note 4, at 223; Andrews, *supra* note 4, at 1177, 1185-88.

be better than the present system of steeply graduated rates combined with so many exemptions that few feel their effects. The administrative arguments for a spendings tax—and against an income tax—are most persuasive as applied to the affairs of the wealthy, and the ability-to-pay argument for income taxation supports only a proportional income tax. Surtaxes are essentially crude forms of class legislation, and if the public can be convinced that a consumption-type surtax is preferable to the progressive rates in the income tax there is little reason to object to its introduction. By freeing many business decisions (but not decisions on whether to spend or save) from tax considerations and by encouraging the rich to invest, an expenditure surtax might even have positive economic effects. The experiment would also give us some useful information about the administrability of an expenditure tax and its resistance to pressure for tax expenditures. My own view is that there is no great need for any surtax. If we must, for political reasons, have one, an expenditure tax might do as well as the present unwieldy structure of high progressive rates, minimum and maximum taxes, and countless relief provisions.

#### CONCLUSION

The case for replacing the income tax with a spendings tax rests partly upon the dubious “double taxation of savings” argument and some questionable conclusions about administrative convenience. At bottom, however, I suspect that much of the vogue the expenditure tax now enjoys is attributable not to these considerations alone, but also to the frustrations of tax theorists with the unavoidable imperfections of the income tax.<sup>86</sup> No definition of “income” can possibly prove satisfactory in all cases; no income tax code can operate without anomalies and injustice, even in principle. But the “careful disorderliness” with which any income tax must be constructed gives no reason for abandoning the effort to do the best we can, improvising as we go along and learning from experience. Consumption may be a more coherent concept than income, but to

---

<sup>86</sup> This is particularly evident in Fisher's despair over attempts to define “income” except as consumption. *THE INCOME CONCEPT*, *supra* note 4, at 1 (“The question ‘What is Income?’ has become a burning question for legislatures, administrators, judges, and statisticians, as well as economists.”). Fisher's “burning question” has no practical importance; what matters is not whether we can define income but whether we can recognize it often enough to use it as a basis for taxation. I doubt that more than a few people in the world can define “red” without consulting an optics textbook, and I have never seen a good definition of “traffic light,” yet laws requiring people to stop at red traffic lights are regularly and satisfactorily enforced.

choose it as a tax base for that reason is to choose a goal not worth reaching. The income tax has worked reasonably well in practice and the costs of drastic change would be enormous.<sup>87</sup> This alone is reason enough to stay with the income tax as our principal source of revenue until reasons for change more forceful than any advanced so far appear.

---

<sup>87</sup> While we may exaggerate the inherent administrative difficulties of a spendings tax, it is hard to avoid understatement in arguing against revolutionary change in existing arrangements. Long experience, here and abroad, has taught us much about problems of income taxation and about the opportunities for salutary reform. We have achieved and preserved a high level of taxpayer morality and taxpayer co-operation; we have gradually developed a system of administrative procedures and techniques of enforcement which, after drastic change in the form of levy, we probably could not rebuild to a similar level of effectiveness within a generation. Given a revenue system which, at many points, does need drastic changes, it would be folly to start over from the beginning with our income tax or to discard the essential structure of established methods and procedures.

H. SIMONS, *supra* note 4, at 230.

This argument may have little force as applied to the English situation, where the tax is so riddled with special provisions for savings that it may already be more an expenditure tax (though a poor one) than an income tax. See MEADE COMMITTEE REPORT, *supra* note 2, at 49-70.