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CONSUMPTION TAXES, FLAT TAXES, CAPITAL GAINS, AND OTHER TAX FANTASIES

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This report discusses some of the tax policies most likely to be considered by the 104th Congress. The author believes that the recent electoral victories of the Republican Party in the 1994 midterm elections makes certain that some such tax "reforms" will be adopted. The historical genealogy of the most significant of these proposals is traced in this article, as are the various claims made for these policies by proponents. Policies that are discussed include various forms of consumption taxes, a flat income tax, and a preferential tax rate for capital gains.

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"[M]odern taxation or tax making in its most characteristic aspect is a group contest in which powerful interests vigorously endeavor to rid themselves of present or proposed tax burdens. It is, first of all, a hard game in which he who trusts wholly to economics, reason, and justice, will in the end retire beaten and disillusioned."

Professor T.S. Adams, "Ideals and Idealism in Taxation" (1928)

The New Republican Tax Agenda?

In recent months, a number of tax proposals right off the Republican tax agenda of the 1980s have been again attracting attention. With the Republican Party taking control of both Houses of Congress for the first time since 1954, the political agenda has changed dramatically. During the fall elections, House Republicans advanced their campaign platform through the so-called "Contract With America." None-too-surprisingly, a considerable portion of the contract consists of policies to be implemented through amendments to the Internal Revenue Code. To a large extent, this reflects the contemporary bipartisan infatuation with using the federal income tax laws to make social and economic policy.

Of the 10 or so most significant proposals contained in the contract, several deal exclusively with the federal income tax. These include the following: an exclusion of 50 percent of net long-term capital gains, indexing of capital assets, the allowance of capital losses recognized on the sale of a principal residence, certain modifications of the Accelerated Cost Recovery System, increasing the current $600,000 unified estate and gift tax lifetime credit to $750,000, increasing the section 179 annual expensing allowance to $25,000, expanding the availability of deductions (and tax-free withdrawals) for IRA contributions, eliminating the so-called "marriage penalty," and a new $500-per-child tax credit for families with income up to $200,000. The Treasury Department estimates that the tax cuts included in the contract would cost $197.2 billion over the first five years and $514.8 billion over the five subsequent years. Of course, these estimates assume that the capital gains tax cut will *cost* the Treasury revenue — an assumption that may go the way of the tax-deductible martini if congressional Republicans replace the staff of the Joint Committee on Taxation with a more optimistic crew of revenue estimators.[1]

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[1]Republicans have already replaced the chief of staff of the Joint Committee and the director of the CBO may soon be replaced. At issue is the use of "static" versus "dynamic" scoring techniques when predicting the impact of tax provisions on revenue raised under the income tax. The Joint Committee, the Office of Tax Policy in Treasury, and the Congres-

(Footnote 1 continued on next page.)

Perhaps the most significant of these tax proposals are those relating to the taxation of capital gains. Ironically, there is no mention in the contract of either consumption taxes or flat taxes. Nevertheless, most attention has focused of late on these as the most significant (and controversial) tax "reforms" on the Republican agenda, and there even has been talk of one or the other as a possible replacement for the federal income tax. The likelihood of that happening next year is much less certain than a capital gains tax cut. Nevertheless, there is surprisingly strong support on both sides of the aisle in Congress for both of these very radical tax proposals, and hence, they must be considered as viable political options.

Proponents of the various forms of consumption taxes have been preaching the gospel in Washington for decades.

Proponents of the various forms of consumption taxes have been preaching the gospel in Washington for decades. Most recently, a national sales tax (one form of a consumption tax) was given serious consideration by Democrats during the first months of the Clinton administration. Specifically, the national sales tax was mentioned as a means for raising new revenue to finance the administration's proposed health care reforms. While that particular justification for new taxes expired along with the Clinton health care initiative itself, strong interest in a sales tax or a European-style VAT persists within and without Congress. A value added tax has been mentioned by leading congressional tax policymakers as a possible supplement or replacement for the federal income tax. Perhaps this reflects the depth of dissatisfaction with the income tax as much as the pressures now felt by federal policymakers to find new sources of revenue. The seriousness (and vacuousness) of contemporary dissatisfaction with the income tax was recently expressed by Sen. Pete V. Domenici, R-N.M., when he pronounced that: "The federal income tax code is un-American in spirit and wrong in principle."[2] One hopes that the senator, now Chairman of the Senate Budget Committee, is not contemplating the resurrection of a Subcommittee on Un-American Taxation during the 104th Congress.

Proposals for consumption taxes and a flat income tax have emerged as serious contenders in the race to reconstitute the fiscal organization of the American state. For example, several legislative proposals for consumption-like taxes surfaced in the waning days of the 103rd Congress, and these had considerable appeal and support within both political parties. Sens. David L. Boren, D-Okla., and John C. Danforth, R-Mo., both of whom retired with the close of the 103rd Congress, sponsored a proposal for a "business activity tax."[3] In addition, Sens. Sam Nunn, D-Ga., and Domenici sponsored a proposal for a so-called "Universal Savings Allowance" with features similar to a consumption tax.[4] And Ways and Means Committee Chairman Bill Archer, R-Texas, championed a consumption tax to replace the current income tax, stating somewhat ineloquently that "we've got to look at a new way of raising revenue than the income tax."[5]

There also was strong support for a consumption tax and/or value added tax among members of the Bipartisan Commission on Entitlement and Tax Reform, which mercifully expired on December 15, 1994, without reaching any consensus with respect to either cutting entitlements or reforming the income tax. Nevertheless, a surprising number of prominent commission members seemed to favor junking the income tax altogether in favor of a consumption tax. For instance, Rep. Sam Gibbons, D-Fla., then-acting chairman of the House Ways and Means Committee, used the commission as a platform from which to announce his support for a broad-based value added tax to replace the individual and corporate income taxes, as well as payroll taxes.[6] Boren similarly took the opportunity to express his interest in a consumption tax based on his undoubtedly erroneous belief that such a tax would be "simple" and administrable compared with the current income tax.

In addition to consumption taxes, reform proposals for a flat tax have resurfaced in recent months. Of course, conservatives have been uncomfortable with the graduated income tax ever since it was first introduced in 1862 during the Civil War. Before the 1994 elections, Rep. Richard K. Armey, R-Texas, proposed a

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sional Budget Office all use somewhat different scoring techniques, but none now use dynamic scoring which assumes that cuts in capital gains rates will result in increased revenue. The issues relating to dynamic scoring are discussed in Sean Ford, "CBO Official Discusses 'New Order' for Estimators," *Tax Notes*, Nov. 21, 1994, p. 940; Sean Ford, "Battle Over Revenue Estimates Takes Back Seat to GOP Contract," *Tax Notes*, Dec. 5, 1995, p. 1172; Paul A. Gigot, "GOP Team Rethinks Its Enemies List," *The Wall Street Journal*, December 23, 1994, p. A10; Barbara Kirchheimer, "Republicans Accuse Treasury of 'Political' Revenue Estimating," *Tax Notes*, Dec. 26, 1994, p. 1583; Lucinda Harper and David Wessel, "A Primer: What Congress Will Face in Debate Over Taxes and Revenue," *The Wall Street Journal*, December 27, 1994, p. A2; Lauara D'Andrea Tyson, "Dynamic Scoring: Not Ready for Prime Time," *The Wall Street Journal*, January 12, 1995, p. A14. However, Republicans seem to have backed off from their position for the time being. In a press conference on January 4, 1995, House Ways and Means Committee Chairman Archer acknowledged the undesirability of turning the revenue-estimating process into a "political football." *See 95 TNT* 3-2 (January 5, 1995); *H&D*, Jan. 5, 1995, p. 169.

[2]Quoted in *The Philadelphia Inquirer*, Nov. 21, 1994, p. A1.

[3]The Boren-Danforth proposal is examined in great detail in Oliver Oldman and Alan Schenk, "The BAT: Is It a Better Value Added Tax?" *Tax Notes*, Dec. 19, 1994, p. 1547.

[4]Senator Domenici presented a convincing and detailed defense of his proposal in "The Unamerican Spirit of the Federal Income Tax," 31 *Harv. J. on Legis.* 273 (Summer 1994).

[5]Quoted in *DTR*, No. 218, Nov. 15, 1994, p. G-6.

[6]*See* John Godfrey, "Bipartisan Commission Members Favor a Consumption Tax," *Tax Notes*, Oct. 10, 1994, p. 154.

truly radical innovation — a flat income tax. (A flat tax is nothing more than a progressive tax that has been stripped of its graduated rate structure; in other words, it's really not that innovative.) Armey laid out his proposal for a 17-percent flat tax in an article appearing in the Fall 1994 issue of *Commonsense*, a Republican policy journal published by GOP Chairman Haley Barbour's National Policy Forum. Armey's proposal justifiably received only negligible notice before the November elections. For reasons none-too-difficult to fathom, the plan has been a very hot item since the elections — particularly once it was clear that Armey would become House majority leader. Armey's proposal (H.R. 4585) would phase in a 17-percent flat tax imposed on wages and pension distributions in excess of some rather high standard deductions ($13,100 for a single taxpayer and $26,200 for a married couple filing jointly in 1997) and generous dependent allowances of $5,300. Such a flat tax, denying all deductions and adjustments, begins to resemble a broad-based consumption tax imposed on taxpayers' gross receipts. The main selling point of Armey's tax appears to be that: "Individuals would fill out a tax form the size of a postcard."[7]

Armey's plan for a flat tax presupposes that all the many "special interest" provisions will be stripped out of the tax code. This is the stuff that liberal economists at the Brookings Institution have been dreaming of for decades, but even they never would have believed such a plan politically feasible short of the Second Coming of the New Deal itself. As for Chairman Archer, while he has announced that he is willing to consider Armey's proposal to dismantle the entire Internal Revenue Code, he thinks it politic to wait until he first implements the tax proposals included in the contract. That is true fiscal conservatism. Armey himself has more recently asserted that the question is not *whether* the federal income tax will be replaced, but whether it will be replaced with a flat tax or a consumption tax. Immediately after the ascendancy of Armey, House Minority Leader Richard A. Gephardt, D-Mo., joined the chorus and proposed his own version of a flat (or flatter) income tax — to be imposed at a 10- to 11-percent rate on all but the wealthiest 20 percent of American taxpayers.

The suggestion here is that notwithstanding all this political rhetoric and braggadocio in favor of such dramatic "reforms" of the federal income tax, prudence dictates against betting the house that any of these proposals will be enacted by the 104th Congress — Armey's protests notwithstanding. Proposals for both a flat tax and a consumption tax have been kicking around for decades, and for perfectly good reasons they never make it onto the serious tax policy agenda. These proposals provide excellent material for grandstanding before constituents, but the considerable institutional resistance to these wholesale assaults upon the federal tax regime makes their adoption unlikely. The federal income tax has become so deeply entrenched and intertwined with the development of the American state over the last eight decades that any threat to the $874 billion of revenue projected to be raised in 1994 from income taxation should be looked at as so much pie in the sky. Flat taxes and consumption taxes simply threaten too many political interests and run counter to too much of what motivates American policymakers (even Republicans) to stand much chance of being adopted. Nor does Speaker Gingrich's proposal (apparently raised in all seriousness at the time, but later described by Gingrich himself as a "dumb idea") for a new tax credit to enable the "poor" to purchase laptop computers stand much chance of being enacted. Still, more absurd proposals than that have found their way into the tax code.

On the other hand, the return of a preferential rate for capital gains became a central tenet of the Republican Party almost as soon as the ink dried on the Tax Reform Act of 1986 (TRA), and thus, is as sure a bet as one can find in Washington. This tax preference is most likely to make its way off the Republican Contract With America and into the tax code within the first 100 days of the Age of Newt. But before rushing head-on into sweeping tax reform, perhaps a bit of quiet reflection is in order. To serve that end, the political war waged over the past eight years for a preferential rate for capital gains is recounted below. Likewise, a bit of history and scholarly jargon on consumption taxes and flat taxes is presented as well. And in the event that in all the headiness of the Republican New Year, federal policymakers are tempted to adopt any of these proposals, some dire words of warning from Old Scrooge are also offered.

Irresistible Urge for a Capital Gains Preference

Republican proposals for a capital gains tax cut have been advanced by Republicans in Washington ever since the tax rates for ordinary income and long-term capital gains were equalized in 1986 pursuant to TRA. Indeed, one of the first and only serious tax initiatives pursued by the Bush administration was for the reinstatement of a preferential tax rate.[8] The remnants of the now-defunct tax shelter industry, which was effectively shut down by TRA in 1986, have yearned for any form of a reinstatement of even a modest preferential rate for capital gains. The great difference in the tax treatment of ordinary income and capital gains was one of the most significant forces behind the original growth of the tax shelter industry in the 1960s. The imbalance between the two rates was eventually resolved by TRA as the tax rates for ordinary income and capital gains were equalized. This took considerable steam out of tax shelter promoters.

[7] Richard K. Armey, "The Flat Tax: Restoring Freedom and Fairness," 1 *Commonsense* 48 (Fall 1994).

[8] For a discussion of that political initiative, see Sean Ford, "Bush Budget Kind and Gentle to Capital Gains and Savings," *Tax Notes*, Feb. 5, 1990, p. 605; Ian K. Louden, "No Tax Surprises in '91 Budget as Bush Seeks Capital Gains Cut, Family Savings Initiative," *Tax Notes*, Feb. 5, 1990, p. 607.

Oddly enough, a limited version of the preferential rate for capital gains was reintroduced during the 1993 legislative initiative begun by President Clinton. This culminated in the enactment of new section 1202 pursuant to the Revenue Reconciliation Act of 1993, which provision provides for an exclusion for 50 percent of the capital gain recognized on the sale of "small business stock" of certain qualified corporations. This tax preference returned tax planning for the conversion of ordinary income into capital gains to the repertoire of the tax lawyer. Now Republicans want to extend the favor to all investors by expanding the 50-percent exclusion to embrace all long-term capital gains.

If critics have denounced a lower capital gains tax rate as a break for the 'rich,' and proponents have rhapsodized over the incredible benefits to be derived, the view of professional economists is mixed, at best.

While the Republican Party has generally supported a preferential rate as a means for stimulating the investment of capital, President Bush became particularly attached to the cause.[9] The 1992 Republican party platform reiterated the president's commitment: "Reducing the tax on investment will be the biggest possible boost for the new technologies, businesses, and jobs we need for the next century."[10] The Republican case for a preferential rate has been stated broadly in terms of specific national economic policies — namely, encouraging the formation of capital and liquidity in the capital markets.[11] Likewise, a preferential rate for capital gains has been justified in terms of raising additional revenue from an increased volume in capital transactions. This theme has been at the heart of Republican tax policy since the 1920s, when Secretary of Treasury Andrew Mellon admonished those skeptical of the value of tax cuts: "It seems difficult for some to understand that high rates of taxation do not necessarily mean large revenue for the Government, and that more revenue may often be obtained by lower rates."[12]

While President Bush adhered to a capital gains tax cut as an article of religious faith, Democrats maintained that a preferential tax rate for capital gains would favor the "rich" at the expense of the middle class and poor. Democrats also argued that any return to a lower rate of taxation for capital gains would breach the bipartisan bargain central to the compromise that made TRA itself possible. Curiously enough, the Democratic opposition ignored the contribution of the capital gains preference to the stimulation of a tax shelter industry.

If critics have denounced proposals for a lower tax rate for long-term capital gains as a special break for the "rich," and proponents have rhapsodized over the incredible benefits to be derived from such, the view of professional economists is mixed, at best.[13] Economist Herbert Stein has perfectly summarized the prevailing absence of consensus: "Economists have made numerous efforts to estimate the revenue effect of changes in the tax on realized capital gains. . . . What the studies do show is that no one knows."[14] Whether a preferential rate for long-term capital will actually produce any economic benefits is open to serious debate. The most recent word on the subject comes from the Treasury's Office of Tax Analysis, which concluded that the short-term effects of introducing a preferential rate will be significant, but that long-term permanent effects will likely be marginal.[15]

In response to the inability to push legislation through Congress to reintroduce preferential treatment of capital gains, Republicans turned to more circuitous routes during the Bush years. In 1992, President Bush contemplated issuing an executive order to implement "indexing" capital gains for inflation through Treasury regulations. The effort was abandoned when legal advisers in the Departments of Justice and Treasury concluded that the president lacked the legal authority to pursue such a route.[16]

With Republicans taking control of Congress and the tax committees, indexing may very well become enshrined in the tax code. And surely, a preferential tax rate for capital gains will soon return to the landscape of the world of taxation. Notwithstanding a technical glitch in the original Republican bill concerning the effective date of the proposed 50-percent exclusion for capital gains, Ways and Means Committee Chairman Archer made sure that corrections were made in time to see the bill formally introduced soon after the com-

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[9]For a more detailed discussion of this issue, I refer the reader to my earlier broadside, "Tax Reform: The 1980's in Perspective," 46 *Tax L. Rev.* 489 (1991).

[10]"The Republican Platform 1992," Republican National Committee, Aug. 12, 1992, p. 28.

[11]*See, e.g.*, Charls E. Walker and Mark A. Bloomfield, "The Case for the Restoration of a Capital Gains Tax Differential," *Tax Notes*, May 22, 1989, p. 1019; Martin Feldstein, "Why Capital Gains Taxes Are Unfair," *The Wall Street Journal*, Nov. 21, 1994, p. A16.

[12]Andrew W. Mellon, *Taxation: The People's Business* (New York: The Macmillian Company, 1924), p. 16.

[13]For presentations of the views of some economists on this issue, in language that noneconomists can understand, see Alan J. Auerbach, "The Effect of Reducing the Capital Gains Tax," *Tax Notes*, May 22, 1989, p. 1009; Staff of the Congressional Budget Office, "Capital Gains and Economic Growth," *Tax Notes*, Oct. 1, 1990, p. 105; Congressional Budget Office, "Indexing Capital Gains," *Tax Notes*, Oct. 1, 1990, p. 103; Ralph Estes, "Should Capital Gains Taxes Be Cut?" *Tax Notes*, Sept. 27, 1993, p. 1755.

[14]Herbert Stein, "The Taxation of Realized Capital Gains," *Tax Notes*, May 22, 1989, p. 1013, 1016.

[15]Leonard E. Burman and William C. Randolph, "Measuring Permanent Responses to Capital Gains Tax Changes in Panel Data," OTA Paper Number 68 (August 1994).

[16]*See* "Capitol Hill Shudders at Capital Gains Indexation Plan," *Highlights and Documents*, Sept. 8, 1992, p. 4003. For a discussion of the legal arguments concerning this issue, see Lee Sheppard, "Capital Gains, Indexation, Administrative Authority," *Tax Notes*, Sept. 7, 1992, p. 1249.

mencement of the 104th Congress. Even President Clinton seems reconciled to the enactment of this article of Republican faith, and the administration seems to be offering its support in exchange for reciprocity over the president's proposed "middle-class" tax cut. (The president's notion of a tax cut for the middle class turned out to mean tax preferences for education, IRAs, and those foolish enough to own up to their progeny.)

Republicans now face the prospect of finally fulfilling their long quest for a capital gains preference, and thereby, face the terrifying prospect that there will be an opportunity for empirical verification of their conviction that a capital gains tax cut can have favorable long-term impact upon investment and the economy — all without depleting the fisc. If this works, it will be Christmas, Hanukkah, Kwanzaa, and one big tax refund all rolled up into one for the Republicans in November 1996.

The Consumption Tax: The Ultimate Tax Reform?

As the legitimacy and revenue-raising capacity of the federal income tax have come to be increasingly questioned over the past decades, there has been renewed interest in abandoning the federal income tax altogether in favor of an alternative tax system. This sentiment is reflected in the many academic articles devoted to analyzing various forms of the consumption tax. Before Dick Armey ever dreamed of 17 percent and flattening the income tax into submission, it was already understood that dumping the federal income tax in favor of a consumption tax would be the ultimate tax "reform." A good deal of the expertise of the tax bar accumulated over eight decades of experience under the federal income tax would also be wiped out by the switch to a consumption tax — a prospect that shouldn't bring tears to too many eyes. But fortunately for my former colleagues from the tax bar, there is little real likelihood that the federal income tax will be abandoned any time soon, or that a national consumption tax will be adopted even as a supplement to the federal income tax. Nevertheless, such proposals are sure to stalk the hallowed halls of Congress during the 104th Congress, and thus deserve some serious attention.

The primary argument in favor of consumption taxation rests on the assertion that there are significant advantages from taxing some commodity other than "income." The notion is that because the current tax regime taxes income, which includes the return on investment capital, economic disincentives against savings and incentives in favor of consumption are created. The taxation of savings, it is argued, is deleterious to an economy that depends on capital formation from investment derived from savings. This is hardly a new observation. Thomas Hobbes expressed the same sentiments in favor of a consumption tax in his 1651 masterpiece, *Leviathan* (which, incidentally, is a book approved by, and on Professor Gingrich's list of recommended reading for The Party Faithful). Hobbes asked loquaciously: "For what reason is there, that he which laboreth much, and sparing the fruits of his labor, consumeth little, should be charged, more then he that living idley, getteth little, and spendeth all he gets; seeing the one hath no more protection from the Commonwealth then the other?"[17] The logic of Hobbes' inquiry remains compelling as the U.S. economy has failed to achieve satisfactory levels of savings and investment in recent decades. It seems the more we spendeth, the less we investeth.

> ***Before Dick Armey ever dreamed of flattening the income tax into submission, it was already understood that dumping the federal income tax in favor of a consumption tax would be the ultimate tax 'reform.'***

There are many different types of consumption taxes, and scholars have their own cottage industry generating a considerable literature covering all the possibilities.[18] The main examples of "direct" consumption taxes include excise taxes, sales taxes, and the value added tax. Excise taxes are essentially consumption taxes imposed on particular commodities (e.g., cigarettes, alcohol, gasoline, or such luxury items as yachts or furs). Sales taxes are imposed on sales of broad categories of commodities or services. The VAT is a variation on a sales tax most common in Europe. It was also recently adopted by New Zealand and Canada. (In the case of Canada, the national sales tax took the form of the much-abhorred Goods and Services Tax, adopted in 1991 much to the delight of would-be cigarette smugglers.) The VAT is imposed on the value added to a particular commodity by businesses engaged in the various stages of the manufacturing process (i.e., the tax is essentially imposed on the difference between the business's sales and its purchases of raw materials). As such, the "cost" of the tax is ultimately borne by the final user of the good (i.e., consumers).

The basic feature common to all of these taxes (sales, excise, and VAT) is that they are imposed on the consumption of goods and services, rather than on savings. For this reason, supply-side economists have tended to favor consumption taxes as an alternative to income taxation. It also is argued that consumption taxes are more "efficient" with respect to avoiding distortions in the formation of capital (an argument commonly advanced by economists).[19] Both claims are also

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[17] Joseph A. Pechman, *Federal Tax Policy* (Washington: The Brookings Institution Press, 1987) (5th ed.), p. 190.

[18] *See, e.g.*, Thomas Hobbes, *Leviathan* Part II, Chapter 30.

[19] For a broad discussion of the various forms of consumption taxes, see Joseph A. Pechman, *Federal Tax Policy* (Washington: The Brookings Institution, 5th ed. 1987), Chapter Six ("Consumption Taxes"); *see also* Nicholas Kaldor, *An Expenditure Tax* (London: Allen and Unwin, 1955); Alice Rivlin (ed.), *Economic Choices 1984* (Washington: The Brookings Institution, 1981); David G. Davies, *United States Taxes and Tax Policy* (New York: Cambridge University Press, 1986), pp. 77-90; Peter Mieszkowski, "The Choice of Tax Base: Consumption versus Income Taxation," in Michael J. Boskin (ed.), *Federal Tax Reform: Myths and Realities* (San Francisco: Institute of Contemporary Studies, 1978), pp. 27-54.

made for a so-called "expenditure tax" — which is nothing more than a consumption tax imposed on individuals, rather than sellers or manufacturers. An expenditure tax may be structured following a "cash-flow" model with taxation imposed on the net consumption of the individual over the relevant accounting period.[20] One of the purported advantages of so taxing an individual's consumption is said to be greater "equity."[21] The notion is that an individual's consumption presents a fairer base for taxation than income. On the other hand, others make contrary claims on the grounds that consumption taxes are necessarily "regressive" since the consumption of lower-income individuals represents a higher percentage of their income than it does for wealthy individuals. This is true, but the problem can be solved through a cash-flow expenditure tax, which can include a progressive tax rate structure. Another major objection to reliance on a consumption tax versus an income tax is that the latter offers built-in flexibility with respect to revenue responses by the government during periods of recession. There seems to be no good response to this criticism of consumption taxation.

The most significant obstacle to adopting an expenditure-styled consumption tax is the great difficulty in phasing out the existing income tax and phasing in the cash-flow expenditure tax.

But in the end, the most significant obstacle to adopting an expenditure-styled consumption tax is the great difficulty in phasing out the existing income tax and phasing in the cash-flow expenditure tax. The problem arises as savings previously taxed under the old tax regime (savings in "after-tax" dollars) must be identified and provided with some form of exemption under the new regime; otherwise, these amounts would be taxed a second time if they are subsequently consumed. Proponents recognize such problems, but generally dismiss them as "solvable." (This is about as reassuring as Armey's profession that the many similar problems in phasing in a flat tax "can be ultimately overcome."[22]) However, if there is some extended period during which the new tax is phased in while the income tax is phased out, there will be two tax regimes that taxpayers must confront and plan around.[23] A truly radical break with the past is impossible, and the transition period promises to be even more complex as two tax systems are in place — three if the alternative minimum tax is counted, but who pays attention to the AMT?

The problem of introducing a consumption tax into an economy already geared to an income tax is less acute than what would be experienced by a nation with a developing, emerging economy. In such cases, the choice of a consumption tax as opposed to an income tax is considerably more appealing.[24] However, introducing a consumption tax within the context of an 80-year experience with an income tax is entirely problematic.

Because of the difficulty in implementing an expenditure-type consumption tax, excise taxes have been more commonly used in recent decades as mere revenue enhancers for the federal income tax. Indeed, consumption taxes currently account for only 14 percent of the total federal, state, and local tax revenues.[25] However, even this also does not always turn out as expected. Witness the recent unfortunate experience with the excise tax imposed on such luxury items as jewelry, yachts, and high-priced imported automobiles. In that case, Congress and President Bush adopted the 10-percent excise tax to raise revenue in conjunction with the spending cuts contemplated by the 1990 budget reduction plan. There also was surely a strong element of "class" politics involved as the luxury tax was supported by the Democratic leadership of Congress, which sought to reimpose the tax burden on the "rich" that allegedly had been shifted to the middle class during the Reagan years.

In enacting this tax, policymakers must have either assumed an unrealistically inelastic demand curve for these goods or else were blinded by their own many illusions about how the "rich" behave. The inherent limit to raising revenues through a commodity-specific tax imposed on nonessential items was quickly revealed as anticipated revenues failed to materialize. The tax was quickly characterized by the Republican Bush administration as "counterproductive." By 1992, congressional Republicans and Democrats alike accepted repeal of the tax for all commodities other than luxury automobiles. However, the effort to repeal the excise tax ended up a victim of the partisan politics that killed the entire 1992 revenue bill. Two years later, the Clinton administration (by the slimmest of margins in Congress) finally dumped the luxury tax. Because revenue from the tax had declined every year since

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[20]This perspective is reflected in Joseph A. Pechman (ed.), *What Should Be Taxed: Income or Expenditure?* (Washington: Brookings Institution, 1980); *see also* Joseph Bankman and Thomas Griffith, "Is The Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?" 47 *Tax L. Rev.* 377 (1992).

[21]For a description of such a tax, *see* William D. Andrews, "A Consumption-Type or Cash Flow Personal Income Tax," 87 *Harv. L. Rev.* 1113 (April 1974). A recent defense is found in Laurence S. Seidman, "A Better Way to Tax," 114 *The Public Interest* 65 (Winter 1994).

[22]*See, e.g.*, Alvin Warren, "Would a Consumption Tax Be Fairer Than an Income Tax?" 89 *Yale L. J.* 1081(1980).

[23]Armey, "The Flat Tax," p. 54.

[24]Charles McLure identifies transition rules as one source of the complexity of the tax laws. *See* Charles A. McLure Jr., "The Budget Process and Tax Simplification/Complication," 45 *Tax L. Rev.* 25, 51 (1989).

[25]*See, e.g.*, Charles A. McLure Jr. and George R. Zodrow, "Implementing Direct Consumption Taxes In Developing Countries," 46 *Tax L. Rev.* 405 (1991).

1990, this merciful act was estimated to cost the Treasury only $270 million over five years.[26]

It is hoped that this experience with the luxury tax has left policymakers with some reservations about excise taxes and consumption taxes as the be-all solution to the budget deficit. But political campaigns constantly generate these kinds of proposals, even if such "innovations" only contribute to the frustration with the current tax regime.

Flat Taxes

As early as the Civil War revenue bills, there has been some degree of progressivity in the federal income tax. This was always defended by proponents from the perspective of both "equity" and revenue, but since late in the 19th century, Progressive and Populist egalitarianism have pushed policymakers toward graduated rates as a means for redistributing wealth among the classes — e.g., forcing the wealthy to pay their "fair" share of the tax burden. It was really the need for increased revenue during World War I and World War II that forced policymakers to adopt the highly progressive rate structure that characterizes the U.S. income tax. In 1914, the federal income tax was a minor source of federal revenue, providing only 9.7 percent of total federal receipts. By the end of the first World War, the top tax rate had reached 77 percent on income over $1 million — this from the initial 6-percent maximum rate adopted only six years earlier in 1913.[27] Revenue from the income tax and excess profits tax supplied 63.1 percent of total federal receipts by 1918. While the wartime rates were withdrawn during the 1920s, they rose again during the revenue crisis of World War II. And thereafter, maximum marginal tax rates remained at or over 90 percent for almost 20 years. Not until the 1980s were the wartime rates entirely withdrawn.

In 1981 and again in 1986, Republican supporters of supply-side economics were able to achieve great victories in reducing the maximum marginal tax rate for individuals even below the reductions that President Kennedy had achieved in 1962. Due to an unusual coalition of convenience, liberal tax reformers joined with Republican supply-siders *both* to cut tax rates and to eliminate many special deductions from the tax code. Even then, there was no shortage of politicians clamoring for even lower tax rates — with Kemp, Roth, and Reagan prominent among them. Interest in a flat tax was also stimulated by certain academics who made it all sound so easy — even to Ronald Reagan. The promise was that with a flat tax, income tax forms would be no longer than a "postcard."[28] (Doesn't that sound familiar.) Of course, these academics never had to worry about balancing a budget, a relatively minor concern that prevented the Reagan administration and congressional policymakers from achieving lower maximum marginal rates and a flatter rate structure for the income tax.

> ***As early as the Civil War revenue bills, there has been some degree of progressivity in the federal income tax.***

Revenue also will present a great obstacle for Armey. As if to put a damper on his celebrations, the Treasury Department estimated that Armey's 17-percent flat tax would cost $244 billion in lost revenue per year. Treasury calculated that a 25.8-percent flat tax would be needed to achieve "revenue neutrality."[29] Armey's staff responded to this imputation of fiscal irresponsibility with the rather lame excuse that the Treasury estimates were politically motivated. They had better come up with some better excuses when critics begin to point out all the considerable difficulties in the flat tax fantasy. It is no easy matter to define income, and more than a few provisions of the current tax are devoted to this rather mundane, but entirely necessary task. One would urge the congressman to read Professor Boris Bittker's lecture offered some 27 years ago to those who idly dreamed of a "simple" tax regime, stripped of all "special interest" provisions.[30] Unless we are prepared to simply tax gross receipts, giving no effect for tax purposes to the costs attributable to the production of such income, we had better learn to live with the inevitable complexities of a tax code that recognizes business expenses as legitimate deductions. And unless we are willing to treat all taxpayers the same, whether similarly situated or not, then the tax code must make subtle distinctions that cannot be made on a postcard.

The real problem with flat tax proposals is that they underestimate the many different elements that go into creating a tax system. Flat-siders think only one Big Thought, at the exclusion of all others. Nothing would be better than to recall the advice of Professor T.S. Adams in his presidential address to the 1927 annual meeting of the American Economic Association:[31] "Idealism as a striving after perfect truth or justice, is mostly a nuisance. It does good, but more harm than good, if injected into practical affairs. . . . Narrowness and restricted thinking are unforgivable sins in those

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[26]Revenue projections for fiscal years 1994-1998 as prepared by the Staff of the Joint Committee on Taxation, "Summary of the Revenue Provisions of the Omnibus Budget Reconciliation Act of 1993," (Washington: Government Printing Office, 1993), p. 38.

[27]The Revenue Act of 1918, Pub. L. No. 65-254, 40 Stat. 1062, provided for a surtax on the "normal" tax of 12 percent on income in excess of $4,000. The surtax started at 2 percent on income in excess of $6,000 and reached 65 percent on income in excess of $1 million. However, the combined tax reached 50 percent on income in excess of $78,000, and thus, was hardly a "millionaire's tax."

[28]The most prominent of such "academic" studies were Alvin Rabushka and Robert E. Hall, who together published *Low Tax, Simple Tax, Flat Tax* (New York: McGraw Hill, 1983) and *The Flat Tax* (Stanford: Hoover Institution Press, 1985).

[29]*See* "Armey Flat Tax Panned by Treasury," *Tax Notes*, Nov. 7, 1994, p. 655.

[30]Boris I. Bittker, "A Comprehensive Tax Base as a Goal of Income Tax Reform," 80 *Harv. L. Rev.* 925 (1967).

[31]T.S. Adams, "Ideal and Idealism in Taxation," 18 *American Economic Rev.* 1, 5 (March 1928).

who essay to guide tax thinking." In the end, flat taxes are a diversion from real efforts to simplify the tax code. And postcards should be reserved for sending to friends from warm islands in the Caribbean in January to invoke deep feelings of jealousy, rather than for filing income tax returns.

Conclusion

So what's the bottom line? A preferred rate for capital gains by February — April 15 by the latest. A flat tax would be dandy, but 17 percent is more likely to be the next prime rate — at least if Alan Greenspan gets his New Year's wish. A VAT sounds like a promising way to hide the true tax burden from the American public; both Democrats and Republicans should appreciate that. But a $500 credit is hardly enough reward for keeping the kids (at least mine). Fortunately, President Clinton and Senate Republicans are now trying to out-bid House Republicans on this one. I'd say about five grand would be the right number. And by all means, throw in the tuition deduction. We college professors have to eat, too.