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Accommodating the "Low-Income" in a Cash-Flow or Consumed Income Tax World

George K. Yin[*]

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* Professor of Law, University of Virginia. B.A. 1970, Michigan; M.Ed. 1972, Florida; J.D. 1977, Geo. Wash.

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ABSTRACT

This article concerns a tax policy issue of keen current interest: the possible replacement of the income tax with a broad-based tax on consumption. The leadership of the new 104th Congress has promised early scrutiny of consumption tax proposals.

The weak link of most consumption tax plans relates to how they would distribute the tax burden across income classes. Critics charge that consumption taxes are regressive or at least not as progressive as the existing income tax. Many theorists believe, however, that one form of broad-based consumption tax, a cash-flow or consumed income tax, is immune to such criticism because it is an individualized consumption tax and could be implemented in a manner very similar to the income tax. Supporters of the cash-flow tax assert that it is flexible enough to attain any desired degree of progressivity.

In this article, I examine that proposition. Focusing on the impact of the cash-flow tax on low-income taxpayers, I conclude that it would be surprisingly difficult to fashion a cash-flow tax as redistributive at the lower end of the income scale as the current income tax system while still preserving the asserted advantages of the cash-flow tax. Although it may still be advisable to move towards a cash-flow tax system, it is important for policymakers to recognize the inherent limitations of such a system for achieving progressivity at the lower end of the income spectrum.

I. INTRODUCTION

Continuing criticism of the complexity and undesirable incentive effects of the income tax has revived bipartisan talk of the possibility of replacing that tax with a broad-based consumption tax.[1] Among the principal contenders are a transactions-based consumption tax, such as a European-style value added tax (VAT), and an individualized consumption tax, such as a "consumed income" or cash-flow tax. A transactions-based tax offers several advantages: It is widely used, it would permit millions of taxpayers to avoid filing tax returns, and it would enhance the government's ability to tax economic activity taking place in the "informal" sector. It also has an important disadvantage: its inflexibility in adjusting the burden of the tax to taxpayers' income or consumption levels or other indications of taxpaying capacity.

Concern about that lack of flexibility has led some policymakers to consider an individualized consumption tax. For example, the Center for Strategic and International Studies' Strengthening of America Commission, chaired by Senators Nunn (D.-Ga.) and Domenici (R.-N.M.), is reportedly developing a cash-flow or consumed income tax to replace the income tax and a portion of the employer and employee payroll taxes.[2] According to the

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1. Immediately after the 1994 midterm election, new House Ways & Means Committee Chairman Bill Archer (R.-Tx.) expressed support for moving in that direction. See Bill Archer, America's Agenda, 94 TNT 228-32 (Nov. 22, 1994) (LEXIS, FEDTAX library, TNT file) (transcript of press conference held Nov. 10, 1994); Laura Saunders, Archer's Agenda, Forbes, Dec. 5, 1994, at 45; Jeff Shear, A New Ball Game, 26 Nat'l J. 2781 (1994). Also, Ways and Means Committee Ranking Minority Member Sam Gibbons (D.-Fl.) has long been an advocate of a value added tax. See William H. Morris, A "National Debate" on VAT: The Gibbons Proposal, 60 Tax Notes 1259 (Aug. 30, 1993); Statement of Acting Chairman Sam Gibbons (D.-Fl.), House Comm. on Ways & Means, Before the Bipartisan Commission on Entitlement and Tax Reform, 94 TNT 198-36 (Oct. 7, 1994) (LEXIS, FEDTAX library, TNT file) (testimony in favor of subtraction method VAT). Finally, new House Majority Leader Dick Armey (R.-Tx.) introduced a bill in the 103d Congress that in some circumstances, would be equivalent to a broad-based tax on consumption. His bill, modeled after a plan proposed by Robert Hall and Alvin Rabushka, would enact a 17% flat tax on earned income and cash-flow business income as a substitute for the existing individual and corporate income taxes. H.R. 4585, 103d Cong., 2d Sess. (1994). See Dick Armey, Review Merits of Flat Tax, Wall St. J., June 16, 1994, at A-16. For bipartisan interest in the Senate in a broad-based consumption tax, see infra note 2 and accompanying text.

2. See Center for Strategic and Int'l Studies, The CSIS Strengthening of America Commission 96-102 (1992); Sen. Pete V. Domenici, The Unamerican Spirit of the Federal Income Tax, 31 Harv. J. on Legis. 273 (1994). In addition, during the 103d Congress, former Senators Danforth (R.-Mo.) and Boren (D.-Ok.) introduced a bill to enact a cash-flow corporate consumption tax to supplant the corporate income tax and reduce individual income and payroll taxes. S. 2160, 103d Cong., 2d Sess. (1994).

conventional wisdom, a cash-flow tax, unlike a transactions-based consumption tax, is flexible enough to attain any desired degree of progressivity.[3]

I examine that proposition in this article. My purpose is not to question the wisdom of income redistribution in the first instance or the relative merits of consumption and income taxes. Rather, my focus is on whether it is possible to design a cash-flow or consumed income tax that mitigates the tax burden of low-income taxpayers—perhaps the one objective of current redistribution policy that enjoys a broad consensus—while preserving the asserted advantages of the cash-flow tax. The feasibility of accomplishing that goal should be a prime factor in evaluating the tax's viability as a policy option. I use as my backdrop the cash-flow tax proposal being formulated by the Nunn-Domenici Commission.

My conclusion is that it would be surprisingly difficult to fashion a cash-flow tax as redistributive at the lower end of the income scale as the income tax without compromising the benefits of the cash-flow tax. Indeed, one of the principal tools for achieving that redistribution under current law—the earned income tax credit—is virtually incompatible with a cash-flow tax. Thus, although it may still be advisable to move towards a broad-based consumption tax, policymakers should recognize the inherent limitations of *both* transactions-based *and* individualized consumption taxes for achieving progressivity at the lower end of the income spectrum.

In Part II, I sketch out what a cash-flow tax is, how it differs from other broad-based consumption taxes, and some of the reasons why its supporters favor it over the income tax. Part III briefly explores some threshold issues relating to whether progressivity concerns would have to be addressed within the contours of a new consumption tax. Readers who are familiar with a cash-flow tax and the various tax and expenditure options for achieving progressivity can easily skip to Part IV, which identifies the principal difficulties in designing a cash-flow tax to accommodate the low-income. Finally, Part V contains a brief summary and conclusion.

II. Overview of a Cash-Flow Tax System

A. *Cash-Flow Tax in Contrast to Other Broad-based Consumption Taxes*

The most common form of broad-based consumption tax is a transactions-based tax that is not individualized, such as a European-style,

3. See David F. Bradford, U.S. Treas. Tax Policy Staff, Blueprints for Basic Tax Reform 122-23 (2d ed. 1984) [hereinafter Blueprints]; David F. Bradford, Untangling the Income Tax 162 (1986) [hereinafter Bradford-Untangling]; Nicholas Kaldor, An Expenditure Tax 48-49 (1955); William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113, 1174-75 (1974).

credit-method VAT or a retail sales tax. Either of those taxes is on a consumption base and arises at the point of the consumption transaction. Neither tax is individualized in the sense that there is no accounting for the total amount spent on consumption by any individual over any period of time.

In theory, such an accounting could be required. When sales taxes were deductible for federal income tax purposes, taxpayers had the option of either deducting the sales taxes actually paid or using a table to estimate that amount. Conceivably, taxpayers could be required to keep account of their consumption expenditures and make annual reports on the amounts so spent. Quite clearly, however, the mandate would be highly impractical; a large majority of those claiming the deduction for sales taxes used the tables. Moreover, it would be difficult to protect against the underreporting of consumption expenditures, a concern not present when the purpose of the accounting was to justify the size of a claimed deduction.

The infeasibility of individualizing a transactions-based consumption tax is a significant design flaw. Policymakers concerned with the distribution of the tax burden need to be able to adjust the tax borne by individuals based upon their consumption, income, or other indication of taxpaying capacity, but cannot do so if there is no accounting for those amounts.[4] A related problem is the absence of a mechanism for delivering desired adjustments to particular individuals.[5] To address this issue, non-individualized broad-based consumption taxes sometimes include exemptions or varying rates for various categories of consumption "necessities," such as food, clothing, shelter, and medical expenses. But these special provisions provide only rough solutions

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4. See Richard A. Musgrave & Peggy B. Musgrave, Public Finance in Theory and Practice 215 (5th ed. 1989) (arguing that *in rem* taxes, which are imposed on activities or property independently of the characteristics of the persons carrying on the activity or owning the property, are inferior to personal taxes in their ability to adjust the burden of the tax among people).

5. If an income tax were retained along with a broad-based consumption tax, a refundable income tax credit could be used to rebate consumption taxes to particular taxpayers. However, I generally assume for purposes of this paper that the broad-based consumption tax will replace, and not merely supplement, the income tax, making a refundable income tax credit mechanism unavailable. See Joel B. Slemrod, The Simplification Potential of Alternatives to the Income Tax, 66 Tax Notes 1331, 1335 (Feb. 27, 1995) ("the United States may be in the unique position of being able to replace the income tax entirely, and stay within the range of VAT collections that has proven viable in other countries").

In some states, taxpayers may, by filing claims with the state's department of revenue, obtain refunds of portions of the sales taxes they pay. See Kan. Stat. Ann. §§ 79-3632 to 79-3639 (1989); S.D. Codified Laws Ann. §§ 10-45A-1 to 10-45A-8 (1989 & Supp. 1994). If these procedures were followed at the federal level in conjunction with a transactions-based consumption tax, they would defeat a principal advantage of that tax—the elimination of tax returns for millions of individual taxpayers.

for distributional concerns. Indeed, an exemption for clothing may actually reduce the progressivity of such taxes.[6]

A cash-flow or consumed income tax offers the potential for overcoming that shortcoming.[7] From a cash-flow standpoint, all of an individual's receipts of money or in money value can be thought of as used for one of the following general purposes: personal consumption, savings,[8] profit-making expenses, taxes (including levies for social insurance), and gifts and bequests made (including support payments). The cash-flow sources of such receipts can be classified as gross income (including the full proceeds from the sale of assets), plus gifts and bequests received (including government transfers and support receipts):

Uses	Sources
personal consumption (C)	gross income (GI)
savings (S)	gifts and bequests received (GBr)
profit-making expenses (E)	
taxes (T)	
gifts and bequests made (GBm)	

Because cash-flow sources must be equivalent to cash-flow uses, then:

$$C + S + E + T + GBm = GI + GBr$$

Rather than trying to monitor purchases of goods and services for consumption, a cash-flow tax uses the foregoing equivalence to measure consumption *indirectly* through a combination of cash-flow sources and uses. Solving the equation for personal consumption (C) shows that consumption for a period equals the sum of an individual's gross income and net gifts and bequests received (NGBr), less savings, profit-making expenses, and taxes over that period:

$$C = GI + (GBr - GBm) - S - E - T$$
$$C = GI + NGBr - S - E - T$$

Further, if gross income and profit-making expenses are netted to produce the existing concept of income (Y), consumption equals:

$$C = (GI - E) + NGBr - S - T$$
$$C = Y + NGBr - S - T$$

6. See David F. Bradford, What Are Consumption Taxes and Who Pays Them? 39 Tax Notes 383, 389-90 (Apr. 18, 1988).

7. For more detailed descriptions of cash-flow taxes and the theory underlying them, see Blueprints, supra note 3, at 25-31, 101-28; Andrews, supra note 3.

8. For a particular period, savings may be a negative amount if, for example, an individual consumes amounts previously saved or amounts borrowed.

With the possible exception of the treatment of gifts and taxes, this formulation is identical to the Haig-Simons definition of individual income as the sum of consumption and the change in the individual's net worth (ΔNW) over the period:

$$Y = C + \Delta NW$$

where $\Delta NW = S$.[9] Solving the foregoing equation for C:

$$C = Y - \Delta NW$$

The principal difference, then, between an income tax base and the base under a cash-flow tax is the deduction for savings under the latter. Indeed, the equivalent of a deduction for savings is already allowed under the income tax in selected instances, such as the exclusion from income of employer contributions to pension funds, the deductibility of certain contributions to IRA, 401(k), and 403(b) plans, and the tax exemption of earnings on those accounts. A cash-flow tax might therefore be thought of as an income tax under which unlimited deductible contributions can be made to IRAs, with no withdrawal restrictions.

Because of its similarity to the income tax, a cash-flow tax could be administered in much the same way as current law. Individual taxpayers would be required to calculate their tax bases periodically based upon the sources and uses of their monetary receipts. They would determine their tax liabilities from rate schedules and report those liabilities on periodic tax returns. It is generally believed that the individualized nature of the tax would afford the same flexibility as under the income tax to tailor the level of taxation to the consumption levels and other characteristics of the taxpayer. At the same time, however, unlike a transactions-based consumption tax, a cash-flow tax would neither reduce the tax return filing burden nor make any inroad into taxing economic activity currently escaping the scrutiny of the income tax authorities.

B. *Illustrative Cases*

The following highly simplified cases may be useful in illustrating the theoretical application of a cash-flow tax to low- and middle-income taxpayers:

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9. Under present law, federal taxes are not deductible and are therefore included in the income tax base. Also, gifts and bequests made are not deductible, but gifts and bequests received are excluded from income. Thus, the current law definition of income might be represented by the following:

$$Y = C + S + T - NGBr$$

which is consistent with the definition of consumption for purposes of the cash-flow tax.

1. *Low-Wage Worker.*—Mr. *A* works 2,000 hours annually at $7.00 per hour, for total earnings of $14,000. His only other income is $1,000 in alimony. Barely able to make ends meet, he consumes every bit of his after-tax income and is unable to save anything. With a 15% cash-flow tax rate, no exemption amount, and no other taxes,[10] he pays $2,250 in cash-flow tax (15% of $15,000) and consumes $12,750 ($15,000 less $2,250).[11]

2. *Student.*—Ms. *B* is a full-time student. Her receipts for the year consist of a $13,000 gift from her parents, a $12,000 student loan, and $5,000 of wages from a summer job. She consumes all amounts after payment of her tuition ($15,000) and taxes. If the tuition payment is treated as consumption and the tax rate is 15%, she pays $4,500 in cash-flow tax (15% of $30,000), pays $15,000 in tuition, and consumes the balance of $10,500. If the tuition is treated as savings or a profit-making expense, her tax is only $2,250 (15% x $15,000), and she consumes the balance of $12,750.[12] In either case, the amount borrowed is treated as dissavings and is therefore included in the student's consumption tax base along with the amount of the gift received.

3. *Altruistic Middle-Income Worker.*—Mr. *C*, who earns $30,000 in wages and $5,000 in dividends, contributes $5,000 to a pension plan during the year, pays off outstanding loans of $4,000, and makes contributions to his church of $11,000. He consumes all remaining amounts after payment of taxes. If the contribution to the church is not treated as consumption, he pays $2,250 in taxes (15% of $15,000) and consumes the balance of $12,750. The loan pay-off and the pension contribution are both treated as deductible savings.

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10. These assumptions apply to all of the illustrations.

11. As in this example, all tax rates are expressed in a "tax-inclusive" way; that is, the rate is applied to the consumption base *inclusive* of the cash-flow tax to be paid. In theory, a "tax-exclusive" rate is more appropriate because the amount paid as cash-flow tax cannot be spent on consumption. (In contrast, because income is defined to include amounts paid as income tax, tax-inclusive rates are proper under the income tax.) However, tax-exclusive rates are higher than tax-inclusive ones and are difficult for taxpayers to understand and apply. In the example, a tax rate of approximately 17.6% of the amount of consumption exclusive of taxes paid ($12,750) produces a tax liability of about $2,250 (17.6% x $12,750 = $2,250) and is therefore equivalent to a 15% tax-inclusive rate. A tax-inclusive rate of 50% is equivalent to a tax-exclusive rate of *100%*, and tax-exclusive rates in excess of 100% would certainly be possible. In general, if r is the tax-inclusive rate, then $r/(1 - r)$ is the tax-exclusive rate. See Institute for Fiscal Studies, The Structure and Reform of Direct Taxation 28-29 (1978) [hereinafter Meade Report]; Michael J. Graetz, Implementing a Progressive Consumption Tax, 92 Harv. L. Rev. 1575, 1582-84 (1979).

12. See Graetz, supra note 11, at 1589 ("items such as educational expenses . . . which do not tend to provide current consumption benefits would probably be more generally deductible [under a cash-flow tax] than under the income tax").

4. *Middle-Income Investor.*—Ms. *D* earns $15,000 in wages, $10,000 in dividends from various mutual funds, and $10,000 of interest accruals on zero-coupon bonds she owns. The dividends are reinvested in additional shares of the mutual funds. She also sells stock investments for $50,000, makes new stock investments for $46,000, and makes a $4,000 gift to her child.[13] She consumes all other amounts after payment of her cash-flow tax. Her tax base is $15,000, consisting of $15,000 of wages, $10,000 of dividends, $10,000 of interest, and $50,000 of proceeds from stock sales (basis is irrelevant), less the sum of $10,000 of dividends reinvested, $10,000 of interest accrued on the zero-coupon bonds, $46,000 of new stock investments, and the $4,000 gift. Her tax liability is $2,250 (15% of $15,000), and her consumption is $12,750.

5. *Senior Citizen.*—Mr. *E* receives $6,000 from Social Security, receives $5,000 from his pension, and withdraws $4,000 from personal savings, all of which, after payment of taxes, is consumed. He pays $2,250 in taxes (15% of $15,000) and consumes $12,750. The withdrawal from savings, the Social Security, and the pension payments are all included in Mr. *E*'s tax base.[14]

C. *Some Rationales for Cash-Flow Tax*

Many arguments have been raised in favor of replacing the income tax with a broad-based consumption tax like the cash-flow tax, and it is not my intention to review and debate those positions in this article. Two arguments, however, relate to later portions of this article and I therefore describe them briefly here.[15]

1. *Neutrality in Treatment of Present Versus Future Consumption.*—According to its advocates, a cash-flow tax is more neutral than the income tax in its treatment of present versus future consumption.[16] This

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13. The stock sold is assumed to have been purchased when the cash-flow tax was in effect. Issues relating to the transition from the income tax to a cash-flow system are ignored in these examples and throughout this paper.

14. It is assumed the savings were accumulated after the adoption of the cash-flow tax and were therefore deducted as accumulated.

15. For a description of the potential welfare gains resulting from such a switch, see Don Fullerton et al., Replacing the U.S. Income Tax with a Progressive Consumption Tax, 20 J. Pub. Econ. 3 (1983).

16. See, e.g., Blueprints, supra note 3, at 36-39; Bradford-Untangling, supra note 3, at 162-66; Meade Report, supra note 11, at 35-37; Andrews, supra note 3, at 1167 ("[t]he most sophisticated argument in favor of a consumption-type tax is that . . . it ultimately imposes a more uniform burden on consumption, whenever it may occur, than does an

argument is expressed in various ways, but can be illustrated by the following example. Saver and Spender each earn $100. Spender immediately spends the $100 on personal consumption; Saver invests her earnings at a 10% annual return. In a world without taxes, Saver would have about $200 in seven years and, at that time, could therefore consume about twice as much as Spender. In present value terms, the two would consume the same amount, regardless of when they decide to consume.

Assume, instead, Saver and Spender are subject to a 40% tax on income. Each pays a $40 tax when the $100 is earned. Spender, who consumes the remaining $60, is taxed no more. Saver, in contrast, continues to pay tax on the earnings from her savings. The 40% income tax reduces the after-tax annual yield from 10% to 6%. After seven years, Saver has only about $90. Consumption of that amount in year seven results in no further tax to Saver, but the $90 is only one and one half times the amount consumed by Spender, not twice Spender's consumption. In other words, relative to a no-tax world, Saver is disadvantaged by her decision to save in an income tax world. In present value terms, Saver can no longer consume as much as Spender.

Now assume a 40% cash-flow tax is substituted for the income tax. Spender again has $60 to consume after payment of a $40 tax and bears no further tax. Saver can invest the full $100 in year 1—there being no consumption and therefore no immediate tax liability—and this amount grows to about $200 by year seven. (The earnings similarly bear no tax because they are reinvested.) Consumption of the savings and accumulated earnings in year seven requires Saver to pay a 40% tax ($80), leaving Saver with $120 for consumption, twice as much as Spender or the same amount as Spender in present value terms.

In short, a cash-flow tax reduces the amount both Saver and Spender may consume but is neutral regarding the choice of saving or spending. With the tax, as in the world without taxes, Saver can consume roughly twice as much as Spender (or the same amount in present value terms) if Saver defers her consumption for seven years. The same cannot be said of an income tax, which diminishes Saver's position relative to Spender's.

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accretion-type tax"). For arguments challenging the propositions that an accretion-type tax disadvantages savers relative to spenders and is therefore unfair, see Barbara H. Fried, Fairness and the Consumption Tax, 44 Stan. L. Rev. 961 (1992); Joseph Bankman & 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).

2. *Ease of Administration.*—Another argument for a cash-flow tax is that it would be easier to implement than the income tax.[17] At first blush, that assertion might seem to be rather dubious, given the close resemblance between a cash-flow tax and the income tax. Indeed, many of the administrative difficulties under current law would continue in a cash-flow tax world. For example, both systems have the problem of identifying and measuring income from labor, such as fringe benefits,[18] and both have to distinguish between consumption and profit-making expenses. The cash-flow tax would have the new problem of separating consumption from savings, as evidenced by the treatment of tuition in the Student's example. There is also an issue of whether a gift to a family member or to an unrelated beneficiary such as a charity should be treated as consumption by the donor (see the Altruistic Middle-Income Worker and the Middle-Income Investor).[19]

Advocates of a cash-flow tax argue, however, that the most intractable issues under current law arise from the accumulation end of the income definition—the measurement of changes in net worth.[20] A cash-flow

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17. See Andrews, supra note 3, at 1149 ("a [cash-flow] tax would avoid all the difficulties that arise from the failure of money income to provide a satisfactory reflection of real accumulation"); David F. Bradford, The Case for a Personal Consumption Tax, in What Should Be Taxed: Income or Expenditure? 75, 77 (Joseph A. Pechman ed. 1980) ("because a satisfactory income base is so much more difficult to implement than a satisfactory consumption base, the former should be chosen only if there is some compelling reason to do so"); George N. Carlson & Charles E. McLure, Jr., Pros and Cons of Alternative Approaches to the Taxation of Consumption, 1984 Nat'l Tax Assn.-Tax Inst. of Am. Proceedings 147, 151-52 ("probably more important than [the] economic arguments for a consumed income tax are its administrative advantages"). Michael Graetz relates the story of Chester Jordan who testified in 1921, when the present version of the income tax was only eight years old, that he could reduce the size of his accounting practice from eight to three people if Congress would replace the income tax with a consumption tax. Michael J. Graetz, Revisiting the Income Tax vs. Consumption Tax Debate, 57 Tax Notes 1437, 1437 (Dec. 7, 1992) [hereinafter Graetz-Revisiting]. For a comprehensive critique of these issues, see Committee on Simplification, ABA Sec. of Tax'n, Complexity and the Personal Consumption Tax, 35 Tax Law. 415 (1982); Graetz, supra note 11.

18. Under current law, a roundabout way of taxing fringe benefits is to disallow the employer's deduction for the benefits' cost. It is not clear whether the taxation of businesses under a cash-flow tax system would provide the same opportunity for imposing such a proxy tax.

19. One argument is that the voluntary nature of the gift suggests a benefit to the donor equivalent to personal consumption and that the gift should therefore be taxable to both the donor and the donee (whose standard of living is tangibly enhanced if and when the gift is consumed). A different, more pragmatic argument in favor of treating a gift to charity as consumption by the donor is that it is not practical to include the gift in the tax bases of the *beneficiaries* of the gift (as opposed to the charity, which is a mere intermediary) and that taxing the donor may be the best available alternative. See Blueprints, supra note 3, at 104-05.

20. See Andrews, supra note 3, at 1115, 1139-40.

tax basically brushes this problem away by exempting net worth changes from the tax base until such amounts are consumed. Accordingly, a cash-flow tax base can be measured more accurately and simply than an income tax base. The difficulties under current law that would be avoided by a cash-flow tax, according to its proponents, include the following:

a. *Realization.*—As a result of the realization principle, changes in net worth are generally taxed only when realized by, for example, a sale of appreciated or depreciated property or savings from cash income. The principle therefore creates a basic inequity depending upon how savings are accumulated and managed. Furthermore, it creates the need to determine when realization, and therefore taxation, occurs. The tax system contains a slew of nonrecognition provisions that basically reflect the judgment that technical realization should not result in immediate taxation if the original investment essentially continues. Additional difficulties created by the realization principle include the lock-in effect and the potential bunching of gains, which introduce the need for a preferential tax rate on realized gains and, therefore, a distinction between capital gains and ordinary income.

A cash-flow tax would avoid these problems. Unrealized gains, realized gains, and current income from savings would all go untaxed until consumed. Indeed, the very notion of gain is foreign to a cash-flow tax system because all amounts invested in savings would be deductible and the full sales proceeds from an investment would be included in the tax base if not reinvested.[21]

b. *Capital Recovery Deductions.*—The income tax system also has difficulty taking into account decreases in value due to wear, tear, and obsolescence of productive assets because there is no money transaction to provide a measure of the decline. The income tax provides conventions for computing capital recovery allowances, but the conventions necessarily produce only estimates of economic depreciation. Under a cash-flow tax, amounts invested in productive assets are immediately deductible, making capital recovery deductions unnecessary.

c. *Inflation.*—Related to both of the foregoing is the problem of inflation. The failure of the income tax law to take inflation into account

21. For other income timing predicaments plaguing the income tax but avoidable under a cash-flow tax system, see William A. Klein, Tailor to the Emperor With No Clothes: The Supreme Court's Tax Rules for Deposits and Advance Payments, 41 UCLA L. Rev. 1685, 1706-09, 1711 (1994); William A. Klein, Timing in Personal Taxation, 6 J. Legal Studies 461, 479 (1977).

systematically results in mismeasurement of real net worth changes.[22] Inflation is often dealt with ad hoc and has been used as a justification for accelerated capital recovery deductions, preferential capital gains rates, and other special provisions in the income tax system. Inflation also distorts the income tax treatment of debt to both debtor and creditor. Because a cash-flow tax would apply only to current consumption, it would not be affected by inflation.[23]

d. *Corporate Taxation.*—The tax treatment of corporate-source income presents a daunting problem under current law. An allocation of all undistributed corporate income among shareholders is generally viewed as too difficult to implement for corporations with complex capital structures. But separate taxation of the income to the corporation, the solution under current law, results in double taxation. Exempting corporate-source income from taxation would create an open-ended tax shelter. Various proposals for integrating the corporate and individual income taxes would all introduce considerable complexity.[24] At least in theory, a cash-flow tax could avoid the necessity of taxing corporate flows: contributions to a corporation could be deductible as savings, transactions involving amounts remaining within corporate solution could all be ignored as savings reinvestments, and only amounts leaving corporate solution would be taxable if not reinvested.

III. SHOULD PROGRESSIVITY CONCERNS BE ADDRESSED WITHIN THE CONTOURS OF A NEW CONSUMPTION TAX?

A chief concern about broad-based consumption taxes is their effect upon the progressivity of the tax system. In the next part of this paper, I discuss whether a cash-flow tax could be designed to address that concern and analyze provisions that might be adopted to mitigate the impact of the tax on the low-income. But a threshold question, which I discuss briefly in this part, is whether *any* special accommodation for the low-income should be incorporated into a new consumption tax. This threshold inquiry raises two issues. First, what would be the impact on the distribution of the tax burden

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22. For changes that might be required to make the tax system sensitive to inflation, see Reed Shuldiner, Indexing the Tax Code, 48 Tax L. Rev. 537 (1993).

23. If a cash-flow tax were adopted with graduated rates, there would be the potential problem of "bracket creep" as consumption levels of taxpayers increase due to inflation, but that problem could be easily addressed by indexing tax brackets as under current law. IRC § 1(f).

24. See George K. Yin, Corporate Tax Integration and the Search for the Pragmatic Ideal, 47 Tax L. Rev. 431, 436-49 (1992) (describing complications of the shareholder-credit form of integration offered by the American Law Institute Reporter).

of a switch from the income tax to a broad-based consumption tax? Second, what avenues outside of the consumption tax might be available to deal with the progressivity issue?

A. *Distributional Impact of Change*

The distributional effect of switching to a consumption tax depends upon the uncertain resolution of several empirical and theoretical issues. Because a consumption tax base excludes savings, whereas the income tax base generally does not, a principal consideration is the estimated rate of savings or consumption by income class. A common intuition is that low-income families consume a greater proportion of their incomes than wealthier families and that changing the tax base from income to consumption would therefore have a regressive impact on the distribution of the tax burden. Thus far, empirical analyses of household survey data have generally borne out that intuition, but the magnitude of the results has varied. For example, where savings was defined as the residual amount after consumption, taxes, and gifts are subtracted from income and other receipts during a year, a recent study found savings to be -72.5% of cash income for families in the bottom income quintile (that is, there was significant net borrowing or dissavings by these families) and 16.8% of cash income for families in the top income quintile.[25] In contrast, where savings was defined as the change in family net worth during a year, savings rates were found to be considerably flatter: 6.7% and 5.7% of cash income for the bottom and top income quintiles.[26] A consumption tax thus appears to be less regressive under a net worth analysis of savings rates than under a residual analysis, but both studies found some degree of regressivity.[27]

The possibility of negative savings rates for a particular class of individuals raises another issue. Presumably, individuals cannot continue to live beyond their means indefinitely. Many economists believe that data indicating negative savings rates reveal a fundamental error in snapshot comparisons of consumption to income. According to this view, an individual who is temporarily unemployed, and therefore has a low level of income, may not adjust spending patterns to that income level. The same might be

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25. See John Sabelhaus, What is the Distributional Burden of Taxing Consumption? 46 Nat'l Tax J. 331, 336 (Table 2) (1993).

26. Id.; see also Barry Bosworth et al., The Decline in Saving: Evidence from Household Surveys, in 1 Brookings Papers on Economic Activity 183, 207 (Table 5) (William C. Brainard & George L. Perry eds., 1991) for a similar finding involving different years.

27. A puzzle is why these two approaches yield such different results. At least in theory, the results should be identical. Sabelhaus concluded that the data from the net worth approach may be more reliable than that from the residual method. Sabelhaus, supra note 25, at 342-43.

true for those with temporarily high incomes. More generally, people may attempt to smooth lifetime spending by living beyond their means in their low-income youth (in anticipation of future, higher earnings) and saving more in high-income years to finance consumption in retirement years when income again is relatively low. Thus, comparisons of consumption to *current* income may overstate the degree of regressivity of a broad-based consumption tax, and comparisons should instead be made over the lifetime of particular taxpayers or classes of taxpayers.[28]

However sound theoretically, lifetime incidence analyses conflict with the reality that taxes are collected annually to fund current government operations. Hence, if the lifetime pattern of consumption described above is accurate, a broad-based tax on consumption would be imposed fairly evenly over a taxpayer's life and may therefore create considerable financial stress during the valleys (youth and old age) of the income earning pattern.[29] An ideal solution might be to link the timing of tax payments to *income*, even if tax liability is based on *consumption*, by permitting taxpayers, at their option, to make early and late payments of consumption tax with appropriate interest credits and charges.[30]

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28. See Don Fullerton & Diane Lim Rogers, Who Bears the Lifetime Tax Burden? 17-21 (1993); Andrews, supra note 3, at 1175; Bradford, supra note 6, at 389-90.

Though constrained by the five-year budget window, the staff of the Joint Committee on Taxation utilizes a methodology to assess the distributional impact of general consumption taxes that approaches a lifetime incidence calculation. See Staff of Joint Comm. on Taxation, Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens 51 (Comm. Print 1993) [hereinafter JCT Methodology]; Alan J. Auerbach, Public Finance in Theory and Practice, 46 Nat'l Tax J. 519, 523-24 (1993); R. Glenn Hubbard, On the Use of "Distribution Tables" in the Tax Policy Process, 46 Nat'l Tax J. 527, 532-33 (1993). Even using that methodology, however, the Joint Committee has concluded that general consumption taxes are "substantially more regressive than the existing Federal income tax." JCT Methodology, supra, at 58. For some qualms about the staff's methodology, see Richard Goode, "Economics in the Policy Process": A Comment, 47 Nat'l Tax J. 403, 404-05 (1994).

29. Witness the potential impact of the cash-flow tax on the Student and the Senior Citizen in my earlier examples.

30. In effect, the government would be an available lender or borrower. For example, the Student might opt to delay paying her current year tax until some future year when her resources are greater. With advance planning, the Senior Citizen may have prepaid his taxes during his productive market work years and therefore not owe anything in the current year.

Tax liability would always be based upon the law for the taxable year of the consumption. Thus, the choice in timing of tax payments would not provide an opportunity for taxpayers to manipulate their tax liabilities through predictions of likely law changes. There might also be a rule that if aggregate tax receipts are insufficient for a particular year, and the government therefore incurs borrowing costs greater than anticipated, an additional interest charge would apply to all taxpayers opting to make late payments of taxes for that year. This rule might protect against excessive tax payment deferrals for unforeseen reasons.

Also, the focus on savings or consumption rates of individuals in different income quintiles, whether in the short-run or over a lifetime, assumes, perhaps incorrectly, that the incidence of a consumption tax falls on consumers. For example, if the introduction of a transactions-based consumption tax causes a general increase in prices, an individual whose income is indexed to price changes, as is the case for many recipients of government transfer payments, would effectively be insulated from the tax unless the indexing mechanism is adjusted to prevent the price effect of the tax from increasing the individual's income. Hence, the burden of a consumption tax may really be borne by those whose incomes and other receipts are unindexed, who may or may not consist disproportionately of the low-income.[31]

Other incidence uncertainties relate to some of the taxes being replaced or modified as a result of the new consumption tax. For example, how should repeal of the corporate income tax be taken into account for distributional purposes? Incidence shifting possibilities, due to changes in behavior or other factors, are also present for taxes on labor, such as payroll taxes and the individual income tax, as well as personal income taxes on capital returns.

Finally, distributional analyses of tax law changes necessarily focus on *observable* income, including imputed income from observable assets. Yet a fair measure of an individual's well-being may encompass much more than that. A good example of this problem is unreported income. According to the IRS, there may be as many as 10 million taxpayers who improperly fail to file returns, and the "tax gap"—the difference between the taxes collected and the amounts that should be paid—may be over $120 billion annually.[32] To whom should all of the unreported income be attributed for distributional purposes? If substitution of a cash-flow or other broad-based consumption tax for the income tax would simplify the tax system, as advocates contend, compliance levels may change with resulting distributional consequences.

B. *Avenues Other Than Cash-Flow Tax for Addressing Progressivity Concerns*

In this section, I assume the change to a cash-flow tax would result in an unacceptable loss of progressivity. The question remains whether there

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31. See Edgar K. Browning & William R. Johnson, The Distribution of the Tax Burden 2-5 (1979). Depending upon federal monetary policy, a consumption tax could result in a decrease in wages rather than a price rise, in which case individuals receiving non-indexed government transfers would not necessarily be burdened. See JCT Methodology, supra note 28, at 51-60.

32. See George Guttman, Increasing Voluntary Compliance to Over 90% Is Unlikely, 63 Tax Notes 146 (Apr. 11, 1994); Catherine Hubbard, Dolan Outlines IRS Efforts to Close Tax Gap, Expand Electronic Filing, 60 Tax Notes 154 (July 12, 1993).

might be ways to deal with progressivity concerns other than through the cash-flow tax. After all, replacement of the income tax with a cash-flow tax would be a major shift, and many other things might also change.

Consider, for example, a change in the expenditure side of the federal budget. At least in theory, an objection to raising revenue in a manner less progressive than before might be overcome if the money raised were spent in a more progressive way. Greater progressivity might be achieved, for example, by increasing the level of expenditures for existing means-tested programs or by means-testing programs that are not yet so limited. Unfortunately, distributional analyses of proposed changes in the tax laws typically ignore the incidence of expenditures.[33] Some artificiality necessarily results from that practice, particularly in a world where the tax and transfer systems are increasingly integrated.

A good illustration of that artificiality is the treatment for distributional purposes of the earned income tax credit (EITC). The EITC is a federal program administered through the tax system to provide cash subsidies primarily to low-income workers with family responsibilities. Program beneficiaries must file tax returns to claim the credit. Some beneficiaries use the credit to offset federal income and self-employment taxes otherwise due, but most take advantage of the fact that the credit is "refundable," meaning that if the credit exceeds income and self-employment tax liability, the beneficiary receives a cash outlay from the government equal to the excess. It is estimated that about 84% of the benefits provided by the program for 1994 consisted of such cash outlays.[34]

The EITC program, therefore, is partly a tax expenditure but mostly a government spending program administered through the tax system.[35] Despite that, the entire program, not just the credits applied to reduce taxes otherwise owed, is taken into account in measuring the distribution of the tax burden because it is classified as a "tax" provision. In other words, even an increase in the spending aspect of the EITC program is treated as enhancing

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33. See JCT Methodology, supra note 28, at 2-3.

34. House Comm. on Ways & Means, 103d Cong., 2d Sess., Overview of Entitlement Programs: 1994 Green Book: Background Material and Data on Programs Within the Jurisdiction of the Committee on Ways and Means 702 (Comm. Print 1994) [hereinafter 1994 Green Book].

35. The Congressional Budget Office classifies the refundable portion of the EITC program as a "means-tested income support program" along with the Supplemental Security Income (SSI) program, which pays cash benefits to elderly and disabled poor people, the Aid to Families with Dependent Children (AFDC) program, which benefits low-income families with children, and the food stamp program. See Congressional Budget Office, Reducing Entitlement Spending 20 (1994) [hereinafter CBO Entitlement Report]. If the EITC is viewed as a reimbursement of employee payroll taxes, more of the benefit might be treated as a tax expenditure, and less might constitute "spending."

the progressivity of the tax system. In contrast, an identical increase in other government spending programs for the low-income, such as food stamps, is treated as having no effect on tax progressivity because it is ignored in determining the tax burden distribution. Quite clearly, the distributional treatment of the EITC program, along with other factors, may well explain its recent popularity among policymakers relative to other spending programs for the poor.[36]

Although the incidence of many government expenditures is difficult to ascertain, it is possible to estimate the incidence of some expenditures, including federal entitlement programs.[37] So long as the distributional impact of proposed changes in the law continues to be important to policymakers, sensitivity to the distribution of federal benefits as well as federal burdens would provide greater flexibility in implementing policy.[38]

If tax law changes must be the sole focus, progressivity concerns could be addressed by accompanying the enactment of a cash-flow tax with

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36. The following table compares the growth in total federal expenditures for the major means-tested income support programs between 1986 and 1996:

Growth in federal expenditures for means-tested income support programs, 1986-96

	Total Federal Expenditures ($ billions) and Growth Rates				
Program	1986 Spending	1993 Spending	1986-93 Increase	1996 Spending (proj.)	1986-96 Increase (proj.)
EITC	2.0	13.2	560%	25.1	1155%
SSI	9.5	20.3	114%	27.0	184%
Food stamps	12.5	24.8	98%	n/a	n/a
AFDC	9.2	13.8	50%	14.8	61%

Source: 1994 Green Book, supra note 34, at 262 (Table 6-25), 389 (Table 10-21), 704 (Table 16-13), 782 (Table 18-11). All spending figures are in current dollars.

The phenomenal growth in the EITC program is attributable to three major expansions adopted in 1986, 1990 and 1993. See Janet Holtzblatt et al., Promoting Work Through the EITC, 47 Nat'l Tax J. 591, 591-95 (1994).

37. See CBO Entitlement Report, supra note 35, at 28-29 (Table 10); Musgrave & Musgrave, supra note 4, at 246 (Table 14-2). In 1993, federal spending for entitlement programs totaled more than $750 billion, or more than half of the federal budget. The major entitlement programs include cash social insurance programs such as Social Security, health insurance programs (Medicare and Medicaid), pension programs for retired civilian and military personnel, and means-tested income assistance programs such as SSI, AFDC, food stamps, and the refundable portion of the EITC program. See CBO Entitlement Report, supra note 35, at 1-4 (Table 1).

38. Some federal programs—for example, AFDC—have significant state and local components. Ideally, changes at that level should also be taken into account in estimating the distribution of burdens and benefits. Alternatively, state and local expenditures might be ignored on the theory that federal policymakers should only worry about distributional issues at that level.

other modifications to the tax laws. For example, some commentators have suggested that if a cash-flow tax were to replace the income tax, there should be a contemporaneous boost in the wealth transfer taxes (the estate, gift, and generation-skipping taxes).[39] The reason is that unlike the income tax, a cash-flow tax may not reach wealth accumulations that are never liquidated for consumption.[40] However, modifications to the wealth transfer taxes would probably do little to affect the distribution of the overall tax burden because only a small percentage of all wealth is transferred in a taxable manner each year.[41] Also, the rate structure of that tax is already quite graduated, reaching a maximum rate of 55% for taxable gifts or estates in excess of $3 million.[42] The existing exemption level could be lowered, but at the cost of extending a highly complex tax system to many more taxpayers with little improvement in the tax burden distribution.

Taxing wealth transfers more heavily has another, more fundamental disadvantage. An individual's decision to save may be motivated, in part, by a desire to leave a bequest, and bequest savings may be relatively sensitive to tax rules.[43] If this is true, taxing wealth transfers more severely conflicts with the desire of consumption tax advocates to increase savings.[44]

A more ambitious solution would be to enact a wealth tax that is imposed periodically, rather than on a transfer. Such a tax could have a significant impact on the overall distribution of the tax burden. It also might not adversely affect the level of savings if, as some have suggested, individuals save mostly with specific dollar targets in mind. However, such a tax would raise obvious liquidity and valuation problems and would

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39. See Richard Goode, The Superiority of the Income Tax, in What Should Be Taxed: Income or Expenditure? 49, 71 (Joseph A. Pechman ed., 1980); Gordon D. Henderson, Alternatives to the Income Tax, in Options for Tax Reform 78, 89-90 (Joseph A. Pechman ed., 1984); cf. Blueprints, supra note 3, at 125; Andrews, supra note 3, at 1172-73.

40. A cash-flow tax can be designed to reach wealth accumulations by treating gifts and bequests as taxable receipts to the donees and consumption to the donors. See Blueprints, supra note 3, at 125; Henry J. Aaron & Harvey Galper, Assessing Tax Reform 66-67 (1985).

41. Presently, estate and gift taxes generate only about one percent of total federal collections. See Internal Revenue Service, 1992 Annual Report 25 (Table 1). Of course, the small amount of revenue produced may mask a large behavioral effect of the tax.

42. IRC § 2001(c)(1).

43. See Edward J. McCaffery, The Uneasy Case for Wealth Transfer Taxation, 104 Yale L. J. 283, 308 (1994) [hereinafter McCaffery-Uneasy Case] (reporting that at least one-fourth of national wealth is held as intergenerational, or bequest, savings); Edward J. McCaffery, Tax Policy Under a Hybrid Income-Consumption Tax, 70 Tex. L. Rev. 1145, 1208 (1992), [hereinafter McCaffery-Hybrid] (bequest savings may be rather elastic to tax law changes).

44. See McCaffery-Uneasy Case, supra note 43, at 337-38. There is no firm evidence that replacement of the income tax with a broad-based consumption tax would actually enhance overall savings levels.

encounter the technical difficulty of having to make sure the same wealth is not repeatedly taxed. It would also be of questionable constitutional validity in the absence of state apportionment.

Another, more effective possibility is to introduce greater progressivity into the federal payroll taxes—a move that would be quite easy to implement if these taxes are not repealed in conjunction with the adoption of a consumption tax. For example, to reduce the impact of the taxes on those with low wage incomes, Congress could exempt a minimum amount of wages earned each year from the payroll taxes. To enhance progressivity at the upper end of the wage income spectrum, Congress could lift the existing cap on taxable wages for purposes of the old-age and survivors and disability insurance taxes.[45] However, changes such as these face strong political resistance because they might alter the perception of the Social Security program as a giant pension plan.[46]

A last possibility is to retain the income tax while adopting a broad-based consumption tax.[47] Some have argued that because a consumption tax is ineffective at reaching upper-income taxpayers, an income tax would still be necessary in a consumption tax world.[48] Others have suggested that if a consumption tax were adopted, an income tax should be retained as a vehicle to deliver benefits to the low-income.[49] Whatever the reasons advanced for maintaining an income tax, it seems highly unlikely that Congress would retain it and enact in addition an individualized broad-based consumption tax like the cash-flow tax.

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45. See George K. Yin et al., Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program, 11 Am. J. Tax Pol'y 225, 280-86 (1994); George K. Yin & Jonathan B. Forman, Redesigning the Earned Income Tax Credit Program to Provide More Effective Assistance for the Working Poor, 59 Tax Notes 951, 958 (May 17, 1993).

46. Considering contributions and benefits together, the Social Security system might already be quite progressive.

47. See William D. Andrews, A Supplemental Personal Expenditure Tax, in What Should Be Taxed: Income or Expenditure 127 (Joseph A. Pechman ed., 1980) (suggesting adoption of a cash-flow tax as a supplement to the existing income tax).

48. See Graetz-Revisiting, supra note 17, at 1439; Morris, supra note 1, at 1264 (describing VAT proposal that would retain a progressive income tax for the very wealthy).

49. For example, some VAT proposals, although designed to replace the income tax system, would retain a portion of that system to facilitate delivery of an EITC-type benefit to low-income taxpayers. See Kathleen A. Matthews, Conference Examines Benefits of U.S. VAT, 60 Tax Notes 255, 256 (July 19, 1993) (describing proposal being developed by Congressman Gibbons (D.-Fl.)); cf. U.S. Treas. Dep't., Tax Reform for Fairness, Simplicity, and Economic Growth, Vol. 3X: Value-Added Tax 44, 100-02 (1984). In other words, the income tax, in all its glory, would be maintained not primarily to collect revenue but rather to make government transfer payments!

IV. Accommodating the Low-Income in a Cash-Flow or Consumed Income Tax World

In this part, I assume that some accommodation for low-income taxpayers will be made within the contours of a new cash-flow tax. A goal of Senators Nunn and Domenici, for example, is to craft their cash-flow tax proposal to have the same degree of progressivity as the current income tax, as measured by the distribution of tax burden among income quintiles.[50] My focus is on how the accommodation might take place and the problems it might present. The following sections outline for illustrative purposes how Nunn and Domenici would try to achieve this objective with respect to taxpayers in the lower income quintiles, and describe some of the difficulties presented by their recommendations.[51]

A. *Nunn-Domenici Proposals Affecting the Low-Income*

The Nunn-Domenici cash-flow tax proposal employs three techniques to ensure that the tax is as redistributive at the lower end of the income spectrum as existing law. First, it would use the tax system to effect positive government transfers to low-income taxpayers by means of a negative tax provision, the earned income tax credit (EITC). Second, it would exempt many low-income taxpayers from paying positive taxes through both a refundable payroll tax credit and a family living allowance. Finally, it would permit those few low-income taxpayers obligated to pay positive taxes to determine their liabilities at the lowest bracket of a graduated tax rate structure. All three methods are presently utilized in the income tax.

As previously described, the EITC is a program within the income tax that provides cash subsidies primarily to low-income working families with children. In most instances, the subsidies exceed the beneficiaries' tax liabilities; in those cases, the refundable feature of the credit provides the beneficiary with a cash outlay equal to the excess. The Nunn-Domenici plan would include an EITC and, based upon the prototype of the plan examined by the Congressional Budget Office, the size of the credit would be roughly

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50. See Domenici, supra note 2, at 288, 295.

51. There are many other possible ways to accomplish this objective, but all likely involve some variation of one or more of the techniques utilized by the Nunn-Domenici proposal. For this proposal, see Center for Strategic and Int'l Studies, note 2; Background Materials, A New Paradigm for Tax Reform: The Saving Exempt Income Tax (Oct. 1993) [hereinafter SEIT Background Materials]; Congressional Budget Office, Estimates for a Prototype Saving-Exempt Income Tax (Mar. 1994) [hereinafter CBO SEIT Estimates]; Domenici, supra note 2; John Hakken & Frank Sammartino, Measuring the Burden of Consumption Taxes, 94 TNT 234-60 (Dec. 1, 1994) (LEXIS, FEDTAX library, TNT file); Alliance USA, Unlimited Savings Allowance (USA) Tax System, 66 Tax Notes 1485 (Mar. 10, 1995). As of this writing, no legislation has been introduced.

30% to 100% larger than the existing credit after all of the 1993 Act changes to it are fully phased in.[52] Thus, by 1996, the maximum Nunn-Domenici EITC would be between $4,628 and $7,120 for a qualifying family with two or more children.[53] The credit would be refundable, as under current law.

In addition to an EITC, the Nunn-Domenici plan includes a payroll tax credit that would permit taxpayers to reduce the cash-flow tax, dollar-for-dollar, by a portion of any payroll taxes paid, thereby effectively creating a partial exemption from the payroll taxes.[54] This credit, which would also be refundable, would phase out for taxpayers with "taxable incomes" between $25,001 and $50,001. Apart from this credit, the employee portion of payroll taxes would apparently continue as under existing law.

The Nunn-Domenici plan also includes a "family living allowance" to replace the personal and dependency exemptions and the standard deduction. According to Senators Nunn and Domenici, the allowance "recognizes that every family's budget includes necessities and that the federal government should not tax the first dollars earned and spent to maintain a minimal standard of living."[55] Thus, like the combination of exemptions and the standard deduction under the income tax, the family living allowance would establish a base amount that the taxable unit could consume during the year without payment of any cash-flow tax. Senators Nunn and Domenici expect that the family living allowance will be 170% of the federal poverty guideline. Therefore, the allowances for 1994 would be as follows:

Taxable Unit	Allowance
Unmarried individual	$12,512
Family of two	$16,728
Family of three	$20,944
Family of four	$25,160
Family of five	$29,376

The additional allowance for each family member beyond the first one is $4,216, with that adjustment being permitted for any size family.[56]

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52. See CBO SEIT Estimates, supra note 51, at 23; Domenici, supra note 2, at 296-97.

53. As a result of changes enacted by the Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66, 1993 U.S.C.C.A.N. (107 Stat.) 436), the maximum EITC benefit for a family with two or more children is projected to be $3,560 by 1996. See 1994 Green Book, supra note 34, at 700 (Table 16-11).

54. See Overview of the Nunn/Domenici Tax Proposal, in SEIT Background Materials, supra note 51, at 3; Domenici, supra note 2, at 296.

55. See Domenici, supra note 2, at 295.

56. Id. at 295 n.73. The allowance would be indexed to inflation. The figures are based on the 1994 poverty guidelines. See Annual Update of the HHS Poverty Guidelines, 59 Fed. Reg. 6277 (1994).

Finally, the Nunn-Domenici cash-flow tax would be implemented with graduated tax rates. The combination of the EITC, payroll tax credit, and family living allowance should ensure that virtually all low-income taxpayers would be exempt from paying positive cash-flow taxes. For any low-income taxpayers not so exempted, the tax would be determined at the lowest of the graduated rates. The Congressional Budget Office estimated that a prototype of the cash-flow tax being considered by Senators Nunn and Domenici might require tax rates in the following ranges for a married couple filing a joint return:[57]

		Prototype Cash-Flow Tax	
Taxable Income[58]	Current Law	High Range	Low Range
0 - $38,000	15%	16%	14%
$38,000 - $91,850	28%	38%	28%
$91,850 - $140,000	31%	49%	36%
$140,000 - $250,000	36%	55%	36%
over $250,000	39.6%	55%	36%

A later description of the Nunn-Domenici plan suggests that the family living allowance will only substitute for the standard deduction, with the personal and dependency exemptions being retained. See Alliance USA, supra note 51, at 1522. Furthermore, taxpayers will be entitled to claim a few itemized deductions in addition to the family living allowance. The combined benefit from the family living allowance and personal and dependency exemptions would, however, be somewhat smaller than the allowance described in the text. For example, the tax-free consumption amount for a family of four wold be only $20,000, not $25,160. Id.

Congressman Armey's bill would also establish a base amount below which no taxes would be due. It would provide a standard deduction of $24,700 for a married couple filing jointly, smaller amounts for taxpayers filing as heads of household or unmarried individuals, and an additional $5,000 deduction for each dependent. Thus, a married couple with two children and earned income of $34,700 or less would owe no tax under this proposal. All amounts would be indexed to inflation. See H.R. 4585, 103d Cong., 2d Sess. § 101 (1994).

Finally, last year's Danforth-Boren bill proposed to increase the standard deduction for taxpayers filing joint returns by $8,650 (to a total of $15,200 if applicable for 1994). Smaller increases were provided for other tax filers. However, the increases only applied to low-income filers and would have been phased out beginning at AGI levels of $45,000 for joint filers and $27,000 for single filers. Once again, all dollar amounts would have been indexed to inflation. See S. 2160, 103d Cong., 2d Sess. § 202 (1994).

57. CBO SEIT Estimates, supra note 51, at 22-23 (Tables 2 and 3). The ranges depend on the assumed incidence of current taxes and whether the savings rate is determined by the residual or net worth method. See supra note 27 and accompanying text.

58. "Taxable income" means taxable *consumed* income for purposes of the prototype cash-flow tax. Also, the "zero-bracket" level—the amount of income that would escape tax altogether due to either the combination of exemptions and the standard deduction under current law or the proposed family living allowance under the cash-flow tax proposal—would not be the same under the proposal and current law. Thus, the rate structures of current law and the proposal are not comparable. The figures are provided only to give a flavor for the type of rate structure that might be necessary under the cash-flow tax.

B. *Implementation Issues*

1. *Eligibility for Negative Tax Subsidy.*—Under current law, the EITC is intended in part to be a work incentive, particularly for people making the transition from welfare to work.[59] Consequently, the credit is calculated as a percentage of the taxpayer's "earned income," which generally means wages, salaries, and other income from employment, including self-employment. Despite being poor, a taxpayer without earned income gets no benefit at all. Moreover, the credit is gradually phased in, meaning that up to some level of income, taxpayers in the phase-in range experience increased benefits as income increases.

However, the credit is restricted to those taxpayers with relatively low incomes.[60] It is not intended to be a demogrant available to all taxpayers or to all working taxpayers. This additional goal is achieved by gradually taking the credit away from taxpayers (phasing it out or clawing it back) as income (no matter from what source) increases beyond a certain level.[61]

If these two objectives are also to be satisfied by the EITC provision in the Nunn-Domenici cash-flow tax proposal,[62] the work incentive aspect

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59. See S. Rep. No. 313, 99th Cong., 2d Sess. 43 (1986); S. Rep. No. 1263, 95th Cong., 2d Sess. 51-52 (1978), reprinted in 1978 U.S.C.C.A.N. 6761, 6814-15; S. Rep. No. 36, 94th Cong., 1st Sess. 33 (1975), reprinted in 1975 U.S.C.C.A.N. 54, 84.

60. See S. Rep. No. 36, supra note 59; S. Rep. No. 938, 94th Cong., 2d Sess. 119 (1976), reprinted in 1976 U.S.C.C.A.N. 3439, 3554.

61. For example, under existing law by 1996, families with two or more children earning not more than $8,900 will be entitled to an EITC benefit equal to 40% of each dollar earned, those with incomes between $8,900 and $11,620 will receive the maximum benefit of $3,560, and families with incomes between $11,620 and $28,534 will lose their benefits at the phase-out rate of 21.06% of income in excess of $11,620. All dollar amounts are based on 1994 projections. See 1994 Green Book, supra note 34, at 700 (Table 16-11).

62. The Nunn-Domenici plan is for the EITC to "accomplish the same objectives" as the existing credit. See Domenici, supra note 2, at 296. Some have argued that because a consumption tax burdens all consumers, not just those with earned incomes, a refundable tax credit should be available more broadly to all poor persons. Such a provision would require millions more people to file tax returns to get this benefit. See Joseph J. Minarik, Making Tax Choices 88 (1985). To mitigate the effects of its corporate cash-flow tax on the low-income, the Danforth-Boren bill included a refundable "individual tax credit" calculated as a percentage of adjusted gross income, not earned income. See S. 2160, 103d Cong., 2d Sess. § 203(a) (1994).

David Bradford has proposed that a provision similar to the earned income credit should be included in a cash-flow tax to compensate for the denial of a deduction at the firm level for salaries paid to workers. See Bradford, supra note 6, at 387; David F. Bradford, An Uncluttered Income Tax: The Next Reform Agenda? (July 1988) (unpublished discussion paper). Ed McCaffery has suggested that such a provision might relieve some of the burden of a cash-flow tax on current period earnings and might shift more of the burden to consumption funded out of savings. See McCaffery-Hybrid, supra note 43, at 1195. In this

of the EITC could be accomplished by continuing to base the credit on the taxpayer's earned income. But how should the benefit be restricted to the low-income? Indeed, who are the "low-income" in a cash-flow tax world: taxpayers with low consumed income or some other group entirely?

Consider two taxpayers with the profile previously described for the Low-Wage Worker, whose annual income consists of $14,000 in wages and $1,000 in alimony. One of them, like the Low-Wage Worker, consumes every bit of her income whereas the other is more frugal and manages to save $1,000 for the year. Thus, before taxes, the first taxpayer has $15,000 of consumed income, and the more frugal taxpayer has $14,000 of consumed income.

If they had much higher levels of income, the more frugal taxpayer would bear a lower cash-flow tax than the other taxpayer in recognition of the frugal taxpayer's decision to consume less and save more. Assume, however, that because of their low consumption levels and the availability of a minimum consumption allowance, neither owes any tax, and the only question is how much EITC each should receive. Consistent with how they would be treated if they had positive tax liability, it might be appropriate for the more frugal taxpayer to obtain the larger subsidy, thereby rewarding her for her thrift. In that case, and assuming they are both in the phase-out range of the credit, "low-income" should mean "low consumed income." The two taxpayers have the same income before savings, but the more frugal one has less consumed income. That being the case, less of the EITC would be clawed back from the more frugal taxpayer.[63]

But consider a third taxpayer, such as the Middle-Income Investor, who has $15,000 in wages, $20,000 in interest and dividend income, and $50,000 in proceeds from the sale of stock investments. Because she reinvests or makes a gift of all of her capital income and proceeds, her consumed income for the year before taxes is only $15,000. Assume that because of her frugality and the availability of a minimum consumption allowance, she owes no positive cash-flow tax. Should she be entitled to the EITC? If, as suggested above, "low-income" is defined as "low consumed income," she might get a substantial EITC. On the other hand, if "low-income" is defined

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paper, I do not consider any of these alternative rationales for an earned income credit in a cash-flow tax world.

63. The consequences would be exactly the opposite if the two taxpayers were in the phase-in range of the credit. In that case, if consumed income were the base for calculating the EITC, the more frugal taxpayer, with less consumed income, would get a smaller credit. I have assumed, however, that in the phase-in range, the credit would be solely a function of earned income, as under current law. See supra note 61 and accompanying text. Hence, if the two taxpayers have the same low level of earnings ($14,000) and are in the phase-in range, they would get the same credit.

as income before savings, the taxpayer probably would not receive any subsidy. Which result is more appropriate? To frame the question slightly differently, should this taxpayer obtain the same EITC as one with $15,000 in wages, no capital income, and no savings?[64]

In part, these questions raise one of the fundamental issues in the income tax versus consumption tax debate: What should the tax base be? Supporters of the income tax argue that income is a better measure of a taxpayer's overall resources and, therefore, ability to pay. Consumption tax proponents respond with several related arguments.[65] They argue that consumption reflects the taxpayer's chosen lifestyle—his or her standard of living—and that what a taxpayer withdraws from the "common pool" is a more appropriate standard for taxation than what the taxpayer contributes to the pool. Further, they argue that consumption is a better measure of a taxpayer's *lifetime* ability to pay because tax liability would be based on the present value of the taxpayer's total lifetime resources. Finally, proponents assert that a cash-flow tax is preferable to an income tax because it more closely resembles an endowments tax; it would place a similar tax burden on taxpayers with equal opportunities, as opposed to those who simply have equal outcomes.

However one resolves the debate about the proper base for imposing positive tax liability, the EITC adds an additional wrinkle. Under an integrated view of the tax and transfer systems, the EITC may simply be one end of the spectrum of low and high taxation, with "low taxation" dipping into negative amounts. Under this view, if consumption is the proper base for positive taxation, it should also be the proper base for negative taxation (or

64. The three other sample taxpayers, the Altruistic Middle-Income Worker, the Student, and the Senior Citizen, have different amounts of earned income and therefore, from a work incentive standpoint, should have different EITC benefits. Under certain assumptions, however, each has $15,000 of consumed income for the year. Thus, from strictly an income security standpoint, should they be entitled to the same amount of EITC, and should this amount be the same as for the taxpayers described in the text?

65. For some of the debate on this issue, see Blueprints, supra note 3, at 35-39; Bradford-Untangling, supra note 3, at 154-56, 165-66, 315; Kaldor, supra note 3, at 46-53; Andrews, supra note 3, at 1165-77; William D. Andrews, Fairness and the Personal Income Tax: A Reply to Professor Warren, 88 Harv. L. Rev. 947 (1975); Don Fullerton, The Consumption Tax: An Idea Whose Time Has Come? 27 Tax Notes 435 (Apr. 22, 1985); Goode, supra note 39, at 49-73; Mark Kelman, Time Preference and Tax Equity, 35 Stan. L. Rev. 649 (1983); Alvin C. Warren, Jr., Fairness and a Consumption-Type or Cash-Flow Personal Income Tax, 88 Harv. L. Rev. 931 (1975) [hereinafter Warren-Fairness]; Alvin Warren, Would a Consumption Tax Be Fairer Than an Income Tax?, 89 Yale L. J. 1081, 1094-95, 1098-1101 (1980) [hereinafter Warren-Would].

positive transfers).[66] In other words, if consumption levels are low enough, one should get the credit.[67]

However, the prospect of negative taxation may introduce a different perspective altogether.[68] Federal welfare programs, for example, uniformly base eligibility on income levels, resource levels, or both, not consumption levels.[69] Moreover, in contrast to a *lifetime,* or even an annual, time frame,

66. Cf. William A. Klein, The Definition of "Income" Under a Negative Income Tax, 2 Fla. St. U. L. Rev. 449, 458-59 (1974).

67. Under this approach, taxpayers should be required to return their EITCs to the government if their consumption levels are subsequently sufficiently high. If all receipts are eventually consumed, any amounts saved (and therefore not taxed) will be consumed (and taxed) at a later time, and the income versus consumption tax issue is simply one of timing. The negative tax system would reach the same result only if all subsidies are eventually returned when consumption levels become high.

68. Some of these points have been discussed in the negative income tax (NIT) literature. In general, commentators have argued that the tax base for purposes of the NIT should be much more comprehensive than that for the positive income tax system, potentially encompassing such items as the imputed net rental value of owner-occupied homes, the value of food grown and consumed on a farm, and other non-monetary forms of income. See, e.g., Sheldon S. Cohen, Administrative Aspects of a Negative Income Tax, 117 U. Pa. L. Rev. 678, 683-87 (1969); Klein, supra note 66; William A. Klein, Familial Relationships and Economic Well-Being: Family Unit Rules for a Negative Income Tax, 8 Harv. J. on Legis. 361, 366-67 (1971) [hereinafter Klein-Family Unit Rules]; William A. Klein, Some Basic Problems of Negative Income Taxation, 1966 Wis. L. Rev. 776, 782-86 (1966); William D. Popkin, Administration of a Negative Income Tax, 78 Yale L.J. 388, 389-92 (1969); James Tobin et al., Is a Negative Income Tax Practical? 77 Yale L.J. 1, 11-14 (1967). See also Anne L. Alstott, The Earned Income Tax Credit and Some Fundamental Institutional Dilemmas of Tax-Transfer Integration, 47 Nat'l Tax J. 609, 611 (1994) [hereinafter Alstott-Fundamental Dilemmas]; Anne L. Alstott, The Earned Income Tax Credit and the Oversimplified Case for Tax-Based Welfare Reform, 108 Harv. L. Rev. 533, 571-76 (1995) [hereinafter Alstott-Oversimplified Case].

69. There are three income-related eligibility tests for AFDC, with "income" generally being defined very broadly to include, for example, support and maintenance assistance and, at state option, items such as food stamp coupons and the value of government housing subsidies. See 42 U.S.C. § 602(a)(7), (18) (1994); 45 C.F.R. § 233.20(a)(1)(i), (3)(ii)(A), (xi), (xii), (xvi) (1993); Center on Social Welfare Policy, AFDC Program Rules for Advocates: An Overview 8 (Welfare Law Ctr. Publ. No. 160, June 1993) [hereinafter AFDC Program Rules]. AFDC recipients also generally may not have more than $1,000 in resources, not including the value of their home and certain other basic maintenance items. See 42 U.S.C. § 602(a)(7)(B) (1994); 45 C.F.R. § 233.20(a)(3)(i)(B) (1993); 1994 Green Book, supra note 34, at 331; AFDC Program Rules, supra, at 8, 11-12. The food stamp and SSI programs have similar income and resource limitations. For food stamps, see 7 U.S.C. § 2014(a)-(g) (1994); 7 C.F.R. §§ 273.8, 273.9 (1994); 1994 Green Book, supra note 34, at 763-66. For SSI, see 42 U.S.C. §§ 1381a, 1382(a), (d), 1382a, 1382b (1994); 20 C.F.R. §§ 416.202(c), (d), 416.1102 to 416.1104, 416.1201 to 416.1266 (1994); 1994 Green Book, supra note 34, at 213-17.

welfare benefits are typically determined on a month-to-month basis.[70] Thus, if the EITC is analogous to a welfare program, eligibility for the credit should be based on a standard of need that refers to current resources (as opposed to standard of living) and current outcomes (as opposed to lifetime expectations). A taxpayer who chooses a low standard of living ought not, by that reason alone, to receive a government outlay. Indeed, the purpose of the subsidy is, in part, to raise the consumption levels of beneficiaries to some minimal level. Taxpayers with low levels of consumption who have the resources to consume at higher levels should be required to use those private resources, rather than the government's resources, if they wish (or need) to consume more.[71]

A welfare perspective of the EITC has three important policy implications. First, a cash-flow tax system is particularly ill-suited as a vehicle for delivering an EITC that is viewed as a welfare program. As previously noted, an important advantage of the cash-flow tax is that it avoids the necessity of calculating income from capital. But all of the problems of capital income computations would be revived by a cash-flow tax system containing an EITC with eligibility criteria based on economic income. The Middle-Income Investor, for example, would need to know not only the amounts received in selling stock investments (a cash-flow concept) but also the amount of gain or loss realized in the sales (an economic income concept).[72] Thus, the presence of the EITC in a cash-flow tax system might require *dual* tax base determinations: one that measures consumed income for purposes of the positive tax system and another that measures economic income for purposes of the negative tax system. Because taxpayers move

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70. See 45 C.F.R. §§ 233.31, 233.36 (1993) (AFDC); 7 C.F.R. § 273.10(a)(1)(i) (1994) (food stamps); 20 C.F.R. §§ 416.1100, 416.1207(a) (1994) (SSI). An annual, or even a lifetime, time frame would help to target the program's benefits for the long-term poor, rather than just the temporarily poor. On the other hand, a monthly test is more responsive to the need of the beneficiary. See CBO Entitlement Report, supra note 35, at 25; Michael R. Asimow & William A. Klein, The Negative Income Tax: Accounting Problems and a Proposed Solution, 8 Harv. J. on Legis. 1, 6-10 (1970).

71. More than 25 years ago, Professors Tobin, Pechman, and Mieszkowski, in discussing whether a negative income tax benefit should be provided to a taxpayer with ample resources but little income, argued that "the mere possibility that the public might be obliged to such a capitalist could discredit the program." See Tobin et al., supra note 68, at 17. It remains to be seen whether public attitudes have changed enough to allow that outcome under a cash-flow tax.

72. Indeed, one would want to know even more about the Middle-Income Investor, including the amount of the *un*realized appreciation or depreciation in her assets during the year. See Klein, supra note 66, at 464. This example epitomizes the inherent conflict between a tax subsidy like the EITC, which may require reliance upon comprehensive income principles to be effective, and the cash-flow tax, which is a step away from such principles.

between the two systems from period to period, many of them might be required to do double calculations.

Second and more generally, a cash-flow tax system would restrict the ability of *both* the tax *and* the transfer systems to respond to policymakers' desires to distribute federal benefits to low-income households. With a cash-flow tax system, means-tested government transfer programs would lose the yardstick of economic income now roughly available under the income tax law, and would have to rely more on an economic resources standard for determining eligibility.[73] As one commentator has stated, "[r]ather than attempt to improve an existing accounting system, a [cash-flow] tax would require the development of an additional accounting system for federal income tax purposes only."[74]

Finally, a welfare view of the EITC suggests that even under current law, the method of clawing back the benefit may be incorrect. After all, the existing income tax is not a pure income tax; it has significant consumption tax components, with various forms of savings being excluded from the tax base. Eligibility for the EITC as a welfare program should ignore those consumption tax elements and should be based upon economic income and/or economic resource levels of potential beneficiaries, not their adjusted gross incomes as under current law.[75]

2. *Problems Associated With Larger Negative Tax Subsidy.*—As noted, the Nunn-Domenici proposal would substantially increase the negative

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73. For some purposes, the definition of "income" used in the SSI program refers to the federal income tax meaning of the term. See, e.g., 42 U.S.C. § 1382(d) (1994). Also, the IRS is required to furnish the Social Security Administration with certain nonwage information about SSI recipients to help identify bank accounts that may contain balances exceeding the resources limitation. See 1994 Green Book, supra note 34, at 216. Thus, adoption of a cash-flow tax system might jeopardize the ability of nontax agencies to measure and verify economic resources.

74. C. Eugene Steuerle, Taxes, Loans and Inflation: How the Nation's Wealth Becomes Misallocated 173 (1985).

75. See Alstott-Oversimplified Case, supra note 68, at 574-76 Cherie J. O'Neil & Linda B. Nelsestuen, The Earned Income Credit: The Need for a Wealth Restriction for Eligibility Determination, 63 Tax Notes 1189 (May 30, 1994) (reporting that taxpayers with "portfolio income" in excess of $299,000 and capital gains as high as $677,900 were eligible for the EITC); Yin et al., supra note 45, at 268 n.153. President Clinton's FY 96 budget proposes to preclude a taxpayer from obtaining the EITC if his or her aggregate interest and dividend income exceeds $2,500. According to the proposal, such taxpayers can draw upon their significant private resources to meet the needs of their family. See U.S. Dep't of Treasury, General Explanations of the Administration's Revenue Proposals, 95 TNT 25-37 (Feb. 7, 1995) (LEXIS, FEDTAX library, TNT file); H.R. 981, 104th Cong., 1st Sess. § 102 (1995) (House bill version of President's proposal); S. 453, 104th Cong., 1st Sess. § 102 (1995) (Senate bill version).

tax subsidy provided through the tax system, apparently as an antidote to the regressive nature of the cash-flow tax. Experience with the EITC suggests, however, that any such increase should be implemented with great caution.

One cause for concern is the difficulty of mitigating the credit's work disincentive effects on those in the phase-out range of the credit. Taxpayers within that range face unambiguously negative work incentives: The diminution of the credit as income rises creates a negative "substitution effect" by decreasing the reward for working more instead of choosing leisure, yet the existence of the credit continues to provide a negative "income effect" by permitting taxpayers to attain a given level of income with less work.[76]

If the existing contours of the EITC are retained, a larger maximum credit would force policymakers to make one of three difficult choices. First, they could maintain the parameters of the current phase-out range and claw back the larger benefit within that range at a faster rate. This option would create higher marginal tax rates and greater work disincentive effects for those in the phase-out range. These effects would need to be evaluated in conjunction with similar consequences arising from the phase-out of other tax and transfer benefits, both federal and state.[77] A second option would be to maintain the existing phase-out rate, with the result that the phase-out would be completed at a higher income level and many more taxpayers would

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76. See Saul D. Hoffman & Laurence S. Seidman, The Earned Income Tax Credit: Antipoverty Effectiveness and Labor Market Effects 37-42 (1990); Holtzblatt, et al., supra note 36, at 593-94; Marvin H. Kosters, The Earned Income Tax Credit and the Working Poor, 4 Am. Enterprise 64 (May/June 1993). The labor supply effects would potentially be mixed for those in the phase-in range of the credit as well as those who must pay higher taxes to finance the credit. The former group would experience a positive substitution effect but a negative income effect; if the credit is financed through higher tax rates, the opposite combination of effects would arise for those in the latter group.

To be sure, in the absence of empirical evidence, one cannot say whether the existence of the credit has any actual effect on the work/leisure decision. But if the credit does discourage work for those in the phase-out range of the credit, then increasing the size of the credit will likely make that effect more pronounced.

77. Two recent studies have examined the cumulative burden of explicit and implicit taxes on low-income households resulting from federal and state tax and transfer programs. One study found that typical tax rates for such households rarely exceed 40% and concluded that "tax rates are not so high as to dismiss the possible effectiveness of policies . . . that try to make work more attractive than welfare." Stacy Dickert et al., Taxes and the Poor: A Microsimulation Study of Implicit and Explicit Taxes, 47 Nat'l Tax J. 621, 636 (1994). Another study of cumulative tax rates faced by AFDC recipients reached a less optimistic conclusion. It found that in deciding whether to work at a full-time minimum wage job or to increase their work effort beyond some minimal level, a significant portion of these recipients face tax rates of *100%* or more. It concluded that welfare reforms providing modest incentives with a gradual phase-out of benefits may no longer be viable options. Linda Giannarelli & Eugene Steuerle, It's Not What You Make, It's What You Keep: Tax Rates Faced by AFDC Recipients 13-14 (Oct. 1994) (draft manuscript).

become eligible for some EITC. This choice would make the credit less targeted toward the low-income and would extend the work disincentive effects of the clawback to a larger group of people.[78] Third, the phase-in rate could be increased, causing benefits to rise more sharply for those in the phase-in range and the maximum benefit amount to be reached at a lower income level. The phase-out of the benefit could then take place more or less at the same rate and up to the same income level as under current law.

The problem with a higher *phase-in* rate is that it increases an incentive for fraud. IRS studies have shown a consistently high noncompliance rate for the EITC program, with between 30% and 40% of claimants being ineligible for any benefit.[79] The revenue loss attributable to EITC ineligibility has been estimated to be as high as $5 billion annually.[80] Until recently, there has been little hard evidence of the proportions of the noncompliance attributable to inadvertent errors due to the complexity of the EITC rules, on the one hand, and to intentional errors, on the other. At a 1994 Congressional hearing, however, the Commissioner of Internal Revenue testified that based upon an IRS study conducted in January of 1994, about 50% of the EITC errors appeared to result from "intentional misrepresentations."[81]

Intuitively, one assumes that the larger the credit, the greater the incentive to commit fraud to obtain it. A prominent feature of the credit—that it *increases* with greater earnings over the phase-in range—makes the program unusually susceptible to fraudulent claims. When taxpayers in that range overstate earned income to obtain a larger benefit, it is difficult for the IRS to identify and disprove the false claims, especially if the overstatement is of income from self-employment.[82] A higher phase-in rate would increase the amount by which the EITC benefit resulting from an income overstatement exceeds the income and payroll taxes on the fictitious income. Hence,

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78. In 1990, before major increases to the EITC program enacted in 1990 and 1993, one-tenth of all families and one-fourth of all families with children received the credit. See CBO Entitlement Report, supra note 35, at 22-23. Current projections are that by 1996, the EITC will be received by about 18.7 million families with incomes up to $28,524. See 1994 Green Book, supra note 34, at 700 (Table 16-11), 704 (Table 16-13). Most of the recipients are already in the phase-out or clawback range of the credit. See Kosters, supra note 76, at 68.

79. See Yin et al., supra note 45, at 247-48, 296 (Table 1).

80. See George Guttman, Improper Refunds Sapping Billions; IRS, Treasury, Hill Seek Answers, 65 Tax Notes 19, 22 (Oct. 3, 1994).

81. See Hearing Before the Senate Committee on Governmental Affairs on High Risks and Emerging Fraud: IRS, Student Loans, and HUD, S. Hrg. 103-975, 103d Cong., 2d Sess. 17 (1994) (testimony of IRS Commissioner Margaret M. Richardson).

82. See Gene Steuerle, The IRS Cannot Control the New Superterranean Economy, 59 Tax Notes 1839 (June 28, 1993); Yin et al., supra note 45, at 259-60.

a higher phase-in rate would likely make this particular form of fraud more common.[83]

Finally, a larger credit would aggravate its effect on the decision to marry. Under present law, the same EITC eligibility rules (including the phase-in and phase-out income cut-off points) apply to married couples filing joint returns and to unmarried individuals.[84] Hence, two unrelated individuals, either or both of whom are eligible for the EITC by themselves, may suffer a loss of most or all of that benefit if they marry and are thereafter required to pool their incomes in determining eligibility. The marriage penalty under existing law from the EITC alone can be as high as $5,686;[85] the penalty would be even greater with a larger credit.

3. *Implementing the Payroll Tax Credit.*—The Nunn-Domenici plan includes a refundable credit against the cash-flow tax for some portion of the taxpayer's payroll taxes. Viewed in isolation, this credit might seem to be a useful device to reduce the tax burden of low-income taxpayers. It could logically be phased in and out based on the taxpayer's taxable wages, the tax base for the payroll taxes.[86] The phase-out would create a work disincentive, but this effect would be mild, given the relatively low rate of the payroll taxes and credit.[87] If the credit is available to all individuals, including both partners to a marriage, there would be no marriage penalty. (On the other

83. To illustrate, assume that in a Nunn-Domenici cash-flow tax world, the phase-in rate is increased so that a taxpayer with $8,900 of earned income is entitled to a maximum EITC of $7,120. (Under current law, it is projected that by 1996, a maximum benefit of $3,560 will be available to a taxpayer with income of $8,900. The illustration assumes a doubling of the phase-in rate to 80% in order to permit a 100% increase in the size of the Nunn-Domenici credit.) A taxpayer with no earned income who, nevertheless, reports $8,900 of such income would have to pay $1,362 in self-employment tax (15.3% of $8,900) but no cash-flow tax. Hence, by so overstating earned income, the taxpayer would obtain a net cash benefit of $5,758 ($7,120 less $1,362) *plus* credit toward Social Security retirement benefits.

84. The credit is denied to married individuals who file separately. IRC § 32(d).

85. [author's calculations] See Daniel R. Feenberg & Harvey S. Rosen, Recent Developments in the Marriage Tax, (Natural Bureau of Economic Research) Working Paper No. 4705, 1994) (Apr. 1994).

86. It is unclear what Senators Nunn and Domenici intend in basing the proposed phase-out of the credit on "taxable income." See supra note 54 and accompanying text. As previously described, in a cash-flow tax system, "taxable income" would presumably be consumed income—the taxpayer's taxable consumption. If the phase-out is to be based on economic income, that amount would have to be ascertained from elements not part of the normal cash-flow tax system.

87. The credit rate would presumably be no higher than either 7.65 or 15.3%, depending upon what portion of payroll taxes are to be rebated and whether the rebate applies only to the employee's share of payroll taxes or to both the employee's and employer's shares. See IRC §§ 3101(a), (b), 3111(a), (b).

hand, two-worker married couples might be advantaged over couples with only one person working outside the home.) The credit might be relatively easy to administer since the information needed to compute the credit and its phase-out—the taxable wage base and the amount of payroll taxes paid—would ordinarily be available from the Form W-2 payroll statement.

However, if enacted in conjunction with the EITC just described, a payroll tax credit makes much less sense. It raises many of the questions presented by the EITC regarding the mechanics and effect of the credit phase-out. Indeed, the payroll tax credit would seem to be wholly subsumed by the EITC, which originated in large part as a partial rebate of payroll taxes.[88] It is unclear why two separate credits are required or desirable. It would be far simpler for both the IRS and taxpayers to offer only one credit.

A more fundamental question is why payroll tax relief should take the form of a credit against the cash-flow tax. The easiest way to mitigate the payroll tax burden of low-income taxpayers is to exempt a certain level of wages from the tax.[89] An exemption ensures virtually 100% participation without the need for beneficiaries to file tax returns, and compliance with an exemption rule could be expected to be high.

A possible disadvantage of an exemption, as opposed to a credit against *income* taxes, is that the resulting subsidy may not be as well-targeted to the poor. To function simply, an exemption would have to be available to all taxpayers, both rich and poor. By raising the payroll tax rate on wages above the exemption amount or lifting the cap on taxable wages for purposes of the OASDI portion of the tax, Congress could recapture the benefit of the exemption from middle- and upper-income wage earners, but neither of these approaches would affect taxpayers with low wage income but large amounts of capital income. Including a payroll tax credit in a cash-flow tax, however, does not overcome that objection because the cash-flow tax base also excludes income from capital. In other words, if the payroll tax credit is phased out based on either consumed income or wages, it would be no better targeted than an exemption, while being much more cumbersome.

To be sure, there is an appealing *political* reason for adopting a payroll tax credit rather than a Social Security tax exemption. By leaving the Social Security system as it is, politicians may be better able to assert that the integrity of that system is unaffected. Indeed, in explaining the payroll tax

88. See S. Rep. No. 938, 94th Cong., 2d Sess. 119 (1976), reprinted in 1976 U.S.C.C.A.N. 3439, 3554-55; S. Rep. No. 36, 94th Cong., 1st Sess. 32-33 (1975), reprinted in 1975 U.S.C.C.A.N. 54, 82-83.

89. For a detailed discussion of these issues, see Yin & Forman, supra note 45; Yin et al., supra note 45, at 280-86.

credit, Senator Domenici made exactly that claim.[90] But the claim is political chicanery. The reality is that with the proposed payroll tax credit (as well as with the existing EITC), the link between Social Security taxes and benefits would be decoupled for low-income wage earners. They would ostensibly pay Social Security taxes, and therefore get to count their wages in computing Social Security benefits, even though they would be reimbursed for the taxes through the proposed refundable payroll tax credit. Roughly the same result could be accomplished more simply by not collecting Social Security taxes from those workers, preserving their Social Security benefits, and transferring (for accounting purposes) the revenue cost of the exemption from general revenues to the trust funds.

A final issue affecting the EITC and, particularly, the proposed payroll tax credit is the manner in which those benefits would be delivered to their intended beneficiaries. Under current law, a portion of the EITC benefit may be received by qualifying individuals during the year through increases in their paychecks, a form of negative withholding.[91] Congress believed that "advance payment" of the benefit during the year serves as a better work incentive and provides the assistance at the time the beneficiary is more likely to need it.[92] This goal is especially important for the proposed payroll tax credit because payroll taxes are withheld throughout the year. Unfortunately, the EITC advance payment system has thus far been an abysmal failure due, in part, to the difficulty of ascertaining the proper amount to award in advance.[93] That determination would be even more difficult in a cash-flow tax system if the negative withholding amount is computed taking into account the taxpayer's projected savings for the year.[94]

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90. See Domenici, supra note 2, at 296 ("[the payroll tax credit] facilitates our goal of retaining the progressivity of the current income tax and helps neutralize the regressive nature of the current payroll tax while maintaining the financial integrity of the Social Security trust fund"); cf. Rudolph G. Penner, Outline of Discussion of Individual SEIT, in SEIT Background Materials, supra note 51, at 2 (under the Nunn-Domenici plan, "[a] credit would be provided for the employee share of the payroll tax. Social Security accounting would not be affected. There would still be a payroll tax levied and deposited in the OASDI trust funds.").

91. IRC § 3507.

92. See S. Rep. No. 1263, 95th Cong., 2d Sess. 52 (1978), reprinted in 1978 U.S.C.C.A.N. 6761, 6815.

93. See General Accounting Office, Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood By the Public (GAO/GGD-92-26) (1992); Yin et al., supra note 45, at 246-47, 257-58.

94. Determining the proper withholding amount would also be a problem for the positive cash-flow tax system. See Committee on Simplification, supra note 17, at 421; Graetz, supra note 11, at 1595-96.

4. *Proper Taxable Unit.*—As is the case with the income tax, many factors affect the choice of taxable unit for the cash-flow tax, and there is no completely satisfactory solution to this issue. In this section, I briefly describe a few of the considerations particularly affecting low-income taxpayers.[95]

Under current law, the basic taxable unit is the individual, although there are important exceptions for married couples, heads of households, and taxpayers with dependents.[96] For example, the so-called "kiddie tax," under which certain unearned income of a minor child is taxed at the parent's marginal rate, requires a tax result comparable to joint filing.[97] However, there is no general rule requiring or permitting aggregate reporting for all members of a family or household.

A welfare perspective of the negative cash-flow tax system supports a broad definition of the taxable unit, perhaps encompassing the taxpayer's "family" or "household."[98] In determining need-based entitlement to the negative tax subsidy, it would make sense to consider the economic status of the taxpayer's entire support group. For example, it would not be appropriate to award the subsidy to a low-income taxpayer who can look for support to a spouse, parent, or other relative with sufficient resources and income.[99] A broad definition of the taxable unit is consonant with federal welfare programs.[100]

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95. For comprehensive analyses of this question in connection with the income tax, see Staff of Joint Comm. on Tax'n, The Income Tax Treatment of Married Couples and Single Persons, 96th Cong., 2d Sess. (1980) [hereinafter JCT Married Couple Report]; Boris I. Bittker, Federal Income Taxation and the Family, 27 Stan. L. Rev. 1389 (1975); Marjorie E. Kornhauser, Love, Money, and the IRS: Family, Income-Sharing, and the Joint Income Tax Return, 45 Hastings L.J. 63 (1993); Edward J. McCaffery, Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code, 40 UCLA L. Rev. 983 (1993); Michael J. McIntyre & Oliver Oldman, Taxation of the Family in a Comprehensive and Simplified Income Tax, 90 Harv. L. Rev. 1573 (1977); Martin J. McMahon, Jr., Expanding the Taxable Unit: The Aggregation of the Income of Children and Parents, 56 N.Y.U. L. Rev. 60 (1981); Stanley S. Surrey, Family Income and Federal Taxation, 24 Taxes 980 (1946); Lawrence Zelenak, Marriage and the Income Tax, 67 S. Cal. L. Rev. 339 (1994).

96. IRC §§ 1(a), (b), 151(c).

97. IRC § 1(g). Under certain circumstances, the parent may elect to have the child's income reported on the parent's return, thereby relieving the child of the need to file a return. IRC § 1(g)(7).

98. See Alstott-Fundamental Dilemmas, supra note 68, at 611; Alstott-Oversimplified Case, supra note 68, at 576-79; Klein-Family Unit Rules, supra note 68, at 370-72; Popkin, supra note 68, at 403-04.

99. See Zelenak, supra note 95, at 398-99.

100. For AFDC, where the recipient is technically the dependent child, the income and resources of any parent or sibling of the child living in the same home is considered. 42 U.S.C. § 602(a)(38) (1994). In addition, under certain circumstances, the income and resources of other persons living in the home is included. See id. at § 602(a)(39) (deemed inclusion of grandparent's income and resources); AFDC Program Rules, supra note 69, at 10-11. For food

In theory, household consumption should be apportioned among the members of the household by including gifts and support transfers in the donee's cash-flow tax base and allowing the donor a deduction for those amounts. Thus, a taxpayer who is supported by others, and is therefore not needy, should report enough consumed income to be disqualified from the negative tax benefit, even if the taxpayer files individually. But it may be difficult to enforce accurate reporting of many common forms of support, including food, housing, and clothing. Moreover, as previously discussed, it may be appropriate to use economic income, not consumed income, as the measuring stick for testing eligibility for the negative tax subsidy, and gifts and support transfers may not be treated as economic income.

At first blush, a family or household taxable unit might also seem to be a necessary feature of the positive cash-flow tax system because of the likely pooling of consumption expenditures within the family or household. However, because the positive cash-flow tax system measures consumption indirectly (generally, by subtracting savings from economic income), no allocation of joint consumption expenditures would *necessarily* have to be made if the basic taxable unit were individual-based as under current law. If people tend to save as individuals rather than through joint investments with other family members, the cash-flow tax base could in theory be determined from the taxpayer's individual income and savings for the taxable period, without any allocation of items among family members.

However, as a conceptual matter, the joint nature of consumption expenditures among family or household members supports a taxable unit consisting of the family or household. Consider two two-person low-income families, each with $15,000 of consumed income before deduction of living allowances. In one family, the consumed income is divided unequally—$10,000 belongs to one member and only $5,000 to the other—whereas in the other family, each member has $7,500 of consumed income. If the family were the taxable unit with a living allowance of $7,500 for each family member, neither family would owe any cash-flow tax. In contrast, if the individual were the taxable unit with a $7,500 per person living allowance, the family in which the consumed income is split unequally would have to

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stamps, eligibility is based on the income and resources of the "household," a broad concept that includes, for example, a "group of individuals who live together and customarily purchase food and prepare meals together for home consumption." 7 U.S.C. §§ 2012(i)(2), 2014(a) (1994). See 1994 Green Book, supra note 34, at 762-63. For SSI, the income and resources of the recipient and his or her spouse living in the same home is counted. 42 U.S.C. § 1382c(f)(1) (1994). See 1994 Green Book, supra note 34, at 220-21. In addition, a recipient living in another person's household who receives in-kind support from such person is only entitled to reduced benefits. 42 U.S.C. § 1382a(a)(2)(A) (1994). See 1994 Green Book, supra note 34, at 217-18.

pay some tax because one of the individual living allowances would not be fully utilized. If standard of living is the proper basis for taxation, there seems to be little policy rationale for taxing the two families differently.[101]

In a cash-flow tax world, the family whose members consume unequally could resort to self help through the simple expedient of deductible support transfers from the higher consuming member to the lower one. But that fact also supports a family or household taxable unit rule. Individual filing would encourage the reporting of real or fictitious intra-household transfers to even out consumption patterns within the household.[102] Rather than foist that degree of tax planning upon taxpayers, with the only losers being the ill-advised, and rather than require the IRS to sort out true consumption patterns within a household, it would be better to mandate a family/household taxable unit rule, allowing intra-household transfers to be ignored altogether.[103]

The problem of intra-household transfers could be avoided, as it is under current law, by treating gifts as consumption by the donor, denying any deduction from the donor's cash-flow tax base for a gift. However, such a rule would be inconsistent with the theory of the cash-flow tax, and it would cause a gift of an amount previously saved to be taxable to the donor, in contrast to the nontaxation of continued or reinvested savings.[104] Moreover, to avoid taxing the gift twice, gifts would have to be excluded from the donee's cash-flow tax base, regardless of whether the donee saves or consumes the amount of the gift. Equity concerns might surface if gifts could be consumed without tax consequences but sweat-of-the-brow income could

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101. The argument in the text is equally applicable to higher income families because of the progressive tax rate structure. Indeed, the same issue arises under the income tax, where the argument is used to justify the joint tax return for married couples. See Bittker, supra note 95, at 1392-95. However, because pooling of consumption is probably more common than pooling of income (the chief difference being whether savings is made jointly or individually), the case for a family/household taxable unit in a cash-flow tax world may be more compelling than under the income tax. See Zelenak, supra note 95, at 354-58.

102. See Graetz, supra note 11, at 1625. For some low-income households, the incentives may run in the other direction. For example, it might be advantageous to report uneven consumption patterns within a household to maximize the negative tax subsidy available to the lower consuming member. The strategy would be beneficial if the additional subsidy to the lower consumer is greater than the additional tax liability borne by the higher consumer.

103. In Blueprints, the Treasury recommended a family taxable unit for both the cash-flow tax and a proposed comprehensive income tax. Blueprints, supra note 3, at 92-94, 104. The latest description of the Nunn-Domenici proposal, however, seems to indicate that it will not change the tax filing unit rules of current law. See Alliance USA, supra note 51, at 1489, 1522-23 (required tax filing by individuals, with permissible joint filing by married couples).

104. See Graetz, supra note 11, at 1625.

not be. On the other hand, if the gift were saved, the donee might unfairly be taxed at some later time when the savings is consumed, in the absence of a complicated earmarking scheme.[105] The illustrations highlight the potential risks of deviating too far from the basic cash-flow tax theory once that tax is adopted.[106]

In short, for both positive and negative cash-flow tax purposes, there are distinct policy reasons for having the family or household be the taxable unit.[107] Unfortunately, such a rule also has severe drawbacks.[108] The most obvious is the need to develop a workable definition of "family" or "household." Even the current law concept of married individuals[109] has been criticized as ambiguous.[110] Any attempt to categorize the extended family living arrangements that are perhaps more common among low-income households would be extremely problematic.[111] Moreover, the self-assessment feature of the tax system, along with an inconsequential rate of audit, would virtually guarantee a haphazard application of the law and resulting

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105. See Domenici, supra note 2, at 303.

106. Another possibility is to tax the same gift twice, but this approach would have the effect of converting the cash-flow tax into a lifetime *income* tax. See Aaron & Galper, supra note 40, at 66-67. It also would be difficult to administer because neither the donor nor the donee would have any incentive to report the gift. For a more complete discussion of the issues raised by the cash-flow tax treatment of gifts and bequests and the resulting problems of consumption-splitting, see Committee on Simplification, supra note 17, at 427-31; J. Clifton Fleming, Jr., Scoping Out the Uncertain Simplification (Complication?) Effects of VATs, BATs, and Consumed Income Taxes, 2 Fla. Tax Rev. 390 (1995); Graetz, supra note 11, at 1624-29. The latest description of the Nunn-Domenici plan indicates that it will treat a gift as nondeductible consumption by the donor and an exempt receipt by the donee. See Alliance USA, supra note 51, at 1489, 1518, 1569.

107. Whether for these or other reasons, in view of its proposal for a family living allowance, the original Nunn-Domenici plan would apparently have adopted a family taxable unit. As previously noted, however, the latest description of the plan indicates no change in the tax filing unit rules of current law. See supra note 103.

108. Indeed, the recent trend in the academic literature has been to favor elimination of joint filing for married couples. See Kornhauser, supra note 95, at 65; McCaffery, supra note 95, at 987; Zelenak, supra note 95, at 342-44.

109. IRC § 1(a).

110. See Toni Robinson & Mary Moers Wenig, Marry in Haste, Repent at Tax Time: Marital Status as a Tax Determinant, 8 Va. Tax Rev. 773, 788-833 (1989).

111. See Popkin, supra note 68, at 404 ("The problem of defining a household to take account of economies of scale and pooling of resources is the most difficult problem in designing a [negative income tax]"); Tobin, et al., supra note 68, at 9 ("Definition of family units for [negative income tax] purposes may be the single most difficult legal and administrative problem").

inequities. IRS efforts to enforce rules in this area would no doubt be highly intrusive.[112]

The definitional problem is compounded by the fact that whatever line is drawn would be a two-edged sword. Some families and households—especially those with only one earner—would find it advantageous to be treated as a unit, thereby maximizing the size of their collective living allowance. Others—typically, families and households with multiple earners—may find it beneficial to splinter themselves into several taxable units in order to avoid aggregating incomes.[113]

Intractable problems would also arise when a family or household unit breaks apart. Consider, for example, a child who leaves home to establish his or her own household. If the child and a parent previously constituted a taxable unit, any transfers between them would have been disregarded for purposes of the cash-flow tax. Once the child establishes a new taxable unit, however, any unconsumed, accumulated transfers would need to be accounted for. At least in theory, all such amounts should be treated as income to the child and deductible by the parent when the separation occurs.[114] (To the extent the prior gifts continue to be saved by the child, there would be an offsetting deduction.) Such a rule would not be manageable, and could result in an artificial bunching of income to the child and deductions to the taxpayer.[115]

A taxable unit based on the family or household would also create potentially undesirable incentives. For example, if the definition of family included a relatedness requirement, there might be a disincentive to marry.[116] A definition incorporating a common residency requirement might discourage that manner of living arrangement. A household taxable unit rule could discourage members of a household other than the primary earner from seeking or continuing work.[117] Because of the additional effects of the

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112. See Bittker, supra note 95, at 1398-99. With potentially greater oversight, the welfare system can be highly intrusive but may at least achieve a more even application of the law.

113. See Klein-Family Unit Rules, supra note 68, at 366.

114. See Blueprints, supra note 3, at 123.

115. Moreover, the mere identification of the proper event for terminating the joint taxable unit would present theoretical and administrative difficulties. See McMahon, supra note 95, at 131-39.

116. See Bittker, supra note 95, at 1416-20. If tax rates are graduated, a tax system cannot tax couples alike, no matter how the tax base is split between the individual members, without violating neutrality between married and unmarried couples. See Bradford-Untangling, supra note 3, at 278; JCT Married Couple Report, supra note 95, at 26 n.1; Michael C. Lovell, On Taxing Marriages, 35 Nat'l Tax J. 507 (1982).

117. See JCT Married Couple Report, supra note 95, at 34-37; McCaffery, supra note 95, at 993-94; McMahon, supra note 95, at 93-95; Zelenak, supra note 95, at 365-72.

phase-out of the negative tax subsidy (EITC) and the payroll tax credit, the work disincentive and marriage penalty effects on low-income households could be particularly severe.[118]

Finally, treating the family or household as the taxable unit would affect legal rights of persons within the unit. For example, family or household members may be reluctant to share income and savings information with one another on a joint tax return.[119]

5. *Proper Size of Family Living Allowance.*—By basing the amount of their family living allowance on the federal poverty guideline, Senators Nunn and Domenici would permit a larger allowance for the first person in the taxable unit ($12,512 for 1994) than for each additional person in the unit ($4,216 for 1994). That feature of their proposal presumably reflects the economies of scale that can be achieved by persons sharing common consumption expenditures.[120] It would, however, place an additional premium on identifying the members of the taxable unit.

Consider, for example, a taxpayer with an adult child or elderly parent living in the home. If the two-person household is considered a single taxable unit, the household would be entitled to a two-person family living allowance of $16,728 (sum of $12,512 and $4,216). If the household is treated as two separate units, these units would be entitled to living allowances of $25,024 ($12,512 times 2). If the example instead involved two unrelated individuals thinking about getting married, it would illustrate another aspect of the marriage penalty potentially created by a joint filing requirement.

Because it is unlikely that the membership of the taxable unit can be determined with precision, it may be preferable to disregard possible economies of scale and allow the same, flat living allowance for each person in the unit. Thus, a two-person unit would have the same allowance as the total of the allowances for two single-person units. Alternatively, if taking account of economies of scale is considered the more important policy objective, the taxable unit definition should be based on the household (and

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118. See McCaffery, supra note 95, at 1014-1020; supra notes 76, 77, 85 and accompanying text.

119. In advocating that a minor child's income should be included on the parents' tax return, Deborah Schenk has argued that there should be no confidentiality concern in requiring disclosure of the child's income to the parents. Deborah H. Schenk, Simplification for Individual Taxpayers: Problems and Proposals, 45 Tax L. Rev. 121, 157 (1989). However, if a family return had to be signed (and, in theory, reviewed) by all members of the family, some disclosure of the parents' tax information to the children would be required. A tax return requiring inclusion of information for other adult members of the family or household would present even greater concerns.

120. See Bittker, supra note 95, at 1422-25.

the sharing of common household expenses) rather than the family. Further, some continuing reduction in the size of the allowance might be appropriate for larger households to reflect additional economies of scale available to them.

Aside from the question of economies of scale, there is another aspect of the proposed Nunn-Domenici allowances that may be inconsistent with horizontal equity principles.[121] Consider two households: One, consisting of three members, has $29,944 of consumed income for the year, and the other, which has two members, has $25,728 of consumed income. After deduction of the living allowance,[122] each household would have $9,000 in taxable consumed income. Based upon the theory of the living allowance, each household might be said to have spent $9,000 on discretionary, and therefore taxable, consumption. Should they therefore pay the same cash-flow tax?

Perhaps not. The two households, after all, are of different sizes. Under an income tax, if the $9,000 represents the discretionary income of each household, it may be appropriate to tax the two alike because the focus is on *income*—the power to consume. Each household could be viewed as having the same power to consume, regardless of how many members there are in the household. Under a consumption tax, the proper judgment may be different. If the tax base is the amount actually consumed, the number of consumers should presumably make a difference. Splitting $9,000 of discretionary consumption among three people is different from splitting that amount among two because per person consumption is higher in the latter case. If tax rates are graduated, the latter household should perhaps pay more cash-flow tax.[123] The argument is not that the taxable unit should be the individual rather than the household. For theoretical and administrative reasons, it may be best to have the basic taxable unit be the household. But in determining the amount of tax owed by any given household, perhaps household size should count. Such an adjustment (which could be incorporated into the rate schedule) would be needed in addition to the adjustment in the size of the household living allowance.

6. *Graduated Tax Rates.*—I conclude this section with a few comments about the rate structure under the Nunn-Domenici plan and its

121. I ignore in this discussion the argument that because the decision to have children is a voluntary one, expenditures for children are not consumption "necessities" and ought not be reflected in a proposed living allowance for necessities. See Lawrence Zelenak, Children and the Income Tax, 49:3 Tax L. Rev. — (forthcoming 1995).

122. $20,944 for the three-person household, and $16,728 for the two-person one.

123. See Zelenak, supra note 121; cf. George K. Yin, Summary of EITC Conference Proceedings, 11 Am. J. Tax Pol'y 299, 314-15 (1994) (statement of Jane Gravelle).

potential effects. Although most low-income taxpayers would apparently be exempted from the cash-flow tax by the combination of the proposed EITC, payroll tax credit, and family living allowance, it is possible that the final version of the tax will not achieve that outcome. Moreover, many taxpayers may only *temporarily* have low-incomes, and may therefore be subject to positive taxes in other years.

As previously described, the CBO has provided an estimated rate structure for the cash-flow tax based on a prototype of the Nunn-Domenici plan.[124] Those estimates—rates in the low range of 14% to 36% and in the high range of 16% to 55%—depend upon a host of assumptions, including how comprehensive the tax base will be, how to measure and compare family economic status, and how transitional issues will be dealt with. In the legislative process, all of those questions will no doubt be scrutinized. However, if one assumes that political considerations will preclude a major expansion of the tax base, the principal impact of the adoption of a cash-flow tax would be to shrink the income tax base by amounts saved in ways not currently deductible, a change that would surely require higher and more sharply graduated rates, at least in the short term.[125]

A cash-flow tax that raises no more revenue than the existing income tax, but accomplishes that result by means of higher and more graduated rates on labor income, could be expected to have an adverse impact on labor supply.[126] It may also increase the time spent on "tax planning"—the financial and legal structuring of economic affairs for tax purposes—and similar, unproductive pursuits.[127] For these and other reasons, optimal tax theorists have concluded that a policy of redistributing benefits to the low-income should ideally be executed by means of a flat rate or even slightly

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124. See supra note 57 and accompanying table.

125. See Graetz, supra note 11, at 1581; McCaffery-Hybrid, supra note 43, at 1170; Warren-Fairness, supra note 65, at 935-36 n.21.

126. With average tax rates remaining about the same (because the same amount of revenue would be collected) but with marginal rates on labor income increasing (due to the smaller tax base), the change would have an adverse substitution effect with no improvement in the income effect of the tax. Thus, more taxpayers could be expected to substitute leisure for work. See Edgar K. Browning & Jacquelene M. Browning, Public Finance and the Price System 359-63 (4th ed. 1994).

127. See Bradford-Untangling, supra note 3, at 276-77; Committee on Simplification, supra note 17, at 420; Graetz, supra note 11, at 1581-82. Joel Slemrod has concluded that "elasticity pessimism" may be overstated and that labor supply and savings may not be as sensitive to taxes as previously thought. On the other hand, taxes do seem to have an important influence on the amount of tax planning and the timing of economic activity. See Joel Slemrod, Introduction, in Tax Progressivity and Income Inequality 6 (Joel Slemrod ed., 1994); Joel Slemrod, Do Taxes Matter? Lessons from the 1980's, 82 Am. Econ. Rev. 250, 254-55 (1992).

declining marginal tax rates, exactly the opposite from the proposed cash-flow tax.[128]

Graduated rates pose another difficulty for the cash-flow tax: They upset the neutrality of the tax as between present and future consumption. Consider again Spender and Saver, who earn $100 each; Spender consumes the $100 immediately, but Saver invests the money at a 10% annual return. As previously described, in a tax-free world, Saver would see his money grow to about $200 in seven years, and could then consume twice as much as Spender, or the same amount as Spender in present value terms.[129] These proportions are preserved under a flat cash-flow tax, but not under an income tax. Hence, it is argued that the cash-flow tax, unlike the income tax, is neutral in the choice between saving and spending.

Consider the same example under a cash-flow tax imposed at 15% on the first $100 of consumed income and 30% on consumed income greater than $100. Spender's consumption is reduced to $85 ($100, less $15 of tax), but he will incur no further tax.[130] Saver could still invest the $100 and have it grow to about $200 in seven years, but there would then be a $45 tax upon consumption of the savings, leaving Saver with $155 for consumption, less than twice what Spender could consume and less than Spender's consumption in present value. In short, just like the income tax, a cash-flow tax with graduated rates would bias the decision to save or consume relative to the choices available in a no-tax world.[131]

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128. Even with flat or declining marginal tax rates, redistribution in favor of the low-income could be achieved by also awarding demogrants to all citizens. See Joseph Bankman & Thomas Griffith, Social Welfare and the Rate Structure: A New Look at Progressive Taxation, 75 Calif. L. Rev. 1905, 1945-58 (1987). For concise and critical reviews of the optimal tax literature, see Joel Slemrod, Optimal Taxation and Optimal Tax Systems, 4 J. Econ. Perspects. (No. 1) 157, 163-66 (1990); Joel Slemrod, Do We Know How Progressive the Income Tax System Should Be? 36 Nat'l Tax J. 361 (1983).

A recent study concluded that the efficiency costs of increased progressivity can be minimized by raising tax rates in intermediate brackets to finance an increase in the EITC. Robert K. Triest, The Efficiency Cost of Increased Progressivity, in Tax Progressivity and Income Inequality 137, 138 (Joel Slemrod ed., 1994). Other options, which resulted in higher efficiency costs, included raising rates in top brackets, providing a demogrant, and increasing the value of the personal exemption. The study was based, however, on the much lower 1987 EITC phase-in and phase-out rates, before major increases to that program enacted in 1990 and 1993, and assumed that beneficiaries were ineligible for food stamps and AFDC and faced no fixed costs associated with working. Id. at 149.

129. See text accompanying note 16.

130. I assume that the tax rates are expressed in a "tax-inclusive" way. See supra note 11.

131. See Warren-Fairness, supra note 65, at 944-45. In some situations, graduated rates can create a bias toward savings. For example, if the taxpayers' lifetime incomes are bunched into a few years and Spender spends her income on consumption as it is earned, whereas Saver spreads his consumption evenly over time, Spender may be exposed to rates

In Blueprints, Treasury's proposed solution to this problem was to provide taxpayers with the option of prepaying the cash-flow tax. In the example, if Saver were allowed to pay tax as though he immediately consumed the earnings, with no further tax consequences from the savings in year 1 or the consumption in year 7, Saver could obtain the identical tax result as Spender, and Saver would not be disadvantaged by the initial decision to save rather than consume. Saver, in effect, would "prepay" the cash-flow tax on the amount saved in year 1 and be excused from tax on consumption of the savings in later years.[132]

Treasury's suggestion was based on a familiar mathematical relation, sometimes known as the "immediate-deduction/yield-exemption equivalence." Under certain circumstances, a deferred tax on an item (and earnings thereon) has the same present value as an immediate tax on the item with no tax on the earnings.[133] As applied to the cash-flow tax, the rule means that a deduction of $100 in savings in the current year (and inclusion of that amount and accumulated earnings in income when consumed) is the same as including the $100 in income initially (forgoing the savings deduction) and exempting it and the future yield from tax when consumed.[134]

Various commentators have questioned the feasibility of the tax prepayment option because of the potential for manipulation by taxpayers to the detriment of the fisc.[135] Another problem is that it would permit anyone able to achieve an above-average return on an investment to pay lower cash-flow taxes by electing the prepayment option with respect to the investment.[136] Finally, even aside from its flaws, the option would not provide a complete solution to the problem created by graduated rates. In particular, if there is an intertemporal *decrease* in tax rates, the tax prepayment choice does not result in neutrality of the cash-flow tax in its treatment of present versus future consumption. A decrease in rates might occur as a result of

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higher than those ever experienced by Saver, with the result that the present value of Saver's tax liabilities may be less than that of Spender's.

132. See Blueprints, supra note 3, at 103, 112-15; Bradford-Untangling, supra note 3, at 91-92.

133. See E. Cary Brown, Business-Income Taxation and Investment Incentives, in Income, Employment and Public Policy: Essays in Honor of Alvin H. Hansen (1948), reprinted in Readings in the Economics of Taxation 525-37 (Richard A. Musgrave & Carl S. Shoup eds., 1959); Stanley S. Surrey, Pathways to Tax Reform 120-25 (1973).

134. See Blueprints, supra note 3, at 110-11; Bradford-Untangling, supra note 3, at 68-69. For the conditions under which this equivalence holds true, see Graetz, supra note 11, at 1602.

135. See Committee on Simplification, supra note 17, at 423-26; Graetz, supra note 11, at 1603-09.

136. See Graetz, supra note 11, at 1600-01; Steuerle, supra note 74, at 174; Warren-Would, supra note 65, at 1097-1109.

statutory changes or, more likely, simply because a taxpayer is subject to a lower marginal rate in a future year. Oddly, low-income taxpayers who move *up* the income scale might find themselves in that situation—facing *lower* marginal rates in the future—if the cumulative effect of tax benefit and transfer phase-outs during the period they have low incomes are taken into account.[137]

To illustrate this last point, assume in Saver and Spender's example that cash-flow tax rates are a flat 30% in year 1 and a flat 15% in year 7. Under those circumstances, Spender could consume $70 in year 1 after payment of $30 of cash-flow tax. If Saver invested the $100 and watched it grow to about $200 in year 7, he could then consume $170 ($200, less tax of 15% thereof), which is more than the present value of what Spender consumed. Spender is now disadvantaged and unless he is allowed to *post*pay his taxes until year 7, there is no way to equalize the two situations.

V. SUMMARY AND CONCLUSIONS

In this article, I have described some of the difficulties in designing a cash-flow tax to be as redistributive at the lower end of the income spectrum as the current income tax. I have shown that two asserted advantages of a cash-flow tax—administrative simplicity and neutrality in the treatment of present versus future consumption—would be seriously compromised by provisions intended to mitigate the tax burden of low-income taxpayers.

A good illustration of the difficulty is the implementation of a negative tax subsidy like the EITC as part of a cash-flow tax. To determine eligibility for such a subsidy, one would ordinarily need to know the economic income and resources of potential beneficiaries. However, under a cash-flow tax system, the economic income yardstick would be lost because the tax would be based on consumption, not income. Thus, it would be extremely difficult to determine in a cash-flow tax world who is low-income and therefore entitled to the negative tax subsidy. The switch to a cash-flow tax, and the resulting loss of the economic income measurement, would also impede the administration of other means-tested government transfer programs.

My review suggests that a cash-flow tax would be much less flexible in achieving progressivity than is often claimed. Policymakers interested in replacing the income tax with a broad-based consumption tax should therefore move toward this goal with considerable caution. If low-income taxpayers are to be accommodated within such a system, there is a great risk that many of

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137. See supra note 77.

the undesirable features of the income tax would have to be replicated in the cash-flow tax. It would be senseless to incur the sizable transition costs of changing tax systems if that were the ultimate outcome. On the other hand, if low-income taxpayers are not to be accommodated, or are accommodated in some manner outside of the tax system, a transactions-based consumption tax like a VAT would seem to be the preferable policy choice. Unlike a cash-flow tax, VATs are widely used. Substitution of a VAT for the income tax would eliminate tax returns for millions of taxpayers, and would increase the government's ability to tax economic activity taking place in the informal sector.