FLORIDA TAX REVIEW

VOLUME 2 | *1995* | *NUMBER 9*

A Consumed Income World—The Low Income and Prospects for Simplification—Replies to Professors Fleming and Yin

*Charles O. Galvin**

I. INTRODUCTION

As chair of the Committee on Tax Structure and Simplification of the Section of Taxation of the American Bar Association, I invited Professors Fleming and Yin to lead a discussion with members of the Committee on the effects of various proposed consumed income tax models. Splendid scholars as they are, each converted his informal remarks into a published article.[1]

Meanwhile, the airwaves have been surfeited with talk shows, interviews, and panel discussions dealing ad nauseam with flat, and flatter, taxes, a consumed income tax, a national sales tax, and various proposals for taxation of business income. The general obfuscation of important and critical issues often seems intentionally deliberate, and in any case, however presented, does little to inform the public. Of all the issues we have on our national platter—abortion, gun control, educational policy, crime in the streets—taxation is the most emotionally supercharged because it affects us all. We all pay taxes, direct and indirect; taxes pervade and permeate our lives. Why can we not have clear and direct demonstrations of what various proposals would accomplish? Some years ago, Louis Eisenstein wrote that the problem is not that the American people do not understand the tax system; rather, the problem is that they may come to understand it too well.[2]

Professors Yin and Fleming ably serve us by their analyses of current proposals. Nothing would be achieved by repeating their excellent exposi-

---

* Centennial Professor of Law, Emeritus, Vanderbilt University; adjunct professor of law, University of Texas; of counsel, Haynes and Boone, Dallas, Texas; M.B.A. 1941, J.D. 1947, Northwestern University; S.J.D. 1961, Harvard University.

1. J. Clifton Fleming, Jr., Scoping Out the Uncertain Simplification (Complication?) Effects of VATs, BATs and Consumed Income Taxes, 2 Fla. Tax Rev. 390 (1995); George K. Yin, Accommodating the "Low Income" in a Cash-Flow or Consumed Income Tax World, 2 Fla. Tax Rev. 445 (1995).

2. Louis Eisenstein, The Ideologies of Taxation 227 (1961).

tions. Some history and statistics, however, may be offer further perspectives on their presentations.

II. THE POLITICS OF TAX PROPOSALS

Both political parties have pandered to the public in offering a smorgasbord of tax benefits, each seemingly trying to outdo the other. The entire process has been overpoliticized. Consider by contrast some events of the past.

In 1977, a conservative Republican Secretary of the Treasury, William E. Simon, in his introduction to *Blueprints*,[3] urged that it was time to start from scratch with a tax system designed on purpose and not left to constant tinkering. Two models were offered: a comprehensive income tax and a cash flow tax.[4] The comprehensive model followed closely, but not exactly, the Haig-Simons model, which was recognized as the ideal. The differences between the Haig-Simons and comprehensive models were explained; most of the deviations from Haig-Simons were offered as more nearly administratively feasible. The cash flow model generally tracked the comprehensive income model but excluded from the base all savings and investment and income, gains, and losses thereon until such amounts were consumed. Under both models the corporate tax would be eliminated by integration with the personal income tax.[5]

In 1984, President Reagan directed his Secretary of the Treasury, Donald Regan, to develop proposals for major tax reform. Regan, also a conservative Republican, produced *Treasury I*,[6] which called for broadening the base, reducing or denying the benefits of deductions for upper income taxpayers, and eliminating tax benefits for various industries; it also included other proposals consistent with a Haig-Simons model.

The White House found *Treasury I* too far reaching and directed Secretary Regan to tone down the proposals. This he did in *Treasury II*,[7] which the President endorsed and which became the forerunner of the Tax Reform Act of 1986. That Act was the product of a bipartisan effort in both

3. William E. Simon, Forward to David F. Bradford, U.S. Dep't of Treasury, Blueprints for Basic Tax Reform at xxi-xxii (1984) [hereinafter Blueprints].

4. David F. Bradford, U.S. Dep't of Treasury, Blueprints for Basic Tax Reform (1984).

5. For an excellent analysis of both models and a plea for a hybrid, see Edward J. McCaffery, Tax Policy Under a Hybrid Income-Consumption Tax, 70 Tex. L. Rev. 1145 (1992).

6. 1 Dep't of the Treasury, Tax Reform for Fairness, Simplicity and Economic Growth: Overview at vii-viii [hereinafter Treasury I].

7. The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (1985). Treasury II is also known as Reagan I.

Houses, supported by the President.[8] It is fair to say that the 1986 Act, which moved in the direction of a Haig-Simons model, was praised by tax professionals, both conservative and liberal, throughout the country.[9]

Bipartisanship in tax legislation seems at an end, however, following the 1994 elections. We seem to have lost our moorings to the ideal of either a pure Haig-Simons model or a pure consumed income model; yet the consumed income model has achieved considerable current popularity, however mangled the versions may be.

III. Some Statistics—Haig-Simons or Consumed Income; Flat or Progressive Rates

Assume that a pure Haig-Simons system is in effect. Assume also that the interest rate is 10% and the tax rate is 20%. Taxpayer has $10,000 of income in Year 1 and, at the end of Year 1, invests the entire amount after taxes. At the end of Year 2, Taxpayer cashes in the investments.

Year 1		Year 2	
Income	$10,000	Investment Earnings (10%)	$800
Less: Tax (20%)	2,000	Less: Tax (20%)	160
Available To Invest	$ 8,000	After-tax Income	$640

Results:

Taxpayer's total resources at the end of Year 2:	$ 8,640
Government's total tax collections both years:	2,160
Total taxpayer's income accounted for	$10,800

Now assume that a pure cash flow, or consumed income, system is in effect:

Year 1		Year 2	
Income	$10,000	Investment Earnings: (10%)	$1,000
Less: Investment	10,000	Withdrawal From Account	10,000
Taxable Income	-0-	Taxable Income	$11,000
		Less: Tax (20%)	2,200
		After-tax Income	$ 8,800

8. For accounts of events leading to the Tax Reform Act of 1986, see Jeffrey H. Birnbaum and Alan S. Murray, Showdown at Gucci Gulf: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform (1987); C. Eugene Steuerle, The Tax Decade (1992).

9. See., e.g., Henry J. Aaron, The Impossible Dream Comes True: The New Tax Reform Act, Brookings Rev., Winter 1987 at 3.

Results:

Taxpayer's total resources at the end of Year 2:	$ 8,800
Government's total tax collections both years:	2,200
Total taxpayer's income accounted for	$11,000

The $200 difference between the two systems ($11,000 versus $10,800) is the result of the taxpayer's retention of an additional $2,000 from Year 1 to invest at 10%.[10] The government gains $40 in taxes (20% of the additional $200 of income), and the taxpayer gains a net of $160.

My own view is that under either a pure Haig-Simons regime or a pure consumed income regime,[11] *all* income should be accounted for at some time during the taxpayer's life. Assume that Taxpayer acquires no assets by gift or inheritance and earns $1 million during life. Under the Haig-Simons model, the $1 million is taxed as it is earned, and if any of the $1 million is saved, invested, and transferred by gift or at death, Taxpayer is taxed on gains and losses in the transferred property at the time of transfer.[12] Under a consumed income model, the $1 million is taxed as consumed, and my contention is that any part not consumed by Taxpayer should be taxed when transferred by gift or at death.[13] Taxpayer, by electing to save rather than consume, has made a decision to consume less in order that his family or others can consume more. Moreover, in either regime, gifts and inheritances should be income to the donee or beneficiary,[14] although, in a consumed income regime, the donee or legatee could immediately offset the income by investment. In either regime, wealth transfer taxes could, and should, be eliminated, I contend, because *all* income is taxed to the taxpayer earning it.[15]

10. A value added tax (VAT) on all consumption would apply to the same tax base as the consumed income tax in the illustration. Thus, a 20% VAT would produce the same result as the 20% consumed income tax.

11. There is an abundance of literature on both models. Professors Fleming and Yin have cited many of the principal authorities. See especially McCaffery, supra note 5.

12. See Lawrence Zelenak, Taxing Gains at Death, 46 Vand. L. Rev. 361 (1993); Charles O. Galvin, Taxing Gains at Death: A Further Comment, 46 Vand. L. Rev. 1525 (1993); Joseph M. Dodge, Further Thoughts on Realizing Gains and Losses at Death, 47 Vand. L. Rev. 1827 (1994).

13. The treatment of gifts and bequests under a consumed income tax is not without controversy. See Blueprints, supra note 3, at 30-39.

14. The concept of the marital deduction could be continued.

15. See Charles O. Galvin, To Bury the Estate Tax, Not to Praise It, 52 Tax Notes 1413 (Sept. 16, 1991); Robert B. Smith, Burying the Estate Tax Without Resurrecting Its Problems, 55 Tax Notes 1799 (June 29, 1992); Charles O. Galvin, More Reasons to Bury the Estate Tax, Letter to the Editor, 59 Tax Notes 435 (April 19, 1993).

How practical is all of the above? Just the maunderings of a superannuated academic? Hard statistics demonstrate otherwise. The vast majority of our citizenry is already taxed by the Haig-Simons or consumed income model. The Commissioner's Statistics of Income for 1992 show that almost 83% of filers reported less than $50,000 of adjusted gross income, and the income of this group is principally from wages and salaries.[16] These are people who live from paycheck to paycheck, consuming their income to defray ordinary living expenses. They do not have large investments in securities, rental properties, limited partnerships, 401(k) plans, and the like. Nor do they have substantial deductions for home mortgage interest, taxes, and charitable contributions; most rely on the standard deduction.[17] For this large group of filers, call it what you like, Haig-Simons or consumed income; their adjusted gross income, essentially cash with no accruals, is consistent with either model. Other statistics show that the bottom 50% of filers received about 15% of all income and paid about 5% of the taxes.[18]

With respect to all federal, state, and local taxes, the Tax Foundation's has found that a typical two-earner couple with two dependent children paid an overall effective tax rate in 1980 of 40.7% on median income of $26,879 and that for 1994, the effective rate is 39.5% on a median income of $53,354.[19] For the years in between (1981-1993), the effective rate on median income did not vary more than two percentage points. The empirical data demonstrate that the more load we take off the federal system the more the states have to pick up. At the median, the overall load changes practically not at all. The sales pitch from politicians for a federal flat tax often ignores the important factor of the regressivity of state and local systems.

IV. RECOMMENDATIONS

1. For all the fine work that Professor Yin and his colleagues have done on the earned income tax credit (EITC),[20] statistics suggest that we

---

16. Chris R. Edwards, Who Pays Federal Income Taxes? 66 Tax Notes 105, 108 (Jan. 2, 1995); Edward B. Gross, Jr., Individual Income Tax Returns, Preliminary Data, 1992; I.R.S. Stat. of Income Bull., Spring 1994 at 10, 11.

17. For 1992, the basic standard deduction was taken on 80,257,000 returns out of a total of approximately 114,000,000 returns (processed at the time of the report). Of the returns claiming the standard deduction, 76,654,000, over 90%, reported adjusted gross income under $50,000. Gross, supra note 16, at 12, 24.

18. See Edwards, supra note 16, at 106.

19. Chris R. Edwards, Typical American Family Pays 40 Percent of Income in Taxes, 66 Tax Notes 735, 736 (Jan. 30, 1995).

20. 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 (1994); George K. Yin & Jonathan B. Forman, Redesigning the Earned Income Tax Credit

might, without substantial loss in tax revenues, drop the bottom half of the filing group completely, eliminating one half the returns, one half the paperwork, and substantial administrative costs.[21] The EITC is a worthy and commendable concept, but for the filing group affected, it is too complicated. Moreover, it has led to some fraudulent practices, difficult to audit, in which low-income taxpayers *overstate* their income in order to obtain larger refundable credits.

2. With the utmost respect for Professor Fleming's concern about a VAT,[22] concerns which I share, I have become persuaded to the view that everyone ought to pay some federal taxes, even if it is a few pennies on a cake of soap or a tube of toothpaste.

We have been warned by the IRS that compliance is down, audits are down, and the tax gap is rising. As a nation, we have also been made aware of groups who believe that the federal government is in a conspiracy against them. As I watch the accounts of these groups on the evening news, I find it difficult to believe that any one of their members sits down before each April 15 and conscientiously completes and signs a Form 1040. As if that were not enough, we are advised by the IRS that some of our most distinguished professionals—yea, even tax professionals—are not filing returns; as a consequence, the IRS proposes to increase the examination of partnership returns to assure, inter alia, that income allocated to partners is correctly reported.[23]

Frankly, I worry about the tax gap. We are not going to close it. It may get even wider, and this has got to be a morale factor for honest citizens who comply. Some form of national sales tax on *all* consumables might at least assure that everyone is contributing something to the cost of the central government.

3. Broadly stated, I favor the Haig-Simons model over the cash flow model, as described in *Blueprints*. With sophisticated computer technology and with the elimination of 50% of the filers, could we not require taxpayers to recognize gain or loss on readily marketable assets by a mark-to-market system? With respect to assets not readily marketable, could we not defer recognition of gain or loss until sale or other disposition (including transfers by gift and at death) and then average back the gain or loss over the holding

---

Program to Provide More Effective Assistance for the Working Poor, 59 Tax Notes 951 (May 17, 1993).

21. See Edwards, supra note 16, at 106.

22. See Fleming, supra note 1, at 395.

23. Barbara Kircheimer, IRS Plans to Double Staffing For Partnership Examinations, 65 Tax Notes 391 (Oct. 24, 1994).

period, perhaps as we now do for complex trusts in applying the throw back rule?[24]

4. In regard to encouraging savings, has not our experience since 1981 demonstrated that we cannot grow ourselves out of deficits by lowering taxes? Does anyone remember that from the middle 30s until 1964, individual income tax rates ranged from 20% to 91%, corporate income tax rates were as high as 54% (with a rate of 95% on excess profits during World War II and the Korean conflict), and estate tax rates ran to 77% (gift tax rates to 57¾%)? With that structure, we paid the cost of World War II and the Korean conflict, financed the Marshall plan to rebuild post-war Europe, and were a creditor nation to all the world. The country had low inflation and good productivity. How did we get mesmerized into believing that low taxes with high deficits would lead us to the Promised Land?

5. Finally, I concede that we cannot have Haig-Simons or cash flow, but must have some hybrid. In this connection, therefore, could we not draw upon some of the literature on Pareto optimality, Kaldor-Hicks efficiency, and Mirrlees models to demonstrate econometrically desirable systems of income distribution?[25] To be sure, any popular discussion of these matters through talk shows, panels, op-ed columns, and the like would invoke yawns and glazed eyes, but in a complex economy, it is just this kind of thoroughgoing research and analysis which we require before plunging headlong into more tinkering that a former conservative Republican Secretary of the Treasury said we should avoid.[26]

We are indebted to Professors Fleming and Yin for their thoughtful disquisitions on complex subjects which continue to occupy such important positions on our national agenda.

---

24. The throwback rule is now an anachronism as the compression of rates on trust income usually militates in favor of distributing trust income rather than retaining it in trust for later years.

25. See, e.g., McCaffery, supra note 5, at 1156; Joseph Bankman & Thomas Griffith, Social Welfare and the Rate Structure: A New Look At Progressive Taxation, 75 Cal. L. Rev 1905, 1946 (1987).

26. William E. Simon, Forward to Blueprints, supra note 3, at *xxi*.