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SIMPLIFYING ASSUMPTIONS:

HOW MIGHT THE POLITICS OF CONSUMPTION TAX REFORM AFFECT (IMPAIR) THE END PRODUCT?

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Preliminary Draft

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I. INTRODUCTION

One of the main advantages of consumption taxation that its advocates, including me, have claimed is simplification. A consumption tax, according to this claim, would be a great deal less complicated technically than the present income tax – requiring, for example, far fewer pages of tax statutes and regulations. More importantly, however, advocates of consumption taxation claim that its enactment would lead to a significant reduction in the resources devoted to tax planning, compliance, and administration, reflecting reduced opportunities to affect one’s tax burden by engaging in purely tax-motivated transactions, or by choosing between economically equivalent tax characterizations of one’s activities. This difference has been attributed, moreover, to eliminating structural features of the federal income tax, such as the realization requirement, rather than to the possible advantages of starting fresh with fewer barnacles than the current system has accumulated.

* Wayne Perry Professor of Taxation, NYU Law School. This article was commissioned for a conference on fundamental tax reform hosted by the James A. Baker Institute for Public Policy, to be held at Rice University on April 27-28, 2006. I am grateful to Alan Auerbach, Joseph Bankman, Itai Grinberg, Edward Kleinbard, Michael Schler, David Weisbach, and the participants in a Tax Policy and Public Finance Workshop at UCLA Law School for helpful comments on an earlier draft.

No responsible advocate of these views has doubted that serious compliance and interpretive issues would remain, such as cracking down on fraud and distinguishing between personal and business expenditures. The thought has been, however, that eliminating realization and related timing issues is bound to make things a lot better. The simplicity gains seem larger still if one takes the view that certain structural features of the current system, such as the two-level corporate tax and the debt-equity distinction, would be easiest to eliminate in a change of systems even though they are not intrinsic to an income tax.

However compelling one finds this line of argument, it cannot be deemed fully persuasive until one has looked carefully at the weak spots and pressure points that an actual consumption tax would likely have. Fortunately, the tax policy literature has recently started to do this (Weisbach 2000, Weisbach 2003, Bankman and Schler 2005). The conclusion that seems to be emerging is that a well-designed consumption tax, while likely to face significantly greater tax planning and compliance issues than its advocates might have expected or hoped, would nonetheless probably be simpler than the current income tax.

This conclusion, although important if accepted, still does not put the tax simplification issue to rest. It reflects comparing a conceptually pure consumption tax, with only limited departures from the ideal other than for administrative reasons, to our actual income tax. Perhaps one could design an income tax, featuring administrative compromises only, that would be simpler than a consumption tax that Congress had been subjecting to its dark arts for the past ninety-odd years.

Given this problem, my aim in this paper is to take the consumption tax literature on simplification a step further, by adding politics to the picture. How would simplification be affected by changes to the proposed models that would be adopted in the course of actually enacting a consumption tax? For example, to what extent would tax shelters, even insofar as they would have been eliminated under the pure models, remain a problem by reason of politically induced changes in the design?

This inquiry necessarily involves stepping deep into the speculative wilderness. As Harold Wilson once said, a week is a long time in politics. Predicting what might happen in coming years is beyond anyone's powers. What is more, since I personally am skeptical about the prospects for replacement of the current income tax by a consumption tax, the issue has overtones for me of the Monty Python inquiry, "What if Queen Victoria could fly?"

The inquiry becomes a bit more tractable, however, if one emphasizes two particular questions. The first is what sorts of political scenarios would be most likely to lead to a major consumption-based tax reform. The second is what sorts of powerful political interests would likely need to be accommodated in the course of enactment.

I analyze these questions in section II, where I select two main scenarios to examine. The first is a bipartisan process, like that underlying the enactment of the Tax Reform Act of 1986, that yields a progressive consumption tax based on David Bradford's X-tax model, but as heavily modified by the need for political compromises. The second is a Republican-led stealth process of moving towards consumption tax treatment of saving and investment without explicitly abandoning the current income tax.

Section II also discusses the main political and policy interests that might need to be accommodated in a major consumption-based reform. Section III discusses the possible implications for the stealth reform scenario of political factors, and section IV does the same for the bipartisan X-tax scenario. Section V offers a brief conclusion.

II. THE POSSIBLE POLITICS OF CONSUMPTION-BASED TAX REFORM

A. Choosing Plausible Scenarios

Consumption-based tax reform cannot just appear one day, like the Ten Commandments in the Biblical tale. There would have to be a particular way in which it happened, including a specific political process that ended in its enactment.

The problem of how it could happen may initially seem more open-ended than I believe it really is. With relatively fixed institutions, including not only Congress and the Presidency but political parties and interest groups, the process that leads to major tax legislation tends to involve one or another of a finite set of recognizable scenarios. In 1981, for example, enactment of the Economic Recovery Tax Act (ERTA) resulted from a Reagan Administration campaign proposal followed by a bidding war between the two parties' Congressional leaderships. By contrast, the Tax Reform Act of 1986 emerged out of cooperation, albeit conflictual at times, between the Reagan Administration, the Democratic leadership of the House, and a relatively independent Republican leadership in the Senate, helped along by an array of retail-level concessions to particular members or interests that was needed because the leaders lacked the clout simply to impose their will. In 2001 and 2003, a Republican Administration with tight parliamentary-style control of both houses of Congress was able to push through pretty much the legislation it wanted, subject to some Congressional redesign and scaling back in 2003 especially. Each of these different scenarios ended up affecting the final content of the legislation.

Obviously, it is impossible to say with any confidence how, if it came to pass at all, consumption-based tax reform would end up being enacted. National politics is a huge chaos system in which not only the inputs, but their relationship to the outputs,

resist prediction. The specific scenario that would prevail, if any did, is fundamentally unknowable in advance. Still, the bold at heart can venture to identify the scenarios that they consider most likely.

Looking at the types of scenarios that have prevailed in recent tax legislation, a bidding war can be ruled out on the view that, in light of the long-term U.S. fiscal gap, the consumption-style reform would need to be at least roughly revenue-neutral over the official estimating period. Proponents therefore could not easily bid for support from one group without taking money from another group – hardly a recipe for bidding wars, which thrive on positive-sum games so far as the represented interests are concerned.

A bipartisan process after the manner of the 1986 tax reform would require that key Democrats embrace switching to consumption taxation in exchange for Republicans accepting sufficient progressivity. The rise of proposals, such as David Bradford's X-tax, that could largely match the progressivity of the current system makes this technically feasible, while leaving open the question of whether it is politically feasible. A process led at all levels by Republicans also seems possible, given their current control of Congress and the executive branch, along with widespread Republican interest in consumption taxation. A purely Democratic-led consumption-based reform is implausible given Democrats' support for income taxation. We have, therefore, two main scenarios to consider: a bipartisan bargain and a Republican-led exercise that is relatively top-down in parliamentary fashion.

B. Scenario 1: Bipartisan Consumption Tax Reform

The bipartisan bargain in 1986 relied on broadening the base and lowering marginal rates, in a manner that was estimated (under official conventions) to be revenue-

neutral and distributionally neutral over a five-year period. The analogous bargain that one might expect in the event of a bipartisan consumption-style reform seems fairly straightforward: the Democrats would agree to exempt capital income (insofar as an income tax reaches it and a consumption tax does not),¹ in exchange for the Republicans' accepting sufficiently graduated rates to bring about approximate revenue and distributional neutrality within the estimating period. This scenario raises three immediate questions, however. Under what circumstances might the parties agree to it? What other political prerequisites might need to be satisfied? And what model for consumption-based reform would the parties adopt?

1. A Bipartisan Bargain?

In today's hyper-partisan political environment, a 1986-style agreement between Republicans and Democrats to pursue consumption-based tax reform seems impossibly remote. Not only are the parties currently averse to cooperating on controversial matters, but the basis for a deal does not exist. For one thing, the unsettled revenue picture that results from the scheduled expiration of the 2001 tax cuts means that the parties lack a common baseline for setting revenue and distributional targets. For another, there has been no indication that Democrats' potential enthusiasm for such reform is any greater than for modifying Social Security to use individual accounts.

If things were to change however, the parties' internal dynamics offer a basis for predicting how they would change. Both parties can be described as having, broadly speaking, two main factions or orientations in fiscal matters: one that is closer to the views of activists in the party "base," and one that is more centrist. Among Republicans,

¹ (Cite to recent i-tax vs. c-tax literature)

while the anti-tax “base” has been ascendant since George W. Bush took office, and to a lesser degree since the “Contract with America” Congressional campaign of 1994, the more deficit-averse centrists often controlled tax policy between 1982 and 1990, and are not entirely extinct at least in the Senate. The centrists might regain some influence if the anti-tax wing were blamed for one or more national political defeats.²

Among Democrats, the battle between the more liberal supporters of traditional party themes and the more centrist Democratic Leadership Council types has been ongoing for many years. President Clinton showed how a deft practitioner of the latter approach can grasp and thereby neutralize seemingly Republican themes, as when he embraced the death penalty, called for making abortion rare albeit still legal, and participated in ending “welfare as we know it.” A Democrat seeking national prominence in coming years via the Clinton strategy would have good reason at least to consider progressive consumption taxation, and indeed to embrace it as a forward-looking “third way” if its political salability seemed good enough (which I admittedly doubt it would).

The party-level prerequisites for a bipartisan embrace of major consumption-based reform therefore seem clear. Centrist Democrats and Republicans would need to have gained sufficient traction to lead their parties towards a deal that could stick despite dissent from the left and right wings. This, in turn, would presumably have to follow a series of Democratic victories that fell short of reversing Republicans’ current dominance and indicated that the parties had no good alternative to working together.

2. Other Political Prerequisites

² Criminal indictments of leading anti-tax movement leaders, such as Grover Norquist, might also affect the Republican’s internal political dynamics.

The 1986 experience helps point us to other political prerequisites that might need to be satisfied, even if not in exactly the same way this time around. For one, the 1986 Act offered the public a sweetener along with the bitter medicine of repealing various tax preferences, by significantly lowering marginal rates. In 2005, the Tax Reform Panel appointed by President Bush attempted to reap a similar political benefit from proposing repeal of the alternative minimum tax (AMT), but found that this was not a good enough sweetener given that the AMT has not yet become as widely applicable as experts anticipate it will.

Perhaps AMT repeal would make more of an impression once it has begun to apply very widely. Or perhaps a revenue-conscious trade-in of the AMT, at least in part for higher rates, would be needed for tax reform once again to offer a sufficiently tolerable tradeoff of gain for pain. Of course, for rate reduction to be possible in the context of moving to a progressive consumption tax without excessive revenue loss, the accompanying revenue gains would have to more than offset the impact of removing the inter-temporal burden of the income tax on investment and saving. Imposing transition losses on existing wealth might need to be part of the story for this to be politically feasible.

Rate reduction and other direct benefits from reform may be needed politically for more than simply making the reform package palatable to the general public. Since interest group opposition to base-broadening is inevitable, reform proponents might need, not just to buy off the most powerful opponents, but to have some real supporters. In 1986, service industries took this role, since they benefited from the rate reduction and were not adversely affected by the hit on capital-intensive industries from repealing the

investment tax credit and slowing down tax depreciation. For a move to consumption taxation, the capital-intensive industries seem the more logical ally, especially if the AMT trade-in had involved moving cost recovery in more of an income tax direction.³ Rate reduction would make the shift an even better deal for these industries, while also creating a possible basis for support from others that were not losing industry-specific preferences.

Again, I am not arguing that any of this is likely to happen. The point, rather, is that this offers a plausible scenario for how it would happen if it did.

3. Choice of a Progressive Consumption Tax Model

A crucial question, under the scenario of bipartisan consumption-based reform, is what model the parties would adopt. Two main alternatives have emerged in the tax reform literature of the last few decades. The first is a cash-flow tax on individuals, such as those discussed in Kaldor (1955), Andrews (1972?), and in the Treasury Blueprints Study (Bradford et al 1977). Under this approach, at least in its pure form, individuals, as opposed to businesses, would generally be the only parties designated as taxpayers. They would file tax returns as under present law, but with unlimited savings account deductions and – importantly – inclusion of borrowing.

The second is a two-tier consumption tax, such as the Hall-Rabushka flat tax or David Bradford's X-tax. Under this approach, both businesses and individuals would make tax payments to the government. The tax system would at least roughly resemble a value-added tax (VAT) such as those in widespread use around the world, modified to

³ Similarly, in 1986, the dramatic move towards income taxation came only five years after 1981's dramatic movement in the direction of expensing-equivalence for capital investment.

make wages deductible by businesses and includable by the individual recipients.

Progressivity would be achieved through the rate structure applied to individuals' wages.

David Bradford, who played a central role in developing both approaches, devoted the design efforts of his later years exclusively to the X-tax. In conversation, he explained this as motivated by his belief that the X-tax was not only simpler (since individuals' borrowing and investments would not need to be tracked), but politically more feasible given the optics of classifying businesses as taxpayers rather than as non-taxpayers.

The subsequent example of the 2005 Tax Reform Panel, which proposed an X-tax but with an appended, if ill-fitting, 15 percent tax on individuals' investment income, helps to dramatize the political dilemma that consumption tax advocates face. So long as people conceive of businesses and their owners as distinct persons, taxing business income at the individual level prompts the complaint that one is exempting "business," while doing so at the business level prompts concern about the owners of financial interests in businesses who are not being directly taxed. This dilemma is potentially bad news not just for consumption taxation, but even for corporate integration under the income tax.

From the standpoint of the X-tax, the possible (whether or not sufficiently salient) responses are not limited to pointing out that taxing a business is a lot like taxing its owners. In addition, one could make the point that the entire wage tax component of the X-tax is simply a device for delivering wage subsidies to the extent of people's wage income below the top bracket. If people accept that coupon-clippers pay a retail sales tax or VAT when they consume, one would like to think that they could recognize that

making a revenue-neutral shift from such a tax to an X-tax actually *increases* the tax burden on coupon-clippers, since higher rates presumably are necessary to pay for the wage subsidy.

While opinions may reasonably differ regarding which of the two structures is politically more feasible, two considerations apart from the business-level tax arguably support considering the X-tax the more likely tax reform vehicle. First, it has received significantly more attention in the last few years than cash-flow prototypes, as in the Tax Reform Panel's modified X-tax proposal. Second, the need expressly to include borrowing as taxable in a workable cash-flow tax strikes me as a political Achilles heel. "Expressly" is the key word here, as no one seems to worry about the fact that retail sales taxes and VATs effectively include borrowing by applying to consumer purchases whether debt-financed or not.

Experts may regard it as obvious that, if saving is deducted, dissaving should be included. The public, however, may not agree, given that loan proceeds, unlike wages, are not "income" in ordinary usage. Thus, consider the USA tax, prominently proposed by Senators Nunn and Domenici in 1995, to which I will refer intermittently on the view that it represents an effort by politically savvy people to design a feasible consumption-based reform. While similar to a cash-flow tax at the individual level, albeit with a business level tax as well, the USA tax did not include loan proceeds as income. This was one reason among others why experts swiftly concluded that it was unworkable (see, e.g., Kaplow 1995; Warren 1995). Given the likely political importance of being able to demonstrate basic workability, cash-flow consumption taxes may face an insoluble

political dilemma, in the form of “damned if you do and damned if you don’t,” with respect to their treatment of loan proceeds generally.

I therefore adopt as my bipartisan scenario the enactment of something based on the X-tax, albeit as modified by passing through the Congressional meat grinder in a process that involves a need to court or at least mollify politically powerful interest groups.

C. Scenario 2: Republican-Led Consumption Tax Reform

It is no secret that many of the Republicans most hostile to the current income tax would like nothing better than to replace it with a national retail sales tax (NRST), perhaps accompanied by some sort of rebate to ease the sting of its lacking a zero bracket for low-income individuals. In my admittedly subjective judgment, however, this is not a political scenario to take seriously. An NRST, in addition to being regarded by experts as unworkable and likely to require an unattractively high nominal rate⁴ (see, e.g., Gale ___), strikes me as no easier to sell to the general public than Social Security privatization. Its evident regressivity (relative to current law) once in place may be disqualifying despite its one-time transition hit on existing wealth upon enactment.

The flat tax is a second Republicans-only possibility, but this as well has proven a hard sell politically. The X-tax would presumably be too progressive to appeal to Republicans in a process that they led unilaterally. What is more, any sort of fundamental tax reform that looks too dramatically new is hard to accomplish with only one party on board, given the likelihood of voter unease (and angry losers if the

⁴ (Note that one reason for a high nominal rate under a national retail sales tax is the convention of stating it tax-exclusively rather than tax-inclusively. Efforts to shift the convention would be noted by foes.)

enactment is anywhere near revenue-neutral) that the opposition party might be all too eager to stoke.

How to proceed in a Republican-dominated consumption-based reform would therefore be a puzzle if the process had to be overt. Recognizing the political problems with this course, however, many Republicans have already been calling for what they openly acknowledge is a stealth approach to consumption-based reform. Under the so-called “five easy pieces” scenario (Christian and Robbins 2002), a de facto switch to a consumption tax would involve the following five steps, all of them already advanced by recent Republican-led legislation:

- 1) Reduce marginal rates (a step that I will ignore, important though it is to the Republicans’ anti-tax wing, as it has nothing to do with the choice of tax base).
- 2) Provide expensing for all business outlays.
- 3) Adopt corporate integration.
- 4) Significantly increase or eliminate the deductible contribution limits for Roth-style IRA savings accounts.
- 5) Move towards a territorial rather than a worldwide system of taxing U.S. businesses, by exempting export and other foreign trade income of U.S. companies.

Leading conservative activists have eagerly embraced the idea. Thus, Stephen Moore, the president of the Club for Growth, urges consumption-based tax reform in “three or four or five easy pieces.” Likewise, the ubiquitous Grover Norquist emphasizes the need for stealth in any consumption-based reform, in order to blunt Democratic political attacks (Andrews and Kirkpatrick 2004).

The proponents of “five easy pieces” have not addressed borrowing, such as by limiting the politically popular home mortgage interest deduction. Indeed, they have not suggested any tax changes to offset the revenue loss from the proposed steps. The proposal that marginal rates be reduced alongside the other changes would seem to refute any notion that the exercise is meant to be revenue-neutral. The anti-tax, “starve the beast” philosophy of leading proponents, who generally come from the Republicans’ currently ascendant anti-tax wing, suggest limiting tax increases to targets with more potential appeal to the base, such as state and local income tax deductions. They might also seek to “pay” for revenue-losing reform by simply shifting other projected revenues forward, such as by requiring or encouraging conversion of traditional IRAs into Roth IRAs. Finally, the centrists, who might be expected to care more about the new system’s effective functioning, might offer little protest if they remain submerged politically.

Even without this exact pattern, stealth by its nature is likely to affect the end product. A one-party process in which public discussion and debate are kept to a minimum eliminates the dynamic whereby multiple players must refine their proposals in the course of their competition, negotiation, and efforts at persuasion. Like other Republican legislative efforts of the last few years, the enactment process would presumably be run by a handful of party insiders and lobbyists with limited interest in making the tax system work well, and less willingness to seek or even permit outside feedback. The improvements and corrections that one might expect either from an open process or from one run by experts might therefore be considerably be less likely than in the more open, bipartisan X-tax scenario.

D. Other Possible Scenarios

Other consumption-based reform scenarios plainly cannot be ruled out. However, only one has attracted enough recent attention to merit brief discussion here. This is Michael Graetz's proposal to adopt a straight VAT while raising the exemption amount (such as to \$100,000) in the present income tax or alternative minimum tax (AMT).

I personally am skeptical about Graetz proposal's political prospects, although then again I am skeptical about my two proposed scenarios as well. From a Republican standpoint, it adds a VAT without slaying the income tax, creating the possibility that the income tax exemption amount would start creeping downward again. From a Democratic standpoint, the difficulty of adjusting for the varying personal and household circumstances of families below the exemption amount suggests that the Graetz plan would raise significant low-end equity concerns. Without individual returns, it becomes difficult to provide rate graduation or adjust for household circumstances (such as the number of children) at lower income levels. Graetz's suggestion that employers might handle such adjustments has been challenged as administratively unrealistic (Center for Budget and Policy Priorities 2005), and might also be unwelcome to companies that did not want to take on the extra burden.

More to the point, however, given that all of the possibilities face political obstacles, I would argue that the Graetz proposal does not really belong in a discussion of the possible simplification gains from a consumption-based reform. While Graetz touts the simplification that would result from relieving individuals with income below the threshold from needing to file annual tax returns, his plan offers less promise of simplifying business taxation and that of wealthy individuals, which is where the really significant amounts of money are spent on tax planning and compliance.

A scenario that I find more plausible than any discussed thus far, but that likewise lies outside the scope of this paper, would be the following two-step shift towards consumption-based reform. First, a VAT is enacted – not, as in the Graetz plan, for tax reform purposes, but rather to fund Social Security and Medicare benefits at a point when they were in imminent fiscal danger (see Shaviro 2004, ___). This alone would not result in simplification if the income tax remained in place, but one could imagine, as the second step, a shift over time towards greater reliance on the VAT, perhaps accompanied by adjusting it in the fashion of the X-tax to reflect distributional concerns. This two-step process, however, strikes me as too long-term and unpredictable to merit separate consideration here.

E. Significance of the Fiscal Gap for Consumption-Based Reform

The United States currently faces an enormous long-term fiscal gap, suggesting that tax increases are highly likely down the road (Shaviro 2006; Kotlikoff and Burns 2004). One feature that addressing the fiscal gap and overtly engaging in major tax reform have in common is that both are likely to be politically wrenching and controversial. Engaging in just one at a time would be difficult enough (even if, in the case of addressing the fiscal gap, it proves unavoidable). In my view, doing the two of them together would be even harder. It has often been said that major tax reform cannot raise revenue if it is to be politically feasible, and indeed that it has much better chances if it loses revenue, given that losers from tax changes tend to complain more strenuously than winners rejoice. In the case of the officially revenue-neutral 1986 reform, individuals as a group nominally gained, with the consequent revenue loss being offset by a tax increase on corporations that had murkier incidence and that came at a time when

corporations' political stock was unusually low due to the flood of contemporary news accounts of highly profitable companies that had paid little or no tax.

Consumption-based reform would therefore likely take place under the shadow of a fiscal gap that was likely to require significant revenue increases soon. This might be important, even if scrupulously ignored in the enactment process, due to its possible effects on planning and on the credibility of legislative commitments under the reform.

F. Important Political Interests That Might Affect the End Product of Consumption-Based Reform

A comprehensive consumption tax with household filing would already be more complicated than a straight VAT, albeit for good reason given the adjustments it would permit for household circumstances. The process of complicating adjustment is unlikely to end there, however. Reflecting both arguments on the merits and raw political power, a whole host of further departures from the simplest consumption-based model would be likely. Accordingly, in this section I catalog some of the main areas where additional complexities, whether merited or not, would likely be demanded by important interests and/or policy considerations.

1) Home ownership – Few tax benefits in the existing income tax are more entrenched politically than those pertaining to home ownership. The true starting point for preferentiality is the exclusion of imputed rental income. Taking this as given, however, the main tax benefits are the itemized deduction for home mortgage interest and real property taxes, along with the exclusion for up to \$500,000 of gain on the sale of a home. Of these benefits, the home mortgage interest deduction appears to be the most

politically sacrosanct. Thus, the USA tax would have retained it, although the Tax Reform Panel proposed significant curtailments.⁵

2) Charities – Deductions for charitable contributions likewise stand on strong political ground, as shown by their retention under the USA tax and in the Tax Reform Panel’s plans. The special rule permitting donors to deduct the value, rather than just the basis, of appreciated property that they donate may be less strongly rooted, although it has defenders. The USA tax, but not the Tax Reform Panel, would have eliminated it.

There also is good reason to expect that the tax-exempt status of charitable organizations would generally be continued. However, the existence under present law of a tax on charities’ unrelated business taxable income (UBTI) suggests the possibility that Congress might want to continue limiting the exemption to what it regarded as core charitable activities.

3) State and local governments – Under the administratively simplest consumption tax models, state and local governments would absorb a number of unfavorable changes. First, they would take a significant indirect hit if the current itemized deduction for various state and local taxes (such as income taxes) was eliminated. The Tax Reform Panel proposed disallowing as well state and local taxes paid by businesses.

Second, if interest income was generally tax-exempt, the state and local government issuers of municipal bonds that yield tax-exempt interest would seemingly lose their competitive advantage. However, if rival issuers lost their interest deductions, the overall effect would be a wash in cases where the business borrower and the lender

⁵ [15% credit, lower ceiling on loan principal. But extended to non-itemizers]

were in the same marginal rate bracket.⁶ Given that municipal bonds are mainly sold to investors with relatively high marginal tax rates, this point casts considerable doubt on the claim that municipal bond issuers would lose a current advantage. On balance, their business competitors might be the ones who lost ground with respect to borrowing, since the businesses would no longer be able to deduct the interest expense associated with payments to tax-indifferent counter-parties.

This analysis shows, contrary to conventional belief, that state and local governments would not lose a competitive advantage with respect to borrowing as such. Under present law, the municipal bond preference merely preserves the advantage of being tax-exempt even in cases where one uses debt financing. The reason governments might lose ground is that businesses competing with them for capital, whether through borrowing or not, would face a lower effective tax rate on their investments. Thus, increased capital might flow to the business sector, potentially drawing from the tax-exempt sector as well as from abroad and from increased national saving.

Nonetheless, it would be unsurprising if complaints focused on the loss of competitive advantage from municipal bonds' tax exemption, as determined by looking purely at taxation of the holder. The USA tax preserved the comparative status of municipal bond interest by making it better than exempt. The mechanism was permitting taxpayers who have deducted the cost of purchasing the bonds to include only

⁶ In illustration, suppose the interest rate was 10 percent and that all taxpayers faced a 30 percent marginal rate. Municipal bonds would presumably pay 7 percent interest, giving them the same after-tax return as taxable bonds. The after-tax interest cost of issuing taxable bonds would also be 7 percent. If the tax rules were changed so that the interest on previously taxable bonds was neither includable nor deductible, their pre-tax rate presumably would change to 7 percent, but this would have no direct effect either on the supply side or on the demand side.

repayments of principal, while excluding interest receipts. Even if this type of proposal lost out due to its peculiar optics, the underlying complaint might conceivably encourage other concessions.

A final, arguably less serious, complaint that State and local governments might make would pertain to the loss of their present ability to “piggyback” on federal tax returns when levying income taxes. It might be easy enough, however, for them to piggyback on the new federal consumption tax instead.

4) Pensions and other retirement-related financial products – Under a standard neoclassical view of rational optimizers making savings decisions to maximize their expected utility over time, one probably would not expect eliminating the special status of tax-favored retirement plans, by excluding *all* returns to saving, to reduce retirement saving. Economists increasingly recognize, however, that savings behavior often does not seem consistent with rational optimization. For example, it appears to be strongly affected by the choice of default rule (e.g., whether one must opt in or opt out of participating in an employer pension plan), even if participants can easily change the default.

A consumption tax, depending on its structure, might undermine the degree of non-incentive-related encouragement of retirement saving that results under present law simply from having official ceilings on deductible contributions to retirement plans. Accordingly, policymakers might conclude that something needed to be done to induce retirement saving after the policy change – whether through incentives (such as affirmatively subsidizing retirement saving) or through default rules and other steering or jawboning devices.

5) Financial service businesses – The taxation of financial service businesses can be a big problem under a consumption tax, because payment for the services may be embedded in financial instruments that some consumption tax models, such as the X-tax, generally ignore. The resulting effective exclusion of financial services from the consumption tax base would create an inefficient tax preference for these services relative to other consumption.⁷

A similar problem exists under the current income tax, where financial institutions embed service fees in the interest rates they pay, thus giving consumers an implicit deduction. A consumption tax may make the problem both larger and more overt, however. Accordingly, unless restrained by the political power of such institutions, one might expect a greater effort to address the issue of exempt services than there has been under the existing income tax.

6) Health insurance and healthcare – The exclusion for employer-provided healthcare is one of the costliest tax benefits under the current income tax. Presumably, repealing it would be politically difficult under the current system. Shifting to a consumption tax, even one with a very different structure, might not greatly change the political considerations.

The biggest policy problem with the exclusion, which is its encouraging over-insurance as a way of making routine healthcare expenditures implicitly deductible, could be handled either by repealing or capping it, or by making all healthcare expenditures deductible. While the Tax Reform Panel proposed capping the exclusion, the approach

⁷ Grubert and Mackie (2003) argue that financial services should be thought of as investment inputs and as facilitating appropriate consumption smoothing, rather than as themselves ultimate consumption goods. Accordingly, they regard as the appropriate and efficient outcome under a consumption tax. But see Auerbach 2003.

of increasing medical deductions might have greater political appeal. In 2003, Congress added a new deduction for contributions to individual health savings accounts, and some experts have recently called for making medical expenses generally deductible (see, e.g., Cogan, Hubbard, and Kessler 2004). It therefore seems possible that favorable treatment, either for health insurance or for healthcare expenditures generally, would continue after the enactment of consumption-based reform.

7) Education – Present law contains a plethora of distinct tax benefits for educational expenses such as college tuition. While having so many makes little sense, the underlying issue of whether to provide tax benefits for education is independent of the choice between income and consumption taxation. The USA tax contained a limited tuition deduction, while the Tax Reform Panel offered the opportunity to make tax-free use of an IRA-style saving account to fund education expenses.

8) Oil and gas companies – Few industries have the political clout of oil and gas, which seems to fare well in a variety of political environments, ranging from the 1986 Act to energy policy under the George W. Bush Administration. While conceptually pure consumption tax systems would not offer special benefits to the oil and gas industry (leaving open the question of whether the benefits would simply migrate to other areas in federal law), one might not want to bet against their being found in any consumption tax that Congress actually enacted.

Often, under the existing income tax, benefits to particular industries involve timing. For example, a favored industry might be permitted to expense capital outlays. This tool for providing tax benefits would be eliminated if capital outlays generally were expensed. This does not mean, however, that the quest for special tax benefits would

cease. Oil and gas companies would have plenty of options regarding the proposed structure of continuing tax preferences. For example, under the VAT-style business component of the X-tax, they might seek lower tax rates, like those applying to particular industries or items under various European VATs. Or, as under the old income tax rules for percentage depletion, they might seek to deduct more than 100 percent of their costs. Another alternative would be tax credits, such as the old investment tax credit, in addition to (or instead of a portion of) the expensing deduction. Yet another possibility would be expensing plus exclusion on the income side, as under the USA tax proposal for municipal bonds.

9) Other special industry rules – While the power of the oil and gas industry is a given, other industries likewise invest enormous resources in lobbying Congress. Even if it is difficult to predict which industries would do best under a newly enacted consumption tax, it seems almost inevitable that a large number, with strong political connections, would seek favored treatment with some hope of success.

10) Necessities such as food and rent – Retail sales taxes in the United States are notoriously less than comprehensive. Among other gaps, they often exclude consumer items that are considered necessities, such as food purchased for home preparation. The idea, presumably, is to increase the progressivity of the given tax instrument, notwithstanding that higher earners may typically spend higher absolute amounts on the excluded items. Under a national consumption tax, even with an individual-level component that permitted the achievement of progressivity, one cannot rule out the possibility that similar motivations would prevail.

For this to happen, optics presumably would have to play an important role. After all, under the present income tax no one has seriously suggested, so far as I know, that the food industry bear a reduced tax rate on the ground that food is a necessity. With a VAT-type structure, however, it is conceivable that retail sales tax-style reasoning would have greater political appeal than it appears to have under the income tax. The difference might lie in the application of folk notions of incidence, which seem to involve automatically assuming that a business-level income tax, as a “direct” tax, is borne by the company earning the income, while any consumption taxes that qualify as “indirect” are assumed to be borne by the consumer.⁸

⁸ The General Agreement on Tariffs and Trade (GATT) distinguishes direct from indirect taxes (with “export subsidies” allowed only on the latter), on the view that the latter are “imposed on the product as opposed to the maker” (Westin 1997, 264 n. 52).

III. “FIVE EASY PIECES”-STYLE CONSUMPTION-BASED REFORM

The “five easy pieces” plan to move towards consumption taxation by stealth has only four pieces that relate to the tax base, given that marginal rates are not a tax base issue. In this section, I examine each of the four pieces, considering both their possible design and how they might interact with the rest of the current tax system.

A. Expensing for All Business Outlays

Expensing for all business outlays, whether capital or ordinary by the light of income tax accounting, is routine and familiar in a consumption tax environment. As part of five easy pieces in the current legal, fiscal, and political environment, however, it can create, exacerbate, or unexpectedly fail to solve a number of significant problems.

1) Expensing within an income tax – There are major differences between expensing in a thoroughgoing consumption tax and, expensing as a feature of the current income tax. Perhaps the most important difference is that the income tax neither requires loan proceeds to be treated as income nor generally disallows interest deductions claimed by businesses. The income tax treatment of interest can interact with expensing to make debt-financed investments better than exempt (i.e., subsidized, and thus potentially profitable after-tax even if they are economic losers before tax). In addition, it can promote a host of tax-motivated transactions.

In illustration, suppose that the interest rate, and the pre-tax return on all assets, is 10 percent, while the tax rate is 40 percent. Under these circumstances, I can acquire a machine that costs \$100, lasts for exactly a year, and yields \$110. Suppose the tax rate is 40 percent. Without debt financing, and ignoring loss limits for the moment, I expense the \$100 outlay this year, leading to a \$40 reduction in tax liability, and I pay \$44 of tax

next year. This is the tax-exempt result that one expects under a consumption tax, since the up-front present value of my net tax payment is zero.

Now, however, suppose that I borrow the entire \$100 for one year, at a 10 percent interest rate, from a tax-indifferent party. My pre-tax cash flow is zero in both years (receive and invest \$100, receive and repay \$110). For income tax purposes, however, I deduct \$100 in Year 1 but then include only a net \$100, rather than \$110, in Year 2 (since I can deduct the \$10 interest payment). The result is that I effectively get to borrow \$40 from the U.S. Treasury for a year at a zero interest rate.

If the lender were paying tax at 40 percent, the problem would be eliminated. Since the lender would include the \$10 interest payment in Year 2, we would simply have shifted the overall pre-tax positive return of \$10 from myself to it, reflecting that it is the party that supplies the capital and thus gets the ordinary return. In a real world situation, however, this may not happen. As Edward Kleinbard (2005, 4) has noted, “the capital markets include large numbers of taxable and tax-indifferent issuers and investors, and those markets are supremely efficient at pairing issuers and investors in ways that maximize their collective returns, and minimize revenues to the fisc.” A shift to expensing might actually increase the number of tax-indifferent players, by increasing (especially in the early years when pre-effective date assets were still being depreciated) the number of taxpayers with losses that they could not use.

These problems already exist under present law, where debt is used to shift taxable income to the tax-indifferent sector, and where debt-financed accelerated depreciation involves a lesser version of the same mismatch between taxable investors’ income and loss sides. Moreover, it might not be a huge problem if tax-indifferent

parties were limited to U.S. persons, such as tax-exempts, loss companies, and taxpayers subject to mark-to-market taxation (who are tax-indifferent so far as engaging in taxable transactions is concerned).⁹ However, with potentially unlimited foreign tax parties that are outside the U.S. tax system, the potential revenue problems are a lot more serious. A shift to expensing that was unaccompanied by newly addressing the tax arbitrage between consumption tax-style cost recovery and income tax-style treatment of debt would make things worse, and thus tend to increase tax planning responses.

2) Expensing and loss nonrefundability – In the present income tax, net losses are not refundable. That is, they may be used to offset other taxable income, but do not generate net refunds from the government. In addition to discouraging risky investment, nonrefundability creates an incentive to shift tax losses from taxpayers who cannot use them to those who can. Nonrefundability thereby generates significant transaction costs, as “taxpayers attempt end-runs around the loss restriction rules, and the law responds with yet more complex rules and doctrines” (Bankman and Schler 2005, 22-23). Even if expensing did not permanently increase the frequency of losses, it surely would do so in the transition period, as taxpayers combined expensing of new assets with continued depreciation of older ones.

The history of the Economic Recovery Tax Act of 1981 offers a handy primer on the possible ploy. Recognizing that many taxpayers would be unable to use the swifter depreciation deductions that the Act was providing, Congress enacted the safe harbor leasing rules, under which tax-motivated leasing transactions could be effective even if they lacked economic significance. Taxpayers responded by engaging in a large

⁹ See Kleinbard 2005b, 4 n.1.

volume of leasing transactions that clearly amounted to little more than the sale of depreciation deductions, leading to a public outcry (and the repeal of safe harbor leasing) even though permitting such transactions had been exactly the point. Similar issues could be expected to arise if expensing is adopted today or in the future under the current income tax.

Leasing transactions are only one possible transactional response to heightened taxpayer problems with nonrefundability. A second common response is loss trafficking, or attempting to purchase and use the favorable tax attributes of loss companies, subject to statutory restriction. Or two companies can merge, when they would not otherwise have done so, because they anticipate that one will have net income while the other will have a period of tax losses.¹⁰

3) Expensing and a more level playing field for business investment – One clear advantage of expensing, relative to the array of cost recovery rules in the current income tax, is that it eliminates inter-asset distortions by creating the same effective tax rate (in principle, zero on the risk-free return to waiting) for all assets.¹¹ Thus, even if one otherwise preferred income taxation to consumption taxation, one might conceivably view the difference as outweighed by the advantages of a uniform rule (Gentry and Hubbard __).

Unfortunately, a shift to expensing would not necessarily reduce inter-asset distortions for long. Lobbyists might soon go to work seeking results for their industries

¹⁰ For another example, when companies are going through bankruptcy proceedings, they may take great care to ensure that their favorable tax attributes will be affected as little as possible by reason of the non-inclusion of their cancellation of indebtedness income. [Note §108 with exclusion in exchange for tax attribute reduction].

¹¹ [Weisbach re. reduced significance using the riskless rate.]

that were better than expensing even without regard to the use of debt. As noted above, the possibilities include special rates, expensing plus additional deductions in subsequent years, the use of credits, and expensing plus exclusion on the income side.

Perhaps it is unfair to blame the shift to expensing for subsequent departures from its use. The reason for nonetheless mentioning the problem here is that one of its apparent advantages over the income tax's current range of cost recovery rules – its providing a salient uniform approach to cost recovery – might help less politically than many now expect. Indeed, the fact that five easy pieces would likely be done in a political environment involving the use of stealth, and dominated by business interests, does little for one's confidence that uniform expensing would endure.

4) Expensing and the prospect of future tax increases – A final problem that could be associated with the shift to expensing concerns the fiscal gap. As shown by the well-known Cary Brown theorem, expensing is equivalent to yield exemption for the normal rate of return where tax rates are constant over time. If tax rates are on average expected to be constant but could randomly rise or fall, expensing yields the same expected tax rate (i.e., zero) as yield exemption, but subject to symmetric risk. However, where tax rates are more likely to rise than fall, as suggested by the fiscal gap, investments that are expensed have a positive expected tax rate. So the presumed consumption tax policy aim of avoiding the discouragement of saving and investment relative to immediate consumption may not be accomplished (although here, for reasons unrelated to the retention in other respects of an income tax).

Arguably, the more deferred the expected payout from an investment, the more likely it is that higher tax rates will have set in by the time the payout is realized.

Accordingly, an expectation of higher future tax rates may give rise to inter-asset distortions even with uniform expensing.

These considerations become all the more important as rising tax rates become more proximate and more predictable. The effective date for a higher tax rate generally is no earlier than the beginning of the calendar year when the change in rate was proposed, although it may be predictable in advance. Taxpayers would be expected to respond by accelerating income recognition and deferring the recognition of losses.

B. Corporate Integration

Corporate integration could be accomplished in a number of different ways. The plans that have recently been proposed in the United States under the current income tax (which are only a subset of the broader set of possibilities) include the following:

1) Exclusion of dividends from recipients' income, without any change in the tax treatment of corporate interest payouts. This was the approach taken in the Bush Administration's corporate integration proposal of 2003, with the further proviso that the exclusion generally would be limited to distributions of previously taxed corporate income.

2) Exclusion of both dividends and corporate interest from recipients' income, with interest as well as dividends being nondeductible at the corporate level. This was the approach taken in the Comprehensive Business Income Tax ("CBIT") that the U.S. Treasury proposed in 1992.

3) Deductibility by corporations of a cost of capital allowance ("COCA"), generally without regard to actual payouts or the tax character of particular financial instruments, with accompanying automatic inclusions by the instruments' holders. This

is the Business Enterprise Income Tax (“BEIT”) recently proposed by Edward Kleinbard (2005a).

4) Allowing shareholders, when including dividends in their taxable income, to claim a tax credit for what is deemed their allocable share of corporate-level taxes paid.¹²

The complexity and tax planning issues that would arise in the aftermath of corporate integration would largely depend on the model that was followed, as well as on the details of its implementation. Since exploring all of the leading models could easily require an entire shelf of books, I will limit my commentary to what clearly seems the most prominent proposal today (as well as the one that would require the least change to current law). This is the Bush Administration proposal from 2003, under which dividends are excludable from shareholders’ income. Congress partly adopted it in 2003, deleting the requirement of previous corporate-level taxation of the distributed income and making the tax rate for dividends 15 percent rather than zero.

Further reducing the tax rate on dividends to zero would potentially revive consideration of conditioning exemption on previous corporate-level taxation of the distributed income. However, there is good reason to suspect that this requirement would not be imposed. Even leaving aside any disinclination by proponents to limit the benefit, the proposed requirement attracted substantial criticism in 2003, on two main grounds. The first complaint concerned its complexity, since keeping track of whether distributions were out of income that had been taxed at the corporate level was by no means simple. The second complaint was that the requirement would unduly reduce the value of corporate tax preferences, by causing Congressionally intended corporate-level tax

¹² [Warren ALI proposal.]

minimization to come, in some instances, at the price of shareholder-level taxability. These complaints might well carry the day even with a zero percent rather than a 15 percent shareholder-level dividend tax.

With or without a previously-taxed-income requirement, corporate integration would do nothing to address what Edward Kleinbard (2005b, 3) calls the “primal flaw” in the current rules for taxing business income. Sophisticated financial engineers can, to a considerable degree, give a corporate financial instrument whatever tax characterization they like while also, and independently, creating whatever set of economic relationships between the investors they like. The consequence is a free pass (leaving aside the significant transaction costs) to give debt instruments to tax-indifferent parties and equity to taxpayers, with the consequence that the debt-financed portion of corporate investment may escape taxation at any level even in the absence of corporate tax preferences. Moreover, if “debt” and “equity” are merely labels that need not have associated economic characteristics, the notion in the economics literature that corporate “debt shields” are limited in practice by the associated default risk ceases to hold.

Putting it in terms of famous economic models of the corporate income tax, the Modigliani-Miller (19__) account of the tradeoff between tax savings and bankruptcy risk has declining validity if financial engineers are ever more skillful at separating tax labels from economic substance. By contrast, the Miller equilibrium (from Miller 19__), in which the ratio of debt to equity depends on the ratio of capital from persons paying less than the corporate marginal rate (including tax-indifferent parties) to capital from persons paying more, would be expected to have increasing validity, as the tax labels

borne by instruments become ever more elective and unrelated to the underlying economic relationships.

In this brave new world of a functioning Miller equilibrium, distortions resulting from the tax-induced holding of debt or equity would be eliminated insofar as the tax character of an interest in a corporation effectively became elective. There is, however, the implication that a significant portion of corporate income would never be taxed. Moreover, if shareholder-level capital gain remained taxable, a further set of tax planning responses, such as paying out dividends and then reinvesting the funds so as to eliminate the excess of value over basis.

C. Expanded Roth-Style Individual Retirement Accounts

Creating expanded tax-free savings accounts is a natural step to take in moving the current income tax in a consumption tax direction. This can be done in either of two ways. The first is to expand “traditional” individual retirement accounts (IRAs), under which contributions are expensed while withdrawals are fully taxed. The second is to expand Roth IRAs, under which contributions are non-deductible but withdrawals are tax-free. The George W. Bush Administration and “five easy pieces” proponents have both favored Roth IRAs, for a reason that is easy to understand in terms of budgetary politics. Even though the two types of IRAs are equivalent over the long run if tax rates are constant, Roth IRAs result in lower near-term budget deficits, albeit in exchange for higher budget deficits down the road. Indeed, one could even reduce short-term budget deficits in the short run, while worsening the fiscal gap over the long run, by offering taxpayers costly inducements to convert their traditional IRAs into Roth IRAs. This could be very tempting if “five easy pieces” proponents are eager to lower the short-term

budgetary cost of their proposals and are not greatly concerned about effects on the long-term fiscal gap.

In principle, Roth IRAs are a perfectly reasonable consumption tax method, involving yield exemption rather than expensing. In an income tax environment, however, either type of IRA may end up creating a money machine for taxpayers that is unrelated to their net savings behavior. The basic idea is simply to finance one's IRA deposits through borrowing, taking care that the loan proceeds not be legally traceable to the accounts. This results in a tax arbitrage whereby one pays deductible interest while earning excludable returns. Indeed, if one can manage to be long and short on identical terms, one has what Eugene Steuerle (1985, ___) calls a "pure tax arbitrage," having zero net effect on one's economic position. Such an arbitrage would not be self-limiting, in the manner, say, of investment in housing, given the lack of any net effect on supply as compared to demand in the capital markets (since one is both long and short).

If one favors a consumption tax as a way of increasing net saving, debt-financed IRAs can be worse than not having IRAs at all, as they can increase current consumption through their income effect on the consumers to whom they offer a money machine. The problem is almost as bad if one favors a consumption tax to achieve neutrality between current consumption and saving for future consumption. A taxpayer who reaches the IRA limits through debt-financed "saving" is back on the income tax at the margin, thereby continuing the bias against saving.

Is this arbitrage scenario realistic, given that the current income tax law disallows deductions for consumer interest expense, along with any other interest expense that does not fall into an expressly allowable category? Perhaps the main ground for concluding

that the scenario nonetheless is realistic is the deductibility of home mortgage interest. The Tax Reform Panel proposed reducing this tax benefit, but “five easy pieces” proponents who wanted to make their changes as anodyne as possible might not be inclined to follow suit. Moreover, other sources of interest-deductible financing would likely be available to well-advised taxpayers as well. For example, business proprietors could presumably increase their business borrowing and use the extra free cash to fund IRA deposits. People who would otherwise have taxable net investment income could borrow enough to zero out this net income, while indirectly using the additional free cash in the same way. Thus, while the consumer interest rule might impede taxpayer use of the arbitrage strategy for funding IRAs, it would by no means make the strategy untenable.

Perhaps the biggest problem with the tax arbitrage strategy, from an individual’s tax planning standpoint, is that it assumes the Congressional pledge not to tax future Roth IRA withdrawals is actually politically credible. Given the fiscal gap and pending entitlements funding crises, it is plausible that Congress will be desperate for revenue by the time that current workers are starting to live off the money in their retirement accounts. Only a few years ago, Congress imposed a tax on “excess” withdrawals from tax-free retirement accounts.¹³ While Congress swiftly repealed the tax on that occasion, it was facing considerably less budgetary pressure than is likely in the future.

It would hardly be a triumph for the enactors of expanded Roth IRAs to escape tax arbitrage responses by not being credible to begin with. Either way, accordingly, the

¹³ (Describe the excess distributions tax.)

enactment would face problems that are not presented in a fiscally stable consumption tax environment.

D. Movement Towards Territorial Taxation

In the international realm, a prominent recent description of the five easy pieces approach refers to “excluding export and other foreign trade income of American companies from tax in much the same way that other countries do in the world marketplace” (Christian and Robbins 2002). This appears to invite two possible interpretations. The first, closer to the words used, is that United States companies would be taxed through a peculiar hybrid of the origin basis, used in all existing income tax systems, and the destination basis, typically used in VATs. Under the origin basis, income from sales to foreigners is included and deductions or cost recovery are allowed for business-related payments to foreigners. Under the destination basis, income from sales to foreigners is excluded and no deduction or cost recovery is allowed for payments to foreigners. Leaving aside administrative and transition issues, the two systems have identical incentive effects on cross-border trade (Shaviro 2004b, 93).

If five easy pieces allowed the exclusion of exports without changing the tax treatment of imports, it would create an inefficient subsidy for cross-border trade that violated U.S. treaty obligations relating to the World Trade Organization (WTO). In the recent past, a much more limited export subsidy in the U.S. income tax led to an adverse WTO finding, authorizing European complainants to levy retaliatory tariffs on U.S. goods. Finally, its blending the “best” features (from a taxpayer’s standpoint) of the origin and destination basis would invite abusive tax planning, such as repeatedly

exporting and re-importing the same items in order to generate deductions without offsetting inclusions.

An alternative interpretation of the proposal, suggested by its reference to what other countries do, is that it would replace the current U.S. international tax regime, involving worldwide taxation of U.S. taxpayers subject to deferral of foreign subsidiaries' foreign source income, with a territorial system under which the U.S. would neither tax foreign source active business income of U.S. companies, nor allow deductions or credits with respect to such income, but would tax U.S.-source income on exports. Various other countries have territorial systems (whereas none, presumably, combine origin and destination methods in the same tax base), and there is widespread academic support for, as well as opposition to, the idea of shifting to a territorial system.

At least if done properly, the shift would likely simplify the tax law on balance. For example, it would eliminate business planning to avoid the repatriation tax under present law, end the application of the highly complicated foreign tax credit regime to the exempted income, and reduce or eliminate the need for various other complex or manipulable rules, such as those for classifying foreign software income as between royalties, the sale of goods, and the sale of services (Gruber and Mutti 2001, 10-12). On the other hand, shifting to a territorial system would strengthen the incentive to treat active business income as foreign source, such as through aggressive transfer pricing.

E. A Capital Gains Exclusion?

One last five easy pieces-style proposal is worth mentioning here, on the ground that it would be a strong candidate for adoption under a Republican-led stealth tax reform, even though it does not appear on the list set forth above. Proponents of a stealth

consumption-style reform sometimes propose lowering the capital gains rate to zero (as in Norquist 2002). Presumably, capital losses would be nondeductible.

Although the proposal is generally made across the board, one could imagine its being limited to shareholder capital gains on sales of corporate stock. This would be an obvious way to broaden corporate integration if one is not concerned about whether income has been taxed at the corporate level.¹⁴ However, such a limitation would encourage taxpayers who were planning to sell appreciated assets to dump them into corporations and sell the stock. This, in turn, would presumably require the adoption of anti-abuse rules of some kind, to which there would then be tax planning responses, perhaps requiring a new generation of anti-abuse rules.

The intention, in any event, may be exempting capital gains across the board. This would simplify tax planning in one sense, by eliminating the issue of whether a given capital gain or loss has been realized. It also would call off the need to time one's taxable realizations for tax purposes, such as by waiting to the next tax year to take a gain, or by carefully pairing losses with gains to avoid net capital gain. In corporate taxation, exempting both dividends and capital gains from the sale of stock would eliminate the need to determine whether a given distribution to a shareholder was a true dividend or a taxable exchange. It also would eliminate the need to pay out dividends so that taxpayers would not have capital gains upon selling stock.

In various other respects, however, a capital gains exemption would be a boon for tax planning. In particular, it would increase the tax benefit from converting ordinary

¹⁴ The original Treasury corporate integration proposal in 2003 would have retained the capital gains on sales of corporate stock, but this reflected its concern about income that was untaxed at the corporate level. It offered increases in the basis of corporate stock to reflect inclusion in the shareholder's taxable income of undistributed dividends.

income into capital gain, and from arbitraging ordinary deductions against capital gain. These issues were highly prominent in tax planning and practice when the differential between the ordinary income and capital gains rates was much higher than it is now, suggesting that they would recur with a vengeance. Again, the deductibility of interest expense, to the extent retained, might be critical to the arbitrage strategy.

F. Five Easy Pieces Overall

Even those who are highly sympathetic to consumption taxation should seriously question whether the five easy pieces approach is likely to advance their objectives in an appealing way. If the pairing of income tax treatment of debt with consumption tax treatment of investments is permitted, and if corporate integration fails to address adequately the distinction under current law between debt and equity, the end product of the process might end up being quite bad.

The political economy of this sort of tax reform process should also excite great concern. If lobbyists run the process without visibility or informed debate, the safeguards that political competition can offer are lost. Recent Congressional corruption scandals help to remind us how much the level of public scrutiny can affect substantive political outcomes.

The five easy pieces reform would also likely prove unstable politically. Not having been chosen by bipartisan consensus, it might prove highly vulnerable when Democrats were in a position to rewrite the tax laws. In addition, the long-term fiscal gap, which it would be expected to increase even if budgetary game-playing muted the short-term impact on deficits, would inevitably make it ripe for revisiting.

IV. BIPARTISAN X-TAX

The second consumption-based reform scenario that I examine has antecedents in tax reform processes (whether successful or abortive) from the past. In both 1977 and 1984, the U.S. Treasury Department released studies of fundamental tax reform that considered both income and consumption-based alternatives. Likewise, the Tax Reform Panel in 2005 offered two reform proposals with consumption tax features. Although consumption-based reform has not yet been identified in any such government-sponsored study as the preferred route, this might change in the future. In particular, suppose that a “new consensus of the experts” (Bradford ___) emerges in favor of progressive consumption taxation, and that Democratic leaders, perhaps in pursuit of Clintonian “triangulation,” embrace it.

Were this to happen, and to involve the selection of the X-tax as the basic reform prototype, politics would affect the degree of simplification that was achieved in two main ways. First, it would affect the resolution of some of the basic structural issues that others, such as Weisbach (2000, 2003) and Bankman and Schler (2005), have identified. Second, the political and policy interests that I identified in section II, and perhaps others as well, would need to be considered and in some cases accommodated.

A. Politics and Some Basic Structural Choices in the X-Tax

1) Choice between origin and destination basis – An initial design choice lies between use of the origin basis and the destination basis in cross-border business transactions. Again, under the former, which income taxes generally use, business payments for imports are deductible, while those received for exports are includable.

Under the destination basis, typically used under VATs, payments made for imports and received for exports are disregarded.

Each of the two methods has its drawbacks. The origin basis requires transfer pricing for cross-border transactions between related parties. That is, if a U.S. company buys from or sells to an overseas affiliate, the deemed price, while potentially economically irrelevant to the affiliated parties, may make a tax difference in the U.S. abroad, leading to tax planning and costly litigation. The destination basis requires monitoring cross-border transactions to ensure that deductions are allowed only for purchases from domestic counter-parties and that exclusions are limited to true exports. The destination basis also gives rise to the “tourism problem” (Bradford __, __), involving the difficulty of taxing U.S. residents on their consumption while abroad.

The administrative choice between the two approaches is sometimes regarded as a close call, although aversion to transfer pricing induces many to prefer the destination basis. Weisbach (2000, 2003) argues emphatically for the destination basis, noting that game-playing under the origin basis is not limited to transfer pricing. For example, he describes opportunities to exploit the distinction that the X-tax draws between real transactions (which are taxed) and financial transactions (which are ignored) if the system, as under the origin basis, is “open,” in the sense that a taxpayer has deductions or credits that need not be matched by the counter-party’s inclusion (2003, 217-218). In “closed” systems, by contrast, inter-business transactions are ignored unless both the payor and the payee are taxpayers. The destination basis results in a closed system as to cross-border transactions.

Bankman and Schler (2005) provide illustrations suggesting that Weisbach is correct. They detail a number of scenarios in which taxpayers conceivably could attempt to game the X-tax system, such as by creating deductions or credits without offsetting income, or by shifting income to non-taxpayers. Under an open system, one might reasonably worry about whether all such transactions could sufficiently be prevented. Under a closed system, however, any transaction (other than paying wages that are taxable at less than the business rate) either is a wash – since both parties or neither will be subject to business tax consequences – or else creates net income as a sale to domestic consumers.

If we assume that Weisbach’s argument for a closed system would win the general acceptance that I believe it deserves, the question becomes one of whether political considerations would impede its acceptance. Politically speaking, the following four main considerations come to mind:

- 1) Destination basis taxes are sometimes lauded by those seeking competitive trade advantages for the United States as “export subsidies” (since exports are tax-free). Economists know better, recognizing that the origin and destination methods, once in place with constant tax rates, have identical incentive effects on cross-border trade. One way of explaining this point is to note that, over the long run, exports are effectively traded for imports. Thus, if you export an item tax-free but then must pay tax on the import that you ultimately consume in exchange, your consumption has been taxed once, just as in the purely domestic case. However, the subsidy view is hard to allay among non-experts, potentially favoring choice of the destination method among those who

combine their lack of understanding of the economics with an eagerness to give U.S. companies a competitive edge in international trade.

2) On the political debit side, some might object to the fact that U.S. companies would be “escaping” tax on their receipt of money for their exports. While it would certainly be unreasonable to complain about this without acknowledging the flip side, their inability to deduct amounts paid for imports, one could imagine this becoming grounds for political controversy. A given company, for example, might have paid no net X-tax despite large net receipts from abroad in a given year. On the other hand, for the X-tax (or any other consumption tax) to be politically feasible to begin with, people would have to be willing to accept differences between net tax paid and the accounting income reported on financial statements. Moreover, the view that this “tax avoidance” reflected an export subsidy that was creating U.S. jobs, although false, might at least create an offsetting talking point.

3) More reasonably on the debit side, since the U.S. is currently a net importer of capital, shifting to the destination basis would hand a net transition gain to foreign investors (Auerbach 1997, 145). Providers of foreign capital, having made U.S.-deductible imports under the origin basis, would now inconsistently get the benefit of U.S.-excludable exports under the destination basis.

4) Finally on the debit side, a destination-basis X-tax might be viewed as violating the General Agreement on Trade and Tariffs (GATT), which permits “export subsidies” (as it would classify the border adjustment, economics notwithstanding) only in the case of “indirect taxes.” It also would violate dozens of bilateral tax treaties. While the distinction between direct and indirect taxes has little if any coherent economic content,

the X-tax would probably be classified as a direct tax, unlike VATs, by reason of its treating wages as deductible by businesses and includable by workers (Shaviro 2004).

Although some analysts regard this as a fatal objection to using the destination basis, Weisbach (2003, 218) argues that it simply means that the United States would need to seek a revision of the GATT. He notes that it is hard to see why anyone would object, given that the destination basis is not in fact an export subsidy. To this one might add that the economic clout of the United States would likely aid us in achieving the desired change to GATT, although perhaps less so if our international profile has not improved by then relative to its current arguably low level.

Perhaps the more pertinent question for current purposes is whether any uncertainty about the needed GATT change would significantly discourage adoption of the destination basis. While this is hard to predict, my own view is that nationalistic pride would provide at least a partial counterweight to GATT-related anxiety. (“We can’t let those foreigners tell us what to do! This is a matter of U.S. sovereignty.”) Given as well the political popularity of supposed export subsidies, I conclude that there are reasonable grounds for thinking that the destination basis would indeed prevail, assuming general expert agreement that it was strongly preferable.

2) Dealing with multiple tax rates – In the simplest comprehensive VAT, there are only two tax rates: the single positive rate that always applies to taxpayers, and exemption for non-taxpayers such as foreign businesses and any domestic businesses that are exempted under a special rule for small businesses. Assuming a closed system, all inter-business cash flows in this simple world yield net tax revenue of zero. Thus, if both parties are taxpayers, the deduction or credit available to one is offset by the inclusion

required of the other. If one or both parties are non-taxpayers, neither of these offsetting tax consequences arises. Only on sales to consumers does the system collect net revenue.

As soon as one introduces multiple tax rates, things become more complicated. For example, inter-business transactions may have net tax consequences unless the buyer's deduction or credit is expressly based on the seller's liability. Relatedly, where particular commodities or types of businesses are supposed to bear special rates, one needs to coordinate the taxation of the various stages in the production process through the final retail stage so that it comes out "right" (however this is defined by the policymakers who created the special rates).

As Weisbach (2003, 226-230) shows, further tax rate coordination issues arise if the production process involves companies that Congress has decided to give more than one tax rate. In addition, suppose that (as is common in VATs) particular consumer goods, such as food or energy, get special tax rates that are supposed to apply throughout the production process. Questions then arise as to which of the receipts and outlays of a business that is involved with multiple types of products qualify for each rate.

For inter-business transactions involving tax-favored (or disfavored) consumer goods, the net tax levied will come out "right" (i.e., as presumably intended) so long as (1) the applicable rate is levied on the final consumer sale, and (2) at all prior stages, the tax consequences of the inclusion and the offsetting deduction or credit are matched to ensure that they are the same. As under existing VATs, however, this can add significant complexity.

3) Loss refundability – Absent concerns about fraud, a well-designed X-tax, like a typical VAT, would provide a net refund for the tax period to any business that had

deductible or creditable outlays in excess of its includable receipts. Businesses would presumably be in a net refund position much more frequently under the X-tax than they are under existing VATs, given that they would be deducting or crediting wages in addition to inter-business payments. With full refundability, moreover, businesses' incentive to over-pay (or pretend to over-pay) related parties, such as owners' family members, as a way of taking advantage of the lower rate brackets for wages, would continue indefinitely past the point of zeroing out current period net tax liability.

Whether justifiably (in light of the fraud problem) or not, full refundability seems unlikely as a political matter. The closest rule to full refundability that one could reasonably imagine is a carryover rule that permits refundable amounts to grow at a suitable interest rate. Even under this system, however, some businesses might be eager to circumvent the bar on refundability, whether due to the inadequacy of the interest rate being provided, or to being liquidity-constrained, or to concern that they would never have net receipts against which the refunds could be used.

Absent full refundability or a sufficiently close equivalent, businesses would have incentives like those under present law to devise end runs around the loss limit. The central anti-tax planning idea of a closed system, that inter-business transactions have zero net tax consequences, ceases to apply once some taxpayers have losses that they cannot use, making them tax-indifferent at least in the short run. Wasteful transactions that shift tax losses to taxpayers with net income, and taxable income to taxpayers with net losses, potentially become profitable to the parties after-tax.

The tax planning responses could take a number of different forms. For example, a taxpayer in a loss posture might find taxable counter-parties to buy and lease back its

business property, generating an inclusion for the sale proceeds in the loss year, followed by offsetting deductions or credits for the rent payments in subsequent years (Bankman and Schler 2005, _). Or a loss taxpayer might make an installment sale of its property to a taxable counter-party, overstating the taxable inclusion of the loan principal and understating the disregarded interest payments.

Additionally, nonrefundability would lead to clientele effects with regard to transactions between taxpayers on the one side and non-taxpayers (such as foreign businesses) on the other. Ordinarily, business taxpayers should be indifferent as between taxable and non-taxable counter-parties (ignoring administrative burdens or delays in receiving rebates). In illustration, suppose that the business tax rate is 30 percent. Taxpayers should be indifferent between (1) buying or selling with a taxable counter-party for \$10 (\$7 after-tax), and (2) doing the same at \$7 with a non-taxpayer. If one has unusable net losses, however, one may be better off selling to taxpayers (so the income can soak up the losses) and buying from non-taxpayers (since the deduction or credit would not have full value).

4) Treatment of small businesses – European VATs typically exempt small businesses on the view that, say, a child's lemonade stand should not have to register as a business taxpayer. The key difference between treating something as a business for VAT purposes and treating the income it generates as taxable under a typical income tax arises from the fact that, under a closed system, businesses must register so that their counter-parties will know how to treat the cash flows. This, presumably, is more demanding than simply filing an income tax return at the end of the year (which in any event is unnecessary for those who earn too little to owe any tax). Such considerations arguably

support keeping very small, intermittent, or temporary businesses outside the system on the view that the compliance obligations would be too burdensome or unlikely to be well understood. The small businesses might also typically present burdensome audit and compliance issues in exchange for relatively little revenue – for example, involving the personal use of what ostensibly are business assets.

Under a closed system, the small business exception should not be a problem with respect to inter-business transactions, other than in relation to nonrefundability. Ignoring both sides of a transaction is just as symmetric as imposing a tax liability that is offset by an identical tax benefit. The problem lies, rather, in the non-taxation of the value-added component of a small business's operations, along with the possible difficulty of applying the graduated wage tax to workers in exempt small businesses.

5) Transition to the new system and subsequent rate changes – Replacing the current income tax with a simple X-tax that used expensing would impose a wide range of transition gains and losses. Perhaps the most important one, however, is the effective wipeout of income tax basis that would result if the X-tax disregarded all unrecovered pre-enactment capital outlays.

David Bradford (___) used a hypothetical involving tomato juice cans to explain the problem. Suppose a retailer bought tomato juice cans on December 31 for \$10,000, and then sold them for the same amount on January 1. If the current income tax were in effect both years, the retailer would have no tax liability, as the outlay would be capitalized in the year it was made and allowed against the cash receipt the next year. If an X-tax tax using expensing were in effect both years, the taxpayer would get a deduction or credit in the first year that precisely offset (ignoring timing) the tax liability

incurred in the second year. If, however, the tax system changed from the one to the other at midnight on New Year's Eve, with each system taking account only of cash flows occurring while it was in place, the taxpayer would never get the deduction, and thus would be taxed on its \$10,000 gross receipt at the full consumption tax rate.

Some commentators laud the basis wipeout as equivalent to a lump-sum and hence non-distortionary wealth tax if no one either sees it coming or expects it to recur. I have elsewhere expressed skepticism about this scenario, noting that the change would not take place by surprise overnight and that it might affect subsequent expectations (Shaviro 2000). However, more germane for present purposes than the question of which of these two views is more correct is the question of whether a basis wipeout is likely, and how the approach to transition that Congress took would affect simplification and taxpayer behavior.

The concentrated and fairly visible losses to well-off taxpayers that would result from the basis wipeout seem unlikely, as a political matter, to be imposed. Thus, it seems plausible that some form of transition relief would be provided. Yet, if we are operating under the assumption that the X-tax actually gets enacted, a transition hit may need to be politically tolerable after all, since otherwise the prospects for offering attractive rates would be dimmer.

Perhaps the simplest form of transition relief would involve permitting businesses immediately to deduct unrecovered basis at the new X-tax business rate, matching the tax rate on subsequent income arising from the capitalized expenditures (Shaviro 2000, ___). This would invite some game-playing by taxpayers, such as disproportionately treating their loss assets as business assets that would generate deductions or credits in excess of

any subsequent income. The up-front budgetary cost might make such a transition rule unlikely, however. It is hard to predict how Congress would resolve the dilemma of up-front budgetary cost versus demand for transition relief, apart from concluding that the resolution would likely be more complicated than a one-shot up-front basis recovery.

If transition were a one-time problem only, the issue would go away once it had been resolved in whatever fashion. Unfortunately, however, transition is an ongoing issue in an X-tax that uses expensing. The broader category to which it belongs is rate changes. Newly enacting an X-tax changes its business rate from 0 percent to whatever positive rate Congress initially chooses. Similar transition issues arise anew each time Congress changes the rate in an X-tax in place. Thus, in terms of Bradford's tomato juice example, the taxpayer had transition losses because the X-tax rate was 0 percent on December 31 and the initial rate (say, 30 percent) on January 1. One would have exactly the same type of problem if the rate changed from 20 percent to 40 percent or (reversing the sign of the transition effect) from 40 percent to 20 percent.

David Bradford came to regard this problem as serious enough that he proposed modifying the X-tax design to use income tax-style accounting, rather than expensing. Outlays that were expected to yield future income would be capitalized, with basis growing at a suitable interest rate so that the deferral of deductions would not reduce their present value relative to expensing.

The disadvantage to this approach is that it makes record-keeping more burdensome. It would require business taxpayers to keep records of basis, which would have to be increased by appropriate interest adjustments and reduced by allowable cost recovery. People might reasonably disagree about whether this is a big enough downside

to overcome the advantages of Bradford's proposal. Computers would make compliance easier. Increased complexity might also, however, have the adverse side effect of inducing Congress to create a higher small business exemption.

Whether the Bradford proposal is meritorious on balance or not, its apparent and real complexity may make its adoption unlikely. Simplification would surely have to be a major part of the sales pitch that would lead to replacement of the current income tax. Retaining income tax-style accounting would cut directly against the sales pitch.

It therefore is worth asking what practical issues tax rate changes would bring up in an X-tax that used expensing. The basic tax planning response that one would expect is clearcut. When tax rates were expected to increase, taxpayers would be eager to accelerate sales and defer outlays so that inclusions, but not deductions, would get the lower current rate. Expected tax rate declines would encourage the opposite response.

For inter-business transactions between two taxpayers, the symmetry of a closed system would eliminate the net advantage of any such tax planning. Nonrefundability would complicate this, however, and uncertainty would create risk. In addition, consumer transactions would not involve this symmetry, and thus would tend to migrate to low-rate years to the extent feasible.

Congress, in turn, might respond through the use of effective date rules such as those that are used at times under present law. For example, the new rate might, if enacted, be effective as of the date of its announcement or introduction. This might not be prohibitively burdensome from a compliance standpoint if business taxpayers were required to have (1) dated invoices for all of their inter-business transactions, and (2)

daily records of their consumer sales. Once again, however, such requirements might strengthen the political case for setting the small business exemption higher.

Even early effective dates would not fully address taxpayer anticipation. A good example arose under the current income tax in 1992, when President Clinton was elected on a campaign platform calling for an increase in the top marginal rate. Some expressed outrage when the effective date turned out to be January 1, 1993, or before he took office but well after there was reason to believe a rate increase was coming. More generally, taxpayers will frequently have good grounds, even before a given legislative change is formally introduced, for anticipating that change in a particular direction is imminent.

Insofar as tax rates follow a kind of random walk, dependent on the vagaries of short-term politics, there would be no long-term systematic direction to the incentive effects of businesses anticipating rate changes. Instead, responses might await concrete information about the likely direction of the next turn in the road. However, the long-term fiscal gap may support a general expectation that, over the long run, marginal rates are likely to increase. With annual expensing, this would amount to imposing an expected positive tax rate on saving and investment, by indicating that business receipts are likely to be taxed at a higher rate than that at which the underlying outlays were deducted or credited.

B. Important Political Interests in the Enactment Process

In the previous section, politics figured only insofar as it would affect the basic structural choices that were made in implementing an X-tax. Analogizing the hypothetical process to the enactment of the Tax Reform Act of 1986, one might think of those choices as akin to the Treasury I stage, in which a basic, very ambitious tax reform

plan was designed that shaped the entire effort, but that lacked most of the political concessions to particular interests, and to policy aims apart from base-broadening-style tax reform, that everyone knew would ultimately be necessary.

The analogy suggests that the end product of an X-tax enactment might not look any more like a pure form of the tax than the 1986 Act looked like Treasury I. From a simplification and tax planning standpoint, the question is to what degree this would compromise the entire system, as opposed to simply creating discrete departures from the pure structure. I address this question by looking at the important political interests identified in section II of this paper.

1) Home ownership – It is difficult to believe that Congress would eliminate or even greatly curtail the home mortgage interest deduction in the course of enacting an X-tax. The most one could imagine it doing is adopting limitations along the lines proposed by the Tax Reform Panel, which would have (i) substantially lowered the ceiling on loan principal that generates deductible interest and (ii) converted the deduction into a percentage credit that was below the top marginal rate.

If one believes that allowing the home mortgage interest deduction is bad policy given the exclusion of homeowners' imputed rental income, retention of the tax benefit would be disappointing. From an X-tax standpoint, however, the subsidy for home ownership is not the only issue. The linkage of the tax benefit to borrowing raises a further concern, given the arbitrage possibilities that are presented by the opportunity to combine borrowing deductibly with investing tax-free.

2) Charities – The deduction for charitable contributions also seems likely to be retained, or alternatively converted into a percentage credit. It also might be made

universally available, in contrast to the present law rule restricting it to itemizers. Such an expansion would likely receive significant political support from churches, whose contributors are thought to be significantly affected by the current law restriction.

Eliminating the present rule under which charitable donors can deduct the full value, rather than simply the tax basis, of donated property is a longstanding tax reform cause that one might expect X-tax proponents to favor (although the Tax Reform Panel proposed retaining it). If the basis of donated property is easier to establish than its value (which seems highly likely, other than for publicly traded property), the change would promote tax simplification. However, the change presumably would be opposed by charities that significantly benefit from the current rule, such as universities and art museums.

On the deduction side, therefore, only modest simplification, if any seems likely. There might, however, be some planning and compliance simplification with respect to the charitable organizations themselves. For many decades, such organizations have been among the tax-indifferent counter-parties that taxpayers use in efforts to create untaxed income alongside deductible losses. Shifting to a closed system would eliminate this tax planning possibility. In addition, the shift to a consumption tax would affect the need for certain rules that currently apply to charitable organizations, such as that imposing the unrelated business income tax (UBIT) on their debt-financed investment income.¹⁵

¹⁵ See Internal Revenue Code section 514.

The UBIT might continue to apply to charities, since its rationale, whether one finds it convincing or not, arguably would survive the shift to a consumption tax.¹⁶ Now, however, it presumably would take the form of requiring charities to register as taxable businesses with respect to the covered activities. Complications might arise if the Internal Revenue Service determined after the fact that a given business activity engaged in by a charity should have been registered as unrelated to the charity's exempt purpose.

3) State and local governments – Consumption-based tax reform is potentially highly adverse to the interests of state and local governments. First, although the issue is unrelated to the choice between income and consumption taxation, any major reform effort is likely to involve considering elimination of the itemized deduction for individuals' state and local tax payments. Thus, both 1984 Treasury I in 1984 and the Tax Reform Panel in 2005 proposed repealing the deduction, and the Panel would also generally have repealed business deductions for state and local taxes. Repeal has significant political support from Republicans who want to curtail state and local government spending, and potentially to “red state” voters who realize that the repeal would result in a relative shift of tax liability to people in the “blue states.” In addition, as noted by the Tax Reform Panel, the fact that the deduction is not allowed in the alternative minimum tax (AMT), which is applying to ever more individuals, means that the deduction is already being scaled back significantly.

On the other hand, both voters and government officials in relatively high-tax states, including prominent Republican governors, are likely to oppose repealing the

¹⁶ The usual political rationale for the UBIT is that it protects taxable organizations against unfair competition. Under a consumption tax, the rationale might be that taxable organizations are unduly disfavored if consumer goods sold by their tax-exempt competitors are not taxable to consumers.

deduction, even if the AMT induces them to accept a compromise. Moreover, given my premise that the X-tax would emerge from a bipartisan process, Democratic approval of the repeal would likely be needed as well. This appears unlikely, given the importance of the issue to Democratic Senators and Congressmen in states such as New York and California. One suspects, therefore, that at least something of the present law regular tax deduction will survive (whether as a deduction or a credit). It also is possible that any scaling back of the deduction would require political compensation to the state and local governments elsewhere in the design of the enacted X-tax.

4) Pensions and other retirement-related financial products – Given the evidence that people’s savings decisions are highly swayed by default rules concerning how much of their paychecks are set aside,¹⁷ it might be sufficient, under an X-tax, to create statutory rules establishing a suitable default. If affirmative incentives for a specified level of retirement saving were thought necessary, one possibility that has been discussed in the past would be to have the government supplement people’s contributions to their special retirement accounts. The availability and amount of the government contribution could be inversely related to wages, although this would add an extra detail in X-tax filing and would effectively create additional marginal rates..

5) Financial service businesses – VATs typically exempt financial services businesses, yielding complicated line-drawing problems (Merrill and Adrion 1995, 1497), and giving an inefficient subsidy to the consumption services these businesses provide.¹⁸ Consider, for example, the common case of a finance company that is associated with a commonly owned active business (e.g., GMAC and General Motors). In the case of the

¹⁷ Liebman article, etc.

¹⁸ [Note Grubert-Mackie but also Auerbach reply.]

X-tax, the impetus to avoid exemption might be stronger, on the optical ground that the wage tax component makes the business level tax look more like a tax on the businesses rather than on consumers.

A solution would probably have to involve requiring financial service businesses, as appropriately defined, to register as such. How to define them is clearly a major problem. Once they were appropriately defined, one possible consequence of their special status would be inclusion of financial transactions, rather than just real transactions, in their tax bases. Thus, all loan proceeds and insurance premiums, among other receipts, of a financial service business might be includable, while all of its loan and insurance outlays were deductible or creditable. Financial services businesses would therefore be under straight cash flow accounting (Bradford 1996).

Treating financial services businesses in this way would involve departing from the closed character of the X-tax system, since the financial firms' business counter-parties would presumably still disregard financial transactions. This might create abuse potential. For example, in the event of a statutory rate increase, financial firms would profit after-tax from issuing financial instruments just before the effective date and settling the instruments through repayment just afterwards. Likewise, if the tax rate was about to fall, they would benefit from making loans that generated deductions at the old higher rate, followed by counter-party repayment that they would include at the new lower rate. The fact that business counter-parties were not reporting reciprocal inclusions and deductions on financial instruments would prevent these inter-business transactions

from being a wash overall. Various solutions have been suggested,¹⁹ but they clearly require further development and exploration.

With constant tax rates, by contrast, full cash flow taxation that was limited to financial firms might lead to over-taxation of the financial services that are provided at arm's length to other businesses. Suppose a financial firm embeds its service fee in the spread between the interest rates it charges and pays to business counter-parties. While it would be taxed on the spread if using straight cash flow accounting, the counter-parties would not be deducting the spread if they were simply disregarding all cash flows from financial transactions. This could lead to inefficient under-consumption of financial services or the shifting of such services to be performed in-house.

The Tax Reform Panel proposed responding to this problem by having financial firms identify (for counter-party deduction) the service component of payments they received from business customers. It did not address the question of how this portion would be identified, given the parties' incentive to overstate it if the identification had no tax consequences to the financial firm. Obviously, this is no trivial problem.

A final political issue posed by the tax treatment of financial service businesses concerns the political clout that various types of such businesses might exert. Thus, consider life insurance companies, which currently can provide tax-free investment income to the consumers who purchase their products. Universalizing the tax exemption for investment returns might prompt complaints about life insurance contracts' loss of

¹⁹ See, e.g., Bradford 1996, __ (suggesting segregation of accounts from years to which different tax rates had applied, but noting that this approach might not be workable given the difficulty of "policing the segregation of different vintages"); Poddar and English 1997 (suggesting the use of "tax calculation accounts" on which positive and negative interest accrue, with adjustment of account balances when the tax rate changes).

relative advantage. Congress might conceivably respond by offering life insurance companies a tax break of some kind relative to the general application of cash flow taxation to financial businesses (if that was the approach generally taken). Or, like the USA tax with respect to municipal bonds, Congress might provide better-than-exempt treatment to consumers holding life insurance policies.

6) Health insurance and healthcare – The importance of addressing over-insurance, whether by capping the exclusion on employer-provided benefits or making medical expenses generally deductible, has attracted increasing attention in recent years from tax policy and healthcare experts. The Tax Reform Panel proposed capping the exclusion, a proposal that would likely attract powerful opposition if it were being seriously considered by Congress. The Cogan-Hubbard-Kessler approach of making all medical expenditures deductible would likely raise concerns about its revenue cost and about its conditioning the value of the tax benefit on one’s marginal tax rate.²⁰

Even if we assume that addressing the incentive for over-insurance will be unavoidable at some point, it is not obvious that tax reform provides the best political occasion for doing so. An alternative approach, sparing tax reform the controversy but also denying it credit for the revenue gain from capping the exclusion, would be to do so in connection with addressing healthcare issues more generally. For example, if Medicare reaches a crisis point at which funding increases or benefit cuts can no longer be postponed, simultaneously reducing the income tax exclusion could conceivably be grouped with any such changes under the rubric of a general “share the pain” approach.

²⁰ The latter concern could be addressed by providing a percentage credit, rather than a deduction, for medical expenditures. The credit could also be made refundable, so that its benefit would not be limited to the amount of one’s positive tax liability.

7) Education – Given the plethora of distinct tax benefits for education in present law, it seems likely that any fresh start, whether involving consumption-based reform or not, could make things simpler. Percentage credits, proposed by the Tax Reform Panel in other settings but not here, would be one possible tool of choice.

8) Oil and gas companies – One of the main advantages sometimes attributed to shifting from an income tax to a consumption tax is that it would make inter-asset and inter-business tax neutrality much easier to achieve. If everything is being expensed, one does not face the issue that arises under an income tax of differing departures from the rate of cost recovery that would be dictated by accurate income measurement.

The oil industry, given its notorious political clout, might provide an immediate test of this proposition. For cost recovery actually to be more neutral under a consumption tax than the existing income tax, its being technically easier to achieve, while helpful, is not enough. One might also have to posit that providing treatment that was better than expensing would be a hard sell politically by reason of its arguably unfavorable optics. However, this would not necessarily be the case, given the variety of means (discussed earlier) that could be used to achieve better than exempt treatment.

9) Other special industry rules – While few if any industries consistently match the political clout of oil and gas, many others might find themselves in a position to get better treatment than expensing. Consider, for example, the tax credits under current law for various energy-related outlays, research and experimentation expenditures, and rehabilitation expenditures. Even if the proponents of these items did not win special concessions at the time when an X-tax was enacted, they or other proponents of special

treatment for particular items could be expected to try again once the initial reform impulse had faded.

10) Necessities such as food and rent – On a more optimistic note, although necessities such as food are often exempted or given lower rates in retail sales taxes and VATs, there may be reason to hope that this special treatment would not extend to an X-tax. For one thing, the treatment of wages in an X-tax provides an alternative vehicle for offering progressivity. For another, the optics would be different in an X-tax if people think of them as being paid at the business level by the business itself, rather than by consumers (presumably the standard popular view of a retail sales tax or VAT). Taxing rental payments for housing might also be feasible given the nominal imposition of the business portion of the X-tax, although an exemption for small businesses might cover small-scale operators in the field.

C. Other Structural Issues

Political considerations, in addition to motivating particular exceptions to a comprehensive consumption tax base, might also induce the adoption of broad structural features that would add complexity. Recent history suggests two possibilities in particular. The first is a 1986-style approach of limiting the deemed over-use of special tax benefits, as opposed to denying the benefits altogether. The second is an approach like that in the Tax Reform Panel's "Growth and Investment Tax Plan," where what was otherwise a consumption tax had as well a provision for taxing individuals' capital income to the extent not sheltered through tax-free savings accounts.

1) Limits on "over-using" tax benefits – One of the most important structural features of the 1986 Act was its expanding the use of what I have called "selective

limitations” on the deemed over-use of tax benefits (Shaviro 1989). These rules condition the allowability of a given tax benefit on its interplay with other items, often by preventing taxpayers from claiming an overall loss with respect to a given set of associated items. Examples from present law, several of which were introduced or expanded in 1986, include nonrefundability, the alternative minimum tax, the passive loss rules, the investment interest limitation, the capital loss limitation, and the at-risk rules.

In the current income tax, such rules serve three distinct purposes. One is limiting the benefit one can immediately reap from outright cheating. A second is limiting the use of tax preferences that Congress deliberately enacted. A third is limiting taxpayers’ ability to exploit the realization requirement, such as by selling loss assets while holding gain assets or borrowing against unrealized appreciation.

While the last of these three purposes would cease to be necessary under an X-tax, the first would remain, and is a commonly cited reason for retaining nonrefundability (Bankman and Schler 2005). The second, limiting the use of deliberate tax preferences, would likewise remain if Congress departed sufficiently from giving the X-tax a comprehensive base. Thus, one could (horribly) imagine something like the AMT being imposed to limit tax benefits at the business and/or individual level.

2) Add-on individual-level tax on capital income – A second set of possible politically induced structural issues is suggested by the decision of the Tax Reform Panel to complicate what was otherwise an X-tax proposal by adding a 15 percent tax on individuals’ investment income, such as from interest, dividends, and capital gain. The apparent motivation, forestalling the criticism that wealthy investors were paying no t tax

(notwithstanding taxation at the business level), could potentially persuade Congress as well if it was enacting an X-tax through bipartisan compromise.

The complications that might result from the use of this approach include the following:

--As under the Tax Reform Panel's plan, taxpayers would presumably be able to avoid the add-on capital income tax to the extent they made use of tax-free savings accounts. Various complications associated with using the accounts might therefore arise, such as tracking distributions from the accounts to the extent that special rules limited their permissible use.

--If some financial assets were exempt from the 15 percent tax, further tax planning would be required, such as not "wasting" one's exemptions by placing assets that yielded tax-free income in a tax-free account.

--If deductions were allowed against taxable financial income (as seems reasonable), items such as interest expense would need to be allocated or apportioned as between taxable and tax-free income. The line between personal and investment expenses, occasionally an issue under present law, would also have to be monitored.

--Taxpayers would presumably try to avoid or at least defer the tax by holding assets at the business level. This might create a need for anti-abuse rules, like the accumulated earnings tax under present law. One might even need rules generally defining the working capital that a business is allowed to count as integral to its operations, given that the definition of a business would not be as entity-based as under present law.

D. Public Assistance Benefits

At present, the earned income tax credit (EITC) is the only major program offering income support to the poor or near-poor that is formally integrated with the income tax. Other income support programs, such as Temporary Aid to Needy Families (TANF), Food Stamps, and Medicaid, rely on separate determinations of need. All of these programs, however, use income in one way or another in determining eligibility and the amount of aid that one gets. (Earnings and assets also matter in particular programs.)

The EITC, by reason of its being administered through the income tax, is the only one of these programs that would be directly affected by enactment of an X-tax. For the other programs, however, a question would naturally arise as to whether they should change towards a consumption base as well. One argument for such a shift would be that the marginal burden of measuring income would be increased if not already necessary under the income tax. A second argument would be that, if consumption or wages is the appropriate distributional measure for tax purposes, it should be considered as such more generally, including under the transfer programs. After all, the basic enterprise of measuring material wellbeing is the same in the tax and transfer systems.

Thus, under the X-tax, one could imagine wages being used to determine who should get TANF, Food Stamps, and Medicaid benefits. However, in the absence of complementary asset tests that do not fit well with a consumption tax philosophy, this would seem to mean that wealthy coupon-clippers should get the benefits. This, in turn, however, might alarm even the most stalwart consumption tax advocates.

How can a distributional measure that many prefer to income on the tax side seem less well-suited to the transfer side? The answer, I think, goes to the choice of time period for measuring how well-off one is. The core distributional argument for a

consumption tax looks at lifetime income, which sets the budget line for lifetime consumption if one can borrow and lend freely between periods. However, we may want to help people who are poor in a given period, even if they had resources in the past or expect to have resources (but cannot borrow against them) in the future. Thus, consider an elderly retiree who has spent all of her lifetime earnings and is now destitute. Leaving aside the point that we can compel her to save through Social Security and Medicare, we may want to help her despite the resources she had in the past and the incentive problems associated with anticipating rescue.

E. Aftermath of Enacting an X-Tax

A final question concerns the effect of X-tax enactment on subsequent tax politics. One certainly would hope that a consensus bipartisan enactment would prove more stable than I have suggested the “five easy pieces” reform would be. But to what extent would the post-1986 history of gradually adding back special provisions repeat itself? After all, the enactment would swiftly become yesterday’s news, of little interest to politicians who wanted to gain political credit for doing something today. Any optimism that this process could be averted might have to rest on some sort of partially exogenous change that resulted in the tax system’s ceasing to be as much of a central political arena as it has been for the last few decades.

Such change has happened before. Tariffs, for example, no longer attract the level of constant political activity that they did for much of the nineteenth century and through the 1930s. Yet it is hard to see what would motivate the change this time around. Tariffs ceased to be as major a revenue source with the rise of the income tax. They also had been blamed for the onset of the Great Depression, and may have lost ground

politically due to the post-World War II rise of a larger export sector that was vulnerable to retaliation by other countries. Personal and business taxation, by contrast, would still be a crucial source of federal revenues, rivaled only by payroll taxes.

Even if special interest activity became less of an ongoing factor in personal and business taxation, the activity might simply move elsewhere. This might be a relief for people who take especial interest in the tax system, but it would not necessarily mean that politically induced economic distortion and complexity were declining overall. An overall improvement would probably require a change in the basic political dynamics that apply at the national level and below, relating to policy transparency, political accountability, campaign financing, and other election dynamics such as the use of gerrymandering.

V. CONCLUSION

While there have been decades of academic debate regarding the relative theoretical merit of ideal income taxes and ideal consumption taxes, a major reason for favoring consumption-based reform has been dismay about the actual income tax that we observe. Its complexity, pervasive encouragement of socially wasteful tax planning, and susceptibility to creative avoidance schemes have prompted the hope that a consumption tax could do much better.

Depending on the particular path to consumption-based reform that Congress actually followed, these hopes might conceivably be realized to an extent. A reasonably well-designed consumption tax would avoid tax planning issues related to the realization requirement. In addition, while an income tax need not distinguish between debt and equity in the manner of the current system, consumption-based reform might aid politically in conforming their treatment. Finally, shifting to a destination-based consumption tax would permit the elimination of transfer pricing issues.

In other respects, however, reformers' simplification hopes might be disappointed. For example, despite the salience of expensing as a uniform cost recovery method, shifting to a consumption tax would not necessarily reduce Congress's inclination to use the tax system (or perhaps some other set of rules) to favor particular industries. Credits, exclusions, extra deductions, and special rates are all feasible routes to industry-specific tax favoritism. The use of special business rates, in the manner of various European VATs, would add a largely novel type of complexity to U.S. federal tax practice, and could undermine the administrative advantages of operating a closed system in which inter-business transactions were always a wash (nonrefundability aside).

Finally, the likelihood of future tax increases by reason of the fiscal gap would cast a shadow over the system, subjecting long-term investment to a positive expected rate and inviting taxpayers to play timing games at the point when rate changes are more imminent.

The tax planning issues are likely to be a great deal worse in the event of a five easy pieces-style stealth reform. A process that relies on one party's tight legislative control and on concealing from the public the actual import of the policy changes does not inspire confidence, for two distinct reasons. The first is the likely lack of open deliberation regarding possible problems with the changes and how they might be addressed. The second is the proponents' possible reluctance to make potentially controversial changes that would be needed for the system to work, such as addressing interest deductions and the arbitrage between consumption tax treatment of receipts and income tax treatment of outlays.

Even in the case of an open and bipartisan reform process, public ambivalence about the consumption tax norm could lead to political compromises that created substantial complexity. One possibility is the use of 1986-style back-up limitations on special tax benefits or dangers of abuse. Nonrefundability would already be one example of such a rule, and something like the current AMT is not out of the question either. A second possibility is the creation of an extra, even if low-rate and avoidable, tax on investment income in the manner of that in the 2005 Tax Reform Panel's GIT proposal.

"Tax simplification" is always an appealing slogan, in addition to being genuinely desirable. Once we get beyond slogans, however, simplification is a public good that few political actors value more than the opportunity to shift their own tax burdens to someone

else. In our frequently corrupt political system, at once too responsive and not responsive enough, this greatly limits the actual tax simplification that one can ever realistically expect.