

"The Cash Flow Version of An Expenditure Tax"

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I. INTRODUCTION

In this paper a comprehensive plan for the introduction of a progressive consumption, or expenditure tax, is presented. As a first step various arguments that favor the use of consumption, rather than income, as the personal tax base are reviewed. Since many of these arguments are based on the shortcomings of the existing income tax system, they depend on the nature of the income tax system an expenditure tax will replace. However, they also depend on value judgments regarding trade-offs among various social objectives. In addition, the advantages of a consumption tax base hinge on factual issues, such as what will happen to savings and growth under an expenditure tax system.

Fundamental criteria or principles of taxation which form the basis of any evaluation of a tax system are considerations of efficiency, or optimality, and the principles of horizontal and vertical equity. Considerations of equity require judgements on what observable economic quantity is the best measure of ability-to-pay and what measure is the best index of equality between households.

Economists have become increasingly aware that income and consumption, as measured in the marketplace are only imperfectly related to a person's ability to pay taxes or his overall endowment. This is because a person's taxpaying capacity depends not only on the amount of goods he can consume but also on the amount of time he can devote to

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Microeconomic*

consumption type activities, like sailing and golf. However, it is not administratively feasible to tax the value of a person's endowment of time that he allocates between leisure, work effort in the marketplace, and household production. One key reason for this is that it is difficult to determine the appropriate value for evaluating an individual's endowment of time. For example, money wages are not necessarily a good measure because professions may differ in nonpecuniary income.

As a result of such considerations, any observable, measureable quantity, such as market income or consumption, is likely to be imperfect as a basis of taxation. However, with a more restricted definition of endowment in a world of certainty, the present value of a person's endowment could be calculated by discounting the stream of his life-time wages and salary income plus the bequests and gifts that he receives. The number so calculated might then be used as the basis of an endowment tax. However, as a practical matter, the tax could not be imposed on such a measure of endowment as this magnitude would be uncertain at any given time. A tax could, however, be imposed on consumption and if the present value of a person's lifetime consumption is equal to the present value of his endowment (his bequests are zero), the basis of an expenditure tax would be equivalent to the basis of an endowment tax.

Consequently, from a life-cycle perspective, neglecting bequests, leisure, household production, and so forth, using

consumption as the tax base appears to be the best means of establishing horizontal and vertical tax equity. The problem of bequests could be handled by means of an accessions tax. Under such a tax, a person who received a gift or bequest would pay a separate tax on this component of his endowment regardless of whether he used it for consumption or not. To the extent that the inheritance was subsequently used for consumption it would be subject to double taxation, first under the accessions tax and then under the expenditure tax.

Although an accession tax would alter a person's savings behavior, the effect would be small in relation to the impact of an income tax where profit and interest income are subject to a double tax. This is because profit and interest income, which had been generated by savings subject to tax in the past, also would be taxed in the current period under an income tax.

As an expenditure tax base does not impose a double tax on profits, people would consume more in later stages of life under such a tax since the price of future consumption relative to current consumption will be lowered. Of course, current consumption would be lowered and the capital stock would increase.¹/ Thus the substitution of an expenditure tax for an income tax, of equal yield, is likely to increase the amount of savings and lead to capital formation and higher overall consumption possibilities in the long run.

While the employment effects of an expenditure tax are somewhat less clear, it is important to recognize that the

apparent increase in tax on earnings implied by an expenditure tax is really only a tax increase on the share of earnings used for current consumption. The expenditure tax corrects the bias against future consumption (saving) inherent in an accretion type income tax. Given the current state of our knowledge, this paper adopts an agnostic stance on possible favorable effects of an expenditure tax relative to a equal yield income tax on the lifetime allocation of time between work effort and consumption. It seems likely, however, that future analysis will show that an expenditure tax reduces work effort less than an income tax of equal yield, and that it would lead to higher levels of social welfare.

This speculation is supported by the fact that individuals are more productive in the first thirty years of their adult lives (as evidenced by age-earnings data) than in last twenty or thirty years. Thus, under an expenditure tax (in contrast to an income tax) a person will tend to work more when he is young and has a comparative advantage in producing income. Leisure activities; travel, cultural appreciation, golf, will be more likely to be postponed until the semi-retirement period. An expenditure tax would facilitate and stimulate more work during the early productive period as it would increase future consumption possibilities by exempting profit and interest income.

A further aspect of the incentive argument is that an expenditure tax would create new incentives for the

accumulation of new fortunes by exceptionally productive young men and women. While the preservation of older fortunes would also be facilitated under this system, it would impose a penalty in addition to the accessions tax on consumption out of inherited wealth.

Another set of arguments favoring the consumption base are the shortcomings of income as a measure of a person's taxable capacity -- "spending power" or endowment. For example, it seems inequitable to impose the same rate of tax on an additional \$5,000 of wage income and on \$5,000 earnings on \$100,000 of wealth, since the person with the capital income will have more time to devote to non market activities. For these reasons a person's endowment or overall wealth is imperfectly measured by income and, in our view, consumption will typically be more closely related to overall endowment or ability to pay than income.

Closely related to this issue are various difficulties in correctly measuring capital income. First, inflation can distort accounting measures of income since depreciation and some interest rates are set in nominal terms, and capital gains are fictitious to the extent that they reflect inflationary appreciations. Although equity problems caused by inflation will not totally disappear under an expenditure tax unless the tax system is indexed, they will be much less pronounced than under an income tax, because the tax base will be less susceptible to measurement errors.

The taxation of capital gains represents a key problem under the current income tax. For administrative reasons,

capital gains are not taxed on an accrual basis and as a result many wealthy persons are able to postpone their taxes indefinitely and to reduce their income tax liability by converting income to capital gains. Thus, persons with the same amount of wealth or spending power often pay very different taxes under the income tax.

Another reason why horizontal and vertical equity are often severely compromised under the current income tax is that the combination of capital gains, borrowing, and various tax shelters in housing, oil drilling, equipment leasing, and agricultural investments, decreases effective tax rates on wealthy persons. In fact, most such devices for reducing income tax liabilities are available and attractive only to those taxpayers with substantial amounts of wealth.

While many of these loopholes might be closed under more comprehensive income tax, such a reform is likely to be very difficult and incomplete. Administrative difficulties are apt to prevent the taxation of capital gains on an accrual basis. This consideration is reinforced by the equity argument that the lower tax rate on capital gains provides some adjustment for the impact of inflation on tax liabilities.

We believe that many, if not most, of the reforms often discussed under income tax reform will come about naturally through the introduction of an expenditure tax. Under the expenditure tax of the type outlined below there is no basis

for the tax preferences granted to homeowners, and no tax advantages to recipients of capital gains income, and municipal bond interest. Income tax reform has made little progress in the past and we believe that the public and Congress are more likely to adopt significant reforms in the context of a complete fundamental reform of the Federal tax system.

The elimination of capital gains taxation and other taxes on capital income would greatly simplify the administration of the Federal tax system. Although the expenditure tax is sometimes regarded as too difficult to administer, strong arguments can be made that the administrative complexities introduced by the expenditure tax are quite manageable and small relative to gains of simplicity that will come about from the elimination of complicated provisions on capital gains taxation, depreciation, depletion, and the tax treatment of corporate earnings.

One of the principal attractions of an expenditure tax is also one of the principal criticisms of the tax. This is that wealth is not subject to taxation under this tax system. Some writers, beginning with Thomas Hobbes, have placed emphasis on the social value or social externalities associated with savings and the accumulation of capital. Consumption has been characterized as representing a withdrawal from the common pool, while net savings are represented as additions to the common pool. Although many

people will have trouble with the notion of withdrawal from the common pool in a system of private property rights where individual effort is viewed as the basis of income and consumption, nonetheless this concept is useful in that it dramatizes the social value of additional capital in improving the productive capacity of society.

Under a consumption basis, wealth is not subject to tax unless it is consumed, although it represents ability to pay. One justification of this exemption is the common pool concept of the social value of wealth. Another justification is that for most persons accumulated wealth represents deferred consumption that will be subject to tax at some later point in their lives.

If taxes are based on consumption the problem of wealth left as bequests or gifts can be solved by taxing this accumulated wealth under an accessions tax. Also, there are various advantages, including efficiency, equity, and administration, which seem to favor a consumption base over an income base for the tax system.

II. GENERAL NATURE OF INTEGRATED PROPOSAL

The main recommendation of this paper is to replace the personal income tax imposed on households and individuals with a progressive expenditure tax. In addition, the paper recommends the elimination of the corporate profits tax and

the replacement of the current gift and estate tax by an accessions tax. Under an accessions tax, tax liability would depend on the amount of inheritances received by donees, rather than the amount of estates left by donors. Together these proposals represent a very comprehensive reform of the Federal tax system. Of course, in making these recommendations it is recognized that they both bear on the parameters (standard deductions, rates, etc.) of the system. The general guideline we suggest for setting these parameters is that the existing vertical burdens of the tax system be maintained as nearly as possible. The vertical pattern of burdens is, of course, a separable issue.

The main objectives of an accessions tax and an estate and gift tax are quite similar. Both stem from the broad political consensus that the tax system should be used to lessen the concentration of wealth and the widely held view that a special tax should be paid by those who are fortunate enough to inherit physical and financial wealth. In a world where there are no substantial income and wealth differences among various households, and inheritances are modest, the treatment of gifts and inheritances would be quite simple under an expenditure tax. Gifts and bequests would be deducted by the donor but would be counted as receipts (income) by the donee. However, as there are marked differences in the earning capacities of indifferent households and in their wealth positions a separate tax should undoubtedly be imposed on inter-generation transfers of wealth.

It might be argued that if an individual does not consume his total endowment over his lifetime that his bequest should be treated as consumption. After all, the donor has the option of consuming his wealth or leaving it to his heirs. As the margin, it is reasonable to assume that a donor values money left to his heirs as much as a dollar used for current consumption. This is an argument in favor of an estate tax. However, an accessions tax, by reducing the consumption possibilities of a donor's heirs, would also effectively impose a tax on the consumption value of donor's bequests. Indeed, overriding considerations seem to favor an accession or inheritance tax imposed on the donee rather than the donor. Although in a sense the burden of an estate tax does fall on the donee, as it decreases the size of the estate, there is reason for making this burden more explicit. For, if a tax is to be imposed on inherited wealth so as to lessen the concentration of wealth, the tax should depend on whether an estate is left to one heir or to twenty.

Also, society may deem certain organizations and institutions more deserving of inheritance than heirs who are individuals and it would be simpler to express this preference in the form of differential taxes on the donee rather than through deductions for charitable donations under the estate tax.

Under the accession tax, as elaborated upon in a later section of the proposal, the tax treatment of gifts and bequests would be integrated. Also, the tax would be on

lifetime accessions rather than on annual accessions. The principle here is that the tax should depend upon the accumulated sum of the good fortune rather than on the size of the receipted bequest. One weakness of the separate accession tax is that it is not based on the total circumstances of the individual but only on lifelong accessions. Part of this difficulty could be handled by allowing a sizable exemption.

The accessions tax proposal is really a new way of addressing the objectives now implicit in estate and gift taxation. In addition to simplifying some aspects of transfer taxation, it seems better suited to attain the objectives of estate and gift taxation. As explained later, all of the issues of deferral which are associated with the taxing of trusts under an accretion tax are easily solved with an accessions tax. Also, under the expenditure tax, we propose to treat transfers as deductible from the cash flow base of the donor and includable in base of the donee so the accessions tax also "corresponds" with this feature of our proposed system.

However, the replacement of the gift and estate tax by an accession tax is not basic to the adoption of an expenditure tax and there is no obvious reason why the existing estate and gift tax system could not be super-imposed on this structure.

The same general point also applies to the corporate profits tax. The expenditure tax could be introduced without

any change at all in the corporate income tax. Yet, it is our view that the benefits of the proposal would be significantly reduced if the corporate tax is not eliminated, as this tax makes even less sense under an expenditure tax than under the present tax system, since the corporation tax would represent a tax on savings used to invest in corporate equities.

Also, the elimination of the corporate tax would considerably simplify the Federal tax system. Provisions on depreciation, depletion, capital gains, inventory evaluations, as well as tax rates and tax credits could be eliminated from the tax code. Stockholders would merely report dividends as part of their cash flow under the expenditure tax and realized capital gains would be included in the tax base, and thus would be taxed if they were not saved. The reporting of profits, gross and net, would not be required for tax purposes. A discussion of the advantages of eliminating the corporate tax follows.

First, corporate profits would not be subject to tax and this would stimulate savings. As corporate equity would no longer be subject to tax, the tax distortion between corporate and noncorporate investment would be eliminated. The tax incentive to retain earnings and to invest them within the firm, rather than in higher yielding investments elsewhere, would also be eliminated. Because of this, misallocation of capital within the corporate sector would be eliminated. Also, the current bias toward using debt financing would be eliminated.

Under the present tax system, the distortionary effects of the tax on corporate equity are in large measure offset by the deferral of tax on capital gains under the realization procedure. For example, in the extreme case a taxpayer in the 50% tax bracket will effectively pay very little, if any, tax on current earnings if earnings are retained and the accrued capital gains are not realized for many years hence.^{2/} If the corporate tax is 50%, then for this special case the high bracket taxpayer will pay approximately the same effective tax on investments in corporate equity and corporate debt and in non-corporate investments. Of course, the offsetting tendencies of the current system are only approximate and integration of the corporate and the personal income taxes would be more neutral with respect to the allocation of savings.

Under an expenditure tax, capital gains and dividends would be taxed at the same rate and would be taxed only when the proceeds are consumed. Consequently, in contrast to the present system where there is a tax penalty for paying our dividends as earnings, with an expenditure cum corporate tax system corporations will have a very strong tax incentive to change their financial structure by paying our most, if not all, of the earnings as dividends and relying much more on debt finance. The share of corporate equity in the financial structure of corporations would be reduced to a minimal amount and it is for this reason that we consider the corporate tax as out of place, if not inconsistent with an expenditure tax system.

The other main disadvantage of retaining the corporate tax is that complicated accounting problems associated with the measurement of corporate income would continue and the principal administrative advantage of an expenditure tax would be eroded. One of the main advantages of a cash flow expenditure tax is that it would no longer be necessary to measure net profit income, for tax purposes. Of course to determine business income it would be necessary to measure the costs of doing business; i.e., wages and other expenses. On the other hand, depreciation, depletion, and inventory evaluations would no longer have to be measured for tax purposes.

To summarize this section, we propose that along with the introduction of a cash flow expenditure tax, the present gift and estate tax be replaced by an accession tax, which is described more fully in a later section of this paper, and the corporation profits tax be eliminated. We view the elimination of the corporate tax as being quite fundamental to the success of this proposal. The accession tax is less fundamental, but would represent a significant improvement over a gift and estate tax system which could also be superimposed on an expenditure tax system.

III. A CASH FLOW TAX AS AN APPROXIMATION TO AN EXPENDITURE
TAX

If we adopt consumption rather than income as the basis of taxation, a choice has to be made between direct and indirect forms of taxation. The direct form of taxation, where the tax liability is imposed directly on households and tax burdens can be tailored with more precision to the specific circumstances of the taxpayers and made directly progressive seems preferable to the indirect form of taxation on transactions. A consumption tax system with a progressive rate schedule is known as an expenditure tax.

The individual household's flow of consumption services can be determined using annual cash flow information. It is for this reason that we refer to this reform as a cash flow tax (CFT henceforth).

It is important for administrative considerations that the CFT be based on current market flow information to avoid the need of keeping information over long periods of time on assets, consumption, and so forth, and not require complicated balance sheet information on changes in net worth.

It was first recognized by Irving Fisher that the flow of annual consumption and savings can be calculated by means of current cash flow information without a complicated tallying of every consumption expenditure. The general

nature of this calculation consists of two basic steps. The first is to calculate all cash receipts over the tax period (year). In these receipts the taxpayer would report:

- (a) wages and salaries,
- (b) interest and dividends,
- (c) gross receipts of personal business enterprises minus expenses (cost of doing business), proceeds from
- (d) the sale of all assets, (except consumer durables) stocks, bonds, real capital, land, producer durables, and so forth, and
- (e) all retirement income, social security, company pension, annuity income, and so forth.

These receipts items are meant to illustrate and are not to be fully comprehensive since more complicated items under receipts are discussed in the next section. But the general principle is straightforward; all receipts whether income or from the sale of assets would be included in receipts.

In order to calculate or to arrive at consumption, the taxpayer will be allowed to deduct:

- (a) purchases of all income-earning assets; real capital, stocks, bonds, savings accounts (net change in value), checking accounts, cash (other than petty cash), land, and inventories;

- (bl) all costs of acquiring income, whether wage or capital;
- (cl) various deductions currently allowed under the income tax, such as charitable deductions, state and local taxes as discussed in the next section of the proposal.

In essence, the consumption or expenditure base would be arrived at by adding together all receipts and deducting from this figure the current (annual) purchases of all income producing assets.

For example, if an asset is sold and the receipts are used to purchase another asset of equal value there would be no tax consequences (regardless of the existence or not of "capital gains" as now defined). If the receipts are not reinvested, but are used for purchasing consumption services, the tax levied would be based on the total consumption. Similarly, wage income that is not consumed and shows up in an increase in savings account would not be taxed as consumption, as the increase in the value of the savings account would be deductible.

While the basic Fisher cash flow approach to calculating current consumption is reasonably straightforward, there are several of conceptual issues associated with the tax treatment of consumer durables and the purchase of assets, financial and otherwise. One main issue is, that there are two alternative ways, more or less equivalent, of treating saving and dissaving under a cash flow tax.

One approach would be to allow a deduction for savings and include all receipts from the savings in the calculation of expenditures in subsequent years. The second possibility would be to tax savings as they are made (not allow a deduction for savings) and then to exempt future consumption made possible by receipts produced from the savings. Also, there are two almost equivalent ways of handling consumer durables. One is to tax the purchase value of the durable at the time of purchase. The second is to tax the future value of the services of the durable over the life of the durable. Similarly, we will see later that there are two equivalent ways of treating consumer durables. The choice between the alternative approaches will be determined by administrative and compliance costs and by averaging considerations. As we shall explain below by allowing the taxpayer to opt for, or chose the type of tax treatment, tax assessment on the basis of lifetime consumption would be automatically provided and the need of direct averaging provisions in the tax code would be eliminated. The averaging provisions in the present law are quite complex and rather haphazard in their use. For example, there is now only up-side averaging.

For expositional convenience we shall begin with a restrictive special case. Consider a situation in which the tax system consists of a single proportional tax rate, where there is one asset and where all individuals can borrow and lend at the same rate of interest.

Then, in order to exempt savings from taxation, the ordinary or standard way of dealing with savings would be to

allow a taxpayer a deduction for purchases of capital assets. So, if a taxpayer's receipts are \$10,000 and he buys \$1,000 of capital assets, his tax (consumption) base will be \$9,000.

On the other hand, if the taxpayer sells the capital asset, he must report the receipts from the transaction as current receipts. In the more general case where there are several assets, sales and purchases of different assets would tend to cancel out, yielding the level of net saving or dissaving.

The alternative way of dealing with savings is to allow the taxpayer to prepay tax on savings that will ultimately be consumed, by not allowing a deduction when an income earning asset is purchased, but by exempting consumption financed by receipts from this account (asset) when it occurs. This tax treatment we shall refer to as the equivalent approach, in contrast with the standard or ordinary approach.

It is a straightforward matter to see that for a proportional tax schedule the present value of taxes under both schemes are the same. Consider \$1.00 of savings under the standard approach. No tax is paid when the asset is purchased and interest accumulates at a rate of $r\%$ a year. When the accumulated wealth is sold t years hence and the proceeds are consumed, a tax equal to $1(1+r)^t(t_e)$ is levied on the $1 \cdot t_e$ which is exactly equal to the tax that would have been paid if the asset had not been deductible from current receipts. So, without rate progressivity the taxpayer would be indifferent between paying tax on the

purchase of an asset or paying tax on the sale of the asset plus accumulated interest (consumption) in the future. Another way of seeing through this equivalence is to note that if the tax is paid at the time of purchase, the government can invest the tax proceeds at the same rate r and end up with the same amount of real resources it collects on the larger tax base in the future when the assets are sold for consumption.

The same general equivalence applies in the case of loans. Under the standard or ordinary approach, loan proceeds would be included in current receipts and the repayments of interest and principal would be deductible. On the alternative or equivalent approach, the taxpayer would not include the proceeds of the loan in receipts, but would not be allowed to deduct interest and principal repayments. When the loan was made for investment purposes, there would be no tax consequences associated with the equivalent approach. No taxes are collected on the transaction, and the loan of \$1.00 at a rate r to purchase an asset which yields r does not increase the taxpayer's net worth. Under the ordinary approach, if the taxpayer in the 50% tax bracket borrows \$1.00 he will pay a tax of \$.50 and then have \$.50 to invest at a rate of interest of say 10%. So, he ends up with investment proceeds of \$.55 and then is able to deduct \$1.10 from tax liabilities next year. This tax deduction is worth \$.55. So, he ends up with \$1.10 from the transaction in the next period which is exactly what he owes the bank.

The equivalence between the two alternative ways of treating loans is of special interest for the treatment of consumer durable loans. Before discussing the equivalence in this context, we consider two equivalent ways of dealing with consumer durables.

One way of taxing consumer durables would be to impute an annual rental value to the durable. For example, consider an extreme case where a durable has a useful service life of 1 year and costs \$1,000; then if the investor's cost is to be covered the rental value is depreciation (\$1,000) + interest (10% of \$1,000) = \$1,100. So, if the tax was assessed on the rental value at the end of the year and the taxpayer were in the 50% tax bracket, he would pay \$550 in tax at the end of the year. The alternative approach is to tax the asset when it is purchased. On that approach the tax liability would be \$500 which is equal, in present value, to \$550 at the end of the year.

The general principle that this example illustrates is that the capital value or the purchase price of the durable is equal to the present value of the services the purchaser expects to reap from the asset. In principle, if the depreciation or useful life of the asset were known, a tax which taxed the services as they accrued would be equivalent in terms of present value to a tax on the original value of the asset. The difference between the sum of the rental values and the initial cost of the durable in each period is the value of the interest cost paid for the capital tied up

in the durable. So, the nominal tax collected is larger for the rental approach, but since the payment is postponed by spreading out tax liabilities over the life of the asset, the tax liabilities in terms of present value will be the same under both the rent imputation method and the approach where the tax is levied on the purchase price of the consumer durable.

While the two approaches to the taxation of consumer durables are equivalent in present value of tax receipts, strong practical considerations point to using the full inclusion of durables in the tax base at the time of purchase. This strategy avoids the necessity of determining the rental value of consumer durables and measuring depreciation. Also, taxpayers would not have to keep complicated records.

Some durables also have an investment aspect associated with them. For administrative and record keeping simplicity, we propose that as investment goods consumer durables be always treated as if tax was prepaid on the asset when it was purchased.

Thus, the following rules would apply to consumer durables:

- (1) Purchases of durables are not deductible under the expenditure tax.
- (2) Any rent on durables, such as the temporary rental of a beach cottage, is not included in receipts.

- (3) The revenue from the sale of any durable including any appreciation on the durable, such as valuable paintings, are excluded from receipts. The principle which applies here is that the tax was prepaid at the time of purchase and that any income earned on the asset is exempt from tax.

When loans are made for consumption purposes, they can be treated by the standard approach where the proceeds are included in current receipts and the interest and repayments of principal are deducted. As noted in the discussion above, a loan does not change the net worth or the tax liability of the taxpayer. It is the use of the proceeds for consumption that leads to an increase in tax payments if the loan results in an increase in the present value of consumption.

Alternatively and typically, a consumer loan will merely change the temporal pattern of consumption, leaving the present value of average consumption spending and consumption taxes unchanged.

An equivalent treatment of consumer loans would be to exempt loan proceeds from receipts and not to allow deductions for amortization of the loan. Suppose for simplicity that a person buys a \$50,000 house and finances it completely with debt. If the loan proceeds are excluded from receipts, the expenditure tax would not be paid at the time of purchase. But, as monthly mortgage payments are

paid, they would be counted as current consumption and expenditure tax would be paid on the interest and loan amortization. This is as it should be, as the tax on the interest payments can be viewed as a tax on the rental value of the house or as a price for postponing the payment of tax.

Give the equivalence between the ordinary or standard way of treating assets and loans, and the alternative or equivalent treatments, the question arises whether the taxpayer should have the right to elect the tax treatment or whether administrative simplicity implies the choice of one, and only one, tax treatment.

Administrative simplicity dictates that savings or the purchases of assets be treated by the ordinary or standard approach since under this approach, the taxpayer would include the sale of investment assets (in contrast to consumer durables), in receipts and deduct the purchase of investment assets. In contrast, loans could be treated in the standard or alternative way. Thus, taxpayers would keep separate accounts on loans which have not been included in receipts (income) when they are made and those which have been included. However, in the absence of averaging considerations, there are good reasons for treating loans in what we have called the equivalent or alternative way. Under this approach, loans would not be counted as current receipts and the repayment of loans and interest charged would not be deductible. Record keeping and other problems of taxpayer compliance would be simplified with only one tax treatment

for loans. As many loans are made to finance consumer durable purchases, the taxation of amortization and interest will approximate the value of services derived from the durable.

Another main advantage of the exemption of loan proceeds, and the taxation of interest and repayments of principal, relates to a consideration we have abstracted from up to this point; namely progressivity of the rate structure and its implications for averaging. For example, if a household purchases a \$50,000 house, its tax liability would go up very substantially because of the magnitude of the purchase and because of rate progressivity. If the household borrows to pay for the house and the proceeds are not taxed, the household would not face a current liquidity problem of having to pay a very substantial tax, and, as it would be taxed on the mortgage payments, an automatic averaging or smoothing of its tax liability would occur.

Considerations of averaging also suggest that the saver be given the option, perhaps restricted in some respects as discussed in a later section on averaging, of buying some assets or accounts on which tax has been prepaid. Thus, we propose that in addition to ordinary or standard assets which are deductible when purchased and includable in receipts when sold, the taxpayer would be able to open up savings accounts that would not be deductible when acquired or added to. However, withdrawals from these accounts would not be included in receipts and so consumption financed with these

assets would not be subject to consumption tax. In effect, the tax is prepaid and is taxed at the marginal tax rate the household is subject to at the time the account is built up.

It is not the intention of this proposal to restrict the type of assets that would qualify for this alternative tax treatment A. Thus, taxpayers would be able to designate stocks, bonds, savings accounts, either as assets (standard assets) or as A assets. The basic rationale for the provision for both types of accounts (assets) is averaging and allowing the taxpayer considerable flexibility in the timing of his tax liabilities.

For example, consider an elaborate wedding planned ten years in advance. If the wedding is financed by means of standard or ordinary savings, the household will incur a large tax liability because of the lumpy nature of the expenditure and the progressivity of the tax structure. To avoid the "lump" in tax liabilities, essentially to average tax liabilities, the household can purchase A type assets and prepay the tax liability on the wedding.

More generally, the availability of two types of accounts which vary in terms of their tax treatment; one which is taxable upon purchase the second which is deductible upon purchase provides the taxpayer considerable flexibility in the timing of tax payments over his life cycle. As the example of the wedding brings out, large lump expenditures and tax payments can often be anticipated and handled by the taxpayer through appropriate accumulation of tax prepaid

accounts (A-assets). Also, if large consumption expenditures cannot be fully anticipated, the taxpayer, by holding A-type assets, can protect himself against large increases in his marginal tax bracket. Furthermore, even in the absence of such assets taxpayers could generally decrease tax liability by borrowing and not taking current loan proceeds into receipts and paying the tax in later periods when they are not able to deduct principal and interest repayments on the loan.

Related portfolio adjustments also provide for downside averaging. If a person expects consumption expenditures to drop in the future, he can borrow without paying taxes currently and pay taxes as he repays what he owes. To provide maximum flexibility in adjusting portfolios to achieve both upside and downside averaging, both types of loans should be available as well as standard assets and alternative assets. Of course, the introduction of full flexibility for averaging introduces complexity into tax administration and complicates record keeping and tax compliance for the taxpayer.

In any case, averaging provisions are not essential to this proposal. As we have explained above investors will be able to use a combination of loans and asset purchases to achieve a kind of averaging. We regard this as a great virtue rather than a limitation since it enables the taxpayer, in effect, to have his tax assessed on the basis of lifetime consumption, rather than on the basis of any

particular reporting period's consumption. An aspect of this is that the averaging problem is dealt with, at least in an ex ante sense. However, while these automatic averaging features obviate the need for complex averaging proposals, there still might be a need for expost averaging. For example, a person who does not correctly anticipate a change in income and consumption will suffer "too high" a tax burden. It is difficult to anticipate how serious the sort of problem is. We will discuss this problem in more detail in a later section of this paper.

IV. A COMPREHENSIVE CASH FLOW TAX BASE

In this section a more detailed discussion of the items which are included in a comprehensive cash flow tax is presented. It is important to recognize that for certain items, such as pension receipts and payments and insurance benefits two apparently very different tax treatments of items are possible and are equivalent to each other. These two treatments correspond to the standard and equivalent treatments of saving discussed above. Either the premiums could be deductible and the receipts taxable or the premiums would be not tax deductible and the receipts would be taxable. So the choice of approach for certain items depends on averaging considerations and on social attitudes rather than on considerations of equity.

Under a comprehensive expenditure tax the tax paying unit will include the following receipts on a current flow basis.

- (a) Wages, salaries, and bonuses.
- (b) Imputations should be made for various fringe benefits, such as company cars, vacations and trips provided at company expense, various discounts of merchandise, company housing and meals, education provided to children, country club memberships, child care facilities, and so forth. In addition, an imputation should be made for food grown and consumed on farms by farm operators and their families.
- (c) All inheritance and gifts, subject to the qualifications in the discussion on intra-family transfers, are to be included as current receipts by the donee. The donor, if he is to deduct a gift, must report the social security number of the donee. Also, all child support payments from a separated or divorced parent would be included in the receipts of the household in which the child resides.
- (d) All receipts from means-tested cash and in-kind government transfers would also be entered. These include AFDC payments, veterans compensation, food stamps (bonus value), and public housing (subsidy

value). Payments received from private charities would also be included under current receipts. Also, all scholarships and fellowships (with the possible exception of tuition scholarships) would be included.

- (e) All interest, dividends, and rent income: rent will be net of normal business expenses, but not of depreciation of capital. State and local taxes on business income and property and rental housing would be deductible in the calculation of net business income. Also, all net cash flow from individual proprietorships and partnerships would be included in receipts.
- (f) Receipts from the sale of all income earning assets; stocks, bonds, real capital, land, and so forth, subject to the qualification that these items were fully taxed at time of purchase are excluded from the tax base.
- (g) Receipts from the sale of consumer durables; houses, cars, jewelry, art objects, and so forth, subject to the qualifications that these items were not taxed initially are included in the tax base.
- (h) Receipts from liability insurance, whether or not they result from successful law suits are included. Deductions for the recovery of medical expenses and for pain and suffering in these suits might be allowed.

- (i) The receipts from flood insurance, fire insurance, and homeowners protection are excluded from receipts. Premiums for these policies are not deducted in the deduction column and are taxed as current consumption. The rationale of this provision is that the insurance protects assets which generate consumption services and the premiums should be taxes as current consumption. However, losses (self-insurance) are not deductible.
- (j) We view life insurance and disability insurance as an investment made to protect a family's consumption level. Life insurance might be treated in one of two more or less equivalent ways. The premiums could be taxed as current consumption. On this approach, life insurance is treated as a tax prepaid asset. On the standard asset approach the premiums would be deductible and the proceeds would be included in current receipts. We prefer the approach where the premiums for life and disability insurance would not be deductible but proceeds would be excluded from the receipts of person(s) who benefit from the insurance. The justification for this treatment is based on averaging considerations. If people are not allowed to average consumption over their lifetimes the inclusion of premia in the tax base and the

exclusion of the benefits will tend to mean taxation of the expected value of the benefits at relatively high marginal rates.

- (k) Essentially for the same sort of averaging reasons we recommend that medical insurance be treated as "prepaid medical services." Insurance premiums would be taxed as current consumption, and employer contributions to medical insurance would be included as current receipts. Proceeds from medical insurance would be excluded from receipts. Any social insurance scheme would be treated on a par with private insurance. Taxes collected to finance medicare or an extended social medical insurance plan would be taxed as current receipts of the household. The basic advantage of this treatment for medical insurance is that averaging problems will be minimized.

At present, the tax code provides for a medical deduction if medical expenses exceed 3% of adjusted gross income. The present system offers a rather haphazard insurance program for high medical expenses, if not catastrophic insurance. If a person does not have medical insurance, unusually high medical expense can be deducted from income and the tax saving will equal the amount deducted

times the marginal tax rate of the individual. Treasury analysis of the use of the medical deduction shows that the tax benefits are concentrated in low adjusted gross income units. This probably reflects an age effect, but we recommend that a provision be made for catastrophic insurance programs that could be made need-related. In the absence of such a program, the present deduction should probably be retained.

- (l) We propose to treat unemployment compensation the same as all other forms of compensation such as life insurance and medical insurance policies. Unemployment insurance has the same element of pure redistribution. Also, one of the current criticisms of the unemployment compensation system is that the non-taxability of receipts promotes more voluntary unemployment than is socially desirable. Although, with this insurance there would be general or approximate equivalence under the two possible alternative tax treatments, we propose to exempt (deduct) contributions to unemployment compensation from income (receipts) but to include the benefits (proceeds) in full.
- (m) For this proposal all contributions to social security and private pensions are excluded from receipts and all retirement income, social security, company pension, community income, and

income from trusts are included. The great advantage of this approach is that it makes social security consistent with other retirement programs. Furthermore, if the tax payments do not match social security benefits, the employee is not regarded as having received the taxes paid as income.

The following deductions will be allowed under an expenditure tax:

- (a) Purchases of all income-earning assets; real capital, stocks, bonds, savings accounts (net change in value), checking accounts, cash (other than petty cash), and land. (Consumer durables will not be deducted from the tax base and will be taxed as current consumption).
- (b) Child support and alimony payments.
- (c) All business and income related expenses; tools, uniforms, dues to professional associations, baby-sitting expenses (with a possible ceiling on this deduction). A standard deduction might be introduced to account for work-related expenses. But we recommend itemization of these expenses.
- (d) Tax deductions would be allowed for charitable contributions. We believe that there is good reason for promoting charities and other good works (universities, hospitals, and museums), through tax expenditures rather than direct expenditures. The

rationale for this preference is that the tax expenditure is a form of matching grant. As the benefits of the expenditure are quite local or regional in their impact, there is good reason for preferring matching grants to untied grants on equity (benefit principle) grounds. Of course, the system could be replicated by a system of matching grants administered through the budgetary process. But, if the grants are open ended, we will have a system that will be equivalent to a system of tax credits.

As there seems to be no strong case on a priority grounds for overriding the present choice of Congress on the matter of charitable deductions, we recommend that the present deduction of charitable contributions be retained. One possible administrative simplification would be to provide that only contributions in excess of some percent of adjusted gross cash flow would be deductible.

- (e) There is no easy solution regarding the deductibility of state and local taxes. On the one hand, if state and local taxes were used primarily for redistribution and, as we have proposed that transfer payments be included in the cash flow tax base of the recipient, considerations of symmetry dictate that state and local taxes should be deductible.

On the other hand, state and local taxes do provide benefits to businesses and households. Firms benefit from police and fire protection, road maintenance, and so forth. Households benefit directly from these services and from educational outlays. Also, in a highly fragmented fiscal structure characteristic of the United States, households with above (below) average demand for certain local public goods and services, can group themselves in stratified communities and internalize the benefits and costs of locally provided goods and services.

It should be noted that in such a world the current deduction of state and local taxes provides a substantial subsidy for state and local public spending the size of the per-unit subsidy is proportional to the marginal tax bracket of the taxpayer. For example, if the taxpayer is in the 50% tax bracket, \$1.00 of public expenditure costs the taxpayer only \$.50. So, if state and local taxes are benefit taxes, they should not be deductible. The more specific proposal is as follows:

- (1) All state and local taxes, gasoline, income sales, property, and so forth paid by households would not be deductible.
- (2) Property taxes and other taxes paid by owners of rental housing would be deductible.
- (3) All business taxes, local corporate taxes, property taxes, licenses, and so forth, will be deducted and would be treated by business as a cost of doing business.

The rationale of treating households and firms in different ways is that the benefits of local tax for business are small or are nil.

On the premise that local taxes are benefit taxes, it follows that local property taxes should not be deductible by homeowners. What is not self evident is that if parity or equity is to be maintained between homeowners and renters, taxes levied on rental real estate should be deductible as a business expense. One general justification is that rental housing is just another business and that any expenses, private or public, will ultimately be borne by the consuming household, but that intermediate expense should be deductible. The principle is the same as the one which allows landlords to deduct mortgage interest, but it should not extend to owner occupants unless an imputation is made for rental income on homeowners' capital.

Take the case where the interest rate is 10% and the homeowner lives in a \$50,000 house. With a 2% property tax, the homeowner will pay an implicit rent of \$6,000 a year if mortgage interest is not deductible, and if an imputation is made for the homeowners' interest costs. The rent consists of a 10% pure interest cost (10% of \$50,000) equal to \$5,000 plus a property tax of 2% which is equal to \$1,000 for a total of \$6,000. In order for the renter to be charged the same rent, the landlord should be allowed the property tax deduction for then the landlord will make the normal return of 10% on the \$5,000. The total rent charged the renters

will be \$6,000 which consists of \$5,000 of pure capital cost and \$1,000 benefit (property tax). Without the deduction, the rent will rise above \$6,000 and penalize the renters relative to the homeowners.

Of course, the view that state and local taxes are pure benefit taxes is a strong, controversial assumption. For some households, the relation between benefits and taxes is weak, and some redistribution takes place at the state and local level. However, to allow the deduction of state and local taxes without imputing benefits of local expenditures seems quite arbitrary, certainly more arbitrary than the alternative of not allowing deductibility of state and local taxes.

A measure which would allow the deductibility of state but not local taxes also presents certain problems. Such a provision would represent an arbitrary incentive for state governments to increase their share of local tax responsibilities; however the share of state responsibilities varies considerably across the nation.

The possible distinction between general and specific taxes for deduction purposes would be of limited value. The writer of this paper favors the partial or complete elimination of the deduction of state and local taxes. However, he recognizes that the basis for the elimination of the deduction would introduce a highly imperfect system for one that, in his opinion, is even more imperfect.

Yet, since state and local taxes are deductible under the current income tax law, the status quo seems advisable on

this specific issue of taxation. The issues regarding the deductibility of state and local taxes are really no different under the expenditure tax than they are under the income tax. Consequently, it seems advisable to avoid a controversial provision, especially one that is not fundamental to the main objectives of the proposal.

V(a). SOME SPECIAL ASPECTS OF A CASH FLOW TAX SYSTEM

In this section we deal with a number of special aspects of a cash flow tax system. One of these is the nature of the filing unit, or the tax treatment of the family.

The basic issue in the tax treatment of the family is how the income (expenditure) should be divided between husband and wife; whether primary household members should be forced to file separate returns, whether income splitting should be allowed, and so forth. There are a number of partially conflicting objectives or issues:

- (a) The first is that families with the same mean income or consumption should pay the same tax. Thus, the total tax burden should be independent of the source of income and not depend on which family member (husband or wife), owns the wealth of the household and so forth.
- (b) Secondly, it should be recognized that household production is not subject to tax. So, when there

is only one wage earner and the family has an income of \$20,000, it is better off than a two worker family with the same income.

- (c) The third objective or issue is "the secondary worker problem." Under joint filing or income splitting, the high income of one family member increases the marginal tax bracket of the secondary worker. Thus, if a husband is in the 50% marginal tax bracket, a substantial tax barrier will exist for the wife. The obvious resolution of this problem is to provide for individual filing, as currently exists under the income tax in Canada.
- (d) The fourth objective is to minimize the tax effects on marriage and divorce. Other things equal, the tax burden of two single people should not go up (or down) if they get married.
- (e) Finally, the code should be as simple as possible with respect to intra-family wealth transfers.

In the development of this proposal, we have considered a number of alternative approaches to the nature of the filing unit. The approach finally settled on does not represent a sharp departure from the current tax treatment of the family. The following rules would apply:

- (a) Separate tax schedules would apply to single taxpayers and to married taxpayers filing joint returns. There would also be a schedule for

married taxpayers filing separate returns and for taxpayers who qualify as head of households. The value judgements on relative rate schedules embodied in the current income tax schedules would carry over to the expenditure tax.

- (b) Concern would be placed on the labor force participation of secondary workers. A partial deduction of tax credit will be allowed for child care expenses. Instead of providing for separate tax filing for the secondary worker, and to avoid various problems of figuring out how to allocate allowable deductions and exemptions between returns, we recommend that the marginal tax rate be decreased on secondary workers by decreasing the inclusion rate of their wage and salary income of secondary workers to rate somewhere between 50% and 75%. The rate of inclusion would be independent of the amount of wage income. Under this proposal, the marginal tax bracket of the secondary worker would be somewhere between one-half to three-fourths of the primary rate on the joint return. In addition to decreasing the marginal rate on the income of the secondary worker, the lower rate of inclusion would decrease the present tax advantage of the single-worker family relative to multiworker taxpaying units. However, the proposal would not be neutral on marriage formation

and the lower inclusion rate may well promote more marriages and joint filing.

- (c) If a minor child has independent capital income from inherited wealth or from whatever source, this income would be reported in the primary return. More generally, as long as the minor child is part of the primary household, his capital transactions would be pooled with those of the person filing the primary return regardless of whether or not the person controls the wealth (trust fund). The capital resources of minors should be pooled with that of the family (the joint return of the husband-wife.) Otherwise there would be tax incentives for the parents to transfer resources to minor children and to finance family consumption out of these resources. The wage and salary income of a minor child would be included in the tax base of the family, but with a minimum exemption of \$750.

In general, minor children who live at home would report their capital income in the primary return of the family. However, as discussed below in the section on inheritance, there is good reason for allowing exceptional children who have substantial wage and salary earning at an early age to be taxed as distinct units from their parents or guardians. There are not many child movie stars, musicians, models, athletes, and so forth; but an allowance should be made for

such individuals. We do not have firm ideas on the specifics of these clauses as they would be related in part to the specifics of the inheritance tax law. In general outline, these clauses would allow minors to file a separate primary return if their wage and salary income exceeds some minimum amount, say \$2,500 a year. In the year that the primary return is first filed, the child (minor) would have the option of declaring wealth that has been inherited outright or in the form of a trust. After a basic exemption of say, \$50,000, an inheritance tax would be paid on the accumulated wealth. The minor who meets the requirement for a minor return would have the option of leaving the inherited wealth in the "porfolio" of the family, for tax purposes, and paying the inheritance tax at age 18 or 21.

However, even if the inherited wealth is not "declared" for tax purposes, the minor child who earns the minimum income to qualify for primary filing would have the assets accumulated from these wage earnings registered in his name and would report the capital transactions on these assets in his primary returns.

- (d) Instead of a personal exemption, this proposal recommends a tax credit of \$250 or more a person. We prefer a tax credit to an exemption as tax relief, provided according to family size, and independent of the family marginal tax bracket. The modest tax credit may significantly understate the real cost of additional children by higher

income groups. But this is consistent with the view that small tax differentiations for family size are unimportant and unnecessary at higher income levels. This is a common sense argument, but might also be justified on the grounds that most children born to middle and upper income groups in the U.S. are planned children and that these families have the economic means to provide a materially secure upbringing for their children. We do not appeal to the notion that will offend many; namely, that children are merely another form of consumption or indulgence. But surely in an affluent society there is little basis for more than modest tax credits based on family size for the well-to-do and the rich.

- (e) We leave open whether the tax credit would be refundable or not. For expenditure tax purposes, a single person is a unit; a married couple and their children are a unit; a widowed or divorced parent and her (his) children are a unit. There are more complicated family situations: children living with grandmothers and aunts, married teenagers, college students.

The following persons will be eligible and required to file individual return:

- (1) Any person over 21;
- (2) Any person, whatever age, who maintains a separate domicile and who does not receive more than half his support from his parent or guardian, and is not studying for his first college degree; and
- (3) Any married couple.

Under this proposal there are few, if any, complications associated with desolution of marriages. If a divorce occurs the property will be divided according to the laws of the state or residents and new tax filing units will be formed. The main shortcoming of proposed treatment of the family unit is that it is somewhat assymetric with respect to the treatment of capital and wage income.

V(b). AVERAGING

As discussed in a previous section of the proposal, by allowing more than one type of tax treatment for saving and dissaving (loans), a mechanism is made available for averaging tax liability over a taxpayer's life cycle. In particular, if a taxpayer can anticipate lumpy expenditures, he can average the tax payments on the expenditures either by buying tax prepaid assets to finance them or by financing the expenditures by borrowing.

One administrative restriction which probably will have

to be imposed on the purchase of tax prepaid assets is to register them. Otherwise taxpayers will have an incentive to redesignate the accounts in their portfolios depending on the relative performance of the different assets or investments. For example, if two assets, A and B, are purchased at time t, each for \$1,000 and tax is prepaid on one of these assets, then the taxpayer will have an incentive to report after the fact, receipts from the sale of the asset which has not risen in value relatively, and to designate the other asset as the asset on which tax has been paid. To avoid this reclassification, we recommend that the assets on which tax is prepaid be limited to assets issued by financial intermediaries, and the equities purchased on a prepaid tax base be recorded in a separate account.

Apart from this restriction, the major issue is whether an additional provision should be made for averaging. For example, it would be possible to adopt the forms of averaging contained in the present income tax law. Alternatively, new averaging provisions might be developed. One argument that could be made in favor of an averaging provision in addition to the averaging provisions inherent in the alternative tax treatment of assets, purchases, and loans is that large numbers of taxpayers whose liabilities fluctuate may find it difficult, or impossible, to make adjustment through financial transactions that will effectively average tax liabilities. Also, investments in family owned businesses of the tax prepaid variety should probably not be allowed to

avoid the problem of the family designating its total labor receipts as capital income from the asset.

V(c) TREATMENT OF INTERNATIONAL TRANSACTIONS

This section is more tentative and more general than the other parts of the paper. One of the problems in dealing with international transactions is that it is very difficult to anticipate the reaction of other governments to the introduction of an expenditure tax in the U.S. and the elimination of the corporate tax here. International tax treaties would have to be renegotiated, and depending on the outcome of such negotiations, it is possible a significant reallocation of capital into the U.S. would occur from abroad. What needs to be emphasized is that the international implications of this proposal are rather major, and the issues raised are not merely technical details, or problems which can be resolved by technical compromise. The introduction of an expenditure tax in the U.S. may have wide reaching implications on tax systems in other major industrial countries, on international investment, and on international relations in general.

It is possible that the uncertainties for international investment raised by the major tax reform in the U. S. will be a serious stumbling block in the acceptance of this reform by certain members of Congress and by the American business community.

In the present situation most major industrial countries impose both corporate taxes and personal income taxes. Dividends paid out to foreign investors are subject to a withholding tax by the country of origin. These withholding rates on dividends are subject to negotiation by a treaty and vary between 5% and 15%.

There are two ways in which double taxation of foreign investment is avoided. One is the allowance of tax credits for foreign tax paid, a practice followed by the U.S. and other major industrial countries. The second is to exempt foreign earnings from domestic taxation, a practice followed by France and the Netherlands.

Under the foreign tax credit system the country of origin collects the taxes as profit income. The U.S. is a larger net exporter of capital; at year end 1973 foreign long-term investments in the U.S. amounted to \$62 billion, or just over 40% of U.S. longterm foreign investment abroad.

While the U.S. as the largest capital exporter in the world loses net tax revenues under foreign tax credits negotiated with other countries, it has played a leading role in the development of tax policy with respect to foreign investment and in establishing a neutral tax system. There are three different senses of neutrality. One is capital export neutrality where a capital exporter is indifferent between an investment at home and abroad. Second is capital import neutrality where, in the host country, foreign investors are treated on a par (equally) with residents. The

third concept of neutrality is that of national neutrality where a country adopts tax measures that are designed to insure that total U.S. returns (taxes plus private returns) are the same whether the capital is located at home or abroad.

Under present tax arrangement, the conditions for export and import neutrality are satisfied, roughly, at least for most industrial countries. In 1968 for "Europe" [inclusive of Canada, Japan, Australia, South Africa and Mexico, and exclusive of Switzerland (17%) and Luxembourg (15%)] effective corporate profit rates tended to vary between 40% to 50%. Tax withholding on dividends, interest and royalties is somewhat more varied. Withholding taxes are placed on dividends by all countries with rates ranging from 5% to 15%; but many industrial countries exempt interest and royalties while others tax them at rates in the 5% to 15% range.

Although it is only approximately true that the international economy is characterized by export and import neutrality with respect to international investment, marked differences in tax systems (a corporate tax plus a withholding tax on dividends) are not observed, tax rates are not significantly different between countries, and there are not striking differences between the taxation of home investments and foreign investments. Certain features of the tax code tend to offset each other: for example, investments abroad gain from the advantages of deferral when foreign taxes are lower than U.S. taxes. On the other hand, foreign

investments by U.S corporations do not qualify for the investment tax credit.

There are a number of ways in which the corporate tax could be integrated with personal income tax. One is the split rate system which reduces the corporate tax levied on distributed profits. In West Germany, corporations are taxed at 51% on retained earnings and an effective rate of 23% on distributed profits.

Another way of providing partial integration is to provide a dividend credit or imputation at the stockholders' level. In France, corporations are taxed at 50% and shareholders allowed to credit 50% of the corporate tax on dividends. Also, the U.K. taxes corporations at 50% and provides a dividend credit equal to three-sevenths of the corporate tax on dividends.

Under full integration of the corporate tax no distinction is made between retained earnings and dividends, and corporate earnings are grossed-up by the amount of the tax and reported by the stockholder with full credit of the corporate tax. No country used this method.

In this proposal we are going beyond full integration, and in addition to eliminating the corporate tax for U.S. corporations investing in America, we propose to exempt all profits from taxation under the cash flow version of the expenditure tax. A key question that arises is whether profit taxes paid abroad would be credited under the expenditure tax imposed on households. There would be no

corporate tax to credit foreign taxes against. A second question is whether the exemption of savings is to extend to foreign investors. We note that other countries who have adopted partial integration have not adopted consistent behavior. In West Germany, foreign subsidiaries have been taxed under the split rate system in the same way as domestic corporations. But branches of foreign corporations are taxed at the full corporate rate of 50%. France has not given the dividend credit to foreign parents, nor to foreign branches or to French investors to foreign corporations. However, France now does extend the dividend credit to foreign portfolio investors, though a withholding tax of 15% is then imposed on the sum of the dividend plus the 50% credit.

In the tax treaty just negotiated with the U.K., American portfolio investors are given the same dividend as U.K. investors, subject to a 15% withholding tax on the total. On the other hand American subsidiaries are given one-half of the normal tax credit. Again the 15% withholding tax applies. Beyond these facts, there is no evidence that countries in general are reluctant to give foreigners the same credits as residents. For example, the U.K. seems not to have preferred the split rate system because they believed the system would extend to foreign shareholders and that the U.S. would not be willing to agree to a compensating withholding system that would offset the tax relief granted foreign investors. The Carter Commission in Canada also assumed that compensating withholding taxes would be

unacceptable to the U.S. and other countries if the full integration proposed by the Commission was extended to foreigners. The Carter report proposed that the benefits of integration be restricted to Canadian residents, and that the gross-up and credit of foreign taxes paid by Canadian investors be limited to a rate of 30%. In both the U.S. and Canada there was strong resistance to a full integration of foreign corporate tax with national personal income taxes.

Should the U.S. initiate a cash flow tax and also eliminate the corporate tax, it would be under strong pressure to eliminate taxes on foreign investments in the U.S. One of the basic principles of international tax arrangements is the nondiscrimination criterion between residents and non-residents. The U.S. has been strongly committed to this principle and has used it in tax treaty negotiations, such as the one just concluded with the U.K. where the foreign country's dividend credit was partially extended to American investors in the U.K.

Counteracting this discrimination criterion is the fact that the U.S. would lose tax revenue if foreign investment was exempt from tax. The U.S. might argue that if American taxes on foreigners were eliminated the foreign country should also exempt this kind of income from taxation or otherwise real resources will shift from the U.S. Treasury to the foreign treasury.

However, initially it would be small comfort to the U.S. to extend complete exemption of profit income to foreigners

if their governments continued to tax this kind of income to U.S. residents.

Another consideration is that while the U.S. would be exempting foreigners from profits taxation, it would not necessarily be exempting them from tax. As there are well established precedents for taxing dividends paid to foreigners as a substitute for the payment of domestic income tax, the U.S. could justify a withholding tax on the earnings of foreign investors as a substitute for the expenditure tax. The basic jurisdictional rule underlying current international tax arrangements is the origin principle. The U.S. can rely on this, especially as a change to the residence principle is unlikely, given that the U.S. would gain from such a change.

It is in the overriding self-interest of the United States to continue the taxation of foreign investments in the United States as long as other countries continue taxing U.S. subsidiaries and branches abroad. We propose that the United States simply admit that it cannot hope to adhere to the principle of non-discrimination if it does not tax domestic profits but other countries do. The United States will have to impose taxes of 40% or more on the earnings of foreign subsidiaries and branch operations. Similar taxes will have to be imposed on foreign portfolio investors and substantial taxes will also have to be imposed on the interest income of foreign investors; otherwise foreign subsidiaries will have a strong incentive to substitute debt for equity.

The second part of the proposal is that foreign profits taxes paid abroad by American investors be passed through and credited to the individual stockholder under the expenditure tax. This is bound to be a very controversial proposal, especially in the Congress as it would result in a substantial revenue loss to the Treasury and would give credits to individuals for taxes paid abroad.

Yet, despite the revenue loss the credit would not necessarily decrease the real income of the United States relative to the existing situation. At present, foreign governments collect taxes on American profit income earned abroad and they would continue to do so. The full credit of foreign taxes paid abroad would weaken, even eliminate, the incentive of the United States citizens to repatriate their capital. Without the credit, relative after tax yields on investments abroad and at home would be changed significantly, and U.S. multinationals would have a strong incentive to liquidate their investments abroad. Such an event would impose severe strains on the world economy, and it is not certain how American business would respond to such a prospect. While maintaining approximate export neutrality for both American and foreign countries, the overall effect of this proposal is to increase the after-tax yield for American investors relative to foreign investors. This would place America in a distinct advantage in the accumulation of capital, and foreign governments would probably be under strong pressure to decrease profit taxes in their countries.

Whatever the stance taken by the United States in subsequent tax treaty negotiations, this proposal has far reaching ramifications for international finance and investment. Those who value harmonious international relations will probably resist the changes, because of the disruptions, and the uncertainties that may arise on account of the proposed tax reform.

Others will be attracted by the international aspect of the tax proposal, as they will view it as an opportunity for a significant restructuring of taxes throughout the industrial world as profits taxes would be adjusted downwards as the result of the American reform.

Nationalists in the U.S. and abroad may welcome the proposal as it is highly likely that significant amounts of American investment abroad would be repatriated to the United States as the crediting of foreign taxes under the expenditure tax would be limited.

V(d). TREATMENT OF TAXPAYERS WITH OVERSEAS CONNECTIONS OR
INTERESTS

The simplest procedure in the taxation of American citizens who reside abroad is to adopt the residence principle. American citizens who are residents of foreign countries would be exempt from filing an expenditure tax return, while foreign nationals who are permanent residents

An alternative proposal is to exempt foreign investors from American taxes and not to credit foreign taxes under the expenditure taxes. An intermediate measure would be to impose modest taxes on foreign investment and to provide modest tax credit relief at the household level.

The two measures generally tend to offset one another in their effects on the real income of the United States. The removal of the taxes on foreign investors will transfer resources (income) from the Treasury either to foreign governments or to foreign investors. The absence of the foreign tax credit under the expenditure tax will compromise export tax neutrality and will lead to a repatriation of American capital from abroad.

In the long run this repatriation will increase American real income, as foreign taxes previously collected on the repatriated capital will now accrue to American citizens. The most nationalistic policy would be to impose a substantial withholding tax on foreign capital and not to provide foreign tax credits under the expenditure tax.

The policy that will be least disruptive to current allocations of capital throughout the world and will have the least effect on distribution of the gains from foreign investment between capital-exporting and capital-importing countries is the first proposal discussed. This is the combination of relatively high taxes on foreign investment in the U.S., and generous, if not complete, credits for foreign taxes paid under the expenditure tax.

sales taxes, value added taxes, and so forth, that have the effect of a proportional income tax, would either be ignored or might be allowed as a deduction.

An intermediate position would be to tax expenditures by American citizens on the residence principle (on a rather severe definition of residence), but to tax the income of foreigners that originates in the United States. The extreme version of this would be to have a separate income tax that would apply to American citizens residing abroad. This is unattractive from an administrative standpoint and such a tax would be minimized by owners of capital by transfer of U.S. resources abroad. A further possibility would be to impose a flat rate withholding tax on all income originating in the United States at a rate substantially higher than any possible withholding tax on foreign nationals, say 50%, and then allowing the American resident abroad to claim a refund if he so chooses by filing an expenditure tax return.

VI. THE ACCESSIONS TAX

In the introductory, or general sections, of this proposal we outlined a number of arguments justifying a separate estate or accessions tax. In a world where bequests are small and no substantial income and wealth differences exist there is no need for a bequest tax. In such a world most individuals would spend their total endowment during the

of the United States would file an expenditure tax return.

Of course, if a person is required to file an expenditure tax return, expenditures would be defined on a worldwide basis and purchases of foreign assets would qualify for a deduction under the expenditure tax.

The difficulty in adopting a strict residence principle of taxation is that residential tax havens are likely to be set up in the West Indies and elsewhere. Wealthy individuals will be able to set up legal foreign residence in Costa Rica and similar countries and jet back and forth without paying much in the way of tax.

The loss of revenue is not likely to be substantial from this practice, but the inequities will be highly visible and may be politically unacceptable. One way of closing this loophole or at least making tax haven residence less attractive is to define a citizen as a non-resident only if he spends less than 30 to 60 days of the year in the United States.

A more extreme solution would be to require every American citizen, regardless of residency, to file an expenditure tax return; to ask that each person report worldwide expenditures, but then to credit the foreign resident for direct income tax paid abroad. Thus, if I am a U.S. citizen residing and working in Canada, I must file an expenditure tax return in addition to the Canadian income tax, but I would be allowed a credit for my Canadian income tax paid under the expenditure tax. Foreign, indirect taxes,

tax incentive to skip his son and to leave the estate to the grandson.

Under the present system an estate is often left in trust for the second generation (the son), and the principal is inherited by the third generation (the grandson). The son has the use of income during the life of the trust. The trust is set up to minimize tax burdens. For example, a \$10,000,000 estate might pay an estate tax of \$5,000,000. However, if left in trust the income generated is \$1,000,000 a year and after paying an income tax of 50% the son has the means to consume \$500,000. With a wealth tax of \$5,000,000 the annual consumption possibility is only \$250,000 a year. Similarly if the aim of the family is to accumulate capital it will build up a stock of wealth much more rapidly if the estate is put in trust:

Consider next an accession tax that is coupled with an expenditure tax. For simplicity we assume that all tax rates are 50%. When the \$10,000,000 is left outright to the son he pays an accession tax of \$5,000,000 and then can spend \$500,000 a year on consumption, consuming \$333,000 a year. Assuming the principal remains untouched, the grandson will inherit \$5,000,000 and in turn pay an accession tax of \$2,500,000 and so on.

Suppose the \$1,000,000 had been left in trust. If no accessions tax is paid upon the formation of the trust; but as the income is generated, it is subject to accessions tax, thus the son, if he pays the same rate of accession tax, will

course of their life. On the other hand, a person who earns and saves a great deal would not be taxed on his total endowment under an expenditure tax. Consequently, a case can be made for a separate tax on the bequests. A related reason for taxing bequests is that the tax system should be used to minimize concentrations of wealth.

The general argument favoring an accession tax over an estate tax is that the magnitude of the tax should depend on the circumstances of the donee rather than on the donor. An accession tax would tend to promote bequests which are more widely dispersed.

By taxing the gifts and inheritances over a person's lifetime we express a social preference supporting a special tax on the total of a person's good fortune which is generally not related to his own efforts. Inheritance should be taxed separately because it is not earned, and is typically not related to merit but is a good fortune of birth. A further rationale for an accession tax is that wealth confers power, security, intangible elements of status, and social respect. An accession tax is a very convenient way of taxing these benefits.

Before turning to the specifics of the proposal, we consider a number of general factors that bear on the features of the design. The key questions are how to tax bequests left in trust, and whether a dual rate structure should be allowed so as to minimize the possible incentive of the accession tax to skip generations where a father has a

have only \$500,000 a year to spend on consumption and will consume \$333,000. However, when the father dies the grandson will inherit \$10,000,000 not \$5,000,000. Consequently, there is a distinct advantage in leaving the estate in trust.

Another way of making the same point is to note that a family that merely accumulates out of inheritance will be able to use the whole \$10,000,000 for purposes of accumulation and will not pay any accession tax until the death of the son.

There are a number of ways in which the advantage of the tax deferral for the property left in trust might be dealt with. The first is to ignore the advantage on grounds of administrative convenience. The second is to follow the suggestion made in the literature on an accession tax; namely, to levy a special estate tax on property left in trust. The special estate tax would then be the basis for a credit against accession taxes on subsequent distributions from the trust. The third approach is to calculate, or approximate the accessions tax that would have been paid if the estate would have been left outright to the person receiving the income from the trust, or to approximate this by considering the size of the estate on an average rate of tax and then "charging" the trust interest on this amount. Thus, if the postponed accession tax is \$5,000,000 and the market rate of interest is 10%, the interest charge would be \$5,000,000.

The second issue is the supposed advantage of generation skipping even without use of a trust. Thus, an older father

who at ninety recognizes that his son, who is sixty, is in poor health, will bypass the son, in favor of a healthy thirty-year old grandson. Otherwise, an accession tax will be paid twice, once when the father dies and the son inherits the estate, and then soon after when the sickly son dies and the grandson inherits the estate. Other biases favoring the grandson are tax advantages of trusts and lower accession tax rates that are presumed to apply to younger grandchildren.

To counteract this tax bias against children, it has been suggested that a dual rate structure be set up that allow sons (immediate relations more generally) a 40% deduction under the accessions tax. The 40% is arrived at by noting that over a wide range of rates, one tax at the full rate has nearly the same effect as two taxes at 60% of the full rate.

Some of the arguments which might be made against the dual rate structure are:

- (1) The code will be more complex and the definition of immediate relation is somewhat arbitrary.
- (2) It is very possible that tax consciousness will be increased by the dual rate structure, and that the accessions tax will have a larger, rather than smaller distortion.
- (3) Although most bequests are to close or immediate relations, it does not strike us as appropriate social policy to favor bequests to immediate

relatives rather than to more distant relatives, friends, colleagues, employees and so forth. In fact, it seems arbitrary to tax gifts and bequests at differential rates depending on the source of the gift. Also, one of the objectives of the accession tax is to disperse wealth as widely as possible.

- (4) The magnitude of the advantage of grandson relative to the son depends crucially on the life pattern of various generations. If the son is in poor health and dies soon after the father, then the advantage is sizable. However, in a steady state where an eighty-year old father leaves an estate to a fifty-year old son who in turn lives to be eighty, and he leaves the estate to a fifty-year old son, and so forth, the tax advantage of generation skipping is much smaller. The point is simply that the present value of a dollar of accession tax paid thirty years from now is rather small. Hence, if the father leaves the estate to the grandson the accession tax is x dollars. If the estate is left to the son the tax is x dollars and x dollars thirty years from now. The present value is $1.1x$, using a discount rate of 8%. So while an advantage remains it is not nearly as dramatic as the case where the deaths of the father and the son are close together.

Some sort of tax relief should be given for two substantial accession taxes paid on the same estate over a relatively short time interval. One provision would be to allow the son the option of treating an outright bequest as if it were a trust. Under this treatment the accession tax would be paid in full (or alternatively the special estate tax on trusts). The donee would place the remainder in a special account where the withdrawals could be accounted for. The prepaid accessions tax would be credited with the accession tax on withdrawals from the "trusts", but if the son dies and the credits of the prepaid accessions tax have not been used by the son they would carry over to the grandson or be returned to the trust.

A more complicated extended provision would allow the grandson to seek tax relief even if the son has not had the foresight to select the trust arrangement and/or died unexpectedly.

Again, the objective would be to allow the heirs of the decedent to reconstruct the situation for tax purposes as if the property has been left in trust during the life of the decedent. Of course, this treatment would apply the special estate tax that would be calculated to compensate for the tax deferral advantages of the trust. These provisions represent administrative complications, but they would provide for an exact tax accounting that would account for varying patterns of death in different families.

The more specific aspects of the accession tax proposal are as follows:

- (1) All inheritances and gifts received would be taxed to the donee and not the donor. There would be no distinction between inheritances and gifts. The tax base would be comprehensive and would include the receipt of employee benefits by survivors' life insurance (though the exemption level might be raised for this receipt.) The question of a dual rate structure would be left open. There are good reasons for believing that the magnitude of the tax incentive favoring grandchildren relative to children would be small under the provisions of the proposal. However, if a dual rate structure does come about from a reduced inclusion rate applying to transfers to one's children, this writer recommends that the inclusion rate be no less than 80%.
- (2) There would be an exclusion of annual per donor exclusions for inter-vivos gifts of up to \$2,000 a year. The annual exclusion would be inapplicable to transfers at death and to trust distributions. There would be a lifetime basic exemption of \$50,000 under the accession tax.
- (3) All inter-spouse gifts and bequests would be exempt from tax. Alternatively, a marital exemption of 50% for inheritances could be allowed along with a special exemption on gifts to the spouse; perhaps up to half of the net worth of the donor.

- (4) The inheritance and gift tax would be progressive and the tax would be assessed on the basis of lifetime inheritances and gifts. Thus, each individual would have an Inheritance-Gift account with the Federal government, and, each gift and inheritance would be added to previous gifts and inheritances and tax would be paid on the accumulated total at an increasingly higher marginal rate.
- (5) No attempt would be made to tax gifts in kind that children receive when they are minors. After the children become adults, gifts in kind such as trips around the world paid for by parents should be reported as gifts. All transfers of durables would be taxed under the accessions tax as well as under the expenditure tax for the donee. If a parent gives a child a valuable painting on which tax has been paid, the parent would report this as a sale of a durable and would receive a tax refund. The child (the donee) would pay the accessions tax and would also report the durable as a receipt under the expenditure tax.
- (6) A child who leaves his family and files a primary return for the first time (this would occur no later than the age of 21) would declare his accumulated wealth (inheritance from grandparents and deceased parents, gifts and accumulated

savings), and this would be taxed as an inheritance. This one time tax treatment of accumulated wealth at age 21, or earlier, when the person sets up an independent household, greatly simplifies treatment of intra-family transfers of assets to children up to the age of 21. The difficulty with this approach is that children who earn wage or salary income and save it run the risk of having the accumulated wealth taxed as inheritance. For small amounts of savings, the basic exemption would seem to be enough. However, for a fixed lifetime exemption under the inheritance tax the young worker-saver may end up paying higher taxes on the same level of inheritance. In the discussion of the tax treatment of the family we have already made provision for a generous "Shirley Temple clause" which allows unusually productive young children to file primary returns as minors. This treatment might be coupled with a provision which would allow minor children to purchase registered alternative assets up to the amount of their wage and salary incomes, if their income does not exceed \$2,500 a year. Once they reach this maximum, they would have to file a primary return. The alternative assets would not be taxed under the gift and inheritance tax.

- (7) Ideally from an administrative standpoint, the law should not distinguish between the source of gifts and inheritances, and gifts from parents to children will be taxed in the same way as gifts from children to parents.
- (8) We propose that any distribution from a trust be taxed under an accession tax. When an estate is left in trust we propose that the accession tax be prepaid either through a special tax on property left in trust or by simply applying the regular accession tax table. The prepayment will then be credited against the tax levied on distributions from the trust. If the credits are not fully used before the death of the beneficiary the credit can be returned to the trust.

VII. APPROACHES TO TRANSITION, OR PHASE-IN OF THE EXPENDITURE TAX

Any change in tax structure would have differential distributive effects on various taxpayers and would change taxpayer expectations. Since the substitution of an expenditure tax for an income tax represents a rather major change in tax structure, transition provisions would have to be made. Otherwise inequities would arise and strong opposition would develop against the introduction of the expenditure tax.

The most serious problem of transition relates to the consumption of accumulated capital in a life-cycle context. The easiest way of seeing this problem is to recognize that in a steady state equilibrium, where wages and interest rates are constant, an individual entering the labor force at age twenty-five with no wealth would be indifferent to a flat rate wage tax and a flat rate consumption tax. The present value of the two tax payments under the alternative tax systems would be the same over the life cycle. However, this proposition is true only when there is a single tax system throughout a person's life.

A person who enters the labor force under a wage tax and accumulates assets for retirement will suffer a loss in real consumption if a consumption tax is substituted for the wage tax just before the time of retirement.

Another problem of transition is the fact that consumption out of social security payments would not be subject to tax. Also, under our proposal the services of owner-occupied homes would be taxed at the same rate as rental housing. A transition or grandfather clause would have to be provided to account for these structural changes.

A related problem is that of accumulated consumer durables. Persons and households who have purchased durables just before the introduction of an expenditure tax will be at a distinct advantage relative to those households who purchase the same items shortly thereafter.

This paper discusses the transition approach under which the income tax and the expenditure tax operate

simultaneously, for some time, during the transition. This approach is an extension of an approach suggested by Andrews in connection with the taxation of high income taxpayers. Andrews suggested that a minimum tax be imposed by initially taxing consumption expenditures in excess of some specified minimum, say \$20,000. Due to the large exemption, this supplemental tax would be a tax on high income groups, but could be the basis of the introduction of a consumption-type tax as the exemption level could be lowered over time and the tax rate raised.

In essence, this approach would involve the introduction of a comprehensive expenditure tax statute alongside a more comprehensive, reformed, income tax statute.

Another approach would be to have every household file two tax returns, first the income tax and then the expenditure tax. Initially the tax rates under the expenditure tax could be very low, say 1% to 5%. Income tax rates could be lowered a little so as to leave total revenues unchanged. Then, over time, expenditure tax rates would be raised and income tax lowered still further in a series of steps until the income tax was phased out completely. Alternatively, the Andrews' version of this proposal would be followed where a substantial exemption would be allowed under the expenditure tax leaving only a small proportion of the total population to file under the expenditure tax. The vast majority of taxpayers would merely verify on their regular income tax returns their consumption was less than the

exemption of \$20,000 a year. Top bracket income rates would be lowered initially and if the corporation income tax was phased out over time, the expenditure tax on the wealthier segment of the population could be used to recapture revenue lost from the corporate tax. So, the impact effect on income of the tax changeover would be neutralized, in large measure.

The main advantage of this phase-in period of ten to fifteen years is that the full statute would be on the books, but only a minority of the population, say the wealthiest 25% would be affected. These persons would be the most sophisticated and able to comprehend and adjust to the complexities of the new law. In sense the partial expenditure tax would be a broadly based experiment or testing ground for the comprehensive expenditure tax.

Many of the provisions of this proposal are not really specific to expenditure tax, and their introduction could be common to the continuation of the income tax and the partial introduction of the expenditure tax. Among these would be the introduction of the inheritance tax in place of the estate tax, the introduction of secondary work filing provisions and various changes in deductions and exemptions.

It is not necessary to combine various structural changes that would occur under the expenditure tax to the reform of the income tax. Whether simultaneous reform of the personal income tax and the introduction of the expenditure tax would enhance the passage of the new tax system is something not speculated about here. Yet, one key provision

that would be important to introduce as quickly as possible, is the elimination of the deduction of mortgage interest on owner-occupied housing under the income tax. Otherwise the taxation of consumer durables during the transition period would be uneven.

The numerical specifics of the phase-in need to be developed and analyzed in terms of their revenue implications. This is especially the case if the corporate tax is to be phased out during the transition to a full blooded expenditure tax.

The choice between different transition approaches has to be based on intuition in large measure. The supplementary tax approach is especially appealing as it can be introduced on a partial basis and can be modified before it becomes more broadly based.

FOOTNOTES

1/ This is because the double tax on interest type income reduces the return on savings. The lower return on savings in turn means a lower opportunity cost of using money for current consumption.

2/ For example, with continuous compounding at a 10% discount rate, one dollar of taxes ten years hence is worth only 37 cents today.