INFORMATION REPORT

The Expenditure Tax: CONCEPT, ADMINISTRATION AND POSSIBLE APPLICATIONS

ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS
Washington, D.C. 20575 • March 1974

M-84

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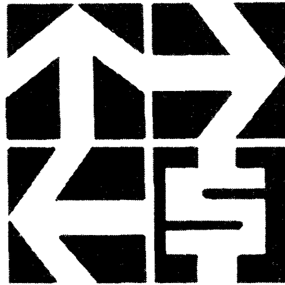

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Preface

This information report reflects work undertaken in response to a request from President Nixon in his State of the Union message on January 20, 1972, asking the Advisory Commission on Intergovernmental Relations to determine whether a national value-added tax was an appropriate and desirable substitute for the residential property tax for the financing of public elementary and secondary schools. In responding to this request the Commission staff examined all viable alternative means of strengthening the Federal revenue system. The expenditure tax was one such area of study.

On December 14-15, 1972 the Commission concluded that no substantial new Federal aid was needed to secure either general local property tax reduction or intrastate school finance equalization. Therefore, the Commission took no action concerning any possible new source of Federal taxation for these purposes.

Because the statute establishing ACIR specifically directs it to examine alternative means for strengthening the Federal tax structure, the Commission believes that the issuance of this study is appropriate. Other reports resulting from this study already have been released: they are *Property Tax Relief and School Finance—A State Respsonsibility* (A-40) and *The Value Added Tax and Alternative Sources of Federal Revenue* (M-78).

The Commission specifically directed that this report when issued should make it eminently clear that it contains no policy recommendations and is published as an information document only.

Robert E. Merriam
Chairman

Acknowledgments

James Griffin conducted and prepared this information report under the general supervision of John Shannon, assistant director. The report was edited by Robert Berney. Griffin and Berney were assisted at various stages by John Gambill and other members of the taxation and public finance staff.

Griffin benefited from reviews of the draft by a number of individuals including John Due, Henry Aaron, Martin Bailey, Gerard Brannon, Edwin Cohen, Laszlo Ecker-Racz, C. Lowell Harriss, Patrick Kelley, Leonard Kust, and Richard Slitor.

The Commission records its appreciation for the contribution of these individuals to this report. Responsibility for content and accuracy rests, of course, with the Commission and its staff.

Wm. R. MacDougall
Executive Director

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1

SUMMARY AND SCOPE

The expenditure tax, sometimes referred to as a "spendings tax," closely resembles the income tax except that the tax base is spending, not income. It is levied directly on the taxpayer and involves taxpayers filing annual returns with exemptions and deductions. The current consensus of opinion assumes that there would be graduated rates, and provisions for withholding. The important difference is that the tax base is expenditure rather than income.

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The direct taxation of personal expenditures for consumption is one of the oldest yet least tried ideas in the history of taxation. A number of distinguished economists for over a century have argued that it is the "ideal" form of taxation. The only "perfectly unexceptionable and just principle of income tax," John Stuart Mill contended, is to "exempt all savings." Because savings are excluded from the tax base, its supporters claim that it encourages thrift, which in turn should stimulate investment.

The only experience with the expenditure tax in practice was in India and Ceylon, where it was applied to a small number of upper-income persons for a few years. Both countries had dropped it by 1966, however. The U.S. Treasury proposed a "spendings tax" in 1942 as a temporary measure to curb inflation during the war. The proposal was rejected by the Senate Finance Committee and the tax has never been seriously considered since that time, in the United States or any other industrial country.

While tax economists generally recognize that an expenditure tax would offer certain advantages and consider it a respectable alternative in theory, there have always been considerable doubts about its administrative feasibility. These doubts and the general view that such a novel tax is not a politically realistic possibility have tended to limit the discussion of the expenditure tax to textbooks.

Irving Fisher, writing in 1942, and earlier advocates of the expenditure tax based their case primarily on the argument that the income tax involved "double taxation" of savings and distorted the choice of individuals in favor of consumption. Thus, not only is the income tax unjust but it encourages consumption and leisure at the expense of thrift and enterprise.

Nicholas Kaldor, writing in 1955, broadened the case for the expenditure tax by arguing that spending was a better measure of ability to pay than income. Kalder viewed the individual's taxable capacity as his "spending power" which includes all the various forms of economic wealth (stocks of wealth as well as recurrent and irregular flows of money) which must be reduced to a common denominator of so much per annum for tax purposes. Also, allowance should be made for differences in individual needs which make

some persons more or less able to pay than others with the same spending power.

Kaldor argued that the necessary operation of weighing a person's spending power against his needs is best done by the individual himself when he decides on the scale of his living expenses. He viewed income as grossly deficient as a measure of taxable capacity because it does not encompass spending power in other forms and takes no account of differences among individuals as to the need to save.

A major argument against the expenditure tax is that the exemption of saving would favor the rich since they are better able to save large portions of their incomes. Apart from the inequity involved, some feel that this would lead to greater concentrations of wealth in the hands of a few. Kaldor argued that this objection overlooked the fact that the rates of an expenditure tax can be made steeply progressive in order to tax the rich as heavily as desired, and that some spending by the rich is out of capital which is untouched by the income tax. Initially, there may be fewer "loopholes" to benefit the rich under an expenditure tax.

Another objection to the consumption base is that it would favor the miser over the spendthrift, even where both had the same spending power or ability to pay. Kaldor's response to this objection goes to the basic rationale of the expenditure tax: People should be taxed on what they take out of the common pool, not on what they put into it. Only by spending, not by earning and saving, he argued, does the individual impose a burden on the rest of the community. In other words, personal consumption drains the resources available to the community for investment and public uses while work and saving add to these resources.

In addition to value judgments as to the fairest method of direct taxation, important economic considerations are involved in the case for and against the expenditure tax. One generally accepted merit of the tax is that it would be highly effective as an anti-inflationary tool. On the other hand, the tax lacks the automatic stabilizing effect of the income tax in periods of recession. Other economic considerations, such as relative effects on incentives to work, invest and undertake risks are more debatable. It is also a moot question as to whether an expenditure tax would

necessitate higher or lower rates of tax than the income tax for the purpose of raising a given amount of revenue or having a given stabilizing effect on the economy.

These considerations, as well as the question of administrative feasibility depend in great part on how the tax would be structured, i.e., the definition of the tax and the specific provisions for taxpayer reporting. The definition of consumption for purposes of the tax which is implicit in the writings of Fisher and Kaldor comes down to "the acquisition of goods and services for the individual's personal use" as measured by the purchase price or fair market value (for housing Kaldor would use imputed rental value). Taxpayers would deduct from their tax base the value of goods which were resold or traded-in on other goods.

In calculating his tax, the taxpayer would not cumulate all his outlays for consumption but would derive them as one residual sum by adding together all funds which became available for expenditure during the tax year and then subtracting amounts which were saved or used for other nontaxable purposes. Saving would be outlays for the acquisition of financial assets as opposed to tangible assets or goods.

Whatever views might be held as to the virtues and shortcomings of the expenditure tax compared to the income tax, the income tax will apparently not be abolished in the immediate future. Also, the mass application of an expenditure tax in addition to the income tax does not now appear to be a politically realistic possibility. However, the expenditure tax has potential as an addition to the tax structure for a number of specific objectives:

1. One possibility which would affect only a small number of taxpayers is the use of the personal consumption base as an alternative to income as the tax base in cases where the taxpayer's ability to pay is clearly in excess of his taxable income as evidenced by large expenditures for consumption. This approach to tax reform would bypass and/or mitigate some of the objections to reducing or eliminating tax preferences under the income tax.

2. Another possibility which would involve a substantially larger number of taxpayers is the use of the tax as a tool to help curb inflation and reduce the adverse effects of spending on the environment and energy resources. An interesting variation of an expenditure tax used for this purpose

would be its application only to spending in excess of a certain percentage of income, permitting persons to avoid the tax altogether by saving a reasonable proportion of income.

Whether an expenditure tax would be worthwhile or acceptable in solving these problems would require extensive exploration and public discussion. Since it is difficult to foresee many of the problems that would be involved in the absence of practical experience with the tax, an initial application might be confined to a few persons on an experimental basis. Then the tax could be continued or expanded after it was shown to be administratively feasible.

The scope of any examination of the expenditure tax of less than book length is necessarily limited. For this study it was considered most useful to devote the major part of the paper to the more practical aspects of the tax, i.e., how it might be structured, administered and initiated on a limited basis, as opposed to the broad issues of equity, economic and social policy.

This selection of emphasis is based on the assumption that political realities preclude the possibility of the income tax being replaced by the expenditure tax in the immediate future and that the relevant question for present day tax policy is whether the expenditure tax would be an appropriate addition to the current tax structure, with no significant changes in the income tax. In this context, the focus is primarily on the additional administrative costs that would be created and on whether the cost would be greater than the limited benefits being sought.

Another reason for the considerable detail on the technical aspects of the tax is that the administration of the expenditure tax has always been considered a formidable and, by many, an overriding drawback to its actual use. Discussion of the economic and social merits of the tax, therefore, is frequently viewed as purely an academic exercise, with little relevance to tax policy in the real world. The administrative feasibility of any tax is ultimately, of course, a judgmental matter but a meaningful decision cannot be made in the absence of a fairly specific indication of what would be entailed in the implementation of the tax.

For these reasons, this paper deals with the definition of the tax base and the administrative aspects of the expenditure tax in considerable detail and devotes much less space to the broad issues that would obviously warrant more attention if the tax were being examined in the context of a replacement for the income tax. These latter issues are briefly summarized in Chapter II for readers who are unfamiliar with the expenditure tax. Readers who have little interest in the technical aspects of the tax may wish to skip over Chapters III and IV dealing with the tax base and administrative aspects and go directly to the final chapter on the potential role of the tax today.

I. BACKGROUND

Historical

The philosophy underlying the taxation of spending rather than income was stated as early as the seventeenth century by Thomas Hobbes: "For what reason is there, that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged than he that living idlely getteth little, and spendeth all he gets: seeing that one hath no more protection from the Commonwealth than the other?"[1]

For more than a century, some of the most distinguished economists, from John Stuart Mill through Alfred Marshall and A. C. Pigou in England, Luigi Einaudi in Italy and Irving Fisher in the United States, have argued that to tax saving "is not only impolitic but unjust."[2] The earliest important contribution toward the practical application and administration of a direct tax on spending was made by Fisher, first in articles published in 1937[3] and later in a book published in 1942.[4]

William Vickrey dealt at some length with the spendings tax in his *Agenda for Progressive Taxation* in 1947 and recommended that consideration be given to "the feasibility of changing to a spendings tax, either as a supplementary tax in the middle income ranges or as a complete substitute for the income tax in all but the highest income ranges."[5] The major work on an expenditure tax in the post-war period, and the best exposition of the case for the tax, was written by Nicholas Kaldor of Cambridge University in 1955.[6]

In spite of the endorsement by some economists exempting saving from taxation, an expenditure tax has never been used in any industrial country. Ogden Mills proposed a spendings tax in 1921 when he was a U.S. Congressman but he did not revive the idea when he later became Secretary of

the Treasury. Secretary Morgenthau proposed a spendings tax in 1942 as a temporary measure to help curb inflation during the war but the proposal was rejected by the Senate Finance Committee, apparently on the basis of its novelty and complexity.[7]

Kaldor proposed that an expenditure tax be substituted for the surtax on higher income taxpayers in Great Britain[8] but the proposal apparently received little serious consideration. India and Ceylon, on Kaldor's suggestion, adopted an expenditure tax for a few years but both countries had dropped it by 1966. The tax was considerably different from that recommended by Kaldor and the small revenue yield was considered not worth the burden of compliance and administration.[9]

The reason why the expenditure tax has not been more widely used appears to be a combination of circumstances. Prior to the work of Irving Fisher, proponents and opponents alike generally believed, that it would not be feasible to administer such a tax. Keynes expressed the opinion that while the tax was "perhaps theoretically sound, it is practically impossible."[10] This view, reflecting the conventional wisdom of most economists, was based in part on the assumption that administration of the tax would require taxpayers to report all individual expenditures, an impossible task from the standpoint of taxpayer compliance and government enforcement.

Irving Fisher pointed out that reporting individual expenditures would not be necessary; rather they could be derived as a residual sum by reporting all funds which become available for expenditure and then subtracting monies saved or spent for other non-taxable purposes. While Fisher's work enhanced the practical possibilities of the tax, oversaving was a concern of economists in the 1930's and a tax which discouraged spending and encouraged saving was not considered consistent with the needs of the times.[11]

While concern with the problem of oversaving receded after World War II, the income tax by then was firmly entrenched and is replacement by an expenditure tax has never been considered a politically realistic possibility by most tax experts. Thus, discussion of the merits of replacing the income base with a consumption base came to be considered an academic exercise; except for Kaldor's work, the expenditure tax received little attention outside textbooks on public finance.

Current Standing

The attention given to tax reform and new sources of Federal revenue in recent years has resulted in some discussion of the expenditure tax as an addition to the Federal tax structure. In 1970, Patrick Kelley of the Harvard Law School International Tax Program, discussed this possibility and concluded that the expenditure tax warranted more serious consideration in this context.[12] George Break, of the University of California, in 1972, proposed that "serious thought be given to the introduction of a broad-based, progressive personal expenditure tax" to supplement the income tax.[13]

A more sweeping proposal was advanced at the 1972 conference of the Tax Foundation by Leonard Kust, who recommended that an expenditure tax in conjunction with a value-added tax be instituted as a complete replacement for the individual and corporate income taxes. Kust argued that this would avoid the "double tax on capital" involved in the income tax and eliminate the "appalling complexities with which the income tax has been encrusted. . . ."[14]

A recent study on tax policy by the Committee for Economic Development includes a chapter on the expenditure tax. The chapter is primarily concerned with the administrative aspects of the tax and makes no recommendations as to the possibilities of instituting an expenditure tax.[15]

One leading tax economist summed up the current standing of the expenditure tax as "a respectable possibility" and as having a "number of attractive features, but it is generally regarded as too difficult to administer."[16] Another expert view is that "It is still a new and exciting idea" which "along with the income tax would rank high on equity grounds" although the administrative difficulties "might be considerable."[17]

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II. MAJOR ISSUES

The case for and against the expenditure tax is usually argued in terms of a comparison with the income tax, although it can also be viewed as an alternative to an indirect tax on consumption, such as the value-added tax. The major difference between the expenditure tax and the income tax is that the former exempts from tax the portion of income which is saved but taxes dis-saving while the latter taxes all income, which is either consumed or saved, and exempts dis-saving.

The rest of this section reviews the major arguments that are traditionally given in support of the expenditure tax along with the major counter-arguments in the context of the tax as an alternative to the income tax. The final section of the paper discusses the considerations that would be involved in using the expenditure tax as an addition to the tax structure, assuming no significant changes in the income tax.

Taxation of Saving

Irving Fisher and the earlier advocates of expenditure taxation based their case primarily on the argument that the income tax involved "double taxation" of saving. The argument is, in the words of Mill, 'To tax the sum invested, and afterwards tax also the proceeds of the investment, is to tax the same portion of the contributor's income twice over. The principal and the interest cannot both together form part of his resources; they are the same portion twice counted: If he has the interest, it is because he abstains from using the principal; if he spends the principal, he does not receive the interest."[18]

In Fisher's view, "Any tax on savings is merely a pre-tax on their yield. If we are to tax yield *after* it comes, we should not also tax it *before* it comes

—unless, of course, we really *want* for some special reason to tax the same thing twice."[19] The double taxation argument has been supported by a number of distinguished economists but the argument has always been controversial. The dispute turned primarily on definition rather than substance.

The taxation of saving has also been criticized for making saving less attractive than it would be in the absence of the income tax. Under an expenditure tax, the reward for abstaining from consumption is equivalent to the rate of interest. Under the income tax, the reward for waiting is reduced by the amount of the tax, thus, it is argued, the tax gives a bias in favor of spending and against saving.[20] However, many economists, believing that saving is not necessarily a function of higher interest rates, challenge this conclusion.

Equity

The presumption that the income tax involved the double taxation of and discrimination against saving was considered by most of the earlier advocates of the expenditure tax as an *a priori* case against the income tax. Kaldor also recognized these arguments but based his case for the expenditure tax primarily on the "more fundamental shortcomings of the concept of 'income' as a measuring-rod of taxable capacity." Kaldor viewed a person's ability to pay, or taxable capacity, as his "spending power" in relation to his particular circumstances. Spending power includes all the various forms of economic wealth: recurrent and irregular flows of money, stocks of wealth, and various other elements which have characteristics of both categories, such as capital gains. For tax purposes, this mixed bag must be reduced to a common denominator, to an amount of money per annum. Also, allowance should be made for differences in individual needs which make some persons more or less able to pay than others with the same spending power.

Kaldor argued that weighing a person's spending power against his particular needs is best done by the individual himself, when, "in the light of all his present circumstances and future proposals, he decides on the scale of his personal living expenses."[21]

Income is seen as grossly deficient as a measure of taxable capacity because it does not encompass spending power in other forms and cannot take account of individual circumstances having an important bearing on peoples' ability to pay. Thus, the income tax burden will be too heavy on one who must save from income for some contingency, such as ill health or retirement and too light on those who have a secure source of income.

The major argument against the expenditure basis of taxation on equity grounds is that the tax would discriminate in favor of the rich since they tend to spend a relatively small proportion of their income. Thus, the person with $100,000 in income who saves $20,000 would be taxed on a smaller proportion of his true ability than would the person with an income of $10,000 who cannot save that large a proportion of his income.

One of the counter-arguments to this objection is that the rates of an expenditure tax could be structured so that the rich would be taxed on a higher proportion of both their expenditure and their income than the less affluent. This would be the case in the above illustration if a tax of 10 percent was applied to expenditures of $10,000 and a tax of 50 percent to expenditures of $80,000.

According to Kaldor, this objection was essentially a red herring. Under the income tax the rich pay a much smaller proportion of their true ability to pay than they would under an expenditure tax with only mildly progressive tax rates since a large amount of spending by the rich (at least in Great Britain) is out of capital and is thus untouched by the income tax.[22]

Whether an expenditure tax would in practice be more or less progressive in relation to total ability to pay than the income tax is a moot question. Critics contend that a comparison between an expenditure tax in theory and an income tax in practice is meaningless since an expenditure tax would undoubtedly be subject to the same pressures for special exemptions. Furthermore, it is argued, long experience with the income tax has, at least, pinpointed the "chinks in the armour," but the opportunities for tax avoidance and evasion under an expenditure tax are as yet unknown and could be substantial.[23]

Another concern with the expenditure basis of taxation involves the question of horizontal equity. Should one person be taxed more lightly than another merely because he chooses to spend less than the other? This question goes to the basic rationale of the expenditure tax which is the proposition that persons should be taxed on what they take out of the "common pool" (essentially the national product) not on what they put into it. In Kaldor's view, "It is only by spending, not by earning or saving, that an individual imposes a burden on the rest of the community in attaining his own ends."[24] While he agreed that it might be a debatable point in morals whether the miser should come off better than the spendthrift, Kaldor maintained that "it is impossible to arrive at any ultimate criteria of 'fairness' without taking the economic and social repercussions of individual behavior into account."[25]

Concentrations of Wealth

The exemption of saving from tax, it is argued, would lead to concentrations of wealth in the hands of a few, which would not be desirable. The validity of this argument, however, depends on whether the specific expenditure tax which was put into effect would, in fact, tax the affluent more heavily or less heavily than the income tax.

One argument given in favor of the expenditure tax is that only by exempting saving from tax will persons whose only source of income is from work be able to accumulate enough wealth to narrow the gap between them and persons who inherit substantial amounts of wealth.

If large concentrations of wealth are considered undesirable, a direct tax on net worth would be a more efficient tool for reducing such holdings than either an income or expenditure tax.

Incentives to Work and Invest

The effect of the expenditure tax on incentives for work, investment and risk-taking is considered another advantage by its proponents. Since the rewards from work and the successful employment of money would escape tax, to the extent that they were not spent for consumption, persons would presumably have a stronger motivation to save. This argument, however, depends on the extent to which persons work and invest in order to increase their ability to consume as opposed to accruing wealth for its own sake.[26]

Corporate Taxation and Capital Gains

Exclusive reliance on the expenditure tax would eliminate the corporate income tax since no consumption takes place at the corporate level. Thus, the various problems arising from this form of business taxation would be avoided. Fisher, Kaldor and other proponents of the expenditure basis of taxation have put major stress on this point.

The desirability of the corporate income tax has always been a major subject of controversy in itself, apart from the question of whether individuals should be taxed on the basis of consumption or income. While the philosophy underlying the expenditure tax argues against business taxation, elimination of the corporate income tax is not a necessary adjunct of the expenditure tax. Problems relating to the treatment of capital gains, which in great part reflect reinvested corporate earnings, would disappear. Under the consumption base of taxation, considerations of gains and losses involved in the sale of capital assets are immaterial as in the distinction between realized and unrealized gains and losses.

Inflation and Recession

One of the major advantages the expenditure tax has over the income tax is its greater efficiency as an anti-inflationary fiscal tool. Since the expenditure tax strikes only at the portion of income spent, it provides an incentive to spend less. Thus, in addition to the reduction in spending as a result of absorption of funds by taxes, spending is further reduced to the extent that it is deterred by the tax. This aspect of the expenditure tax is particularly effective in the case of a temporary increase in tax rates since additional taxation can be avoided by deferring some spending for a temporary period. Thus, under an expenditure tax, additional restraint on spending can be achieved without necessarily raising additional revenue and increasing tax burdens. To the extent that this aspect of the tax would make an increase in tax rates

politically more feasible than with an income tax, the expenditure tax could be considered a more readily available tool than the income tax for checking inflation.

It should be noted, however, that a tax on consumption can be absorbed out of saving; thus the deterrent effect of the expenditure tax varies in accordance with persons' spending power. At the lowest income levels an expenditure tax is little different from an income tax. Since persons in the lower income group tend to spend their entire disposable income for consumption, the expenditure tax and the income tax are equally effective in reducing spending and the former would not be expected to have much additional impact in the form of spending deterred.

An offset to the advantage of the expenditure tax in inflationary periods is the fact that it lacks the automatic stabilizing effect of the income tax in downswings of the business cycle. Since the income tax takes a smaller proportion of incomes as incomes decline, it leaves a greater proportion of incomes available for spending in such periods.

Under an expenditure tax there is no such offset to a decline in total spending power. On the other hand, a temporary cut in expenditure tax rates in such periods would be more effective than a temporary cut in income tax rates in stimulating spending.

Tax Rates

One of the major questions involved in an expenditure tax relates to the rates of the tax. Since the consumption base is smaller than the income base one can argue that the rate of tax on a given amount of consumption under the expenditure tax would have to be higher than the rate on the same amount of income in order to yield the same amount of revenue. In addition, one can postulate that the gap between the consumption base and the income base would be even greater if the expenditure tax were actually put into effect because the application of the tax would discourage some consumption thus further decreasing the tax base. Therefore, since no direct tax can provide for perfect equity and tax neutrality, it would follow that the inequities and economic distortions would be greater under an expenditure tax than under an income tax.

On the other hand, Fisher contended that it was fallacious to assume that the base of an expenditure tax would be smaller. In fact, he argued, the opposite would be true for two reasons. First, because savings and investment would be increased, future output would be greater, eventually producing a larger consumption base. Secondly, account must be taken of the additional revenue which would immediately be raised from "spendthrifts" whose expenditures for consumption out of capital escape the income tax but would be taxed under the expenditure tax.[27]

It can also be argued that less revenue is needed under an expenditure tax because the taxation of savings or any kind of wealth which is not spent for

consumption either has no effect on the demand for real resources and/or reduces investment and hence future output. This "functional-finance" or "real-resources" approach to public finance is not generally accepted because of its implication that a permanent government deficit is of no economic consequence.

Home Production

The consumption of home produced goods and services would presumably be excluded from the tax base of the expenditure tax, just as income in the form of home production is excluded from the base of the income tax. In theory, such production should be included in the base of both taxes in order to insure tax equity and neutrality. However, the difficulties involved in measuring such production and consequently in enforcing taxpayer compliance have caused its exclusion from the income base as would probably be the case with the expenditure tax.

While this omission is not generally considered a major problem in the case of the income tax, it has been argued that an expenditure tax would encourage substantially more home production at the expense of the supposedly more efficient exchange economy.[28] To the extent than an expenditure tax did stimulate more home production, the effect on economic efficiency would depend on whether such production was an alternative to the individual's:

(1) exerting additional effort at his regular work in order to earn the money to purchase the goods or services on the market,
(2) purchasing the goods or services on the market out of available funds, and
(3) doing without the goods or services.

In case (1), home production would be less efficient since persons are, as a rule, most productive in their regular work. In case (2), home production would be economically beneficial since it would increase the supply of goods and services. Home production as an alternative to (3) would have no economic effect on the rest of the economy. Therefore, no *prima facie* case can be made as to whether home production stimulated by an expenditure tax would increase or decrease economic efficiency.

Administrative Feasibility

The feasibility of administering an expenditure tax has always been a major question and the doubts in this regard are probably the chief reasons why the tax has received so little serious consideration. Although Irving Fisher's work showed that the procedure for reporting by taxpayers and monitoring by tax collectors would not involve the impossible morass of details on individual expenditures which had previously been assumed,

doubts have persisted as to the administrative feasibility of the tax. But as mentioned earlier, Fisher contended that the administration of an expenditure tax would actually be simplier than that of the income tax.

Kaldor was somewhat less sanguine about the administrative feasibility but "found nothing in the basic conception (as laid out by Fisher) which would present insuperable problems from an administrative point of view. . . ."[29] Kaldor maintained that while the expenditure tax would be a more complicated tax to administer than the "present income tax" (in Great Britain) the relative simplicity of the latter was not an inherent feature of the taxation of income "but merely of the defective and inadequate notion of income which underlies the tax system. If income tax was based on the comprehensive definition of income (as measured by consumption plus changes in net worth . . . the evaluation of a person's income would require much the same information as is needed to evaluate expenditure. . . ."[30]

This observation by Kaldor bears on an important point which should be kept in mind in comparing the administrative aspects of an expenditure tax with those of an income tax. A judgment based on the two taxes in *concept* might be substantially different from a judgement based on the two taxes *in practice.* While the latter comparison is perhaps the more meaningful and relevant, the lack of experience with the expenditure tax means that such a comparison must be on a hypothetical basis.

There are numerous variations in the manner in which an expenditure tax might be implemented. Much would depend on how the tax base was defined and the specific provisions for reporting and monitoring the tax. As in the case of most taxes, administrative feasibility is, in the end, a function of the extent to which perfect equity and economic and social objectives can be compromised for the sake of administrative simplicity.

Another important variable in assessing the administrative problem is the context in which the tax is applied. If the tax is *in addition* to the income tax the considerations are different than if it is *in replacement* of the income tax. In the latter case, the new problems of administration arising from the expenditure tax would have to be weighed against the problems of the income tax which would disappear, a major example being the elimination of the troublesome problem of capital gains. In the former contingency, however, the new problems of the expenditure tax would be in addition to those of the income tax, assuming no change in the latter as a result of the expenditure tax. In this case, while the consideration of "feasibility" would be essentially the same from the standpoint of enforcing the tax, the burden on taxpayers and tax collectors would be greater than if the income tax were abolished at the same time. However, the information supplied in expenditure tax returns would be helpful in enforcing compliance with the income tax.

In addition to Fisher and Kaldor, assessments on the administrative problems of the expenditure tax have been made by other students of tax policy. Kenyon E. Poole, who worked on the U.S. Treasury's proposal for a spend-

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ings tax in 1942, concluded that after an initial period of a year or so the administrative difficulties of the tax would not be substantially greater than those of the income tax.[31] Milton Friedman, who was also with the Treasury at that time, gave a concurring view.[32]

More recently, Patrick Kelley concluded that the tax would not be simple to enforce but noted its possible benefits in raising levels of compliance with the income tax. His overall assessment of the administrative feasibility of the tax was, "In the context of highly developed societies, there seems little reason to doubt the possibility of effectively imposing an expenditure tax."[33] George Break's view on the administrative feasibility of the tax was that "the addition of such a levy at the Federal level would be practicable if there was a widespread belief that additional revenues were needed and that personal expenditure taxation provided the best means of supplying them."[34] Kust contended that Fisher and Kaldor had demonstrated that the tax could be administered as readily as the income tax.[35]

Richard Slitor, in his study of the administrative aspects of an expenditure tax, concluded that "it probably is practicable within a relatively restricted scope of high-income, substantial wealth taxpayers." "The practicability issue," in Slitor's view, "in a sense boils down to the question of how far down in the income and wealth scale it is feasible to go before the tasks of compliance and record keeping become disproportionate to the sophistication and resources of the taxpayer on the one hand and the revenue yields and desired economic effects attained on the other."[36]

III. THE TAX BASE

The tax base for an expenditure tax is personal consumption. Thus, a crucial task is the definition and measure of consumption to meet reasonable standards of equity and administrative feasibility.

Consumption Defined

The term "consumption" in its broadest sense includes anything which gives satisfaction to the individual. Fisher defined consumption as "consisting of those particular uses or services which give direct satisfactions to the user, that is, satisfactions without the intervention of further productive processes or of money payments."[37] To make the tax administratively feasible some kinds of consumption may need to be excluded. It would not be practicable to include in the tax base all the various kinds of direct satisfactions which individuals enjoy.

The most convenient and meaningful reference point is the "common pool." This is a broader concept than national product in that it includes all goods and services in the possession of or produced by anyone outside the taxpaying unit. Withdrawals from the common pool thus include acquisitions from other individuals or from the open market and includes the sale of used goods as well as newly produced goods and services.

The common pool concept would serve to make the tax neutral as to the sources and kinds of goods and services consumed except for the consumption of goods and services which individuals produce for themselves in so-called "home production." The extent of the inequities and economic distortions which might arise as a result of excluding home production from the tax base was discussed in the previous chapter. These problems would be substantially the same under the expenditure tax or the income tax unless

the tax rates under the former were significantly higher. In any case, it would not be practicable to include home production of services in the tax-base, which include all satisfactions which individuals derive directly from their own efforts (e.g., star-gazing, bird-watching, walking, reading).

Acquisitions from the common pool for business purposes would not be included in the expenditure tax base. As under the income tax, it would be up to the taxpayer to prove his acquisitions were for business purposes and up to the tax collector to minimize the cases of such acquisitions which were in whole or in part for personal use.

Any acquisition from the common pool which cannot be shown to be for business use would automatically be included in the individual's tax base, without regard to the physical characteristics or use of the item purchased. Certain items such as land, houses, and works of art, are sometimes considered "investments" even though they are not used in a business. Thus, it might appear that such acquisitions should not be included in the tax base, or at least treated differently from acquisitions which the individual "consumes."

Confusion on this point arises in part from misconceptions which are conveyed by the term "consume." As Fisher noted, the term is unfortunate since it implies that consumption takes place only when something is used up or worn out. Many goods, such as pictures, can yield consumer services without sustaining any wear and tear. The misconception is buttressed by the fact that land and houses and certain other goods tend to rise in value over time if properly cared for. Thus, their purchase by individuals has the outward charactaristics of the purchase of a financial asset such as a bond or share of stock.

For purposes of the expenditure tax, however, the only relevant consideration is whether or not the individual has withdrawn an item from the common pool, and denied its use to other persons. When an individual buys a house for $50,000 the drain on the common pool is the same as if he had bought $50,000 in perishable goods and services, and the rest of the community has no reason to differentiate between the two kinds of purchases so long as the individual withholds the house from the common pool. If and when the individual returns the house to the common pool he is duly compensated by the market place but this possibility cannot be taken account of at the time of purchase.

Whether an individual actually derives a consumer service from any acquisition from the common pool is irrelevant so long as it cannot be shown that the acquisition was for a business use. To take an extreme example, assume that an individual purchases a vacant tract of land as a speculative investment and has no intention of developing the land, building a house on it, or using it in any manner. His only purpose is to hold it as an investment and he derives no consumer benefits whatsoever from it. From the standpoint of the individual that is clearly an investment, no different from the purchase of a financial asset such as a growth stock paying no dividend. From the

standpoint of the community, however, and hence for purposes of the expenditure tax, there is an important difference since the purchase of land constitutes a drain on the common pool of resources whereas the purchase of the stock does not. The object of the expenditure tax is to ration the total drain on the pool of resources by individuals. When a person denies the use of land or any other resource to the rest of the community it is immaterial from the standpoint of the community whether or not the person derives a consumer benefit from it. The economic effect is the same in either case and continues so long as the individual holds the item out of the common pool.[38]

To recapitulate, consumption for purposes of the expenditure tax should be defined as the acquisition of goods and services (including land) from the common pool for the personal use of persons within the taxpayer unit.

Measuring Consumption

In analyzing how consumption would be measured, there are two ideas which should be kept separate. One is the *conceptual* question of how consumption should be measured. The other is the *mechanical* aspect of how the taxpayer should compute his consumption, after it is determined what is to be included in the tax base.

Misconceptions on how consumption would be measured can arise because of the mechanical procedure for computing the individual's expenditure base. For reasons of administrative practicability taxpayers would not cumulate all their individual expenditures when filing their annual returns. They would derive their consumption by subtracting their savings from the total of funds which become available during the year, which can be termed for convenience "receipts." It is important to note, "receipts" are not the same as "income" for purposes of an income tax since receipts include all cash flows irrespective of their source or form (e.g., gifts, bequests, gross revenue from the sale of stock). Readers should avoid the error of automatically applying concepts which are applicable to the income tax, such as capital gains and losses, to the expenditure tax.

If all personal consumption were in the form of services purchased in the market place, the measure of consumption for the expenditure tax would be simply the total amount paid. In the case of consumer services derived from goods owned by the taxpayer, questions arise as to the appropriate method for measuring and taxing the consumption involved. For the relatively inexpensive and less durable goods, such as food, clothing and minor household items, the generally accepted measure of consumption would be the purchase price, just as in the case of consumer services purchased on the market. In the case of the more expensive and longer lasting goods, such as houses, a different treatment is usually assumed.

The problems foreseen for these major consumer purchases are as follows: One involves the practical *financial* consideration that many taxpayers would

not have the financial resources to pay the total tax liability all at once on a major purchase such as a house. A second problem arises in connection with the *graduated rate structure,* if one exists. The total value of the housing service rendered over a period of years would be bunched up into one year, the year of purchase, and put the taxpayer in an inordinately high tax bracket. How these difficulties could be administratively alleviated are discussed in the following chapter. This section is concerned with the theoretical aspects of how consumption is measured.

Fisher and Kaldor both assumed that consumer durables would be taxed on the basis of their purchase price. For administrative convenience Kaldor suggested that owner occupied housing should be taxed on the basis of the imputed rental value, and that the cost of other major purchases such as an automobile should be spread over their useful life. Fisher did not discuss these problems although he did observe in the case of house purchases the payment is usually spread out over a period of years in the form of mortgage payments.

In the case of goods which were resold before they were fully consumed, both Fisher and Kaldor noted that it would be appropriate to credit the taxpayer in the amount of the resale price. The need for allowing credits for resales and trade-ins, which can be termed "negative consumption," is self-evident in the case of goods which depreciate in value. When a person returns an item to the common pool before it is fully consumed the net drain is less than if he had retained the item its entire useful life. The resale or trade-in is essentially a barter transaction. If Smith sells his used refrigerator for $100 and uses the money to buy a lawn mower for $100 it is as if he had swapped the refrigerator directly for the mower and no additional consumption is involved. Thus, the positive consumption involved in the acquisition of the mower must be washed out by allowing Smith a credit for his negative consumption involved in disposing of his refrigerator.

Negative Consumption

It should be noted that negative as well as positive consumption arises from transactions with other individuals as well as from those in the commercial market. Thus, if Smith sells his refrigerator to his neighbor Jones for $100, both parties are involved in a transaction with the common pool (anyone outside the individual's tax unit) and Smith would be credited with negative consumption and Jones charged with positive consumption. If Smith swapped his refrigerator for Jones' mower on even terms no additional consumption is involved on the part of either party.

Since the expenditure tax is levied on consumption, negative consumption must give rise to a negative expenditure tax. To illustrate, assuming a proportional expenditure tax rate of 30 percent, when Smith buys his refrige-

rator for $500 he is charged a positive tax of $150 and when he sells it for $100 he is charged a negative tax of $30. Persons cannot, of course have negative consumption over their entire lifetime, but since the expenditure tax must be levied and collected at periodic intervals, individuals can incur negative taxes as a result of negative consumption in a given year. For example, if in the year that Smith resold his refrigerator he had no other transactions, his expenditure tax would be negative; he would be entitled to a refund of $30. His net tax for the refrigerator would thus be $120 ($150 when purchased new less $30 when resold) which is equivalent to charging a 30 percent tax on his net consumption of $400.

A key point often overlooked in measuring the expenditure tax base is time. The measure of consumption involved is a function not only of the value of what is withdrawn from the common pool but also of how long it is held out from the pool. The longer an item is held by the individual the greater the loss to the community and the greater the cost to the individual of doing without the money (i.e., the loss of interest).

This time function is best understood by considering a consumer durable such as an oil painting, which requires no outlays in the form of upkeep and which maintains its original value over an indefinite period of time. If such a good is purchased for $1,000 and resold for the same price after one year and the cost of money is 5 percent, the cost of the individual's consumption is $50, the interest lost for one year on $1,000. It could be said that the individual, in effect, rented the painting from the community for one year at a charge of $50. If it is assumed that an expenditure tax is levied at a proportional rate of 30 percent on *positive and negative consumption,* the purchaser would be charged tax on $50 of consumption just as if he had consumed $50 worth of perishable goods such as food. The individual would *make* a tax payment of $300 at the beginning of the year and *receive* a tax payment of $300 at the end of the year, thus his effective tax cost would be the cost of doing without $300 for one year, or $15 which is the same tax that would be charged on $50 worth of consumption in any other form.

The $300 which the individual would receive from the tax collector on resale of the painting should be viewed as a negative tax rather than as a tax rebate. This differentiation will help in avoiding the misconception that the compensation received for returning an item to the common pool should be related to the tax paid when the item was withdrawn from the pool. The expenditure tax is levied on the individual's *net* consumption (i.e., the net drain on the common pool for each year *taken individually* and without regard to any transactions in previous years).

Now let us assume that the picture in the above illustration instead of merely maintaining its value had doubled in value to a market price of $2,000. The owner's decision as to whether to sell the picture or keep it for some future period would be unrelated (at least logically) to the fact that he originally paid only $1,000 for it. Also, the compensation which the rest

Table 1

Comparison of Tax Base of Income Tax and Expenditure Tax

	1968 ($ billions)			
	Income Tax*		Expenditure Tax	
Personal income		688.7		688.7
Deduct: Portion of personal income not included in "AGI" or Receipts"		137.7		75.2
A. Transfer payments (except military retirement pay)	57.0			
B. Other labor income (except fees and military reserve pay)	23.2		23.2	
C. Imputed income	37.1		37.1	
D. Other types of personal income				
1. Income received by non-individuals	5.4		5.4	
2. Difference in accounting treatment	4.2		4.2	
3. Other exemptions and exclusions				
a. Excluded business expense	5.3		5.3	
b. Excluded sick pay	—			
c. Excluded moving expenses	—		—	
d. Excluded contributions to retirement plan by self-employed	—		—	
e. Excluded dividends	1.1			
f. Tax exempt military pay and allowances	3.3			
g. Tax exempt interest income	0.9			
h. Tax exempt dividend distributions	0.2			
Add: Portion of "AGI" or "Receipts" not included in personal income		48.7		22.8

A. Personal contributions for social insurance	22.8		22.8	
B. Net gain from sale of financial assets	17.8			
C. Other types of income				
1. Annuities and pensions reported on tax returns	6.0			
2. Other income in "AGI" but not in personal income	2.1			
Equals total adjustment for conceptual differences		—89.0		—52.4
Estimated "AGI" or "Receipts" of taxable and non-tax individuals		559.7		636.3
Deduct: "Savings" reported by individuals in expenditure tax returns				9.8
A. Personal saving			39.8	
B. Minus:				
1. savings not made by individuals			5.3	
2. imputed savings			15.4	
3. private pension reserves			9.3	
Equals "Gross Expenditures"				626.5
Adjustment for differences in allowable deductions				—8.9
A. Deduct:				
1. Personal contributions for social insurance			22.8	
2. Private life insurance reserves			4.6	
B. Add: deductions of interest payments in income tax returns			18.5	
Equals "AGI" and, "Gross Expenditures" on comparable basis		599.7		617.6

* Source: John A. Gorman, "The Relationship Between Personal Income and Taxable Income," *Survey of Current Business,* May, 1970.

of the community and the tax collector would be prepared to give him for returning the picture to the common pool would be unrelated to the charge which they imposed for withdrawing the picture from the pool. The owner must now consider whether the picture is worth $100 per annum to him (the opportunity cost of doing without the $2,000 he could now have if he sold it) taking into account his enjoyment from possessing and viewing the painting and the prospects for its future value.

The rest of the community and the tax collector are only concerned with the individual's current net drain on the common pool and they are prepared to credit the owner with a negative drain on the common pool of $2,000 if he chooses to sell the picture.

Part of the difficulty in grasping the validity of crediting individuals with negative consumption is the appearance of windfalls where goods are resold at a higher price. While individuals often enjoy windfalls from consumer goods there are several points in this connection which are often overlooked.

First, windfalls can be negative as well as positive. An individual who buys a picture for $1,000 with the expectation that it will approximately maintain its value over a period of years enjoys a positive windfall when the picture turns out to be worth $2,000 in a year's time. The same individual, however, may also purchase a car with the expectation of a certain minimum performance in terms of service and maintenance costs and later discover that he has purchased a "lemon," thus sustaining a negative windfall.

Since positive and negative windfalls should approximately balance out over time, there would be no case in equity for limiting the negative tax in cases where taxpayers were (in retrospect) under-taxed at purchase while at the same time requiring them to sustain the full tax on items on which they were over-taxed at purchase.

Windfall gains can occur even where the resale price is less than the original purchase price. If a car, picture or any other consumer good is found at time of resale to have depreciated in value less than originally anticipated, a windfall is realized even though it might not be so apparent as in cases where goods have appreciated in value.

Windfall gains can also be realized without having to resell the goods. The fortunate individual whose picture unexpectedly doubles in value will undoubtedly enjoy a greater satisfaction from viewing and displaying a $2,000 picture than from a $1,000 picture, even though they are one and the same. The individual whose car performs well above expectations in all departments can realize his windfall through continued possession and use of the car.

Finally and most importantly, in many cases where consumer goods appreciate in value the apparent windfall gain is in fact a recoupment of an investment element which was reflected in the original purchase price. For ease of explanation, the investment element of consumer goods may be defined as the additional amount which the individual pays because of the

expectation that the goods will appreciate in value over time. Common examples of such goods are houses, works of art, and antiques. The fact that the resale price of such goods reflects in part this investment element is an important reason why the negative tax paid to the individual under the expenditure tax must be based on the resale price irrespective of whether it is higher or lower than the original purchase price.

Housing

An example of a housing development in which all the houses are initially identical is useful to illustrate this point: The houses are all valued at $50,000. Now assume it is generally known that in three years a highway will be built which will run along the east side of the development and that a golf course will be built fronting on the west side of the development. Assume that the market anticipates that when these developments are completed houses fronting on the highway will depreciate in market value by $5,000, houses fronting on the golf course will appreciate by $5,000 and houses in the center of the community will be unaffected.

These anticipated changes in future values will be immediately reflected in the present market values of the affected houses even though the housing services rendered by them will continue to be exactly the same as before up until the completion of the two projects. Now assume that the cost of money is 5 percent, the rate of the expenditure tax is 30 percent, and that three individuals buy houses in the community, one on the east side, another on the west side and the third in the center of the community. We can further assume that each of the three has a given sum of cash immediately before buying the houses and that those who have cash remaining after the purchase invest it in a stock which is expected to appreciate in value at an annual rate of 5 percent and that all three persons resell their houses and stock at the end of three years. The details of this example are given in Illustration A.

This illustration shows that the positive-negative tax mechanism has the effect of looking through or bypassing the investment element in consumer goods and charging tax only on the consumption element. The investment element in this example is the amount by which the purchase prices of House East and House West deviated from $50,000. The purchase price of House West had a positive investment element of $4,319, the present value of $5,000 three years hence, and the purchase price of House East a negative investment element of the same amount. In all three cases the expenditure tax would be neutral as to the investment content of houses and investments in stock, or more accurately, it would be inapplicable to both kinds of investment.

The purchaser of the West House did not actually have a tax gain even

though his negative tax exceeded his positive tax by $204. The $204 merely compensated him for his interest loss over the three years period on account of the expenditure tax charged on the investment element of his outlay for the house. That is, $204 is the interest loss on $1,296 (the expenditure tax attributable to the $4,319 investment element) compounded at 5 percent over a three year period.

Consumer goods which have an investment content in their purchase price would not need to be resold in order to compensate the purchaser for the tax charged on the investment element. Illustration A was drawn up in terms of a "round trip" in a consumer good primarily to demonstrate the aspect of the negative tax which appears to be the most difficult to grasp,

Illustration A

	East House	Center House	West House
Year of Purchase			
Purchase price	$45,681	$50,000	$54,319
Expenditure tax paid	13,704	15,000	16,296
Purchase of stock	11,233	5,615	—
Total outflow	$70,615	$70,615	$70,615
Year of resale			
Resale price	$45,000	$50,000	$55,000
Expenditure tax received	13,500	15,000	16,500
Sale of stock	13,000	6,500	—
Total inflow	$71,500	$71,500	$71,500

i.e., that the negative tax is correctly based on the resale price even where the good appreciates in value between purchase and resale. It should be reiterated, however, that goods would not carry a "tax history" and once a good is withdrawn from the common pool and taxed the transaction can be considered as ended forever more and no tax consideration is involved as to whether the good is retained by the purchaser forever more or subsequently returned to the common pool.

A key point to bear in mind is that the retention of a good which can be sold for a given amount is tantamount to purchasing the good for that amount. For example, if any or all of the owners of the three houses in Illustration A should decide to keep their houses at the end of the three year period it would be as if they had bought the houses after the highway and golf course were completed rather than before.

This can be seen by considering that the owner of House West contemplates his options after completion of the golf course. He can continue to live in the house or he can sell the house. If he sells the house he can use the proceeds from the resale price and the negative expenditure tax (a) to buy another house or other consumer goods and services and pay a positive expenditure tax, (b) to invest the proceeds in a financial asset and pay no expenditure tax or (c) some combination of these. In any event, the only tax consideration involved is that the greater his consumption the greater the tax. The tax is neutral as to the form of his consumption. If he stays in the house he must reckon the annual cost of the housing service at $2,750 per annum, (the annual interest foregone on $55,000) plus the cost of the expenditure tax at $825 per annum (the interest foregone on the $16,500 negative tax he would receive if he sold the house) which is equivalent to applying the tax on a per annum basis to the $2,750 he is consuming in the form of housing services.

From this it can also be seen that the expenditure tax would be neutral as between homeowners and renters. Assume that the owner of House West had another option of selling the house to someone who would agree to let him stay on as a renter. The rent charged would, in theory, be the amount required to cover the cost of capital to the landlord plus annual maintenance costs. Since the maintenance costs would be the same irrespective of who had title to the house, for simplicity these can be left out of the accounting. Since the cost of capital (or return on capital) to the landlord would come to $2,750 on his investment of $55,000, the cost of renting the house and the expenditure tax thereon would be the same as the cost and tax incurred by the owner occupant. Thus, the methodology of levying positive and negative tax on the purchase and resale price is equivalent, in theory, to charging a per annum tax on the basis of the imputed rent, i.e., the rent that would be charged to the occupant if he were a renter instead of the owner of the house.

That the individual's tax base under the expenditure tax can be correctly computed with no violation of tax neutrality simply by relying on market values of goods is an important advantage of the expenditure tax. The current income tax in the United States gives a tax incentive to individuals to own the goods that yield a consumer service rather than to rent them or to purchase the services directly on the market place. This is not an inherent feature of the income tax for, in theory, individuals could be charged tax on the imputed income derived from all goods which they own. However, the obvious administrative difficulties involved in imputing income to all consumer goods or even to the major ones, probably preclude this approach as a practical possibility.

Taxes on real estate and other kinds of wealth require periodic assessments of property values. While market values are the conceptually correct basis for these valuations as they are for the expenditure tax, the important difference

is that taxes on property necessitate periodic valuations whether or not the property is sold whereas under the expenditure tax market values are relevant only when transactions actually occur. In other words, the correct measurement of the tax base for taxation of income and property requires hypothesizing what the market would charge or pay if the goods or the services they render were bought or sold on the market place while the expenditure tax mechanism relies on what the market did in fact charge or pay.[39]

To recapitulate, the definition and measure of consumption which would constitute the individual's tax base under an expenditure tax is as follows:

> the market value of goods and services (including land) acquired from the common pool during the tax year for the personal use of the taxpayer (and/or persons within his household) minus the market value of goods contributed to the common pool.

Goods held for business use would be exempt.

Interest Payments

Interest payments paid to finance consumption expenditures would be included in the tax base given that consumption in the present has a higher value than consumption in the future viewed from the current time period. Thus, the interest charged to enable the borrower to advance consumption from the future to the present is a measure of the value of the "additional" consumption.

Interest payments to finance investments should not be included in the tax base. If a person borrows money and invests in shares of stock, the interest charge incurred does not represent payment for advanced consumption.

While the two kinds of interest payments should in principle be treated differently under an expenditure tax, it is often difficult to determine whether the borrowed funds are in fact applied to investment or to consumption. The administrative problems involved in attempting to separate the two kinds of interest payments are discussed in a later section.

Education Expenses

It is sometimes suggested that expenditures for education should be excluded from the base of an expenditure tax on the grounds that they represent investment rather than consumption. While a case can be made for exempting certain educational expenses, this is a judgmental matter and would not follow from the concepts of investment and consumption developed here. Under an expenditure tax, it might be considered desirable to broaden the definition of expenses for education which are directly related to earning a living or which are socially desirable. For example, the costs of a college education might be

considered expenditures which, from a social standpoint, should be treated more favorably than other kinds of expenditures for personal consumption.

The Aggregate Tax Base

The history of the income tax indicates that the conceptual base of an expenditure tax might be substantially eroded by exclusions from the base reflecting the value judgments and influences of the various forces which shape tax policy. For this reason, a meaningful estimate cannot be made of what the total tax base for an expenditure tax would be if actually put into practice.

Nevertheless, it is desirable to compare the conceptual base of an expenditure tax with the actual base for the income tax before allowing for deductions and personal exemptions. This is done in Table 1 for the year 1968, the latest year for which the derivation of "Adjusted gross income" from personal income has been calculated.

Table 1 shows that the *conceptual base* for an expenditure tax would have been somewhat larger than the *actual* base for the Federal income tax before deductions and exemptions under either tax. It should be emphasized that Table 1 serves only to indicate the general order of magnitude of the base for an expenditure tax as compared to the base of the income tax. If an expenditure tax had actually been in effect in 1968, the base might have been smaller to the extent that individuals contracted expenditures in order to decrease their tax liability. Also, no account is taken of the effect that an expenditure tax might have on increasing or decreasing total personal income and hence the ability of persons to make expenditures for personal consumption.

IV. ADMINISTRATIVE ASPECTS

The administration of an expenditure tax has always been considered its major drawback. When Irving Fisher realized that expenditures would not have to be reported individually, a major part of the problem was solved. Fisher pointed out that expenditures could be derived as one residual sum by adding together the gross receipts from all sources and then deducting savings and any exempt expenditures.[40]

The reporting for an expenditure tax, then, would be essentially an extension of that done for the income tax; but the definition of "income" is broadened to include all funds which become available for expenditure during the year plus any receipts in kind.[41] Then, the taxpayer must show the extent to which these funds were used for non-taxable purposes. The residual is, by definition, taxable expenditures.

The Tax Return

The mechanics of reporting and deriving taxable expenditures are best understood by examining the structure of an expenditure tax return (Figure A). The form is drawn up to conform as closely as possible to the terminology used in the income tax.

The following is a comparison of the basic formats used for the two taxes:

Expenditure Tax	Income Tax
Receipts	**Adjusted gross income**
Minus savings	
Equals gross expenditures	
Minus deductions	**Minus deductions**
Minus exemptions	**Minus exemptions**
Equals taxable expenditures	**Equals taxable income**

Most of the items listed in Figure A are reportable under the income tax in one form or another and are self-explanatory. The definition of which outlays would qualify as "savings" would, of course, be critical. As noted in the previous section, consumption would be defined as all acquisitions of goods and services for the individual's personal use. For any entries made under "savings," the burden of proof of their non-consumption nature would be on the taxpayer.

The reporting of changes in bank accounts would be a departure from what taxpayers are familiar with under the income tax. This should not cause major difficulties. For each bank account the taxpayer would need only to subtract the balance as of the end of the year from that at the beginning of the year as shown in his bank statements and enter the difference (under "receipts" if a decrease and under "savings" if an increase). An information return to the taxpayer and IRS would simplify the preparation and checking of this entry.

Negative Expenditures

As noted in the discussion of the tax base, a credit in the form of a negative expenditure would have to be given for any good not fully consumed when the good was subsequently resold. How the purchase and resale would be reflected in the taxpayer's tax return is best seen through example. Assume that a person bought a car for $3,000 and in a later year sold the car for $1,000 in cash, depositing the proceeds in his bank account. His tax return would be affected as follows:

	Year of Purchase	Year of Resale
Receipts		
Net decrease in bank account	**3,000**	**—**
Other receipts	**—**	**1,000**
Minus Savings		
Net increase in bank accounts	**—**	**1,000**
Equals Gross Expenditures	**3,000**	**0**
Minus Deductions		
Negative expenditures	**—**	**1,000**
Equals Net Expenditures	**3,000**	**–1,000**

Thus, the taxpayer would be charged tax on $2,000, on balance, which would be the proper measure of his consumption of the automobile. If he traded in his old car on a new car, only the additional cash outlay would be

Figure A

Expenditure Tax Return

Receipts

1. Wages, salaries, tips, etc. .... ______
2. Dividends .... ______
3. Interest income .... ______
4. Rents and royalties .... ______
5. Pensions and annuities .... ______
6. Net receipts of sole proprietorships and professions .... ______
7. Withdrawals from partnerships .... ______
8. Receipts from:
   a. sales of financial assets .... ______
   b. gifts and bequests .... ______
   c. insurance .... ______
   d. other .... ______
9. Net decrease in: (leave blank if net increase)
   a. bank checking accounts .... ______
   b. savings accounts .... ______
10. Total (add lines 1 through 9) .... ______

Savings

11. Purchases of financial assets .... ______
12. Capital contributed to partnerships .... ______
13. Net increase in: (leave blank if net decrease)
   a. bank checking accounts .... ______
   b. savings accounts .... ______
14. Other savings and investments .... ______
15. Total (add lines 11 through 14) .... ______

16 **Gross Expenditures** (subtract line 15 from line 10) ______

Deductions

17. A. Itemized deductions .... ______
   or
   B. Standard deduction .... ______
18. Federal income tax paid in .... (tax year) .... ______
19. Expenditure tax paid in .... (tax year) ______
20. Total (add lines 17 through 19) .... ______
21. **Net Expenditure** (subtract line 20 from line 16) .. ______
22. **Exemptions** .... ______
23. **Taxable Expenditures** (subtract line 22 from line 21) .... ______

reflected in his tax return. For example, if a car dealer allowed him $1,000 on a new car costing $4,000, only the decrease of $3,000 in his bank account would be reflected in his return in the year of the transaction. In case of resales for cash, since the reported receipts would be exactly offset by the deduction for negative expenditures, requiring the taxpayer to report the two offsetting transactions might be considered unnecessary. However, two reasons can be presented on why such transactions should be recorded on a gross basis. First, it would help insure that taxpayers did not report receipts which they were not entitled to offset with negative expenditures. Second, in cases where the proceeds from resale are quite large (for example the sale of a house) a negative balance for total taxable expenditures could result. In such cases, taxpayers would be entitled to receive a negative tax payment or at least a carryover for future years.

Cash Holdings

Changes in the taxpayer's holdings of cash should in concept be reported, since such changes reflect expenditures and savings. As a practical matter, however, it would not be worthwhile to require the reporting of changes in cash holdings, since it would be almost impossible to enforce accurate reporting. In most cases little gain or loss would accrue to taxpayers or to revenue yield if cash holdings were simply ignored.[42] While this would enable taxpayers to reduce their tax base in a future year by holding out cash, now, it would be at the expense of increasing their tax base for the present year.

If cash holdings were not reportable, however, persons who made substantial amounts of savings in the form of cash would be taxed on these savings unless they were willing to at least make overnight bank deposits of their cash holdings at the end of the year in order to have them recorded by a bank statement.

Receipts in Kind

Receipts in kind would be treated as if the receipt had been in the form of cash and the item had been purchased with the proceeds. The test of whether the transaction was for business or investment purposes or for personal consumption would then be the same as for ordinary cash transactions. In cases where the goods or services received were admittedly for the personal use of the taxpayer, the procedure would be the same as for income-in-kind under the income tax: the taxpayer would be required to report the "fair market value" of the item. To eliminate the reporting of Christmas, birthday and other miscellaneous gifts, receipts in kind with a total value below a certain minimum could be exempt.

In the case of receipts of business and investment property which were maintained in the same form in which they were received (at least until the

end of the taxable year in which received) two "wash" entries would be made. For example, if a person inherited a business establishment and did not dispose of it in the same year, the value of the business would be entered under "receipts from bequests" and an offsetting entry made under "other savings." If instead, the business was sold in the same year, the taxpayer would report the cash proceeds of the sale under "receipts from bequests."

Business Receipts, Expenses and Investments

Owners of unincorporated businesses would be required to report transactions related to their businesses on a cash flow basis, without regard to non-cash items such as depreciation and bad debts. The relevant consideration would be the extent to which such businesses increased or decreased the amount of funds available to the taxpayer for expenditure on personal consumption. The net profit or loss as calculated for the income tax would be irrelevant.

In the case of sole proprietorships, the owner would file a form similar to that now filed for the income tax (Schedule C) except that only transactions which actually resulted in cash flows during the year would be reported. In the case of partnerships it would only be necessary to report withdrawals from and contributions to the partnership. The current partnership return of income (Form 1065) would probably be sufficient for this purpose.

The purchase of a business would be treated as savings. Entries would be made in lines 12 and 14 in the sample form for partnerships and proprietorships respectively. Expenditures by on-going proprietorships for plant and equipment could be handled similarly or included along with ordinary business expenses.

Writing off as business expenses expenditures for consumption by the owners or key employees, a common problem with the income tax, would also be a problem with the expenditure tax. Whether there would be a greater or lesser incentive for this kind of practice would depend on the marginal rates of taxation.

Borrowing

Borrowing could be treated in either of two ways. One approach would require the taxpayer to report any proceeds from borrowing as receipts and their repayment as deductions or savings. This would necessitate the reporting of installment purchases, changes in charge account balances, credit card balances, etc. This would be done by computing and reporting the change during the year in the balance outstanding for each account, with an increase in the balance reported as a receipt and a decrease as saving.

An alternative approach would be to ignore the proceeds of borrowing and their repayment. Since borrowing for consumption and repayments wash

out in the end, this would give the same net result as the first procedure but would reverse the timing of the tax liability and deduction. Thus, "gross expenditures" would be reduced to the extent that there was a net increase in borrowings and increased by the amount of net repayments of borrowings.

This alternative would be considerably easier from an administrative standpoint. It would eliminate the need to report individually all the various kinds of credit purchases and repayments. In the year of the borrowing the proceeds of the loan would have the same effect as negative expenditures since they would be automatically reflected in the taxpayer's return by an increase in his bank account of an equivalent amount (or less of a decrease than would have occurred in the absence of the borrowing). Positive expenditures would be reflected in the year of repayment through the opposite effect on his bank account.

A further advantage of this procedure is that it would help taxpayers smooth out the tax impact of "lumpy" expenditures, such as house purchases, which are usually financed through borrowing. It would also help in smoothing out the tax impact of the "hump" in the life cycle which typically shows net dis-saving by younger persons and net saving in middle age.

If this "reverse" procedure for handling borrowing was used, it would be an additional reason for including interest payments in the tax base, since it would discourage borrowing made solely to avoid taxation. If tax rates were raised temporarily as an anti-inflationary measure taxpayers might be inclined to borrow in order to push their tax liability into the future when tax rates, hopefully, would be lower. The additional cost of the interest plus tax on the interest payments would *tend* to discourage this kind of activity.

Other considerations would also discourage the use of borrowing purely for tax avoidance. Taxpayers would be aware that a temporary tax increase could in fact stay in effect indefinitely. They could also expect their tax base to rise in future years as their expenditures rose as a result of higher prices and higher real income. For these reasons, the additional tax incurred as a result of the borrowing could turn out to be more than any saving from the reduced tax bill in the earlier period.

Housing

As shown earlier, under a proportional expenditure tax the consumption and investment elements in consumer goods would be automatically taken into account if tax was charged on the full purchase price in the year of purchase and taxpayers were credited with negative expenditures by the amount of the resale price in cases where goods were resold. This procedure would put homeowners and renters on the same basis and would be equivalent, assuming a perfect capital market, to charging homeowners tax on the basis of an annually imputed rental service of their houses.

Under a progressive tax, however, this equivalence would not hold if tax was charged on the full purchase price in the year of purchase because the

"lumping" of the home buyer's entire outlay into one year would increase his tax rate relative to the renter. The relatively large sums involved in house purchases would also create a financial problem for many home buyers if they were required to pay the full tax liability in the year following purchase. For these reasons, it is usually considered that some procedure would be devised to tax homeowner housing on an annual basis comparable to the taxation of rental housing.

The problem arising from the progressive rate structure could be substantially eliminated by a special provision for taxing house purchases. For example, it might be provided that the expenditure for the purchase of the house could be set aside from other expenditures and taxed from the bottom up; that is, taxed independent of other consumption expenditures.

To illustrate how this would work, assume that the tax rate schedule for the expenditure tax was the same as that for the current income tax. Assume that two persons (each filing a joint return) have annual taxable expenditures of $20,000 each excluding expenditures for housing and one rents his housing while the other buys a house. The renter would be taxed at a rate of 32 percent on his additional expenditures for rent (up to $4,000). If the home buyer was taxed separately on his expenditure for a house he could pay up to $44,000 for the house without attracting a higher rate of tax on this account than the renter. That is, the average rate of tax on $44,000 is 32 percent. A house purchased for $50,000 would be taxed at about 34 percent and one purchased for $38,000 would be taxed at 30 percent.

The major problem arising from the taxation of the purchase price of the house in the year of purchase would probably not be so much from the effects of the progressive rates as from the financial impact on home buyers if they were required to pay the full tax in the year following purchase. The tax on a $44,000 house under the above assumptions, for example, would be about $14,000, and on a $50,000 house about $17,000.

This financial impact would be substantially mitigated if the "reverse" treatment of borrowing, discussed earlier, was employed. In such a case, the additional tax impact in the year of purchase would be limited to the tax on the down payment. In the above illustration, if the home buyer was taxed separately on the down payment, the tax (on a joint return) on a 25 percent down payment for a $44,000 house would be about $2,000 and about $2,400 on a $50,000 house. The remainder of the purchase price would be taxed annually for the life of the mortgage on the house. The monthly mortgage and interest payments would automatically increase the homeowner's tax base by an equivalent amount since they would be reflected in drawdowns of his checking account or other kinds of dis-saving.

If the "reverse" borrowing procedure was not used, any inordinate financial impact of the expenditure tax on home buyers could be relieved by permitting home buyers to postpone payment of the tax liability and by paying an annual interest charge on the amount postponed. This would come to the

same thing, in theory, as if the home buyer paid the full tax in the year of purchase from his own assets or paid the tax by borrowing from private sources.

As demonstrated in the previous chapter, the mechanism of charging full tax on the purchase price of consumer goods and rebating the tax on the resale price (through permitting credits for negative expenditures) would automatically separate out and exempt from tax the investment portion of goods acquired for the individual's personal use and would put on the same basis persons who derive consumer services by owning goods and those who derive the same services by renting the goods or paying directly for the services.

Illustration B shows an example of how this principle would work in the case of housing by comparing two persons who are alike in all respects except that one is a renter and the other a homeowner. It is assumed that both are a marginal tax rate of 32 percent and that house purchases would be taxed from the bottom up as discussed above. With a five percent interest charge, the effective cost of the expenditure tax would be the same in both cases, bearing in mind that the homeowner will be credited with negative expenditures when he resells the house.

Illustration B

Renter

Value of house	$44,000
Annual rent	3,500
(landlord's return on capital @ 5%)	(2,200)
(annual maintenance costs, property tax, etc.)	(1,300)
Expenditure tax @ 32%	$ 1,120

Homeowner

Purchase price of house	$44,000
Expenditure tax on purchase price @ 32%	14,080
Annual cost of payment of expenditure tax @ 5%	704
Annual maintenance costs, property tax, etc.	1,300
Expenditure tax on maintenance costs, etc. @ 32%	416
Total annual cost of expenditure tax	$ 1,120

Another way to show that the renter and homeowner would be treated equally under these assumptions is to assume that both have a capital sum of $58,080 before renting and buying their houses. The renter invests his capital at 5 percent interest, earning $2,904 per annum and the homeowner uses his capital to purchase the house for $44,000 and pay the expenditure tax of $14,080. Then the annual cash flow of each would be as follows:

Illustration C

Renter	
Cash Inflow	
Annual earning on $58,080 investment @ 5%	$2,904
Cash Outflow	
Annual rent payments	3,500
Expenditure tax (on rent)	1,120
Total	4,620
Net Cash Outflow	1,716
Homeowner	
Cash Inflow	—
Cash Outflow	
Maintenance costs, etc.	$1,300
Expenditure tax (on maintenance costs)	416
Total	1,716
Net Cash Outflow	1,716

Under these assumptions, the problem of home buying boils down to the *financial* problem which some home buyers might have in finding the money to pay the expenditure tax in one lump sum in the year of the purchase of the house. In these cases, the government could act as banker. Using the figures in Illustration B, the mechanics would be as follows:

For the year in which the house was purchased, the homeowner would file a return showing $14,080 tax due on account of the house purchase. He could then borrow, in effect, this amount from the I.R.S. at 5 percent interest, making annual interest payments of $704. He would have no obligation to

repay any part of the principal of the loan until he disposed of the house, at which time the entire $14,080 would be due and payable. Since he would be credited with negative expenditures in the amount of the resale price of the house, this amount would more or less cancel out the back taxes, depending upon whether he resold the house for more or less than he paid for it.

The major alternative to this method would be the imputed rent approach, whereby the homeowner would be charged tax on the hypothetical annual rental value of the house. In Illustration B this would be $2,200 a year on a net basis and $3,500 a year on a gross basis. In theory, this would amount to charging tax on the purchase price of the house but the administrative difficulties would be formidable. In order to maintain a reasonable equality between homeowners and renters the imputed rental values would have to be continually readjusted, giving rise to problems similar to those involved in property taxes.

Taking the purchase price of houses as the tax base would involve only one assessment which would remain unchanged so long as the homeowner remained in the house. Furthermore, the assessment would be based on the objective test of the market place, assuming an arms length transaction.

If the government loan approach was used to relieve the financial impact in the initial year, the interest rate would have to be set arbitrarily and this would give rise to some inequities. However, the disparities in interest rates are less between different regions of the country than are the disparities in rental values; if a uniform but adjustable rate of interest was used the arbitrariness involved would be less than that involved in assessing imputed rental values periodically.

Another possibility would be to exempt expenditures for housing by both homeowner and renter. This would, of course, result in a large erosion of the tax base. It could also cause difficult problems of defining and enforcing the exemption. Sellers and buyers of rental and owner-occupied housing would have an incentive to include in the purchase price of houses and rental payments goods and services which were not related to housing costs (television, furniture, use of a swimming pool, golf course, etc.)

Insurance

Insured casualty losses could be treated in the same manner as under the income tax with a deduction of any excess of the casualty loss over the insurance proceeds. Premium payments could either be included in the tax base or deducted, as is presently done with medical insurance under the income tax.

Life insurance premiums would raise an administrative problem, since they contain an element of savings, varying from zero in the case of term insurance up to a significant proportion in the case of endowment policies. The technically correct way to handle these premiums would be to allow as savings that part of premium payments which increase the cash value of the policy. This could be something of a chore for taxpayers, and not subject

to proof except by audit unless insurance companies were required to submit an information return.

It might be desirable, therefore, to exclude all payments of life insurance premiums from the tax base. The bias this would introduce in favor of expenditures for life insurance as opposed to other taxable expenditures would probably not be a significant consideration.

Interest Payments

As noted in the previous section, interest payments on borrowing undertaken to finance consumption expenditures should, in concept, be included in the tax base while those for investments should be excluded. From an administrative standpoint, it would be difficult, however, to separate the two kinds of interest payments.

The difficulty arises because individuals, unlike business establishments, borrow to finance both consumption and investments and the fungibility of money causes an ambiguity as to which loans and interest payments thereon are related to the one and/or the other. For example, if a person takes out an installment loan of $3,000 to finance the purchase of an automobile, the loan might be considered to be for consumption. If at the same time, however, he should buy stock for $3,000 the individual could be considered as having borrowed to buy the stock.

A solution for this dilemma might be found by permitting taxpayers to deduct interest payments to the extent that they owned financial assets or business interests equivalent in value to the amount of indebtedness from which the interest payments arise. For example, if a person reported interest payments on total indebtedness of $3,000 in a given year, he would be allowed to deduct the interest if he filed a statement showing that he owned financial assets or business interests with a value of at least $3,000. If he owned only $2,000 in such assets, he would be allowed to deduct two-thirds of his interest payments.

This treatment would be based on two propositions. First, that a parallel increase in indebtedness and the value of investments means that the indebtedness is in effect financing the investment, irrespective of whether the individual links the two together in his decision to undertake them. Second, that the decision *to continue to hold* an investment and remain in debt is tantamount to a decision *to undertake* an investment and new indebtedness.

International Transactions and Movements

Just as the income tax base includes the world-wide income of U.S. citizens, presumably the expenditure would be levied without regard to the extent to which expenditures were made in foreign countries. However, transactions with foreign entities relating to gifts, bank accounts and investments may have to be treated differently from their domestic counterparts.

Gifts to foreign individuals and organizations presumably would not be deductible, following the practice of the current income tax. The allowance of deductions for deposits and investments in foreign banks and institutions might raise a difficult enforcement problem since the authorities' access to these institutions would be limited. Some circumscription of such deductions, therefore, might be necessary.

Transitional Problems

The initiation of an expenditure tax would raise certain transitional problems which would require special handling. If the tax was to become effective at some future date, people might rush to buy goods and services before the effective date. Some persons might draw large amounts of cash from bank accounts which could be used for unreported expenditures after the effective date. Holdings of cash on the effective date could be required to be reported but there would be no satisfactory way of checking such reports.

These anticipatory developments could be forestalled by making the tax effective as of the date the administration announced it was proposing the legislation to Congress.[43] The public would then be on notice that expenditures from that day forward would be subject to tax if the legislation was approved by Congress and there would be no advantage in accelerating purchases or withdrawing large amounts of cash.

A major question relating to the transitional period would be the extent to which persons should be charged tax on houses and other consumer goods which were purchased before the effective date of the tax. To tax only those purchases made after the effective date would give an advantage to persons who are already in possession of consumer goods which have a high value and yield their services over a considerable period of time. Perfect equity on this account would require the taxation at present market value of all consumer goods owned by taxpayers before the effective date of the tax, as if they had been purchased on the effective date.

It would probably not be practicable to require taxpayers to submit an inventory of all their consumer goods as of the effective date of the tax. However, some procedure for at least reducing the worst inequities on this account would have to be established.

The major case in point would be housing. It would appear necessary to require homeowners to report the market value of their houses as of the effective date of the tax. "Fair market value" is always a difficult question in the absence of an actual sale and howeowners would tend to under-value for this purpose. A requirement to report the purchase price in addition to the market value would serve as something of a guideline for determining whether reported values were grossly out of line with market values. Since enforcement of this requirement would be a one-time "start-up" cost it might be considered worthwhile for the tax authorities to go to some lengths to check on reported market values.

Automobiles represent another important consumer good for most persons. Since estimated market values are available for cars in the so-called "blue book" used by automobile dealers, requiring taxpayers to report the value of all automobiles owned on the effective date should present little difficulty.

If taxpayers started on a reasonably equal basis relative to houses and automobiles, the remaining inequities on account of consumer goods owned before the effective date of the tax would not be great in the majority of cases. In cases of taxpayers who had purchased other goods with relatively high values such as second homes, yachts, expensive antiques, works of art, jewelry, etc., a blanket provision might be stipulated to at least pick up the most extreme cases. For example, it could be stipulated that any consumer good with a market value of more than $1,000 must be reported if the total of all such items exceeds $10,000. In such a case the excess would be reportable as a "receipt," in the first year of the tax.

Another question relating to the transitional period involves the life cycle. Younger people typically spend relatively high proportions of their income establishing households in the early years of marriage, while older persons would have a great part of these expenses already behind them. In the case of elderly persons, it might be considered unfair to tax them on expenditures out of past savings on which they had already paid the income tax.

The extent to which relief would be appropriate on these accounts would depend on the tax rate structure and the consideration of how much tax each age group would have been subjected to under alternative taxes. If some relief was deemed appropriate one approach could be to establish a "humped" tax rate schedule to conform to the "hump" in the life cycle. For example, for the first five years of the tax, persons below 40 years of age could be given a concession which would decrease with increasing age up to 40. Persons over 60 years old could be given a special concession which would increase with increasing age.

Taxpayer Compliance and Enforcement

In examining problems of taxpayer compliance and enforcement, it is useful to distinguish between two kinds of transactions which would constitute new reporting and enforcement requirements for taxpayers and tax collectors. One set of transactions involves savings and dis-savings and the other involves all other transactions which, for ease of reference, we may refer to as receipts of income. It is also useful to distinguish between reportable transactions with institutions as opposed to those with other individuals.

Receipts of income from institutions which are not already reportable under the income tax would constitute a relatively small proportion of total receipts for most taxpayers. The major example of such receipts is transfer payments, primarily social security and other pension benefits. (Very few persons receiving unemployment benefits would have total expenditures above the minimum exempt level). Payments by insurance companies for life

insurance and casualty claims would be another kind of receipt in this category.

In the case of these receipts, taxpayer compliance and enforcement would be enhanced if the paying institutions were required to make reports to the I.R.S., with duplicates to the individual recipients, as they do now in the case of payments that constitute taxable income. Alternatively, it might be sufficient to rely on the fact that the bulk of such payments are made by government and other large institutions which maintain records of their outpayments, which could be made available to the I.R.S. on a spot check basis. Knowledge of this fact might be sufficient to prevent widespread underreporting of such receipts by taxpayers.

Receipts from individuals which are not taxable under the income tax and which would be reportable under an expenditure tax would have a self-enforcing feature. While the individual receiving such payments would have an incentive not to report them, the individual making any such payments would have an incentive to report them because they would reduce the latter's tax liability. For example, if Smith received $1,000 from Jones as a loan[44] or a gift, Jones would have an incentive to report it because it would represent an outpayment which would be deductible and hence reduce his tax base. In order to take the deduction he would have to specify Smith as the recipient. Thus, I.R.S. would have a record of the transaction and Smith's knowledge of this fact would be a deterrent against his failing to report it.

In some cases, receipts from individuals would not necessarily involve a reporting of the transaction on the part of the donor. One example would be the case where the donor's total expenditures were not sufficient to require an expenditure tax return on his part. However, payments to taxable persons by individuals of such modest means would obviously be quite rare. Another example would be inheritances. A record of such receipts would be available to I.R.S. in all cases where the estate was large enough to require the filing of an estate tax return.

The final and most important new category of reporting under an expenditure tax would relate to transactions by individuals with institutions where savings and dis-savings were involved, e.g., purchases and sales of financial assets and increases and decreases in bank accounts. Sales of financial assets are also reportable under the income tax but the incentive for evasion would be greater under an expenditure tax with rates of tax equal to or greater than those of the income tax.

Under the income tax only the gain is taxable and only the loss is deductible. Under the expenditure tax the entire amount of the proceeds of the sale affect the taxpayer's tax base. While the proceeds from the sale of financial assets would not be taxable if reinvested, taxpayers would still have an incentive not to report them. For example, if a taxpayer sold Stock A for $10,000, he would have an incentive to report the purchase of Stock B and a disincentive to report the sale of Stock A.

On the other hand, the expenditure tax has a self-enforcing feature in the case of sales of capital assets which is lacking in the income tax. Taxpayers would have an incentive to report saving and once they were reported, the taxpayer would be "on the hook" at any time thereafter to produce evidence that he still had those particular assets unless he subsequently reported their sale. In the above example, the taxpayer, in all probability, would have reported the purchase of Stock A in his tax return for the year in which he purchased it. In filing his return for the year in which he sold Stock A he would have to take into account that he was still on record as owning Stock A and consider the consequences of being unable to show he still possessed it if I.R.S. checked his return. The inability to prove ownership would be *prima facie* evidence of evasion.

The continual obligation to be able to prove that financial assets are still owned by the taxpayer would also tend to deter over-reporting of savings.

There is a kind of overall safeguard against evasion under both the income and expenditure tax which is somewhat more potent under the latter. Under the income tax, a standard of living which is out of proportion to an individual's reported income might be cause for investigation but means little in itself because there are various sources of funds which can be used for personal consumption which are not taxable under the income tax. Under the expenditure tax, however, the return itself reflects the taxpayer's standard of living, by definition, and any significant disparity would be *prima facie* evidence of evasion.

In order to evade taxation under an expenditure tax, the individual must spend unreported funds for personal consumption. Under the income tax it is necessary only to hide the funds which would be taxable if reported. The fact that evasion under the expenditure tax involves an overt and visible act of spending might be a more effective deterrent against evasion than the necessity to merely conceal the existence of funds.[45]

V. POTENTIAL ROLE TODAY

The expenditure tax is sometimes advocated as a complete replacement for the income tax or as an alternative to a broad-based indirect tax on consumption, such as the VAT. The application of an expenditure tax on such an extensive basis would have far-reaching effects on the distribution of the total tax burden and on the allocation of economic resources. Such a drastic innovation in tax policy, however, would not appear to be a practical political possibility within a reasonable time period.

The income tax will undoubtedly continue as the major instrument of Federal tax policy for the indefinite future; this likelihood may eliminate any real possibility of applying an expenditure tax on a mass basis as an addition to the tax structure. The imposition of another kind of direct tax on the entire taxpayer population would be in direct opposition to the increasing pressures to reduce the complexities and burdens of compliance of the existing tax laws. Political considerations alone, therefore, would appear to rule out the use of an expenditure tax on a mass basis in the near future.

The remaining possibility is a selective application of the tax to a portion of the taxpayer population. While this would not involve the major economic and social implications of a full-blown expenditure tax, other difficult questions and problems would arise. Nevertheless, the addition of an expenditure tax would give a new dimension to the tax structure which would be useful in dealing with some of the major problems of current and future public policy. In the remainder of this section, some of the possible applications for a limited expenditure tax, along with some of the problems that would be involved, are briefly discussed.

Tax Reform

A major problem of current tax policy involves the dilemmas posed in

many cases by the desire, on the one hand, to stimulate (or at least not hamper) certain kinds of activities and, on the other hand, to assure that all persons carry their "fair share" of the total tax burden. Increasing concern with the second aspect of this dilemma has led in recent years to an alternative approach to tax reform by establishing a minimum taxable capacity for individuals. The *Tax Reform Act of 1969* provided for a kind of "catch-all" in the form of a minimum tax of 10 percent on certain kinds of tax preferences. The Administration's 1973 recommendations for tax reform included a proposal to replace the minimum tax approach with a minimum tax base which would prevent the combination of exclusions and itemized deductions from offsetting more than one-half of a taxpayer's income. This "minimum taxable income" would then be taxed at the same rates which are applicable to normal income.[46]

The minimum taxable capacity approach to tax reform represents a new kind of compromise between the conflicting goals of economic objectives and a fair share. It shifts the compromise position away from the economic objectives underlying tax preferences and toward the fair share objective.

The use of personal consumption as an alternative test of taxable capacity would open a new possibility for improving the terms of this trade-off and in some cases the economic objectives-fair share dilemma would be bypassed altogether.

The consumption test would not affect income which represents the cost of capital consumed in earning income, such as depreciation and depletion, since such amounts are presumably not available for personal consumption.

Since capital gains would be unaffected except to the extent that they were spent for personal consumption the "lock-in" problem would not be exacerbated nor would the discrimination between realized and unrealized gains. The "bunching" problem (involved with capital gains which are earned over a period of years but taken in one year) would not be intensified. Gains which were reinvested would be unaffected. Where gains (or any part of the proceeds of sales of assets) are spent for consumption, the taxpayer could average-out the incidence of the tax himself by spreading his expenditures over a period of more than one year.

One of the reasons for tax preferences is that they are considered necessary as an incentive to compensate taxpayers for risks, hardships or for devoting their efforts and resources to accomplishing some national goal. Such incentives would be compromised less by a minimum taxable capacity based on consumption than by one based on income since taxpayers involved in such activities could avoid tax on the income by not spending it.

The use of an expenditure tax for this purpose would mean that all taxpayers would in theory be subject to the alternative test of personal consumption. In keeping with the minimum tax approach, however, there could be a substantial exemption so that only a small minority of taxpayers would be subject to the tax. In those cases where consumption expenditures exceed-

ed taxable income by the stipulated minimum amount, consumption would be taken as the tax base and taxed at the same rate as taxable income.

This approach to tax reform would not be without objections. One could argue that the scheme would go too far since it would be tantamount to a tax on accumulated and inherited wealth which would otherwise be untouched by any kind of test based on income. Thus, it would do by indirection something which has been consciously avoided by direct measure, i.e., the taxation of wealth *per se*. Or it could argue that the scheme would not go far enough. Some individuals with large incomes could continue to escape taxation on substantial portions of their income through saving large amounts.

Both of these objections are encompassed in an overall objection: So long as income is the accepted test of taxable capacity for *all* persons, no case can be made for subjecting *some* persons to the additional test of consumption. A further question arises as to whether the administrative burdens of an expenditure tax for this limited purpose would be disproportionate to the gains.

Where the balance of advantages and disadvantages would lie under this scheme would be a value judgment of the lesser-of-evils kind. A major factor in making this judgement would be the factual question of how many persons would be affected and by how much. More information on the personal consumption of persons in the upper income brackets is needed than is presently available.

Curbing Inflation

As noted earlier, the expenditure tax is highly effective in curbing spending since tax liability can be reduced by not spending. If inflation is viewed as a continuing problem for the indefinite future the expenditure tax could play an important role as a new fiscal tool for this purpose.

To have a significant effect on total spending, however, the tax would have to be applicable to several million taxpayers and this would involve administrative costs, both to taxpayers and tax collectors, of an entirely different order than that involved in the use of the tax merely as a tax reform measure. Whether the trade-off between these administrative considerations and the anti-inflationary impact could be made acceptable would require intensive study.

Some indication of the number of returns that would have to be filed in order to have a significant effect on total demand can be obtained from the income tax data shown in Table 2. The last column of the table gives an indication of the proportions of total disposable income of all taxpayers which are accounted for by various income levels. For example, in 1971 the 4.9 million taxpayers with AGI of $20,000 or more had $88.3 billion remaining from their AGI after subtracting amounts allocated for tax deductible expenses, personal exemptions and Federal income tax. Taking this residual

Table 2

Income Tax Returns, Taxable Income and Income Tax by Level of Adjusted Gross Income: 1971

AGI	Number of Returns ($ mil.)	Percent	Taxable Income ($ bil.)	Tax ($ bil.)	Taxable Income Minus Tax ($ bil.)	Percent
$50,000 or more	0.5	0.7	34.3	14.1	20.2	6.2
30,000 "	1.6	2.1	65.0	22.0	43.0	13.1
25,000 "	2.5	3.4	84.5	26.3	58.2	17.7
20,000 "	4.9	6.6	122.4	34.1	88.3	26.9
15,000 "	11.4	15.3	197.9	48.5	148.4	45.2
10,000 "	26.0	34.8	310.2	68.4	241.8	73.7
5,000 "	47.3	63.6	396.8	82.9	313.9	95.7
Total	74.6	100.0	413.6	85.5	328.1	100.0

Source: *Individual Income Tax Returns, Preliminary Statistics of Income,* 1971, Dept. of the Treasury, Internal Revenue Service, March, 1973.

as a proxy for disposable income, or funds available for what might be termed "voluntary" expenditures, we see that it accounted for 26.9 percent of the comparable residual for all taxpayers.

As a very rough approximation, therefore, if persons with an income of $20,000 or more were required to file an expenditure tax return, something in the order of 5 million returns would be filed (in 1971) by persons who account for about one-fourth of total disposable income. The critical questions are what is the total spending done by these persons and by how much could this spending be reduced by an expenditure tax? Would the reduction in spending be enough to have a significant effect on total demand and would this effect be sufficient to justify the administrative costs involved with an additional 5 million tax returns? If not, would the terms of the trade-off be better if the tax base was broadened to include all persons with incomes above, say, $15,000 at the cost of another 6 to 7 million returns?

Apart from administrative considerations, other major questions would be involved in the application of a direct tax on anything less than a mass basis. One question requiring study relates to the kinds of consumption which would be most affected by the tax. Would the reductions be fairly broadly dispersed across the spectrum of consumption expenditures or would they be concentrated on a few luxury-type goods and services? If the latter contingency is more likely, the adverse effect on the incomes and employment of persons engaged in or dependent on the production of these items might be inordinate.

Another question involves the equity of singling out a particular segment of the population for the incidence of the tax. The current income tax is applicable to all persons with incomes greater than the "poverty level." The quantitative definition of the poverty line is arbitrary but has the merit of having been generally accepted for a considerable number of years.

While a departure from the principle of applying direct taxes to all persons with minimum ability to pay would involve a new and, undoubtedly, controversial judgement, there would be some case in equity for drawing the line substantially above that drawn for the income tax. An important difference between the expenditure tax and the income tax is that under the former persons can avoid taxation by spending less while under the latter the comparable option necessitates a reduction in income. Thus, while persons who are well above the poverty line would have a reasonable opportunity of avoiding or substantially reducing liability under the expenditure tax by saving significant portions of their income, the same opportunity would not be very meaningful to persons closer to the poverty line who feel compelled to spend virtually all of their disposable income in order to maintain a "decent" standard of living.

An interesting possibility for an expenditure tax applied solely for the purpose of curbing inflation would be to apply the tax only to expenditures in excess of a certain percentage of total money income, with the percentage

declining with increasing income. For example, it might be stipulated that only persons with income in excess of $20,000 were required to file a return and that persons with incomes of $20,000-25,000 would be taxed on expenditures in excess of 90 percent of income, persons with incomes of $25,000-30,000 would be taxed on expenditures in excess of 85 percent of income, and so on. This would give the tax something of a voluntary character since it could be avoided altogether by saving a reasonable proportion of income. It would also concentrate the tax on persons with a relatively high propensity to consume and maximize the anti-inflationary impact per dollar of revenue.

Environmental and Energy Problems

An expenditure tax limited to persons with relatively high levels of consumption would be consistent with the increasing concern with environmental problems and energy shortages. Since these problems are directly related to consumer spending, the concept of "excessive" or "conspicuous" consumption may be taking on a new social significance and argue for a progressive penalty on spending in excess of a reasonable amount.

The extent to which a given reduction in spending by persons in upper income brackets would alleviate problems of the environment and energy shortages would depend on what kinds of consumption would be curtailed. The gains in these areas would be offset to the extent that such persons switched to more economical ways of achieving certain kinds of consumer services which actually involved more pollution and energy consumption than more expensive alternatives. For example, there might be a reduction in expensive vacations involving travel to distant (and foreign) places by airplane and cruise ship and more vacation travel by automobile.

If concern with environmental and energy problems should point to the necessity of imposing excise taxes to discourage certain kinds of consumption, an expenditure tax on persons in the middle and/or upper income brackets would tend to complement and justify such taxes by making them more effective and less regressive. For example, if a tax was imposed on gasoline to discourage its consumption, an individual whose total spending put him in the 50 percent bracket under an expenditure tax would effectively be charged half again as much as the charge on those exempt from the expenditure tax. Thus, the objection that excise taxes are regressive would be less valid and they would be politically more acceptable.

Summing Up

While it does not appear to be realistic to view the expenditure tax as a replacement for the income tax or as a mass tax in addition to the income tax, the expenditure tax may have a considerable potential as a limited addition to the Federal tax structure. However, a meaningful judgement as to whether the advantages of such an addition would outweigh the extra admin-

istrative costs and burdens on the taxpayers affected as well as the objections to a discriminatory application of a direct tax would require more extensive exploration and public discussion.

Since it is difficult to foretell the effectiveness and problems of such a novel tax without the benefit of experience, consideration might be given to applying the tax to a small number of individuals on an experimental basis. For example, the tax might be initiated as an alternative test of taxable capacity for persons with incomes in excess of $100,000, involving about 100,000 persons on the basis of 1971 data. This would hold down the start-up costs to manageable proportions and give some indication of whether the tax was feasible for a wider application.

The value of an experimental expenditure tax should also be viewed in the context of the possible course of the Federal tax system in the longer run. Conceivably, future developments will point to the necessity of putting more emphasis on the consumption and wealth bases of taxation. The expenditure tax constitutes a major alternative to broad-based indirect taxes on consumption and it would complement and reinforce a tax on wealth. Some experience with the tax in practice, therefore, would be useful in assessing the broad possibilities for future tax policy.

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[1] Hobbes, *Leviathan*, Chapter 30.

[2] J. S. Mill, *Principles of Political Economy*, Book V, Ch. 11, Section 4.

[3] "Income in Theory and Income Taxation in Practice," *Econometrica*, Jan., 1937. "A Practical Schedule for an Income Tax," *The Tax Magazine*, (later, *Taxes*) July, 1937.

[4] *Constructive Income Taxation*, New York, Harper and Bros., 1942.

[5] William Vickrey, *Agenda for Progressive Taxation*, The Ronald Press Co., N. Y., 1947, p. 398.

[6] Nicholas Kaldor, *An Expenditure Tax*, Unwin University Books, London, 1955.

[7] The Treasury's scheme involved a flat rate, refundable (after the war) tax on spendings up to a certain minimum and then a progressive surtax thereafter which would not be refundable. According to one report, "Senator Byrd called it 'the most complicated and unworkable' plan in his experience; Senator Clark the 'most complicated monstrosity' he had ever seen. Most members found the details incomprehensible." *New York Times*. September 5, 1942.

[8] Cf. Kaldor, *op. cit.*, pp. 224-42.

[9] Cf. Patrick Kelley, "Is An Expenditure Tax Feasible." *National Tax Journal*, September, 1970, pp. 248-49.

[10] As quoted in Kaldor, *op. cit.*, p. 12.

[11] Even Kaldor, who later became the leading proponent of the expenditure tax, criticized Fisher on this account at the time. Cf. Kaldor, *op. cit.*, p. 12.

[12] Kelley, *op. cit.*, pp. 237-53.

[13] George F. Break, "Alternative Federal Revenue Sources: A View of Some Less Explored Possibilities," *National Tax Journal*, September 1972, pp. 443-50.

[14] Leonard E. Kust, "Alternatives for New Federal Revenues," *The Challenge of Tax Reform*, Tax Foundation, Inc., New York, January, 1973, pp. 14-18.

[15] Richard E. Slitor, "Administrative Aspects of Expenditures Taxation," *Broad-Based Taxes—New Options and Sources*. (Richard A. Musgrave, ed.) Johns Hopkins University Press, 1973, pp. 227-263.

[16] Joseph A. Pechman, *Federal Tax*

Policy, the Brookings Institution, Wash., D. C., 1971, p. 164 and p. 168.

[17] Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice,* McGraw Hill, New York, 1973, p. 315.

[18] As quoted by Kaldor, *op. cit.,* p. 79-80, from Principles of Political Economy, Book V. Ch. 11, section 4.

[19] Fisher, *op. cit.,* p. 56-57.

[20] To illustrate: compare an income tax applied at a rate of 50 percent with an expenditure tax applied at a rate which permits the same amount of after-tax consumption from a given amount of income as the income tax. If money earns 6 percent, under the income tax $1,000 of income will allow $500 of consumption now or $515 one year hence. The expenditure tax will also allow $500 now but $530 one year hence.

[21] *Ibid.,* p. 47.

[22] *Ibid.,* p. 50.

[23] One recent proponent of the expenditure tax, however maintains that the newness of the tax would be an advantage in this respect because starting with a "clean slate" would shift the advantage to the Congress and the Administration and result in a fairer tax system than "a desperate assault on each citadel of privilege in the present system." Cf. Kust, *op. cit.,* p. 17.

[24] Kaldor, *op. cit.,* p. 53.

[25] *Ibid.*

[26] Kaldor felt that there is an *a priori* case in favor of the expenditure tax as to the incentive for risk-taking but only a "presumption in its favour" as to the work incentive. Cf. Kaldor, *op. cit.,* p. 133.

[27] Fisher, *op. cit.,* p. 75-76.

[28] Cf. Slitor, *op. cit.,* p. 245-46.

[29] Kaldor, *op. cit.,* p. 222.

[30] *Ibid.,* fn. It should also be noted that there was no capital gains tax in Great Britain at the time.

[31] Kenyon E. Poole, "Problems of Administration and Equity Under a Spendings Tax," *The American Economic Review,* 1943, p. 63.

[32] Milton Friedman, "The Spendings Tax as a War-time Fiscal Measure," *The American Economic Review,* 1943, p. 50.

[33] Kelley, *op. cit.,* pp. 252-53.

[34] Break, *op. cit.,* p. 448.

[35] Kust, *op. cit.,* p. 16.

[36] Slitor, *op. cit.,* p. 257-58.

[37] *Op. cit.,* p. 25.

[38] There would be no practicable way for the authorities to determine whether land and other purchases ostensibly made for personal investment purposes only were in fact also yielding consumer benefits. Consideration of administrative feasibility alone, therefore, would preclude the exemption of such acquisitions.

[39] Excepting consumer goods (and services) received in kind.

[40] Fisher, *op. cit.,* p. 5.

[41] Excluding goods and services produced and consumed by the taxpayer.

[42] Except in the first year of the tax. See page on transitional problems.

[43] This procedure was followed for the Interest Equalization Tax which was made effective as of the date of its announcement although the legislation did not become law until more than a year later.

[44] If borrowing was treated in the "reverse" manner suggested earlier, the transaction would not be reportable by either party. In this case, Jones' (Smith's) tax base would be increased (decreased) by $1,000 in the year the loan was made and decreased (increased) by $1,000 in the year of the repayment.

[45] Cf. Kaldor, *op. cit.,* pp. 219-20.

[46] Cf.*Proposals for Tax Change,* Department of the Treasury, April 30, 1973, pp. 13-14 and 83-93.

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[2] Vacancy created by resignation of Howard H. Callaway, Pine Mountain, Georgia.
[3] Appointed 2/20/73 to replace Senator Sam J. Ervin, North Carolina.
[4] Replaced Congresswoman Florence P. Dwyer, New Jersey.
[5] Replaced George H. Romney, former Secretary of HUD.
[6] Replaced Ronald Reagan, Governor of California.
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