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Chapter 1. Introduction

1. Objectives
2. Scope of the Study
3. Outline of the Report

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DRAFT REPORT
ADMINISTRATIVELY
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PRELIMINARY STAFF REPORT:
BASIC TAX REFORM

Chapter 1
INTRODUCTION

The following pages describe alternatives for a radical reform of the income tax system, which over a period of time will substantially replace the present Internal Revenue Code. The objective is a tax system which is fair, which is simple and understandable, and which reduces the inefficiencies and distorted incentives of the present structure.

1. Objectives

Equity

There is no single property of a tax system more important than fairness. The tax system should allocate the burden of financing the government fairly.

Unfortunately, there is no ready definition of fairness which can be used to derive a perfect tax system. Two broad criteria frequently applied are "horizontal" and "vertical" equity. The first requires that two taxpayers similarly situated should bear similar tax burdens. The second requires that if one taxpayer is better situated than another, the former should bear a larger share of the tax burden.

To implement these principles it is necessary to spell out what is meant by both "similarly situated" and by "tax burden." It is the function of the tax code to specify when two taxpayers are similarly situated from the point of view of the tax payments they must make to the Treasury.

This liability is not necessarily the same as the burden borne by the taxpayer. This is partly because the tax system influences the outcome of the economic process, and the after-tax situation of participants in the economic process. It is also becasue the payments made in any year often do not include the liabilities implied for future years by the current year's events. For example, a tax-payer who resorts to a "shelter" usually reduces his current tax payment by more than he reduces his actual tax burden, since his future tax liability is increased.

In analyzing the tax system, judgments have to be made about the situations of different individuals and about the actual tax burdens they bear. The latter requires making some guesses about how the economy has adjusted to the present tax structure. This is particularly difficult in the case of the corporation income tax, but the difficulty extends to the effects of such current tax provisions as the exemption of interest on state and municipal bonds. In each case apparent tax burdens are different from the actual

ones, and in this study particular judgments have been made which determine the distribution of actual tax burdens today.

In this report, an effort is made to make value judgments about relative situations of taxpayers broadly consistent with those presently expressed in the tax law. That is, it is not the intent of this study to impose wholly new values on the tax system. Naturally, different judgments have been made about particular situations; otherwise we would be led back to the present code. But the basic attitude taken is that the Federal tax system rests on a broadly acceptable equity footing. The objective of the reform is to express more consistently and simply these values.

The rule of following generally the values expressed in current law has been extended as well to vertical equity. That is, the objective in this study is to maintain the same average degree of progressivity as presently obtains.

While the estimated vertical equity of the tax structure is preserved in the alternatives considered here, this would not prevent very considerable redistributions of tax burdens within income groups; nor would it prevent great changes in the economic circumstances of taxpayers if reforms along the lines here described were instituted overnight. It cannot be too greatly emphasized that a critical problem of equity

is the fairness with which the gains and losses from reform are distributed. Transition considerations are extremely important. A strong case can be made for making changes to a new system gradually so that the extent of gains and losses for individual taxpaying units is small, and so that people can adjust to the new rules with as few disruptions as possible. The way the transition is designed can have a major impact on the fairness of the change (as distinguished from the attractiveness of the new rules once in place) and on its political acceptability. Considerable effort has been devoted in this study to thinking through problems of transition.

Efficiency

Considerations of equity often must compete with considerations of efficiency in the design of tax systems. By "efficiency" is meant here the property of an economic system that resources are put to their most productive use. In a market system, the measure of productive use is the relative values placed on outputs by those demanding them, either directly or via collective institutions such as governments. These relative values are reflected in the prices that demanders are willing to pay.

The general proposition is that the outcome of the market process usually tends toward efficiency of resource use. That is, resources tend to flow to the uses most valued by the individuals in the economic system. Insofar as taxes introduce a difference between the prices paid by buyers and those received by sellers, they upset the efficiency-seeking property of the market system. In general, activities that are relatively heavily taxed will be underdeveloped relative to the efficient level.

All taxes introduce some distortions to this system. The choice for tax policy is not how to avoid efficiency losses completely, but how to choose a tax base that keeps the losses as small as possible, consistent with other goals of taxation. Broad-based taxes are presumed to be less distortionary than taxes which give special treatment to different commodities or services. The narrower the class of goods being taxed, the greater the possibilities for avoiding tax by shifting purchases to other goods, or by not supplying productive labor or capital services.

Within the class of broad-based taxes, however, there are choices to be made about where disincentive effects are sufficiently serious to warrant special treatment. Particular concerns are (1) the effect of the corporation income tax as it influences the amount of production in the corporate

sector, (2) the effect of individual income taxes on the supply of productive services (especially the supply of labor services by secondary workers in families), and the effect of both of these present taxes on the supply of capital, in the form of savings. These efficiency effects are taken into account in the present study.

Simplicity

A universally acclaimed objective of the tax system is that of simplicity. Simplicity means a tax code that is relatively understandable in the sense that the determination of tax liability can be accomplished without undue difficulty and also a code that is reasonably easy to administer. Although simplicity receives as much attention as any other tax objective, there is really no "simplicity lobby," and when conflicts arise between simplicity and other objectives, the other objectives generally prevail. In fact, efforts to achieve equity by defining precisely the economic circumstances of individual taxpayers often becomes a source of considerable complexity in tax law. Similarly, complexities arise from attempts to use the tax code to influence resource allocation. Even in the absence of conflicting objectives, however a complex economy which generates complex transactions poses further obstacles to the achievement of a simple tax structure.

Thus, to achieve genuine simplicity it is first necessary to recognize this as an important objective so that conflicts need not always be resolved in ways which introduce greater complications into the tax code. Furthermore, it should be pointed out that the greatest complexities in the tax code do not result from the formal elements of exemptions, credits, or the structure of rates, but rather the definition of the tax base itself. If genuine simplicity is to be achieved, the tax base must be one that can be easily calculated and documented to the broadest extent possible by actual transactions.

2. Scope of the Study

What Federal Taxes Are Included?

The Federal Government derives its tax revenues from five major tax sources:

1. The individual income tax (about 44 percent of Federal receipts),
2. The corporation income tax (about 14 percent),
3. Payroll taxes (about 31 percent),
4. Excise taxes (about 6 percent), and
5. Estate and gift taxes (about 2 percent).

A decision was necessary about which of these sources were to be encompassed in the basic reform.

The double taxation of corporate income is widely regarded as a serious problem under present law, and much work has already been accomplished concerning proposals to integrate the individual and corporation income taxes. It has been taken for granted that both these sources would be included in the scope of this study.

There are also serious problems with payroll taxes, a major revenue source. They are regarded, on the one hand, as regressive, because they are levied only on earnings and only up to a ceiling level. On the other hand, it is noted that they finance benefits which replace a larger fraction of the earnings of a low-earner than a high-earner. There is also concern about their efficiency effects. The tax-benefit combination embodied in the social security system may significantly affect household labor supply, including the retirement age decision and the decision of secondary workers to enter the labor market. The failure to fund social security retirement benefits according to actuarial principles has major implications for private capital formation. By enacting the earned income credit, Congress has already recognized that there is an interaction of this source of taxes with the individual income tax.

Can a revenue source as important as payroll taxes be left out of a basic tax reform effort? The answer depends upon the directions Social Security, Medicare, etc., are to take. If they are regarded as compulsory insurance programs with actuarially sound rates and funding, a good case can be made for separating them from income tax reform. If, on the other hand, social security benefits are to be separated from the "contributions" which finance them, the payroll taxes should probably be regarded as just another revenue source, and therefore included in a major reform program.

In order to place workable boundaries on this study, a decision was made to regard Social Security, Medicare and Unemployment Compensation programs as essentiallv analogous to private insurance schemes. Like other insurance schemes, they enter into the calculation of taxable income and, in this way, they are part of the reform plans discussed below. But payroll taxes *per se* are regarded as outside the domain of the income tax structure. The data base which has been assembled for this project will, however, allow future analyses of approaches to integrating payroll and income taxes.

The appropriate treatment of transfers between individuals, now the subject of estate and gift taxes, depends

importantly on the equity objectives of the tax system. The need for and character of any special taxes on transfers depend upon these equity objectives and upon the treatment of transfers in the income tax. The study considers the role of the estate and gift taxes in the overall system. However, because these are particularly complicated taxes, a thorough integration of transfer taxes to the reform is not attempted.

Excise taxes (the most important being on tobacco, alcohol, telephone services, gasoline) have been excluded from consideration. Interactions between excise and income taxes are minor. Except for the issue of deductibility under an income tax, no special attention is given to excise taxes.

The Relationship to Welfare Reform

The welfare system is one part of a two-part public transfer system. The first part consists of the social insurance programs, such as Social Security, Unemployment Insurance, and Workmen's Compensation, and the second part--the welfare system--consists largely of means-tested cash and in-kind transfer programs, such as AFDC, SSI, Food Stamps, Medicaid and public housing. The combination of the tax system with means-tested assistance programs can lead to serious incentive problems and add equity results. However,

the subject of welfare reform is so vast, having its own array of institutional, political and sociological features, that a decision was made not to attempt an integration of the tax and means-tested grant systems. At the same time, the data base assembled for this study will also facilitate study of such an integration should this become an objective.

3. Outline of the Report

The next chapter presents a general discussion of the choice of a tax base. The discussion in that chapter suggests that serious consideration should be given to consumption as an alternative to income as the principal tax base. Accordingly, two plans have been developed. The first, described in Chapter 3, is a comprehensive income tax. The second, described in Chapter 4, is a consumption type tax, called a cash flow tax. Chapter 5 contains a discussion of the important problems of transition from the current system to a radically changed one, and proposes methods for dealing with these problems in moving toward either the comprehensive income or the cash flow taxes. Chapter 6 contains preliminary simulations of the difference between current law tax burdens and those which would arise under the alternative plans once in place. No attempt has been made to simulate the transition.

Chapter 2. What is to be the Tax Base?

1. Introduction
2. Two Basic Matters of Equity
3. Definition of Income and Consumption
4. The Present Tax Base
5. Alternative Bases: Equity Considerations
6. Alternative Bases: Simplicity Considerations
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Chapter 2

WHAT IS TO BE THE TAX BASE?

1. Introduction

The dominant complaint heard about the present tax system is that it does not tax all income alike. This complaint expresses concern about equity: taxpayers that have the same circumstances as measured by the level of their income bear different tax burdens. It expresses concern about efficiency: taxes at rates that differ by industry or by type of financial arrangement lead to misallocation of resources. And it expresses concern about simplicity: the enormously complex tangle of provisions the taxpayer confronts in ordering his affairs and calculating his tax leads to the differential rates of tax.

The usual approach to this complaint, that all income is not taxed alike, is to attempt to make income as defined by tax law correspond more closely to the "real thing." By the real thing is generally meant the Haig-Simons definition of income, also called an "accretion" concept of income. It is most often stated in terms of the uses of purchasing power; namely, as the sum of consumption and the accumulation of wealth over an accounting period.

Unfortunately, the accretion concept of income has many shortcomings as a tax base. Several of them are serious, and, indeed, attempts to deal with them account for much of the complexity of the present tax code. Among these shortcomings are severe measurement problems. Many items that are required for the calculation of net income must be imputed, i.e., either guessed at or determined by applying relatively arbitrary rules (as in the case of depreciation). Since such rules are never perfect, they are the subject of continual controversy. A particular problem with the rules presently followed is their inability to measure income correctly in periods of inflation.

An additional drawback of an accretion income base is that it leads to what is sometimes called the "double taxation" of savings. This results from the fact that savings must be accumulated after payment of taxes, and the yield earned on those savings is then taxed again. This is recognized as a problem in the tax law, and many techniques have been adopted introduced to make the tax system more neutral with respect to savings. For example, the investment tax credit, accelerated depreciation, special tax rates for capital gains, and other provisions, are generally viewed as desirable to offset the incentive, or efficiency effects, of taxing accretion income. In addition, substantial

amounts of investment for retirement purposes can be made on a tax-deferred basis. This tends to be viewed as desirable for reasons of equity. All these techniques have the same practical effect as exempting from tax the income from the investment, which turns out to be equivalent to converting the base from accretion income to consumption.

The present tax system thus may be regarded as having a mixture of a consumption base and an accretion income base. In view of this, the question arises whether the proper objective of tax reform is to move more explicitly toward consumption rather than toward a purer accretion base. The issue is considered in this chapter.

The analysis suggests that the consumption tax is superior to the income tax with respect to several important criteria and should be seriously considered in designing a reformed tax system. There is reason to believe that a broad-based consumption tax is more equitable than a broad-based income tax. It is also easier to design and implement and has fewer harmful disincentive effects on private economic activity. In many important ways, a broad-based consumption tax more closely approximates the current tax system than a broad-based income tax does and would constitute a less radical tax change.

The sections of this chapter present a comparison of the consumption and income tax with respect to various criteria. Section 2 takes up some rather general issues of equity. In section 3, the concepts of consumption and income are explained, and some problems of definition are presented. In section 4, the treatment of personal savings under the current tax system is compared with the treatment of savings under a broad-based consumption tax and under a broad-based income tax. In particular, the similarity between current methods of taxing savings in pension plans, home ownership, and long-term capital gains, and taxation of these categories under a consumption tax is presented. Section 5 considers the merits of the alternative tax bases on criteria of equity. In section 6, they are compared on grounds of simplicity. It is shown that many problems of measurement of the appropriate tax base under an income tax would not occur under a consumption base system. Section 7 discusses the economic efficiency effects of tax policies and compares the efficiency losses under a consumption tax and an income tax, with special emphasis on the disincentive to savings and capital formation under an income tax.

2. Two Basic Matters of Equity

As has already been suggested, the specification of a tax code has the effect of defining the circumstances in which two taxpayers are regarded as having the same circumstances, so that they should properly bear the same tax burden. This section considers two aspects of such a comparison that have important implications for tax design. These are the question of the period of time over which the circumstances of two taxpayers are to be compared and the question of what the units are--individuals or families--between which comparisons are to be drawn.

Equity Over What Time Period?

Most tax systems make liabilities to remit payments depend upon events during a relatively short accounting period. In many cases this is a matter of practical necessity rather than principle. That is, tax liabilities must be calculated periodically on the basis of current information. Generally, there is nothing sacred about the accounting period--be it a week, a month, or a year--as far as defining the period over which taxpayer circumstances are to be compared. Indeed, it is usually regarded as regrettable that practical procedures do not allow the calculation of liabilities to take a long view.

An example from another program will illustrate. Under many welfare programs the accounting period is one month. A family earning just at the eligibility level at an even rate for the year will receive nothing. A family earning the same amount during the year, but earning it all during, say, the first three months will appear to have no earnings during the remaining nine months. That family will then be eligible for full benefits for nine months, in spite of being no worse off than the first family in the perspective of a year's experience.

It is assumed in this study that the period over which such comparisons should be made should be as long as possible. Such a notion is reflected in current tax law by such provisions as those for averaging and loss carryover. Ideally, two taxpayers should be compared on the basis of a whole lifetime of circumstances, and this is taken here to be a general goal of tax system design: lifetime tax burden should depend upon lifetime circumstances.

Is the Family or the Individual the Appropriate Unit?

What is the taxpaying unit that is the subject of this comparison of situations? When it is asked whether one taxpayer is in the same situation as another, is the taxpayer an individual or a family? The answer seems obvious

when the circumstances of, say, a married couple with limited resources is compared with a large family with the same resources. It seems that the family must be the unit of comparison.

On the other hand, a family is not a simple institution, with a lifetime, a constant identity, etc. Quite apart from the problem of distinguishing varying degrees of formality in family structure, (e.g., is the second cousin living in the guest room part of the family?), the family necessarily is a changing unit, with births, deaths, marriages, and divorces continually altering family composition.

In this study differences in family association have been regarded as relevant to that comparison of lifetime situation by which relative tax burdens are to be assigned to different individuals. The practical consequence of this will be that the tax liability of, for example, a father will depend in part upon consideration of the situation of the whole family.

3. Definition of Income and Consumption

Introduction

A tax base is not a quantity like water in a closed hydraulic system, wherein the total remains constant regardless of how it is directed by valves and pumps. Rather,

it is an aggregation of <u>transactions</u> (sometimes implicit), mostly voluntary, and the transactions that take place will depend upon how they are treated by the tax system. The choice of a tax base is a choice about how to tax certain transactions.

A tax base is necessarily defined by a set of accounting rules, which classify actual and implicit transactions, placing each in or out of the total to which a tax schedule is applied in determining the taxpayer's liability. The Internal Revenue Code prescribes an "income" tax, and an elaborate body of statutory and administrative law has evolved that gives meaning to that concept for purposes of calculating taxes. But this definition is clearly not accepted by many observers, who feel that tax burdens should be related to a broader tax base; in other words, a wider set of transactions.

As was pointed out above, the concept of income generally used in discussion of tax reform has been labeled "accretion" concept. It is supposed to measure the command over resources acquired by the taxpayer during the accounting period, that command having been either exercised in the form of consumption or held as potential for future consumption in the form of an addition to wealth. Hence,

the apparently paradoxical practice of defining "income" by an "outlay" or "uses" concept--consumption plus change in net worth.

Everyday usage tends to associate income with the sources side of the accounts. Thus, one speaks of income "from labor," "from capital," and "from proprietorship." Because sources and uses must be equal in a double entry accounting system, it is of no importance which side is taken for purposes of measurement, provided only that all uses are regarded as appropriate for inclusion in the tax base.

Definition of Income and Consumption

In this section, a very rudimentary classification of transactions is developed to define income and consumption. The accounts considered first are those of a wage earner whose only source of funds is his earnings on labor services and his accumulated balance in a savings account.

In the simplest case, the possible applications he can make of these funds may be divided into the purchase of goods and services for his immediate use and additions to or subtractions from his accumulation of savings. Thus, an account of his situation for the year might be the following:

SOURCES	USES
Wages Interest Balance in savings account at beginning of period	Rent Clothing Food Recreation Balance in savings account at end of period

The two sides of this account are, of course, required to balance. Of the uses on the right hand side, the first four are generally lumped under the concept of "consumption," the last constituting the net worth of the household. Thus, the accounts may be schematically written as:

SOURCES	USES
Wages Interest Net worth at beginning of period	Consumption Net worth at end of period

The concept of income concerns the <u>additions</u> or <u>accretions</u> to source and the application of that accretion during the accounting period. This can be found simply by subtracting the accumulated savings (net worth) from both sides, to give:

ADDITION TO SOURCES	USES OF ADDITION TO SOURCES
Wages Interest	Consumption Savings (equals increase in net worth over the period)

"Income" is <u>defined</u> to be the algebraic sum of <u>consumption and increase in net worth</u>. For the simple situation of this individual:

ADDITION TO SOURCES	USES OF ADDITION TO SOURCES
Wages Interest	Income

The last version of the accounts makes clear the way in which information about sources is used to deduce the individual's income. To calculate his income for the year, this individual would obviously not add up his outlays for rent, clothing, food, recreation, and increase in savings account balance. Rather, he would simply add together his wages and interest and take advantage of the accounting identity between this sum and income.

This classification of uses into consumption and increase in net worth is, however, not sufficient to accommodate distinctions commonly made by tax policy. It will be helpful, next, to refine the accounts to the following:

ADDITION TO SOURCES	USE OF ADDITION TO SOURCES
Wages Interest	Consumption Cost of earnings Certain other outlays Increase in net worth

An individual's outlay for, say, special work clothes needed for his profession requires the category "cost of earnings." These are netted out in defining income. The category of "other outlays" is introduced for want of a better label for a category of transactions that do not fit into one of the other categories. For example, in everyday usage, State income taxes would not be an application of funds appropriately labeled "personal consumption," much less "increase in net worth." (By a stretch of the imagination, they might be allocated to the "cost of earnings" category.) Thus, we now have:

ADDITION TO SOURCES	USES OF ADDITION TO SOURCES
Wages Interest	Income Cost of earnings Certain other outlays

Again, to calculate income, it is generally convenient to work from the left-hand, "sources" side of the accounting relationship described above. Thus, in this case,

Income = Earnings
minus
Cost of earnings
minus
Certain other outlays.

Similarly, consumption may be calculated by starting with sources data:

Consumption = Earnings
minus
Cost of earnings
minus
Certain other outlays
minus
Increase in net worth.

One further addition to the accounting scheme is needed at this point, the item "gifts and bequests given." This is a use of funds that some would regard as consumption, but in this report the term "consumption," without modifier, is

reserved for the narrower notion of goods and services of direct benefit to the individual in question. The accounts now have the following structure:

ADDITION TO SOURCES	USES OF ADDITION TO SOURCES
Wages Interest	Consumption Gifts and bequests given Cost of earnings Certain other outlays Increase in net worth

It must be decided whether gifts and bequests given are to be regarded as "income," that is, as a component of the total by which taxpayers are to be compared for assigning burdens. The term "ability-to-pay" is used to describe the income concept that considers income to be the sum of consumption plus gifts and bequests given plus increase in net worth, because it is within the taxpayers ability to choose among these uses, and, hence, all three equally measure taxpaying potential. This income measure would also generally be calculated by starting on the sources side:

Ability-to-pay income = Earnings
minus
Cost of earnings
minus
Certain other outlays.

Ability-to-pay consumption = Earnings
minus
Cost of earnings
minus
Certain other outlays
minus
Increase in net worth.

The difference between consumption and income is the savings or increase in net worth over the period. Thus, equivalently:

Ability-to-pay consumption = Ability-to-pay income
minus
Increase in net worth.

Finally, there is the pair of income and consumption concepts that excludes gifts and bequests given from the category of uses by which tax burdens are to be apportioned. These are given the label "standard-of-living" because they are confined to outlays for the taxpayer's direct benefit. Thus,

Standard-of-living income = Ability-to-pay income
minus
Gifts and bequests given,

while

Standard-of-living consumption = Standard-of-living income minus Increase in net worth.

This discussion leads us to a four-way classification of tax bases:

		Gifts given: Included	Gifts given: Excluded
Increase in net worth	Included	Ability-to-pay income	Standard-of-living income
	Excluded	Ability-to-pay consumption	Standard-of-living consumption

4. The Present Tax Base

Is the Present Base Consumption or Income?

The idea of consumption as a tax base sounds very strange and even radical to many people. Indeed, an attempt to introduce a spendings tax (to be levied on one version of a consumption base) in the United States during World War II, was met with vociferous opposition in the U.S. Senate. Nonetheless, as has been mentioned, there are many similarities between a consumption base tax and the current tax system. Adoption of a broad-based consumption tax might actually be a less radical departure from current tax treatment of savings than adoption of a broad-based income tax.

The current tax system exempts many forms of savings from tax. In particular, the two items that account for the bulk of savings for most Americans, pensions and home ownership, are treated by the present tax code in a way that is more similar to the consumption base model than to the comprehensive income base model.

Retirement savings financed by employer contributions to pension plans are currently treated exactly as they would be under a consumption tax. Savings in employer-funded pension plans are not included in the tax base, but retirement income from those plans, which is available for consumption in retirement years, is included. Contributions to Keogh plans for the self-employed receive similar tax treatment. Employee contributions to pension plans are treated only somewhat less liberally. The original income is subject to tax, and a tax is also paid, at full rates, on the portion of retirement income representing interest earnings on the original contributions when these are received as retirement payments. If the tax on those interest earnings were paid as these earnings accrued, treatment of employee contributions to pension plans would be the same as that under a comprehensive income tax. However, the tax on interest earnings in pension funds is lower than under a comprehensive income base because the tax is deferred. If

no tax were paid on the capital earnings portion of retirement pay, then the present value of tax liability would be exactly the same as the present value of tax liability under a consumption tax. Thus, the current treatment of employee contributions incorporates elements of both the comprehensive income model and the consumption model, but, because of the quantitative importance of deferral of tax on pension fund earnings, the treatment is closer to the consumption model.

The current tax treatment of home ownership is very similar to the tax treatment of home ownership under a consumption tax. Under a consumption tax, two alternative treatments are possible. Either the initial purchase price of the house would be included in the tax base (i.e., not deductible in calculating the tax base) and the flow of returns in the form of housing services would be ignored for tax purposes, or the initial purchase price would be deductible and an imputation would be made for the value of the flow of returns, which would be included in the tax base. In both cases, the present value of the tax base would be the same. For example, if an individual purchased a $40,000 house, the present value of his future tax base for that item of consumption would be $40,000 regardless of how he chose to be taxed.

Under a comprehensive income base, the entire return on the investment in housing, received in the form of value of housing services, would be subject to tax, while the purchase price would not be deductible from the tax base.

Many special provisions of the tax law, including the most prominent tax shelters, approximate a consumption tax in the lifetime tax treatment of savings. For example, allowing immediate deduction for tax purposes of the purchase price of an item which economically will be used up over a period of years is equivalent to consumption tax treatment of investment income because it allows the full deduction of savings; accelerated depreciation approximates the consumption tax approach. While depreciation provisions under the present law are haphazard, a consumption base tax would allow the immediate deduction of saving to <u>all</u> savers.

In conclusion, taxation of a significant portion of savings under the current system more closely resembles the consumption model than the comprehensive income model.

<u>Is the Tax System Presently on an Ability-to-Pay or Standard of Living Basis?</u>

Three possibilities may be considered for the income tax treatment of the transaction consisting of a gift from one person to another: (1) the gift might be deducted from uses in calculating the tax base of the donor and included

in sources in calculating the base of the donee; (2) it might be left in the base of the donor and also included in the base of the donee or (3) it might be left in the base of the donee but excluded from the base of the donee.

The first of these treatments is that implied by a "standard of living" basis for determining relative tax burdens. The second treatment expresses an "ability to pay" view. The third treatment is that of the present income tax law, at least with respect to property with no unrealized appreciation at the time the gift is made.

To understand the treatment of gifts and similar transfers it is necessary to examine the situation of both the giver and the receiver. Consider the case of taxpayers A and B who start life with no wealth and who are alike except that A decides to accumulate an estate. Their sons, A' and B', respectively, consume their available resources and die with zero wealth. Thus, A has lower consumption than B; A' (who consumed what his father saved) has higher consumption than B'. Under a standard-of-living approach, the pair A-A' should bear roughly the same tax burden as the pair B-B'. This is so because the larger consumption of A' is simply that which his father, A, did not consume. Under an individual ability-to-pay approach, the combination A-A' should bear more tax than B-B'. A and B have the same

ability to pay, but because A chooses to exercise his ability to pay by making a gift to his son, A' has a greater ability to pay than B', by virtue of the gift received.

Neglecting the effect of progressivity, present income tax law taxes the combination A-A' the same as it does the combination B-B' (whether or not A and A' are related). In this respect, present income tax law incorporates a standard-of-living basis. The way this is accomplished is, however, "backward." That is, instead of taxing A on his standard-of-living income and then taxing A' on his standard-of-living income, present law taxes A on his consumption plus increase in net worth plus the gift given (i.e., the gift is not deductible in calculating the income tax due from A), while A' is taxed on the value of his consumption plus increase in net worth minus the value of the gift received (i.e., the receipt of the gift is not included in calculating the tax due from A').

This procedure clearly mis-measures the income of A. It mis-measures the income of A, as well, if a standard-of-living concept of income is used. The income of A' is understated (gift received not included) and that of A is overstated (gift given not excluded). However (continuing to neglect the effect of progressivity), the impact of the tax system on A and A' is much the same as if the treatment

were the other way around, at least as far as intentional gifts are concerned. Suppose, for example, that A wants to enable A' to have an extra $750 worth of consumption. Under present law, A simply gives A' $750 cash and A' consumes it. Under a standard-of-living concept of income (assuming A and A' are both in the 25 percent rate bracket) A would give A' $1,000. After paying taxes of $250, A' would have $750 to consume. At the same time, A would deduct $1,000 from his tax base, saving him $250, making the net cost of the gift by A $750.

The result is somewhat different, but perhaps not greatly so, for an unintentional gift arising from the unexpected death of A. If A is saving in expectation of consuming in his old age, under present income tax law treatment, he will need $750 in savings for each $750 he plans to consume. This is also the amount he needs to put aside if he wishes A' to consume $750 in the event of his death. The treatment that would allow a deduction for the gift by A (with inclusion by A') would have a different result, because the $750 gift on death would result in a saving of $187.50 in the final income tax return of A. This could also be bequeathed to A'. After A' had paid income taxes on the total of $937.50 received, he would again have $703 available for consumption. For A to provide A' with $750 of consumption under this approach requires A to put aside $800.

Although the effects of progressivity would alter this story somewhat, it is not clear that the differences in rates between giver and receiver would be likely to be large if a lifetime view were taken. Naturally, under present law, an adult donor will tend to have a higher marginal rate of income tax than a child donee. It is for this reason that present income tax law treatment of gift and bequest transactions may come closer than the more intuitively obvious one--excluding to donor, including to donee--to measuring standard of living correctly. Certain administrative aspects also favor the present treatment of gifts and bequests for income tax purposes.

Whether by accident or design, present income tax law incorporates a rough sort of standard-of-living view of the concept of income. That is, it results in a gift given being treated much as though not part of the income of the donor and but rather part of the income of the donee, even though the mechanics of calculating the tax are on the opposite basis.

It is, then, mainly the estate and gift tax that introduces the ability-to-pay element into the tax system. The value implicitly expressed is that taxes should generally be assessed on a standard of living basis, except that some account is to be taken of ability to pay in the case of

individuals whose ability to pay is (a) very large, and also (b) whose standard of living is low relative to ability to pay (i.e., who refrain from consuming as much as they can in order to make gifts and bequests).

5. Alternative Bases: Equity Considerations

The previous section considered what tax base is implicit in present law. In a sense, the answer itself is an equity judgment, because equity has traditionally played an important role in the tax legislation process. In this section, relative equity claims of a "consumption" as compared with an "income" basis, of either ability-to-pay or standard-of-living type, as well as the ability-to-pay or standard-of-living version of either consumption or income are taken up.

Consumption or Income: Which the Better Base?

This section examines the merits of using income as a measure on which to base relative tax burdens. This depends on more than a simple subjective judgment as to whether, of two individuals having the different income in a given period but who are identical in all respects in all other periods, the one with the higher income should pay the higher tax. Examples of tax burdens considered within a life-cycle framework suggest that a consumption base is

superior to an income base on the criterion of fairness, whether one takes an ability-to-pay or a standard-of-living view.

Many observers consider income and consumption to be simply alternative reasonable ways to measure well-being, and often income is regarded as somewhat superior because it is a better measure of ability to pay. However, in a life-cycle context, income and consumption are _not_ independent of each other. Specifically, for two individuals with equal earning abilities at the beginning of their lives, the individual with _higher_ consumption early in life is the individual who will have a _lower_ lifetime income. This is true because savings is not only a way of using wealth, but also a way of producing income. Although an individual's initial endowment of financial wealth and of future earning power _is_ independent of the way he chooses to use it, his lifetime income is not independent of his consumption/savings decisions.

The examples presented below show that a consumption base would be more likely to maintain the same relative rankings of individuals ranked by initial wealth than an income base, where wealth is defined as the initial cash value of all monetary and physical assets plus the present discounted value of future labor earnings. The point is

likely to be so surprising that it bears repeating: A consumption base is superior to an income base as a measure of lifetime wealth.

If individuals consume all of their initial endowment during their lifetime (i.e., leave no bequest), a consumption tax is exactly equivalent to an initial endowment tax. However, an income tax treats individuals with the same endowment differently, if they have either a different pattern of consumption over their lifetime or a different pattern of earnings.

In the first example, consider two individuals with no initial capital wealth, no bequest, the same pattern of labor earnings, and different patterns of consumption. Intuition suggests that unless these individuals differ in some respect other than how they choose to use their available resources (e.g., with respect to medical expenses or family status), they should bear the same tax burden, measured by the present value of lifetime taxes. The tax system should not bear more heavily on the individual who chooses to purchase better food than the one who chooses to buy higher quality clothing. Nor should it bear more heavily on the individual who chooses to apply his endowment of labor abilities to purchase of consumption late in life (by saving early in life) than it does on the one who consumes early in life.

While an income tax does not discriminate between the two taxpayers in the first case, it does in the second. An income tax imposes a heavier burden on the individual who prefers to save for later consumption than on the one who consumes early, and the amount of difference may be very significant. The reason is the "double taxation" of savings under an income tax. The "use" of funds for savings is taxed, and then the yield from savings is taxed again. The result is that the individual who chooses to save early for later consumption is taxed more heavily than one who consumes early. The tax burden may be reduced most by borrowing for early consumption.

In the second example, suppose that the two individuals have different time paths of labor earnings but that the two paths have the same present discounted value. For example, individual A may earn $10,000 per year in a given two-year period, while individual B earns $19,524 in the first of the two years, nothing in the second. (The figure of $19,524 is the total of $10,000 plus the amount which would have to be invested at a 5 percent rate of return to make $10,000 available one year later.) Each individual prefers to consume the same amount in both periods, and in the absence of tax each would consume the same amount, $10,000 per year.

Intuition suggests these two individuals should bear the same tax burden. However, under an income tax (even at a flat rate, i.e., not progressive) they would pay different taxes, with B paying more than A. The reason, again, is the double taxation of B's savings. The differences may be very large if a long time period is involved. An income tax imposes a higher burden on the individual who receives labor income earlier even though both have the same initial endowments in present value terms and the same consumption paths.

Standard-of-Living or Ability-to-Pay: Which Criterion?

Although for the vast majority of individuals, bequests and gifts of cash and valuable property comprise a negligible portion of sources and an equally negligible portion of uses of funds, the tax treatment of these transactions will have significant consequences for a minority of wealthy individuals and, therefore, for the perceived fairness of the tax system.

The equity judgment about the treatment of relatively small transfers between individuals embodied in current law, i.e., the amount transferred is included on only one side of the transaction, under the income tax, and is not taxed under the estate and gift tax, seems to have a general

appeal. The usual reaction to the idea that gifts given, presently not deducted from the income tax base of the donor, should be included in the tax base of the donee is that this would be an unfair double taxation. Although it may not be possible to derive this result from some fundamental ethical postulate, it does not appear that present income tax law treatment is an inadvertent deviation from the general sense of what is fair.

Present estate and gift tax law does impose an extra tax on large transfers. As has been pointed out, the circumstances under which large transfers occur are relatively large wealth and low consumption of donor. This is consistent with a common argument for this tax, namely, that it is desirable to prevent extreme accumulations of wealth. If this is, indeed, the equity objective, it suggests that the current law pattern of relatively large exemptions and rather high rates on very large transfers is sensible.

Summing Up: The Equity Comparison of Consumption and Income Bases

As a general matter, the important conclusions to be drawn from the foregoing discussion are:

.Either an income base or a consumption base tax may be designed to fulfill ability-to-pay or standard-of-living objectives. The difference is not between

these two types of tax but rather between a tax in which gifts given are considered part of the tax base of either donor or donee, or, instead, part of the tax bases of both donor and donee. In the latter case, the tax embodies an ability-to-pay approach; in the former, the tax follows a standard-of-living approach. The present income tax system expresses a standard-of-living basis of comparison.

.The difference between a consumption base and an income base tax of either the standard-of-living or the ability-to-pay type is between one that depends upon the timing of consumption and earnings (and gifts, in the case of an ability to pay tax) during an individual's lifetime and one that does not. The income tax discriminates against people who have their earnings early or prefer their consumption late. That is, if a tax must raise a given amount of revenue, the income tax makes early earners and late consumers worse off than late earners and early consumers. A consumption tax is neutral between these two patterns.

.A consumption tax amounts to a tax on lifetime endowment. It may be viewed as an ideal wealth tax, that is, a tax that which makes an assessment on lifetime

wealth. An income tax will tend to assess tax burdens in a way presumably correlated with lifetime wealth, but because it depends upon matters of timing discussed above, the correspondence is nowhere near as close as would be the case under a consumption base tax.

.Present law introduces an ability-to-pay element into the tax system through the estate and gift provisions. The same device is equally compatible with either an income base or a consumption base tax. As will be discussed later in this report, in some respects an estate and gift tax system fits more logically with a consumption base system, which allows deduction of gifts by the donor and requires inclusion by the donee.

6. Alternative Tax Bases: Simplicity Considerations

Of central importance in determining the complexity of a tax system, to the taxpayer in complying and to the tax collector in auditing compliance, is the ease with which the required transaction information can be assembled and the objective nature of the data. Two desirable characteristics of the required information are the following:

.Transactions should be objectively observable--as in the case of the transaction of a wage payment. Such transactions are called here "cash" transactions. "Imputed" transactions, that is, values arrived at by guesses or rules of thumb -- as in the case of depreciation -- should be kept to a minimum.

.The period over which records need to be kept should be as short as practicable.

Consumption or Income Preferable on Grounds of Simplicity?

With respect to simplicity criteria, the consumption base is much superior to the income base. as can be seen on examination of the accounting relationships. At this stage, both the concept of "consumption" and the concept of "income in net worth" must be complicated by adding imputed elements to the simple example.

The portion of consumption calculable from cash transactions includes are the cash outlays for goods and services and transfers to others (optional, depending upon the choice between standard-of-living and ability-to-pay versions). In addition, an individual usually obtains directly the equivalent of certain consumption services that he could purchase

in the market. The most important of these are the services from durable goods, such as owner-occupied houses, and household-produced services (such as child care, recreation, etc.).

The change in net worth over a given time period, the other component of income, also has a portion evidenced by cash transactions. These include such items as net deposits in savings accounts. Imputed elements are, however, extensive and lead to some of the most irksome aspects of income tax law. These include the change in value of assets held over the period, including the reduction in value due to wear and tear, obsolescence, etc. (depreciation), increases in value due, for example, to retained earnings in corporate shares held or to changed expectations about the future or to changed valuation of the future (accruing capital gains), accruing values of claims to the future (such as pension rights, life insurance), as well as changes in the net present value of future labor earning power.

Thus, both consumption and the change in net worth can be expressed as the sum of items calculable from cash transactions within the accounting period and items that must be imputed. The cash items are easy to measure; the imputed items are a source of difficulty. Because the imputed consumption elements are needed for a comprehensive

income <u>or</u> consumption base, consider first some of the more significant imputed elements of the change in net worth, representing necessary <u>additions</u> to complexity if an income base is used.

Four commonly encountered problems in measuring change in net worth are depreciation, inflation adjustment, treatment of corporate retained earnings, and treatment of unrealized capital gains on nonmarketed assets.

<u>Measurement Problems</u>

<u>Depreciation</u>. Depreciation rules are necessary under an income base to account for the change in value of productive assets due to wear and tear, obsolescence, and increases in maintenance and repair costs with age. Because productive assets often are not exchanged for long periods of time, imputations of their annual change in market value must be made.

Depreciation rules for tax accounting rarely conform exactly to the actual rate of decline in the value of capital assets. To the extent that the relationship between tax depreciation and economic depreciation is different in different industries and for different types of capital, returns to capital investment in different industries and on different types of equipment are taxed at different effective rates. Differences in the tax treatment of capital income among industries create distortions in the allocation of

resources across products and services and in the use of different types of capital in production. Accelerated depreciation at rates much faster than economic depreciation have been allowed in some industries as a deliberate subsidy, e.g., mineral industries, real estate, some farming. But it is difficult to measure the amount of subsidy because the actual rate of economic depreciation is often unknown.

Adoption of a consumption tax would end the depreciation problem because depreciation of a capital asset is neither added to nor subtracted from the consumption base. Thus, the rate at which assets are depreciated does not affect the tax base of owners of capital. Adoption of a consumption base tax would automatically eliminate current tax shelters in industries for which the present tax code allows very rapid depreciation. Substitution of other tax subsidies in these industries is possible (i.e., portions of income earned in minerals industries or in motion pictures could be excluded in deriving the consumption base), but the subsidies would have to be much more explicit and would be easier to measure. Under a consumption tax, the accidental taxation of capital income in different industries at different rates that results under the current system from imperfect knowledge of true economic depreciation rates would not occur.

Inflation Adjustment. During a period of rapid inflation, the current income tax assesses capital income at too high an effective rate by including inflationary gains along with real gains in the tax base. For example, an individual who buys an asset for $100 at the beginning of a year and sells it for $110 one year later (or, alternatively, earns $10 in dividends and no capital gain) has not had any increase in the purchasing power of his assets if the inflation rate is also 10 percent. Yet, under the current system he would include at least part of any capital gains in the sources side of his tax base calculation or include all of the dividend received. An appropriate income base would have to adjust for capital losses on existing assets, including deposits in savings banks and checking accounts, resulting from inflation. Such adjustments would pose complicated administrative problems, especially for assets held for long periods of time. The current tax system effects a rough compromise in its treatment of long-term capital gains by including only half in calculating taxable income and allowing no inflation deduction. However, dividends and interest income are taxed at the same rate as labor income even though the underlying assets may be losing real value.

Under a consumption tax, there would be no need for inflation adjustment. If an individual loses real wealth as a result of inflation that will be reflected in lower real consumption at a future date, the loss would be adjusted for by a correspondingly lower real tax burden at that time. A decline in the value of assets in any year because of inflation is neither a positive nor a negative entry in the consumption base.

Treatment of Corporate Income. Under a comprehensive income concept, there is no justification for a separate tax on corporate income. Given the difficulty of taxing capital gains as they accrue, however, a corporate income tax under the present system serves the practical function of preventing individuals from reducing their taxes by accumulating income within corporations. Under an income tax concept, an alternative to the corporation income tax is integration of corporation and individual income taxes, whereby corporations would be treated somewhat like partnerships in that their incomes would be attributed to individual stockholders. Integration is desirable because under the progressive tax different stockholders have different marginal tax rates, and a uniform tax on corporate income, combined with exclusion of dividends and capital gains, cannot assess all

individual owners at the appropriate rate. Although certainly feasible and desirable in an income tax system, integration is not administratively simple.

Treatment of corporate income under a consistent consumption base tax is much simpler. The corporation profits tax as such would be eliminated; individuals would normally include in their tax base all dividends received and the value of all sales of capital assets, and would deduct the value of all assets purchased. There would be no need to treat receipts from sales of capital assets differently from other sources or to attribute undistributed corporate profits to individual shareholders.

Treatment of Unrealized Capital Gains. An increase in net worth due to all capital gains, whether realized or not, is included in the comprehensive concept of income. An individual who sells a stock at the end of the year for $100 more than the purchase price at the beginning of the year and an individual who holds a parcel of land that increases in value by $100 during the same time interval both experience the same increase in net worth. However, the value of unrealized capital gains is often difficult to determine, especially if the asset has unique characteristics and has not been exchanged recently on an open market. Further, there is a question as to whether the increase in value of

an illiquid asset should be viewed in the same way as an equal dollar flow of labor, interest, or dividend income. For example, if the value of an individual's house rises, he is unlikely to find it convenient to realize the gain, for example, by selling it immediately.

A similar measurement problem arises in the treatment of increments in the present value of a person's potential income flow from selling his human services in the labor market. It is not practical to measure either the increased human capital value from a rise in the demand for an individual's labor services or the depreciation of the value of human capital with age, although, clearly, changes in human capital affect the future income-earning power of most individuals more than changes in monetary wealth. Present law makes no attempt to capture this income.

Under a consumption tax, unrealized capital gains would not need to be measured because consumption from capital income does not occur unless either flow income is received from the asset or the asset is converted into a monetary value by sale.

Finally, the problem of income averaging can be minimized with techniques of cash flow management. Averaging is necessary under an income tax because, with a progressive rate structure, an individual with an uneven income stream

will have a higher tax base than an individual with the same average income in equal annual installments. The consumption tax may be viewed as a tax on the present value of an individual's lifetime consumption expenditures in the initial time period. Deferral of consumption by saving raises total lifetime consumption with positive interest rates but leaves unchanged the present value of both lifetime consumption and the tax base.

The annual cash flow measure of the consumption tax correctly measures the present value of lifetime consumption but may lead to averaging problems if annual cash flow varies from year to year. The major averaging problem results from lumpy expenditures such as the purchase of consumer durables. There are two alternative ways of measuring the tax base for loans and investment assets, both of which yield the same present value of consumption over time but which enable an individual to alter the timing of his recorded consumption expenditures. The availability of alternative treatment of loans and assets enables individuals to even out their recorded pattern of consumption for tax purposes and represents an effective averaging device under a consumption tax.

The discussion thus far suggests strongly that, contrary to popular belief, a consumption base may be much easier to implement from annual accounting data, in an

appropriate and consistent fashion, than is an income base. The next section suggests that, also contrary to popular belief, the present tax system is probably closer to a consumption tax than to a comprehensive income tax.

7. Efficiency Issues in a Choice Between An Income and a Consumption Base

Comparison of the efficiency losses experienced under a general income tax and an equal-yield general consumption tax requires application in a complex formula of hard to obtain information about the magnitude of behavioral responses of individuals to tax changes. It is thus difficult to make a precise efficiency comparison. However, there is reason to believe that a consumption tax would involve a smaller efficiency loss than an income tax and that the disincentives to savings and capital formation under an income tax should concern policymakers. Both consumption and income taxes distort the choice between market and nonmarket activity. An income tax, however, also distorts the choice between present and future consumption, or stated another way, the choice between consumption and saving.

An income tax distorts the allocation of resources between present and future consumption by driving a wedge between the before-tax rate of return on capital investments and the net interest rate received by savers. The existence

of a positive market interest rate reflects the fact that society, by sacrificing a dollar's worth of consumption today and allocating that dollar's worth of resources to the production of capital goods, can increase output and consumption by more than one dollar next year. Under an income tax, the potential increase in output tomorrow to be gained by sacrificing a dollar's worth of output today exceeds the percentage return to an individual, in increased future consumption, to be derived from saving. In effect, the resources available to an individual for future consumption are double-taxed; first, when they are earned as current income and second, when interest is earned on saving. The present value of an individual's tax burden may be reduced by shifting consumption from future periods to the present.

A consumption tax, on the other hand, is neutral with respect to the choice among consumption in different periods because current saving is exempted from the base. The expected present value of taxes paid is not affected by the time pattern of consumption. A switch from an income tax to an equal-yield consumption tax would thus tend to increase the fraction of national output saved and invested and thereby raise future output and consumption.

Because consumption is lower than income if there are any savings, substitution of a consumption base for an income base would require higher tax rates to raise the same revenue. Suppose there are three composite "goods" people choose among: present consumption, future consumption (purchased by saving), and present leisure. An income tax distorts the choice between present consumption and leisure, future consumption and leisure, and present and future consumption. A consumption tax distorts the choice between present consumption and leisure and between future consumption and leisure, but is neutral in the choice between present and future consumption. An income tax has more "wedges" than a consumption tax, but each "wedge" is smaller. Although there is not a definite case for one tax base over the other on the efficiency criterion, research on the subject using plausible values of behavioral parameters suggests that the efficiency loss from a consumption tax may be considerably smaller than the efficiency loss from an equal-yield income tax.

The possible efficiency gains that would result from adopting a consumption base tax system relate closely to frequently expressed concern about a deficient rate of capital formation in the United States. Switching from an income to a consumption base would remove a distortion that

discourages capital formation and would lead to a higher growth rate in the short-run, and a permanently higher capital/output ratio in the long run. Although it cannot be stated categorically that the net social welfare gain from this shift would be positive, it appears likely that it would be so and possible that it would be quite large.

Standard-of-Living or Ability-to-Pay Preferable on Simplicity Grounds?

The choice between ability-to-pay and standard-of-living under the consumption or income tax has significant implications for simplicity of administration. It is relatively easy to assure that a gift transaction is in the tax base of either the donor or the donee. Under present law, this is assured because gifts (other than charitable gifts) given are not deductible from the tax base of the donor. Under a system in which gifts are deductible, it would be a rather easy matter to require identification of the donee. A requirement that gifts be taxed to both donor and donee, as would be implied by a thorough-going ability-to-pay approach, would introduce a great temptation to evade. Taxing both sides would require that the gift not be deductible to the donor and required to be included in the base by the donee. Particularly for relatively small gifts and gifts

in-kind, auditing compliance with the rule that gifts be included in the base, where no evidence is provided in another person's return of having made the gift, could be a formidable problem. For much the same reason, compliance with the existing gift tax law is believed to be somewhat haphazard.

The issue of gifts in-kind is a very important one. It is very difficult to establish whether a gift has been given, particularly in cases of gifts in-kind (e.g., loan of a car or a vacation home). Again, if the gift need only be taxed to one of the parties to the transaction, failing to note a gift at all, simply means it is taxed to the giver and not the recipeint.

Gifts in-kind are signficant in another sense. Gifts and bequests can be treated as a minor matter to most people only if the terms are taken to refer to transfers of cash and valuable property. If account were taken of the transfers within families, which take the form of supporting children through development as an adult, often including large educational outlays, inheritance would certainly be seen to constitute a large fraction of the true wealth of very many individuals. Any discussion of gifts and bequests should bear in mind that the parent who pays for his child's

college education makes a gift no less than the parent who, instead, makes a gift of the family farm, or of cash, even though this equivalence is not recognized in present tax law. Taxing such transfers to the recipients is generally infeasible in any case.

Where large gifts of cash and property are involved, it seems likely that enforcement of a "double" tax on transfers will be less costly, and this is exactly the procedure under current law.

8. Summing Up

The foregoing sections have attempted to provide a systematic approach to the concept of income as composed of certain uses of resources by individuals. It is well known that the current income tax law does not reflect the consistent application of this or any other basic principle. Perhaps less well known is that one of the most significant respects in which current law income deviates from a more comprehensive measure is in exclusion of a major part of income used for savings (often in the form of accruing rights to future benefits). Eliminating savings from the tax base changes an income tax to a tax on consumption.

This chapter has considered whether there is merit in making the explicit choice for a consumption base. It has been suggested that there is much to be said for this on

grounds of equity because such a base would not have the drawback, characteristics of an income tax, of favoring those who consume early, rather than late in life and of taxing more heavily those whose earnings occur early rather than late in life. The argument has been made that the choice is <u>not</u> between a tax favoring the rich--who save--and the poor--who don't and a tax favoring the latter over the former. The choice is between an income which <u>at each level of endowment</u> favors early consumers and late earners over late consumers and early earners and a consumption tax which is <u>neutral</u> between these two types of individuals. The relative burdens of rich and poor are determined by the degree of progressivity of the tax. Either tax is amenable to any degree of progressivity of rates.

A distinction has been drawn between a tax based on the uses of resouces for the taxpayer's own benefit and one based on these uses plus the resources he gives away to others (recognizing the imprecision of these terms). The shorthand term adopted for the former is a standard-of-living approach to assigning tax burdens, and for the latter an ability-to-pay approach. It has been suggested that either a consumption or an income tax could be designed to fit either objective. Examination of current practice suggests that the basic tax, the present income tax, is

broadly speaking of the standard-of-living type. An ability-to-pay element is introduced by special taxes on gifts and estates.

In view of this the following two chapters consider two different pathways to reform of the tax system. Chapter 3 contains a plan for a comprehensive income tax, while Chapter 4 contains a plan for a very different tax, called a cash flow tax, which is essentially equivalent to a consumption tax. In both cases, a standard-of-living approach is adopted, under the assumption that a transfer tax of some sort, perhaps the existing estate and gift tax, will continue to be desirable as a complement.