BOOK REVIEWS

MICHAEL J. McINTYRE†

Reviewing: What Should Be Taxed: Income or Expenditure? Edited by J. Pechman. Brookings Institution 1980. 332 pages. $14.95.

In October of 1978, the Brookings Institution brought together for a debate the leading protagonists of the expenditure tax and a number of other tax specialists, including some of the longtime champions of a broad-based income tax. The edited papers of that conference, plus commentaries and a summary of the debate, recently were published in a vibrant book: *What Should Be Taxed: Income or Expenditure?* Although the book does not provide a consensus answer to the question posed in its title, the reader is left with the impression that we will have the income tax to kick around for many years to come.

An expenditure tax is an income tax with a deduction for taxpayers who save. Commentators generally prefer to view it as a graduated tax on personal consumption. It would be assessed by subtracting from a taxpayer's net income his net savings (or adding to income his net dissavings). It is often called a progressive consumption tax. It differs from more familiar consumption taxes in two respects—the rates are graduated and the base is broader, including, for example, amounts paid to charities, to educational institutions, to the government, to persons providing casual services, and to persons outside the tax jurisdiction. The idea is an old one, dating back at least as far as John Stuart Mill.[1] When the income tax was adopted in the United States in 1913, however, the expenditure tax alternative was barely considered. Virtually all of the political support for the income tax derived from the view that it would fall predominantly on the propertied class, thereby providing some minimum check on the swollen fortunes of the rich. In fact, due to a relatively high exemption level, the overwhelming majority of wage earners were totally exempt. In that political context, no one of serious intent would propose that the surplus income of the well-to-do should be deductible, as the expenditure tax requires. The cry of unfairness would have been loud.

This fairness complaint against the expenditure tax seems to have lost its bite. The *lingua franca* of public finance economists today is the language of elementary statistics. Since fairness is too vague and

†Professor of Law, Wayne State University. A.B. 1964, Providence College; J.D. 1969, Harvard University.—ED.

1. J.S. MILL, PRINCIPLES OF POLITICAL ECONOMY 813 (W.J. Ashley ed. 1965).

subtle a concept to be expressed in that language, it has been transmogrified into a concern for steady state interpersonal utility maximization of representative individuals and other such utilitarian gobbledygook.[2] In this environment, the now generation of public finance economists and their fellow travelers give decisive importance in the choice between expenditure and income as the ideal tax base to three factors: (1) the effect of each on economic growth; (2) the relative neutrality of each toward individual economic decision-making; and (3) the relative ease of administration. A consideration of these factors provided the basic agenda for the Brookings debate.

Two papers, one by Richard Goode of the International Monetary Fund in defense of the income tax, the other by David Bradford of Princeton University in defense of the expenditure tax, form the centerpiece of the book. Goode's paper is an elegant, occasionally witty commentary on what he sees as the best arguments for and against the income tax. He makes the traditional ability-to-pay pitch for taxing "the total increase in a person's power to consume marketable output" (p. 52), rather than limiting the tax base to the actual exercise of that power through expenditure. He shows that both the income tax and the expenditure tax are likely to produce inefficiencies in the allocation of economic resources but suggests that these effects are unlikely to be significant (pp. 56-62), and could be offset by other governmental policy instruments (p. 63). He scores a telling point for the income tax in his discussion of the international aspects of the choice between the two taxes. Citing a recent study in the United Kingdom of the expenditure tax, he shows that widespread tax avoidance by highly mobile taxpayers would be virtually unstoppable under an expenditure tax (pp. 65-67).[3] He also suggests that the practical administration of an expenditure tax requires balance sheets from many taxpayers (p. 70).[4] Congress however, is unlikely to impose a balance sheet obligation, since many taxpayers would find it an onerous burden and an invasion

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2. *See, e.g.*, Bradford, *The Case for a Personal Consumption Tax*, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 75, 103 (J. Pechman ed. 1980).

3. For example, Mr. A earns two million dollars in the United States and saves one million, thereby obtaining a deduction of one million. He then moves to Canada and begins spending his savings, without subjecting himself to United States tax on the dissavings.

4. This same judgment is expressed by Sven-Olof Lodin of the University of Stockholm. Comments by Sven-Olof Lodin to Graetz, *Expenditure Tax Design*, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 276, 281 (J. Pechman ed. 1980). The Graetz article has been expanded further in Graetz, *Implementing A Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979). Without balance sheets it is difficult to tax individuals on dissavings, especially during the period of transition from the income tax regime. Graetz asserts without much discussion that balance sheets are not essential. *Id.* 1580.

of privacy. The administration of the expenditure tax is more problematic, therefore, than its supporters have suggested.

Bradford's paper is fairminded and informative, but despite his best efforts, it reflects all of the utilitarian biases of the now generation economists. A major part of his paper addresses the problems of administration already discussed extensively in *Blueprints for Basic Tax Reform*, a study produced under Bradford's direction by the Treasury Department toward the end of the Ford Administration. Bradford shows that many problems of administration once thought insolvable can be handled without debilitating complexity if we are willing to accept, in some circumstances, a tax on potential, rather than actual, consumption. Bradford assumes that the trade off is clearly an acceptable one. Most of us, however, would find it troublesome; it would mean, for example, that Mr. A, whose investment went sour, would pay the same tax as Mr. B, whose investment became a bonanza, as long as both started with the same capital. For a utilitarian, the trade off requires no comment. Under the assumptions of utilitarianism, the two investment yields are presumed equivalent, since A and B both enjoyed the benefit of the same opportunities.

Bradford's utilitarian biases are exposed most vividly in his discussion of the equity of the expenditure tax. Bradford presents uncritically the discovery of the devotees of the optimal tax theory that equity, when properly understood, is best achieved by maximizing the efficiency of the tax system (pp. 105-06). Since the perfect tax under the optimal tax theory is a lump-sum levy imposed despotically on everyone, without regard for any personal characteristics, this understanding of equity obviously is far removed from the popular understanding of the term.

Bradford understands, of course, that outside professional economics circles the utilitarian framework plays no role in tax policy discussions (p. 107). To appeal to those interested in what he calls "less formal but perhaps more persuasive" equity arguments (p. 107), Bradford makes an interesting suggestion out of keeping with conventional tax policy analysis. In choosing the tax base, Bradford argues, we should consider the period over which we wish to measure an individual's material well-being. In Bradford's view, the relevant period is a person's entire lifetime. On this ground, he concludes that expenditure is the preferred tax base, since an expenditure tax can be assessed uniformly and progressively against lifetime economic benefits, whereas an income tax cannot (pp. 107-08).[5] I approve heartily of this

5. Progressive rates applied to actual expenditures are inconsistent with the "endowment rationale" of the expenditure tax. Comments by Alvin C. Warren, Jr. to Bradford, *The Case for a Personal Consumption Tax*, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 120, 212 (J. Pechman ed. 1980). Bradford's argument for lifetime averaging is too complex to be summarized fairly here.

wholistic approach to tax policy formulation,[6] but I find its application in the present instance unsatisfactory. Since individuals do not all live the same number of years, assessments based on lifetime benefits could produce some utterly bizarre results. For example, with lifetime averaging, Achilles would get a big tax refund and Methuselah would lose his support hose, even though Achilles enjoyed a much higher standard of living during his brief day in the sun.

Why does Bradford ignore the obvious differences in taxable capacity of individuals with identical lifetime wealth resulting from differences in life span? Again we see the effect of the utilitarian blinders. For a utilitarian, whatever one actually does presumptively is what one has chosen to do. The only differences in individuals that are important are measurable differences in income producing potential, or "endowments," to use the current phraseology. Thus *consumption* for a utilitarian becomes *potential consumption*, and, in fantasizing about potential consumption, the idiosyncratic characteristics of real individuals—lifespan, energy level, home environment, attractiveness, concern for others—all are assumed away. Thus, at the starting gate Achilles and Methuselah would be presumed to have the same life span. However long each actually lived, each presumptively consumed the same opportunity for a long life. Actual lifespan, like actual investment yield, is an after-the-fact result that under the peculiar equity standard of utilitarianism should have no bearing on the measurement of taxable capacity.

In the commentary following the Goode/Bradford exchange, Alvin Warren of the University of Pennsylvania Law School emerges from his assigned cameo role as the most forceful advocate of the income tax. Warren attacks the "ex ante" perspective of the expenditure tax advocates, arguing that "outcomes rather than expectations are what matter for equity in taxation" (p. 125).[7] Perhaps his most novel point is his contention that the fairness claim of the income tax is grounded in the moral claim of society, anterior to any individual claims, for some share in the nation's annual product (p. 121). All of us who earn income, we must remember, are in part reaping rewards

6. My efforts and those of my co-author to integrate thinking about income attribution rules into the discussion of the ideal tax base received an antagonistic reception from many economists at an earlier Brookings conference. *See* McIntyre & Oldman, *Treatment of the Family*, in COMPREHENSIVE INCOME TAXATION 205 (J. Pechman ed. 1977), expanded further in McIntyre & Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 HARV. L. REV. 1573 (1977).

7. Not all writers on the expenditure tax espouse the "ex ante" perspective common within the economics profession. Andrews, for example, has attempted to articulate the ideal expenditure tax in terms of actual consumption. *See* Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV L. REV. 947, 947 (1975).

of the labors of our ancestors and our neighbors. Society, in effect, is a silent partner in the production and sale of most marketable output.

Following the Goode/Bradford exchange is a paper by William Andrews of the Harvard Law School on the use of the expenditure tax as a supplement to the existing income tax. Andrews sees this supplemental tax, which would be accompanied by a reduction in the top marginal rates of the income tax, as either a replacement for the minimum tax on income found in the current Internal Revenue Code or a transitional step toward full substitution of an expenditure tax for an income tax. His discussion of technical issues is skillful and complements his earlier writings on the topic.[8] His ambivalent pose on the function of his supplemental tax was criticized, however, by the two commentators on his paper, William Klein of the UCLA Law School and Nicholas Kaldor, the great English economics writer who elaborated the expenditure tax ideal more than 25 years ago. Both commentators felt that at this stage of the debate, political half-measures that blur ideological lines are out of place.

The final paper of the volume, by Michael Graetz of the California Institute of Technology and the University of Southern California Law Center, provides a lengthy and valuable analysis of the array of problems that must be overcome in order to implement an expenditure tax in the United States. Graetz finds these problems "substantial, but not absolutely prohibitive" (p. 275). The problems are far greater, however, than the advocates of an expenditure tax had realized or had been willing to admit. Paul McDaniel of the Boston College Law School, in his comments on Graetz's paper, concludes that an expenditure tax that was modified to take account of the problems that Graetz had uncovered would bear little resemblance to the ideal championed in the economics literature and would be inferior to the existing income tax (p. 295).

Perhaps the most interesting part of Graetz's paper is his discussion of the potential for tax manipulation under an expenditure tax. Supporters of the expenditure tax have assumed that tax shelters would disappear if a full deduction for savings were available under the normal tax structure—on the theory that a boat with its bottom removed need not worry about leaks. Cynical tax lawyers have assumed that a new law would mean new shelters; Graetz shows that cynicism to be justified. He shows, for example, that the once-popular movie shelter, now virtually closed under the present income tax, would be open city under an expenditure tax, with benefits far in excess of those available in its former heyday (p. 175-81). With sufficiently complex rules, the

8. For one of his major works, see Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

expenditure tax shelters probably could be closed, but the reform likely would parallel the hot and cold, piecemeal process we have endured under the income tax.

I have left until now a discussion of the opening paper of the book, a detailed study by E. Phillip Howrey and Saul Hymans, both of the University of Michigan, of the impact of the interest rate on the supply of resources for capital formation. The paper is somewhat out of place in this book, for its topic should have little or nothing to do with the choice between an income tax and an expenditure tax. Since the impact on total national savings of changes in the interest rate is unavoidably uncertain, and since the government has far more effective mechanisms for influencing aggregate savings, and, more importantly, aggregate investment, the use of tax policy to manipulate aggregate savings is decidedly inappropriate. Some of the most vocal supporters of the expenditure tax, nevertheless, have asserted that the income tax, by lowering the rates of return on savings, dramatically reduces the funds available for investment. For example, Michael Boskin of Stanford University has claimed that a social cost of a *trillion dollars* is being paid in the United States by the use of an income tax instead of an expenditure tax.[9] In light of these grandiose claims, a discussion at the Brookings conference of the impact of income taxes on savings was virtually unavoidable.

No one can predict, on the basis of economic theory, how individual savers will respond to increases in the interest rate. For those saving for a rainy day, or to acquire a particular sum of money—a down payment on a house, for example—higher interest rates should reduce the amount saved. Other persons may be tempted by the higher rates to save more now in order to become richer and more powerful later. The sum of these substitution and income effects may be either positive or negative. (For convenience, economic theory ignores the majority of savers who have muddled or mixed motives for saving.) If the impact of interest rates on savings is to be discovered, therefore, it must be by empirical studies, not by theory.

Howrey and Hymans provide a detailed critique of the various empirical studies that have attempted to determine the response of individual savers to changes in the interest rate. Much of their attention is given to a recent paper by Boskin, in which Boskin reports a positive and significant interest elasticity of savings. Howrey and Hymans show that Boskin's findings depend heavily on his figures for the real rate of interest over the past 40 years. Plugging into Boskin's formulas a vast

9. Boskin made his trillion dollar estimate after receiving the negative comments on his paper at the Brookings conference. *See* Boskin, *Taxation and Capital Accumulation*, 8 TAX NOTES 51, 52 (1979). For my exchange of views with Boskin on that article, see Letters to the Editor, 8 TAX NOTES 188-91, 703-06 (1979).

array of different assumptions about the real interest rate, Howrey and Hymans uniformly obtained results that conflicted with those of Boskin (pp. 12-13). Estimating the real interest rate, adjusted for inflation and uncertainty, apparently poses serious conceptual problems not yet resolved within the economics community (p. 3). Boskin's technique for estimating the real interest rate was the great mystery of the Brookings conference (p. 33). We are told that Boskin used a "smoothed and processed" rate of return series to generate his results (p. 46), but Boskin guarded his processing method the way a cabinetmaker might conceal his formula for a special varnish.

The debate over the sensitivity of savings to the interest rate no doubt will continue. Boskin, in a strident rebuttal, complained that Howrey and Hymans had attacked a paper that, for economic and statistical reasons discussed in other writings, did not represent his "best results" (p. 35). A subsequent paper, coauthored with Lawrence Lau, reports an even higher interest elasticity than the paper criticized by Howrey and Hymans. He also argued that the standard sensitivity tests to which his equations were subjected were unfair—that "any battery of re-estimates of any time-series equation is likely to change the results" (pp. 35-36). Another commentator, John Brittain of the Brookings Institution, concluded, however, that "Howrey and Hymans have cast great doubt on Boskin's elasticity estimate" (p. 46) and that "the empirical problem [of correctly determining the elasticity of savings] is quite intractable" (p. 41).

The case for an expenditure tax presented in *What Should Be Taxed?* is a refinement of the case made by John Stuart Mill over 130 years ago. Mill, who equated equality in taxation with equality of sacrifice, saw the saver as sacrificing more than the spender under an income tax, on the ground that the saver paid the same amount initially as the spender and then paid tax again on the interest from the savings.[10] Mill could have extended his argument to show that a wage earner sacrifices more than a stargazer, since both started off with the same ability to work which the state chose not to tax, and then the wage earner was taxed on the income stream generated by his ability while the stargazer paid nothing. The above point is summarized by the assertion of economists that an income tax (and, incidentally, any tax on "outcomes") favors leisure. The now generation economists would eliminate all these biases by taxing individuals on the basis of their "endowments"—that is, on the present value of all their potential future wealth. They favor the expenditure tax because it is better than an income tax as an approximation of an endowment tax.

10. J.S. MILL, *supra* note 1, at 813. Mill was not as single-minded in his pursuit of neutrality as the now generation economists. He advocated very high taxes on inheritances, *id.* 809, and confiscatory taxes on rents, *id.* 817-19.

Why has equality of sacrifice, rephrased as equal burdens on equal endowments, made the comeback with economists that is so evident in this book? The economists do not tell us, and, quite frankly, I do not think they know. I suspect, however, that an attraction for utilitarianism is an occupational hazard of the economics profession. Economics, in general terms, studies human choice, or at least the material component of individual and group choices. To predict how someone will choose, the economist must quantify the gains the chooser can expect to obtain from each alternative. Consequently, the measure of gain becomes an "ex ante" concept, a measure of potential income. The equal sacrifice doctrine of the utilitarians has this same "ex ante" perspective, as is illustrated by Mill's argument for treating a saver and a spender the same, despite the differences in outcome.

In addition, as economists have applied their craft to the analysis of marriage, race discrimination, pricing of public goods, home ownership, child bearing, and a host of other nonmarket areas, they have been forced to impute quantities to serve as proxies for prices, rates of return, capital investments, and so forth. The proxies tend to be based on estimates of opportunity costs, again an "ex ante" concept. More significantly, the underlying premises of imputation are that human beings tend to maximize the returns on their endowments and that they are essentially homogeneous in their capacity for enjoying those returns. The utilitarians, of course, used to make the identical assumptions about the human psyche.[11]

Ironically, Henry Simons, famous for his brilliant and unrebuttable putdown of utilitarianism,[12] may be in part the indirect cause of its revival. Simons demonstrated that equality of sacrifice can never be determined and, in any case, has little or no relevance to any policy objectives of personal taxation that citizens of a democracy would care to profess. His alternative measure of taxable capacity, personal consumption plus net change in savings, became the foundation for the ideal income tax advocated for years by most economists. When pressed to extremes, however, this ideal shows some flaws. In particular, the economists have interpreted it to require that a host of unmeasurable and undeterminable benefits obtained outside the market place be included in taxable income. As that interpretation became widespread among economists, Simons' ideal, once rooted in popular notions of fairness, became inextricably linked with the definition of income

11. The utilitarians are noted for their pseudoscientific search for "the greatest good for the greatest number," which in taxation provoked a search for taxes that minimized total sacrifice in the society. To simplify their search, the utilitarians assumed that pleasure and pain were the same for everyone and could be measured by reference to material benefits and deprivations.

12. H. SIMONS, PERSONAL INCOME TAXATION 5-15 (6th ed. 1970).

developed for purposes of economic analysis. Since the economic definition of income has come to be viewed by many economists as an "ex ante" concept, they have been led to reinterpret Simons' definition along utilitarian lines. The economists who support a broad-based income tax have fumed at this development, but they have had difficulty articulating the basis for their objections.

The debate carried on in *What Should Be Taxed?* ends in midsentence. We are shown that both the income ideal and the expenditure ideal, as currently understood by the economists, would produce tax regimes unacceptable to the voting public, but we are not told how to proceed toward the development of a better normative model for our most important tax. The task of the 1980s is to find a way to build a model for personal taxation that explicitly incorporates some of the values and concepts of fairness shared by the citizenry that the tax system is supposed to serve.