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The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve

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THE SOURCES OF TAX COMPLEXITY: HOW MUCH SIMPLICITY CAN FUNDAMENTAL TAX REFORM ACHIEVE?

DEBORAH L. PAUL*

The complexity of the federal income tax exacts obvious social costs. It leads to wasteful compliance and administrative activity and deters productive activities that would otherwise be undertaken. But if tax complexity is undesirable, why has it thrived? In this Article, Professor Paul argues that the desire for equitable distribution of tax liabilities and the desire for certainty of application cause tax complexity. Pressure to achieve those goals comes to bear on the federal income tax and would come to bear on possible replacements, such as a federal tax on human consumption, causing complexity in both the current system and possible alternatives. Professor Paul applies her model of complexity to the debate over adoption of a consumption tax and challenges the prevailing wisdom that consumption taxes are simpler than income taxes.

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*And all the loveliest things there be
Come simply, so, it seems to me.*

—Edna St. Vincent Millay¹

*Measured by any and every index, our law is exploding
Statutory codes, such as those in the fields of commercial law and
taxation, are becoming ever more particularistic, longer, more
complex, and less comprehensible. We are drowning in law.*

—Bayless Manning²

1. Edna St. Vincent Millay, *The Goose-Girl*, in THE HARP-WEAVER AND OTHER POEMS 12, 12 (1923), reprinted in EDNA ST. VINCENT MILLAY, COLLECTED POEMS 161, 161 (1956).

2. Bayless Manning, *Hyperlexis: Our National Disease*, 71 NW. U. L. REV. 767, 767 (1977).

I. INTRODUCTION

Tax complexity is itself complex, as a substantial literature has shown.³ I propose a new framework for analyzing tax complexity and

3. See, e.g., DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* 313-15 (1986); FEDERAL INCOME TAX SIMPLIFICATION (Charles F. Gustafson ed., 1979); JOHN F. WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX* 20 (1985); George T. Altman, *A Simplification of the Income Tax*, 22 TAXES 146 (1944); Walker J. Blum, *Simplification of the Federal Income Tax Law*, 10 TAX L. REV. 239 (1954); James S. Eustice, *Tax Complexity and the Tax Practitioner*, 45 TAX L. REV. 7 (1989); Louis Kaplow, *Accuracy, Complexity, and the Income Tax* (National Bureau of Econ. Research Working Paper No. 4631, 1994); Bayless Manning, *Hyperlexis and the Law of Conservation of Ambiguity: Thoughts on Section 385*, 36 TAX LAW. 9 (1982); Paul R. McDaniel, *Federal Income Tax Simplification: The Political Process*, 34 TAX L. REV. 27 (1978); Sidney I. Roberts, *Simplification Symposium Overview: The Viewpoint of the Tax Lawyer*, 34 TAX L. REV. 5 (1978); Sidney I. Roberts et al., *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 325 (1972); Adrian J. Sawyer, *Why Are Taxes So Complex, and Who Benefits?*, 73 TAX NOTES 1337 (1996); Michelle J. White, *Why Are Taxes So Complex and Who Benefits?*, 47 TAX NOTES 341 (1990); Edward Yorio, *Federal Income Tax Rulemaking: An Economic Approach*, 51 FORDHAM L. REV. 1 (1982); Edward A. Zelinsky, *Another Look at Tax Law Simplicity*, 47 TAX NOTES 1225 (1990); see also Remarks of Hon. Leslie B. Samuels, Assistant Secretary (Tax Policy) of the U.S. Dept't of the Treasury, at the American Bar Association Tax Section's May Meeting (May 11, 1996), available in 93 TNT 217-8 (May 16, 1996), LEXIS, FEDTAX Library (suggesting that complexity is inevitable because of other policy goals of the tax regime).

Many authors have observed a tension between simplicity and the policy goal of taxing equitably. See, e.g., Robert B. Eichholz, *Should the Federal Income Tax Be Simplified?*, 48 YALE L.J. 1200, 1204 (1939); Louis Kaplow, *How Tax Complexity and Enforcement Affect the Equity and Efficiency of the Income Tax*, 49 NAT'L TAX J. 135, 138-39 (1996) [hereinafter Kaplow, *Tax Complexity and Enforcement*]; John A. Miller, *Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation*, 68 WASH. L. REV. 1, 5 (1993); Randolph E. Paul, *Simplification of Federal Tax Laws*, 29 CORNELL L.Q. 285, 285 (1944); Stanley S. Surrey & Gerard M. Brannon, *Simplification and Equity as Goals of Tax Policy*, 9 WM. & MARY L. REV. 915, 916 (1968). But see Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 WIS. L. REV. 1267, 1284-91 (arguing that complexity does not favor equity).

Some authors have argued that tax complexity is inevitable. See, e.g., Boris I. Bittker, *Tax Reform and Tax Simplification*, 29 U. MIAMI L. REV. 1, 2 (1974); Charles E. McLure, Jr., *The Budget Process and Tax Simplification/Complication*, 45 TAX L. REV. 25, 44 (1989); Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROBS. 673, 673 (1969); Michael J. Stepek, Note, *The Tax Reform Act of 1986: Simplification and the Future Viability of Accrual Taxation*, 62 NOTRE DAME L. REV. 779, 795 (1987).

Others have proposed simplification within the context of an income tax. See, e.g., Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1354-55 (1996); Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121, 129-30 (1989); Stephanie J. Willbanks, *Simplifying the Internal Revenue Code Through Reallocation of Decisionmaking Responsibility*, 6 AM. J. TAX POL'Y 257, 315-17 (1987); see also Stanley A. Koppelman, *At-Risk and Passive Activity Limitations: Can Complexity Be Reduced?*, 45 TAX L. REV. 97, 121 (1989) (suggesting a repeal of the 1986 passive activity loss limitations).

use the framework to challenge the prevailing wisdom that consumption taxes are simpler than income taxes.

My model of complexity integrates and enhances formulations that have appeared in the tax and general legal literature over several decades.⁴ Intuitively, tax complexity refers in part to the regime's "complication"—the number and detail of the legal authorities that define the regime. In addition, the concepts underlying a regime contribute to complexity. A short one-sentence regime could be complex depending on the difficulty of the concepts upon which it relies—a quality that I call "intractability." Further, even a short regime based on tractable concepts might nevertheless be complex if it were at war with its purposes, or "incoherent."

4. See BRADFORD, *supra* note 3, at 266-67 (characterizing tax complexity as including "rule," "transactional," and "compliance" complexity); RICHARD E. EPSTEIN, *SIMPLE RULES FOR A COMPLEX WORLD* 27-29 (1995) (arguing that complex rules create public regulatory obstacles to achievement of private objectives); RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 541 (4th ed. 1992) (arguing that production of judicial precedents reduces legal uncertainty); Anthony D'Amato, *Legal Uncertainty*, 71 CAL. L. REV. 1, 1 (1983) (pointing out that legal uncertainty is increasing with time); Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65, 67 (1983) (arguing that rule precision consists of (1) "transparency," which is the degree to which the words used have well-defined and universally accepted meanings within the relevant community; (2) "accessibility," which is the ease with which rules are applicable to concrete situations; and (3) "congruence" with underlying policy objectives); Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 257 (1974) (arguing that the degree of specificity of legal authorities produces social costs and benefits); Louis Kaplow, *A Model of the Optimal Complexity of Legal Rules*, 11 J.L. ECON. & ORG. 150, 150 (1995) [hereinafter Kaplow, *Optimal Complexity*] (characterizing legal complexity as "the number and difficulty of distinctions" made); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 560 (1992) [hereinafter Kaplow, *Rules Versus Standards*] (noting that *ex ante* and *ex post* creation of law influences legal costs and behavioral conformity to law); McCaffery, *supra* note 3, at 1270-72 (dividing tax complexity into "technical," "structural," and "compliance" complexity); Miller, *supra* note 3, at 12-13 (describing tax complexity as "elaborative" and "judgmental" complexity); J.B. Ruhl, *The Fitness of Law: Using Complexity Theory to Describe the Evolution of Law and Society and Its Practical Meaning for Democracy*, 49 VAND. L. REV. 1407, 1416-17 (1996) (characterizing law as a dynamic system, the evolution of which depends on predictable adaptations and random behavior); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379, 426 (1985) (denoting the dispute between rules and standards as "irreducible"); Peter H. Schuck, *Legal Complexity: Some Causes, Consequences, and Cures*, 42 DUKE L.J. 1, 3 (1992) (analyzing legal complexity in terms of density, technicality, differentiation, and indeterminacy); Cass R. Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953, 957 (1995) (suggesting that pervasive enthusiasm for rules should be tempered with appreciation for advantages of case-by-case decisionmaking); cf. JOHN L. CASTI, *COMPLEXIFICATION* 9 (1994) (noting that complexity of an object is directly proportional to the length of its shortest possible description); WEBSTER'S ENCYCLOPEDIA UNABRIDGED DICTIONARY OF THE ENGLISH LANGUAGE 301 (1989) (defining "complex" as, *inter alia*, (1) a synonym for "composite" or "compound," (2) involving a complicated "arrangement of parts," or (3) sufficiently complicated as to be "hard to understand").

Two processes contribute to tax complexity. First, complexity arises because policy ideals are insufficiently tractable to administer, but practical second-best solutions are also complex *by virtue* of being second-best. Complexity is a by-product of a tax regime's reconciliation of the lofty aspiration to distribute tax burdens equitably and the mundane requirement that the tax be susceptible to administration and compliance.⁵

Second, complication is caused by a desire to reduce "open texture," or uncertainty. Taxpayers and administrators need guidance where the law is unclear. Lawmakers respond by producing new authorities that clarify but complicate the law. The pace of complication depends on revenue. A new legal authority is produced when the amount of tax revenue at stake in resolving an uncertainty exceeds the transaction costs necessary to produce the authority. Regimes that raise large amounts of revenue are therefore likely to become complicated more rapidly than regimes that raise smaller amounts.⁶

I apply my analysis of those two processes to the argument that a consumption tax would be simpler than an income tax.⁷ Income has traditionally been understood to consist of consumption *plus*

5. See *infra* notes 52-74 and accompanying text.

6. See *infra* notes 75-88 and accompanying text.

7. This Article forms part of a long-standing tax policy debate over the equity, efficiency, and simplicity advantages of consumption taxes as compared with income taxes. See BRADFORD, *supra* note 3, at 285-334; DEPARTMENT OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977) [hereinafter BLUEPRINTS]; DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH (1984) [hereinafter TREASURY I]; MICHAEL J. GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX (1997); ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d ed. 1995); THOMAS HOBBS, LEVIATHAN 238-39 (Richard Tuck ed., Cambridge Univ. Press 1996) (1651); INSTITUTE FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION: REPORT OF A COMMITTEE CHAIRED BY PROFESSOR J.E. MEADE (1978) [hereinafter MEADE REPORT]; NICHOLAS KALDOR, AN EXPENDITURE TAX (1955); JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY, bk. 5, chs. II-VI (Jonathan Riley ed., Oxford Univ. Press 1994); THE CONSUMPTION TAX: A BETTER ALTERNATIVE? (Charles E. Walker & Mark A. Bloomfield eds., 1987); WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? (Joseph A. Pechman ed., 1980) [hereinafter WHAT SHOULD BE TAXED?]; William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974) [hereinafter Andrews, *Consumption-Type Tax*]; William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1975) [hereinafter Andrews, *Reply to Warren*]; Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961 (1992); Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979) [hereinafter Graetz, *Implementing*]; Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975); see also Bill Archer, *Goals of Fundamental Tax Reform*, in FRONTIERS OF TAX REFORM 3, 7 (Michael J. Boskin ed., 1996) (comparing a consumption tax and a flat tax).

accretions to wealth.⁸ Thus, an income tax is imposed on consumption *and* accretions to wealth, while a consumption tax is imposed only on consumption. Theoretically, a consumption tax is more tractable than an income tax, because the former covers only consumption, while the latter covers changes in wealth as well.

The argument for consumption tax simplicity emphasizes the theoretical and formal simplicity of taxing consumption, but disregards the dynamic development of tax law. I argue that the two processes—achievement of equity and achievement of certainty—would lead to complexity of a consumption tax over time. Equity-based complexity would arise because legal authorities would be produced to correct the undertaxation or overtaxation implicit in a consumption tax base that approximated, but did not achieve, the ideal tax base of ability to pay or well-being. Indeed, even the limited effort to tax consumption comprehensively would produce complexity in any real-world consumption tax, because of the inherent intractability of consumption. Certainty-based complication would arise under a consumption tax because the large amounts of revenue at stake in the resolution and clarification of the underlying concepts would lead taxpayers and administrators to seek new legal authorities that reduced uncertainty.

Law sometimes develops to serve the interests of *lawmakers* rather than the public interest, as assumed by my analysis of equity-based and certainty-based complexity. Departures from serving the public interest tend to make tax law complex. In particular, complexity stems from pressure from interest groups, incompetence of some lawmakers, and a legal “taste” for complication. Such sources would contribute to the complexity of a consumption tax as they do under the federal income tax.

Part II of this Article analyzes three categories of complexity—

8. See HENRY CALVERT SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 50 (1938); Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, in READINGS IN THE ECONOMICS OF TAXATION 54, 59 (Richard A. Musgrave & Carl S. Shoup eds., 1959). A standard economics textbook defines consumption as “spending on final goods and services bought for the satisfaction gained or needs met by their use” and savings as “that part of disposable income not spent on consumption.” PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* 421 (15th ed. 1995); see also MEADE REPORT, *supra* note 7, at 33 (defining consumption as appropriation of the community’s productive resources for personal use); William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 314-15 (1972) (defining consumption as private preclusive use of resources); *id.* at 322 (stating that personal consumption relates to the distinction between *ultimate* consumer goods and services, and *intermediate* goods and services produced as a step toward the production of something else).

complication, intractability, and incoherence.⁹ Part III builds my model of complexity using those three categories.¹⁰ In Part IV, I discuss the two principal consumption tax structures, direct and indirect.¹¹ Part V reviews the traditional argument for consumption tax tractability in terms of my framework.¹² Then, in Part VI, I argue that a commitment to equity would be a source of complexity under a consumption tax.¹³ Financial pressure to address areas of uncertainty under a consumption tax would lead to complication, as I argue in Part VII.¹⁴ Part VIII argues that self-interested behavior by lawmakers also would contribute to the complexity of a consumption tax.¹⁵ In Part IX, I analyze empirical studies and quantitative predictions relating to compliance and administrative costs and argue that those studies and predictions provide little support for the view that consumption is simpler to tax than income.¹⁶

I conclude that a consumption tax that aimed at achieving equity and raising the same amount of revenue as the federal income tax would inevitably be complex. Further, because complexity of a tax regime depends on the degree to which the regime approximates an equitable distribution of tax liabilities, the debate over the relative equity of a consumption tax and the federal income tax logically must precede the debate over their relative complexity. The complexity of a tax regime depends on its degree of equity. Consumption tax proponents cannot successfully argue for the relative simplicity of a consumption tax unless they also persuade that a consumption tax is more equitable than the federal income tax. Equity, rather than complexity, should therefore be the focus of the debate over fundamental tax reform.

II. THREE TYPES OF COMPLEXITY

My model of tax complexity distinguishes among three ways in which a tax regime may be complex. It may be "complicated," "intractable," or "incoherent." That is, it may consist of numerous and detailed authorities,¹⁷ rely on concepts that are difficult to apply,

9. See *infra* notes 17-48 and accompanying text.

10. See *infra* notes 49-113 and accompanying text.

11. See *infra* notes 114-33 and accompanying text.

12. See *infra* notes 134-54 and accompanying text.

13. See *infra* notes 155-80 and accompanying text.

14. See *infra* notes 181-229 and accompanying text.

15. See *infra* notes 230-37 and accompanying text.

16. See *infra* notes 238-78 and accompanying text.

17. I use the term "authority" or "legal authority" to refer to a rule, standard, or

or embody purposes that are inconsistent with one another.¹⁸ Each type of complexity makes a regime difficult to comply with or to administer.

A. *Complication*

The federal income tax is often criticized for the abundance and intricacy of the rules and standards in the Internal Revenue Code (the "Code") and Treasury Regulations.¹⁹ A "complicated" regime, such as the federal income tax, consists of numerous detailed authorities.

Complication increases costs of tax compliance and enforcement. Specific answers become buried as the number of authorities increases.²⁰ Complication undermines a tax regime's

other norm with legal weight. For example, the Internal Revenue Code and Treasury Regulations contain many authorities. A judicial opinion may contain one or more authorities.

18. Those categories represent my integration and reworking of prior interpretations of legal complexity, in general, and tax complexity, in particular. For example, Professor Schuck has proposed that legal complexity be analyzed in terms of density, technicality, differentiation, and indeterminacy. *See* Schuck, *supra* note 4, at 3. A dense legal system has numerous legal authorities that collectively apply to a broad range of conduct. *See id.* at 3-4. His concept of density thus appears to combine complication with attention to the scope of a regime. Schuck also observes that the wide ambit of a dense legal regime causes the rules to clash periodically with the regime's motivating policies, *see id.*, a form of incoherence in my framework. Technical rules, in Schuck's system, require expertise for their application and comprehension. *See id.* at 4. Under my system, complication, intractability, and incoherence contribute to technicality. A legal regime is differentiated, in Schuck's system, in proportion to the number of its separate decision-making institutions with independent legitimacy, expertise, and procedures. *See id.* I analyze complication, intractability, and incoherence by examining pressures on judicial, administrative, and legislative institutions. Indeterminacy for Schuck is uncertainty, dependence on multiple factors, and fluidity. *See id.* In my framework, indeterminacy arises from intractability and incoherence.

19. The number of Code sections relating to the income tax has grown from 103 in 1954 to 698 in 1994, an increase of 578%. *See Replacing the Federal Income Tax: Hearings Before the House Comm. on Ways and Means*, 104th Cong. 164 (1995) [hereinafter *1995 Hearing*] (testimony of Arthur Hall, Senior Economist, Tax Foundation, Washington, D.C.). The number of words in the Code relating to the income tax grew by 369% over that period, while the number of words in the corresponding Treasury Regulations grew by 730% over the same period. *See id.*; *see also* David J. Shakow, *The Flood of Tax Legislation*, 71 TAX NOTES 521, 521 (1996) (stating that the annual amount of tax legislation, measured by the number of pages, burgeoned in the 1980s). For examples of especially detailed and lengthy Code sections and regulations, see I.R.C. § 469 (West 1988 & Supp. 1997) and Treasury Regulations thereunder (limitation on deduction of passive activity losses), I.R.C. § 704(b) (1994) and Treasury Regulations thereunder (allocations of partnership income, loss, deduction, and credit), and I.R.C. §§ 1272-1275 (1994) and Treasury Regulations thereunder (inclusion of original issue discount).

20. *See* Roberts et al., *supra* note 3, at 327 (asserting that reasonably certain

accessibility, leading laypersons to seek the assistance of accountants and lawyers or risk noncompliance. Even for experts, complication increases the likelihood of mistakes and misinterpretations. As Professor LoPucki argues, lawyers apply the law by relying on “mental models” of written law.²¹ Those models are simpler than the written law and are prone to error.²² The more complicated the written law is, the more likely that lawyers will miss or misunderstand an important, if arcane, distinction.²³ Indeed, frustration with the complication of the federal income tax leads politicians periodically to request administrative freezes and even the elimination of the Internal Revenue Service (the “IRS”).²⁴

It is probably impossible to count legal authorities or to determine their level of detail with any degree of precision.²⁵ The differences in structure among rules, standards, and other legal authorities impede efforts to define generally what constitutes a single legal authority.²⁶ Nevertheless, large differences in complication are readily apparent. The federal income tax is clearly more complicated than the sales and use tax of the State of Wyoming.²⁷

B. Intractability

A tax regime, despite being uncomplicated, may be complex. A tax on “geniuses” would be complex, even if uncomplicated, because of the difficulty of determining whether a person is a genius.

conclusions are determinable in some circumstances only after excessive expenditure).

21. See Lynn M. LoPucki, *Legal Culture, Legal Strategy, and the Law in Lawyers' Heads*, 90 NW. U. L. REV. 1498, 1513-15 (1996).

22. See *id.*

23. A complicated regime may be *more* accessible than a regime with few intractable authorities, however, because for lawyers with cost-effective access to legal authorities, the former regime facilitates a lawyer's ability to find an authority “on point” using basic legal research skills.

24. See Mike McNamee, *Death to the IRS: GOP Tax Reformers Are Tapping into Public Resentment*, BUS. WK., July 31, 1995, at 84, 84.

25. See RONALD DWORKIN, *TAKING RIGHTS SERIOUSLY* 46, 76 (1977) (refusing to commit to a particular theory of individuation of laws); JOSEPH RAZ, *THE CONCEPT OF A LEGAL SYSTEM: AN INTRODUCTION TO THE THEORY OF LEGAL SYSTEM* 70 (2d ed. 1980) (arguing that the importance and difficulty of the problem of individuation of laws are underestimated).

26. See, e.g., DWORKIN, *supra* note 25, at 14, 24-28 (arguing that principles have dimensions of weight or importance, while rules do not have such dimensions); Kaplow, *Rules Versus Standards*, *supra* note 4, at 560-61 (arguing that rules specify outcomes *ex ante* and standards *ex post*); Sunstein, *supra* note 4, at 961, 964-65 (same).

27. The Wyoming sales and use tax statute contains little detail. See WYO. STAT. ANN. §§ 39-6-401 to -702 (Michie 1997).

Similarly, an income tax expressed in only one short sentence would be complex. The tractability of a tax regime is thus the ease with which the regime's underlying concepts may be applied. Tractability makes the amount of a person's tax liability, as well as the time and manner of payment, as Adam Smith stated, "clear and plain" to the taxpayer and "every other person."²⁸ The federal income tax is intractable, relying on such difficult concepts as income,²⁹ realization,³⁰ dividend,³¹ and corporate business purpose.³²

Concepts that produce few borderline cases tend to be tractable. For borderline cases, it is a close call whether the case is or is not within the concept.³³ Concepts differ in terms of the likelihood that

28. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS bk. V, ch. II, at 350 (Edwin Cannan ed., Univ. of Chicago Press 1976) (1789).

29. See I.R.C. § 61(a) (1994) (providing that a taxpayer must include income from whatever source derived); *id.* § 446(a) (providing that a taxpayer's accounting method must currently reflect income). Numerous cases, statutory provisions, and IRS pronouncements have analyzed the meaning of "income," *see, e.g.*, I.R.C. § 83 (providing that nonvested property received as compensation is not includible in gross income); *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 432-33 (1955) (holding that punitive damages are income); *United States v. Gotcher*, 401 F.2d 118, 120 (5th Cir. 1968) (holding that an expense-paid trip is not income for an employee-investor); *Treas. Reg.* §§ 1.61-1 to -21 (as amended in 1992) (interpreting "gross income"), and of "currently reflect," *see, e.g.*, *Schlude v. Commissioner*, 372 U.S. 128, 136-37 (1963) (holding that advance payments for dance lessons must be included by dance studio upon receipt); I.R.C. § 461(h) (holding that economic performance is required in order for an expense to be deductible); *Rev. Rul.* 83-106, 1983-2 C.B. 77 (holding that a casino using the accrual method of accounting must include gambling revenue from customers who gamble on credit in its income for the year in which gambling obligations arise and gambling occurs).

30. The seminal case establishing that income must be realized before it is required to be included in gross income is *Eisner v. Macomber*, 252 U.S. 189 (1920), which held that shareholders did not realize income when they received a pro rata distribution of stock. *See id.* at 219; *see also* I.R.C. § 1001 (requiring that a taxpayer include in income the excess of amount realized over basis).

31. Under I.R.C. § 316, "dividend" is defined as a distribution out of corporate "earnings and profits." *See* I.R.C. § 316. Section 312 provides several rules for calculating earnings and profits, *see* I.R.C. § 312, but the Code does not contain a comprehensive definition of earnings and profits.

32. Under Treasury Regulation § 1.355-2(b), in order to qualify for nonrecognition, a corporate division must have a corporate business purpose, not merely a shareholder purpose. *See* *Treas. Reg.* § 1.355-2(b) (as amended in 1989). From one perspective, the purpose of corporate businesses is to provide a return on shareholders' investments. *See* SAMUELSON & NORDHAUS, *supra* note 8, at 487 (discussing the assumption of modern portfolio theory that investors balance risk and return). On that view, business purposes are, by definition, shareholder purposes as well.

33. Borderline cases can arise in two ways. First, a case may be borderline because the border itself is blurry, and because the case partakes of some features of the concept but not others. For example, a sculpture created by Michelangelo *and* his apprentices is a borderline case of a Michelangelo sculpture. Second, the border may be sharp, but determining whether the case is or is not within the concept may be difficult. For

borderline cases will arise.³⁴ Further, the likelihood of borderline cases of a particular concept can change over time.³⁵

A concept also may be intractable because of the cognitive or intellectual difficulty of identifying clear, generic, *nonborderline* cases of the concept.³⁶ Compare, for example, the concept of rabbit with the concept of a Matisse painting. It is easier to identify generic cases of rabbits than generic cases of Matisse paintings, because the latter concept requires a more sophisticated cognitive framework than the former. Further, some concepts carry greater depth, subtlety, or nuances. For example, compare “flower” with “crocus,” “horse” with “thoroughbred,” “noise” with “cacophony,” and “wood” with “mahogany.” In each pair, the second concept is more subtle, and therefore less tractable, than the first concept.³⁷

C. Incoherence

A tax regime’s level of coherence depends on the degree to which its purposes are expressed in, and served by, the legal authorities.³⁸ A coherent tax regime forms a logical whole. An incoherent regime expresses inconsistent purposes or no purpose at all. Particular purposes of an incoherent regime are subverted by legal authorities.

Incoherence generates social costs. First, coherence eases application of a tax regime. Under a coherent regime, people may interpret the law in the absence of a specific authority on point by

example, a baseball pitch that barely skirts the corner of home plate is not a strike, but is a borderline case because of its proximity to the strike zone.

34. For example, borderline cases of Michelangelo sculptures arise more frequently than borderline cases of sculptures by other artists who did not use apprentices.

35. The distinction between debt and equity in the federal income tax, for example, has generated increasing numbers of borderline cases over time, as new financial instruments have been created. See BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 4.03 (6th ed. 1994) (stating that numerous factors, including parties’ intent, risk, and issuer’s debt/equity ratio, determine whether a financial instrument is debt or equity).

36. Cf. Kaplow, *Optimal Complexity*, *supra* note 4, at 150 (characterizing legal complexity as the number and difficulty of distinctions made).

37. Some concepts that have subtlety and depth of meaning are nevertheless tractable. The concept of U.S. citizenship, for example, is both deep and tractable. It is deep because the meaning of U.S. citizenship is controversial and rooted in history and tradition. It is nevertheless tractable because it is relatively simple to determine whether a person is a U.S. citizen.

38. A tax of \$1000 on each pollution emission is less correlated with the goal of reducing environmental harm than a regime under which the amount of tax depends on the harmfulness of the pollution that is emitted. The latter tax may be more coherent by taxing more harmful pollutants more heavily. See Kaplow, *Optimal Complexity*, *supra* note 4, at 150.

considering the regime's purposes. Under an incoherent regime, interpretation of the law is more difficult because the competing purposes embodied in the regime favor inconsistent interpretations.³⁹ Second, incoherence undermines taxpayers' faith in the tax system. Taxpayers are more likely to evade tax, or take aggressive tax positions, under a regime that they perceive as arbitrary.⁴⁰

The federal income tax reflects numerous competing purposes. Although one purpose is to raise revenue in proportion to a person's income,⁴¹ many provisions are, by their terms, inconsistent with that purpose. Many types of income, such as unrealized appreciation,⁴² imputed income,⁴³ gifts,⁴⁴ and certain employee fringe benefits,⁴⁵ are excluded from the tax base for practical reasons. Corporate income is taxed at the corporate level and again at the shareholder level.⁴⁶ And savings are treated inconsistently because savings for retirement receive beneficial tax treatment.⁴⁷

A tax regime may lack global coherence but have local coherence in the sense that particular portions of the regime reflect a consistent framework and purpose. For example, the double taxation of corporate earnings under the federal income tax is developed in a logical framework in Subchapter C of the Code.⁴⁸ Local coherence enables practitioners to reason about legal consequences, within

39. See LEARNED HAND, *THE SPIRIT OF LIBERTY* 213 (1952) (stating that income tax provisions "merely dance before my eyes in a meaningless procession"), cited in MICHAEL GRAETZ & DEBORAH SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 33 (3d ed. 1995).

40. See JAMES L. PAYNE, *COSTLY RETURNS: THE BURDENS OF THE U.S. TAX SYSTEM* 103-18 (1993) (arguing that avoidance and evasion of taxes impose heavy social costs).

41. See I.R.C. § 1 (West 1988 & Supp. 1997) (imposing tax on "taxable income"); *id.* § 61 (defining "gross income"); GRAETZ & SCHENK, *supra* note 39, at 31 (stating that the current tax base is income).

42. See I.R.C. § 1001 (1994); *Eisner v. Macomber*, 252 U.S. 189, 207-08 (1920).

43. For example, income from services performed for oneself is excluded. See Nancy C. Staudt, *Taxing Housework*, 84 *GEO. L.J.* 1571, 1576 (1996).

44. See I.R.C. § 102. *But see* Andrews, *supra* note 8, at 349 (pointing out that, economically, a gift to a family member is not income to the donee).

45. See I.R.C. § 132 (excluding from income *de minimis* fringe benefits and qualified transportation fringe benefits); I.R.C. § 119 (West 1988 & Supp. 1997) (excluding from income certain employer-provided meals and lodging).

46. See I.R.C. § 11 (1994) (imposing tax on corporations); *id.* § 61(a)(7) (including dividends in gross income); *id.* § 301(c)(1) (including dividend distributions in shareholders' gross income).

47. Amounts that are contributed to retirement plans, and the income earned on such amounts, are not taxed until they are withdrawn at retirement. See I.R.C. § 401(k) (West 1988 & Supp. 1997); *id.* § 403(b).

48. Subchapter C consists of I.R.C. §§ 301-385.

limits, because statutory purposes are developed in portions of the tax regime.

My model of complexity rests on the three building blocks—complication, intractability, and incoherence—that I have outlined in Part II. The model, an analysis of two processes that cause tax complexity, follows in Part III.

III. A MODEL OF COMPLEXITY

Two processes inevitably cause complexity in a tax regime committed to raising significant revenues equitably. First, as discussed in Part III.A below, a regime committed to taxing equitably would ideally impose tax burdens in accordance with a value, such as well-being or ability to pay, that is too intractable to adopt as a measure for tax liabilities.⁴⁹ The ideal value's intractability leads such a regime to tax a proxy for the ideal value rather than the ideal itself. But the gap between the ideal and the proxy produces incoherence in the form of inequitable taxation. The incoherence of the proxy and the intractability of the ideal lead the regime to produce new authorities that adjust the regime's degree of tractability, coherence, and complication. Complexity is thus inescapable in such a regime.

Second, as discussed in Part III.B below, complication depends upon the amount of revenue that a tax regime raises.⁵⁰ Tax regimes that raise large amounts of revenue are likely to be more complicated than regimes that raise smaller amounts of revenue because the greater the revenue, the greater are the perceived benefits of reducing legal uncertainty by producing new authorities that clarify but complicate the law. Uncertainty hinders taxpayers' efforts to comply with the tax law and administrators' efforts to enforce it, leading to the production of new authorities aimed at reducing uncertainty. New authorities will be produced when the benefits outweigh the transaction costs. The benefits depend on the amount of tax revenue at stake with respect to the uncertain issue, which amount in turn correlates with the amount of revenue that the tax regime raises. Complication is thus a by-product of reducing legal uncertainty, and increases with the amount of revenue raised.⁵¹

Those two processes, achieving equity and achieving certainty, assume that law develops to serve the public interest. As discussed in Part III.C below, the tendency of lawmakers to fail to act in the

49. See *infra* notes 52-74 and accompanying text.

50. See *infra* notes 75-88 and accompanying text.

51. See *infra* note 88 and accompanying text, and Table 1.

public interest creates additional sources of complexity. Interest group pressure, the incompetence of some lawmakers, and a legal cultural taste for complication are likely to spawn each of the three types of complexity.

A. *A Commitment to Equity Causes Complexity*

A tax regime committed to equity confronts a dilemma. For such a regime, taxing equitably is an intractable ideal, but failing to tax equitably is incoherent. The regime mediates the dilemma by producing new authorities that adjust the regime's levels of coherence, tractability, and complication, exchanging one type of complexity for another, but never escaping the dilemma altogether. Any particular combination of coherence, tractability, and complication is unstable as changes in background facts pressure the regime to produce a new combination of the three types of complexity.

The ideal values for taxation in a regime committed to equity are intractable. Such regimes therefore adopt more tractable measures as proxies. The proxy bears a probabilistic relationship to the desired value and therefore produces the "right" answer with some level of frequency. The gap between the proxy and the desired value creates incoherence because cases exhibiting the desired value in the same degree are not taxed identically. The incoherence worsens as taxpayers avoid tax by avoiding the proxy, while nevertheless obtaining the value that would ideally be taxed.⁵² Incoherence prompts the production of new authorities to narrow the gap.⁵³ Those new authorities increase coherence but tend also to increase

52. For example, the federal income tax imposes tax on realized income as a proxy for true income, which is, in turn, a proxy for well-being or ability to pay. See Deborah L. Paul, *Another Uneasy Compromise: The Treatment of Hedging in a Realization Income Tax*, 3 FLA. TAX REV. 1, 5-7 (1996). Under the Haig-Simons concept of income, a gap exists between realized income and true income because increases in wealth constitute true income, even if those increases are not realized. Taxpayers exploit the gap by enjoying true income that is not taxed because it is not realized. For example, taxpayers have used hedging strategies to simulate a sale of appreciated securities. See *id.* at 26-39. Such strategies have not been treated as sales under the federal income tax. See Rev. Rul. 72-478, 1972-2 C.B. 487 (holding that a "short sale against the box" does not constitute a sale of the underlying appreciated security). From the perspective of taxing true income, there is incoherence in the failure of the federal income tax to tax significant amounts of unrealized income, such as unrealized appreciation. See Paul, *supra*, at 40-41.

53. Recently enacted legislation treats a taxpayer who simulates a sale of appreciated securities by hedging the securities as having sold the securities. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1001, 1997 U.S.C.A.N. (111 Stat.) 788, 903-08 (to be codified at I.R.C. § 1259).

complication and reduce tractability.⁵⁴

Under regimes committed to equity, people who are better off should pay more. Such regimes therefore ideally would tax well-being, utility, means, or ability to pay.⁵⁵ But those values are intractable because many circumstances are relevant to their application.⁵⁶ Consumption, wealth, and income are proxies that appear to be simpler to measure.⁵⁷ In fact, consumption, wealth, and income are themselves not particularly tractable, and proxies are needed for them.

Adam Smith's discussion of a tax on house rents illustrates the adoption of successive proxies aimed at balancing tractability and coherence. Smith's first maxim of taxation was that tax liabilities should be distributed in proportion to people's "respective abilities," which he equated with "revenue."⁵⁸ Consumption was a proxy for revenue, because people's consumption would "in most cases be nearly in proportion to their revenue."⁵⁹ But consumption was itself difficult to measure. A proxy for consumption was house rents. According to Smith, there was perhaps no better measure of "the liberality or narrowness of a man's whole expence" than his house rents.⁶⁰ House rents presented practical problems, however, because tenants could easily conceal the amount of rent they paid.⁶¹ The difficulty of measuring house rent led to the adoption of a tax on hearths. The number of hearths in a person's house was a "more obvious circumstance" than rent and was believed to correlate with

54. See Section of Taxation, N.Y. Bar Ass'n, *Comments on "Short-Against-The-Box" Proposal*, available in 96 TNT 46-35 (Mar. 6, 1996), LEXIS, FEDTAX Library (expressing concern about uncertainty regarding the scope of proposed constructive sale legislation).

55. Any of the concepts of well-being, utility, means, and ability to pay could undergird a theory of equitable taxation. Yet the concepts differ. For example, means and ability to pay emphasize how well-off a person is economically, but they likely do not take into account psychological or emotional factors unrelated to a person's economic situation. In contrast, well-being and utility do take such psychological and emotional factors into account.

56. For example, differences in health affect well-being and, therefore, ideally would be taken into account under a tax that reflects individuals' well-being. Careful measurement of differences in health would be impractical, but the deduction for medical expenses in I.R.C. § 213 provides a crude estimate. See I.R.C. § 213 (West 1988 & Supp. 1997); Andrews, *supra* note 8, at 335.

57. Nicholas Kaldor, for example, argued that consumption reflected "spending power," or "means." See KALDOR, *supra* note 7, at 25-30, 47.

58. See SMITH, *supra* note 28, bk. V, ch. II, at 350.

59. *Id.* at 399.

60. *Id.* at 369.

61. See *id.*

rent.⁶² Despite its apparent tractability, the tax on hearths was widely resented because in order to count hearths, tax inspectors needed to visit every room in the house. Such "odious" visits led to abolition of the tax.⁶³ Not easily deterred, Parliament imposed a window tax in place of the hearth tax. The number of windows in a house, like the number of hearths, was thought to vary with house rent; but counting windows was more tractable than counting hearths or determining house rents. Inspectors could count windows without entering people's houses, making enforcement of the window tax "less offensive" than enforcement of the hearth tax.⁶⁴

There is inevitably a gap between the desired value for taxation and the proxy.⁶⁵ Window taxes, for example, were deficient because of their "inequality"; large houses in the country often had lower rent and poorer tenants, but many more windows than expensive houses in London.⁶⁶ From the perspective of taxing equitably, the window tax was incoherent because of the poor correlation of the proxy with the desired measure.

Even if a proxy correlates closely with the desired measure, imposition of a tax on the proxy eventually will increase the gap. For example, under the window tax, people might reduce the number of windows in their houses by boarding windows. In response, a rule aimed at narrowing the gap between the number of windows and house rent would treat boarded windows as windows for purposes of the tax. As another example, even if, prior to enactment of the window tax, there were a perfect correlation between house rent and the number of windows, enactment of the window tax would provide an incentive for people to reduce the number of windows in their

62. *See id.* at 372.

63. *See id.*

64. *See id.* at 372-73.

65. *See* Larry Alexander, *The Gap*, 14 HARV. J.L. & PUB. POL'Y 695, 695 (1991); Duncan Kennedy, *Legal Formality*, 2 J. LEGAL STUD. 351, 384-85 (1973). Reliance on the proxy, like reliance on a rule, subverts substantive purposes by emphasizing facts that are unimportant from the point of view of purposes. *See* DWORKIN, *supra* note 25, at 24; JOSEPH RAZ, *PRACTICAL REASON AND NORMS* 49-50 (1975); FREDERICK SCHAUER, *PLAYING BY THE RULES: A PHILOSOPHICAL EXAMINATION OF RULE-BASED DECISION-MAKING IN LAW AND IN LIFE* 5-6, 29 (1991); Kaplow, *Rules Versus Standards*, *supra* note 4, at 560; Kennedy, *supra*, at 355; Miller, *supra* note 3, at 5; Schuck, *supra* note 4, at 4. For example, Professor Alstott argues that, contrary to its intended purpose of helping the working poor, the earned income tax credit of I.R.C. § 32 is available to some relatively well-off individuals, because eligibility is based on a complicated definition of income that does not correlate with wealth. *See* Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533, 571-72 (1995); I.R.C. § 32 (West 1988 & Supp. 1997).

66. *See* SMITH, *supra* note 28, bk. V, ch. II, at 372-73.

houses. Because house rents depend on many factors, it is unlikely that, after enactment, the number of windows would be as good a proxy for house rents as prior to enactment. Similarly, imposition of a tax on house rent would reduce the correlation between house rent and consumption.⁶⁷

Over time, the correlation between a proxy and the desired value is therefore likely to weaken, prompting the production of new authorities that aim to narrow the gap. For example, the federal income tax uses taxable income as a proxy for true income because true income is too difficult to measure.⁶⁸ Dissatisfaction with the gap between taxable income and true income has led to the production of new rules⁶⁹ and standards⁷⁰ aimed at narrowing the gap.

The discussion thus far has assumed that the desired value for taxation is the value consistent with equitable taxation. It could be argued, however, that the desired value is the value consistent with the optimal trade-off among the numerous goals of a tax regime, one of which may be equity.⁷¹ Under that view, optimal tax regimes are

67. If the house rent tax were high enough, people would buy smaller houses and consume through "some other channel." See SMITH, *supra* note 28, bk. V, ch. II, at 369. John Stuart Mill agreed that a steep house tax would cause "over-crowding" as people avoided "the tax by restricting their house accommodation." See MILL, *supra* note 7, bk. 5, ch. VI, § 1, at 241.

68. See *supra* note 65; see also Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 983-84 (1967) (stating that the federal income tax confronts "the paradox of the 'second best'" because it excludes some income from the base).

69. See, e.g., I.R.C. §§ 55-59 (West 1988 & Supp. 1997) (alternative minimum tax).

70. See, e.g., I.R.C. § 357(b) (1994) (establishing a "principal purpose" test for gain recognition upon the contribution of encumbered property to a corporation); Treas. Reg. § 1.701-2(b) (as amended in 1995) (providing that application of partnership tax provisions must be consistent with the provisions' "intent"); *id.* § 1.1275-2(g) (as amended in 1996) (permitting the Commissioner to depart from original issue discount regulations if "a principal purpose" of the transaction is "unreasonable in light of the purposes of [the statute]").

71. See Ehrlich & Posner, *supra* note 4, at 261 (suggesting the use of cost-benefit analysis to determine the optimal degree of specificity of a legal command); Kaplow, *Optimal Complexity*, *supra* note 4, at 150-51 (same); Kaplow, *Tax Complexity and Enforcement*, *supra* note 3, at 136 (suggesting the application of a unified social welfare analysis to determine the optimal trade-off); cf. Louis Kaplow, *A Fundamental Objection to Tax Equity Norms: A Call for Utilitarianism*, 48 NAT'L TAX J. 497, 498 (1996) (recommending that the Pareto principle be followed in the formulation of tax policy). A "Pareto efficient" situation is one in which no transfer could improve one person's utility without reducing the utility of another person. See SAMUELSON & NORDHAUS, *supra* note 8, at 743-44.

A difficulty with the trade-off theory is the challenge of measuring the costs of equity violations in order to compare them with simplicity benefits. Cf. JOHN RAWLS, *A THEORY OF JUSTICE* 26-28 (1971) (refusing to balance claims of liberty and right against

coherent, even though they do not tax in as equitable a manner as possible. For example, suppose that people tend to fall into three categories of well-being: A, B, and C, with the people in group A the least well-off, the people in group B moderately well-off, and the people in group C the most well-off. Suppose further that group B consists of two subgroups, B1 and B2, and that it is especially difficult to distinguish between people in group A and people in group B1. In a bow to tractability, but a sacrifice of equity, Congress could decide to undertax people in group B1 by taxing them in the same manner as people in group A.⁷² The regime's trade-off would arguably be coherent. Indeed, many federal income tax statutory provisions and regulations exhibit trade-offs that accomplish such "rough justice."⁷³

However, an optimal trade-off is difficult to achieve. First, the determination whether proposed tax legislation is optimal must be based on expectations about how many people will be overtaxed or undertaxed, and by how much, *in equilibrium*, rather than at the time the legislation is enacted. Suppose that in the example, the trade-off was acceptable because the equity cost, consisting of undertaxation of people in group B1 (and consequent overtaxation of people in groups A, B2, or C), was low because there were few people in group B1. Congress decided that the costs of undertaxing the few people in group B1 by a large amount and overtaxing the many people in groups A, B2, or C each by a small amount were offset by the simplicity benefit of treating people in groups A and B1 the same. The tax legislation is itself likely to change the distribution of people among the groups. People in group B2 will have an incentive to move into group B1 because they will maintain their level of well-being but reduce their taxes. In equilibrium, the number of people in group B1 will be higher than at the time the legislation is enacted. It is unlikely that all the people in group B2 will move into group B1 because there are likely to be transaction costs associated with such movement. Thus, determining the distribution of people among the groups in equilibrium, and consequently whether a particular trade-

increases in social welfare). Nevertheless, Congress may be satisfied with undertaxing one person by a huge amount and overtaxing one million people by a very small amount, but not with undertaxing 1000 people by a large amount and overtaxing 999,000 people by a small amount.

72. In fact, assuming that revenues are to remain constant, the undertaxation of people in B1 must lead to overtaxation of people in groups A, B2, or C.

73. See, e.g., Treas. Reg. § 1.162-2 (1960) (providing formulaic allocation for transportation expenses incurred in a trip undertaken for both business and pleasure); *id.* § 1.1221-2 (as amended in 1996) (providing a rigid identification requirement for hedging transactions to qualify for ordinary treatment).

off is optimal, depends on, among other things, an estimation of the transaction costs associated with moving into the undertaxed group.⁷⁴

Second, even if the equilibrium distribution can be predicted, a trade-off is likely to be optimal only temporarily. The distribution of people in groups A, B1, B2, and C will change for nontax reasons. A trade-off that is optimal based on an expectation that, in equilibrium, only a few outliers are being undertaxed, may not be optimal if it turns out that more people are undertaxed than expected. Suppose that Congress determined that taxing people in groups A and B1 in the same manner was optimal because in equilibrium there would be only ten people in group B1. Suppose further that many people in group B2 move into group B1 because, for example, an improvement in technology reduces the transaction costs associated with so moving. If the number of people in group B1 in equilibrium greatly exceeds ten, the decision to tax people in group B1 in the same manner as people in group A may no longer be optimal.

Moreover, a trade-off also is likely to be optimal only temporarily because notions of equity change over time. A trade-off that is optimal, based on an expectation that there will be ten people in group B1 and 100 people in each of groups A, B2, and C in equilibrium, may not remain optimal because of changes in views about equity and progressivity. If the trade-off became suboptimal, new authorities would be produced to treat people in group B1 differently from people in group A, increasing the complication and reducing the tractability of the regime.

B. Financial Pressure to Reduce Uncertainty Causes Complication

The number and detail of new authorities produced by a tax regime depends on the financial stake that taxpayers and the government have in reducing uncertainty. Any words and phrases used by a legal regime have some degree of uncertainty because

74. There are many examples of tax regimes providing for disparate tax burdens on similar persons when equity is compromised in favor of practical considerations. For example, states that impose retail sales taxes often do not enforce their compensating use taxes, encouraging residents of those states to shop in neighboring jurisdictions that impose lower retail sales taxes. See Steven Prokesch, *New York State Crosses the Hudson in Search of Taxes*, N.Y. TIMES, Dec. 9, 1992, at B5 (describing how New York City residents travel to New Jersey to shop in order to avoid New York City's 8¼% sales tax). A decision not to enforce the use tax may be optimal because the cost of enforcement outweighs the equity benefit of collecting it. The optimality must be assessed based on the number of state residents who will shop out-of-state to avoid sales tax *in equilibrium*, not the number who shop out-of-state prior to enactment.

language is “irreducibly open-textured,” according to H.L.A. Hart.⁷⁵ There is, according to philosopher J.L. Austin, a contemporary of Hart, “no terminus to the business of making ever finer divisions and discriminations.”⁷⁶ And Georg Wilhelm Friedrich Hegel believed that even under a tax regime that attempts to settle matters precisely, a “certain latitude of settlement accordingly is left; and each point may be determined in one way on one principle, in another way on another, and admits of no definitive certainty.”⁷⁷ The application of a tax provision is clear in core cases, but uncertain in others.

A new legal authority can reduce uncertainty, but producing it involves transaction costs. Such new authorities are therefore likely to be produced only if the parties incurring the costs receive a benefit. That connection was recognized in 1921 by Ogden Mills, a congressman from New York. Attacking the view that a retail sales tax would be simple, he argued that

from past experience, it is doubtful whether any tax which involves the payment of . . . [substantial sums] can be collected without considerable difficulty. As long as the amounts involved are small, questions of interpretation are not raised, but when the amounts become really important, any number of intricate and doubtful points come to light.⁷⁸

When revenue stakes are high, complication is likely to develop as new judicial opinions and administrative authorities are created to reduce uncertainty.

For example, a judicial opinion is produced when the amount of money at stake in a dispute between the taxpayer and the government exceeds the transaction costs of litigating. Each party will litigate if its expected benefits exceed its expected costs.⁷⁹

75. See H.L.A. HART, *THE CONCEPT OF LAW* 128 (2d ed. 1994); POSNER, *supra* note 4, at 541. Tax laws, like other laws, are indeterminate at some points of application. They have *open texture*.

76. J.L. AUSTIN, *SENSE AND SENSIBILIA* 127-28 (1962).

77. G.W.F. HEGEL, *HEGEL'S LOGIC* § 16, at 21 (William Wallace trans., Oxford Univ. Press 3d ed. 1975) (1873).

78. Ogden L. Mills, *The Spendings Tax*, 7 BULL. OF THE NAT'L TAX ASS'N 18, 19 (1922). Mills was challenging the view that a sales tax would be simpler than the direct consumption tax that he advocated. See *id.*; see also Bittker, *supra* note 3, at 2 (arguing that only an “incorrigible optimist” could expect simplicity from a tax that raises billions of dollars).

79. See POSNER, *supra* note 4, at 541. The taxpayer's expected benefits are the taxpayer's probability of success multiplied by the amount at stake for her. The taxpayer's amount at stake includes the amount at stake in the potential litigation and, if the taxpayer is a repeat player with respect to the disputed issue, the amount at stake in the future for the taxpayer with respect to that issue. The taxpayer's amount at stake also

Judicial authorities are likely to be produced at a more rapid pace in a larger economy than in a smaller economy because all else equal, as the size of the economy increases, tax liabilities, and therefore the expected benefits of litigation, are likely to rise more quickly than the transaction costs of litigation. In addition, smaller economies are likely to exhibit fewer cases outside the core case of a tax provision simply because smaller economies exhibit fewer cases altogether. Further, two tax regimes that raise the same amount of revenue but differ in the number of taxpayers are likely to generate new judicial authorities at different rates. The regime with fewer taxpayers is likely to generate new judicial authorities more rapidly because tax revenues per taxpayer are higher in that regime and are therefore more likely to exceed the transaction costs of litigation.

Administrative authorities, like judicial opinions, aim to reduce uncertainty. Consider a regime under which a person was taxed based on the square footage per resident in the person's primary residence. Numerous technical questions would arise. Does the square footage include outdoor areas? Patios? Closet space? Unusable outdoor or indoor space? The boiler room? Sleeping lofts? How are units in multi-family residences delineated? Does a college student who lives most of the year in a dorm constitute a resident of her parent's house? How about a live-in nanny? Does a traveling salesman with no permanent residence owe tax?

Administrators can address those issues efficiently.⁸⁰ Transaction costs consist primarily of the opportunity costs of the administrator's time. Taxpayer costs are relatively low because taxpayers have limited involvement in the promulgation of

reflects the possibility that another person will litigate the issue to judgment, enabling the taxpayer to free-ride on the other person's efforts. The taxpayer's expected costs are the transaction costs of litigating, including lawyers' fees and opportunities lost because resources are devoted to litigation. The government's expected benefits are its probability of success multiplied by the amount at stake for the government, taking into account the many taxpayers for whom the disputed issue arises. The government's expected costs are its transaction costs, including opportunity costs, such as the opportunity to pursue other litigation.

If a party's expected benefits from litigation do not exceed its expected costs, then it likely will not initiate a lawsuit and would be inclined to settle a lawsuit brought against it. In either event, no judicial opinion would be generated. *See id.*; cf. White, *supra* note 3, at 348-50 (applying economic analysis to the IRS's decision whether to settle or litigate).

80. *See* Letter from Michael L. Schler, Chair, N.Y. Bar Ass'n Tax Section, to the Hon. Bob Dole and the Hon. Newt Gingrich (Jan. 19, 1995) (on file with the *North Carolina Law Review*) (arguing that suspension of and obstacles to regulatory rulemaking in H.R. 450, S. 219, and H.R. 9 should not apply to the IRS); *see also* Ehrlich & Posner, *supra* note 4, at 257 (explaining that the social costs and benefits of a legal command depend on the command's specificity).

administrative guidance.⁸¹

Dedication of social resources to the production of administrative authorities becomes increasingly efficient as the amount of money at stake in resolving an issue increases.⁸² Thus, jurisdictions with smaller economies and smaller governments tend to dedicate fewer resources, including administrators' time, to the production of administrative guidance, resulting in less complication than arises in jurisdictions with larger economies and governments.

The production of new judicial or administrative authorities tends to increase complication over time. First, new authorities often supplement, rather than supplant, old authorities.⁸³ Second, in a classic example of a collective action problem, the cumulative effect of producing many legal authorities, each of which reduces uncertainty for the parties involved, is likely to be a net increase in uncertainty requiring yet more legal authorities to address the new uncertainty. The more authorities that exist, the more likely that tensions will develop among them. New authorities that reduce uncertainty in one respect may increase uncertainty in other respects by creating new categories, leading to the need for yet more guidance.⁸⁴ A particular authority may raise more questions than it

81. Taxpayers are entitled to comment on administrative regulations under the Administrative Procedure Act, 5 U.S.C. §§ 701-706 (1994), at relatively low cost, and some taxpayers do so. Obtaining a private letter ruling from the Internal Revenue Service, on the other hand, is more expensive and time-consuming. A private letter ruling provides guidance on specific legal issues relating to an anticipated transaction and applies only to the taxpayer who requested it. Accordingly, the taxpayer must stipulate or demonstrate facts, and must brief legal arguments. See, e.g., Rev. Proc. 77-37, 1977-2 C.B. 568 (establishing the requirements for requesting that the Internal Revenue Service issue a ruling with respect to a reorganization). Litigation is more expensive still.

82. Cf. Kaplow, *Optimal Complexity*, *supra* note 4, at 150-51 (analyzing costs and benefits of legal complexity).

83. For example, a new judicial opinion increases complication by increasing the number of authorities that constitute the tax regime. In rare cases, a new opinion will not increase complication, because it eliminates other legal authorities. For example, if a new Supreme Court opinion rejected a complicated doctrine, the net result would be fewer authorities. One new authority would be traded for numerous old authorities. It is possible, for example, that the Supreme Court may overturn the "continuity of interest" doctrine that applies to corporate reorganizations. See David S. Miller, *The Devolution and Inevitable Extinction of the Continuity of Interest Doctrine*, 3 FLA. TAX REV. 187, 189-90 (1996) (suggesting that the continuity of interest doctrine may soon be abandoned). Such a decision would eliminate a host of authorities that delineate the doctrine. See, e.g., *John A. Nelson Co. v. Helvering*, 296 U.S. 374, 376-77 (1935); *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332, 334 (5th Cir. 1951). See generally POSNER, *supra* note 4, at 539-40 (explaining that precedents obsolesce over time).

84. See D'Amato, *supra* note 4, at 4-5.

answers.⁸⁵ An additional authority may undermine certainty of an answer that otherwise would have seemed settled.⁸⁶ Complication paves the way for yet more complication.⁸⁷

Empirical data confirm that complication of a tax regime is correlated with the amount of tax revenue that the regime raises. Table 1 illustrates a relationship between state tax revenues and a rough measure of complication—the number of Commerce Clearing House (“CCH”) tax reporter volumes for each state. Such reporters include statutes, regulations, summaries of cases, other authorities, and CCH commentary and explanation. The two states raising the greatest amount of revenue, California and New York, have the largest number of CCH volumes, with four and seven, respectively. The medium revenue raisers, Illinois, Michigan, Massachusetts, North Carolina, and Alabama, each have two reporter volumes. The states raising the least revenue, Rhode Island, North Dakota, and Wyoming, each have one volume.

At the federal level also, complication is approximately correlated with the amount of revenue raised. Table 2 compares tax collections for the federal income, excise, customs, and estate and gift taxes with the number of reporter volumes for each type of tax. The individual and corporate income taxes dwarf the others in terms of revenues raised and number of reporter volumes. Excise taxes raise more revenue than estate and gift taxes but have fewer reporter volumes, perhaps because the estate and gift tax regime is older than many excise taxes and therefore has had more time to develop.⁸⁸

85. See, e.g., *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 222 (1988) (unsettling the scope of the I.R.C. § 1221 inventory exclusion by narrowly interpreting the doctrine of *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 51-54 (1955), to mean that the only hedging transactions covered by the exclusion are those that are “an integral part of a business’s inventory-purchase system”); *Lessinger v. Commissioner*, 872 F.2d 519, 526-28 (2d Cir. 1989) (appearing to curtail the scope of I.R.C. § 357(c) gain recognition by upholding a simple tax avoidance technique).

86. See, e.g., *Arkansas Best*, 485 U.S. at 222; *Lessinger*, 872 F.2d at 526-28. Indeed, substantial uncertainty exists in the application of the federal income tax, notwithstanding the regime’s many and detailed legal authorities. See Roberts et al., *supra* note 3, at 327 (“A reasonably certain conclusion cannot in some instances be determined despite diligent and expert research.”).

87. Complication, however, increases the transaction costs associated with producing new authorities. For example, complication increases the transaction costs of litigation, which deter litigation over small issues and thereby slow the pace of complication.

88. The estate tax was enacted in 1916, see RANDOLPH E. PAUL, *TAXATION IN THE UNITED STATES* 108 (1954), while many of the energy-related excise taxes were enacted in the late 1970s and early 1980s, see, e.g., Surface Transportation Act of 1982, Pub. L. No. 97-424, § 512(b)(1), 96 Stat. 2097, 2174 (1983) (codified as amended at I.R.C. § 4051 (1994)) (establishing an excise tax on heavy trucks and trailers sold at retail); Energy Tax

TABLE 1: STATE TAX COLLECTIONS AND COMPLICATION

State	Total Tax Collections for Year Ending December 1993 (in thousands) ^a	Number of CCH Reporter Volumes ^b
California	\$48,590,818	4
New York	31,528,418	7 ^c
Illinois	14,499,367	2
Michigan	12,122,489	2
Massachusetts	10,771,498	2
North Carolina	10,047,866	2
Alabama	4,631,460	2
Rhode Island	1,409,744	1
North Dakota	821,468	1
Wyoming	628,685	1

a. See BUREAU OF THE CENSUS, DEP'T OF COMMERCE, NO. GT/93-Q4, QUARTERLY SUMMARY OF FEDERAL, STATE, AND LOCAL TAX REVENUE, OCTOBER-DECEMBER 1993, at 9 (1995).

b. See COMMERCE CLEARING HOUSE, INC., STATE TAX REPORTERS (1996).

c. The New York volumes consist of five New York State volumes and two New York City volumes.

Thus, taxpayers and the government each take steps to reduce uncertainty as to a particular tax issue if the costs of taking those steps are less than the expected benefits of reducing tax uncertainty. Those steps will in many cases lead to the production of a new legislative provision, judicial opinion, or administrative regulation that reduces uncertainty on the particular issue but increases the overall complication of the tax regime. Furthermore, that increased complication creates new areas of uncertainty, which generate the need for yet further clarifying authorities.

Act of 1978, Pub. L. No. 95-618, § 201(a), 92 Stat. 3174, 3180 (1978) (codified as amended at I.R.C. § 4064) (establishing an excise tax on gas guzzlers). The estate and gift tax may also be less tractable than excise taxes, contributing to greater complication.

TABLE 2: FEDERAL TAX COLLECTIONS AND COMPLICATION

Type of Tax	Total Tax Collections for 12 months Ending December 1993 (in millions) ^a	Number of CCH Reporter Volumes ^b	Number of RIA Reporter Volumes ^c
Individual Income	\$510,188	22	20
Corporate Income	123,601		
Excise	46,782 ^d	1	1
Customs Duties	19,144	0	0
Estate and Gift	13,111	3	2

a. See BUREAU OF THE CENSUS, DEP'T OF COMMERCE, NO. GT/93-Q4, QUARTERLY SUMMARY OF FEDERAL, STATE, AND LOCAL TAX REVENUE, OCTOBER-DECEMBER 1993, at 4 (1995). Total collections of customs duties reflects actual U.S. customs plus an estimated amount from Puerto Rico.

b. See COMMERCE CLEARING HOUSE, INC., STANDARD FEDERAL TAX REPORTER (1996); COMMERCE CLEARING HOUSE, INC., FEDERAL ESTATE AND GIFT TAX REPORTER (1996); COMMERCE CLEARING HOUSE, INC., EXCISE TAX REPORTER (1996).

c. See RESEARCH INSTITUTE OF AMERICA, INC., UNITED STATES TAX REPORTER: INCOME TAXES (1996) (18 volumes); RESEARCH INSTITUTE OF AMERICA, INC., UNITED STATES TAX REPORTER: INTERNAL REVENUE CODE (1996) (two volumes); RESEARCH INSTITUTE OF AMERICA, INC., UNITED STATES TAX REPORTER: ESTATE & GIFT TAXES (1996) (two volumes); RESEARCH INSTITUTE OF AMERICA, INC., UNITED STATES TAX REPORTER: EXCISE TAXES (1996) (one volume).

d. The amount of revenue from excise taxes is for the 12-month period ending in September 1993, because of the unavailability of December 1993 data in the original source. See BUREAU OF THE CENSUS, DEP'T OF COMMERCE, NO. GT/93-Q4, QUARTERLY SUMMARY OF FEDERAL, STATE, AND LOCAL TAX REVENUE, OCTOBER-DECEMBER 1993, at 4 (1995).

C. Interest Groups, Lawmakers' Competence, and Legal Taste

The equity-based and certainty-based sources of complexity assume that law develops in a manner that serves the public interest.

That assumption is open to question. First, public choice theory urges that collective action problems and lawmakers' desires to promote their self-interests place disproportionate influence in the hands of small, well-organized interest groups.⁸⁹ Second, a lawmaker who intends to act in the public interest will fail if her competence level is low. Third, lawmakers in the United States indulge preferences of *lawyers* for particular legal styles, including a taste for complication.⁹⁰ Satisfaction of such preferences does not always serve the public interest. Those three ways in which the law departs from serving the public interest contribute to complication, intractability, and incoherence.

Under the public choice view, dramatic reduction in federal tax complexity is not possible over the long run. Simplicity is always undercut by the self-interested behavior of legislators and by collective action problems. Legislators advance their own interests by seeking to maximize their chances of reelection. Legislators' preferences do not mirror the preferences of the majority of their constituents, however, because collective action problems subvert the ability of members of the diffuse general public to communicate their views to legislators. Instead, small, well-organized interest groups exercise a disproportionate impact on legislation.⁹¹

89. Foundational writings on public choice theory are KENNETH J. ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (1951), JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT* (1962), and George J. Stigler, *The Theory of Economic Regulation*, 2 *BELL J. ECON. & MGMT. SCI.* 3 (1971). More recent works include DANIEL A. FARBER & PHILIP P. FRICKEY, *LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION* (1991) (providing a comprehensive analysis of public choice theory), DENNIS C. MUELLER, *PUBLIC CHOICE II* (1989) (analyzing the game theory component of public choice), Edward L. Rubin, *Beyond Public Choice: Comprehensive Rationality in the Writing and Reading of Statutes*, 66 *N.Y.U. L. REV.* 1, 5-23 (1991) (explaining that the three major strands of public choice theory—the reelection-maximizer model of legislators, the collective choice model, and the interest-group model—do not follow directly from the assumption that politicians are rational egoists), and Robert D. Tollison, *Public Choice and Legislation*, 74 *VA. L. REV.* 339 (1988) (surveying the literature on public choice). Public choice theory explains politics as a process in which each actor seeks to maximize her individual self-interest. See Rubin, *supra*, at 5.

90. See *infra* notes 110-13 and accompanying text.

91. Public choice theory assumes that political actors aim to maximize their individual utility. The theory has three principal components each related to that assumption. First, taking its cue from mathematical game theory, public choice argues that the decisionmaking process by which preferences of members of a group are aggregated to produce a "collective choice" often produces surprising results. See Rubin, *supra* note 89, at 6. For example, Arrow's Theorem argues that majority rule sometimes produces inconclusive results. Suppose that three people, Alice, Bill, and Charlie, must choose among swimming, tennis, and badminton. Alice likes swimming best, tennis second, and badminton third. Bill likes tennis best, badminton second, and swimming

Public choice scholars view tax legislation as reflecting the diverse competing interests of the most powerful, well-organized groups.⁹² Richard Doernberg and Fred McChesney describe tax legislation as the result of an “auction” in which constituencies transfer money and in-kind benefits to legislators in exchange for “tax favors.”⁹³ Congress sells subsidies and incentives, or “tax expenditures,”⁹⁴ to the “highest bidder.”⁹⁵ Since tax simplicity is not an ideal that is likely to develop its own independent constituency, complicated, intractable, and incoherent legislation is likely to ensue, according to the public choice view, as self-promoting politicians pander to the special interests by sprinkling loopholes throughout the federal income tax without any regard for the costs imposed on the rest of society.⁹⁶

third. Charlie likes badminton best, swimming second, and tennis third. Any pair of choices will produce a majority. For example, if the group is offered a choice between swimming and tennis, swimming wins. As between swimming and badminton, badminton wins. And, as between tennis and badminton, tennis wins. Thus, depending on the order in which the choices are offered, any one of the three activities could be chosen. *See id.* at 7. Second, public choice argues that legislation reflects special interests, rather than the public interest, disproportionately. On this view, powerful wealthy people and institutions join together around a common goal and influence legislators to pass favorable legislation. The benefits of joining together far exceed the costs. For a member of the general public, the transaction costs associated with joining with others who share his interests and with influencing legislators are prohibitive. *See id.* at 9-13. Third, public choice theory argues that legislators seek to maximize their chances of reelection. *See id.* at 14-15.

92. *See* J. Clifton Fleming, Jr., *Scoping Out the Uncertain Simplification (Complication?) Effects of VATs, BATs and Consumed Income Taxes*, 2 FLA. TAX REV. 390, 442 (1995) (arguing that the political process is “likely to deliver a much more complicated consumption tax package” than “textbook descriptions” would indicate). Under a consumption tax, lobbyists would continue to agitate for special benefits for their clients. In fact, at least one consumption tax bill reflects the inevitable concessions that would be made on the path to enactment by including special deductions for charitable contributions and mortgage interest. *See* S. 488, 104th Cong. §§ 2, 3 (1995).

93. *See* Richard L. Doernberg & Fred S. McChesney, *Doing Good or Doing Well?: Congress and the Tax Reform Act of 1986*, 62 N.Y.U. L. REV. 891, 896-98 (1987) (book review essay).

94. *See* McDaniel, *supra* note 3, at 48, 72-75 (observing that lobbyists increase complexity by preserving or expanding “tax expenditures”). *But see* Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165, 1166 (1993) (defending tax expenditures on the public interest grounds that tax legislation is less susceptible than direct spending programs to “interest group capture”).

95. *See* Doernberg & McChesney, *supra* note 93, at 898.

96. All else equal, interest groups favor legislation that simplifies their own tax compliance, but such legislation might make the regime more complex overall. For example, small businesses might join forces to narrow the scope of a value added tax by seeking optional exemptions. *See infra* note 271 (discussing reasons for small businesses to seek tax exemptions). But such a change would increase the number and detail of

Complexity serves the interests not only of legislators, but also of the IRS. As Professor Schuck has argued, complexity enhances the power and autonomy of administrative agencies by constraining regulatees yet preserving agency flexibility.⁹⁷ Complicated regulations with a broad scope limit the ability of regulatees to avoid an agency's jurisdiction or requirements.⁹⁸ Intractability meanwhile enhances the agency's flexibility and limits the ability of Congress, the media, and the public to control the agency.⁹⁹

Public choice theory has been criticized as overly reductive.¹⁰⁰ Even if the theory is correct that legislators aim to maximize their own utility, it possibly takes an overly narrow view of legislators' perceptions of their own utility. Its assumption that a legislator's self-interest consists exclusively of attaining reelection overlooks that legislators often have other goals, such as enhancing their personal prestige, wealth, and career prospects, and improving the public welfare.¹⁰¹ Professor Shaviro has argued, for example, that legislators advance their own prestige through tax legislation, which serves as a statutory monument to its proponents.¹⁰²

Under such a modified public choice view, legislators aim to maximize their own multidimensional utility functions, advocating tax legislation that enhances prestige and serves as a social symbol to advance legislators' goals. In addition to providing legislators with a slush fund from which they can dole out benefits, the tax system provides a forum for them to pursue larger social themes.¹⁰³

authorities and decrease tractability because the regime would rely on a new concept of "small businesses." Cf. I.R.C. § 1361(b) (West 1988 & Supp. 1997) (defining "small business corporation"). Complication would develop in identifying which businesses were eligible for the exemption. Cf. Schenk, *supra* note 3, at 123 (pointing out that no constituency exists for simplicity).

97. See Schuck, *supra* note 4, at 30-31.

98. For example, the IRS was criticized as exceeding its regulatory authority when it proposed and then finalized "anti-abuse" rules relating to partnerships. See 1 WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 1.05[1] (3d ed. 1997).

99. See Schuck, *supra* note 4, at 30-31.

100. See Rubin, *supra* note 89, at 31-38; Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 76-106 (1990).

101. See Rubin, *supra* note 89, at 31 (noting that legislators exercise "comprehensive rationality" to advance a broad range of goals); Shaviro, *supra* note 100, at 8 (arguing that public choice scholarship inappropriately views the pursuit of self-interest as equivalent to wealth maximization).

102. See Shaviro, *supra* note 100, at 9-10.

103. See 1995 Hearing, *supra* note 19, at 213 (testimony of Leslie Samuels) (arguing that a consumption tax, like the federal income tax, would "still promote social and economic goals").

Under that view, as under the unmodified public choice view, tax legislation is likely to be complex. First, a legislator can pitch herself as for or against virtually any social policy by supporting or opposing tax legislation. For example, a candidate could advocate a tax credit for adoption to bolster an anti-abortion plank, or advocate benefits for businesses to prove that she is for economic growth.¹⁰⁴ To the extent that legislators have a genuine concern for the social policies promoted or harmed by a tax provision, different legislators are likely to be attracted to different social policies. Thus, the tax regime is likely to be complicated, intractable, and incoherent, reflecting compromises among competing purposes. Second, to the extent that a legislator's commitment to particular social policies is a pretense, the legislator is likely to tinker with the tax regime, producing new statutory provisions that serve the legislator's current allegiance.¹⁰⁵ Symbolic positioning with respect to tax issues has a long history¹⁰⁶ and is likely to result in the three types of complexity.

The competence of public officials varies. A low level of competence contributes to complexity, even when public officials intend to act in the public interest. Only the Tax Court, the Court of Claims, and the Federal Circuit have a regular docket of tax cases. Grounds for tax decisions are often surprising.¹⁰⁷ Louis Eisenstein

104. The names of tax bills often express broad social themes. *See, e.g.*, Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997); Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (1996); Family Reinforcement Act, H.R. 11, 104th Cong. (1995); American Dream Restoration Act, H.R. 6, 104th Cong. (1995).

105. Under the modified public choice view, allegiance to a social policy is often a pretense for the legislator's true allegiance to something else. A legislator will favor and promote legislation that serves the interests of the legislator's true allegiance without regard to whether the legislation serves the public good. Different legislators will have different allegiances. Special tax benefits for particular types of taxpayers are likely to be enacted in a manner that reflects no comprehensive social policy, but rather a compromise among inconsistent allegiances. *See generally* Shaviro, *supra* note 100, at 81-87 (emphasizing legislators' desire for power, prestige, and influence).

106. Robert Stanley argues that nineteenth-century politicians manipulated intricate tariff schedules in order to satisfy constituents and meanwhile maintain "simplistic poses" favoring protectionism or other social positions. *See* ROBERT STANLEY, *DIMENSIONS OF LAW IN THE SERVICE OF ORDER* 26-27 (1993). Congressional debate over tariff legislation gave legislators "ready-made speeches" at election time "couched in the rhetoric of flag and Republic." *See id.*

107. For example, at issue in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988), was whether a sale of subsidiary stock gave rise to capital or ordinary loss. *See id.* at 223. The Supreme Court's discussion of the treatment of business hedging, which was not involved in the case, undermined a 30-year-old doctrine upon which taxpayers had until then relied. *See id.* at 222; *see also* *Lessinger v. Commissioner*, 872 F.2d 519, 526 (2d Cir. 1989) (holding that a transfer of assets and liabilities of a sole proprietorship with negative net worth to a wholly-owned corporation does not result in a taxable gain).

questioned whether the Supreme Court could “in a four-week period overcrowded with vital issues of statecraft” adequately understand technical tax issues and refrain from “indulging in generalities” that would resolve the immediate case, but “wreak havoc in other contexts.”¹⁰⁸ Indeed, Supreme Court tax decisions periodically have been overruled by new legislation.¹⁰⁹ A poorly drafted statutory provision, administrative ruling, or judicial opinion creates new intractability and incoherence, prompting the need for additional clarifying legislative, administrative, or judicial pronouncements.

Finally, lawmakers indulge a legal cultural taste for complication. United States legal culture prizes intricacy and elaboration.¹¹⁰ Agreements drafted by United States lawyers tend to be more detailed than agreements drafted by European lawyers.¹¹¹ Complication appeals aesthetically as a “craft value” to legal scholars, as Professor Schuck argues,¹¹² and, I would add, to lawyers and lawmakers in general. Thus, United States lawmakers favor complicated regimes even if such regimes do not serve the public interest.¹¹³

I have identified two sources of tax complexity previously unanalyzed in the literature. First, the aspiration to achieve an equitable system creates intractable goals. Tractable proxies are introduced, but the aspiration is never entirely lost. New authorities produce complication that mediates between the intractability of the ideals and the incoherence of a tractable system. Second, financial pressure to reduce uncertainty produces complication. Finally, I have discussed the role in creating complexity of special interest groups, lawmakers’ competence, and the taste of lawyers for complication. I

108. Louis Eisenstein, *Some Iconoclastic Reflections on Tax Administration*, 58 HARV. L. REV. 477, 525 (1945).

109. See, e.g., I.R.C. §§ 311(b), 336(a) (1994) (reversing the doctrine of *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200, 204 (1935), to require corporate tax on distributions of appreciated property); see also Treas. Reg. § 1.1221-2 (as amended in 1996) (defining the scope of the I.R.C. § 1221 inventory exclusion more broadly than suggested in *Arkansas Best Corp.*, 485 U.S. at 222).

110. According to one experienced lawyer and observer of legal culture, American lawyers seek “scientific certainty” through precise crafting of words designed to anticipate every contingency. See PHILIP K. HOWARD, *THE DEATH OF COMMON SENSE* 29 (1994). Precision is considered the “highest art of American lawmaking.” *Id.*

111. See *id.* at 26 (pointing out that United States business agreements often comprise several hundred single-spaced pages, while similar agreements in Switzerland would typically be 10-20 pages).

112. See Schuck, *supra* note 4, at 34-35.

113. See Manning, *supra* note 3, at 14 (urging lawyers to restrain their “intellectual urge to ‘fix’ the law by complicating it”).

will now tie my model to the debate over adoption of a federal consumption tax.

IV. CONSUMPTION TAX STRUCTURES

My model of complexity challenges the formal and theoretical argument that consumption taxes are simpler than income taxes. Before analyzing that argument and applying my model of complexity to consumption taxes, I describe in this Part IV, for readers who are unfamiliar with consumption taxes, the traditional structures by which such taxes are imposed.

Consumption taxes aim to distribute tax liabilities in proportion to human consumption.¹¹⁴ *Direct* consumption taxes require individuals to file tax returns and pay tax directly to the government, as individuals presently are required to do under the federal income tax. Direct consumption taxes use a “cash flow” approach, a “tax prepaid” approach, or both to measure consumption. *Indirect* consumption taxes, such as retail sales taxes and value added taxes, are believed to burden consumers but formally collect tax only from businesses.¹¹⁵ Businesses, rather than individuals, file tax returns and make payments to the government under an indirect consumption tax.

A. *Direct Consumption Taxes*

Direct consumption taxes measure an individual's tax liability primarily on a “cash flow” basis.¹¹⁶ In calculating the tax, individuals include all cash receipts and deduct the amount of cash that they save.¹¹⁷ How does including cash receipts and deducting cash saved

114. See JOINT COMMITTEE ON TAXATION, DESCRIPTION AND ANALYSIS OF PROPOSALS TO REPLACE THE FEDERAL INCOME TAX 51-52 (1995) (stating that value added tax, retail sales tax, flat tax, and consumed income taxes fundamentally aim at the same consumption tax base); David Bradford, *What Are Consumption Taxes and Who Pays Them?*, 39 TAX NOTES 383, 384-88 (1988).

115. See KALDOR, *supra* note 7, at 21 (pointing out that direct taxes are levied on persons, while indirect taxes are levied on transactions); SAMUELSON & NORDHAUS, *supra* note 8, at 305 (stating that indirect consumption taxes are imposed on sales of goods and services and, therefore, indirectly on individuals). Businesses do not consume, however; people consume. The imposition of tax on businesses is designed to tax human consumption.

116. A direct consumption tax is sometimes referred to as a “cash flow consumption tax,” “expenditure tax,” or “consumed income tax.” The “cash flow” approach, characterized by a deduction for savings, is also known as the “qualified account” approach. See BLUEPRINTS, *supra* note 7, at 114.

117. See *id.* at 9-10, 113; BRADFORD, *supra* note 3, at 89-94, 113; Andrews, *Consumption-Type Tax*, *supra* note 7, at 1116, 1151; William D. Andrews, *A Supplemental*

measure consumption? Consider a simple case in which a person receives cash in the form of wages.¹¹⁸ She could spend the cash on consumption, such as housing, clothing, food, and recreation, or she could save the cash, for example, by depositing it in a bank account or purchasing a share of stock. Suppose that she receives \$100 in cash wages, spends \$25 on dining, and uses the remaining \$75 to purchase shares in a mutual fund. A direct consumption tax would calculate the amount of her consumption by subtracting her cash that is saved from her cash receipts. The formula correctly calculates consumption as \$25, equal to the \$100 cash receipts minus the \$75 mutual fund purchase.

The formula tracks consumption, not only in simple cases, but also in more complicated cases.¹¹⁹ Suppose that a taxpayer earns cash income from an investment, for example, by receiving \$10 of cash dividends during the year. If the taxpayer reinvests the \$10 by purchasing gold, then her consumption for the year is zero. The

Personal Expenditure Tax, in WHAT SHOULD BE TAXED?, *supra* note 7, at 127, 129-33.

Perceptions about the simplicity of a direct consumption tax have changed over time. Initially, it was thought that a direct consumption tax would be virtually impossible to implement. In 1938, Henry Simons viewed such a proposal as "radical" and its implications for administration and enforcement as "extremely obscure." See SIMONS, *supra* note 8, at 226-27. He believed that a direct consumption tax would involve "all the present problems" of measuring income and new problems associated with measuring savings. See *id.* at 228. Two decades later, Nicholas Kaldor agreed that a direct consumption tax would "undoubtedly" be "more complicated to administer" than the British income tax. See KALDOR, *supra* note 7, at 222; see also *id.* at 11-12 (pointing out that John Stuart Mill, Alfred Marshall, A.C. Pigou, and Lord Keynes believed that the consumption tax was impractical); WILLIAM VICKREY, AGENDA FOR PROGRESSIVE TAXATION 355 (1947) (stating that an approximate measure of income is more feasible than an approximate measure of consumption).

In 1974, William Andrews turned the tide with a ringing endorsement of the simplicity of a direct consumption tax. See Andrews, *Consumption-Type Tax*, *supra* note 7, at 1115-16. He argued that a direct consumption tax eliminated the need to measure savings and could rely on easily observed cash flows. See *id.* Those arguments were developed by David Bradford in the late 1970s and the 1980s. See BLUEPRINTS, *supra* note 7, at 42-49 (supervised by Bradford); BRADFORD, *supra* note 3, at 82; see also MEADE REPORT, *supra* note 7, at 44 (arguing that consumption tax raises "less acute" definitional problems than income tax). However, in 1979, Michael Graetz countered with an exhaustive discussion of administrative difficulties posed by a direct consumption tax. See Graetz, *Implementing*, *supra* note 7; Michael J. Graetz, *Expenditure Tax Design*, in WHAT SHOULD BE TAXED?, *supra* note 7, at 161 [hereinafter Graetz, *Design*]. Others have elaborated on those concerns. See Committee on Simplification, American Bar Ass'n Section of Taxation, *Complexity and the Personal Consumption Tax*, 35 TAX LAW. 415 (1982); Fleming, *supra* note 92.

118. See BLUEPRINTS, *supra* note 7, at 27-30 (defining income and consumption by reference to sources and uses of funds).

119. *But see infra* notes 173-80 and accompanying text (discussing the gap between consumption measured by cash flows and true consumption).

formula reaches that result by requiring her to include \$10 of cash dividend receipts and deduct \$10 of savings.

Alternatively, suppose that an investment that the taxpayer owns, such as a share of stock, increases in value by \$10 but does not generate cash. Because the taxpayer neither received nor invested cash, the formula does not require the taxpayer to include or deduct any amount, which is appropriate because the taxpayer's consumption for the year is zero.¹²⁰

Measuring consumption as the excess of cash receipts over cash saved is a simplified version of the familiar Haig-Simons definition of income as the sum of consumption and accumulation of wealth.¹²¹ Symbolically, the Haig-Simons definition asserts that $I = C + \Delta W$, where I is income, C is consumption and ΔW is accumulation of wealth.¹²² The Haig-Simons definition therefore also asserts that $C = I - \Delta W$. Thus, consumption is measured as cash receipts minus cash saved under a direct consumption tax, and as income minus the taxpayer's accumulation of wealth under Haig-Simons. Those alternate measures of consumption should be equivalent because under Haig-Simons, I and ΔW take into account noncash accruals, as well as cash accruals.

An alternative approach to measuring consumption is the "tax prepaid" approach, which is, under certain assumptions, equivalent to the cash flow approach.¹²³ Under the tax prepaid approach,

120. Borrowed funds may be treated in one of two ways under a direct consumption tax. Either borrowing proceeds are included as cash receipts in the year of borrowing and payments of principal and interest are deducted, or borrowing proceeds are not included and payments of principal and interest are not deducted. Suppose that a taxpayer earns \$100 in wages each year, borrows \$10 in Year One and agrees to repay \$10 of principal and \$1 of interest in Year Two. Assume that the taxpayer spends all her cash on consumption, making no savings deposits in either year. In Year One, she consumes a total of \$110, consisting of the \$100 in wages and \$10 in borrowed cash. In Year Two, she consumes only \$89, equal to her \$100 Year Two wages minus the \$11 principal and interest payment. The first approach accurately measures consumption because under that approach, in Year One, she includes the \$100 in wages and the \$10 in borrowed cash for a total of \$110, and, in Year Two, she includes the \$100 in wages and deducts the \$11 principal and interest for a total of \$89. The second approach measures consumption on a present value basis. In each of Year One and Year Two, she includes only her wages of \$100. She is undertaxed in Year One because her consumption in Year One is \$110, and overtaxed in Year Two because in that year her consumption is only \$89. But the undertaxation in Year One and overtaxation in Year Two offset one another. The Year Two overtaxation equals the amount of the Year One undertaxation plus a time value of money factor. See BLUEPRINTS, *supra* note 7, at 124-25, 131.

121. See *id.* at 27-30, 113-14; BRADFORD, *supra* note 3, at 313; MEADE REPORT, *supra* note 7, at 150; Andrews, *Consumption-Type Tax*, *supra* note 7, at 1148-65.

122. See SIMONS, *supra* note 8, at 50; Haig, *supra* note 8, at 55.

123. See BLUEPRINTS, *supra* note 7, at 123-24; Andrews, *Consumption-Type Tax*,

individuals are taxed on their income from labor, such as wages, but are not taxed on income earned on investments, such as interest and dividends. For example, the \$100 wage-earner would be taxed on the full amount of her \$100 wages, even if she deposited all \$100 in the bank. The tax prepaid approach taxes the full \$100 because \$100 is the *present value* of the consumption that the \$100 wages will purchase. Suppose that, after a year, the \$100 bank deposit has grown to \$110, having earned 10% interest, and that, at such time, the taxpayer withdraws the \$110 and uses it for dining. Under the tax prepaid approach, the taxpayer would not be taxed on the \$110 withdrawal of cash because the taxpayer paid tax on the \$100 wages when they were earned. At such time, \$100 was the present value of the taxpayer's \$110 meal one year later.

A direct consumption tax thus requires each individual to calculate her own consumption based on her cash flows for the taxable period. Tax is collected directly from the individual.

B. Indirect Consumption Taxes

Indirect consumption taxes burden human consumption but are collected from businesses. A retail sales tax, for example, requires a business to pay tax equal to the tax rate multiplied by the business's gross receipts from *retail* sales, or sales to the ultimate consumer.¹²⁴ A value added tax collects the same amount of tax by taxing businesses on each sale over the chain of production.¹²⁵ Value added taxes are thought to be less susceptible to evasion than retail sales taxes.¹²⁶

supra note 7, at 1126-28. The tax prepaid approach would not tax consumption of windfall gains or wealth existing at the time of enactment of the consumption tax, while the cash flow approach would tax those items. The equivalence of the tax prepaid and cash flow approaches also assumes that tax rates are constant over time. See Andrews, *Reply to Warren*, *supra* note 7, at 953.

124. See 2 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 12.03, at 12-8 to -9 (1992).

125. See 3 TREASURY I, *supra* note 7, at 7-10; Charles E. McLure, Jr., *Economic, Administrative, and Political Factors in Choosing a General Consumption Tax*, 46 NAT'L TAX J. 345, 346-48 (1993).

126. First, retail sales taxes are collected exclusively from retail sellers, many of which are small businesses that may be less likely to keep accurate records of sales. See 3 TREASURY I, *supra* note 7, at 16, 58. Second, value added taxes are collected from a larger number of businesses, thereby spreading the risk of evasion more broadly than retail sales taxes. See *id.* at 14. The greater number of taxpayers under a value added tax does, however, require greater anti-evasion monitoring and enforcement efforts by the government. Third, it has been argued that the credit invoice method value added tax, see *infra* text accompanying notes 131-32, deters evasion because businesses must present invoices in order to claim value added tax credit. See 3 TREASURY I, *supra* note 7, at 8. That argument also would apply to a subtraction method value added tax, see *infra* text accompanying note 131, under which an invoice is required to support a deduction.

Consider a simple economy, in which Alice produces apple pies and sells them to consumers. The amount of consumption each year is the value of the pies that are consumed that year. Thus, disregarding consumer surplus,¹²⁷ if Alice sells \$100 of pies, consumption is \$100. A retail sales tax would impose tax on each pie sale, appropriately taxing \$100 of aggregate consumption.¹²⁸

A value added tax would tax Alice *and* the businesses from which she made purchases.¹²⁹ Suppose that, this year, Alice purchases ingredients from a farmer for \$10, and a stone hearth for \$40. She also pays wages of \$30 to an assistant baker. Alice's value added is \$50, equal to the excess of her sales proceeds of \$100 over the cost of her business inputs, which are the \$10 of ingredients and the \$40 hearth.¹³⁰ In addition to Alice, the farmer and the hearthmaker are taxpayers. Their value added would equal the excess of their sales over the cost of their business inputs. For simplicity, assume that the farmer grew all the ingredients and the hearthmaker quarried the stone, so that each made no purchases and incurred no input costs. The farmer's value added is therefore \$10, and the hearthmaker's is \$40. The total value added by Alice, the farmer, and the hearthmaker is thus \$100, which equals the total apple pie consumption.

Under a "subtraction method" value added tax, Alice, the farmer, and the hearthmaker would pay taxes equal to the tax rate multiplied by their respective values added of \$50, \$10, and \$40. If the tax rate was 10%, they would pay taxes of \$5, \$1, and \$4, respectively.¹³¹ Under the alternative "credit-invoice method," each

127. See *infra* notes 178-79 and accompanying text (explaining the concept of consumer surplus).

128. See H.R. 3039, 104th Cong. (1996) (bill introduced by Rep. Schaefer providing for tax on services and retail sales of property).

129. See 3 TREASURY I, *supra* note 7, at 7-10 (describing the mechanics of a value added tax); McLure, *supra* note 125, at 346-48 (same); see also S. 2160, 103d Cong. (1994) (providing for a tax on the excess of gross receipts from business activities over business purchases in a value added tax bill introduced by Senators Danforth and Boren).

130. Wages are not considered business inputs. See 3 TREASURY I, *supra* note 7, at 8-9. Instead, the \$30 wages paid to the assistant baker constitute part of the value added by Alice's business.

131. The principal difference between a value added tax and a "flat tax" is the treatment of wages. The flat tax is a hybrid direct and indirect tax because it imposes tax on businesses and individuals. Under a value added tax, Alice pays tax on \$50 of value added reflecting no deduction for her \$30 payment of wages to the assistant baker. Under a flat tax, however, Alice would deduct that \$30 payment, with the result that she would pay tax on only \$20, and the baker would pay tax on the \$30 of wages. See HALL & RABUSHKA, *supra* note 7, at 55-56; Robert E. Hall & Alvin Rabushka, *A Proposal to Simplify Our Tax System*, WALL ST. J., Dec. 10, 1981, at A30; see also H.R. 2060, 104th

business owes tax equal to the excess of the tax collected on the business's sales over the tax that the business paid to its suppliers for business inputs. Assuming a 10% tax rate, under the credit-invoice method, Alice would pay taxes of \$1 to the farmer and \$4 to the hearthmaker, which amounts the farmer and the hearthmaker would then pay over to the government. Alice would collect \$10 of tax from the consumers of her apple pies. She would pay over to the government only \$5, equal to the excess of the \$10 she collected and the \$5 that she paid to the farmer and the hearthmaker. In simple cases, the two methods reach identical results.

However, the credit-invoice method is more flexible than the subtraction method because the subtraction method calculates a gross value added for each business, whereas the credit-invoice method, like a retail sales tax, calculates tax on each sale. Under either a credit-invoice method of imposing value added tax or a retail sales tax, a jurisdiction may impose different tax treatments for different types of goods and services.¹³² For example, suppose that the value added tax rate is generally 10%, but that sales of apple pies are "zero-rated." Alice would still pay \$1 of tax to the farmer and \$4 to the hearthmaker because those sales would be subject to the standard 10% rate. The farmer and the hearthmaker would in turn pay over those amounts to the government. Alice would collect zero tax on her sales of apple pies, however, because such sales would be subject to the special 0% rate. Her tax liability is thus *negative* \$5, equal to her tax collections of zero minus her tax payments of \$5. Alice would be entitled to a refund of \$5, and a net amount of zero tax would therefore be imposed on apple pie consumption.

"Exemptions" from value added tax operate differently from zero rating. An exempt business does not *collect* from its customers tax on its sales to them. It nonetheless pays tax on its purchases of

Cong. (1995) (flat tax bill introduced by Rep. Arney providing for a tax on wages of individuals and on value added *minus* wages paid of businesses); S. 1050, 104th Cong. (1995) (same, introduced by Sen. Shelby); S. 488, 104th Cong. (1995) (same, introduced by Sen. Specter).

The flatness of the flat tax arises because it imposes tax on wages at a single rate. Professor Bradford has proposed an "X-tax," which is structured like the flat tax, except that wages are taxed at progressive rates. See Bradford, *supra* note 114, at 384-85.

Another hybrid tax is the Unlimited Savings Allowance ("USA") tax, which combines a value added tax on businesses and a cash flow tax on individuals. See S. 722, 104th Cong. (1995) (bill introduced by Senators Domenici, Kerrey, and Nunn providing for USA tax); Ernest S. Christian & George J. Schutzer, Alliance USA, *Unlimited Savings Allowance (USA) Tax System*, reprinted in 66 TAX NOTES 1485, 1487-91 (1995).

132. See McLure, *supra* note 125, at 350. Defining the different types of goods and services may be complicated. See *infra* notes 164-70 and accompanying text.

inputs, provided that the seller of the inputs is not exempt. Thus, exemptions relieve only a portion of the tax on goods and services. For example, if Alice were exempt, but the farmer and hearthmaker were not, she would pay them \$1 and \$4 of tax, respectively, which they would pay over to the government. She would not collect any tax on her pie sales. There would thus be \$5 of tax imposed on pie consumption. Exemptions are sometimes used to relieve small businesses of the burden of complying with value added tax.¹³³

Thus, consumption taxes may be implemented in a direct or indirect structure. Either structure aims to collect tax in proportion to human consumption. As discussed in Part V, below, it has been argued that, whichever structure is used to tax consumption, taxing consumption is invariably simpler than taxing income. I challenge that argument in Parts VI through IX by demonstrating, using my model of tax complexity, that complexity would develop in a consumption tax.

V. INTRACTABILITY OF INCOME

A consumption tax imposes tax on a smaller set of values than an income tax. By taxing only the C component of the Haig-Simons equation $I = C + \Delta W$, a consumption tax eliminates the need to account for ΔW .¹³⁴ This Part V summarizes the traditional argument that consumption taxes are simpler than income taxes because the elimination of ΔW does away with the intractability associated with measuring income from capital.¹³⁵ As discussed below, the

133. Ironically, under the credit method, exemptions for businesses at intermediate stages in the chain of production *increase* the amount of tax relative to a tax without exemptions. See ALAN A. TAIT, *VALUE ADDED TAX: INTERNATIONAL PRACTICE AND PROBLEMS* 49 (1988). Some businesses, therefore, would reject exemption and elect instead to remain within the value added tax system.

134. The equation asserts that income equals consumption plus accumulation of wealth. See *supra* note 122 and accompanying text.

Under Haig-Simons, consumption is a subset of income. See SIMONS, *supra* note 8, at 50; Haig, *supra* note 8, at 55. Any amount consumed is also an amount of income, but the reverse is not true. Income may be earned without being consumed. In the case of a person who earns \$100 in wages and spends \$25 on dining and \$75 on a mutual fund investment, consumption is only \$25, while income is \$100.

135. See BLUEPRINTS, *supra* note 7, at 33-35; BRADFORD, *supra* note 3, at 313-15; HALL & RABUSHKA, *supra* note 7, at 52-56; MEADE REPORT, *supra* note 7, at 44; Andrews, *Consumption-Type Tax*, *supra* note 7, at 1115; David Bradford, *The Case for a Personal Consumption Tax*, in *WHAT SHOULD BE TAXED?*, *supra* note 7, at 75, 80-90.

Although the distinction between income from labor and income from capital is not clear-cut, income taxes and consumption taxes traditionally have been distinguished on the basis that an income tax imposes tax on income from labor and income from capital, while, under certain assumptions, a consumption tax imposes tax only on labor income.

intractability includes determining the appropriate timing of inclusions and deductions relating to changes in wealth, taking into account inflation, and coordinating the treatment of businesses and their owners.¹³⁶ Second-best income taxes address such intractability by either overtaxing or undertaxing relative to a tax on accrued income. But defining the scope of a second-best income tax introduces alternative sources of intractability.

A. *Ideal Income Tax*

The measurement of changes in wealth is a source of intractability under an ideal income tax,¹³⁷ but not under a consumption tax. First, a comprehensive income tax requires

See Warren, supra note 7, at 938-41. Recall that, under a direct consumption tax, the tax prepaid approach imposes tax on labor income, but not on capital income. *See supra note 123 and accompanying text.* Other methods of measuring consumption should, at least in theory, have the same effect. For example, under a retail sales tax, if a consumer immediately consumes her \$100 in wages by making retail purchases, tax is imposed on the full \$100 of purchases. Thus, a retail sales tax is equivalent to a tax on labor income if such income is immediately consumed. Even if labor income is saved, a retail sales tax burdens income from labor, but not income from capital on a present value basis. Suppose that, instead of consuming her wages immediately, the wage earner invested the \$100 for one year in a bank account that earned 10% annually and then consumed after one year by spending the bank account balance of \$110 on retail purchases. Tax would be imposed on the \$110 of retail purchases. On a present value basis, an immediate tax on \$100 is equivalent to the tax on \$110 one year later. Because the immediate tax on \$100 is clearly a tax on labor income, so is the tax one year later. Thus, a retail sales tax, like the tax prepaid approach of imposing a direct consumption tax, burdens labor income, but exempts income from capital.

The equivalence of a retail sales tax and a tax on labor income depends on numerous assumptions. For example, it assumes that there is no wealth existing at the time of enactment of the tax, there are no windfall gains, all labor income is consumed within the taxpayer's lifetime, and tax rates remain unchanged over time. A retail sales tax applies to consumption funded by windfall gains or wealth existing at the time of enactment of the tax, while a wages tax disregards such gains and wealth. A labor income tax applies to labor income whether or not such income is consumed within the laborer's lifetime, while a retail sales tax applies only to amounts that are in fact consumed. *See Andrews, Reply to Warren, supra note 7, at 953-56.*

A cash flow direct consumption tax is, by a similar argument, equivalent to a tax on labor under certain assumptions. *See BLUEPRINTS, supra note 7, at 43.*

136. *See BLUEPRINTS, supra note 7, at 42-49; BRADFORD, supra note 3, at 313; Committee on Simplification, supra note 117, at 418-20; Andrews, Consumption-Type Tax, supra note 7, at 1140-48; Bradford, supra note 135, at 75, 82-85; George R. Zodrow & Charles E. McLure, Jr., Implementing Direct Consumption Taxes in Developing Countries, 46 TAX L. REV. 405, 428-34 (1991); Robert H. Scarborough, Taxation of Capital Income and the Case for a Consumption Tax, Tax Forum No. 509, at 3 (June 3, 1996) (on file with the North Carolina Law Review).*

137. *See BRADFORD, supra note 3, at 313* (noting that it is "very difficult" to tax accrued income); *Andrews, Consumption-Type Tax, supra note 7, at 1115* (stating that the income tax's "worst inequity, distortion, and complexity arise out of inconsistency in the treatment of accumulation").

determinations of the timing and amount of inclusions and deductions relating to changes in wealth. As to inclusions, income should be included as it accrues economically, but measuring appreciation is often difficult. For example, if a taxpayer purchases a plot of real estate for \$10 in early 1997, and the plot appreciates to \$100 by the end of 1997, under a comprehensive income tax that used an annual accounting period, the taxpayer would include \$90 of income in 1997. As to deductions, costs relating to the production of current income are deducted under an ideal income tax when such costs are incurred, while costs that relate to income that will be earned in the future are capitalized and deducted over time. The economically appropriate recovery period for many expenses is difficult to determine. For example, if a taxpayer spends \$100 for business travel, the \$100 would be deductible in the year that it was incurred. But if a taxpayer spends \$100 to purchase a machine for use in the taxpayer's business, the taxpayer would recover the \$100 cost over a period of years relating to the period over which the machine produced income.¹³⁸

Taxing consumption, rather than income, would avoid those problems. On the inclusion side, income from capital appreciation is not taxed, thereby eliminating valuation problems associated with measuring changes in wealth. On the deduction side, consumption taxes do not aim to match expenses with the income that those expenses generate and, therefore, do not raise a question about the appropriate depreciation rate for capital expenditures.¹³⁹

Second, an ideal income tax would not tax inflationary gains because such gains do not reflect increases in wealth. An ideal income tax would therefore provide an adjustment to derive real (noninflationary) gains from nominal gains. If a taxpayer purchases a share of stock for \$100 on January 1, and sells it for \$110 on December 31, an income tax without an inflation adjustment would impose tax on \$10 of gain, even if the \$10 excess of sales price over

138. Additional intractability relating to timing of income and expense includes whether, or to what extent, contingent items of income or expense should be disregarded and whether a benefit that increases a person's savings but is not transferable, such as restricted stock, should be considered income prior to its becoming either transferable or consumed.

139. Consistent with allowing taxpayers a deduction for savings, cash flow consumption taxes and value added taxes allow taxpayers to deduct the entire amount of a capital expenditure in the year such cost is incurred. *See supra* notes 116-22, 129-31 and accompanying text. Alternatively, under the tax prepaid approach, a direct consumption tax would not grant taxpayers a deduction for the cost of capital assets but would exempt income earned by the asset. *See supra* note 123 and accompanying text.

purchase price reflects no real gain because inflation of 10% occurred over the year and the \$110 on December 31 therefore represents the same spending power as the \$100 on January 1. In this example, an ideal income tax would increase the taxpayer's basis to \$110, to result in zero tax, because there has been zero real gain. A consumption tax would not require adjustments for inflation because expenses are deducted when paid and receipts are included when received. Under a consumption tax, today's dollars are not compared with yesterday's dollars because consumption taxes do not measure income from capital.

Third, income taxes must coordinate the treatment of business or investment entities, such as corporations and partnerships, with the treatment of individuals that own such entities. An ideal income tax would tax owners on income associated with their ownership interests. One approach is to tax owners on income earned by entities.¹⁴⁰ Alternatively, an ideal income tax could tax the entity on its income and ensure that the owner is not *also* taxed when such income accrues, or is distributed, to the owner.

A direct consumption tax eliminates the need to coordinate the treatment of business and investment entities with the treatment of their owners. Such an entity may either distribute its earnings to its owners or retain its earnings. If the entity distributes (or loans) its earnings to an owner, the distributed cash is available for the owner's consumption. The distribution will therefore be a cash receipt, taxable to the owner except to the extent that the owner reinvests the cash. If the entity retains its earnings, then the owner is not taxed. The owner has no consumption or cash receipts because the funds are retained by the entity. Indirect consumption taxes also overcome the coordination problem because individuals are not taxed at all.

B. Second-Best Income Tax

One approach to addressing the intractabilities of an ideal income tax is to acknowledge that taxing all income as it accrues is unworkable and to introduce new boundaries that result in overtaxation in some cases and undertaxation in other cases relative to an ideal income tax. Those new boundaries would eliminate certain difficulties associated with taxing accrued income, but would introduce alternative sources of complication, intractability, and

140. The federal income tax, for example, taxes partners on their allocable share of partnership income, *see* I.R.C. §§ 702, 704 (1994), and shareholders in "S" corporations on their allocable share of corporate income, *see id.* §§ 1363, 1366.

incoherence.

The federal income tax has followed that route. For example, in response to valuation and liquidity problems that would arise under an ideal accrual income tax,¹⁴¹ the federal income tax defers taxation until income is realized.¹⁴² The realization requirement improves tractability by reducing valuation and liquidity problems, but the concept of realization is itself intractable.¹⁴³ The federal income tax goes a step further by failing to tax certain *realized* gains, introducing yet another intractable concept—recognition.¹⁴⁴

The federal income tax addresses the intractability of matching capital expenditures with the income to which those expenditures relate by prescribing mechanical depreciation schedules for trade or business or investment property based on the property's presumed useful life.¹⁴⁵ The depreciation provisions introduce new intractability, however, because applying them requires determinations relating, for example, to when assets are placed in service and who is entitled to depreciation deductions.

The federal income tax does tax inflationary gains, requiring the taxpayer to treat the value of dollars as static over time. Proposals

141. Many assets and liabilities are difficult to value on a periodic basis, as would be required for accrual taxation. In addition, taxpayers might not have cash to pay tax on appreciated assets. See 1 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS* ¶ 5.2, at 5-16 to -17 (2d ed. 1989) (stating that taxing unrealized appreciation would require "cumbersome, abrasive, and unpredictable" valuations, and that many taxpayers would be forced to sell or mortgage assets in order to pay the tax). But see David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1113-14 (1986) (arguing that accrual taxation is feasible).

142. See I.R.C. §§ 61(a)(3), 1001 (1994); *Eisner v. Macomber*, 252 U.S. 189, 194 (1920).

143. See, e.g., I.R.C. § 551 (1994) (preventing taxpayers from relying on the realization requirement to avoid U.S. tax on income earned abroad); I.R.C. § 951 (West 1988 & Supp. 1997) (same); *id.* § 956 (same); I.R.C. § 1291 (1994) (same); *id.* § 1293 (same); see also Paul, *supra* note 52, at 7-8 (arguing that the realization requirement is formalistic).

144. See, e.g., I.R.C. § 351 (1994) (providing nonrecognition to a shareholder upon contribution of property to controlled corporation); I.R.C. § 354 (West 1988 & Supp. 1997) (providing nonrecognition to a shareholder or security-holder upon reorganization exchange); I.R.C. § 361 (1994) (providing nonrecognition to a corporation upon reorganization exchange); *id.* § 721 (providing nonrecognition to a partner upon contribution of property to partnership); *id.* § 1031 (providing nonrecognition upon like-kind exchange).

145. See I.R.C. § 168 (West 1988 & Supp. 1997). Such schedules generally enable taxpayers to recover costs more quickly than they would be able to recover the same costs under a schedule based on economic depreciation. See *id.* (providing for "[a]ccelerated cost recovery system" (emphasis added)).

have been made to take account of inflation,¹⁴⁶ but they have not succeeded because of the intractability that they would introduce.¹⁴⁷

Finally, the federal income tax coordinates the tax treatment of corporations and shareholders by taxing the corporation *and* the shareholder on corporate income. That departure from the ideal is implemented in a manner that depends on intractable distinctions, including distinctions between debt and equity,¹⁴⁸ between capital gain and ordinary income,¹⁴⁹ and between sales and dividends.¹⁵⁰

Not only do the federal income tax regime's departures from an ideal income tax introduce intractability, many of them also have been criticized as incoherent. The federal income tax excludes many types of income from the tax base, while taxing others. A prominent example is the inconsistent treatment of savings. Although income that is saved is generally taxed, the federal income tax provides incentives to save for retirement by granting a deduction for contributions to retirement plans.¹⁵¹ Consumption taxes arguably would be more coherent by treating savings uniformly.¹⁵² Another

146. See, e.g., BLUEPRINTS, *supra* note 7, at 83; Reed Shuldiner, *Indexing the Tax Code*, 48 TAX L. REV. 537 (1993).

147. Indexation of assets to eliminate tax on inflationary gains would enable taxpayers to create tax deductions without suffering economic losses if borrowings were not also indexed. See N.Y. Bar Ass'n Tax Section Ad Hoc Comm. on Indexation of Basis, *Report on Inflation Adjustments to the Basis of Capital Assets*, 48 TAX NOTES 759, 760 (1990); *Indexation of Assets: Hearing Before the U.S. Senate Comm. on Finance*, 104th Cong. 55 (1995) (letter from Michael L. Schler, Chair, New York State Bar Association Tax Section, to Hon. Bill Archer, House of Representatives, criticizing the tax basis indexing provisions of H.R. 9, 104th Cong. (1995)).

148. See, e.g., I.R.C. § 163 (West 1988 & Supp. 1997) (providing a deduction for interest, but not for dividends).

149. See, e.g., I.R.C. § 1(h) (West 1988 & Supp. 1997) (imposing maximum rate of 20% on certain net capital gains); *id.* § 1211 (limiting the use of capital losses).

150. See, e.g., *id.* § 301(c)(1) (providing for inclusion of dividends in gross income); *id.* § 302 (treating certain redemptions as dividends and others as sales or exchanges); *id.* § 1001 (providing for inclusion of gain, measured by the excess of the amount realized over basis, from a sale or exchange).

151. See, e.g., *id.* § 402 (providing for taxation of employees in the year of distribution from a qualified pension plan); *id.* § 408 (providing for taxation in the year of distribution from an individual retirement account).

152. It is debatable whether the inconsistent treatment of savings under the federal income tax is coherent. On the one hand, if savings should be encouraged, then the limitation of the deduction to retirement savings seems arbitrary. On the other hand, the special treatment of retirement savings may be coherent from the perspective of distributing tax burdens in accordance with people's incomes. As Boris Bittker has argued, the federal income tax inevitably excludes some items of income from the tax base. See Bittker, *supra* note 68, at 984. It cannot tax all income. Since some income is inevitably tax-exempt, particular provisions should not be evaluated by reference to whether they constitute another exclusion of income from the tax base. Instead, the

incoherence of the federal income tax is the double tax on corporate income.¹⁵³ Consumption tax proposals would treat all businesses, whether in corporate form or not, alike.

Proponents of the consumption tax thus have argued that taxing consumption is simpler than taxing income.¹⁵⁴

VI. EQUITY-BASED COMPLEXITY UNDER A CONSUMPTION TAX

I have presented my model of tax complexity,¹⁵⁵ discussed structures by which consumption taxes can be implemented,¹⁵⁶ and set forth the traditional formal argument for consumption tax simplicity.¹⁵⁷ Now, I will challenge the traditional argument by applying my model of tax complexity to consumption taxes. Although the traditional argument validly identifies difficulties associated with taxing income, it overstates the simplicity of a consumption tax, because it disregards the dynamics of lawmaking in a regime committed to taxing equitably and raising substantial revenues.

Reliance on a consumption tax as the federal government's primary revenue source, like reliance on an income tax for that purpose, reflects a commitment to equity as a significant tax policy goal. Abandonment of the goal of tax equity would lead to adoption of a head tax, rather than a tax on consumption. In this Part VI, I argue that the aspiration to tax equitably would be a source of complexity in a consumption tax.¹⁵⁸

inquiry should be whether a provision results in a more desirable distribution of tax burdens among taxpayers. *See id.* Therefore, although deductions for retirement savings constitute an exclusion of income, they would be consistent with taxing income if they made the distribution of tax burdens more proportional to income. To the extent that the federal income tax already favors income from capital earned by more affluent taxpayers by, for example, failing to tax unrealized appreciation, the deduction for retirement savings may help achieve an equitable distribution of tax burdens by allowing wage earners to exclude some of their income. *See id.*; Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145, 1147, 1179 (1992) (suggesting that tax treatment of retirement savings should differ from treatment of bequest and "precautionary" savings).

153. *See* U.S. DEP'T OF THE TREASURY, REPORT OF THE DEPARTMENT OF THE TREASURY ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 1 (1992) (contending that the double tax on corporate earnings perversely discourages use of the corporate form).

154. *See* BLUEPRINTS, *supra* note 7, at 42-43; BRADFORD, *supra* note 3, at 313-15; HALL & RABUSHKA, *supra* note 7, at 52-56; MEADE REPORT, *supra* note 7, at 44; Andrews, *Consumption-Type Tax*, *supra* note 7, at 1115.

155. *See supra* notes 49-113 and accompanying text.

156. *See supra* notes 114-33 and accompanying text.

157. *See supra* notes 134-54 and accompanying text.

158. *See infra* notes 159-80 and accompanying text.

In Part VII, I argue that the certainty-based process discussed in my model would generate complication in a consumption tax.¹⁵⁹ Although a consumption tax would eliminate some specific sources of complexity that are found in an income tax, it would duplicate others and introduce yet others.

A. *Consumption as a Proxy for Ability to Pay or Well-Being*

Ability to pay and well-being are each possible criteria for distributing tax burdens in a system that seeks to tax equitably. Yet the actual tax burden under a consumption tax would not be borne in proportion to ability to pay or well-being. That gap would be a source of incoherence. Changes aimed at narrowing the gap would decrease tractability and increase complication.

Consumption is not perfectly correlated with ability to pay or well-being¹⁶⁰ because ability to pay and well-being depend on consumption *and* other factors, such as income, wealth, and opportunity. For example, a person who has the opportunity to earn \$100 but chooses not to earn the \$100 has the ability to pay tax on \$100 (because she has the ability to earn the \$100), but she does not have any consumption because she does not in fact earn the \$100 and consume it. Consumption taxes are criticized as regressive precisely because consumption does not capture all relevant aspects of ability to pay and well-being.¹⁶¹ Indeed, defenses of the equity of

159. See *infra* notes 181-229 and accompanying text.

160. I focus in Part VI.A on ability to pay and well-being as possible desired measures under a regime that seeks to tax equitably. The concepts of means and utility are alternative possible desired measures. See *supra* note 55. Means is sufficiently close to ability to pay, and utility is sufficiently close to well-being, that I do not discuss means and utility separately.

161. For example, a frequent criticism of consumption taxes emphasizes that lower-income families tend to spend a higher percentage of their income on consumption than higher-income families. See generally SAMUELSON & NORDHAUS, *supra* note 8, at 422-23 (explaining how consumption patterns vary across income levels). The criticism reflects the relevance of income to an evaluation of a tax regime's equity. See 3 TREASURY I, *supra* note 7, at 19-20, 89, 109-11; see also Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961, 963-67 (1992) (arguing that consumption taxes achieve none of the fairness goals implicitly adopted by consumption tax proponents, namely, distributions in accordance with either income, endowments, or pre-tax welfare); Alan Gunn, *The Case for an Income Tax*, 46 U. CHI. L. REV. 370, 385-88 (1979) (noting that advocates of progressive consumption taxes acknowledge that income is relevant to equity); Warren, *supra* note 7, at 946 (stating that the consumption tax fails to mitigate "lifetime wealth disparities"); cf. SIMONS, *supra* note 8, at 5-7 (discussing Mill's idea that income taxation should be based on equal sacrifice by individuals); Andrews, *Consumption-Type Tax*, *supra* note 7, at 1169-70 (treating income as a proxy for wealth, which represents power and security).

consumption taxes often treat consumption as a proxy for another value, such as wealth, income, or spending power, reflecting that consumption itself is not the ultimate measure for equity.¹⁶²

The incoherence of the gap between consumption, on one hand, and ability to pay or well-being, on the other hand, spawns efforts to narrow the gap. One approach is to supplement the consumption tax with an income or wealth tax. In fact, most, if not all, European countries that have a consumption tax rely also on an income tax.¹⁶³ That approach, of course, introduces all the complexity of an income tax or a wealth tax that the formal argument favoring a consumption tax claims to eliminate.

Another common approach in the case of a retail sales tax or a value added tax is to exclude necessities, such as food and prescription drugs, from the tax base.¹⁶⁴ Each such exclusion would

162. See KALDOR, *supra* note 7, at 47 (stating that actual consumption expenditures reveal an individual's spending power); HARVEY S. ROSEN, PUBLIC FINANCE 479 (4th ed. 1995) (arguing that lifetime consumption as a proportion of *income* is constant over all income levels); Bradford, *supra* note 114, at 389-90 (stating that the "X-tax," a consumption tax with progressive rates based on wages, would address regressivity); Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283, 350 (1994) (contending that a progressive consumption tax without an estate tax serves wealth-based norms).

The argument, originally made by Thomas Hobbes, that consumption taxes are equitable because they burden private use of resources that could otherwise be used for public purposes, views consumption as a proxy for the degree to which individuals take from the common pool. See HOBBS, *supra* note 7, at 238-39. Hobbes believed that consumption, rather than "riches," was the appropriate tax base for purposes of equity. See *id.* The benefit that everyone receives from society is the "enjoyment of life." *Id.* at 238. Poor and rich alike owe a debt to society for that benefit. See *id.* at 238-39. Consumption, or use, measures the degree to which persons enjoy the protection of the commonwealth. See *id.*; RAWLS, *supra* note 71, at 278-79 (arguing that a proportional expenditure tax is consistent with "common sense precepts of" justice); Andrews, *Reply to Warren*, *supra* note 7, at 949. Hobbes's argument has been recast as a defense of consumption taxes on the grounds that such taxes do not "discriminate" against savers as an income tax does. See BLUEPRINTS, *supra* note 7, at 39-40; BRADFORD, *supra* note 3, at 162, 315; MEADE REPORT, *supra* note 7, at 33; MILL, *supra* note 7, bk. V, ch. II, § 3; Andrews, *Consumption-Type Tax*, *supra* note 7, at 1165-69.

163. See, e.g., THE STATESMAN'S YEAR-BOOK 415 (Brian Hunter ed., 133d ed. 1996) (Denmark); *id.* at 481 (Finland); *id.* at 496 (France); *id.* at 543 (Germany); *id.* at 724 (Ireland); *id.* at 748 (Italy); *id.* at 1079 (Russia); *id.* at 1182 (Spain); *id.* at 1223 (Switzerland); *id.* at 1317 (Great Britain).

164. The United Kingdom, Ireland, Italy, Portugal, Turkey, and Mexico provide a zero rate for basic foods in their value added taxes. See TAIT, *supra* note 133, at 52, 59. In addition, many countries exempt or zero-rate for medical, educational, and dental services. See *id.* at 59. Similarly, many states exempt food, utility services, household fuel, drugs and medicine, and clothing from retail sales tax. See JOHN F. DUE & JOHN L. MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 75-80, 84-88 (2d ed. 1994).

become a locus of complication and intractability.¹⁶⁵ Further, incoherence remains in a consumption tax that excludes necessities. Such exclusions are overbroad, applying to purchases by both well-off and less well-off people. Exclusions also distort consumers' decisions by encouraging consumers to purchase the nontaxed items. That behavioral response further reduces the correlation of taxable consumption with ability to pay or well-being.

A variation on the theme of excluding necessities is to impose different tax rates on different items. John Stuart Mill argued that indirect taxes on widely consumed items, such as tea, coffee, sugar, tobacco, and alcohol, raised a disproportionate amount of revenue from less well-off people, since such items constituted a disproportionate part of the consumption pattern of less well-off people. Correcting that "flagrant injustice" was "not an easy matter."¹⁶⁶ One approach is to impose a higher tax on higher-quality goods that are used disproportionately by wealthier consumers.¹⁶⁷ But multiple rates create new complicated and intractable categories.¹⁶⁸ As Adam Smith observed in the case of English

165. See, e.g., TAIT, *supra* note 133, at 50, 58-68, 399; 3 TREASURY I, *supra* note 7, at 98. For example, New York State's retail sales tax exemption for "drugs and medicine" is administered using a list describing the status of more than 6000 items. See Richard D. Pomp, *Simplicity and Complexity in the Context of a State Tax System*, in REFORMING STATE TAX SYSTEMS 119, 135 (Steven D. Gold ed., 1986). Under New York's drug and medicine exemption, Head and Shoulders shampoo is exempt, but Prell shampoo is not, presumably because Head and Shoulders treats dandruff, while Prell merely cleans. See *id.* In order to test the ability of retailers to apply such subtle distinctions, NBC news reporters purchased a basket of identical goods from each of seven pharmacies and were charged seven different amounts of sales tax, none of which was the correct amount. See *id.*

The "food" exemption in many states similarly depends on fine distinctions because states typically do not exempt candy, soft drinks, or restaurant food. See 2 HELLERSTEIN & HELLERSTEIN, *supra* note 124, ¶ 12.03, at 12-11. New York State's food exemption, for example, applies to fruit juices and small marshmallows, but not fruit drink and large marshmallows. See Pomp, *supra*, at 135-36. In many states, determining whether food sold at a drive-in restaurant or a prepared food department in a supermarket is a taxable meal is problematic. See JOHN F. DUE & JOHN L. MIKESSELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 67-68 (1983). For example, Ohio taxes food purchased at a drive-in only if the customer plans to eat it on the premises. See OHIO REV. CODE ANN. § 5739.02(B)(2) (Anderson 1995); *id.* § 5739.01(K).

166. MILL, *supra* note 7, bk. V, ch. VI, § 3.

167. See *id.*

168. Jurisdictions that impose a retail sales tax, a value added tax, or customs duties have balanced the equity and other advantages of multiple rates against the complication and intractability that multiple rates inevitably engender. For example, state retail sales taxes have tended to use a single uniform rate, perhaps reflecting the relatively small size of the economies of the jurisdictions imposing tax. See DUE & MIKESSELL, *supra* note 164, at 52, 54. Several states, however, impose a lower rate on sales of motor vehicles, food

customs duties, the question of how "a particular sort of goods ought to be classed" causes "much trouble, expence, and vexation."¹⁶⁹ Congress likely would reach a temporary trade-off between the incoherence resulting from use of only one rate and the complication and intractability of using multiple rates. That trade-off would be unstable, however, as factual circumstances changed.¹⁷⁰

The degree to which equity is a source of complexity may differ depending on the type of consumption tax that is imposed. Consumption taxes may be adapted to reflect equity concerns in a more sophisticated manner than traditional retail sales taxes and value added taxes. For example, Professor Bradford has proposed an "X-tax" comparable to the flat tax, except that wages are taxed at progressive rates.¹⁷¹ The X-tax may be more equitable than other consumption taxes because of its built-in progressivity. As a result, the X-tax and comparable sophisticated consumption taxes that take

and drugs, and certain goods used for production. *See id.* at 40-41.

Many countries that impose value added tax increased the number of rates after initial enactment. For example, Austria increased from two rates at enactment to three rates as of July 1, 1989, Belgium from three to six, France from four to five, Italy from three to four, and Korea from one to three. *See TAIT, supra* note 133, at 40.

That trend seems to be reversing. As awareness of the complexity burdens of multiple rates grows, newer value added taxes have tended to use fewer rates. *See id.* at 249. For example, New Zealand and South Africa each introduced a single-rate broad-based value added tax in 1986 and 1991, respectively. *See U.S. GENERAL ACCOUNTING OFFICE, VALUE-ADDED TAX: ADMINISTRATIVE COSTS VARY WITH COMPLEXITY AND NUMBER OF BUSINESSES #78 (1993), microformed on Sup. Docs. No. GAO/GGD-93-78 (U.S. Gov't Printing Office), available in 93 TNT 98-23 (May 6, 1993), LEXIS, FEDTAX Library [hereinafter GAO].*

The European Community member states now use two or three rates. *See Guido DeWit, The European VAT Experience, 10 TAX NOTES INT'L 49, 53 (1995).* Many countries impose tax using two or more positive rates. *See TAIT, supra* note 133, at 40-41; KPMG PEAT MARWICK, *STUDY OF VALUE-ADDED TAXATION IN THE UNITED STATES II-5 (1989)* (on file with the *North Carolina Law Review*) [hereinafter KPMG].

Customs duties traditionally have been imposed using numerous rates. Adam Smith bemoaned Britain's "extremely comprehensive" book of customs rates, which enumerated "a great variety of articles." *See SMITH, supra* note 28, bk. V, ch. II, at 412-15. The Harmonized Tariff Schedule used by the United States contains 8500 eight-digit tariff lines distinguishing among different types of products. *See JOHN H. JACKSON ET AL., LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS: CASES, MATERIALS AND TEXT 395 (3d ed. 1995); see also 2 RUTH STURM, CUSTOMS LAW AND ADMINISTRATION §§ 50-53 (1995)* (discussing principles of classification of tariffs, including rules of construction of tariff schedules, aids in applying tariff statutes, and types of tariff classifications).

169. SMITH, *supra* note 28, bk. V, ch. II, at 413.

170. One expert has informally predicted that the United States could not sustain a single value added tax rate. *See McLure, supra* note 125, at 357 n.27 (reporting comments of Sijbren Cnossen); *supra* notes 71-74 and accompanying text.

171. *See Bradford, supra* note 114, at 384-85.

progressivity to heart may temporarily forestall equity-based changes leading to complexity. But eventually, one would expect the X-tax to become complex as gaps between its base and an ideal value for taxation become increasingly apparent.

The desire to tax equitably is certainly a source of complexity under a consumption tax, and could be an even greater source of complexity under a consumption tax than under an income tax. Although it is beyond the scope of this Article to undertake a full-blown defense on equity grounds of income over consumption as a tax base, there is reason to believe that income is a more equitable tax base. Income may be a closer proxy for well-being than is consumption. For example, because of the declining marginal utility of a dollar, two people each with the *same* dollar value of lifetime consumption on a present value basis differ in their well-being and their income if one of them consumes evenly over her lifetime and the other consumes all in one period. The person who consumes evenly has more well-being and more income, but the same level of consumption, as compared with the person who consumes in one period.¹⁷² Further, wealth ownership increases well-being by providing security against extraordinary adverse circumstances, such as medical illness. Wealth ownership also increases income but may not increase consumption.

B. Cash Flows as a Proxy for Consumption

A consumption tax not only would mismeasure ability to pay and well-being, it also would mismeasure consumption by relying on a proxy.¹⁷³ Consumption taxes approximate consumption by

172. Consider two individuals, "Some in Each Year" and "All at Once," each of whom enjoys \$100 of consumption on a present value basis. Some in Each Year receives \$100 on June 30 of Year One, while All at Once receives \$110 on June 30 of Year Two. Some in Each Year consumes a portion of his \$100 on June 30 in Year One, invests the remainder at a 10% interest rate, and consumes the balance, including interest, on June 30 in Year Two. All at Once consumes her entire \$110 on June 30 in Year Two. Some in Each Year has greater well-being than All at Once. The declining marginal utility of a dollar means that All at Once's consumption pattern brings her less utility than Some in Each Year's pattern brings to him. Some in Each Year also has more income than All at Once. Both Some in Each Year and All at Once have \$100 of present value of consumption, but Some in Each Year also has interest income.

173. Any real world consumption tax will fail to tax some consumption. The Department of the Treasury and the Congressional Budget Office estimated that, at 1988 levels of consumption, even a broad-based value added tax would reach only 77% or 75%, respectively, of total domestic consumption. See 3 TREASURY I, *supra* note 7, at 87; CONGRESSIONAL BUDGET OFFICE OF THE U.S. CONGRESS, EFFECTS OF ADOPTING A VALUE-ADDED TAX 22 (1992) [hereinafter CBO]. The Treasury estimated total consumption at \$3127 billion. Exclusions for housing (other than sales of new housing),

measuring cash flows.¹⁷⁴ Consumption often occurs in the absence of a cash payment, however, making cash flows a tractable, but incoherent, basis for a consumption tax. In order to improve the measurement of consumption relative to a tax that relied solely on cash flows, new authorities would be produced that increased complication and reduced tractability.

The following three gaps undoubtedly would be addressed under a consumption tax, leading to complication and intractability. First, measuring consumption of consumer durables and housing would depend on estimates of rental value, rather than cash flows.¹⁷⁵ Second, compensation for labor paid in kind, rather than in cash, should be taxable under a consumption tax, as it is under the federal income tax.¹⁷⁶ Third, barter transactions undermine the correlation between cash flows and consumption because a taxpayer can trade an investment asset for a consumption item, thus consuming without receiving or paying cash.¹⁷⁷

Two additional gaps might be considered too difficult to address, but the failure to do so would leave the tax system incoherent. First, cash payments do not measure "consumer surplus." Market prices measure the amount of consumption enjoyed by the marginal buyer, not the actual buyer, of a consumption item. Although dinner at a particular restaurant may cost, say, \$100 per person, some diners would be willing to pay more. A diner willing to pay \$300 enjoys "consumer surplus" of \$200 because she is only required to pay

medical care, insurance and finance, education, certain food, and other items brought the comprehensive value added tax base to \$2408 billion. See 3 TREASURY I, *supra* note 7, at 86. The Congressional Budget Office estimated total consumption at \$3774 billion, and, assuming exclusions similar to the Treasury's, a comprehensive base of \$2823 billion. See CBO, *supra*, at 22.

174. Under a direct consumption tax, consumption is measured by the excess of cash receipts over cash saved. Under an indirect consumption tax, consumption is measured by the amount of cash paid in exchange for goods or services. See *supra* notes 116-32 and accompanying text. Some consumption tax proposals rely on an even more distant proxy for consumption than cash flows, resulting in even less coherence than is present in the case of a cash-flow consumption tax. See Martin D. Ginsburg, *Life Under a Personal Consumption Tax: Some Thoughts on Working, Saving, and Consuming in Nunn-Domenici's Tax World*, 48 NAT'L TAX J. 585, 598 (1995) (arguing that the "USA" tax is riddled with loopholes because of its failure to include borrowed proceeds in the tax base).

175. See *infra* notes 200-04 and accompanying text.

176. See Treas. Reg. § 1-61-2(d) (as amended in 1995) (requiring inclusion in gross income of fair market value of property paid as compensation for services); Graetz, *Implementing*, *supra* note 7, at 1586-88.

177. For example, a taxpayer who owned a share of stock worth \$100 could pay a restaurant for dinner by transferring the stock. The dinner constitutes consumption and therefore should be taxed even though no cash changes hands.

\$100.¹⁷⁸ The \$100 market price measures the consumption of the marginal diner who is willing to pay \$100, but no more, for dinner. To measure consumption accurately, consumer surplus should be taken into account because consumer surplus is a part of a person's overall consumption.¹⁷⁹ Second, cash flows do not reflect *nonmarket* consumption, such as consumption of leisure, services provided by the government, and self-provided services.¹⁸⁰ Those two gaps exist in the federal income tax and are tolerated.

Consumption does not correlate perfectly with any ideal criterion by which an equitable regime would distribute tax liabilities, and taxable consumption would not correlate perfectly with true consumption (or with the ideal criterion). Thus, a consumption tax would embody a gap between its ideal and its actual measure. That gap would be a source of complexity. A consumption tax, like an income tax, would shuttle between intractable taxation closer to the ideal and incoherent taxation farther from the ideal, mediated by complication. As discussed in Part VII below, the certainty-based process also would produce complication.

VII. CERTAINTY-BASED COMPLEXITY UNDER A CONSUMPTION TAX

Consumption tax proponents argue that the narrower scope of a consumption tax would not only increase tractability, but also reduce complication. The complicated provisions in the federal income tax measuring changes in wealth would be unnecessary under a consumption tax.¹⁸¹

Although a revenue-neutral¹⁸² consumption tax might be

178. See SAMUELSON & NORDHAUS, *supra* note 8, at 83 (defining consumer surplus as "the gap between the total utility of a good and its total market value"); ROSEN, *supra* note 162, at 57-58 (defining consumer surplus as the excess of the amount that individuals would have been willing to pay over the amount that they actually have to pay).

179. See Henry Aaron, *What Is a Comprehensive Tax Base Anyway?*, 22 NAT'L TAX J. 543, 545 (1969). Measurement of consumer surplus would not be necessary to achieve the *efficiency* goals of a consumption tax. Distortions in taxpayers' decisions occur only at the margin. Moreover, although consumer surplus undoubtedly contributes to a person's well-being and utility, it may not contribute to a person's ability to pay or means. Thus, if those are the desired measures for tax liability, the failure to tax consumer surplus would not be troublesome.

180. See Graetz, *Implementing*, *supra* note 7, at 1593-94.

181. See BRADFORD, *supra* note 3, at 272-76; Andrews, *Consumption-Type Tax*, *supra* note 7, at 1140.

182. A "revenue-neutral" tax is one that raises as much revenue as the current federal income tax that it would replace. For the year ending in December 1993, the federal government collected a total of \$510,188,000,000 in individual income taxes and

uncomplicated initially, complication would increase over time. As Hegel saw, a tax regime must "precisely and definitively" settle issues that "lie beyond the competence of the absolute lines laid down by the pure notion."¹⁸³ In the abstract, the pure notion of consumption may be simple. A consumption tax would, however, become complicated as it comes "into contact with actual facts."¹⁸⁴

Measurement of consumption under a consumption tax would be more complicated than the measurement of consumption under the federal income tax.¹⁸⁵ A revenue-neutral consumption tax would put more financial pressure on the definition of consumption than the federal income tax does. All tax revenue would be raised with respect to consumption resulting in a higher tax rate on consumption than under the federal income tax. The revenues at stake in the measurement of consumption under a consumption tax would spur lawmakers to produce new legal authorities to address uncertainties.¹⁸⁶

As discussed below, under a consumption tax, the economics of litigation and administration and the desire for certainty would lead to greater complication in the measurement of consumption than exists under the federal income tax.

A. Frequency of Litigation

A consumption tax could generate judicial authorities at a faster

\$123,601,000,000 in corporate income taxes, for a total of \$633,789,000,000. See BUREAU OF THE CENSUS, DEP'T OF COMMERCE, NO. GT/93-Q4, QUARTERLY SUMMARY OF FEDERAL, STATE, AND LOCAL TAX REVENUE, OCTOBER-DECEMBER 1993, at 4 (1995). Therefore, a revenue-neutral consumption tax would have to raise at least that amount of revenue.

183. HEGEL, *supra* note 77, § 16.

184. *Id.*

185. Recall that under the Haig-Simons ideal, income equals consumption plus changes in wealth. The federal income tax, accordingly, attempts to measure both amounts. The authorities relating to the measurement of consumption are less complicated than the authorities relating to the measurement of changes in wealth. Compare, e.g., I.R.C. § 262 (1994) (nondeductibility of personal expenses), Treas. Reg. § 1.162-2 (1960) (deductibility of certain traveling expenses), Treas. Reg. § 1.162-5 (as amended in 1967) (deductibility of certain educational expenses), and Treas. Reg. § 1.162-6 (1960) (deductibility of certain professional expenses), with I.R.C. § 469 (West 1988 & Supp. 1997) (limitation on deductibility of passive activity losses), and I.R.C. § 704(b) (1994) (allocations of partnership income, loss, deduction, and credit). The relatively uncomplicated measurement of consumption likely reflects the relatively small amount of money at stake in distinguishing consumption from savings and the limited legal resources of taxpayers affected by that measurement.

186. See Committee on Simplification, *supra* note 117, at 421-33; Fleming, *supra* note 92, at 421-39; Graetz, *Design*, *supra* note 117, *passim*; Graetz, *Implementing*, *supra* note 7, at 1659-61.

pace than the federal income tax by reducing the number of taxpayers and thereby increasing the amount of money at stake for each taxpayer. Indirect consumption taxes require businesses, but not individuals, to file tax returns and pay the government.¹⁸⁷ Therefore, such taxes drastically reduce the number of taxpayers relative to the federal income tax.¹⁸⁸ Under a revenue neutral consumption tax with fewer taxpayers than the federal income tax, the average tax liability per taxpayer would be substantially higher than under the federal income tax. That consolidation of tax liability around fewer taxpayers would likely increase the pace of litigation relative to the federal income tax because the amount at stake in a particular taxpayer's litigation likely would increase more rapidly than transaction costs.¹⁸⁹

B. *Current Versus Future Consumption*

Direct consumption taxes that utilize the cash flow approach and indirect consumption taxes rely, like the federal income tax, on a troublesome distinction between current and future consumption. Uncertainty in the application of the distinction would create a need for new authorities.

Under the cash flow approach, expenses for current consumption are not deductible, while expenses for future consumption generally are deductible on the assumption that the future consumption will be taxed at the time that it occurs. Thus, the costs of investment assets, such as shares of stock, and "trade or business" expenses, such as business travel, are deductible. If the taxpayer eventually sells the stock or the business eventually generates funds, and the taxpayer spends such sale proceeds or funds

187. Under an indirect consumption tax regime, businesses are required to collect tax and pay such tax over to the government regardless of the form in which the business is organized. Thus, corporations, partnerships, and sole proprietorships alike that operate businesses collect tax. Individuals do not pay taxes on wages or investment income. Thus, under indirect consumption taxes, an individual collects and pays tax only on transactions of a sole proprietorship that the individual operates. See *supra* notes 124-31 and accompanying text. Notwithstanding the formal imposition of taxes on businesses under an indirect consumption tax, the burden of the tax is borne by individuals. See *supra* notes 114-15 and accompanying text.

188. Estimates of the number of taxpayers under an indirect consumption tax range from six million to 24 million, depending on whether small businesses are exempt. See *infra* Table 3. By contrast, in 1996, individuals and corporations filed 118,784,000 and 2,714,500 income tax returns, respectively. See *Selected Historical and Other Data*, 17 INTERNAL REVENUE SERVICE STATISTICS OF INCOME BULLETIN, Summer 1997, at 133, 162 tbl.21.

189. See POSNER, *supra* note 4, at 541.

on consumption, the taxpayer will be taxed on her consumption at that time.¹⁹⁰

Some expenses are incurred for mixed motives, however. Goods and services are sometimes purchased for personal satisfaction *and* either investment or a trade or business activity.¹⁹¹ The federal income tax grapples with mixed motive expenses for child care,¹⁹² meals,¹⁹³ clothing for work,¹⁹⁴ home offices¹⁹⁵ and education.¹⁹⁶ In theory, under a consumption tax, the portion of a mixed motive expense that relates to investment or a trade or business activity could be deducted under the cash flow approach or excluded under a retail sales tax or value added tax.¹⁹⁷ But determining the appropriate percentage is often difficult.¹⁹⁸ For example, how much of the cost of babysitting that allows a parent to work relates to personal satisfaction and how much to business? How much of the cost of a personal computer purchased by a law professor should be deductible if she uses it for playing computer games as well as writing articles?¹⁹⁹

190. See *supra* notes 116-20 and accompanying text.

191. See Graetz, *Design*, *supra* note 117, at 223-27; Graetz, *Implementing*, *supra* note 7, at 1588-91.

192. See I.R.C. § 21 (West 1988 & Supp. 1997) (providing credit for expenses paid for dependent care that enables taxpayer to be gainfully employed).

193. See I.R.C. § 274 (1994) (limiting meal and entertainment deductions for ordinary and necessary trade or business expenses).

194. See *Pevsner v. Commissioner*, 628 F.2d 467, 469 (5th Cir. 1980) (holding that there is no deduction for cost of work clothing that is adaptable for streetwear).

195. See I.R.C. § 280A (West 1988 & Supp. 1997) (limiting the deductibility of expenses relating to the business use of a residence); see also *id.* § 280F(b) (limiting the depreciation deduction for luxury automobiles used for business and personal purposes).

196. See Treas. Reg. § 1.162-5 (as amended in 1967) (establishing deductibility of certain educational expenses). Additional problematic expenses include medical treatment, charitable contributions, and payment of state and local taxes. See Graetz, *Implementing*, *supra* note 7, at 1591-93.

197. See Boris I. Bittker, *Income Tax Deductions, Credits, and Subsidies for Personal Expenditures*, 16 J.L. & ECON. 193, 202-04 (1973); Daniel I. Halperin, *Business Deduction for Personal Living Expenses: A Uniform Approach to an Unsolved Problem*, 122 U. PA. L. REV. 859, 863 (1974).

198. See Bittker, *supra* note 197, at 202-04; Halperin, *supra* note 197, at 863.

199. It is likely that the distinction between consumption and production is becoming increasingly difficult to draw. Traditionally, the distinction has been facilitated by a paradigm of "affluent, child-centered suburban household[s]" with neatly defined gender roles involving a male breadwinner and female homemaker. See Elaine Tyler May, *Myths and Realities of the American Family*, in 5 A HISTORY OF PRIVATE LIFE: RIDDLES OF IDENTITY IN MODERN TIMES 539, 581 (Antoine Prost & Gerald Vincent eds., 1991). Contemporary culture, however, integrates production and consumption. For example, increasing numbers of people work at home. See *Home Office Guide; Home Is Where the Hard Work Is*, N.Y. TIMES, Sept. 29, 1994, at C1.

The purchase of housing and consumer durables²⁰⁰ also implicates the distinction between current and future consumption. Under the cash flow approach, such purchases therefore require complicated provisions imputing rental values.²⁰¹ The purchase of a house, for example, would be deducted as an investment. The homeowner would then be taxed on the annual amount of the homeowner's consumption. Such amounts could be estimated based on the rental value of comparable houses.²⁰²

The cash flow approach could be modified to avoid imputation of rental values for consumer durables and housing, but such a change could result in liquidity problems. Under the modified approach, no deduction would be allowed for the purchase price. Assuming that the purchase price reflects the present value of the taxpayer's future consumption,²⁰³ failing to allow a deduction for the purchase price should be equivalent to taxing annual consumption and preempt the need to impute rents. The inability to deduct the investment portion of the cost of housing in the year of purchase could result in a huge tax in that year, however.²⁰⁴

C. Additional Problems

Consumption taxes introduce numerous other areas of uncertainty, absent or insignificant under the federal income tax, that would lead to complication.²⁰⁵

First, the tax prepaid approach inaccurately measures consumption because it relies on questionable assumptions²⁰⁶ and

200. Examples of "consumer durables" include household furniture, household appliances, and automobiles for personal use.

201. See Graetz, *Implementing*, *supra* note 7, at 1613-14.

202. See SMITH, *supra* note 28, bk. V, ch. II, at 369.

203. In the case of consumer durables and housing that will be resold by the taxpayer, the taxpayer's purchase price reflects the present value of the taxpayer's future consumption *plus* the present value of subsequent purchasers' future consumption. See Graetz, *Implementing*, *supra* note 7, at 1616-18.

204. Adam Smith recognized that, in the case of consumption goods that "last a considerable time," it is "more convenient" for the buyer to make "moderate annual" tax payments than to suffer "a heavy tax of equal value" at the time of the purchase. SMITH, *supra* note 28, bk. V, ch. II, at 406. *But see* BRADFORD, *supra* note 3, at 85-86 (discussing methods of alleviating taxation of consumer durables under direct consumption tax).

205. See Alan L. Feld, *Living with the Flat Tax*, 48 NAT'L TAX J. 603, 605-13 (1995) (cataloguing the uncertainties that exist under a flat tax regime).

206. Michael Graetz argues that *ex ante* measurement of consumption under the tax prepaid approach is accurate only assuming that (1) tax rates are not progressive and do not change over time; (2) taxpayers have no accumulated wealth at the time of enactment of the tax; (3) taxpayers consume all their wealth during their lifetimes (or are treated for tax purposes as having done so); (4) there exists a perfect capital market without

depends on a problematic distinction between income from capital and income from labor²⁰⁷ that is of relatively little importance under the federal income tax.²⁰⁸ Tax planning opportunities consequently would exist, as they do under the federal income tax. Such opportunities would be plugged by new complicated authorities.

Second, indirect consumption taxes distinguish between "real" and "financial" transactions.²⁰⁹ The distinction is new²¹⁰ and would be defined in complicated authorities.²¹¹ The payment or receipt of

uncertainty, and taxpayers can borrow and lend unlimited amounts at the risk-free rate; and (5) all income consists either of wage income or income from capital. See Graetz, *Implementing*, *supra* note 7, at 1602; see also Andrews, *Reply to Warren*, *supra* note 7, at 953 ("Gain or accretion is not limited to wages and investment alone.").

207. Recall that under the tax prepaid approach, labor income is taxed, but income from capital is exempt. See *supra* note 123 and accompanying text. By its terms, the approach requires that income from labor be distinguished from income from capital. In the case of individuals who own businesses for which they provide services, payments from the business to the individual could constitute either income from capital, such as dividends, compensation for services, or a combination of the two. See Committee on Simplification, *supra* note 117, at 423.

208. Certain Code provisions require a determination of whether income is compensation for labor. See, e.g., I.R.C. § 83 (1994). But because gross income under the federal income tax includes both income from labor and income from capital, see *id.* § 61(a)(1), (3), it is generally irrelevant whether an item of income arises from labor or capital. Indeed, even the important distinction in the federal income tax between capital gain and ordinary income, see I.R.C. § 1(h) (West 1988 & Supp. 1997); I.R.C. § 1211 (1994); *id.* § 1221, is not aligned with the distinction between income from capital and income from labor. Not all income from capital assets is subject to the special rules applicable to capital gain. For example, interest and dividends are derived from capital assets—namely, bonds and stocks—but are not considered capital gain because they do not arise as a result of a *sale or exchange* of a capital asset. See *id.* Interest and dividends are therefore not subject to the maximum tax rates applicable to capital gains under I.R.C. § 1(h) (West 1988 & Supp. 1997), nor are they treated as capital gains for purposes of the limitations on the use of capital losses under I.R.C. § 1211 (1994).

209. See, e.g., S. 1050, 104th Cong. § 102 (1995) (proposing to tax "gross active income" minus the cost of "business inputs" and "wages" of businesses (emphasis added)); see also HALL & RABUSHKA, *supra* note 7, at 55-56 (defining the base for business tax as the total revenue from sales of goods and services minus purchases of inputs from other firms, wages, and purchases of plant and equipment).

210. The distinction in consumption taxes between "real" and "financial" transactions is related to the distinctions in the federal income tax between capital gain and ordinary income, see I.R.C. § 1(h) (West 1988 & Supp. 1997); I.R.C. § 1211 (1994); *id.* § 1221, and between investment activity and trade or business activity, see I.R.C. § 163(d) (West 1988 & Supp. 1997); I.R.C. § 165(c) (1994); *id.* § 212.

211. Cf. DUE & MIKESSELL, *supra* note 164, at 38 (discussing the distinction between cash and accrual basis for sellers on credit under retail sales tax); TAIT, *supra* note 133, at 376-82 (listing numerous alternatives for the timing of supply and payment under a value added tax); Committee on Value Added Tax, American Bar Ass'n Section of Taxation, *Analysis of Tax Treatment of Financial Services Under a Consumption-Style VAT*, 44 TAX LAW. 181, 188-91 (1990) (considering whether services provided by financial intermediaries would be exempt under a consumption tax).

The distinction between "real" and "financial" transactions parallels the distinction

interest is the paradigm "financial" transaction, while the purchase or sale of goods or services in the ordinary course of business is the classic "real" transaction. Interest expense incurred by a business is generally considered part of the business's value added and therefore, like wages, is not deductible by the business under a value added tax. Correspondingly, receipt of interest is not considered value added by lenders. Institutions that function exclusively as financial intermediaries are therefore often exempt from value added tax.

Transactions between businesses, however, often reflect real and financial components. Suppliers and customers frequently extend credit to one another or make purchases pursuant to forward contracts under which the purchase price reflects an interest component.²¹² Further, businesses often enter into financial contracts in order to hedge their exposure under real business transactions.²¹³ Such hedges result in the business having an overall cost for business inputs that differs from the amount paid to suppliers, or an overall receipt from business outputs that differs from the amount paid by customers. Financial markets would exploit the ambiguities of the distinction between real and financial transactions, leading to complicated authorities designed to clarify the distinction.

Third, the precise scope of a national consumption tax would need to be clarified. In general, only domestic consumption would be taxed. Consumption by French citizens in France, for example, would not be taxed by the United States.²¹⁴ If the sale and

between labor income and capital income under the tax prepaid approach. Indeed, to a large extent, the distinctions are the same. Individuals provide labor to businesses in exchange for payment. Assume that individuals invest their labor income by lending to businesses. The businesses eventually repay the loans with interest. At that time, the individuals purchase consumption items from the businesses. Under the tax prepaid approach, the individuals' labor income is taxed but neither interest income from the loans nor the consumption purchases are taxed. Under a value added tax or retail sales tax, businesses pay tax on their receipts from the consumption purchases but do not deduct the cost of wages or interest.

212. See JOHN HULL, *OPTIONS, FUTURES, AND OTHER DERIVATIVE SECURITIES* 51 (2d ed. 1993).

213. See Treas. Reg. § 1.1221-2(b) (as amended in 1996) (defining "hedging transaction" to include a transaction into which a taxpayer enters in the normal course of its trade or business primarily to reduce risk with respect to inventory).

214. The text describes consumption taxes that rely on the "destination" principle, under which the jurisdiction in which goods are *consumed* is entitled to impose tax. Under the alternative "origin" principle, the jurisdiction in which goods are *produced* is entitled to impose tax. See Harry Grubert & T. Scott Newlon, *The International Implications of Consumption Tax Proposals*, 48 NAT'L TAX J. 619, 622-23 (1995). An origin principle consumption tax is better understood as a tax on domestic production,

consumption of a product both occur within the United States or both occur outside the United States, then taxing at the point of sale is appropriate. Domestic consumption is taxed, while foreign consumption is not. Difficulties arise if either the sale or consumption, but not both, occurs abroad. State retail sales taxes, for example, address the problem of goods purchased outside the state but consumed within the state by imposing a "compensating use" tax on such goods.²¹⁵ However, enforcement is often lax, especially for low-cost items.²¹⁶ Value added taxes require complicated border tax adjustments to ensure that exports are not taxed, while items that are imported for domestic consumption are taxed.²¹⁷ A national retail sales tax or value added tax would thus require a dramatic expansion of control of United States territorial borders.²¹⁸ Boxes shipped into the United States would need to be examined to determine if they contained taxable goods, and, if so, the value of the goods and whether tax had been paid. The distinction between domestic and foreign consumption would differ from the domestic and foreign distinctions in the federal income tax.²¹⁹

Fourth, taxation of services presents another difficult area. Most state retail sales taxes do not tax services. Taxpayers must tease

rather than consumption.

215. See 2 HELLERSTEIN & HELLERSTEIN, *supra* note 124, ¶ 16.02, at 16-4 to -8.

216. See DUE & MIKESSELL, *supra* note 164, at 275.

217. See Grubert & Newlon, *supra* note 214, at 638-39; see also Wayne G. Eggert, *Globalization of the Marketplace: Sales and Use Tax Implications*, in SALES TAXATION: CRITICAL ISSUES IN POLICY AND ADMINISTRATION 143, 144-51 (William F. Fox ed., 1992) [hereinafter SALES TAXATION] (describing tax policies in Alabama, Canada, California, Hawaii, and Texas, and noting the importance of placing the tax burden on the ultimate consumer in order to shift administrative costs strategically).

218. Such controls would be particularly difficult in the case of sales from outside the United States directly to consumers in the United States. States have attempted to address the analogous problem in the context of state retail sales taxes by requiring out-of-state mail-order vendors to collect use tax. However, such requirements were held to violate the Interstate Commerce Clause. See U.S. CONST. art. 1, § 8; *Quill Corp. v. North Dakota*, 504 U.S. 298, 317 (1992).

219. The federal income tax applies to all United States persons on their worldwide income. It nevertheless distinguishes between United States and non-United States source income for purposes of the credit allowed for foreign taxes paid or accrued, see I.R.C. § 901 (West 1988 & Supp. 1997) (allowing foreign tax credit), *id.* § 904 (limiting foreign tax credit), and determination of the amount of United States tax liability of non-United States persons, see *id.* § 861 (defining income from sources within the United States); I.R.C. § 862 (1994) (defining income from sources outside the United States); I.R.C. § 871 (West 1988 & Supp. 1997) (taxing certain nonresident alien individuals); I.R.C. § 881 (1994) (taxing income of foreign corporations not connected with a United States business); *id.* § 882 (taxing income of foreign corporations connected with a United States business).

apart taxable sales of goods from excluded sales of services,²²⁰ a time-consuming and ultimately futile task. A photographer who takes photographs for use in a department store catalogue, an optometrist who prescribes and supplies eyeglasses, an artist who paints a portrait, and a computer programmer who supplies a software program could each be viewed as selling goods, services, or both.²²¹ Indeed, even a paradigmatic retail sale, in which a customer buys shoes from the shoe store, applies pressure to the distinction between goods and services because such a sale involves merchandising services of the retailer.²²² The distinction between sales of services and sales of inventory is not a source of significant complexity under the federal income tax because both result in ordinary income or loss.

The complication associated with the distinction between goods and services would be avoided in a retail sales tax or value added tax that taxed consumed services as well as goods.²²³ But taxing services is no easy matter.²²⁴ Some services, such as education, are purchased partially for consumption and partially for business or investment purposes.²²⁵ Other services, such as medical and legal services and local transportation, are likely to be exempt for equity reasons.²²⁶ Further, determining whether a service has been consumed within the United States would be difficult in many cases.²²⁷

220. See John L. Mikesell, *General Sales Tax*, in REFORMING STATE TAX SYSTEMS, *supra* note 165, at 211, 212.

221. See 2 HELLERSTEIN & HELLERSTEIN, *supra* note 124, ¶ 12.07[1], at 12-20. Courts have decided such cases by inquiring whether the "true object" or "dominant purpose" of the buyer was to obtain the product or service. See *id.* at 12-19 to -23.

222. See JOHN F. DUE, SALES TAXATION 374-75 (1957).

223. Indeed, many commentators recommend that the coherence of state retail sales taxes would be vastly improved if such taxes were expanded to apply generally to services. See, e.g., 2 HELLERSTEIN & HELLERSTEIN, *supra* note 124, ¶ 12.05, at 12-17 (arguing that the uniform tax on consumer expenditures should apply to services); William F. Fox, *Sales Taxation of Services: Has Its Time Come?*, in SALES TAXATION, *supra* note 217, at 51, 52-53 (explaining that sales taxes were originally enacted during the Depression in order to raise revenue conveniently, without regard to conceptual basis); John P. James, *Sales Tax on Services: A Tax Administrator's Perspective*, in SALES TAXATION, *supra* note 217, at 63, 69, 74 (stating that the predominance of goods taxation reflects the U.S. economy's historical but not current emphasis on goods).

224. See JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION: CASES AND MATERIALS 758-60 (5th ed. 1988) [hereinafter, HELLERSTEIN & HELLERSTEIN, CASES AND MATERIALS] (describing Florida's failed attempt to implement a broad-based sales tax on services).

225. See GRAETZ & SCHENK, *supra* note 39, at 328-29.

226. See *supra* notes 164-65 and accompanying text.

227. Situs has been a thorny issue for states' efforts to tax services because services may be performed in one jurisdiction and consumed in another. See HELLERSTEIN & HELLERSTEIN, CASES AND MATERIALS, *supra* note 224, at 758; Walter Hellerstein, *Sales*

Finally, the imposition of different tax rates upon different categories of consumption would lead to complication in the definition of the rate categories.²²⁸ Comparable classification complexities have developed in the federal income tax in distinguishing ordinary income from capital gain because of the different rates that historically have applied.²²⁹

VIII. PUBLIC CHOICE CONSIDERATIONS REVISITED

In addition to the equity-based and certainty-based complexity discussed in Parts VI and VII above, public choice pressures would lead to complication, intractability, and incoherence under a consumption tax.

Some plausible arguments can be made that a consumption tax would be more resistant to manipulation than an income tax. For example, under an income tax, depreciation schedules²³⁰ for capital

Taxation of Services: An Overview of the Critical Issues, in SALES TAXATION, *supra* note 217, at 41, 42-49; James, *supra* note 223, at 69-74. Situs of services might be less of a problem for a national retail sales tax or value added tax than for state retail sales taxes because there are fewer consumer purchases of services that cross *national* boundaries than *interstate* consumer purchases of services. Consumers' purchases of services could in general reasonably be presumed to be consumed within the United States and, therefore, appropriately subject to tax.

228. See, e.g., KPMG, *supra* note 168, at II-4; TAIT, *supra* note 133, at 399; 1995 Hearing, *supra* note 19, at 159-69 (testimony of Arthur Hall on behalf of the Tax Foundation); *supra* notes 164-70 and accompanying text. Rate differentiation may be used for efficiency reasons, rather than equity reasons. Multiple rates allow the government to remove distortions that, ironically, are present in a uniform rate tax. Efficiency recommends minimizing "excess burden" or "deadweight loss," which is a result of behavioral distortions caused by tax considerations. See ROSEN, *supra* note 162, at 303-07. A uniform rate on all consumption products will have different effects on consumers' appetites for different products. Some products are highly inelastic to price, meaning that the quantity purchased depends little on the price charged. See SAMUELSON & NORDHAUS, *supra* note 8, at 58. A value added tax or retail sales tax would increase the price to consumers of those goods, but would have little effect on the quantity of those goods purchased. See *id.* at 65-66. For price-elastic products, however, the increase in price to consumers caused by a value added tax or retail sales tax would distort behavior by causing a substantial decrease in the quantity purchased. See *id.* In order to minimize distortions, a consumption tax could impose a high rate of tax on price-inelastic goods and services and lower rates on price-sensitive goods and services.

229. See, e.g., I.R.C. § 302 (1994) (treating certain stock redemptions as capital and others as ordinary); *id.* § 304 (treating certain sales of stock to related corporations as capital and other sales as ordinary); *id.* § 306 (treating certain gain from the sale of preferred stock as ordinary). The Tax Reform Act of 1986, Pub. L. No. 99-514, § 301, 100 Stat. 2085, 2216, temporarily eliminated the rate differential between capital gain and ordinary income—a change that was hailed as reducing complexity. See GRAETZ & SCHENK, *supra* note 39, at 567.

230. Depreciation schedules specify how much of a taxpayer's basis, or cost, for property used in a trade or business or held for investment may be deducted each year. Generally, basis is deducted over the "useful life" of the property. The current

expenditures can be adjusted to help or harm different taxpayers.²³¹ Under a direct consumption tax or a value added tax, there is arguably less potential for tinkering because all businesses are entitled to an immediate deduction for capital expenditures.

Those arguments, even if successful, do not show, however, that a consumption tax would foreclose complication, intractability, and incoherence arising from the tendency of public officials to advance their own interests. One means to manipulate a value added tax or retail sales tax, for example, would be to exclude, or to tax at a low rate, particular types of consumption.²³² The benefit of exclusions or low rates could be doled out to influential groups of consumers or producers.²³³ Soon after the initial enactment of a consumption tax, reductions in rates for specific consumption goods or services would be difficult to accomplish. Special rates would be prominent and invite accusations of unwarranted special treatment. But publicly acceptable arguments could be made for special treatment of virtually any consumption good or service.²³⁴ Eventually, one would expect legislators to use exclusions or variations in rates or other tax legislation to advance legislators' interests.

Exclusions and low rates lend instability to a consumption tax, contributing to further increases in complexity. First, exclusions and low rates invite demands for more exclusions and low rating.²³⁵ Once any departures are made from taxing all consumption, any type of consumption is a candidate for an exclusion. Second, exclusions and

depreciation system, the Modified *Accelerated* Cost Recovery System, allows deductions that are faster than economic depreciation. See I.R.C. §§ 167, 168 (West 1988 & Supp. 1997).

231. Generally, a faster depreciation schedule helps businesses more than a slower schedule. A faster depreciation schedule results in greater deductions in early years than a slower schedule. See GRAETZ & SCHENK, *supra* note 39, at 337.

232. See *supra* notes 164-70 and accompanying text.

233. See, e.g., STANLEY, *supra* note 106, at 26-27 (noting that nineteenth-century politicians manipulated tariff rate schedules to appeal to favored constituencies).

234. See *supra* notes 164-70 and accompanying text. The trend among state retail sales taxes has been to increase the number of exempt goods. See Mikesell, *supra* note 220, at 213; see also 2 HELLERSTEIN & HELLERSTEIN, *supra* note 124, ¶ 12.01, at 12-4 to -5 (charting state-by-state sales tax rates and exemptions). For example, in 1970, 15 states exempted food, 11 exempted utilities, and four exempted clothing. See Steven D. Gold, *State Tax Policy: Recent Trends and Future Directions*, in REFORMING STATE TAX SYSTEMS, *supra* note 165, at 11, 23. In 1986, 29 states exempted food, 32 exempted utilities, and six exempted clothing. See *id.*; see also DUE & MIKESSELL, *supra* note 164, at 75-80, 84-88, 326 (discussing treatment of exemptions, and the increasing number and complexity of them, under various states' sales taxes). Only two states, Hawaii and New Mexico, failed to exempt prescription medicines in 1986, compared with 19 states in 1971. See Mikesell, *supra* note 220, at 216.

235. See DUE & MIKESSELL, *supra* note 164, at 88, 326.

low rates lead to a backlash. A government hard-pressed for revenue is likely to identify excluded or low rated consumption as a strong candidate for taxation, or taxation at a higher rate.²³⁶ Expansion, whether incremental or in a large step, would lead to complication, intractability, and incoherence. For example, an exclusion of sales of food from the consumption tax might be replaced by a transfer payment or subsidy. Elimination of the food exclusion would eliminate intractability and complication associated with the exclusion but would introduce intractability and complication associated with the welfare law that provided for the transfer payment. For example, thorny issues would arise regarding who is eligible and how much of a payment or subsidy they should receive.²³⁷

IX. COMPLIANCE COSTS AND ADMINISTRATIVE COSTS UNDER A CONSUMPTION TAX

Tax regimes cause taxpayers and the government to incur costs. Taxpayers spend time and money complying with, interpreting, and transacting around the tax laws ("compliance costs").²³⁸ The government incurs costs administering the system ("administrative costs"). At first blush, quantitative studies suggest that taxing consumption is less expensive than taxing income. In fact, the studies lend only mild support to that view.²³⁹

First, estimates of compliance costs and administrative costs are unreliable because it is difficult to measure, much less predict, the amount of such costs.²⁴⁰ Estimates range widely. Second, compliance costs and administrative costs are sensitive to many factors, such as

236. For example, revenue needs have prompted the incremental expansion of state retail sales taxes into the area of services. See Bill Hamilton & John L. Mikesell, *Sales Tax Policy During the Next Decade*, in SALES TAXATION, *supra* note 217, at 27, 28-38.

237. Obviously, an income tax credit would not be a possibility for a national consumption tax that *replaced* the income tax.

238. In addition to the time and money that taxpayers spend on tax compliance, compliance costs deter taxpayers from undertaking socially productive activities. See JAMES L. PAYNE, *COSTLY RETURNS: THE BURDENS OF THE U.S. TAX SYSTEM* 87-89 (1993). For example, compliance costs deter taxpayers from becoming self-employed, starting a business, or hiring a domestic servant. The social cost of such distortions in people's behavior caused by taxes is known as "excess burden" or "deadweight loss." See *id.* at 87-88; *supra* note 228.

239. See *infra* notes 267-69 and Table 3.

240. Most studies of compliance costs are based on taxpayers' recollections of the amount of time or money they spent on tax compliance. Such recollections are not always reliable. In one case, researchers estimated compliance costs without relying on a survey. See Mark M. Pitt & Joel Slemrod, *The Compliance Cost of Itemizing Deductions: Evidence from Individual Tax Returns*, 79 AM. ECON. REV. 1224, 1230 (1989).

frequency of audit and number of taxpayers, that are largely independent of the choice of tax base. Much of the cost reduction reflected in studies of a hypothetical United States value added tax arises from the relatively low number of taxpayers under a value added tax, rather than from its consumption base. Thus, the studies suggest that *indirect* taxes have lower compliance and administrative costs than *direct* taxes, and that regimes with *fewer* taxpayers have lower costs than regimes with *more* taxpayers, but not that *consumption* taxes have lower costs than *income* taxes. Rather than switching to a consumption tax, perhaps cost savings could be achieved by implementing an income tax with fewer taxpayers than the current federal income tax. Fourth, extrapolating from European value added taxes and state retail sales taxes, the value added tax studies assume relatively simple tax regimes. But such extrapolations and assumptions are questionable because the United States raises more revenue than those regimes, has a legal culture that values complication more highly than in Europe, and is more litigious than Europe. Further, European countries and most states rely on personal income taxes in addition to value added taxes or retail sales taxes, thus forestalling some equity-based complexity that would arise in the United States if the United States *replaced* the income tax with a value added tax.

A. *Quantitative Studies*

Conclusions based on studies of administrative costs and compliance costs should be tempered with a healthy respect for the difficulty of measuring, much less predicting, such costs. Professor Graetz has warned against "illusions of precision" from undue emphasis on numerical predictions.²⁴¹ Measurements of compliance costs are especially unreliable because they generally depend on survey respondents' vague recollections of the amount of time they spend on tax matters. Nevertheless, such quantitative studies can suggest general trends and therefore merit examination.

At first glance, quantitative studies suggest that compliance costs and administrative costs are lower under consumption taxes than under income taxes. As reflected in Table 3, the total annual administrative costs of the IRS are approximately \$7415

241. See Michael J. Graetz, *Paint-By-Numbers Lawmaking*, 95 COLUM. L. REV. 609, 613 (1995).

TABLE 3: ANNUAL ADMINISTRATIVE COSTS OF FEDERAL TAX SYSTEM AND HYPOTHETICAL UNITED STATES VALUE ADDED TAX

	Annual Administrative Costs (in millions of dollars)	Number of Taxpayers (in millions)	Annual Administrative Costs Per Taxpayer
Federal Tax System	7415 ^a	121 ^b	61
Value Added Tax— Treasury Report ^c	700	20	35
Value Added Tax— KPMG Report ^d	300	6	50
Value Added Tax— CBO Report ^e	750-1500	7	107-214
Value Added Tax— GAO Report ^f	1220-1830	24	51-76
Value Added Tax— IRS Report ^g	2280	13	175

a. See BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1998—APPENDIX 872-76 (1997) (listing \$1725 million, \$4180 million, and \$1510 million as the costs for “processing, assistance, and management,” “tax law enforcement,” and “information systems,” respectively).

b. See *Selected Historical and Other Data*, 17 INTERNAL REVENUE SERVICE STATISTICS OF INCOME BULLETIN, Summer 1997, at 133, 162 tbl.21. The number of taxpayers is based on the filing of 118,784,000 individual income tax returns and 2,714,500 corporate income tax returns (other than S Corporation returns) in 1996. See *id.* In addition, in that year, 90,600 estate tax returns and 232,000 gift tax returns were filed. See *id.*

c. See 3 DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 113 (1984).

d. See KPMG PEAT MARWICK, STUDY OF VALUE-ADDED TAXATION IN THE UNITED STATES i-4, V-3 (1989).

e. See CONGRESSIONAL BUDGET OFFICE OF THE U.S. CONGRESS, EFFECTS OF ADOPTING A VALUE-ADDED TAX 69 (1992).

f. See U.S. GENERAL ACCOUNTING OFFICE, VALUE-ADDED TAX: ADMINISTRATIVE COSTS VARY WITH COMPLEXITY AND NUMBER OF BUSINESSES #78 at 3 (1993), *microformed on Sup. Docs. No. GAO/GGD-93-78* (U.S. Gov't Printing Office), *reprinted in 93 TNT 98-23, available in LEXIS, FEDTAX Library* (annual administrative costs); *id.* at 38 tbl.3.1 (number of taxpayers).

g. See INTERNAL REVENUE SERVICE, A STUDY OF ADMINISTRATIVE ISSUES IN IMPLEMENTING A FEDERAL VALUE ADDED TAX (1993), *reprinted in 93 TNT 217-8, available in LEXIS, FEDTAX Library*.

million.²⁴² Table 3 also shows that studies by the Department of the Treasury ("Treasury"),²⁴³ KPMG Peat Marwick ("KPMG"),²⁴⁴ the Congressional Budget Office ("CBO"),²⁴⁵ the General Accounting Office ("GAO"),²⁴⁶ and the IRS²⁴⁷ of hypothetical federal value added

242. See BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1998—APPENDIX 872-76 (1997) (listing \$1725 million, \$4180 million, and \$1510 million as the costs in 1996 for "processing, assistance, and management," "tax law enforcement," and "information systems," respectively); *infra* Table 3. The \$7415 million figure reflects administrative costs for all taxes administered by the IRS, including estate, gift, and excise, as well as income taxes. Separate figures for the different taxes are not available. It is likely that the income tax accounts for the lion's share of total administrative costs, however, because it accounts for by far the greatest revenues. See *supra* Table 2.

243. The Treasury's 1984 study concluded that a fully phased-in value added tax would cost approximately \$700 million to administer and require approximately 20,000 new staff. See 3 TREASURY I, *supra* note 7, at 1. The Treasury assumed that the value added tax would supplement an income tax and be administered primarily by the IRS. See *id.* The U.S. Customs Service would collect tax on imports. See *id.* at 113. Based on the number of state retail sales taxpayers, there would be a total of 20 million value added taxpayers. See *id.* Certain consumption goods and services would be excluded. See *id.* Returns would be filed quarterly, but deposits would be made monthly or semi-monthly. See *id.* at 115-16. An average of 2.2% of taxpayers would be audited. See *id.* at 120. The Treasury did not believe that the benefits of a value added tax outweighed its costs and therefore did not recommend adoption of a value added tax. See *id.* at 1.

244. KPMG estimated that a value added tax would require only 6100 new staff. See KPMG, *supra* note 168, at i-4. Annual administrative costs would be \$49 per registered taxpayer, see *id.* at V-14, for a total of approximately \$300 million, see *id.* at i-4. Building on the Treasury study, KPMG assumed that businesses with less than \$50,000 of gross business receipts would be exempt, resulting in only six million taxpayers. See *id.* at V-3. KPMG also assumed that there would be a standard tax rate, a reduced rate for necessities, and exemptions for food, health care, financial services, and nonprofit activities. See *id.*

245. The CBO estimated that approximately seven million businesses would have been registered in 1988 resulting in administrative costs between \$750 million and \$1500 million. The CBO assumed that businesses with less than \$25,000 in annual sales would be exempt, and, based on data relating to administrative costs of European value added taxes, that administrative costs per taxpayer would be between \$100 and \$200, significantly higher than estimated by Treasury and KPMG. See CBO, *supra* note 173, at 68-69.

246. The GAO concluded that total annual administrative costs would be between \$1220 million and \$1830 million and require approximately 30,577 new staff. The GAO assumed approximately 24 million taxpayers, a single rate for all taxable goods (other than exports, which would be zero-rated), a broad tax base, and an annual audit rate of approximately 8%. The GAO analyzed IRS costs for administering corporate income tax, employment tax, and excise tax, consulted with state retail sales tax administrators in six states, and obtained information on value added tax administration from the United Kingdom, New Zealand, and Canada. See GAO, *supra* note 168, at 4-6 (discussing a basic value added tax lacking exemptions and multiple rates).

247. The IRS concluded that approximately 28,125 new staff would be required. Administrative costs over a four-year start up period would be approximately \$5978 million. In the fourth year, such costs would be approximately \$2280 million. The IRS assumed a registration threshold of \$100,000 in gross business receipts and therefore

taxes each estimated substantially lower aggregate administrative costs.²⁴⁸

Consumption taxes also appear to fare better than income taxes in a comparison of administrative costs as a percentage of revenue raised. Table 4 shows costs of complying with and administering income, value added, and excise taxes in the United Kingdom as a percentage of the revenue raised by such taxes.²⁴⁹ The total costs as a percentage of revenue for the value added tax are lower than such costs for the United Kingdom's income and capital gains tax.²⁵⁰ Excise tax costs are lower still.

Compliance costs for individuals would be largely eliminated under a value added tax²⁵¹ but are undoubtedly steep under the federal income tax.²⁵² Two 1984 surveys conducted for the IRS suggested that individuals spent 1.6 billion hours on federal income

approximately 13.3 million registered businesses, a single rate tax, and modest audit rates of 2% for the smallest businesses to 8% for the largest businesses. The IRS reviewed prior studies, interviewed officials from Canada, Great Britain, New Zealand, France, Spain, Germany, and Sweden, and consulted with IRS officials on internal assessments of resources and potential problems. See INTERNAL REVENUE SERVICE, A STUDY OF ADMINISTRATIVE ISSUES IN IMPLEMENTING A FEDERAL VALUE ADDED TAX (1993), available in 93 TNT 217-8 (Oct. 22, 1993), LEXIS, FEDTAX Library.

248. See also Sijbren Cnossen, *Administrative and Compliance Costs of the VAT: A Review of the Evidence*, 63 TAX NOTES 1609, 1610 (1994) (noting that there would be approximately \$1 billion, or \$100 per registered business, in administrative costs for United States value added tax, assuming a small business exemption of \$75,000).

249. See *infra* Table 4; see also CBO, *supra* note 173, at 68-69 (noting that the value added tax administrative costs in European countries typically are \$100 to \$200 annually per registered business and approximately 0.4% to 1.0% of value added tax revenue; moreover, costs tend to be largely independent of the amount of revenue raised); DUE & MIKESSELL, *supra* note 164, at 325 (noting that the average administration cost as a percentage of revenue, for state retail sales taxes in 1979-81, was 0.73%); CEDRIC SANDFORD ET AL., ADMINISTRATIVE AND COMPLIANCE COSTS OF TAXATION 131-35 (1989) (noting that value added tax administrative costs as a percentage of revenue for selected European countries and New Zealand in the mid-1980s ranged from 0.32% in Norway to 1.09% in Belgium, and that value added tax administrative costs per registered business ranged from \$46 in New Zealand to \$235 in Finland).

250. See *infra* Table 4; see also ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TAXING CONSUMPTION 203 (1988) [hereinafter OECD] (noting that administrative costs for value added tax and income tax as a percentage of revenue in Sweden were 0.8% and 1.6%, respectively, in 1981 and 1982).

251. Indeed, consumers would not even recognize that they were paying the tax if it was not separately stated on their receipts. See Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLA L. REV. 1861, 1875-76 (1994). Individuals' visible compliance costs would be zero under such a "hidden" tax. Alexander Hamilton extolled the "imperceptible agency of taxes on consumption." THE FEDERALIST No. 12, at 92-93 (Alexander Hamilton) (Clinton Rossiter ed., 1961). Businesses likely would pass their compliance costs on to consumers, however.

252. See, e.g., 1995 Hearing, *supra* note 19, at 15-63 (testimony of small business owners that the tax system is burdensome).

tax compliance in that year.²⁵³ A 1982 survey of Minnesota households suggested that in that year the aggregate compliance costs for federal and state individual income taxes were between \$17 billion and \$27 billion, which was between five and seven percent of the revenue raised by those taxes.²⁵⁴ The compliance costs reflected approximately two billion hours of individual taxpayer time and \$3 billion spent on professional assistance.²⁵⁵ Self-employed taxpayers had significantly higher compliance costs than employees.²⁵⁶ Taxpayers with capital gains or losses also had especially high compliance costs.²⁵⁷ And in 1982, taxpayers who itemized deductions incurred approximately \$1.44 billion of compliance costs as a result of itemizing.²⁵⁸ The Tax Reform Act of 1986 did not reduce compliance costs for individuals.²⁵⁹

TABLE 4: ADMINISTRATIVE COSTS AND COMPLIANCE COSTS AS A PERCENTAGE OF REVENUE, UNITED KINGDOM, 1986-87

Type of Tax	Administrative Costs as a Percentage of Revenue	Compliance Costs as a Percentage of Revenue	Total Costs as a Percentage of Revenue
Income Tax and Capital Gains Tax ^a	2.28%	3.86%	6.14%
Value Added Tax ^b	1.03	3.69	4.72
Excise Taxes ^c	0.25	0.20	0.45

a. See CEDRIC SANDFORD ET AL., ADMINISTRATIVE AND COMPLIANCE COSTS OF TAXATION 108, 109 tbl.7.3. (1989).

b. See *id.* at 119 tbl.8.5.

c. See *id.* at 168 tbl.10.3. The main excise taxes imposed by the United Kingdom at the time of the study were taxes on hydrocarbon oil, tobacco products, and alcoholic drinks. See *id.*

253. See ARTHUR D. LITTLE, DEVELOPMENT OF METHODOLOGY FOR ESTIMATING THE TAXPAYER PAPERWORK BURDEN I-7 (1988).

254. See Joel Slemrod & Nikki Sorum, *The Compliance Cost of the U.S. Individual Income Tax System*, 37 NAT'L TAX J. 461, 461 (1984) (extrapolating from the Minnesota results to derive compliance costs for the entire nation).

255. See *id.*

256. See *id.* at 468-69.

257. See Joel Slemrod, *The Return to Tax Simplification: An Econometric Analysis*, 17 PUB. FIN. Q. 3, 16 (1989).

258. See Pitt & Slemrod, *supra* note 240, at 1224.

259. See Marsha Blumenthal & Joel Slemrod, *The Compliance Cost of the U.S. Individual Income Tax System: A Second Look After Tax Reform*, 45 NAT'L TAX J. 185, 200 (1992).

B. Measures of What?

Those quantitative studies do not lead to the conclusion that income is more expensive to tax than consumption because they do not isolate the effect of taxing income rather than consumption. In fact, compliance costs and administrative costs measure numerous features of a tax regime, some of which are largely independent of the choice of tax base. First, the measure used in Table 4, costs as a percentage of revenue, depends on the amount of revenue raised, which is, in turn, sensitive to tax rates.²⁶⁰ Second, administrative costs are highly sensitive to the quality of enforcement of tax laws.²⁶¹ Different assumptions about the frequency of audit, or the number of personnel per taxpayer, can change estimates of the costs of hypothetical tax regimes dramatically.²⁶² Third, administrative costs reflect the degree to which the government devotes resources to taxpayer education and information. Enforcement quality and taxpayer education levels could range high or low under either an income or a consumption tax.

C. Number of Taxpayers

One of the most important variables affecting administrative costs and compliance costs is the number of taxpayers.²⁶³ Fewer taxpayers tends to translate into lower overall costs.²⁶⁴ In their studies of a hypothetical United States value added tax, the Treasury, KPMG, CBO, GAO, and the IRS assumed as their base case 20, 6, 7, 24, and 13 million taxpayers, respectively, as compared with an estimated 121 million taxpayers under the federal income tax, as shown in Table 3. A value added tax applies to dramatically fewer taxpayers because, as an indirect tax, it taxes only businesses, not individuals. Further, reflecting the practice of many countries that

260. See OECD, *supra* note 250, at 203.

261. See, e.g., *id.*; SANDFORD ET AL., *supra* note 249, at 203.

262. For example, the Treasury's hypothetical value added tax study assumed that one staff person would be needed for each 1000 registered businesses, see 3 TREASURY I, *supra* note 7, at 113, a ratio that is substantially lower than the ratios in every country that utilizes a value added tax, see TAIT, *supra* note 133, at 250 (noting that the ratio of staff to taxpayers in selected European countries ranges from 1:130 in Ireland to 1:726 in Italy).

263. See, e.g., TAIT, *supra* note 133, at 245 (stating that the "most important factor affecting staffing needs is number of taxpayers").

264. Recall, however, that reducing the number of taxpayers could increase the pace at which legal authorities are produced. The resulting increase in complication would increase some compliance and administrative costs. See *supra* text accompanying note 189.

impose a value added tax,²⁶⁵ some of the studies assumed that there would be an exemption for small businesses that would further reduce the number of taxpayers, and thereby reduce administrative costs.²⁶⁶

When administrative costs are measured taking into account the number of taxpayers, the picture of the federal income tax is far less bleak. Based on the data in Table 3, costs per taxpayer are only approximately \$61.²⁶⁷ That number is moderate compared with the administrative costs per taxpayer under most of the value added tax studies, which range from \$35 per taxpayer, in the case of the Treasury study,²⁶⁸ to a possible \$214 per taxpayer, in the case of the CBO study.²⁶⁹

The value added tax studies therefore suggest that taxing many taxpayers is more expensive than taxing fewer taxpayers—an intuitively correct result. Strides could be made in that direction within the context of the federal income tax. The federal income tax became a “mass” tax during World War II. Prior to that time, only a small percentage of the population paid income tax.²⁷⁰ The expansion of the income tax could be reversed by eliminating some taxpayers from the rolls. For equity reasons, low-income individuals and perhaps also small businesses²⁷¹ would be the appropriate candidates

265. See TAIT, *supra* note 133, at 118, 124-30.

266. The size of a business, for purposes of determining whether it was small enough to qualify for an exemption, would likely be measured by gross receipts. See KPMG, *supra* note 168, at V-19 tbl.V-6. For example, in KPMG’s base case, a \$50,000 small business exemption resulted in six million taxpayers, *see id.* at V-3, and \$300 million in administrative costs, *see id.* at i-4. Assuming a \$25,000 exemption, however, KPMG calculated 8.2 million taxpayers, *see id.* at III-8 tbl.III-1, and \$390 million in administrative costs, *see id.* at i-6. A \$100,000 small business exemption resulted in 4.1 million taxpayers, *see id.* at III-8 tbl.III-1, and only \$220 million in administrative costs, *see id.* at i-6. See also TAIT, *supra* note 133, at 118, 124-30 (describing the range of treatments of small businesses in selected countries).

267. See *infra* Table 3. Costs per taxpayer of administering the income tax actually should be somewhat less than \$61, which would be the correct number only if the entire \$7415 million of administrative costs were spent on *income* tax administration. In fact, \$7415 million is the IRS’s cost for administering *all* taxes, including the federal income tax, which presumably accounts for the lion’s share of costs.

268. See 3 TREASURY I, *supra* note 7, at 113.

269. See CBO, *supra* note 173, at 69.

270. See WITTE, *supra* note 3, at 126 fig.6.2.

271. Small businesses might be appropriate candidates for tax exemption because compliance costs for businesses tend to be regressive. Regardless of the type of tax, large businesses enjoy economies of scale in tax compliance. See, e.g., SANDFORD ET AL., *supra* note 249, at 116 (pointing out economies of scale in value added tax); Arthur P. Hall, *The High Cost of Tax Compliance for U.S. Business*, 63 TAX NOTES 887, 887-88 (1994) (pointing out economies of scale in federal income tax compliance); *see also* GAO, *supra*

for tax relief.

D. Extrapolations from Europe and the States

The hypothetical United States value added tax studies extrapolate from the experience of European countries that use a value added tax and states that use a retail sales tax. Such extrapolations may be misleading. The United States raises far more revenue through its income tax than those jurisdictions raise from a value added tax or retail sales tax, creating greater pressure for complication.²⁷² In addition, European taxes may be less prone to complication than United States taxes because the United States legal culture prizes complication more than European cultures,²⁷³ and because the United States is almost certainly a more litigious society.

Further, European countries adopted value added taxes out of dissatisfaction with other *indirect* taxes that they perceived as incoherent.²⁷⁴ In fact, no country has used a value added tax to replace a direct income tax.²⁷⁵ Instead, many countries that have a value added tax also have a personal income tax.²⁷⁶ In those countries, perceived regressivity in the value added tax can be addressed with adjustments to the income tax. If the United States adopted a value added tax to *replace* the income tax, however, equity concerns could not be mitigated in that manner. Instead, such concerns would likely be addressed through the enactment of multiple rates, exclusions or other changes in the value added tax,²⁷⁷ making the regime more complex and costly.²⁷⁸

note 168, at 61 (pointing out that small New Zealand firms spent 500 times as much as a percentage of sales to comply with New Zealand's value added tax as large firms). Administrative costs are high for small businesses also because they have high delinquency rates. See DUE & MIKESSELL, *supra* note 164, at 192, 205; cf. I.R.C. § 448(b)-(c) (1994) (permitting small corporations and partnerships to use the cash method of accounting). Defining which businesses are eligible for a small business exemption could itself become complicated.

272. See *supra* notes 75-88 and accompanying text.

273. See *supra* notes 110-13 and accompanying text.

274. See Henry J. Aaron, *Introduction and Summary*, in BROOKINGS INST., THE VALUE-ADDED TAX: LESSONS FROM EUROPE 1, 7 (Henry J. Aaron ed., 1981) (stating that value added taxes supplanted "cascading" taxes on business-to-business sales).

275. See TAIT, *supra* note 133, at 10-14 tbl.1-2, 398.

276. See *supra* note 163 and accompanying text.

277. Another alternative is transfer payments through a separate welfare system. Cf. Alstott, *supra* note 65, at 535 (explaining that the earned income tax credit is a kind of welfare program known to economists as an income transfer program).

278. Commentators agree that the greater the number of rates, the higher the compliance costs and administrative costs. For example, prior to 1979, the United Kingdom imposed a two-rate value added tax. Researchers estimated that a single rate

X. CONCLUSION

The simplicity of a consumption tax has been overstated because the debate over fundamental tax reform has not adequately acknowledged that tax complexity is itself a complex phenomenon. My method of analysis, distinguishing among complication, intractability, and incoherence, lends clarity and rigor to the debate. The narrower scope of a consumption tax does not automatically lead to greater overall simplicity.

I have argued that a tax regime committed to taxing equitably inevitably will be complex because there will be a gap between the desired distribution of tax burdens and the actual distribution. Efforts to narrow the gap increase coherence but also increase complication and decrease tractability. Thus, a tax regime committed to equity continually trades off among the three types of complexity.

I also have argued that uncertainties in the application of a tax regime lead to complication if there is more revenue at stake in an issue than the transaction costs required to produce a legal authority addressing the issue. Complication is therefore sensitive to the amount of revenue raised by a tax regime, the number of taxpayers in the regime, and the period of time since the regime has been enacted.

Finally, I have argued that departures from the public interest model assumed by my discussion of the equity-based and certainty-based sources of complexity would contribute to complexity. To the extent that public officials intentionally act in their own self-interest, collective action problems will be a source of all three types of complexity. Public officials who intend to act in the public interest but fail because of incompetence are another source of complexity. Further, the legal profession cultivates a taste for complication that is likely not in the public interest. Many public officials who create tax

would reduce compliance costs by more than 8%. See SANDFORD ET AL., *supra* note 249, at 123. In 1979, the United Kingdom replaced the two-rate system with a single-rate system resulting in "an abrupt drop in compliance costs." *Id.* at 131; *see also id.* at 213 (estimating an 8-9% increase in compliance costs following the initial establishment of the two-rate system in 1974). Similarly, officials in a state with a complicated retail sales tax rate structure believe that administrative costs could be cut in half if the rate structure were simplified. See GAO, *supra* note 168, at 72. Retail sales tax auditors estimate that rates or exemptions can cause a 30-50% increase in examination costs. See GAO, *supra* note 168, at 80; *see also* KPMG, *supra* note 168, at i-6 (comparing administrative costs under a single-rate system with administrative costs under a three-rate system); TAIT, *supra* note 133, at 42 (stating that tax administrators prefer to use a single rate); *id.* at 114 (explaining that the United Kingdom's decision to use multiple rates "greatly complicated what ought to have been a simple [value added tax]"); 3 TREASURY I, *supra* note 7, at 45 (stating that multiple rates result in audit issues that are hard to resolve, thus creating difficulties for tax administrators).

law were trained as lawyers and therefore tend to serve lawyers' tastes for complication.

The equity-based, certainty-based, and public choice sources of complexity would each apply to a consumption tax. Under a consumption tax that raised as much revenue as the federal income tax, large dollar amounts would be at stake in the resolution of legal uncertainties, leading to complication.²⁷⁹ Indeed, complication might develop at a more rapid pace under an indirect consumption tax than under the federal income tax because such a consumption tax would impose tax on fewer taxpayers than the federal income tax.

Further, adoption of a consumption tax by the federal government, like reliance on an income tax, would be accompanied by a commitment to equity, resulting in trade-offs among complication, intractability, and incoherence. Whether a consumption tax would be simpler overall than the federal income tax depends in part on whether consumption or income is the more equitable tax base. The debate over equity is therefore logically prior to the debate over complexity and should be the focus of tax reform analysis. Even if a consumption tax were more equitable, complexity would be inevitable because taxable consumption would not match the equitable ideal, because financial pressures to resolve uncertainty would lead to complication, and because of the tendency of public officials to create laws that serve special interest groups, lawyers, or the officials themselves.

279. The federal government raises approximately \$634 billion from income taxes. See BUREAU OF THE CENSUS, DEP'T OF COMMERCE, NO. GT/93-Q4, QUARTERLY SUMMARY OF FEDERAL, STATE, AND LOCAL TAX REVENUE, OCTOBER-DECEMBER 1993, at 4 (1995).

