

Considering a Consumption Tax

A combination of electronic commerce and the "Flat Tax" could eliminate the IRS as we know it.

BY PROFESSOR DANIEL S. GOLDBERG

Now that April 15 has come and gone, and income tax filing is just a fond memory, one wonders what life in America would be like without our annual correspondence with the IRS. Indeed, what would a spring be without the searching for 1099s, finding a year's worth of old brokerage company stock records, receipts for charitable contributions, and the somehow misplaced but required valuations of personal property given to charity. In short, March madness.

Perhaps surprisingly, neither an April 15 deadline nor the IRS as we currently know it is necessary for raising revenue for the Federal government. Imagine a credit invoice, European-style Value Added Tax (VAT) collected much like a retail sales tax, except that it is collected in pieces, at all stages of production, thereby making evasion more difficult. Further imagine that it is collected automatically on all electronic transactions, which include credit card purchases, checks cleared electronically (now the bulk of all checks), and electronic funds transfers—these account for the vast bulk of commerce today. Then add on the requirement for all remaining transactions, including cash retail purchases, as well.

Such a system would eliminate the need for annual filing for taxpayers, other than VAT collecting-businesses, who would have to reconcile VAT collections and VAT credits (which, as we've seen, would already have been tracked electronically).

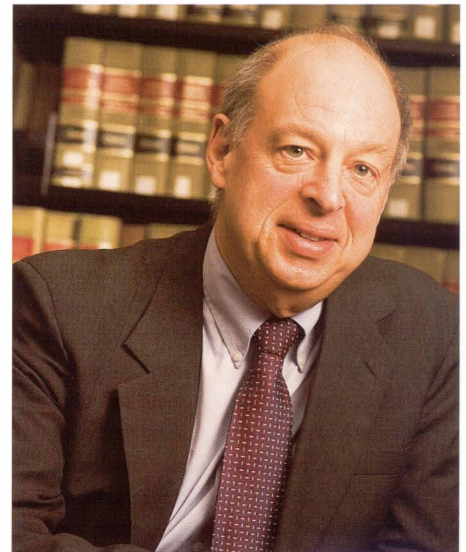
Abandoning the income tax as it currently exists would result in huge savings of government tax administration expenses, tax preparer and planner expenses, and taxpayer expenses. (This last item has been

computed by estimating the number of hours spent on income tax compliance and planning by individuals and businesses, and multiplying that number by a reasonable hourly rate.) The aggregate savings could amount to between \$75 billion (in 1989 dollars) as estimated by Joel Slemrod, in his article on a simple tax system in *Economic Effects of Fundamental Tax Reform*, and approximately \$225 billion (in 1995 dollars) as projected by the consulting firm Arthur D. Little. Subtract the much more modest costs of the substitute system and you determine the net savings from the elimination of what economists call the deadweight loss in the current tax system. (No offense intended to either myself or my tax colleagues in the bar.)

What about fairness and progressivity? Can a tax on consumption replacing an income tax equitably allocate the burdens of the costs of government and redistribution of wealth payments? Further, can a VAT be "fair" if everybody pays tax in the same proportion as their consumption? These are questions that must be resolved politically.

A consumption tax, that is, a tax based on what individuals consume, rather than on what they earn as under an income tax, is viewed by economists as superior to an income tax. Whether done as a VAT, as described above, or by computing income, as is currently done under the income tax, and then allowing a deduction for savings, thereby leaving only consumption in the tax base, a consumption tax relieves amounts invested from the burdens of taxation and limits taxation to amounts spent on consumption. In that manner it encourages saving.

Most economists believe that a change to a consumption tax from our current



system would stimulate capital formation, thereby creating greater production and efficiency, and generally enlarging the pie. This view, of course, is not without controversy and detractors, but it is gaining support among policymakers.

One of the stumbling blocks for acceptance of consumption taxes has been the argument that it places an undue tax burden on those earning lower wages. But the issue of progressivity can be handled under a VAT form of consumption tax. In general, a VAT, like a sales tax, would be imposed at a single rate on all purchases, although in theory, different goods can be assigned different VAT rates (e.g. higher rates for luxury goods), resulting in significant computational and administrative complexity as it does in Europe. Without that complexity, opponents of a VAT believe that the absence of progressivity should disqualify it from consideration as a replacement for the income tax, regardless of its other merits.

A VAT, however, can be made progressive without necessarily assigning different

rates to different types of goods. Suppose, for example, wages were treated as the purchase of raw materials, and were thereby subject to the VAT. Employers would be allowed a VAT credit for the tax paid on those wages. The wage earner, however, would treat the wages and the VAT funds paid by the employer as taxable under a new wage tax; that the new wage tax would be imposed using progressive rates. The employer-paid VAT on those wages would be viewed as advance payments by the wage earners on the tax they would eventually pay, as if those employer-paid VAT payments were employee-withheld tax payments, similar to withholding under the current income tax. Then, it would be a simple matter to construct a wage tax rate structure to accomplish progressivity. The structure could have a zero bracket for low-wage earners, who would get a refund for withheld taxes (and even an earned income tax credit, if that were desired); a moderate rate of tax for middle wage earners, who would neither get a refund nor pay extra tax; and a higher rate for high-wage earner, who would owe some tax. Capital gains, dividends, interest, and other investment income would not be taxed at the individual level. Businesses owned by those investors, however, would have already paid the bulk of the taxes needed by the government through the VAT.

The consumption (not income) tax system that I described above is the subject of my recent article entitled "E Tax: The Flat Tax as an Electronic Credit VAT," published in *Tax Notes*; the background and justifications are more fully described in my earlier article "E-Tax: Fundamental

Tax Reform and The Transition to a Currency-Free Economy," published in *Virginia Tax Review*.

The system is based on the "Flat Tax" proposed by economists Robert Hall and Alvin Rabushka, which became the centerpiece (indeed, the only piece) of Steve Forbes' presidential nomination campaign several years ago, but has some important differences—naturally, I would call them improvements. These improvements would make the E-Tax easier and much less expensive to administer than the Flat Tax, and much easier and less expensive than the current income tax, because it can be collected and tracked electronically. It also bears a resemblance to President Bush's Tax Reform Panel's proposed "Growth and Investment Tax, or GIT," also a consumption tax.

Philip Morrison, a principal in Deloitte Tax LLP's Washington international tax group, recently criticized the GIT for significant shortcomings in redressing the U.S.'s disadvantage in international trade, because of its choice of a tax on business. (He detailed his points in an article in the Feb. 16, 2006 issue of the *BNA Daily Tax Report*.) That kind of tax is likely to be viewed as a "direct tax," and would thereby be deemed illegal under U.S. World Trade Organization obligations. The credit invoice VAT, on the other hand, is technically a tax on transactions, and therefore an indirect tax. Morrison noted, however, that my E-Tax proposal solves this problem as well, because a credit invoice VAT need

not be collected on exports without violating WTO rules.

Finally, even if the E-Tax or some other form of consumption tax were to be considered for adoption, could we get there from here? I am in the midst of studying the difficulties of transition from our hybrid income tax to various forms of consumption tax. Probably the greatest obstacle to its adoption would be the adverse effects of such a tax on existing wealth, used to purchase consumption goods and services.

How does this kind of tax policy analysis relate to the teaching of income tax, corporate tax, and partnership tax? Advocating the replacement of a tax system with a better one requires knowing the positive attributes of the current tax system, as well as its defects and blemishes. It is only with knowing and understanding the nature of those attributes, and the myriad defects that attend them, that we can devise ways to exploit them. A complete and well-rounded knowledge of the system assists in both compliance and planning. As a teacher, I strive to integrate this continually changing body of knowledge into the repertoire of all of my law school courses.

Daniel Goldberg is the Carole & Hanan Sibel Research Professor of Law. An expert in tax law, his recent research has focused on the transition from the income tax to a consumption tax. Professor Goldberg has published several articles on aspects of this transition, as well as other tax policy issues, in scholarly journals including the Tax Law Review and the Tax Lawyer.

