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The Social Contract Revisited

The Case for a Progressive Spending Tax

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3

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Executive Summary

- A progressive spending tax is an attractive policy tool to address the related social problems of too little savings, too much consumption, and vast inequality.

- A progressive spending tax can be implemented on a general cash-flow basis by rearranging the basic definition of income: income = consumption + savings, to: consumption = income – savings. The only necessary reforms to an income tax are to allow an unlimited deduction for savings into what the proposal calls Trust Accounts, and to include debt as a taxable input.

- Special exemptions or lower rates can be carved out for certain highly urgent uses of wealth, such as medical, educational, and philanthropic ones.

- The progressive spending tax never taxes the social goods of work and savings, but falls instead on the potential social bad of personal spending. Hence progressive rates can be increased, perhaps dramatically, under it.

- A traditional view of tax that viewed consumption taxes as a way to avoid taxing savings is flawed. A progressive spending tax stands between an income tax, which double-taxes all savings, and a wage tax, which ignores all savings. A progressive spending tax implements simultaneously two widely held norms about savings: the ordinary-savings norm, which holds that savings for emergencies or to smooth out uneven labour earnings through even consumption paths is commendable and ought not be 'double-taxed'; and the yield-to-capital norm, which holds that savings that enable higher material lifestyles ought to bear some tax.

- A progressive spending tax needs no direct taxes on capital, no wealth transfer or gift and estate tax, and no corporate income tax. Heirs will be taxed when and if they spend, at progressive rates.

- The progressive spending tax redefines property rights and implements a general law against waste. The Trust Accounts represent a joint private–public pool of social capital, which the government can regulate to prevent economic and political harms.

- The common objection that 'consumption is good' is misplaced, because savings is also good, and savings is non-consumption, and because the aim of the progressive spending tax is to facilitate lower- and middle-class consumption in part by accommodating upper-class savings. It aims towards a model of class teamwork, not warfare.

The Case for a Progressive Spending Tax

Introduction

Problems abound. Savings rates are low. Spending rates are high. There is vast wealth, vastly unequally held. The rich are spending more than ever, putting pressure on the environment, the social structure, and our collective future. Tax policy could be a cure for these ills, but it is not. As presently constituted, the tax system in America and elsewhere is a cause of inequity and strife. The income tax has become a de facto wage tax. Taxes fall heavily on workers and lightly, if at all, on wealth-holders. It is time to change course; it is time to adopt a progressive spending tax.

A progressive spending tax consistently taxes people on what they spend, not on what they earn or save. At its most fundamental level, the tax realigns self and social interests in the spirit of Adam Smith. It does not tax the social goods of work or savings, but rather the potential social bad of private spending, and at progressive rates that mean that the highest spenders pay the highest rates of tax. A progressive spending tax leads to radical and systematic, yet easily obtainable, reform. Under its guiding principle, we can and should eliminate all direct taxes on capital, including wealth transfer and corporate income taxes. A progressive spending tax is a tax on capital, at the individual level, when (but only when) capital is used to finance enhanced lifestyles or greater consumption of material resources – spending – and not when capital is used simply to move around uneven labour market earnings within or between generations or for emergencies.

A progressive spending tax, explained

A progressive spending tax is a simple alternative to an income tax. Consider the so-called Haig-Simons definition of 'income', which holds, in essence, that income equals consumption plus savings. This accounting identity – a tautology – tell us no more and no less than that all sources equal uses or, more simply, that all material resources (income) are either spent (consumption) or not (savings). This is hardly profound, but great wisdom can be built on simple truths.

The basic definition can be used, through a simple rearrangement of terms, to show the essential difference between an income and a consumption tax. If income = consumption + savings, then consumption = income – savings. A spending tax focuses consistently on income minus non-consumed wealth, or savings, to target consumed wealth, or spending.

We can convert the current income tax, which is far from a true income tax in that it already exempts most savings from its base, into a spending tax simply by allowing an unlimited deduction for savings. Call the savings vehicles Trust Accounts (akin to Individual Retirement Accounts [IRAs] under current US law). The only other step we need take is to include debt, or borrowing, as income. This may sound odd, but is perfectly parallel to a sales tax or value-added tax (VAT), which is paid when money is spent, even if financed on a credit card. Repayments of the principal of debt, which represent positive savings (increases in one's net wealth), are not taxed: principal payments are deductible.

To the base of spending, we apply progressive marginal rates, just as under current law. Indeed, rates can *increase*, perhaps significantly, because the tax is falling on spending, not work or savings. By giving the materially fortunate and productive a way out of high tax rates by working and saving without present consumption, the progressive spending tax makes for a better alignment of self and society than the current, highly flawed tax system.

A progressive spending tax is an annual, cash-flow tax on consumed income: on all income minus non-consumed income, or savings. We can add a few

exemptions or special rates, for medical, educational, and philanthropic uses. But that is it. We need no complex provisions for the taxation of savings – no capital gains, 'basis', 'realization' rules and the like – because we never tax savings. And we can do all of this on an annual form, without the need for taxpayers to keep receipts. A progressive spending tax is not a specific sumptuary tax. High levels of spending, on any consumer goods, trigger high rates of tax.

For further simplification, the fact that a progressive spending tax is analytically equivalent to a sales tax or VAT means that we can substitute a national sales tax or VAT, combined with a general rebate mechanism, for the lowest rate brackets of the tax, leaving only individuals or households spending over, say, $100,000 a year liable to fill out forms and pay a supplemental spending tax, at increasingly progressive marginal rates.

Moving beyond the income versus consumption debate

A spending tax is a simple and highly attractive idea, based on the common sense of taxing people as they spend: it has been favoured by political theorists from Thomas Hobbes to Adam Smith, John Stuart Mill, and John Rawls. Why then, do we see income and not spending taxes in the West?

The case for a spending tax has been obscured by a traditional view of tax that opposes income and consumption taxes, and sees all forms of consumption taxes as being roughly equivalent and consonant only with flat rates. But in fact there are three, not two, choices of tax, and there is no reason at all that a spending tax should not have progressive rates.

An income tax applies to all inflows into a household or taxpaying unit, whether from capital or labour (or, indeed, beneficence). This means, as Mill pointed out in his 1848 treatise, that savings are 'double-taxed': in order to have principal to invest, one has to have paid tax on some prior receipt, but the yield to capital is taxed again.

Consumption taxes, in contrast, are *single* taxes on the flow of funds into and out of a household. This way of presenting the issue points to two basic forms of consumption tax, which differ according to the time when the single tax is levied. In one model, the tax is imposed up-front and never again: a wage tax. The second form of consumption tax imposes its single tax on the back-end, when resources flow out of households: a spending tax. Under flat or constant tax rates, the two principal forms of a consumption tax are in fact largely equivalent, a result that can be proven in relatively simple algebraic terms.[1] This equivalence has led to confusion in the traditional view of tax, which confers an over-hasty equivalence on wage and spending taxes. But the equivalence does not hold under non-constant or progressive rates. Now there are three, rather than two, alternatives for the tax policymaker to choose. The differences manifest themselves *when* the tax falls, affecting choices of work, savings, education, and so on, and, most importantly, *how* the tax redistributes material resources. Consider each tax in turn.

An income tax falls on all labour market earnings and the yield to savings at the time they come into a household. Savers are hurt by the 'double-taxation' of savings, whatever their intended or actual use. Certain individuals, such as the highly educated, whose earnings may come in relatively short, concentrated, periods, are also hurt by the timing of the imposition of progressive rates.

A wage tax falls on labour market earnings alone, again at the time they come into a household. Once more, people whose earnings profiles are

1. Consider what happens to a principal sum, P, invested over time, for n periods, at a rate of return r. Untaxed, the sum grows at the rate of (1 + r), which gets compounded by the n periods. A single tax, t, is taken away from the taxpayer at one time, leaving her with (1 – t). Now it does not matter, under the commutative principle of multiplication, which holds that ab = ba, where, or, better put, when, the (1-t) is applied. Assuming constant t and r (assumptions to be discussed in the text) the following identity holds: $\{(1 - t) P\} (1 + r)^n = \{P (1 + r)^n\}(1 - t)$.

uneven throughout their lifetimes are hurt by the timing of the imposition of the progressive rate structure. However, and here is the rub for most liberals and even moderates, those who live off the yield to capital are never taxed.

A spending tax does not come due at the time of initial inflows, but rather at the time of outflows, when money is spent in consumption. This means that a progressive spending tax stands between an income tax, which double-taxes all savings, and a wage tax, which ignores all savings. A consistently progressive spending tax treats savings differently depending on their use.

Two norms of capital

What should be done about taxing capital? Mill's claim that the income tax is a double-tax on savings is descriptive, an analytic fact. It is true both within the income tax's own base, where savers are penalized vis-à-vis spenders, and relative to a hypothetical no-tax world, where the income tax destroys the equivalence, in present value terms, between savers and spenders, Ants and Grasshoppers. Yet neither of these facts exert a strong pull on our moral intuitions; it is difficult to move from Mill's *is* to any compelling *ought*.

At the dawn of the creation of comprehensive individual tax systems in the United States and elsewhere, reformers actively desired an income tax because it included the yield to savings, and thus would impose an added burden on financiers and the like. Those were, however, simpler times. As the income tax expanded in both scale, becoming a higher burden and more steeply sloped in its rate progression and scope, reaching the majority of earners in the United States and elsewhere, things changed. Law-makers began to rethink double-taxing the yield to savings, anywhere and everywhere. A near century of experience with a so-called income tax in the United States and elsewhere in the developed world has shown a deep split about the normative propriety of taxing the yield to capital. More and more exceptions to the income tax's theoretical commitment to double-taxing savings have been piled on one another, whether by happenstance, inertia, deliberate policy plan, or mere mistake.

The result is that we now observe 'hybrid' taxes, uneasily perched between an income tax model, with its double-tax, and a consumption tax, with its principled nontaxation of savings. However, the compromises necessary to bring about this state of affairs have been effected without suitable normative or practical reflection, resulting in a tax system in which the well-endowed capitalist class can live well and *consume away*, tax-free. We are neither favouring savings nor effecting a fair distribution of tax burdens across taxpayers, since individuals who can live off the yield to capital quite simply need pay no tax.

On reflection, the schisms in contemporary tax systems are not random. Considered reflection reveals that ordinary moral intuitions in fact reasonably reach different normative judgements about different uses of savings. On the one hand, we are sympathetic to the noble Ant, especially when she is manifest as a middle-aged wage-earner, struggling to make ends meet while paying her taxes and setting aside some funds for her later retirement, or medical or educational needs within her family. Why should we punish her, with a second tax, for her prudence? And so we observe tax-favoured retirement, medical, and educational savings accounts. On the other hand, we are haunted by the spectre of the socially privileged, such as a second- or third-generation rich child, living well off the fruits of someone else's prior capital accumulation. Surely this 'trust fund baby' should be taxed more than the hard working Ant? Surely his income, in the form of rents, royalties, interest, dividends, and the like should count in the tax base, at least as much as the product of Ant's blood, sweat, and tears?

These simple insights and intuitions in fact resolve themselves into two discrete norms about capital. The *ordinary-savings norm* holds that capital transactions (borrowing, saving, investing) that are simply used to move around uneven labour market earnings in time, allowing people to save for their retirement, or for periods of high spending needs or low earnings, such as times of education

or medical urgency, should not be double-taxed or otherwise discouraged and burdened. The *yield-to-savings norm* holds that capital that enables a higher, better, lifestyle should bear a burden, one at least commensurate with normal wage earnings.

The trick is to design a tax system that implements both norms, simultaneously, without undue complexity. A progressive spending tax does just this.

Three uses of savings

Consider in financial terms how most of us live out our lifetimes. As any parent knows full well, we emerge into the world nearly fully formed as consumers: we cost money from the outset. But (as any parent also knows) we do not earn anything for quite some time. When we do start earning, we have to earn more than we spend (let us hope!), to pay off the debts of youth, including school loans, and to set aside funds for retirement, so that we do not have to keep working all the days of our lives. Our lives look like one fairly steady consumption profile, from cradle to grave, financed by a lumpy period of labour market earnings concentrated in midlife. If we lived as islands unto ourselves, we would have to balance the books on our own account, borrowing in youth, first paying off our debts and later saving for retirement in our mid-life, spending down in old age. Financial intermediaries such as banks and insurance companies would help us to effect these results. In practice, many families work as more or less informal annuities markets, between generations. Thus, our parents pay for our youths, and we pay for our children's youths; we also stand ready to pay our parents back, should their needs exceed their resources in their old age. And so on.

In this perhaps untypical depiction of a typical life, note three broad uses of savings. One is to *smooth out* consumption profiles, within lifetimes or across individuals, to translate uneven labour market earnings into even consumption flows. We do this by borrowing in youth and saving for retirement, and/or other times of special need, such as health and education demands, in mid-life. We can do this using third-party financial intermediaries, or within the family.

A second use of savings is the analytic complement of smoothing: capital transactions can *shift* consumption profiles, up or down. An upward shift occurs when the fruits of our own or another's savings (via beneficence) allow us to live a 'better' lifestyle than we could on the basis of our own labour market earnings alone, smoothed out over time. A downward shift occurs when our own beneficence or bad fortune means that we live at a lower lifestyle than we otherwise could, again on the basis of our smoothed out labour market earnings profile alone.

The two norms considered in the prior section correlate perfectly with these two uses of capital. Smoothing effects the ordinary-savings norm, shifting the yield-to-capital one. Ordinary moral intuitions, reflected in a near-century of experience with actual tax systems, suggest that society ought not to burden smoothing transactions with a double-tax, but that the yield to capital is an element of value that can properly be taxed when used to enable a 'better', more expensive lifestyle.

A third use of savings is to provide for periods of emergency, such as heightened medical or educational needs, or times of low income due to un- or under-employment. Economists call this precautionary savings.

Now return to the three basic tax systems: income, wage, and spending. Under progressive rates, the three tax systems affect different patterns of savings and spending differently. An income tax double-taxes all savings, come what may, and makes its judgements of progression on the basis of inflows, however uneven. A wage tax ignores all capital transactions, again whatever their use, and also makes its judgements of the fair degree of progression on the basis of inflows, burdening the uneven wage earner. But a consistent progressive spending tax, wondrously enough, implements the ordinary-savings and yield-to-capital norms, simultaneously, seamlessly, and by design.

Trust Accounts and a new understanding of property

A common objection to the plan for a consistent spending tax is that it allows for large stores of capital to build up in private hands, in what we are calling Trust Accounts. That may be true, but what this objection fails to take account of is that the progressive spending tax effects a fundamental redefinition of property.

Consider, briefly, two concepts of ownership. The first, drawn from feudalism, economic history, and modern trust practice, is the *life estate understanding*. The second, which emerged in Anglo-American law certainly by the time of Adam Smith and William Blackstone, is the *absolute understanding*, turning on a specific estate, the fee simple absolute. It turns out that there are but two legal differences in the two term structures of ownership: first, the absolute owner can alienate or dispose of the entire asset(s) she owns, whereas the life estate holder, lacking the future interest, can only dispose of any assets for her life (creating a *life estate pur autrie vie*); and second, the absolute owner has the *jus abutendi* or right to waste, meaning that she can consume or destroy the whole of what she owns, whereas the life estate owner is constrained by the doctrine of waste to preserve a remainder for the future: she cannot waste the property.

Current law abundantly reflects the absolute understanding. Thus, under contemporary tax practices, one pays tax as value comes into a household, via work or savings. But then one is free to do whatever she wants with her property, *even to waste it*. Under the progressive spending tax, in contrast, the owner of property is free to *manage* her assets, within her Trust Accounts, but she cannot consume or use it all up without paying a toll charge in the form of a hefty tax on her spending. She becomes, that is, a life estate owner. She can draw down modest amounts of income, pull out capital for urgent uses reserved for special tax treatment (medical, educational, philanthropic uses), and make investment decisions. But she cannot spend all of 'her' money on herself, because the government stands ready to assert the social stake at the moment of private spending. The progressive spending tax becomes a general law against waste.

Once we understand that the Trust Accounts, being *not yet taxed*, are a form of joint private–public asset – a common pool of savings to be managed by private owners but for the benefit of all – we see that property rights have changed. Thus the government can regulate, however loosely, the Trust Accounts, to insure that these funds are not used for illegitimate political or economic purposes, or for consumption. Details aside, the key insight is that the progressive spending tax privatizes the management of capital while rendering public its use.

The case against (direct) capital taxation

The progressive spending tax can lead to a dramatically simpler tax system that is at the same time far fairer than the status quo. A central insight is that a consistent progressive spending tax is a tax on the yield to capital, under just the circumstances in which ordinary moral intuitions suggest taxing such yield, and no other. Financial capital is taxed when, but only when, capital is used to enhance lifestyles. No other tax on capital would then be needed; moreover, in part because any other tax on capital is *not* so individuated and hence risks falling on ordinary savings as well as the yield to capital, all 'direct' taxes on capital should be eliminated.

Consider first the role of 'second' taxes on the yield to capital under the basic individuated tax system, such as capital gains under the income tax. These are simply not needed under a progressive spending tax. If a taxpayer sells an asset and reinvests the proceeds, she has continued to save, and there is no reason to tax her – yet. On the other hand, *any* mechanism to finance her lifestyle – wages, the ordinary yield to capital (interest, dividends and the like), someone else's beneficence, the proceeds of sales of capital assets or, for that matter, borrowing against present assets or future earnings – is taxed, at the moment of private

preclusive use. Whether or not to sell an asset can be left to the personal decisions of investors, for efficiency; how to tax the proceeds of investments can be left to the moment of consumption, when society can better judge what kind of lifestyle these investments enable.

Consider next the gift and estate tax. The current system aims to 'backstop' the income tax, which tax is (in ideal theory) supposed to burden savings, by levying a hefty tax on those decedents who die with large estates. This tax is obviously desired as a matter of fairness. But its very existence encourages the rich to consume more, and die broke, whether they spend on themselves or their heirs. A consistent progressive spending tax never taxes savings directly. Saved assets thus have a zero 'basis' in technical tax terms. These assets can therefore be passed on to heirs in life or at death, without the moment of transfer itself triggering tax. On the other hand, and at a different time, *spending* by the heirs will generate tax, and under a progressive rate structure. A progressive spending tax does not need, in principle, a separate gift and estate tax, because the very design of the tax entails an accessions or inheritance tax: the trust fund baby pays the tax.

Finally, parallel (though, indeed stronger) arguments can be made against a separate corporate income tax. The problems with this tax begin with its uncertain incidence: since corporations are not real people, they do not really pay taxes, but must pass these on. A corporate tax falls on workers and consumers, on capital generally, or on some combination thereof. To the extent that it falls on ordinary workers and consumers, a corporate income tax's claim to fairness is quite obviously questionable. But even to the extent that such a tax falls on capital, it cannot do so in any *individuated* way. Savers bear the burden of the corporate income tax whether they are rich or not; saving for lifetime needs or emergencies or to support a high-end lifestyle. Once again, under a consistent, progressive, postpaid consumption tax (which falls on the yield to capital as a source of personal consumption, making individuated judgements at that time) such a tax is not needed.

The elimination of these other taxes follows from the principle of a consistent progressive spending tax: to tax individuals as they spend, not as they work, save, give, or die. Such a tax enhances simplicity, transparency, and efficiency while promoting fairness. Specifically in terms of capital, the tax would apply to the yield to capital, but only when it is appropriate to do so. The rich would not be let off the hook; their tax would come due when, as, and if they spend wealth on themselves. Progressivity could be maintained, even strengthened.

One last objection

Perhaps the most common objection to a progressive spending or consumption tax comes from those who point out that consumption is, in itself, good, in that it is the 'engine of our economy'. And so it is. But there are three ready and interrelated replies to this criticism, which help to illustrate and make more attractive the appeal of the proposal.

First, consumption is good, but so is savings – *and savings is non-consumption*. This is a matter of definition. We cannot have savings unless some people do not consume all that they can. So we need both consumption and non-consumption, spending and savings, and the question then comes down to who does what.

Second, an income tax *includes* consumption (income = consumption + savings) and, since most taxpayers worldwide do not save at all, *is a consumption tax for most individuals.* There is no radical change here.

Third, the principal aim of the progressive spending tax is to interject *more progressivity* into the tax system, which has sorely lacked any meaningful progressivity for decades. In short, the point is to raise tax rates on high spenders, or the rich, while lowering them on the poor. This will make it easier for lower- and middle-class citizens to consume, while making it easier for the rich to save and harder for them to spend. In sum, the progressive spending tax aims at a model of class teamwork, a role for all citizens of modern democracies. It stops an almost

certainly counter-productive social policy of trying to get the lower classes to save. To the rich, it provides a choice: continue to work hard, spend modestly, and save well, helping all through a contribution to a common pool of capital; or spend large sums of good fortune on yourself, but in so doing, cut a cheque to your fellow citizens for the privilege.

Conclusion

Advocates for fairness in taxation have long supported an income tax because it gets at the yield to capital, and because, they think, consumption taxes do not. In fact, a better understanding of the analytics of tax shows otherwise. Under progressive rates, the two canonical forms of consumption taxation, wage and spending, are not equivalent. An income tax is a double-tax on all savings, come what may. A wage tax ignores the yield to capital, everywhere and anywhere. But a progressive spending tax splits the difference, by design. It falls on the yield to capital only when this yield is used to elevate lifestyles, not when used to smooth out in time, within or between generations, uneven labour market earnings or to provide for emergencies.

It turns out that this is the right thing to do. Not only can we derive this from first principles, and the ordinary-savings and yield-to-capital norms, but we can also observe it from a century of practice with a so-called income tax. Whatever one thinks of ideal taxation, we ought to note well the fact that we have never had, and almost certainly never will ever have, an ideal income tax in practice, or anything rather too close to it, at all. The real debate in practical tax politics is, and always has been, over what form of consumption taxation to have. And here the stakes are large and dramatic for the fate of progressivity in tax, and point towards a consistent progressive spending tax.

The final insight is that, once the comprehensive tax system is reformed, strictly on grounds of fairness, by adopting a consistent progressive spending tax, we no longer need any direct taxes on capital. This is not because capital per se is good, or because of a naïve horizontal equity approach to policy. Rather, it is because we are now taxing the yield to capital, in an individuated way, at the right time. We can and should repeal all capital taxes under the income tax, the separate gift and estate tax, and corporate taxes of all forms. This will add considerably to the simplicity, administrability, and efficiency of the tax system. But these have not been the point, here. It is, rather, the fair thing to do.

References

I have deliberately avoided extensive citations or technical vocabulary in this policy brief. Those interested in learning more, including citations to the literature, can see my book, *Fair Not Flat: How to Make the Tax System Better and Simpler* (Chicago: University of Chicago Press, 2002 and 2006); my extended law review article, 'A New Understanding of Tax', *Michigan Law Review* 103: 807–938 (2005); or my forthcoming book, *The Case Against Waste: Towards a New Understanding of Property* (Chicago: University of Chicago Press).

The Foundation

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