Getting Serious About Curtailing Deferral of US Tax on Foreign Source Income

Robert J. Peroni
University of Texas School of Law, rperoni@law.utexas.edu

J. Clifton Fleming Jr.
BYU Law, flemingc@law.byu.edu

Stephen E. Shay
Harvard Law School, sshay@law.harvard.edu

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REPLACING THE FEDERAL INCOME TAX WITH A POSTPAID CONSUMPTION TAX: PRELIMINARY THOUGHTS REGARDING A GOVERNMENT MATCHING PROGRAM FOR WEALTHY INVESTORS AND A NEW TAX POLICY LENS*

J. Clifton Fleming, Jr.**

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** Ernest L. Wilkinson Chair and Professor of Law, J. Reuben Clark Law School, Brigham Young University. Thanks to Alice Abreu, Neil Buchanan, Joseph Dodge, Debby Geier, Christopher Hanna, Steve Johnson, Marty McMahon, Julie Roin, Bill Turnier and Larry Zelenak, not all of whom agree with this article but each of whom provided helpful comments on earlier drafts. Thanks also to my peripatetic colleague Cole Durham for allowing me to make him the focal point of most of the examples in this article.
I. THIS ARTICLE AND CHARLEY GALVIN

I have long admired Charley Galvin as a prominent, fearless, and consistent advocate of sound tax policy. Consequently, I was delighted when Chris Hanna asked me to participate in this symposium. It is surely appropriate for the SMU Law Review to recognize Charley’s exemplary service to the American tax system, and I am pleased to be part of the exercise.

In addition, my participation has a personal element. A major reason for the topic of this piece is that in 1993, Charley asked me to appear before an ABA Tax Section Committee that he chaired to discuss the simplification properties of consumption tax regimes. That opportunity led to a 1995 article, which was the beginning of my serious thinking about consumption taxation as an alternative to the federal income tax. Thus, if I were to participate in this symposium, it seemed appropriate for my contribution to involve a consumption tax theme.

Unfortunately, Chris’s invitation came when I had already obligated 110% of myself to other projects and, therefore, could only respond with an incomplete product. After full disclosure, Chris said he wanted the piece anyway, but readers should know that this article needs additional development before it can be more than a “preliminary thoughts” piece, and many more dense footnotes are required before it satisfies the current fashion in law review publications. Thus, I put it forward as only a tentative product, but such as it is, here it is for Charley.

II. INTRODUCTION

This article deals with postpaid consumption taxes as complete


2. Comments from readers to flemingc@lawgate.byu.edu will be welcomed.

3. “Postpaid consumption tax” means that savings, and the yield thereon, are left out of the tax base until spent on consumption. Thus, taxation is postpaid in the sense that tax is not levied when the taxpayer’s wealth increases, but instead is deferred until wealth is consumed. Retail sales taxes, value added taxes, and cash-flow consumption taxes are postpaid consumption taxes. A wage tax, by contrast, is a prepaid consumption tax. See generally President’s Advisory Panel on Fed. Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System 90 (2005), available at http://www.taxreformpanel.gov/final-report/TaxReform-ch5.pdf [hereinafter President’s Advisory Panel on Fed. Tax Reform]; Edward J. McCaffery, A New Understanding of Tax, 103 MICH. L. REV. 807, 813, 820-21, 824-25, 829 (2005); Fleming, supra note 1, at 392-93.
replacements for the federal income tax. Supplementing the federal income tax with a consumption tax that raises sufficient revenue to permit a greatly enlarged standard deduction, thereby removing large numbers of low and middle income individuals from the income tax system, is a different matter, that is not addressed in this piece. 4

In recent years, proposals have been made to replace the federal income tax with a postpaid consumption tax—that is, a federal value added tax ("VAT"), a federal retail sales tax ("RST"), or a federal cash-flow (consumed income) tax. 5 Because these taxes can be constructed so that they are indistinguishable at the level of the ultimate consumer in terms of their principal effects, 6 and because a prominent recent proposal is the RST approach, 7 I have written this article in terms of an RST/income tax comparison. The analysis, however, would be mostly the same if the income tax was compared with the other forms of postpaid consumption taxes. 8

Commentators and analysts have often noted that complete replacement of the federal income tax with a consumption tax regime would

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8. See generally authorities cited at supra note 6. For one instance in which the form of postpaid consumption tax might make a difference, see infra part XVII.
cause a substantial downward shifting of the federal tax burden to low and middle income taxpayers.\textsuperscript{9} This article, however, does not deal with that important point. Instead, it argues that complete replacement would create an unlimited federal obligation to make a tax-rate-prescribed match of all private saving, regardless of the amount or purpose of that saving and regardless of the saver's income level. This argument also produces a new lens through which to examine postpaid consumption taxes. Using that lens, the discussion re-examines familiar matters that are generally related to the debate over whether investment income is taxed once under a comprehensive income tax and not at all under a postpaid consumption tax, or is taxed twice under a comprehensive income tax and once under a postpaid consumption tax.

\textbf{III. THE INITIAL QUESTIONS}

Let us begin with an example that illustrates the familiar difference in the outcomes of an income tax and a postpaid consumption tax.

Example 1. Cole, a well-known legal scholar who is on the road for long periods participating in various conferences, earns $100 of wages on January 1, Year 1. He immediately uses these wages, after any applicable tax, to buy a bluechip corporate debenture that will pay him the principal plus 5\% interest on January 1, Year 2. On that date, Cole spends the cash proceeds from the debenture to buy flowers for Louise, his wife, as partial penance for his frequent and lengthy absences. Assume that the debenture's 5\% interest rate equals the return on riskless investments.\textsuperscript{10} To work out the tax consequences of this example, alternately hypothesize that the United States Government is financed exclusively by (1) a 30\% income tax (i.e. both labor income and realized\textsuperscript{11} capital income are taxed), or (2) a 30\% retail sales tax, (that is, only retail consumption expenditures are taxed). Finally, to simplify matters, assume that each tax is imposed when the relevant taxable event occurs—that is, when in-


\textsuperscript{10} My intention is to have Cole earn interest at a rate equal to the riskless rate of return. Commentators have disagreed on that rate with their conclusions ranging from less than 1\% to 5\%. Compare Daniel Shaviro, \textit{Replacing the Income Tax with a Progressive Consumption Tax}, 103 TAX NOTES 91, 101 (2004), with Joseph Bankman & Barbara Fried, \textit{Winners and Losers in the Shift to a Consumption Tax}, 86 GEO. L.J. 539, 542 n. 10, (1998). See also SLEMROD \& BAKIJA, supra note 5, at 334 n.6; Avi-Yonah, supra note 4, at 1656 (1.5\% to 3.3\%). I take no position on that matter, but have chosen 5\% to generate numbers in Table 1 and other examples that are sufficiently large to provide useful illustrations. The significance, if any, of limiting Cole to the riskless rate of return will be discussed in infra part XVI.

\textsuperscript{11} A pure Schanz-Haig-Simons income tax would take unrealized gains and losses into account. See \textsc{President's Advisory Panel on Fed. Tax Reform}, supra note 3, at 20. But even Henry Simons, the most prominent popularizer of this form of tax, conceded that the realization requirement is an inevitable feature of a workable income tax. See HENRY C. SIMONS, PERSONAL INCOME TAXATION 100, 207-08 (1938); see also William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 HARV. L. REV. 1113, 1141-48 (1974).
come is realized and when a retail purchase is made. Table 1 shows the results:

### TABLE 1

<table>
<thead>
<tr>
<th></th>
<th>Income Tax</th>
<th>Retail Sales Tax (RST)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/1 Wages</td>
<td>$100.00</td>
<td>$100.00</td>
</tr>
<tr>
<td>1/1/1 Tax @ 30%</td>
<td>-30.00</td>
<td>-0.00</td>
</tr>
<tr>
<td>1/1/1 After-tax Investment</td>
<td>70.00</td>
<td>100.00</td>
</tr>
<tr>
<td>Interest earned @ 5%</td>
<td>+3.50</td>
<td>+5.00</td>
</tr>
<tr>
<td>1/1/2 30% income tax</td>
<td>-1.05</td>
<td>-0.00</td>
</tr>
<tr>
<td>Gross 1/1/2 amount for consumption</td>
<td>72.45</td>
<td>$105.00</td>
</tr>
<tr>
<td>1/1/2 30% RST on flower purchase</td>
<td>-0.00</td>
<td>-31.50(^{12})</td>
</tr>
<tr>
<td>Net 1/1/2 consumption</td>
<td>72.45</td>
<td>73.50</td>
</tr>
</tbody>
</table>

Note that the difference between the $72.45 Cole can spend on flowers in the income tax scenario and the $73.50 available to him in the RST scenario is the $1.05 tax on the Year 2 interest that is collected under the income tax regime. In other words, Cole has more available for Year 2 consumption in the RST scenario, and the "more" equals the Year 2 income tax on the $3.50 of interest that was received in the income tax scenario.

Some would argue that unlike an income tax, postpaid consumption taxes do not reach riskless returns to capital and that Table 1 merely con-

12. Actually, RSTs usually calculate the tax on an "add-on" or "tax exclusive" basis. Thus, to achieve the $31.50 tax in the RST column of Table 1 under the usual approach for administering an RST, the price of the flowers would be $73.50 and the RST rate would be 42.857% ($73.50 x .42857 = $31.50). See President's Advisory Panel on Fed. Tax Reform, supra, note 3, at 208; Shaviro, supra note 10, at 93-94; Slemrod and Bakija, supra note 5, at 242. But RSTs needn't operate that way. Thus, I have structured the RST column so that the $31.50 tax is included in the $105 price paid to the florist. This allows me to simplify the example by using the same 30% rate for both the income tax and the RST, accord, President's Advisory Panel on Fed. Tax Reform, supra note 3, at 255, and it means that when Cole paid $105 to the florist, he got $73.50 of flowers and $31.50 went to the government. Of course, the RST would have a narrower base than the income tax. Accordingly, revenue neutrality would probably require that the RST's tax inclusive rate be higher than the income tax's 30% tax inclusive rate. See Dodge, Fleming and Geier, supra note 6, at 140-41. For the purpose of simplification, I have ignored that point throughout this article.

Superficially, Cole's RST payment suggests that the government collects more revenue in the RST scenario ($31.50) than in the income tax scenario ($30 + $1.05 = $31.05). But the $30 1/1/1 income tax is not comparable to either of the 1/1/2 taxes because the government has the use of the 1/1/1 tax throughout Year 1, but cannot use the 1/1/2 taxes until Year 2. To make all the taxes comparable, either both of the 1/1/2 taxes must be discounted back to 1/1/1 using a 5% discount rate or the $30 of 1/1/1 income tax must be brought forward to 1/1/2 using a 5% interest rate. When the latter is done, the total income tax yield is $31.50 + $1.05 = $32.55 which is $1.05 greater than the RST yield. The $1.05 excess, of course, reflects the 1/1/2 income tax that was collected on the $3.50 of interest in the income tax column.
firms this point. Others would contend that because the Year 1 income tax on Cole’s $100 of wages was a levy on the present value of all future returns from investing those wages, the January 1, Year 2 income tax on his interest was actually a second levy on capital income. By comparison, so this argument goes, the RST reached the interest only once, when it was consumed, and this illustrates that an income tax double burdens capital income while a postpaid consumption tax burdens it only once.

This is an interesting controversy to which I will return near the end of this article. Table 1, however, raises other important questions regarding the comparative Year 2 effects of the income tax and the RST that have been little explored. To be specific, by what means did the RST achieve a bottom-line result in Table 1 that was $1.05 “better” for Cole than the income tax result, and does the answer have significant implications? Let us now turn to those questions.

IV. A FIRST STEP TOWARD ANSWERS

To begin a search for answers, recall that if Cole had spent $100 for flowers on January 1, Year 1 in the RST scenario of Example 1, Table 1 shows that he would have gotten only $70 of flowers—the remaining $30 of his $100 payment to the florist would have effectively gone to finance the government. Thus, when Cole received $100 of wages on January 1, Year 1 in an RST world, those wages represented $70 available for his personal use and $30 of federal government RST revenue. Indeed, if the debenture debtor had immediately become bankrupt and the debenture worthless, Cole’s only real loss would have been the $70 of consumption that he could have enjoyed but for the debenture purchase. The remaining $30 of the loss would have been borne by the Treasury.

This is a necessary implication of the “Power to lay and collect Taxes” granted to Congress by the United States Constitution. When a Congress, elected by “we the people,” lawfully exercises its constitutionally delegated taxing power, the legitimate allocation of the tax base between federal uses and other uses is then defined until Congress takes further action. Thus, it is reasonable to say that the federal government has a claim on each taxpayer’s tax base equal to the portion that must be turned over to the federal government under existing constitutionally compliant revenue laws. This means that in our Example 1 RST hypothetical, the federal claim is $30 of Cole’s $100 of wages.

13. See generally, e.g., DODGE, FLEMING & GEIER, supra note 6, at 75; Murphy & Nagel, supra note 6, at 101; Avi-Yonah, supra note 4, at 1658; Goldberg, supra note 4, at 23; McCaffery, supra note 3, at 809-11; David A. Weisbach, The (Non)Taxation of Risk, 58 TAX L. REV. 1-2 (2004).
15. U.S. Const. art. 1, § 8, cl. 1.
16. See Murphy & Nagel, supra note 6, at 190.
17. See infra parts VI-VIII.
V. AN OLD CANARD: THE GOVERNMENT OWNS ALL YOUR INCOME

An RST proponent might respond that the preceding analysis assumes government ownership of all income generated within the United States (and abroad by U.S. citizens and residents) and, therefore, that it implicitly argues for a government claim to 100% of Cole's wages, not just 30%. But this is merely a version of the red herring that has been used for years to support illegitimate criticism of tax expenditure analysis. Not only is it baseless in the tax expenditure setting, but it also lacks validity with regard to the analysis of Cole's situation.

The Example 1 RST hypothetical actually argues that the federal claim to Cole's wages is a percentage that is defined and limited by a legitimate process. Specifically, if a Congress elected by the American voters exercised its constitutionally-delegated power to impose a federal RST with a 30% rate, the federal government has a 30% claim with respect to Cole's wages. The 30% benchmark is wholly dependent on the fact that it was chosen through a legitimate law-making process. Stated differently, lawful congressional action has set the federal claim at 30% until a future Congress adopts a change. Because 30% was as far as Congress went in the Example 1 RST scenario, there is no implication that the federal claim is 100% or any other amount greater than 30%.

Of course, a future Congress could, in theory, enact an RST with a rate approaching 100%. If it did so (clearly an implausible event in a world where the top VAT rate for Organization for Economic Cooperation and Development ("OECD") countries is 25% and where the U.S. tax burden has been remarkably stable over time and actually trending downward since 2000), its action would raise the federal claim from 30% to the new percentage because the new percentage would be the product of a legitimate democratic process. But until Congress takes such action in the Example 1 RST scenario, there is no implication that the federal claim is 100% or any other amount greater than 30%.


19. Presumably, an RST with a 100% rate (calculated as in Table 1) would be an impossibility because it would divert all sales revenue to the Government and leave nothing for sellers.


VI. THE ALLEGATION OF INDETERMINATENESS

An RST proponent might respond that the preceding argument is incorrect because it admits that through congressional modification of the RST rate, the federal share of Cole’s wages can change before Cole consumes the debenture investment. Therefore, so this response goes, it is meaningless to regard the government as having a share of Cole’s wages because the federal share is fatally indeterminate. Let us consider that point. What if the law does change after Cole buys the debenture? What if the RST rate is cut to 20%, or raised to 40% halfway through the year in Example 1? This merely means that the government elected to surrender ten percentage points of its claim to Cole’s saved wages in the first case and to expand its 30% share by ten percentage points in the second case. Neither conclusion undermines the fact that the federal share was 30% when Cole received the wages. Moreover, VAT rates in OECD countries have hardly changed in the last fifteen years.22 This suggests that a U.S. RST would likely have stable rates and that speculative, improbable changes should not be allowed to trump the conclusion that Cole purchased the debenture with wages that included a 30% federal share.

Moreover, to argue that the government does not have a 30% claim on Cole’s wages when they are earned because the RST rate might change before consumption occurs effectively amounts to asserting that the federal claim on Cole’s unconsumed wages is zero. But we live in a time when a U.S. president who regularly proposes budgets that exceed $2 trillion is generally regarded as a fiscal conservative.23 The present and future of the United States is one in which trillions of dollars of federal taxes must be raised each year to pay for at least a major portion of the spending programs of either the right or the left, and there is no plausible scenario that would suggest change.25 Indeed, for all except low income Americans, the decision to continue living in the United States in the face of these facts, instead of emigrating to the Cayman Islands or some other tax haven, amounts to acquiescing in a substantial present federal tax claim over one’s present and future income.26 Therefore, in the context

22. See Owens, supra note 20, at 9.
26. In this vein, Bruce Bartlett, a well-known conservative public finance economist who has been prominently identified with efforts to reduce taxes, federal expenditures and the size of the federal government recently said:
[T]here is really no hope of significantly cutting entitlement spending. Republican support for the Medicare drug benefit convinced me that spending in the U.S. is eventually going to rise to European levels and not much of
of Example 1, it is fatuous to believe that with complete RST replacement of the income tax, Cole can consume the $100 invested in the debenture without paying any RST. From the moment he earns his wages he is under a "tax cloud." Accordingly, when the choice between defining the federal tax claim as of the time Cole earns his wages is either zero or the then applicable 30% RST rate, viewing the federal tax claim as 30% instead of zero is the better choice.

VII. EFFECT OF PERMANENTLY FORGONE CONSUMPTION

An RST proponent might respond that the preceding arguments assume that all of Cole’s savings are ultimately consumed (thereby triggering the RST) when the fact is that some amounts are invested in perpetuity and passed from generation to generation without ever being consumed. Because these perpetually invested sums would never be subjected to an RST, the RST advocate might assert that it is fallacious to regard the government as having any share in the $100 of wages that Cole used in the Example 1 RST scenario to purchase the debenture. But this response works only with respect to permanently saved amounts. Cole ultimately consumed the debenture investment and can not rely on the perpetual savings argument. When he liquidated the debenture and spent the proceeds on flowers for Louise, he revealed that the government had a 30% share of the wages embedded in his investment.

VIII. EFFECT OF DEFERRED CONSUMPTION

The RST proponent might next respond that the government’s share of Cole’s wages did not arise in the Example 1 RST scenario until, and to the extent that, Cole consumed his debenture investment. Therefore, so the argument goes, the government had no share of Cole’s wages at the time he purchased the debenture because 100% of the money invested in the debenture was Cole’s until he chose to consume it. Thus, there was no joint investment with government money. This is more powerful than the preceding argument about permanently saved amounts, and it invites a consideration of the fact that there is a spectrum of possible points at which the government’s 30% claim could be said to attach to Cole’s $100 of wages. That spectrum is illustrated by the time line in Table 2.

The preceding analysis has argued that the proper point on this time line at which to view the government as having a definite interest in Cole’s $100 of wages in the Example 1 RST scenario is the first point—when the wages are earned—and not the third point when Cole buys the flowers. This is because without a change in the law, it is certain that whenever Cole converts either the wages or the debenture principal and

anything can be done about it because it is being driven by programs with broad political support and a rapidly aging society.


interest to consumption, 30% will go to the government; the government is always lurking in the shadows to claim its constitutionally legitimate share, as defined by congressional legislation then in effect. Moreover, if Cole thinks carefully about the issue, he will know that whenever he converts the wages or the debenture investment to consumption, the best prediction is that only 70% of the proceeds can be enjoyed as consumption benefits.

IX. JOINT INVESTOR ANALYSIS

On balance, regarding the government as having not less than a 30% RST share of Cole's wages when they are earned, so that Cole and the government are joint investors (with the government exposed to a $30 loss if the debenture becomes worthless), seems a better interpretation than regarding Cole as the sole owner of the debenture. Viewed in this light, Cole's January 1, Year 1 purchase of the $100 debenture in the Example 1 RST scenario was actually a joint investment of $70 of his own money and $30 of the government's money. The following table shows the results of this conclusion:

<table>
<thead>
<tr>
<th>Table 2</th>
<th>Points in Time at which the Government's 30% RST Claim Might Be Said to Attach to Cole's Wages</th>
</tr>
</thead>
<tbody>
<tr>
<td>When Wages Are Earned</td>
<td>When Cole Buys Debenture</td>
</tr>
</tbody>
</table>

29. See Murphy & Nagel, supra note 6, at 175 ("Property rights are the rights people have in the resources they are entitled to control after taxes, not before.").
30. Some authorities have implicitly reached a similar conclusion with respect to the cash flow consumption tax, a tax which, when it employs a single rate, is generally equivalent to a single-rate RST. See 1 U.S. Treasury Dep't, Tax Reform for Fairness, Simplicity, and Economic Growth 208 (1984) ("The deduction [in a cash flow consumption tax] for saving and investment has the effect of making the government a 'silent partner' in the investment."); Graetz, supra note 6, at 1603 (stating that under a cash flow consumption tax, "the government can be regarded as automatically becoming a joint venturer in taxpayers' investments"); Weisbach, supra note 13, at 23. ("The cash flow tax means that the government effectively has purchased t units of the asset where t is the tax rate."). See also Comm. on Simplification, Section of Tax'n, Am. Bar Ass'n, Complexity and the Personal Consumption Tax, 35 Tax Law. 415, 438 (1982) (characterizing a cash flow corporation tax as "equivalent to a government matching program"). See also E. Cary Brown, Business Income Taxation and Investment Incentives, in Income Employment and Public Policy: Essays in Honor of Alvin H. Hansen 300, 309-10 (1948) (arguing that if an income tax allowed the cost of long-lived business assets to be deducted entirely in the year of purchase, "the government would literally be a partner in the firm. It would make a capital contribution on new investment at the same rate at which it shared in the future net receipts of the enterprise.").
From this perspective, the $5 of interest that Cole received on January 1, Year 2 in the Example 1 RST scenario, illustrated by Table 1, was actually composed of $3.50 of untaxed interest on his $70 investment in the debenture and $1.50 of interest on the government’s $30 share of the debenture principal. Accordingly, Table 3 shows that Cole’s total return on January 1, year 2 in the Example 1 RST scenario was not the $105 shown in Table 1. It was only $73.50 (tax-free recovery of his $70 investment plus $3.50 of tax-free interest thereon). Consistent with this analysis, Cole’s $31.50 RST payment on January 1, Year 2 was actually nothing more than a delivery to the government of its $30 share of the $100 of debenture principal plus its $1.50 share of the $5 of January 1, Year 2 interest. Stated differently, the RST merely allowed the government to collect its $30 investment in the debenture plus $1.50 interest thereon, but no tax was levied on Cole’s $3.50 share of the $5 of interest. Thus, the $1.05 tax imposed on Cole’s $3.50 of interest in the Example 1 income tax scenario disappeared in the RST scenario because the joint investor analysis shows that the RST, in contrast to an income tax, did not reach Cole’s

31. This $30 is the government’s investment in the form of deferred tax that Cole uses along with $70 of his own money to purchase a $100 debenture instead of a $70 debenture.

32. This $1.50 is effectively the government’s share of the $5 of gross interest rather than a tax collected from Cole.

33. Other commentators have suggested this conclusion with respect to a postpaid consumption tax, albeit indirectly. See Anne L. Alstott, The Uneasy Liberal Case Against Income and Wealth Transfer Taxation: A Response to Professor McCaffery, 51 TAX L. REV. 363, 365 n.11 (1996) (“Although amounts withdrawn from savings are nominally taxed when consumed, the apparent tax on investment income is actually offset by the earlier exclusion accorded to savings.”); Joseph Bankman & Barbara H. Fried, Winners and Losers in the Shift to a Consumption Tax, 86 GEO. L.J. 539, 540 (1998) (“The conventional explanation. . .is a taxpayer’s ability. . .to use the tax savings from writing off her initial investments in year one to increase the level of her initial investment. This grossed-up investment generates a return that is greater. . .by the amount of tax eventually owed on the aggregate return when dissaved.”); Alvin C. Warren, Jr., How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax?, 52 TAX L. REV. 1, 3 (1996) (“As long as investment of the tax savings from expensing produces the same rate of return as the taxpayer’s original investment, the proceeds from investment of the tax savings will fully fund future taxes on the total amount invested.”). Christopher H. Hanna, The Virtual Reality of Eliminating Tax Deferral, 12 AM. J. TAX POL’Y 449, 456-57 (1995) reaches this conclusion regarding the expensing of investment assets under an income tax regime.

Stephen Land has advocated treating the government as a joint investor as a means to eliminate the deferral benefit that results under the income tax from the realization requirement. He does not, however, suggest that the joint investor analysis should be used to deconstruct a consumption tax regime. See Stephen B. Land, Defeating Deferral: A Proposal for Retrospective Taxation, 52 TAX L. REV. 45, 73, 84 (1996). See also Deborah H. Schenk, An Efficiency Approach to Reforming a Realization-Based Tax, 57 TAX L. REV. 503, 544-47 (2004).
The foregoing joint investor analysis indicates that if the federal income tax were replaced with the RST illustrated in Table 1 and deconstructed in Table 3, the result would be to create a taxing regime in which Cole's decision to save would force the government to become a 30% joint participant in all of Cole's investments. Stated more broadly, an RST or other form of postpaid consumption tax necessarily amounts to a scheme for providing government assistance to all private investors just as the government "matched" Cole's $70 investment in the debenture with its own $30 participation.

XI. DISTINGUISHING THE INCOME TAX

How is the income tax different in this respect? Let us investigate that question by rearranging the results of the income tax column of Table 1 into a format similar to Table 3. Table 4 shows the results.

| Table 4 (Reformulation of Table 1 Income Tax Scenario) |
|--------------------------------|----------------|----------------|
| Cole | Government | Totals |
| 1/1/1 $100 of wages | $70.00 | $30.00 (1/1/1 tax) | $100.00 |
| 1/1/1 Debenture Investment | $70.00 | -0- | $70.00 |
| 5% Interest for One Year | $2.45 | $1.05 (1/1/2 tax) | $3.50 |

Table 4 characterizes the government as having no part of the debenture investment because the $30 of tax collected from Cole's $100 of wages on January 1, Year 1 was held by the government free and clear for immediate public use instead of being embedded in an investment chosen by Cole. And from Cole's standpoint, his January 1, Year 1 $30 income tax payment with respect to his wages took care of the government so that Cole's $70 January 1, Year 1 debenture purchase was an investment play made entirely with his money. This conclusion is reinforced by the fact that on January 1, Year 2, the debenture produced total interest of only $3.50 in the Example 1 income tax scenario, not $5 as in the RST scenario, and the government imposed a $1.05 income tax on the $3.50 of Year 2 interest, instead of collecting a $1.50 share of $5 of Year 2 interest as in the Example 1 RST scenario.

Nevertheless, the government does have a financial interest of sorts in the Example 1 income tax scenario, as deconstructed in Table 4. To be

34. As indicated in supra note 10, Cole's interest is assumed to equal the riskless rate of return.

35. See generally authorities cited in supra note 33.
specific, the government will collect (1) $1.05 of income tax on January 1,
Year 2 in this income tax hypothetical if the $70 debenture yields the full
$3.50 of contract interest, (2) zero tax if none of the interest is paid, or (3)
a tax somewhere between zero and $1.05 if the interest is only partially
paid. On the downside, if the debenture principal is not fully collected, Cole's loss deduction will cost the government revenue—$21 of revenue ($70 x .30) where the debenture becomes completely worthless. Because of these upside and downside possibilities, the government is not indifferent to Cole’s investment results in Example 1’s income tax scenario.

There are, however, important differences between the Example 1 income tax and RST settings. First, in the income tax scenario deconstructed in Table 4, the government can never get its hands on any portion of the $70 debenture principal. When the debenture matures, Cole will have the entire $70 of principal available for consumption. In contrast, the RST scenario deconstructed in Table 3 gives the government a 30% interest in the $100 of debenture principal. When the debenture matures and Cole consumes, the government will get 30% of the $100 principal as part of its tax take. Second, on the downside, the government’s loss exposure from worthlessness of the debenture is $30 in the Example 1 RST scenario, but the government’s loss will provide Cole with no protection against loss of his $70 if the debenture implodes. In comparison, the government’s maximum loss exposure from worthlessness of the debenture is only $21 in the Example 1 income tax setting, but if it were to occur, it would effectively reduce Cole’s loss from $70 to $49. Thus, on the downside, the government is a full joint investor in the Example 1 RST scenario but only a limited insurer in the Example 1 income tax setting. Third, the government’s $30 joint investment in the RST scenario allows Cole to scale the debenture investment up from $70 to $100. In contrast, the government’s financial interest in the Example 1 income tax scenario does not involve a matching financial contribution

36. Granted, Cole’s investment was assumed to be riskless. See text supra note 10. However, even “riskless” plays have a small chance of going bad.

37. In Schanz-Haig-Simons terms, complete worthlessness would cause Cole’s wealth to decrease by $70 without any consumption benefit. Therefore, a $70 deduction is appropriate. See DODGE, FLEMING & GEIER, supra note 6, at 37-39, 57-60. This would probably be a capital loss deduction under I.R.C. § 165(g). This simplified hypothetical, however, assumes that Cole’s deduction would be taken against ordinary income that is taxable at 30%.


40. Professor Lederman has said that the loss sharing imposed on the government by loss deductions in an income tax regime means that “the government has become a partner in the investor’s wager.” See Lederman, supra note 38, at 1439. As indicated by Cole’s hypothetical, however, the government’s partnership role in an income tax scenario is considerably more limited than in a postpaid consumption tax setting, and the differences justify treating the two cases as distinct. See also Joseph M. Dodge, Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles, 58 TAX L. REV. 399, 444-48 (2005).
that permits Cole to scale up—the debenture investment is limited to Cole's $70. (The full consequences of this latter point will be explored in the next section.) For these reasons, it makes sense to view the government as a joint debenture investor in the Example 1 RST scenario, but not in the income tax setting, even though the preceding explanation shows that the government does have a contingent financial stake in Cole's affairs under an income tax regime.

XII. DISQUIETING CONSEQUENCES

So the RST and other postpaid consumption taxes can be analyzed in terms of a joint investor construct. So what? Is the joint investor approach just a clever trick or does it have practical consequences? Indeed, there are practical consequences.

At the outset, this “joint investor” or “government matching” interpretation of the RST as a replacement for the income tax raises two process issues. First, Cole decides how the government’s 30% will be invested. In our example, he put the money into a safe, innocuous investment—a bluechip corporate debenture. But it could have been a high-risk crapshoot (say a purchase of a racehorse) with government funds presently needed for education, homeland security, etc. Or it could have been a socially problematic investment (a cigarette factory, a factory turning out cheap handguns, a legal Nevada brothel, etc.). Stated differently, Cole’s decision about how to invest the government’s money may differ radically from the way most Americans would prefer to see public funds handled and, therefore, may result in public funds being allocated in ways that would never occur through the congressional appropriations process.

41. See also Linda Sugin, Tax Expenditure Analysis and Constitutional Decisions, 50 Hastings L.J. 407, 435 n.126 (1999). Of course, the I.R.C. § 170 charitable contribution deduction is often analyzed as a program of government matching grants to donees selected by contributing taxpayers. See, e.g., Saul Levmore, Taxes as Ballots, 65 U. Chi. L. Rev. 387, 404-13 (1998). But the amount of the “match” is constrained by the §§ 170(b), (e) limitations on the deduction, and the purposes for which the government will make its “grants” are restricted by the limited range of donees listed in § 170(c). There are no such constraints on the government “match” in a postpaid consumption tax regime. Moreover, § 170 donees often do things that the government would otherwise have to pay for with appropriations funded by taxing the public. This is unlikely to be true of the beneficiaries of the government “match” in an RST regime. For these reasons, the objections raised by joint investor analysis to proposals for replacing the income tax with a postpaid consumption tax do not apply directly to §170. However, the distributional problem that results from the fact that §170 deductions provide greater benefits to high-bracket taxpayers than to low-bracket taxpayers is related to the distributional problem described hereafter regarding the joint investor effect of a postpaid consumption tax.

42. Of course, the present income tax would give the U.S. Treasury a portion of Cole’s profits from these problematic businesses, (see I.R.C. § 61(a) (West 2006)), and, through the §165 loss deduction, would cause the Treasury to bear a portion of any losses suffered by Cole. This is entirely appropriate with respect to the profits because they represent previously untaxed accessions to wealth. It is also appropriate with respect to the losses because they are wealth diminutions that cannot be classified as consumption. More importantly, for reasons explained in section XI supra, these incidents of the present income tax give the government a mere contingent interest in Cole’s socially problematic invest-
The second process problem is that Cole, not our elected representatives, determines the amount of the government's investment by his own choice of how much to invest. In this example, every $0.70 that Cole invests compels a $0.30 matching investment by the government, and every $1 that he invests mandates a $0.43 government match. Moreover, there is no limit, other than low income, to the number of taxpayers who can, like Cole, force the government to match their investments. Stated differently, an RST that replaced the income tax would allow private savers to achieve unlimited preemption of the congressional appropriations process. 43

These points about process lead to a distributional concern arising from the fact that the same investments are not open to all savers. Instead, the types of investments that are available depend on the amount of capital that the investor has at her disposal. Small savers are limited to mutual funds, passbook savings accounts, and other modest-return savings vehicles. Only big savers have the kind of investment scale that allows them to get into, or expand participation in, the high return investments—IPOs, 44 hedge funds, 45 private equity funds, 46 real estate syndications, foreign direct investments, etc. Moreover, big savers get various kinds of advantageous treatment that are not available to small savers. 47 But the government “match” in an RST regime is large for the big saver and assists her in scaling up her investments while the government “match” for small savers is small and leaves them unable to participate in the most lucrative investment media or receive the best treatment. Big savers are disproportionately high income individuals. 48 Thus, an RST is a government that is materially less significant than the joint investor position that the government would assume under a postpaid consumption tax.

43. If, as suggested in the text supra note 4, a postpaid consumption tax were adopted as a supplement to the income tax, this process issue would still be present, but savers would be forced to pay for the government match with income tax payments.


45. See, e.g., Henny Sender, Hedge Funds Nip at Wall Street, WALL ST. J., May 26, 2005, at C1.


ment investment assistance scheme that is tilted toward the wealthy.49

One way to evaluate this outcome is to ask if Congress were to con-
sider a scheme of encouraging private investments by having the Treasury
make direct matching investments with Treasury cash, would Congress
shape the scheme so that there was no limit on the government’s obliga-
tion to match and so that high income taxpayers got a much larger match
that assisted them in exploiting investment media from which lower in-
come taxpayers were foreclosed? Not likely. Thus, it seems problematic
to accomplish the same result indirectly by replacing the federal income
tax with an RST.

XIII. AN INCOME TAX BIAS?

Is the joint investor analysis based on an assumption that the income
tax is normatively superior to an RST? Stated differently, is the joint
investor analysis the product of a pro-income-tax bias? The answers
would seem to be “no” because the joint investor analysis is actually em-
bedded in consumption tax orthodoxy. The standard explanation of post-
paid consumption taxes points out that, as shown in the RST column of
Table 1, the government loses none of the deferred consumption tax50 by
postponing collection until the taxpayer consumes.51 According to the
standard explanation, there is no loss to the fisc because the tax base
grows through investment returns during the deferral period so that when
consumption finally occurs, the tax base is greater by the amount of the
investment return. Thus, the government collects a larger tax that fully
compensates it for the delay.52 But this amounts to arguing that the gov-
ernment is a joint investor with the taxpayer during the time that consum-
able funds are diverted into an investment. In other words, the joint
investor analysis is an essential part of the orthodox explication of post-
paid consumption taxes and does not depend on income tax norms for its
validity.53

Christopher Conkey, Typical U.S. Family’s Net Worth Edged Up Only 1.5% in ’01-’04,
WALL ST. J., Feb. 24, 2006, at A-4; see also Robert Guy Matthews, Recovery Bypasses

49. If, as suggested in the text supra note 4, a postpaid consumption tax were adopted
as a supplement to the income tax, high income savers could be forced to pay for the tilt
through the income tax.

50. Of course, the government does lose the income tax in Table 1 on the investment
return.

51. This assumes that tax rates and interest rates remain constant during the deferral
period.

52. See, e.g., U.S. TREAS. DEP’T, BLUEPRINTS FOR BASIC TAX REFORM 123 (1977)
[hereinafter Blueprints]; Andrews, supra note 11, at 1150; McCaffery, supra note 3, at 823-
25; Shaviro, supra note 10, at 104-05.

53. See McCaffery, supra note 3, at 932 (“a postpaid consumption tax importantly re-
defines property rights: it changes what it means for wealth to be one’s own. Society has a
stake in the private savings accounts, and is justified in regulating them, just as it does now
with IRAs and pension plans.”).
XIV. SO WHAT'S NEW? AREN'T WE ALREADY THERE?

It has been long noted that the present income tax has many consumption tax features. For example, if in the income tax column of Table 1 Cole had used his $100 of wages to make a deductible contribution to an IRA, then he would have had a $100 after-tax investment and $5 of January 1, Year 2 interest, just as in the RST column. Other prominent consumption tax elements within the federal income tax are the non-taxation of unrealized gains, the substantial non-taxation of realized gains from selling owner-occupied homes, the exemption for interest on state and local government obligations, and various forms of tax-preferred retirement plans in addition to the IRA. The point is sometimes made that these features have substantially converted the federal income tax into a consumption tax regime and that formally replacing the federal income tax with an explicit consumption tax system would not be a significant change.

It should be noted, however, that these consumption tax features represent either practical concessions to administrative difficulties (non-taxation of unrealized gains) or decisions to effectuate discrete federal policies through the tax expenditure process—that is, (1) encouragement of private home ownership through substantial non-taxation of gains from selling owner-occupied homes, plus the mortgage interest deduction, (2) federal aid to state and local governments in the form of the I.R.C. § 103 exemption, and (3) encouragement of private retirement savings by means of various tax-preferred savings plans. Like most tax expenditures, these consumption tax features are mostly overbroad, inefficient, and incoherent. Nevertheless, they are intentionally targeted to particular ends and have substantial built-in limits. In contrast, replacement of the federal income tax with a postpaid consumption tax regime would effectively require the federal government to match any private saving regardless of purpose or amount. This would take us substantially beyond where we are today.

XV. UNREALIZED GAINS: ACHILLES' HEEL REDUX

The realization requirement, which Professor Andrews has called the Achilles' heel of the income tax, is indeed a serious structural flaw. This is because it allows income tax on accrued but unrealized investment gains.
yields (that is, appreciation in land and growth stocks) to be deferred until the investments are disposed of in taxable transactions, while the yields from investments that generate realized gains (that is, dividend-paying stocks and interest-paying bonds) bear a current tax. This difference powerfully distorts investor choices in favor of making unrealized yield investments and in favor of continuing to hold such investments instead of selling them and moving on when economically superior opportunities appear.

There have been several thoughtful proposals to significantly limit the realization requirement's distortions, but none have been adopted, and it seems that for the time being, Henry Simons was correct in characterizing a broad realization requirement as a necessary feature of a practical income tax. Accordingly, property appreciation gains are generally not subject to U.S. federal income taxation until they are realized through a transaction qualifying as a realization event, and even then taxation will be deferred if the realization event is covered by any of several nonrecognition provisions. This seems similar to the non-taxation under a postpaid consumption tax of investment earnings prior to their being spent on consumption. In addition, neither the income tax nor a postpaid consumption tax will ever be collected on unrealized property appreciation to the extent that the appreciation is erased by value declines occurring prior to realization or consumption. These facts invite a consideration of whether there is any meaningful difference between the treatment of unrealized property appreciation under an income tax versus its treatment under a postpaid consumption tax. If not, then for a broad range of investments, the distributional consequences of a postpaid consumption tax and an income tax are the same. There clearly is a significant difference, however, as illustrated by Example 2.

Example 2. The facts are the same as in Example 1 except that on January 1, Year 1, Cole purchases an investment that produces only unrealized appreciation at 5% per year, and Cole does not sell the investment and spend the proceeds on flowers for Louise until January 1, Year 3. Table 5 shows the results.

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61. See, e.g., I.R.C. § 1001.
62. See id. §§ 61(a)(4), (7).
64. See Schenk, supra note 33, at 520-47.
67. See, e.g., I.R.C. §§ 351, 1031 (West 2006).
### TABLE 5 (TABLE 1 WITH A THREE YEAR APPRECIATING PROPERTY INVESTMENT)

<table>
<thead>
<tr>
<th></th>
<th>Income Tax</th>
<th>RST</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/1 Wages</td>
<td>$100.00</td>
<td>$100.00</td>
</tr>
<tr>
<td>1/1/1 Tax @ 30%</td>
<td>-30.00</td>
<td>-0</td>
</tr>
<tr>
<td>1/1/1 After-tax investment</td>
<td>$70.00</td>
<td>$100.00</td>
</tr>
<tr>
<td>Appreciation during Year 1 @ 5%</td>
<td>+3.50</td>
<td>+5.00</td>
</tr>
<tr>
<td>Year 2 investment</td>
<td>$73.50</td>
<td>$105.00</td>
</tr>
<tr>
<td>Appreciation during Year 2 @ 5%</td>
<td>+3.68</td>
<td>+5.25</td>
</tr>
<tr>
<td>1/1/3 income tax (.30 x [$3.50 + $3.68])</td>
<td>-2.15</td>
<td>-0</td>
</tr>
<tr>
<td>Gross 1/1/3 amount for consumption</td>
<td>$75.03</td>
<td>$110.25</td>
</tr>
<tr>
<td>1/1/3 RST on flower purchase @ 30%</td>
<td>-0</td>
<td>-33.08⁶⁸</td>
</tr>
<tr>
<td>Net 1/1/3 consumption</td>
<td>$75.03</td>
<td>$77.17</td>
</tr>
</tbody>
</table>

The next step is to bring the January 1, Year 1 income tax forward with 5% annual compound interest to January 1, Year 3, thereby making it comparable to the two January 1, Year 3 taxes. This gives the $30 January 1, Year 1 income tax a January 1, Year 3 value of $33.08 (which equals the January 1, Year 3 RST). Thus, the total income tax paid in Table 5, valued as of January 1, Year 3, is $35.23 ($33.08 + $2.15), which is $2.15 greater than the January 1, Year 3 RST. In other words, the difference between the income tax and RST scenarios in Table 5 is that the RST allowed Cole to avoid the $2.15 income tax on his two-year investment gain just as the RST allowed him to avoid the $1.05 income tax on his investment gain in Table 1. Moreover, as was the case with Table 1, the Table 5 RST scenario outcome is explained by the joint investor analytical approach under which Cole's January 1, Year 1 investment is regarded as made with $30 of the government's money (30% RST rate x $100) and $70 of his own money ($100 - $30 deferred RST). Table 6 illustrates this point.

⁶⁸. See supra note 12.
<table>
<thead>
<tr>
<th></th>
<th>Cole</th>
<th>Government</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/1 Debenture Investment</td>
<td>$70.00</td>
<td>$30.00</td>
<td>$100.00</td>
</tr>
<tr>
<td>Appreciation During Yr 1 @ 5%</td>
<td>+ 3.50</td>
<td>+ 1.50</td>
<td>+ 5.00</td>
</tr>
<tr>
<td>1/1/2 Investment</td>
<td>$73.50</td>
<td>$31.50</td>
<td>$105.00</td>
</tr>
<tr>
<td>Appreciation During Yr 2 @ 5%</td>
<td>+ 3.67</td>
<td>+ 1.58</td>
<td>+ 5.25</td>
</tr>
<tr>
<td>Total Return on 1/1/3</td>
<td>$77.17</td>
<td>$33.08</td>
<td>$110.25</td>
</tr>
</tbody>
</table>

In other words, the $5.00 of asset appreciation that occurred in Table 5 during Year 1 was actually composed of $3.50 of untaxed appreciation on Cole’s $70 portion of the investment and $1.50 of appreciation on the government’s $30 portion. Likewise, the $5.25 of Year 2 asset appreciation was $3.67 of untaxed appreciation on Cole’s share of the investment plus $1.58 on the government’s share. Thus, Table 6 shows that in the RST scenario of Table 5, the $33.08 January 1, Year 3 RST merely allowed the government to collect its $30 portion of Cole’s investment, plus $3.08 of the two years of asset appreciation on the government portion ($1.50 + $1.58), while Cole totally avoided tax on his portion of the investment’s two-year run-up in value. More broadly, Tables 5 and 6 show that in spite of the application of the income tax’s realization requirement in Example 2, the income tax and a postpaid consumption tax produce significantly different results with respect to appreciating investments and that joint investor analysis explains the comparatively taxpayer-friendly nature of the RST outcome.

But in the income tax scenario of Example 2, Cole bought the appreciating investment with after-tax income. How significant is that fact? Let us consider the result if, in Example 2, Cole purchased the investment with pre-tax income. First, we must note that for our purposes, this is a limited class of income. It excludes amounts that are the after-tax residue of receipts taxed in prior years. For example, assume that Cole earned $100 of wages in Year 1, paid $30 of income tax on those wages, and used the remaining $70 to acquire an appreciating investment that grew to $113 in Year 2. Further, assume that he then sold the investment, paid 30% income tax ($13) on his $43 gain, carried the remaining $100 ($70 basis + $30 after-tax gain) into Year 3, and used it to purchase an investment. Cole’s Year 3 $100 purchase is simply an investment of his $70 of after-tax Year 1 wages plus his $30 of after-tax Year 2 appreciation. The

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69. This $30 is the government’s investment in the form of deferred tax that Cole uses along with $70 of his own money to purchase a $100 debenture instead of a $70 debenture.
70. This $1.50 is effectively the government’s share of the $5 of Year 1 appreciation rather than a tax collected from Cole.
71. This $1.58 is effectively the government’s share of the $5.25 of Year 2 appreciation rather than a tax collected from Cole.
72. Stated differently, because the government had a 30% share of the joint investment, the government had a 30% share of the $10.25 of investment appreciation that occurred during Years 1 and 2 and that 30% appreciation share equals $3.08 ($10.25 x .30).
fact that he paid tax on the $100 in Years 1 and 2 does not convert the $100 into Year 3 pre-tax income.

Pre-tax income does literally include amounts that are rendered pre-tax because they are deductible investments in tax-favored savings plans. As explained previously, however, this class of income is rendered pre-tax by congressional intervention for a narrow purpose and should be evaluated by tax expenditure analysis rather than as part of an income tax/postpaid consumption tax comparison.\textsuperscript{73}

Thus, for our purposes, pre-tax income is limited to such things as gifts and bequests excluded from Cole's income by I.R.C. § 102(a), personal injury recoveries excluded by I.R.C. § 104(a)(2), and asset appreciation that has been excluded by the realization requirement and that Cole now uses to purchase an investment in a transaction covered by a nonrecognition provision, such as I.R.C. § 351, § 721, or § 1031, so that the purchase itself does not trigger taxation of the asset appreciation under the principle of \textit{United States v. Davis}\textsuperscript{74} and \textit{International Freighting Corp. v. Commissioner}.

With that background, let us assume that in Example 2, Cole purchased the investment with $100 of cash that he had received as a § 102(a) excluded bequest. Table 7 shows the results.

\begin{table}[h]
\centering
\caption{Table 7 (Table 5 with the investment funded by §102(a) excluded dollars)}
\begin{tabular}{lll}
\hline
 & Income Tax & RST \\
\hline
1/1/1 Bequest & $100.00 & $100.00 \\
1/1/1 Tax @ 30\% & -0- & -0- \\
1/1/1 Investment & $100.00 & $100.00 \\
Appreciation during Year 1 @ 5\% & + 5.00 & + 5.00 \\
Year 2 investment & $105.00 & $105.00 \\
Appreciation during Year 2 @ 5\% & + 5.25 & + 5.25 \\
1/1/3 Income tax (.30 x [$5.00 + $5.25]) & - 3.08 & -0- \\
Gross 1/1/3 amt for consumption & $107.17 & $110.25 \\
1/1/3 RST on flower purchase @ 30\% & -0- & - 33.08 \\
Net 1/1/3 consumption & $107.17 & $ 77.17 \\
\hline
\end{tabular}
\end{table}

In Table 7, unlike situations previously considered, the income tax gives Cole a better result than the RST, $30 better in fact ($107.17 - $77.17). The explanation, of course, is simple. Cole had $100 of investment basis in the income tax scenario,\textsuperscript{76} but not in the RST scenario, and the $30 superiority of the income tax result over the RST outcome is

\textsuperscript{73} See supra Part XIV.
\textsuperscript{74} 370 U.S. 65 (1962).
\textsuperscript{75} 135 F.2d 310 (2d Cir. 1943).
\textsuperscript{76} The income tax gave Cole a $100 basis in the excluded cash bequest, and in property purchased with that cash, so that the effect of the § 102(a) exclusion would be preserved. In contrast, basis plays no role under an RST.
nothing more than the $30 of tax that Cole saved in the income tax scenario by recovering his $100 basis free of the 30% tax. Thus, Cole paid only $3.08 of tax in the income tax scenario ($10.25 investment gain x .30) but paid $33.08 in the RST scenario ($110.25 consumption x .30). Moreover, the Table 6 joint investor analysis of the Example 2 RST scenario remains fully applicable in Table 7. That is, the government was a 30% joint investor with Cole in the initial $100 investment that Cole made with the gift proceeds, and the government's $33.08 Year 3 RST collection is the sum of 30% of the initial investment plus 30% of the $10.25 of appreciation on that investment during Years 1 and 2.

Assume, however, that Cole had used a substantial amount of unrealized appreciation to make the investment in Table 7. Let us say he transferred $50 basis property worth $100 in a §351 tax-deferred exchange for corporate stock and the other facts involved in Table 7 are unchanged. Table 8 shows the results.

**TABLE 8 (TABLE 5 WITH THE INVESTMENT HALF-FUNDED WITH UNREALIZED APPRECIATION)**

<table>
<thead>
<tr>
<th></th>
<th>Income Tax</th>
<th>RST</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/1 Investment</td>
<td>$100.00</td>
<td>$100.00</td>
</tr>
<tr>
<td>Appreciation during Year 1 @ 5%</td>
<td>+ .50</td>
<td>+ 5.00</td>
</tr>
<tr>
<td>Year 2 investment</td>
<td>$105.00</td>
<td>$105.00</td>
</tr>
<tr>
<td>Appreciation during Year 2 @ 5%</td>
<td>+ 5.25</td>
<td>+ 5.25</td>
</tr>
<tr>
<td>1/1/3 Income Tax (.30 x [$50 + $10.25])^77</td>
<td>- 18.08</td>
<td>-0-</td>
</tr>
<tr>
<td>Gross 1/1/3 amount for consumption</td>
<td>$ 92.17</td>
<td>$110.25</td>
</tr>
<tr>
<td>1/1/3 RST on flower purchase @ 30%</td>
<td>-0-</td>
<td>- 33.08</td>
</tr>
<tr>
<td>Net 1/1/3 consumption</td>
<td>$ 92.17</td>
<td>$ 77.17</td>
</tr>
</tbody>
</table>

In Table 8, the income tax continues to give Cole a better result than the RST, but the Table 7 gap has narrowed by half (from $30 to $15) because the amount of Cole's recoverable income tax basis was reduced by half (from $100 to $50). Indeed, if Cole had been in the rare situation of making his §351 exchange with equipment that had been depreciated to a zero income tax basis but that was nevertheless worth $100, then he would not have had any income tax basis to recover, and there would have been no income tax saving therefrom. His income tax and RST results would, therefore, have been identical in Table 8.

To recapitulate, where Cole's investment was made with after-tax dollars in which he had a full income tax basis (for example, dollars excluded under §102(a) or §104(a)(2)), there was a difference between the income tax and the RST scenarios, but unlike other situations we have con-

^77. Section 358 gave Cole a $50 basis in the $100 worth of stock that he received in exchange for property worth $100. Thus, when Cole sold the stock on January 1, Year 3, he realized $50 of appreciation that was built into the stock when he acquired it plus the $10.25 of additional appreciation that occurred during years 1 and 2.
sidered, the income tax provided the taxpayer-friendly result. Thus, in that discrete situation, replacement of the income tax with a postpaid consumption tax would actually cause a tax increase for Cole and concern for the fisc supports the replacement. But where Cole made his investment with unrealized appreciation and did so in a way that did not trigger recognition of the appreciation, the difference in the income tax and RST scenarios was dependent on the relative amounts of income tax basis and unrealized appreciation inherent in the property transferred by Cole, and where the income tax basis in the property was zero, there was no difference between the income tax and RST results. Thus, where taxpayers can invest with pretax dollars, the fisc is either better off, or no worse off, with a switch from an income tax to a postpaid consumption tax, and the tax burden carried by upper income taxpayers who do the lion's share of investing is either increased, or unchanged, by the switch.

As noted previously, however, these observations cover a rather narrow slice of the investing done in the United States and do not significantly detract from the general thrust of my analysis. Moreover, the joint investor analysis is fully applicable to the RST scenarios illustrated in Tables 7 and 8.

XVI. EXTENT OF THE EXEMPTION OF CAPITAL INCOME UNDER A POSTPAID CONSUMPTION TAX

A significant body of commentary disaggregates returns to capital into several components. A prominent example of this literature describes investment income as consisting of (1) riskless returns (compensation to investors for merely waiting), (2) inflation premia, (3) returns to risk takers, and (4) supernormal returns. This literature then argues that neither an income tax that is properly adjusted for inflation nor the various approaches to postpaid consumption taxation reach inflation premia and that if both forms of taxation are structured according to their respective ideals, both reach supernormal returns but neither reaches returns to risk taking. Thus, so the argument goes, there is no distinction between an ideal income tax and an ideal postpaid consumption tax with respect to items (2), (3), and (4), and the only difference is that an ideal income tax reaches the riskless return to capital (item (1)), while an ideal postpaid consumption tax does not. Because the riskless return to capital has been very low historically, this literature raises the possibility that there is no meaningful difference between an ideal income tax and an ideal postpaid consumption tax regarding the treatment of capital in-

78. See Slemrod & Bakić, supra note 5, at 200-05; see also President’s Advisory Panel on Fed. Tax Reform, supra note 3, at 153.

If this line of argument is correct, it may be a blow to those who favor an income tax on the ground that its application to capital income, which is concentrated in the hands of the wealthy, advances the concepts of ability-to-pay and vertical equity.

There are, however, good reasons for rejecting this dismissal of the income tax as an effective levy on capital income. First, if the risk-free rate of return is towards the upper end of the range within which commentators have asserted that it falls, it generates consumption tax exempt returns that are too large to be dismissed as inconsequential. Second, the contention that an income tax does not fall on returns to risk taking depends on certain problematic assumptions, one of the most important of which is that the income tax provides both an unrestricted deduction for losses and unlimited refundability to the extent that the taxpayer lacks insufficient income to fully absorb loss deductions. But this article is discussing postpaid consumption taxes as possible replacements for the federal income tax as it is, not an ideal federal income tax. Unlimited refundability of excess loss deductions is not part of the federal income tax and is unlikely ever to be so. (In general, refundability presently exists only to the extent of refunds generated by the two-year carryback of net operating losses allowed by § 172(b)(1)(A).) Moreover, the federal income tax has important restrictions on the deductibility of losses, such as the limitation on capital loss deductions, and that will always be the case so long as there are tax-preferred forms of income. Thus, in the real world, the federal income tax does apply to returns to risk taking in addition to the riskless rate of return, and substitution of a postpaid consumption tax for the current federal income tax would exempt more capital income than merely returns on riskless investments.

Finally, even if we were to grant the claim that postpaid consumption taxes and the income tax are effectively indistinguishable with respect to taxation of capital income, joint investor analysis shows that a postpaid consumption tax nevertheless makes the government a joint participant in all private investments. Moreover, the size of the riskless rate of return is irrelevant to this point because the extent of the government’s participation is defined by the consumption tax rate. Thus, even if the riskless rate of return was zero or less, a 30% postpaid consumption tax would make the government a 30% joint investor in all private investments, and this fact presents the distributional and process issues discussed in part XII supra. An income tax does not have these effects.

80. See Weisbach, supra note 13, at 23-25.
81. See supra note 10.
82. See Avi-Yonah, supra note 4, at 1656-57; Lederman, supra note 38, at 1435-40.
83. See Weisbach, supra note 13, at 8-9; Lederman, supra note 38, at 1436-39.
84. See supra Parts IX and X.
85. See id.
XVII. THE DOUBTFUL EFFECT OF PROGRESSIVE RATES

Professor Edward J. McCaffery has written that even if some of the returns to capital are exempted by a postpaid consumption tax, exemption occurs only if the tax has a flat rate. He asserts that a postpaid consumption tax will actually reach income from capital if the tax employs progressive rates.

Professor McCaffery's argument starts with the well-recognized equivalence of prepaid and postpaid consumption taxes that employ an identical flat rate. Thus, it is useful to begin by thinking about a single-rate wage tax, which is a prepaid tax because it is imposed when the wages are earned, not when they are spent on consumption. Such a tax applies only to wages; it expressly exempts all yields to capital and all consumer purchases. Thus, a wage tax appears to be merely a narrow-base income tax and not a form of consumption tax. But as is well-known to students of tax policy, under certain assumptions, a flat-rate wage tax actually produces an after-tax outcome identical to that of a postpaid consumption tax that has the same flat rate. This can be shown by applying the facts of Example 1 to a scenario involving a 30% wage tax and a 30% RST. Table 9 shows the familiar results.

### TABLE 9 (TABLE 1 WITH A 30% WAGE TAX AND 30% RST)

<table>
<thead>
<tr>
<th></th>
<th>Wage Tax</th>
<th>RST</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/1 Wages</td>
<td>$100.00</td>
<td>$100.00</td>
</tr>
<tr>
<td>1/1/1 Wage tax @ 30%</td>
<td>-30.00</td>
<td></td>
</tr>
<tr>
<td>1/1/1 After-tax investment</td>
<td>$70.00</td>
<td>$100.00</td>
</tr>
<tr>
<td>Interest earned @ 5%</td>
<td>+ 3.50</td>
<td>+ 5.00</td>
</tr>
<tr>
<td>Tax on interest</td>
<td>-0-</td>
<td></td>
</tr>
<tr>
<td>Gross 1/1/2 amount for consumption</td>
<td>$73.50</td>
<td>$105.00</td>
</tr>
<tr>
<td>1/1/2 Tax on flower purchase</td>
<td>-0-</td>
<td>-31.50</td>
</tr>
<tr>
<td>Net 1/1/2 consumption</td>
<td>$73.50</td>
<td>$73.50</td>
</tr>
</tbody>
</table>

Table 9 demonstrates that the 30% wage tax explicitly exempts Cole's $3.50 of interest while creating the same end result—$73.50 of net consumption—as the 30% postpaid RST in Table 1. This equivalence of outcomes is typically used to make two important points. First, the flat-rate wage tax must be a consumption tax, rather than a narrow-base income tax. This is so because it produces the same after-tax result as an RST with the same flat rate, which means that it also produces the same after-tax result as a VAT and a cash-flow tax with the same flat rate, and all

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86. McCaffery, supra note 3, at 873-80.
87. See id.; see also SLEMROD & BAKIJA, supra note 5, at 203.
88. See McCaffery, supra note 3, at 813-18.
89. See DODGE, FLEMING & GEIER, supra note 6, at 72-73; SLEMROD & BAKIJA, supra note 5, at 199-200, 205.
90. See generally Graetz, supra note 6, at 1598-1602.
three of these taxing regimes are levies on consumption. Second, since the wage tax and RST (and the VAT and cash-flow tax) produce equivalent outcomes and the wage tax explicitly exempts Cole's $3.50 of interest, the necessary implication is that the RST and the VAT and cash-flow tax also effectively exempt Cole's interest, even though the RST (and the VAT and cash-flow tax) appears to tax $5 of interest in the Example 1 Table 1 when Cole pays $105 to the florist on January 1, Year 2.

According to Professor McCaffery, however, if a postpaid consumption tax has progressive rates, the equivalence of prepaid and postpaid consumption taxes dissolves, and the progressive postpaid consumption tax will apply to capital income when a spike in the taxpayer's consumer spending pushes her into a higher tax bracket. But the only form of postpaid consumption tax that can employ progressive rates is a cash-flow tax. Thus, to test Professor McCaffery's assertion within the context of the examples used in this article, I must again temporarily alter Example 1 by stipulating that the consumption tax involved there is a cash-flow tax that employs progressive rates, say 30% on the first $100 of consumption and 50% on amounts above $100. Table 10 reformulates the Table 1 RST scenario to reflect these changes.

<table>
<thead>
<tr>
<th>TABLE 10 (TABLE 1 WITH A PROGRESSIVE CASH-FLOW TAX)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/1 Wages</td>
</tr>
<tr>
<td>1/1/1 Tax</td>
</tr>
<tr>
<td>1/1/1 After-tax investment</td>
</tr>
<tr>
<td>Interest earned @ 5%</td>
</tr>
<tr>
<td>Gross 1/1/2 amount for consumption</td>
</tr>
<tr>
<td>Tax on first $100 @ 30%</td>
</tr>
<tr>
<td>Tax on next $5 @ 50%</td>
</tr>
<tr>
<td>Total 1/1/2 cash-flow tax</td>
</tr>
<tr>
<td>Net 1/1/2 consumption</td>
</tr>
</tbody>
</table>

Table 10 shows that on the stated facts, the progressive cash-flow tax rate schedule raises $1 more tax ($32.50) than did the flat rate RST in Table 1 ($31.50). Moreover, the 50% marginal rate became applicable in Table 10 because Cole consumed the $5 of interest. Thus, the twenty point difference between the 30% rate and the 50% rate arguably falls entirely on interest income and it appears that, as predicted by Professor McCaffery.

91. See Dodge, Fleming & Geier, supra note 6, at 68-73; Slemrod & Bakiya, supra note 5, at 199-200.
92. See Dodge, Fleming & Geier, supra note 6, at 75; Slemrod & Bakiya, supra note 5, at 199; Andrews, supra note 11, at 1126; Avi-Yonah, supra note 4, at 1658.
93. See McCaffery, supra note 3, at 813-18, 873-880; see also, Alstott, supra note 33.
94. See Graetz, supra note 6, at 1578-79.
95. A cash-flow tax requires Cole to include his $100 of wages in the tax base but allows an offsetting $100 deduction for the contemporaneous investment in the debenture. This deduction fully shelters the wages so that no tax is due on 1/1/1.
96. For the sake of argument, I am giving Professor McCaffery the benefit of the doubt and proceeding on the assumption that the twenty point difference falls entirely on
sor McCaffery, the progressive rate table caused the cash-flow regime to impose a $1 tax on Cole’s consumption of the $5 of January 1, year 2 interest. Taking this view, the interest bore only a 20% rate of tax ($1/$5) compared to the 30% tax that applied in Tables 1 and 10 to Cole’s consumption of his wages, but the interest apparently did bear some tax.

The joint investor analysis, however, reaches a different conclusion. The discussion of the government’s “share” in Parts IV to X supra shows that where the postpaid tax employs a 30% flat rate, we can regard the government as having a 30% share of Cole’s debenture investment. But in a progressive rate scenario, the ultimate tax rate cannot be known at the time of the investment. For previously discussed reasons, however, the rate will surely be greater than zero. Thus, it is inappropriate to regard the government as having no ex ante claim on Cole’s investment merely because the postpaid consumption tax employs progressive rates rather than a flat rate. The better alternative is to regard the government as having a share of Cole’s debenture investment at the time the debenture is purchased, just as in the flat rate scenario, but to rely on hindsight by defining the government’s share in terms of its actual take.

The government’s tax take in the progressive cash-flow tax scenario (Table 10) was 30.95% ($32.50/$105). Thus, the joint investor analysis views the government as owning a $30.95 share of the $100 debenture and as being entitled to $1.55 of the $5 of January 1, Year 2 interest (.3095 x $5 = $1.55). The sum of the government’s principal share ($30.95) and interest share ($1.55) equals $32.50. This means that Cole’s $32.50 cash-flow tax payment on January 1, Year 2 was nothing more than his delivery to the government of its $30.95 share of the $100 of debenture principal and its $1.55 share of the interest thereon. Cole’s $3.45 portion of the interest ($5 - $1.55) did not bear any tax. Accordingly, the joint investor analysis contradicts Professor McCaffery’s argument that a postpaid consumption tax with progressive rates reaches investment returns that would escape a flat-rate postpaid tax.

This conclusion, however, depends on acceptance of the argument that the government had a 30.95% share of Cole’s investment in the debenture, even though the progressive rate structure made it impossible to know the precise amount of the government’s share until Cole consumed the investment. If that contention is unpersuasive, then Professor McCaffery wins the point and the progressive cash-flow tax does impose a $1 tax on capital income in Table 10. But more importantly, even if one rejects the argument that the government had a 30.95% share of Cole’s deben-

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97. Thus, $5 interest x .20 rate difference = $1 tax. Obviously, the width of the rate brackets is very important. If the 30% bracket in this hypothetical had ended at $105 instead of $100, then the tax would have been the same as in the RST column of Table 1 ($31.50).

98. See supra Part VI.

99. See supra Part VIII.
ture investment in Table 10, the analysis in Part VI supra demonstrates that the government’s share was at least equal to the 30% initial rate in the progressive rate table. Thus, to that extent, even the progressive cash-flow tax in Table 10 results in the government becoming a joint investor with Cole and presents the distributional and process concerns discussed in Part XII supra.

XVIII. THE IRRELEVANCE OF EQUIVALENCE

As explained in Part XVII supra, the equivalence of a wage tax and a postpaid consumption tax is often used in the literature to show that a postpaid consumption tax does not impose a tax (or a second tax\textsuperscript{100}) on investment income. However, it is well recognized that this equivalence is destroyed if tax rates change in the period between payment of the wage tax and payment of the postpaid consumption tax\textsuperscript{101}. This point can be illustrated by changing the facts of Example 1 to provide that (1) there is a third hypothetical financing alternative for the United States Government—a 30% wage tax, and (2) that between January 1, Year 1 and January 1, Year 2, the income tax and RST rates increase from 30% to 50%. Table 11 shows the results.

<table>
<thead>
<tr>
<th></th>
<th>Income Tax</th>
<th>RST</th>
<th>Wage Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/1 Wages</td>
<td>$100.00</td>
<td></td>
<td>$100.00</td>
</tr>
<tr>
<td>1/1/1 Tax @ 30%</td>
<td>-30.00</td>
<td>-0-</td>
<td>-30.00</td>
</tr>
<tr>
<td>1/1/1 After-tax investment</td>
<td>$70.00</td>
<td>$100.00</td>
<td>$70.00</td>
</tr>
<tr>
<td>Interest earned @ 5%</td>
<td>+3.50</td>
<td>+5.00</td>
<td>+3.50</td>
</tr>
<tr>
<td>1/1/2 50% income tax</td>
<td>-1.75</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>Gross 1/1/2 amount for consumption</td>
<td>$71.75</td>
<td>$105.00</td>
<td>$73.50</td>
</tr>
<tr>
<td>1/1/2 50% RST on flower purchase</td>
<td>-0-</td>
<td>-52.50</td>
<td>-0-</td>
</tr>
<tr>
<td>Net 1/1/2 consumption</td>
<td>$71.75</td>
<td>$52.50</td>
<td>$73.50</td>
</tr>
</tbody>
</table>

Table 11’s difference in bottom lines between the income tax and the wage tax is $1.75 ($73.50 - $71.75). This was expectable because $1.75 exactly equals the January 1, Year 2 tax that applied to the interest in the income tax scenario but not in the wage tax scenario. Now note that the difference between the income tax and RST bottom-lines is $19.25 ($71.75 - $52.50) and that this excess of the income tax bottom-line over the RST bottom-line equals the 20 point rate increase between the time of the January 1, Year 1 income tax payment and the January 1, Year 2 payment.

\textsuperscript{100} See text supra notes 13-14.

\textsuperscript{101} See Dodge, Fleming & Geier, supra note 6, at 72; Andrews, supra note 11, at 1126; Avi-Yonah, supra note 4, at 1658; McCaffery, supra note 3, at 825. Other changes can also destroy the equivalence, see Graetz, supra note 6, at 1598-1602, but for purposes of this paper, it makes no difference how the equivalence is broken, and a tax rate change provides a simple scenario within which to examine consequences.
RST payment, *minus the $1.75 January 1, Year 2 tax on the interest* ([\$105 \times .20] - $1.75 = $19.25). Thus, even though the rate increase destroyed the wage tax/RST equivalency, this analysis shows that the January 1, Year 2 $1.75 interest tax was avoided in the RST scenario.

Moreover, the joint investor analysis still provides the explanation for the interest tax avoidance in Table 11 if we follow the line of argument in Parts VI and XVII *supra*, and treat the RST rate increase from 30% to 50% as retroactively moving the government from a 30% joint investor position to a 50% joint investor status. Table 12 shows the results of this approach.

**TABLE 12 (REFORMULATION OF THE RST SCENARIO IN TABLE 11)**

<table>
<thead>
<tr>
<th></th>
<th>Cole</th>
<th>Government</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/1 Debenture investment</td>
<td>$50.00</td>
<td>$50.00</td>
<td>$100.00</td>
</tr>
<tr>
<td>5% Interest for one year</td>
<td>+ 2.50</td>
<td>+ 2.50</td>
<td>+ 5.00</td>
</tr>
<tr>
<td>Total return on 1/1/2</td>
<td>$52.50</td>
<td>$52.50</td>
<td>$105.00</td>
</tr>
</tbody>
</table>

In other words, Table 12 shows that the government’s $52.50 RST collection in Table 11 was simply the government’s half of the $100 investment principal plus the government’s half of the investment return. The government did not collect any tax on Cole’s half of the investment income.

More broadly, Tables 11 and 12 show that the wage tax/postpaid consumption tax equivalence is unnecessary either for purposes of showing that postpaid consumption taxes do not impose a tax (or a second tax\textsuperscript{102}) on investment returns or for purposes of explaining that result through joint investor analysis.

**XIX. JOHN STUART MILL REDUX**

John Stuart Mill famously argued as follows that an income tax was objectionable on both efficiency and fairness grounds because it taxed savers twice while imposing only a single layer of tax on those who immediately consumed all their earnings:

[\textit{T}he proper mode of assessing an income tax would be to tax only the part of income devoted to expenditure, exempting that which is saved. For when saved and invested (and all savings, speaking generally, are invested) it thenceforth pays income tax on the interest or profit which it brings, notwithstanding that it has already been taxed on the principal. Unless, therefore, savings are exempted from income tax, the contributors are twice taxed on what they save, and only once on what they spend. A person who spends all he receives, pays 7\textit{d.} in the pound, or say three per cent, to the tax, and no more; but if he saves part of the year’s income and buys stock, then in addi-

\textsuperscript{102} See *supra* Part III.
tion to the three per cent which he has paid on the principal, and which diminishes the interest in the same ratio, he pays three per cent annually on the interest itself, which is equivalent to an immediate payment of a second three per cent on the principal. So that while unproductive expenditure pays only three per cent, savings pay six percent: or more correctly, three per cent on the whole, and another three per cent on the remaining ninety-seven. The difference thus created to the disadvantage of prudence and economy, is not only impolitic but unjust. To tax the sum invested, and afterwards to tax also the proceeds of the investment, is to tax the same portion of the contributor's means twice over.

No income tax is really just from which savings are not exempted.

... People should be taxed, not in proportion to what they have, but to what they can afford to spend.103

Although Mill seems to suggest that his double tax argument establishes that the income tax is unfair and, on that ground, should be replaced with a consumption tax, scholars have long recognized that this gets things backwards. The income tax can be properly characterized as imposing an unfair double tax on saving only if it is first established on other grounds that consumption taxation is normatively correct and income taxation normatively wrong.104 This follows from the fact that if income taxation is actually the correct approach, then income tax principles apply to Table 1, and under those principles, there is no double tax in the income tax column of Table 1 because Cole's $3.50 of interest income in the income tax column is a new accession to wealth105 that is an appropriate object of income taxation, even though it was produced by investing previously taxed wages.106

The contrast between Tables 3 and 4 supports this argument by showing that when the government took its $30 income tax on Cole's January 1, Year 1 wages, the government had no continuing investment in the principal of Cole's debenture (Table 4), unlike the RST scenario where the government was a $30 joint investor in the debenture (Table 3). Thus, the initial round of income taxation was closed by Cole's $30 tax payment on


106. See Dodge, Fleming & Geier, supra note 6, at 74-75; Musgrave, supra note 14, at 162; Slemrod & Barba, supra note 5, at 28-29. Contra Edward J. McCaffery, The Uneasy Case for Capital Taxation, 13 (USC CLEO Research Paper No. C05-11, 2005), available at http://ssrn.com/abstract=802888 ("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 a vis spenders, and relative to a hypothetical no-tax world.").
January 1, Year 1 (Table 4), and if Cole had spent his $70 of after-tax wages on consumption instead of a debenture, there would have been no further income taxation. Cole's decision to invest the $70 of after-tax wages in the debenture was, therefore, a new transaction, and the resulting interest income was a new accession to wealth that was taxable under income tax principles. From this standpoint, an income tax imposes a single tax on investment income and a postpaid consumption tax exempts such income.

Of course, the preceding analysis only addresses a matter of form, not economics. With respect to economics, there is a widely-held view that, as seemingly illustrated in Table 1, an income tax burdens saving for future consumption more heavily than present consumption while consumption taxes are neutral between savers and present spenders.\(^\text{107}\) The income versus consumption battle must be fought out primarily on the basis of (1) whether these differential burdens have meaningful economic consequences,\(^\text{108}\) (2) which of these two forms of taxation is superior on ability-to-pay fairness grounds,\(^\text{109}\) and (3) the weight to be given to the distributional and process insights provided above\(^\text{110}\) by the joint investor analysis. For this purpose, Mill's double-tax rhetoric is unhelpful as well as misleading.\(^\text{111}\)

XX. CONCLUSION

There has been much recent discussion of replacing the federal income tax with a postpaid consumption tax. The disturbing downward shift of the yearly tax burden that could result from such a change is often noted in the literature.\(^\text{112}\) In this article, however, I have looked in a different direction and attempted to show that postpaid consumption taxes make the government a participant in private investments and that complete substitution of a postpaid consumption tax for the federal income tax would move the United States much further along the road to a scheme under which the government effectively matches all private savings, without any limitation and without regard to the purpose of the savings, and

\(^{107}\) See Slemrod & BakiJa, supra note 5, at 197-99; Andrews, supra note 11, at 1168-69; McCaffery, supra note 3, at 823-24. But see Dodge, Fleming & Geier, supra note 6, at 138-39 (arguing that substitution of a consumption tax for the federal income tax might cause offsetting events that would prevent an improved outcome for savers).

\(^{108}\) Mill was presumably asserting that there are meaningful economic consequences when he said, "The difference thus created to the disadvantage of prudence and economy, is . . . impolitic." Mill, supra note 103, at § 4. But see Dodge, Fleming & Geier, supra note 6, at 138-43; Slemrod & BakiJa, supra note 5, at 127-31; Gregg A. Eisenwein, Federal Tax Reform and Its Potential Effects on Saving, 110 Tax Notes 759, 761-62 (2006) (all suggesting that reducing the tax burden on saving will not necessarily cause saving to increase).

\(^{109}\) See Dodge, Fleming & Geier, supra note 6, at 137-38 (the ability-to-pay norm favors income taxation).

\(^{110}\) See supra Part XII.

\(^{111}\) See also Warren, supra note 33, at 15.

\(^{112}\) See, e.g., President's Advisory Panel on Fed. Tax Reform, supra note 3, at 207-11, 222; Slemrod & BakiJa, supra note 5, at 256-64.
gives the largest match to the wealthiest taxpayers. I have also attempted to show that this insight serves as a useful lens through which to scrutinize other facets of the income tax versus consumption tax debate and that this scrutiny shows, among other things, that a postpaid consumption tax with progressive rates arguably does not impose any greater burden on investment income than a flat-rate postpaid consumption tax, that the wage tax/postpaid consumption tax equivalence is not essential to an understanding of the effects of a postpaid consumption tax, and that within its premises, the income tax does not double-tax investment income.