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The Consequences of Undoing the Federal Income Tax

Julie Roin†

This celebration of the University of Chicago Law School's Centennial brings to mind another upcoming centennial which is unlikely to be so heralded. Indeed, it may never come to pass at all, due to the disappearance of the institution for which it would have been held. That centennial date is 2013, and the institution is the federal income tax.¹

The income tax is currently under sustained and increasingly effective attack from two quite different sources. Consumption tax advocates contend that the income tax is unnecessarily complex² and economically harmful — penalizing saving and investment in general,³ and favoring for-

† Seymour Logan Professor of Law, The University of Chicago Law School.

¹ Although Congress levied an income tax for a brief period during the Civil War, see William A. Klein, Joseph Bankman, and Daniel N. Shaviro, *Federal Income Taxation* 4 (Aspen 12th ed 2000), the Supreme Court struck down a second attempt to impose such a tax as violative of the constitutional requirement that direct taxes be apportioned “in Proportion to the Census or Enumeration.” US Const Art I, § 9, cl 4. See *Pollock v Farmers' Loan & Trust Co*, 157 US 429, 582 (1894), aff'd on rehearing, 158 US 601 (1895). Enactment of the modern income tax immediately followed the adoption of the Sixteenth Amendment of the Constitution in 1913. The Sixteenth Amendment provides, “The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.” US Const Amend XVI. In recent years, some scholars have discussed whether various consumption tax proposals would violate the “census or enumeration” test. See, for example, Lawrence Zelenak, *Radical Tax Reform, the Constitution, and the Conscientious Legislator*, 99 Colum L Rev 833, 835 (1999) (arguing for the constitutionality of two proposed consumption taxes — the flat tax and the USA tax — because they do not violate the “Direct Tax” clause of the Constitution and constitute income taxes under the Sixteenth Amendment); Erik M. Jensen, *The Apportionment of “Direct Taxes”: Are Consumption Taxes Unconstitutional?*, 97 Colum L Rev 2334, 2402–04 (1997) (arguing that value-added and sales taxes would be indirect taxes and therefore constitutional, while the flat tax and the USA tax would be direct taxes, and therefore unconstitutional).

² See, for example, Gary Clyde Hufbauer and Carol Gabyzon, *Fundamental Tax Reform and Border Tax Adjustments* 5 (Institute for International Economics 1996) (describing the “mind-numbing complexity of the current system”); Joseph A. Snoe, *Tax Simplification and Fairness: Four Proposals for Fundamental Tax Reform*, 60 Albany L Rev 61, 63 (1996) (“Americans complain their income tax system is too complicated.”); Barbara Kirchheimer, *Tax System Seen as Crippling: Lawmakers Urge Move Toward VAT*, 54 Tax Notes 1595, 1595 (1992) (reporting statements by Representative Sam Gibbons that he “would like to ‘scrap’” much of the tax system and replace it with a “much simpler” VAT).

³ See, for example, Kenneth L. Judd, *The Impact of Tax Reform in Modern Dynamic Economies*, in Kevin A. Hassett and R. Glenn Hubbard, eds, *Transition Costs of Fundamental Tax Reform* 5, 5–6 (AEI 2001) (citing studies showing that the optimal tax rate on capital income is zero and that switching to consumption taxation would increase savings); Hufbauer and Gabyzon, *Fundamental Tax Reform and Border Tax Adjustments* at 5–6 (cited in note 2) (stating that the potential benefit of a new tax system is to encourage saving and investment, and noting that the current U.S. investment rate is lower than that of most other countries).

eign production over domestic production in particular.⁴ Considerable political momentum exists for replacing it with a “better” system.⁵ Meanwhile, the income tax’s utility as a revenue-raising device has been undercut by the growth of new avoidance techniques. Not only have financial engineers devised ever more sophisticated instruments for the legal avoidance of this tax,⁶ but the globalization of financial markets has made illegal tax evasion easier and more widespread.⁷ The convergence of these trends bodes ill for the survival of the federal income tax system. Even if a renewed belief in the desirability of the tax were to develop, the tax may be doomed by its inefficacy.

My purpose here, though, is not to mourn the imminent passing of the income tax, but rather to point out the various ways that tax has embedded itself in our economic and cultural landscape, and to explain how its death would likely reshape the world that we take for granted. Although economists have long trumpeted the benefits of “economically neutral”⁸ tax systems, Congress has always used the tax code to help favored groups and to encourage certain activities. Indeed, one commentator recently concluded that “[w]hen policymakers decide to change the way we and our economy behave, the tax code more often than not is their tool of choice.”⁹ The question is what will happen when that tool

⁴ See, for example, James R. Hines, Jr., *Fundamental Tax Reform in an International Setting*, in Henry J. Aaron and William G. Gale, eds, *Economic Effects of Fundamental Tax Reform* 465, 465–66 (Brookings 1996) (examining the proposition that “consumption-oriented tax reforms would boost the competitiveness of U.S. companies”).

⁵ See, for example, Mike Allen, *Bush to Get Tax Overhaul Ideas*, Wash Post A9 (Sept 26, 2002) (discussing then-Treasury Secretary Paul O’Neill’s plan to give tax code recommendations to President Bush); John Berlau, *Tax-code Trauma*, 18 *Insight on the News* (Aug 12, 2002) (discussing the potential impact of tax code simplification on corporate malfeasance); Dale Jorgenson, *A Smarter Type of Tax*, Fin Times 17 (June 19, 2002) (discussing the benefits and negative aspects of a consumption tax); John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 Cal L Rev 2095, 2101–02 (2000) (describing “political excitement” over proposed tax law changes in the last five years of the twentieth century); Michael J. Graetz, *The Decline (and Fall?) of the Income Tax* 196–97 (Norton 1997) (noting that after the congressional elections of 1994, “[p]roposals for substituting a consumption tax for the income tax vaulted back into the forefront of the nation’s political dialogue”).

⁶ See, for example, Lee A. Sheppard, *Tax Shelter Opponents Turn Practical*, 95 Tax Notes 1111, 1111 (2002) (describing a recent tax shelter transaction requiring “no upfront cash investment by the shelter customer”).

⁷ Both the popular and trade press report new tax avoidance and tax evasion schemes on a weekly basis. See, for example, David Cay Johnston, *Death Still Certain, but Taxes May Be Subject to a Loophole*, NY Times A1 (July 28, 2002) (describing a popular scheme to avoid income, gift, generation-skipping, and estate taxes by exploiting a tax exemption on life insurance); Glenn R. Simpson, *A New Twist in Tax Avoidance: Firms Send Best Ideas Abroad*, Wall St J A1 (June 24, 2002) (describing a practice in which companies “stash[] their intellectual property abroad to shelter income from overseas sales”); John D. McKinnon, *IRS Estimates Scope of Offshore Credit-Card Use*, Wall St J A3 (Mar 26, 2002) (“As many as two million Americans may be using credit or debit cards issued by offshore banks to maintain easy access to hidden income.”).

⁸ See Michael J. Graetz and Deborah H. Schenk, *Federal Income Taxation Principles and Policies* 26 (Foundation 2001).

⁹ Gene Steuerle, *Tax Expenditure Debate*, 95 Tax Notes 1521, 1521 (2002). See also Linda Su-

disappears. Some previously favored groups may find themselves bearing a heavier tax burden. But even those who find their tax burden (or lack thereof) unchanged may find their position relative to other groups altered—and with that alteration may come behavioral changes. We cannot look to foreign countries for clues as to what will happen; although many have adopted consumption taxes, all left pre-existing income tax regimes in place.

This Essay seeks to outline some of the likely changes. I leave the reader with the task of evaluating these results. Mere opposition to such changes is not in itself grounds for opposing the elimination of the income tax, of course. Most of the disappearing tax benefits can be replaced by direct financial subsidies,¹⁰ and perhaps some adjustments in the terms of the new tax regime. However, such replacements will not spontaneously appear. They will require deliberate action by Congress. Whether such action will—or should—be taken remains uncertain. What is certain is that the withdrawal of the current subsidies will cause adversely affected taxpayers to clamor for relief. In the ensuing political battles over the existence and shape of replacements for existing subsidies, politicians and interest groups will each have large roles to play. Not all of them will have the public interest at heart when playing these roles. In one sense, then, what I offer is a roadmap of future political battles and a warning of the need to prepare for them, on both intellectual and strategic levels.

As the previous paragraph intimates, there is no reason to believe that the demise of the income tax will trigger a concomitant decrease in the size of the federal government. Instead, Congress will likely create a new tax system to replace the revenues currently generated by the income tax. This Essay assumes that the replacement will take the form of a European-style value added tax, or VAT. Inasmuch as most current proposals for elimination of the income tax are tied to the enactment of some form of a consumption tax,¹¹ this assumption seems at least as reasonable as any other. But in fact very little of the analysis that follows turns on which alternative revenue-raising device Congress chooses. Though it is easier to discuss the implications of abolishing the income tax with reference to a single replacement tax, the same issues will arise and have to be dealt with whatever alternative revenue raising mechanism is chosen. Indeed, this Essay points out how the various flat-tax proposals recently

gin, *Tax Expenditure Analysis and Constitutional Decisions*, 50 Hastings L J 407, 408 (1999) (“[T]he federal government spent more money through the [tax code] [in 1998] than through the discretionary appropriations process.”).

¹⁰ Indeed, many scholars have long argued for such a switch. See, for example, Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 Duke L J 1155, 1205–06; Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 Harv L Rev 705, 737–38 (1970).

¹¹ See, for example, McNulty, 88 Cal L Rev at 2105 (cited in note 5).

under consideration¹² stake out different positions on some of these issues.

This Essay is far from comprehensive. It omits discussion of progressivity, an issue that has long been at the heart of the income tax/consumption tax debate.¹³ The effect on nonprofit organizations has also been the subject of extensive previous commentary,¹⁴ and is omitted here. My focus instead is on less-discussed, but important collateral consequences of a shift in taxing mechanisms.

I. FRINGE BENEFITS

An obvious place to start looking for collateral consequences is the tax expenditure budget.¹⁵ Although much dispute exists about which tax

¹² The VAT is just one of many ways to implement a consumption tax. Two different “personalized, direct consumption-based tax reform proposals” have been introduced in Congress. *Id.* at 2101–02. Representative Armey’s “Flat Tax” proposal, based on the work of Stanford professors Robert Hall and Alvin Robushka, would have imposed a cash-flow, subtraction-method VAT on businesses, coupled with a wage tax on employees. *See id.* at 2117–21. Senators Domenici, Nunn, and Kerry’s proposed “USA [Unlimited Savings Allowance] tax” amounted to an “income tax with an unlimited deduction for net new savings.” *Id.* at 2121. For a more extensive discussion of these proposals, *see generally* David A. Weisbach, *Ironing Out the Flat Tax*, 52 *Stan L Rev* 599 (2000) (arguing that the case for the flat tax is weakened by analysis revealing that it is both more complex and less efficient than claimed); Graetz, *Decline of the Income Tax* at 212–43 (cited in note 5) (describing the proposed flat tax and USA tax in detail and examining the proposals’ implications for fairness, ease of administration, and effect on the size of government).

¹³ *See generally* George K. Yin, *Accommodating the “Low-Income” in a Cash-Flow or Consumed Income Tax World*, 2 *Fla Tax Rev* 445 (1995) (examining the potential effects on progressivity of switching to a broad-based consumption tax or the Nunn-Domenici proposed tax and concluding that the implementation of progressivity measures would compromise the proposals’ stated advantages of simplicity and neutrality in treatment of present versus future consumption); Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 *Yale L J* 1081 (1980) (comparing the income tax to the consumption tax for purposes of fairness and concluding that the truly important issue is the taxation of wealth, which can be achieved by either); Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 *Harv L Rev* 1575 (1979) (arguing that the practical problems of implementing a progressive personal tax on consumption are more severe than suggested and as such, the income tax should remain in effect).

¹⁴ *See generally* Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 *Tenn L Rev* 687 (1999) (examining the direct and indirect tax benefits enjoyed by nonprofit organizations under existing law and predicting the effects of various proposed tax changes—incremental to fundamental—both in the absence of and coupled with direct government subsidies); Price Waterhouse LLP and Caplin & Drysdale, Chartered, *Impact of Tax Restructuring on Tax-Exempt Organizations* 3 (1997) (noting that consumption tax proposals abolishing or altering the charitable deduction would have a significant effect on giving); Charles T. Clotfelter and Richard L. Schmalbeck, *The Impact of Fundamental Tax Reform on Nonprofit Organizations*, in Aaron and Gale, eds, *Economic Effects of Fundamental Tax Reform* 211 (cited in note 4) (providing an overview of current tax treatment of nonprofit organizations and concluding that the various proposals for fundamental tax reform—though not targeted at nonprofit organizations—could have a deleterious financial effect on them).

¹⁵ Most readers know that the tax expenditure budget, published annually as part of the federal budget document, estimates the implicit cost of tax rules that depart from the normal tax structure. The construction of this budget, involving as it does the identification of a “normal tax structure” and “departures” from it, has been the subject of continuing controversy. *See* Bruce Bartlett, *The End of Tax Expenditures as We Know Them?*, 92 *Tax Notes* 413, 414–17 (2001) (recounting the

provisions should be included in the budget and whether associated revenue losses have been properly computed, all agree that specifically favorable tax treatment of an activity can encourage increases in participation and investment in that activity. For many years, two fringe benefits, qualified pension plans and employer-provided health care plans, have appeared as the largest revenue-losers in the tax expenditure budget.¹⁶ These benefits qualify for the same favorable tax treatment: In both cases, the tax system treats their cost as a deductible business expense of the employer while excluding their value from the income of recipient employees.¹⁷ Employees covered under employer plans come out better, financially, than those who receive higher cash salaries and use their extra dollars to purchase similar coverage individually.¹⁸ These cost differentials provide a powerful impetus for employer, as opposed to individual, provision of these benefits. Eliminating the income tax will reduce this financial incentive for employer provision, with the potential for significant real-world effects. As these effects on pension plans and health insurance will be somewhat different, each is discussed in turn.

A. Health Care

About 80 percent of Americans covered by private medical insurance receive their insurance through employer-sponsored plans.¹⁹ The prevalence of employer provision is no accident, but rather a response to economic factors. One of these factors, as described above, is the existence and operation of the federal income tax system. The other factor is employer access to group insurance plans, which charge favorable group insurance rates.

Very few employers provide health insurance out of altruistic motives. They do so because it makes economic sense: They can (and do) recoup the cost of such programs from their employees in the form of lower cash wages. Employees implicitly accept lower wages in return for health insurance coverage. But employees, too, are rational. They will not trade

history of disputes over the existence and meaning of baseline).

¹⁶ See Jonathan Gruber and James Poterba, *Fundamental Tax Reform and Employer-Provided Health Insurance*, in Aaron and Gale, eds, *Economic Effects of Fundamental Tax Reform*, 125, 125 (cited in note 4) (stating that both employer-financed health insurance and pension plans “reduce[] federal income tax revenues by nearly \$60 billion a year [each]”).

¹⁷ See 26 USC § 106(a) (2000) (excluding employer-provided coverage under a health plan); 26 USC § 402(a) (2000) (providing for taxation of distributions from employee trusts).

¹⁸ Individual taxpayers can claim an itemized deduction for medical expenses, including premiums for health insurance, only to the extent they exceed 7.5 percent of the taxpayer’s adjusted gross income. 26 USC § 213(a) (2000). Although some individuals can contribute on an income tax-free basis to individual retirement accounts, the allowable amounts are very limited. See 26 USC § 219(b)(5)(A) (stating that the maximum deductible amount shall not exceed \$3000, phased up to \$5000 in 2008 and beyond).

¹⁹ See Employee Benefit Research Institute, *EBRI Databook on Employee Benefits* 238 (3d ed 1995) (Table 8.1).

away more cash salary than these health insurance benefits are worth to them. Further, there is reason to question whether employees value such benefits even at their market cost. At present, the favorable tax treatment helps elide this valuation issue. A taxpayer facing a marginal income tax rate of 34 percent is happy to trade \$100 in cash salary for health insurance “worth” only \$80, while the employer is happy to provide such insurance as long as it costs less than \$100. The question is what will happen when that tax advantage disappears.

The first thing to realize is that the disappearance primarily affects higher-income employees, and even they will not lose their entire tax benefit. The federal income tax is only one of several taxes providing preferential treatment for employer-provided health insurance. The federal social security tax and state income taxes accord similar treatment. That is, the social security wage tax base and state income tax bases also exclude employer contributions to health plans. For a large segment of the population, the social security tax is a heavier financial burden than the federal income tax.²⁰ Thus, this segment of the employee base will continue to receive the lion’s share of their pre-existing tax benefit even after elimination of the income tax, assuming employer-provided health plans remain in place. Nonetheless, the social security tax rate is lower than income tax rates; the benefit of the social security tax exclusion also largely phases out as an employee’s cash income exceeds the social security tax wage limit.²¹ Repeal of the federal income tax will significantly diminish the tax benefits currently enjoyed by higher—and even middle—income employees. For example, an employee with \$100,000 of taxable income currently faces a marginal income tax rate of 31 percent. Under current law, she saves \$1,550 in taxes, or enjoys an after-tax income that is \$1,550 higher, if her employer pays her with a \$5,000 health insurance policy rather than an additional \$5,000 in cash salary.²² Eliminating the income

²⁰ The social security tax levy begins on the first dollar of earned income. By contrast, the combination of the standard deduction, personal exemptions, and, where applicable, earned income tax credits and child care tax credits precludes federal income taxation of most low-income people. For example, in 2001, a single, childless individual would have had to have earned \$8,580 before paying a single dollar of income tax; a married couple with two dependent children would have been able to earn \$33,825 (which would put them in the third quartile—or middle—of the U.S. income distribution) prior to paying any income tax. See Len Burman, Elaine Maag, and Jeff Rohaly, *The Effect of the 2001 Tax Cut on Low- and Middle-Income Families and Children*, 96 Tax Notes 247, 254 (2002) (Table 5c). Even at those income levels, however, most taxpayers would have substantial payroll tax obligations. See id. at 256–57.

²¹ There is no wage cap for the Medicare portion of the payroll tax, but at present it represents only about one-quarter of the payroll tax burden. See Jeff Lemieux, *Federal Budgeting in an Era of Surpluses*, 5 Georgetown Pub Pol Rev 7, 19 (1999) (stating that a potential Social Security reform would be to have a portion of workers’ current payroll taxes paid to a new Social Security personal investment account, for which the government would match funds for lower income workers only).

²² The employer may appropriate some of this money for itself through salary adjustments. If so, the loss of the tax benefit will hurt both the employer and the employee, though their total loss will not exceed the \$1550 identified in this example. Regardless of who benefited from the income

tax eliminates the financial incentive to choose the health insurance policy over cash compensation. Although she may not have to pay any tax on account of her receipt of health coverage under a VAT regime, the applicable VAT²³ will not be avoided by having her employer purchase the insurance on her behalf. Either her employer will have to pay the VAT when purchasing the insurance, in which case it will pass the additional tax cost through to her in the form of a lower cash salary, or the employer will raise her cash salary by the amount previously spent on health insurance and the employee will have to pay the VAT upon her purchase of health coverage. The important point is that from the employee's standpoint, under a VAT regime it makes no difference (all other things being equal) whether she receives the last \$5,000 of her compensation in the form of cash or health coverage. The same tax is paid in either case. The question is what difference this will make. Will these employees push for a higher cash salary instead of employer-provided health insurance?

They may do exactly that if they value this coverage at less than its cost or if they feel they can get it less expensively from other sources. The first possibility is relatively unlikely. After all, higher-income people tend to have more assets to protect against the financial demands of an expensive accident or illness; they are also less likely to qualify for government or charity care than less highly compensated employees.²⁴ The second possibility is more difficult to evaluate. Employers will continue to have preferential access to group insurance rates.²⁵ But many people have the opportunity to join other groups for health insurance purposes, from local bar associations to the American Association of Retired Persons (AARP). These groups may provide more attractive options for some, and possibly many, highly compensated employees.

One financial fact of employer-provided coverage that tends to be overlooked is the extent of employee cross-subsidization. Premiums for the group are set in accordance with the experience ratings²⁶ of the group,

tax exemption, the effect of removing the tax incentive remains the same; cash and health insurance become equivalent methods of providing compensation.

²³ As discussed in text accompanying note 31, purchases of health insurance policies may be excluded from the VAT. While that may make such purchases relatively more attractive than other consumption goods, this attractiveness does not hinge on employer provision as does the current tax incentive. An employee could obtain the same advantage by receiving a higher cash salary and personally purchasing individual health coverage.

²⁴ See Gruber and Poterba, *Fundamental Tax Reform and Employer-Provided Health Insurance* at 140 (cited in note 16) ("Explicit public insurance (medicaid) and implicit public insurance (care at public hospitals) may be more relevant alternatives for low-income persons than for those in higher-income brackets.").

²⁵ See *id.* at 148 ("[T]he cost of insurance for groups with fewer than five persons is an estimated 35 percent higher than the cost for groups with ten thousand or more members.").

²⁶ See Cheralyn E. Schessler, *Liability Implications of Utilization Review as a Cost Containment Mechanism*, 8 J Contemp Health L & Pol 379, 390 n 78 (1992) (stating that under the experience-ratings process "the employer receives a credit or dividend for the amount of premium paid over that paid out for claims and expenses and a debit for any amount by which claims and expenses exceed

rather than each insured individual. The cost of providing care for a small number of very expensive members shows up as an increase in general premium levels. Healthy members of the employee group may be able to join with other healthy individuals to obtain a better rate than that paid through the employer in the form of lower wages. If a significant number of low-cost individuals self-select out of the employer plan, the cost of insuring those left behind in the employer plan will rise. Even if the remaining employees agree to shoulder these increased costs²⁷ in order to receive continuing health coverage, they will be worse off financially than they are under the current regime. A vicious cycle may ensue that in the end virtually eliminates the insurance function of group health insurance, turning it into little more than a scheduled payment plan for medical costs, and imperils the financial feasibility of employer-provided health insurance. It may turn out that the benefits of the income tax subsidy were narrower than they appeared, mostly limited to the working sick.²⁸

Although many sophisticated observers routinely disparage the country's reliance on tax-favored, employer-provided health insurance coverage, claiming it leads to excessive utilization and excessively high fees,²⁹ there has been little discussion of what its elimination or reduction would do to the truly ill. Elimination of the federal income tax may, of necessity, spark such a conversation in the private insurance market about the obligations of the healthy (if any) toward those who are unhealthy. This is not an easy subject, either morally or practically, although a model might be found in the assigned risk or bad driver pool maintained for car insurance purposes.³⁰ Of course, national health insurance would be another option.

the premium").

²⁷ They will not have many alternatives if they want health coverage, due to their pre-existing medical conditions.

²⁸ See Gruber and Poterba, *Fundamental Tax Reform and Employer-Provided Health Insurance* at 148–49 (cited in note 16) (stating that the net-of-tax benefit of employer-provided health insurance to families in poor health is more than twice as high as that to families in good health).

²⁹ See Bryan Down, et al, *The Effect of Tax-Exempt Out-of-Pocket Premiums on Health Plan Choice*, 64 Natl Tax J 741, 741–42 (2001) ("Generally, the exemption of health insurance premiums from personal income and FICA taxes is unpopular among health economists."); Martin S. Feldstein, *The Welfare Loss of Excess Health Insurance*, 81 J Polit Econ 251, 251–55 (1973) (stating that the tax benefits of employer-provided health insurance and employees' assumption that employer payments for health insurance do not result in lower wages cause employees to be overinsured, and arguing that a reduction in insurance coverage would result in a net utility increase).

³⁰ All fifty states have "financial responsibility laws" requiring drivers or car owners to purchase liability insurance. See Ryan A. Earhart, *Lifting the Iron Curtain of Automobile Insurance Regulation*, 49 SC L Rev 1193, 1195 (1998). States have come up with several devices to help drivers unable to find insurance on the voluntary market because of their poor driving records. The most common of these devices, the assigned risk plan, randomly assigns risky drivers to insurance companies; the number of such drivers assigned to each company varies in proportion to such company's share of the state's automobile liability market. See Suzanne Yelen, *Withdrawal Restrictions in the Automobile Insurance Market*, 102 Yale L J 1431, 1434 (1993) (discussing liability policies in forty-two states and the District of Columbia). Insurance companies are forced to write policies covering the

Merely exempting purchases of health insurance premiums from VAT will not replicate the benefits accorded these programs under the current income tax system because VATs are cumulative. Excluding the premiums avoids payment of tax only on the “value added” at the level of the insurance company. This means, essentially, the tax due on the insurance company’s cost of administration and profit. Tax will already have been collected with respect to the underlying health care expenditures. Only if those expenditures are “zero-rated”—a much more complicated process³¹—will the amount of the government subsidy approach its current value. The complications will increase if the zero-rating is limited to employer-provided health care, as would be necessary to maintain the current incentive structure.

The various flat tax proposals could have provided tax favors that more closely approximate the status quo. Interestingly, neither of the recent proposals did. The original Hall-Rabushka model, on which the Ar-mey “Flat Tax” bill was based, would have taxed health insurance benefits by denying employers a deduction for the cost of the premiums when calculating the tax due at the business level.³² The Nunn-Domenici “USA Tax” proposal required imputation to employees of the value of employer-provided insurance, thus taxing it in their hands.³³

B. Pension Benefits

Given that one of the major selling points of consumption taxes is their propensity to encourage savings (at least as compared to income taxes),³⁴ it is ironic that the substitution of a VAT for the income tax is likely to reduce the savings of some groups of taxpayers. Current law entices many employers to maintain pension plans for the benefit of employees.³⁵ Such pension plans are not mandatory; rational employers provide them, like health insurance plans, only if their costs can be recouped

drivers assigned to them. Often these policies must be offered at regulated rates that fail to cover the expected costs of such coverage. In such situations, insurers use the premiums of low-risk drivers to subsidize high-risk drivers. See *id.* Some have suggested a similar approach be used in the health insurance market, with insurance companies forced to write policies for high-claims individuals at rates subsidized in part by higher premiums paid by healthier individuals. See H. Richard Beresfor, *The Health Security Act: Coercion and Distrust for the Market*, 79 Cornell L Rev 1405, 1423–25 (1993) (suggesting different approaches to guaranteeing assured access to private health insurance).

³¹ See Alan A. Tait, *Value Added Tax: International Practice and Problems* 50–54 (IMF 1988) (noting five reasons why the European Community disfavored the zero rate, including “high administrative costs”).

³² See McNulty, 88 Cal L Rev at 2118 (cited in note 5).

³³ See Gruber and Poterba, *Reform and Employer-Provided Health Insurance* at 137 (cited in note 16) (discussing problems with imputation).

³⁴ See Henry J. Aaron and William G. Gale, *Introduction*, in Aaron and Gale, eds, *Economic Effects of Fundamental Tax Reform* 1, 2 (cited in note 4).

³⁵ In 1993, 57 percent of civilian workers worked for an employer sponsoring a retirement plan, and 76 percent of them (44 percent of overall employees) participated in such plans. Employee Benefit Research Institute, *Databook* at 69 (cited in note 19).

by payment of lower cash salaries. In today's world, where many employees value a dollar of cash salary more than the compounded value of that dollar received after retirement, only the spread between the after-tax benefit of cash and the after-tax benefit of pension plans makes this necessary offset possible in many cases.

The tax benefits accorded to pension plans will not disappear with the advent of a VAT. Assuming the rate at which the VAT is imposed approximates current marginal rates of income tax, the benefits of investing in a pension plan will remain the same. Monies invested in such a plan, whether as initial contributions or reinvestments of earnings, will avoid taxation until distribution just as under current law. However, as this treatment will be afforded all forms of savings, employer-provided pension plans will lose their monopoly on favorable tax treatment. Given that employer pension plans are expensive to administer, employers and employees may both decide they are better off letting workers save for their own retirement independent of the workplace. Workers may be unwilling to forgo the additional salary necessary to compensate employers for administrative costs when they have the ability to invest their salary on equally tax-favored terms. Employers may refuse to incur the considerable expense and aggravation involved in maintaining an employer plan without such compensation. The same effects would follow from the adoption of any other consumption tax.³⁶

This would not be a problem if employees in fact invested the corresponding increase in cash salary. However, all evidence indicates that many employees will lack the financial discipline to do so. A very large percentage of employees fail to roll-over the balances in their 401(k) or other defined contribution plan accounts when those accounts are paid out because of a change in employers.³⁷ This failure occurs despite the imposition of a tax penalty, a penalty that is imposed at a rate higher than any likely VAT rate.³⁸ Further, a startlingly large number of employees fail to make elective contributions towards employer-subsidized defined contribution plans.³⁹ Recent scholarship indicates the large role played by inertia and the importance of default rules.⁴⁰ Employee decisions as to

³⁶ The American Academy of Actuaries predicted that replacing the income tax with a consumption tax would have "a major adverse impact on the private pension system," a view shared by one of the originators of the flat tax concept, Alvin Robushka. Graetz, *Decline of the Income Tax* at 238 (cited in note 5).

³⁷ See Susan J. Stabile, *The Behavior of Defined Contribution Plan Participants*, 77 NYU L Rev 71, 96 (2002) (stating that 68 percent of 401(k) plan participants take cash distributions instead of rolling over their plan account balances upon switching jobs).

³⁸ Withdrawals are subject to a 10 percent penalty tax in addition to the regular income tax. See *id.* at 95.

³⁹ See *id.* at 80 (stating that participation in pension plans ranges from 50 percent to 90 percent).

⁴⁰ See *id.* at 81–83 (citing studies revealing the role of "inertia" as evidenced by the experience of companies offering pension plans featuring automatic enrollment with an opt out).

whether to participate in a 401(k) plan and how much to contribute to such plans seem to depend as much on the plans' default rules as on employee choice. Plan participation, especially by employees with the lowest compensation, increases markedly when employees have to opt-out, rather than opt-in, to such plans.⁴¹ In addition, employees tend to contribute whatever percentage of income is set as the default contribution rate under the plan.⁴² If many employees lack the initiative or financial sophistication to sign up for a readily available, already structured, and relatively hassle-free employer sponsored retirement plan that seems compatible with their personal financial objectives, it seems unlikely that they will save more under a wholly privatized system, since under a privatized system, employees will have to locate appropriate investment vehicles,⁴³ as well as decide on a contribution rate, take care of paperwork, and the like.

Even if the total amount of saving goes up, as economists predict, ownership of those savings may be even more skewed than it already is.⁴⁴ The absence of private retirement savings will leave more people wholly dependent on social insurance for their retirement income, increasing the pressure placed on this country's social security system. Those who begin by viewing the goal of increased investment with some skepticism will doubtless consider these distributional consequences particularly troublesome.

II. HOMEOWNER EQUITY

Employer-provided pension plans have been one common form of savings for retirement; so too has home equity. One question is whether such equity will be impaired by the move to a VAT. Home ownership receives extraordinarily favorable treatment under the rules of the current income tax. Not only does the tax system ignore the non-cash income

⁴¹ See Cass Sunstein, *Switching the Default Rule*, 77 NYU L Rev 106, 115–16 (2002), referring to a study by Brigitte C. Madrian and Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, online at <http://ssrn.com/id=223635> (visited Dec 3, 2002); Stabile, 77 NYU L Rev at 81 (cited in note 37).

⁴² See Stabile, 77 NYU L Rev at 82 (cited in note 37).

⁴³ A related question is the effect on insurance companies, which have traditionally offered a variety of savings plans for relatively unsophisticated (and sophisticated) investors. On the one hand, insurance-mediated savings will lose their unique claim to tax benefits; all savings vehicles will be treated the same. On the other hand, they will have a larger pool of potential purchasers if employers bow out of the pension enterprise.

⁴⁴ See Daniel I. Halperin and Michael J. Graetz, *Comprehensive Tax Reform and Employee Benefits: The Case of Employment-Based Pensions and Health Insurance*, in Dallas L. Salisbury, ed., *Tax Reform: Implications for Economic Security and Employee Benefits* 35, 39 (Employee Benefit Research Center 1997). In addition, private savings arrangements would be free of the various regulatory safeguards currently applicable to employer-provided pension plans. See Weisbach, 52 Stan L Rev at 654 (cited in note 12) (“[U]nder the Flat Tax, the law could not impose any significant requirements on pensions except perhaps to the extent the pensions provide some market benefit above and beyond private savings.”). Though recent events have cast doubt on the utility of some of those safeguards, they also illustrate the lack of financial sophistication of the average employee.

generated by such ownership (in other words, imputed income equal to the rental value of the premises), but it also allows deductions for some of the costs of generating this non-taxable income, such as mortgage interest⁴⁵ and property taxes.⁴⁶ It even exempts a substantial portion of the cash income realized with respect to such property in the form of capital gains at the time of sale.⁴⁷ Given these advantages, it is perhaps not surprising that close to 40 percent of this country's capital stock comes in the form of owner-occupied housing.⁴⁸ How will this investment fare under a consumption tax regime? The economic literature presents a mixed, if not incoherent, picture of the likely results.⁴⁹

The seeming incoherence comes from the cross-cutting results of changing tax rules. Assuming that expenditures on housing are treated as consumption rather than investment expenditures, purchasers of new homes would have to pay VAT on the full purchase price, raising the cost of purchase.⁵⁰ Meanwhile, sales of existing houses would be exempt from VAT,⁵¹ immediately increasing their value relative to that of new houses.⁵² The result in the short run would be a reallocation of wealth from new entrants in the housing market to established homeowners, which may help ease the pain of homeowners faced with the loss of the mortgage interest deduction.⁵³ However, the across-the-board increase in housing

⁴⁵ See 26 USC § 163(a) (2000) (allowing deduction for interest paid on indebtedness). The mortgage interest deduction extends the benefit of the income exclusion to a larger class of taxpayers, those who must borrow to finance their housing purchases.

⁴⁶ See 26 USC § 164(a)(1) (2000).

⁴⁷ See 26 USC § 121(a) (2000).

⁴⁸ See Dennis R. Capozza, Richard K. Green, and Patric H. Hendershott, *Taxes, Mortgage Borrowing, and Residential Land Prices*, in Aaron and Gale, eds, *Economic Effects of Fundamental Tax Reform* 171, 171 (cited in note 4) (stating that owner-occupied housing constitutes 40 percent of the nation's capital stock).

⁴⁹ Compare id at 197–98 (projecting a 10–20 percent decrease in house prices), with Donald Bruce and Douglas Holtz-Eakin, *Will a Consumption Tax Kill the Housing Market?*, in Hassett and Hubbard, eds, *Transition Costs of Fundamental Tax Reform* 96, 110 (cited in note 3) (projecting a “modest” price impact).

⁵⁰ See Bruce and Holtz-Eakin, *Will a Consumption Tax Kill the Housing Market?* at 100, 112–13 n 3 (cited in note 49) (stating that “tax on purchase price is equivalent to ‘prepaying’ a stream of future taxes on the annual consumption value” of the house).

⁵¹ See Tax Executives Institute, *Value-Added Taxes: A Comparative Analysis* 24 (Tax Execs 1992) (“Under most existing value-added systems, the purchase of a previously constructed home does not constitute a taxable transaction.”). Although this treatment may be the result of practical considerations, it can be defended theoretically since (except in the transition period) the first purchaser should have paid a VAT covering the entire consumption stream generated by the house. See also note 54.

⁵² See Bruce and Holtz-Eakin, *Will a Consumption Tax Kill the Housing Market?* at 98 (cited in note 49) (“Older, existing homes would enjoy a tax-based advantage of 20 percent, leading to a rise in their value.”).

⁵³ See id (noting that the loss of deductibility would mitigate the tax reform's effect of enhancing the value of older homes). A separate issue is whether interest payments will be treated as taxable consumption expenditures. Most VAT regimes exempt financial intermediaries from the tax base due to the difficulty of calculating the appropriate tax under the credit method; some impose alternative taxes. See Tax Executives Institute, *Value-Added Taxes: A Comparative Analysis* at 23 (cited in

prices may drive away potential home purchasers. Particularly when combined with the fact that, under a consumption tax, other investment assets will enjoy the same or better tax treatment than housing (not to mention the non-deductibility of interest expenses), consumers may decide to rebalance their portfolios away from housing (or consumption generally).⁵⁴ People may opt for rental units or smaller houses as they do in Europe. If so, the demand for, and thus the price of, housing will decline. It is impossible to predict with confidence which of these effects will predominate.

These issues are equally open when it comes to other forms of consumption taxation. Decisions have to be made as to whether to allow the deduction of home mortgage interest and real estate taxes, whether to treat house purchases as investment or consumption, and whether to tax gains generated from the sale of real estate. The difficulty of these issues, at least in political terms, is illustrated by the fact that the different legislative proposals for such taxes proffered different answers to these questions—answers in no way justified by theoretical purity. The USA tax provided a deduction for home mortgage interest⁵⁵ while Representative Armey's flat tax did not.⁵⁶

Because of the prevalence of property taxation, any fluctuation in housing prices is likely to have an impact on the financial health of governmental units that directly rely upon property tax revenue, at least until the will develops to adjust property tax rates. But the elimination of the income tax will have more profound effects on state and local governments than temporary fluctuations in property tax revenues. These effects are discussed in the next Part.

III. STATE AND LOCAL GOVERNMENTS

The current tax rules provide several advantages to state and local governments. First, certain tax payments to state and local governments

note 51) (stating that it is difficult to calculate liability under the credit method for service industries because "the value of the service is imbedded in the price of the overall transaction"); Tait, *Value Added Tax: Practice and Problems* at 92–100 (cited in note 31) (noting that no countries using a VAT fully taxed financial services, but arguing that "[v]alue added in banking and insurance is no less appropriate for inclusion in the VAT base than any other service or provision of goods").

⁵⁴ See Bruce and Holtz-Eakin, *Will a Consumption Tax Kill the Housing Market?* at 105 (cited in note 49) (noting that "the increased cost of new homes would channel scarce capital to other, more valuable uses in the economy"); William G. Gale, *Commentary* in Hassett and Hubbard, eds, *Transition Costs of Fundamental Tax Reform* 115, 116 (cited in note 3) (noting that under a consumption tax, "the real value of old houses relative to other consumption goods would not . . . change[], even though the nominal price of old housing would . . . increase[]"). At least, consumers will rebalance away from housing to the extent their housing decision includes an investment component, since other investments (not subject to VAT) will be cheaper; it will maintain its relative value compared to other consumption goods since a VAT would apply to all such purchases. See *id.*

⁵⁵ See McNulty, 88 Cal L Rev at 2121 (cited in note 5).

⁵⁶ See *id.* at 2120.

can be taken as itemized deductions. Second, some of such governments are allowed to sell bonds bearing tax-exempt interest. Finally, they gain certain administrative advantages by basing their own income tax systems on the federal tax system. All of these advantages will disappear along with the federal income tax. The effect of each disappearance will be discussed in turn.

A commonly expressed fear is that the elimination of the deduction for state and local taxes will reduce subordinate governments' ability to generate tax revenue.⁵⁷ Taxpayers will increase their resistance to tax increases in the absence of the partial relief provided through the federal income tax system. It is unclear how much significance this claim has. Relatively few taxpayers itemize their deductions;⁵⁸ those who do not would lose nothing from the switch. Indeed, members of the nonitemizing group may regard tax payments more favorably under a VAT regime, since presumably such tax payments will not themselves be subject to a VAT.⁵⁹ To the extent such taxes fund benefits that are properly viewed as consumption expenses, state provision may be slightly more favored relative to private provision in a VAT regime than under the present income tax regime.⁶⁰

The effect on debt capacity may be more serious. Under current law, the interest generated through ownership of state and local bonds can be excluded from income for tax purposes.⁶¹ In most cases, purchasers of such debt end up about where they would have been had they purchased corporate debt; the value of the exclusion passes through to states and localities, which offer debt bearing interest at a rate lower than comparably risky corporate bonds. The move to a consumption tax will provide all borrowers with the same tax treatment.⁶² Though interest rates on current debt will remain fixed for the life of the debt,⁶³ new issuances will become

⁵⁷ See Tax Executives Institute, *Value-Added Taxes: A Comparative Analysis* at 29–30 (cited in note 51) (“[T]he States are concerned that the imposition of a federal consumption tax would adversely affect their revenue-generating ability.”).

⁵⁸ Only about 31 percent of individual taxpayers claimed itemized deductions in 1998. See U.S. Census Bureau, *Statistical Abstract of the United States: 2001* 314 (GPO 121st ed 2001) (Table 473).

⁵⁹ The amount of the tax levy may be higher, however, because the burden of the tax will have been built into the prices of products and services purchased by the government. As discussed earlier in the health care context, see text accompanying note 31, exempting from VAT only the last in a string of interlocking payments may not significantly reduce the economic burden of the tax.

⁶⁰ The extent of the advantage will depend on the tax treatment of purchases by state and local governments. Taxpayers may avoid only the last increment of the VAT, that payable on the “value added” by the government administrator, or more, depending on how far down the chain of purchase the tax exemption goes. See text accompanying note 31 (discussing difference between exemption and zero-rating in the health insurance context).

⁶¹ See 26 USC § 103(a) (2000).

⁶² No one will owe VAT solely on account of receiving interest income; tax will be collected when such interest is consumed, regardless of its source.

⁶³ Holders of such debt will see its value, and their wealth, decrease when the tax benefits evaporate, assuming no transition rule.

more expensive as the purchasers refuse to accept anything less than the market rates of interest. As a result, governments may decide to reduce the amount of future issuances, either funding projects out of current income or forgoing them altogether.

The extent of the harm to states and localities will depend on how great an increase they experience in interest rates. If enactment of a consumption tax in fact drives up savings rates, the resulting increase in investable capital may depress the market rate of interest. Still, it seems unlikely that the general market rate of interest will fall all the way down to the current tax-exempt rate.

There is also the matter of the states' administrative capacity to maintain their own income taxes in the absence of a federal income tax. At present, most states rely on the federal definition of taxable income as the starting point for their own tax base calculations.⁶⁴ They also obtain considerable amounts of information from federal authorities on the auditing side, information generated by the federal government in the course of monitoring and auditing the implementation of the federal income tax.⁶⁵ The federal government, for example, passes on to states information gleaned from its much more extensive system for matching information returns to individual and corporate returns.⁶⁶ State tax authorities often piggyback on federal dispute resolution procedures as well.⁶⁷ In short, although states maintain their own income tax administrations, they benefit greatly from the existence of a federal tax administration, an administration that will disappear along with the tax. State tax systems will become more expensive to run; the additional expense may cause states to move to another revenue-raising mechanism, a decision that may itself have collateral consequences.

These same issues have to be dealt with under other consumption tax proposals. Deductions may, but need not, be granted for state and local tax payments; state and local bonds may, but need not, be granted favorable treatment.⁶⁸ The only way to avoid the administrative complica-

⁶⁴ See Jerome R. Hellerstein and Walter Hellerstein, *State and Local Taxation: Cases and Materials* 888 (West 7th ed 2001) (personal income taxes); id at 417–18 (corporate income taxes).

⁶⁵ See Robert P. Strauss, *Administrative and Revenue Implications of Alternative Federal Consumption Taxes for the State and Local Sector*, 14 Am J Tax Pol 361, 387–96 (1997) (reciting the evolution of federal-state information sharing for tax audit purposes).

⁶⁶ See id at 392 (describing federal and state reporting systems as “increasingly entwined”).

⁶⁷ See id at 394–95.

⁶⁸ The “USA tax” would have preserved the relative advantage of state and local bonds by allowing investors both to deduct the cost of purchasing the bonds and to exclude the interest received from them. While investors would have been able to deduct the cost of other investments, the income generated from them would have been included in the tax base. See McNulty, 88 Cal L Rev at 2122 (cited in note 5) (stating that the USA tax would maintain the “familiar” exclusion of state and local bond interest). The Arney flat tax did not have a similar provision. See Strauss, 14 Am J Tax Pol at 405–07 (cited in note 65) (discussing the details of the Arney flat tax proposal and its effect on items included in the calculated tax base); Alice G. Abreu, *Untangling Tax Reform: Simple Taxes, Complex*

tions would be for the states to eliminate their income tax systems and piggyback on whatever the federal tax rules happen to be.⁶⁹

CONCLUSION

Once one starts looking, one can find the shaping force exerted by the federal income tax on practically every arena of economic and civic life. This Essay just begins to identify and evaluate the myriad dislocations and changes that would be brought about by its repeal. Not all change is bad, of course. But when so many changes will occur in such short order, the task of identifying and correcting undesirable ones will be far from easy.

It will be interesting to see how well our political institutions cope with this task. There are grounds for both optimism and pessimism. Congress can look on this as an opportunity to engage in zero-based-budgeting,⁷⁰ a chance to sweep away out-dated or ill-conceived incentives and subsidies. Or Congress's members can take advantage of the situation, using it to pry ever more campaign contributions out of special interest groups anxious to arrange replacements for extinguished tax benefits.⁷¹ No other government has faced this precise challenge. Although many other countries have imposed VATs, they used them as sources of additional revenue rather than as replacements for pre-existing income tax. Ultimately, of course, it is up to us, the voting public, to make sure that some version of the optimistic story comes to pass.

Choices, 33 San Diego L Rev 1355, 1366 n 34 (1996) (stating that the USA tax has exclusions for tax-exempt bond interests, unlike the Armeiy flat tax).

⁶⁹ See Weisbach, 52 Stan L Rev at 659 (cited in note 12) ("Unless states switched to a base similar to the Flat Tax, few of the implementation benefits of the Flat Tax would be achieved.").

⁷⁰ Zero-based budgeting requires lawmakers to use zero governmental expenditures as a starting point and to justify all funding for each program after specifying and ranking objectives and considering all the possible means of obtaining those objectives. See Elizabeth Garrett, *Rethinking the Structures of Decisionmaking in the Federal Budget Process*, 35 Harv J on Legis 387, 393 (1998). Instead of evaluating cash expenditures, of course, in this context Congress would be evaluating tax expenditures, or revenue concessions. This is precisely the sort of analysis that Stanley Surrey hoped to provoke by constructing and publishing the tax expenditure budget. See Stanley S. Surrey, *Pathways to Tax Reform* 180–81 (Harvard 1973). It will be truly ironic if it is provoked instead by the death of the taxing mechanism he cherished.

⁷¹ See Richard L. Doernberg and Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 Minn L Rev 913, 959 (1987) (noting that in the "real world of taxation," politicians' "personal demands . . . also drive the tax legislation process").