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THE FUTURE OF TAXATION

Joseph Isenbergh *

Of course, taxation has a future. Its presence somewhere on the scene is proverbially as certain as that of the grim reaper. But where, and in what guise? On that front, I’ll try to look just a bit further here than this morning’s financial pages. On some aspects of the future tax landscape I can in fact offer a precise picture, framed with arithmetic certainty; on others mere conjecture, laced with pure aspiration or even fantasy.

An important first step in thinking about the future of taxation, unsurprisingly, is a look at its past and present. To gain more than a surface view, it is essential to appreciate the difference between real taxes and current (or nominal) taxes. The real tax over any significant period is the level of government spending in relation to national output. The higher public spending as a percentage of GDP, the higher the real tax. That amount must in time be transferred from private to public hands—be it now or later. The current tax, for its part, is the amount actually paid to a government in any given period, and is almost never equal to the real tax.

The level of current taxes in the future follows arithmetically from their level in the present in relation to the real tax. A current tax lower than the real tax (that is, a public deficit) implies higher current taxes in the future, while a current tax higher than the real tax (a public surplus—a phenomenon observable in only three of the past 50 years) implies lower current taxes in the future. Deferred taxes are simply claims against the public. There are two ways to meet these claims: 1) higher current taxes in some future period or 2) inflating the claims away. Inflation, which generally induces a shift of wealth from private to public hands, is the functional equivalent of a tax increase. These relations do not follow from any policy or ideology, but are purely matters of arithmetic. The stated political orientation of the administration presiding over a gap between current and real taxation—be it social democratic or of the supply-side right—does not matter.

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Viewed in this light, the record on taxation of the previous four administrations is strikingly different from widespread perception. Real taxes (federal spending as a percentage of GDP, remember) reached a peacetime high (prior to 2008) during the Reagan administration (at 23.5 percent of GDP in 1983) and maintained nearly that level (holding consistently at or above 22 percent) through the first (GHW) Bush administration. Real taxes fell considerably during the Clinton years (to a low of 18.4 percent of GDP in 2000). Real taxes then rose sharply in the second (GW) Bush administration. You may not have appreciated it at the time, but in real effect taxes were lowered substantially during the Clinton administration and were raised significantly in the Bush II administration. The 2001 and 2003 tax cuts were mirages.

The fiscal policy habitually associated with social-democratic political orientation is tax-and-spend. Considering the true nature of taxation, what passed as supply-side fiscal policy in the past 30 years boils down to spend-and-tax. In the bigger picture there is little or no functional difference between them. The spend level in these patterns drives the tax level either way. Self-styled supply-side economics in the 1980s, and then again earlier in this century, was simply old-style fiscal stimulus, Keynesian policy delivered on the tax side. It implied no significant possibility of lower taxes over time.

Filtered through ideological lenses, a number of myths have emerged about those times. One, for example, is the myth of prodigious economic growth during the 1980s. To illustrate, average real GDP growth during the Reagan and Bush I administrations was a whopping 3 percent. In contrast, during the Carter administration average real GDP growth was a puny 3.2 percent. During the second (GW) Bush administration real GDP growth averaged 2.4 percent. The only period in the past three decades where something roughly akin to supply-side economics has been practiced in our economy—and by this I mean lower real taxes acting as a spur to economic output—was the latter half of the 1990s, during which average real GDP growth of 4 percent comfortably outpaced growth during the self-styled supply-side administrations.
In this look at the future of taxation I promised arithmetic certainty, and here it is. Over the next 10 to 15 years current taxes will increase mightily. I take no position here on the necessity or wisdom of massive fiscal stimulus to restart the U.S. economy. But it has arrived—and in its wake will pull up current taxes for a decade at least (or spread inflation, another form of higher taxation).

The only question still in doubt is the form higher future taxes will take and who will pay them. While current taxes and deferred taxes in the aggregate add up to the real tax in any given period, there is one crucial difference between them. We know the form of current taxes and, roughly, who pays them. All I can say about future taxes is that they will be higher. Beyond that I can’t say who will pay them—whether consumers or savers, suppliers of capital or suppliers of labor, or both in a maelstrom of inflation.

Tax planning with respect to future taxes is therefore as much as anything an exercise in political action. What appears on the surface to be public debate over the appropriate level of taxation—and this goes on all the time—is in fact political maneuver by interested constituencies to get out of the line of fire of inevitable tax increases while deflecting the higher taxes onto someone else.

Having exhausted (and in barely three pages) the limits of certainty on these matters, I can offer, for the rest, only conjecture and wishful thinking. On the latter front, like many, I have a view of the best regime of taxation for the future, which I have spun together in the pages that follow. Unsurprisingly, it is largely based on my understanding of the role of the tax system in our recent financial and economic woes.

A number of commentators pondering our current financial and economic condition have observed that during the past decade people in America saved too little while in Asia people saved too much. Although obviously reductionist, this account has considerable force. Our own consumption, fueled by debt, outstripped our incomes in recent years, while foreign savers, predominantly from Asia, financed the bulk of new investment in the U.S. economy. In that light predictions have surfaced of late that to set right the
imbalances in our spending and saving (“imbalance” being the standard euphemism for our decade-long spending binge) we will become savers again in upcoming years.

Although the baseline observation is sound—we did not save enough earlier in this century to foster long-term growth or even to sustain our current standard of living—I rather doubt the corollary. Of course we will save somewhat more in upcoming years than we did in the past few. We could hardly save less, because it is hard to save less than zero for more than a brief while when you are already deep in debt. But whether there is a substantial and abiding change in our macroeconomic habits depends importantly on taxation in the future.

Let me explain. I believe that our tax system contributed significantly to our national orgy of leverage, in ways both large and small. This is so because the U.S. income tax system imposes a heavier burden on personal saving than on immediate consumption, and particularly favors consumption fueled by debt. Most readers understand this, but compulsively I’ll explain it anyway. When income from labor is saved rather than consumed, the income from that saving (now capital income, in economic terms) is taxed again. This “second” tax on saving makes the tax cost of capital income greater than that of labor income spent on immediate consumption. The particular strain of income taxation indigenous to the United States exacerbates this tendency. The two separate layers of income tax imposed on corporate earnings and then again on dividends distributed to shareholders actually imply a third tax on corporate profits. This goes far toward explaining why we don’t save.

That said, there has self-evidently been new investment in the U.S. economy in recent years. Where did the capital come from? Not from us, but from foreign savers, particularly those Asians who, as noted, save so much. An obvious question is: why aren’t foreign savers put off by our double tax on capital income? The answer is that they would be, if they paid it. But they don’t. For many people—although surely not for readers here—it would come as a surprise to learn that the baseline U.S. tax rate on capital income derived from the United States by foreign savers is zero. We reward
foreigners for saving and investing in the United States with zero taxation, and we punish ourselves for doing the same with double taxation of capital income. Given our present fiscal straits, why don’t we tax the capital income of foreign savers? Because we can’t. Foreign savers, unlike us, are free to take their saving and investment to any tax environment of their choosing. We are entirely dependent on them and must let them in and out of U.S. capital markets at no tax cost.

In this light I think that the best way (and perhaps the only way) to bring capital formation in the U.S. economy in line with the demands of the future is a major reorientation of the U.S. tax system—specifically a shift in the burden of taxation away from capital income and onto consumption. In short, some form of consumption tax should be the predominant national tax.

Let me explain what I mean by a consumption tax. Turnover-type taxes such as sales taxes and value-added taxes are widely and correctly understood as consumption taxes. But for present purposes, so is any tax that does not reach capital income. The allocative effect of sales taxes, value-added taxes, and taxes imposed solely on labor income (such as payroll taxes) is much the same over time, because none entails a second tax on saving.

Mechanically, rather than adopt a value-added tax or a national sales tax, I would propose to transform the U.S. tax system by converting the income tax into a tax on consumed income. A tax on consumed income is an income tax in which personal saving is deductible from taxable income, thus excluding capital income and leaving only the amount of income that is consumed subject to current taxation. At the same time I would propose to extend the reach of payroll taxes. Payroll taxes are also consumption taxes because capital income is excluded from the amount taxed at the threshold. The combined measures I just described therefore add up to a consumption tax regime.

But why, you might ask, adopt this particular combination of consumed income and payroll taxes rather than, say, a value-added tax, which is a special favorite of many
advocates of consumption taxes? A value-added tax, I’ll concede, may be easier to administer and enforce than a tax on consumed income. But that is so only if the value-added tax is flat and comprehensive. If you attempt to inject elements of progressivity and redistribution into a value-added tax—for example, by varying the level for different types of goods and services—it becomes both more complex and less efficient. Another problem with a value-added tax is that people can to a considerable extent earn their incomes in one tax environment and spend them (either at retail on vacation or wholesale in retirement) in a different (and VAT-free) environment, so that ultimately both their incomes and their consumption are untaxed.

To put this point more broadly, value-added taxes and payroll taxes are analogous to an income tax that is imposed territorially, whereas a tax on consumed income is imposed on worldwide income, minus the component of saving, and is therefore a tax on the worldwide consumption of a taxpayer.

A further advantage of these proposals is that transition from the present tax system to a tax on consumed income is easier than its replacement by a value-added tax. As for payroll taxes, they are already in place. We need only change their range and rate structure. On the income tax side, a tax on consumed income would emerge simply from the overlay of something like unlimited individual retirement accounts. Of course, more would have to be done, including a new regime for debt incurred and repaid by individuals. The core mechanism of a tax on consumed income, however, entails little more than the introduction of one or more types of individual saving and investment accounts.\footnote{An entity such as a corporation or an LLC owned by an individual could also serve as a tax-deferred investment account.} Amounts paid into these accounts would be deductible from taxable income, and withdrawals includible. This regime also encompasses gifts and bequests, along with current consumption and saving.

Even more importantly, taxes on consumed income and payroll taxes can be structured as progressive taxes. Social democrats tend to recoil from consumption taxes as
insufficiently redistributive. But taxes on consumed income and payroll taxes can be graduated, even steeply so. Uncap the payroll tax and add a substantial exemption amount both to it and to the consumed income tax in the lower range, and you have remade the U.S. tax system as a graduated and redistributive consumption tax—aspects that should pacify at least some social democrats—while still leaving capital income untaxed.

In somewhat subversive fashion this regime would also meet one of the stated objectives of the Obama administration on tax policy. The administration has asserted the goal of taxing the foreign and domestic operations of U.S. corporations equally. I agree with this goal, but through my particular prism on the question. Both the foreign and domestic operations of U.S. corporations should be untaxed or lightly taxed. Such a tax regime would place us, as savers, on the same footing as our worthy counterparts in Asia.

Having spun this fiscal fantasy for readers’ amusement, I must admit that it brings to mind the cartoon characters of old, who would dash off the edge of a cliff and remain briefly suspended in mid-air, their little legs churning madly, before crashing to the ground. My proposals and others like them are unwelcome, or worse, at every point along the ideological spectrum. On the left, social democrats by and large cannot abide taxes that do not reach capital income. On the right, supply-siders are dogmatically opposed to all new taxes and will keep chanting to the end of time that the only good tax is a low tax.

Given that—and shifting for the moment from fantasy to pragmatic forecast—what manner of taxation can we expect in upcoming years? First, as noted, taxes will be higher. Anyone who can add understands this; all pronouncements on taxation from the Obama administration confirm it. The administration has also indicated strongly that taxes on capital income will rise more, in relative terms, than taxes on labor income. This general drift is reflected as well in the mood of Congress. Those within the ranks who are looking to take a bigger bite from no one except the plutocrats who got us into our present fix appear to overmatch, both in numbers and influence, the dwindling few still pitching the supply-side miracle.
At the same time, the tax measures adopted in the next few years will most likely include a cluster of special provisions aimed ostensibly at promoting saving and capital formation. These will take the form of targeted investment incentives—such as rapid depreciation and the usual array of hearth, hot rod, and jobs credits—along with new vessels for tax-deferred saving, perhaps 401(x), (y), and (z) plans.

Targeted investment incentives in the form of special allowances grafted onto an income tax, however, are not worth the price. Selective tax benefits of this sort may well channel investment into favored areas, but at the cost of significant misallocation, and without lifting the basic tax burden on capital formation. To dispel any lingering doubt of such a misallocative effect, consider the story of owner-occupied housing in the past decade. Systematic subsidies for home ownership delivered by our tax system—along with various pathologies of the financial system—channeled saving and investment into housing beyond reason, leaving us with bloated inventories that will take years to work off. But despite the battery of incentives for this particular form of capital formation, our net personal saving dwindled to nothing, as we borrowed to consume against illusory home equity.

Tax-deferred saving vehicles (such as 401(k) plans) also do not work. Perversely, they may even reduce saving. First, people with 401(k) plans can borrow to consume in their taxable environment (on home equity, for example). Second, a 401(k) plan converts long-term capital gains that accrue in the plan into high-taxed ordinary income, and thus may actually increase the tax burden on capital income in the end. Lower-income savers can overcome this effect by contributing to a Roth 401(k) plan, but these are not yet widely available to most employees.

There will also be, no doubt, some new taxes on consumption, but cast in various stealth guises and not broad-based. Among them, perhaps, will be a carbon or a BTU tax, or their implicit cousin Cap and Trade.
If the taxation of the future looks substantially like what I have just outlined, our national habits of capital formation will not change appreciably. Rather, personal saving will remain anemic as far as the eye can see and we will continue to draw investment capital from foreign savers, which, as always, we will not tax.

My reasons for these expectations on future taxation—which I believe to be realistic—are grounded largely in the current political landscape. In steering clear of increased taxes on consumption, the Obama administration will have an unexpected ally on the right, in the form of unrepentant supply-siders. Supply-siders will of course oppose tax increases on capital income. But, because any and all tax increases are against their religion, they will also oppose higher taxes on consumption, the necessity of which they refuse to acknowledge. Therefore, faced with the inexorable arithmetic of higher taxes in due course, the administration and Congress will find the path of least resistance to be raising taxes on capital income. The supply-siders will rage on, naturally, but will have no answer for the manifest shortfall in their own fiscal arithmetic. Hence, increased taxes on capital income will slouch through our political process over their ineffective resistance. Readers with long memories will recall that something similar happened in the gestation of the Tax Reform Act of 1986. The 1986 Act went through extensive ministrations by the Treasury and congressional committees, culminating in one of the heavier tax increases on capital income (relative to labor income) in our history, and turned out in the main to be a social-democratic tax law garlanded with a few supply-side gestures.

There is one more thing. Taxes in the next ten years, even though considerably higher than today’s, will nonetheless be insufficient, in all likelihood, to fill the revenue gap that opened wide during the last ten (and will persist for a few more). Somewhere in the mix, therefore, expect significant inflation. Because it decreases the value of deferred claims against treasuries, inflation provides governments some relief from fiscal straits they have spent themselves into. And because inflation, at least on the surface, operates outside the political process, it is ever present as a last resort open to governments and to markets. Above all, once you have given up on the alternatives, inflation is all that remains. For a government, it is like letting go to the pull of gravity. This does not necessarily mean, let
me add, 1970s-style 12-percent inflation\(^2\) but considerably more than today’s. When can we expect it? I can’t say for sure. Maybe not today, maybe not tomorrow, but soon and, for those of us already on the back nine, for the rest of our lives.

I have not even mentioned thus far a conceivable third way to pacify deferred taxes: reduce spending to the level of the current tax, or below. Even though this has happened within memory—in the 1990s—it won’t happen again for a long while. We are a world away from the gridlock of the 1990s. The current administration still sees only new horizons, while the backbenchers have every reason to persist in the win-win clamor for tax cuts without asking anyone to give up anything, for fear of unmasking the supply-side illusion.

The problem runs deeper, in fact, than the particular composition of Congress today. It may well be that allocatively neutral fiscal policy is impossible in a democracy, however admirable that form of government may be in other respects. That is because rent-seeking has a particularly wide range in tax measures massaged through the political process. Commonly (and justifiably) we associate rent-seeking with special interests and minorities. But rent-seeking is not the unique province of small well-connected groups. In tax matters there are rent-seeking opportunities for majorities. The tax laws are shot through with reallocation both to narrow minorities and to the great majority, the latter being reflected most evidently in a rate structure that collects the bulk of federal income taxes from a narrow band at the top of the income range. To be sure, the approach to taxation that I have sketched here by no means attains perfect allocative neutrality. But it comes closer to that end, both nationally and internationally, than what we have today or are likely to have tomorrow. That, however, is no advantage in the legislative trenches.

\(^2\)While there are similarities between today’s monetary and financial environment and that of the 1970s—an era that was the perfect incubator for inflation—there is at least one crucial difference. Currently the money supply is expanding rapidly as we emerge from a recession compounded initially by high oil and commodities prices. To that extent, the situation is strongly reminiscent of 1976-77. The vital difference, however, is China. In 1977 China—just throwing off the Cultural Revolution—had an insignificant role in the world economy. Today China is a prodigious producer and purveyor along the entire spectrum of consumable goods—in effect a Wal-Mart to the world. If the 2010 version of China had been there in 1977, we would likely still have had inflation, but considerably less.
Taking a step back from the fray, it seems to me that on both ends of the political spectrum there is remarkably little concern with the allocative effects of taxation in its various forms. From their pronouncements on the question, in fact, it appears that both social democrats and supply-siders minimize, or even ignore altogether, differences in allocative effect among different taxes, although from diametrically opposite perspectives. By this I mean that social democrats tend to question whether differences in taxation have any allocative effect at all, while supply-siders hold indiscriminately that all taxes, simply by being taxes and especially by being high, have large and adverse allocative effect. To put the point more technically, social democrats hold that the income effect of most taxes overwhelms the substitution effect, while for supply-siders the substitution effect of all taxes overwhelms the income effect. That is why social democrats contend that higher taxes on income (and in particular income from capital) will have little effect on the level and distribution of economic activity, and supply-siders for their part insist that any and all tax increases and new taxes of any stripe will crush economic activity and starve the Treasury.

What I have to contribute on these questions is a simple and important point: that it matters how you tax. Different taxes do have different allocative effects. My concern about future taxes is not that they will be higher—there we have no choice—but that they will perpetuate or even compound the misallocative effects of the present tax system.

I should add, in closing, that I have no illusions about the influence of this concern on the future of the tax system—I know better. My purpose in these remarks is simply to get on record some positions on fundamental questions, so that in a decade or two, should I be so lucky as to be around, I will be able to compare notes with others who take different positions on these issues, and perhaps to say: I told you so. Some day, as my second grade teacher used to say, you’ll realize.
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