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A Lifetime Expenditure Tax

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This paper is concerned with a direct tax on personal expenditure (an expenditure tax). Such a tax would be based on the total spending of an individual, or household, and could be levied at different rates on different persons; in contrast to conventional taxes on spending which take no account of the circumstances of the purchaser and if differentiated at all are levied at different rates on different commodities. The American lawyer W.D. Andrews, in process of noting some administrative advantages of an expenditure tax, was somewhat surprised to discover 'a considerable body of economic literature arguing that a consumption-type tax would be more desirable, but assuming it to be less capable of practical implementation.' (Andrews, 1974, p. 1165). But that is probably an accurate summary of the views of most economists. The arguments to be presented here arise from the work of the Meade Committee, which has attempted perhaps the most detailed analysis of what is involved in the direct taxation of personal expenditure yet undertaken (Meade, 1978), and they will seek to stand that conventional wisdom almost precisely on its head; to suggest that the theoretical arguments are, at best, rather indecisive and that the case for an expenditure tax is essentially practical.

This opportunity to challenge these views results partly from changes in the direction of the economic analysis of problems in taxation policy. The traditional theory of public finance — the kind of approach that reaches its highest point in a work like Musgrave's treatise (1959) — now seems unconvincing in its treatment of problems like the choice between income and expenditure taxation. It asks how this choice will affect such aspects of economic behaviour as the amount of savings and the incentive to work. These seem to be important questions, but even if unambiguous answers to

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them could be given it is not obvious what implications the answers would have. Aggregate savings would probably be greater under an expenditure tax than under an income tax, but to see this as an argument for an expenditure tax it is necessary to believe that savings should be encouraged or at any rate that savings decisions should not be distorted by the tax system. But neither of these things are ends in themselves, and what is needed to justify them is some more basic specification of the objectives underlying the tax system. When this is done, it becomes clear that the theory of taxation is properly a branch of welfare economics and that simple answers to these questions are not available. It is impossible, or at any rate undesirable, to raise tax revenue without distorting some decisions and, given that, it is not obvious that eliminating one distortion makes things any better.

If these analyses are not very satisfying at the theoretical level, it also turns out that they are not as successful as one might hope in illuminating practical problems. The difficulty is that the effects of the ways in which theoretical taxes differ from each other are often rather small when compared with the effects of the ways in which actual taxes differ from theoretical taxes. There is not much evidence to suggest that aggregate savings are very sensitive to the returns from saving, but there is good reason to believe that the ways in which people save are highly responsive to the returns on different kinds of saving. Now most real-life income taxes treat some forms of saving as they would be dealt with under a true income tax but others in ways closer to those which would be applied under an expenditure tax. If this is so, then it is possible that savings behaviour might not differ very much under a pure expenditure tax from what it would be like under a pure income tax; but that either of these would be very different from the status quo. It follows that the anomalies and loopholes in tax systems often have much more substantial economic effects than the taxes themselves. An analysis of tax problems which is to describe actual behaviour must therefore be closely concerned with these loopholes and anomalies, and thus rooted in the operating detail of actual tax systems. This paper is intended as a contribution to this 'practical' side of modern public finance. But it follows from this description that such analysis must be rather institutional in outlook, and I shall have to apologise for using English examples for this purpose since these are the institutions with which I am relatively familiar.

The idea of an expenditure tax has a good deal of superficial appeal. It has also an extensive intellectual history, which can be traced back at least to its advocacy by Hobbes (1651). I shall first consider a number of arguments which although common are not the ones on which I would wish to rely.

First, it is widely thought that the disincentive effects of taxation on work effort can be reduced or avoided by shifting from income-based taxes to

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expenditure-based taxes. This argument is of course quite misconceived, and is only worth mentioning because at least in the U.K. it appears that it is widely believed by politicians of all persuasions.

A second argument for an expenditure tax is that although it might not increase incentives to work it would provide an increased incentive to save. This argument is certainly correct, but it is not clear that it has much force. As I have already noted, the comparisons which have to be made in the real world are a good deal more complex than those which are involved in contrasting textbook income and expenditure taxes, and at least in Britain it is not obvious that an expenditure tax would give a greater incentive to savings as a whole than the present system, which gives considerable incentives to particular forms of savings, although under an expenditure tax relief would no longer be conditional on saving in these ways. It is also worth repeating that there is no reason why one should regard the possibility of an increase in savings, as such, as an argument for an expenditure tax; nor is the case made much more convincing if rephrased in terms of the distortion of choice implied by a tax which bears more heavily on future consumption than on present consumption. One might, however, note an argument in the optimal tax literature (see Sandmo, 1976) which indicates that if utility is given by $u_1(c_1, c_2) + u_2(l)$ and u_1 is homothetic then c_1 and c_2 should be taxed at the same rate; interpreting c_1 and c_2 as present and future consumption and l as labour this points to an expenditure tax which falls equally on both c_1 and c_2. (Bradford and Rosen, 1976). But the application of this result in an intertemporal context raises a number of difficulties, since we have to take account of overlapping generations and be careful in the formulation of the revenue constraint. It is possible — and necessary — to continue escalating the level of sophistication of the argument and spelling out the assumptions involved; but it is clear that the outcome is unlikely to be a decisive argument in favour of either income or expenditure taxation. (Atkinson and Sandmo, 1977).

Another common argument for expenditure taxation supposes that consumption is a *fairer* tax base than income. Hobbes asked 'what reason is there, that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged, than he that living idlely, getteth little and spendeth all he gets ?', while Kaldor (1956) contrasted the Indian prince who lives on his stock of gold with the beggar outside his palace, each of whom pay no tax because they have no income. It is by means of striking examples of these kinds that this part of the debate is usually conducted. But do we really think that the beggar should pay as much tax as the miser whose principal pleasure in life is derived from counting his money each night ? Or that the man whose income is so large that he is unable to think of anything to spend it on should be relieved from tax on that account ? There are things to

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be said for and against both potential consumption and actual consumption as possible tax bases, and neither completely corresponds to our intuitive perceptions of a just or comprehensive measure of taxable capacity.

But before leaving these arguments, it is worth noting that both the Hobbes and Kaldor examples cited are really very misleading. The injustice in Hobbes' example arises essentially because one man 'laboureth much' while the other 'liveth idlely'. If the man who laboureth much were to seek at any time to enjoy the fruits of his labour rather than to spare them, he would pay more than his counterpart who liveth idlely under both expenditure based and income based tax regimes. The real difficulty is that we cannot tax leisure, or conversely that we cannot tax potential rather than actual earnings, and this is a problem with consumption based taxes as much as with income taxes. The force of Kaldor's example, on the other hand, arises because it invites us to infer that the Indian prince had not worked for his gold but had inherited it. If he had saved up out of taxed income to buy the gold, he would already have paid substantially more taxes than the beggar, and it would not necessarily seem unjust that he should now be able to spend his net-of-tax receipts without being charged with tax again. Kaldor's problem really arises because gifts and inheritances are in general less heavily taxed than earnings, and while this raises important issues of equity they are not the ones involved in the choice between income and expenditure taxation.

As these examples illustrate, it can be highly misleading to compare the effects of income and expenditure taxes by looking at what happens in a single year. The central point is that an income tax bears more heavily on those who defer their consumption, the expenditure tax on those who anticipate it. The right comparison is between the canny retired couple who dissipate the proceeds of a lifetime's thrift in a round-the-world cruise, and the profligate student who runs a sports car on his overdraft. It is difficult to work up much emotion on behalf of one or the other.

What then are the arguments for an expenditure tax ? There are, I think, three I would emphasise. The first is that the taxation of income from capital is generally in a mess, and something needs to be done to sort it out. The situation of the U.K. is probably rather extreme, because of the existence of absurd rates of tax — in 1977-8, the rate nominally payable on investment income in excess of £2000 by those whose total taxable income is greater than £21,000 is 98% — combined with a sophisticated financial system. The reason these rates do not impose severe strains on the British tax structure — and indeed the British social structure — is that they are sufficiently easily avoided that the base on which they are levied means very little, and certainly does not correspond to any measure of the consumption possibilities availa-

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ble to rich taxpayers. Tax on investment income can be avoided by transforming the income into capital gains, which are relatively lightly taxed. But the most important avoidance device is the use of tax shelters, by which income is accumulated not by individuals but by institutions — companies, trusts, life insurance companies, pension funds — which are necessarily taxed on a different basis. As this list indicates, tax shelters exist for bona fide reasons which need in the first instance have nothing to do with tax avoidance, and there is little that can be or has been done except to check extreme or obvious abuses. Tax payments can also be reduced by taking income in forms which do not attract liability, of which the benefits obtained from the consumption or use of durable goods are perhaps the most important.

The result is that the apparently confiscatory rates of tax do not mean what they appear to say, which is upsetting both for those who would wish them to and for those who dislike legislative humbug and hypocrisy. A system of high rates of tax which are only erratically effective is bound to be arbitrary and unfair. A further consequence is that the pattern of savings is determined, not by the choices of individual savers, not even by the tax system, but by the exigencies of tax avoidance. For the average person, the principal savings media which attract favourable tax treatment are owner-occupied housing, life insurance and pensions, and the consequence is that these now account for approximately 100 % of net personal saving in the U.K. and a rapidly increasing proportion of personal assets. This has a wide range of economic effects, few of which seem very desirable and fewer of which have ever been intended by anyone. I mention three examples; the immobility, both geographical and professional, which is the result of having one's assets locked into a house and a pension fund; the unlet British-owned office blocks in Brussels, erected by property developers who had flourished on the ready availability of long term mortgage finance; and the exceptional attrition of the British small business sector in the face of the growing institutionalisation of personal saving.

The second argument for an expenditure tax rests on the misdirection of the redistributive elements of the tax system which tends to be characteristic of tax structures which rely on high rates of income tax for this purpose. Whatever may be the declared intentions of those who construct income tax rate schedules, the general outcome is that income tax bites most effectively on employment incomes and less heavily on incomes from capital and from trading activities. We illustrated this rather vividly for the U.K. by tracing out the career of a typical chief executive of a leading U.K. corporation (Kay and King, 1978) and showing that even extreme frugality from his after-tax income would not put him within the top 100,000 wealth-holders in the U.K.

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The effect of top rates of income tax is not to prevent there being substantial numbers of rich people, but to ensure that none of them became rich as a result of savings out of earnings. There must, of course, be a tradeoff between equity and efficiency in the design of tax systems; but this method of handling it seems more than slightly inept. We achieve a good deal of disincentive effect for relatively little redistributive impact; and justify both left and right wing criticisms of the status quo. By shifting the emphasis of the redistributive elements of the tax structure away from earnings and towards wealth and spending we can achieve more fairness with less damage to incentives.

The final argument for an expenditure tax reflects the need to find a way to reduce the administrative complexity of existing income tax systems. At first sight, there seems to be a potential for tension between the academic, who approaches problems of tax policy by attempting to define the underlying principles, and the practical man, who is concerned to resolve day-to-day problems in the most expedient manner and for whom analysis of principles may seem rather abstract. But in fact there is no such conflict. Indeed the major source of administrative complexity in practice is departure from underlying principles. Once these begin, generally for good reasons, distortions are introduced into the system; these cause strains, and further modifications have to be introduced to restrict or relieve them. As this process continues, it necessarily becomes increasingly ad hoc in outlook because appeal to the basic principles is now ruled out : and the ultimate consequences of measures become less and less obvious. Hence a system which sticks closely to a well-defined set of underlying principles, and which departs from them only in a limited number of clearly recognised ways, is likely to be simpler to administer than one which is forced to devise new rules to deal with each new situation as it emerges.

This argument suggests that a tax system should be based on *some* defined set of principles, but not what they should be. But if the choice is between income and expenditure, then there is much to be said for preferring expenditure. Many of the deficiencies of existing income taxes exist because income is such a difficult concept to apply in practice. That this is likely to be the case is evident simply from considering the famous Hicksian definition of income as 'the maximum amount which a man can expect to spend in some accounting period while still being as well-off at the end of it as at the beginning.' Two words in this present immediate difficulties — expect and well - off. The measurement of 'well-offness' implies the regular valuation of all assets, and for a tax which was based on an accurate measure of income this would indeed be required. It is hardly necessary to spell out the reasons why this is not and could not be done for any practical income tax. What tends to happen is that changes in values are ignored until some tangible

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evidence of them forces itself on the attention of the tax-collector — by realisation of all or part of the assets concerned, by the payment of interest or dividends on them or by the occurence of some other recognisable transaction of this kind. The difficulty with these expedients is that changes in values do in fact occur before these realisations, so that this basis is bound to be anomalous and distortionary : and moreover the timing of realisation is susceptible to control by the taxpayer, so that the tax shelters already alluded to emerge as devices for postponing realisation.

The word 'expect' in the definition implies, broadly, that unexpected capital gains should not be included in income but that expected capital gains should be. It is hard to imagine how one could begin to think of implementing a tax which treated expected and unexpected returns differently, and as a rule the most common expedient is to treat all capital gains in the same way but to tax them more lightly than income. This may give the appropriate treatment on average, but gives the wrong treatment in every particular case.

Expenditure, on the other hand, presents relatively few difficulties of definition — indeed the Hicksian definition of income presupposes a measure of expenditure. Of course, there are some — how to distinguish personal from business expenditures, how to treat assets such as valuable pictures which are held from motives of both investment and consumption, and whether any part of personal consumption, such as education expenditures or engagement rings, should be regarded as investment rather than a source of direct utility. But these problems arise equally with an income tax, and only the first, which is an unavoidable difficulty for any tax system, appears to be regarded as particularly serious.

How then would an expenditure tax work ? The description here will necessarily be rather sketchy, and much fuller discussions are to be found in the Meade Report (1978) and Kay and King (1978). It is necessary to begin by stressing that it does not work by observing the amounts rung up on supermarket tills, or by asking people to remember and list everything which they spent in the course of the year. What is monitored is not expenditure itself, but the sources of expenditure. The tax base therefore begins with an individual's receipts — the amount he earns from employment, the difference between the incomings and outgoings of his trading activities, the net amount of his withdrawals from any businesses in which he is an owner or participator, and so on. He is taxed on these receipts, but is relieved on that part of them which he chooses not to consume. This is achieved by allowing him to deduct what he can identify as having spent on financial assets; conversely, he will be taxed on anything he subsequently withdraws from them. We have envisaged the designation of a class of 'registered assets'. The distinction between registered and unregistered assets is broadly the distinc-

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tion between financial and physical assets, and the characteristic of registered assets is that anything deposited in them may be deducted in computing tax liability while anything withdrawn from them will be added. There is no discrimination between receipts of income and receipts of capital.

I have described this method of operating an expenditure tax as one which monitors sources of expenditure rather than expenditure itself. Over an individual's lifetime, the total of expenditures will necessarily be equal to its sources. Since this is so, it is not really important that the sources of expenditure be closely matched with expenditure in any particular year. The traditional view that an expenditure tax would be very difficult to operate administratively may largely be the result of a supposition that it is essential to measure actual expenditure rather than resources for expenditure — which requires that we identify every use of funds which is not a use for consumption, and which requires us to worry about the appropriate attribution between different time periods of expenditure on durable goods. But if we fail to identify some savings, all that happens is that the taxpayer prepays some expenditure tax. As a rule, people will not want to do this, and will therefore tend to put their savings into registered assets. But they might have reasons for wishing to prepay — if their expenditure is likely to rise then under a progressive tax structure prepayment allows them to enjoy the benefit of their lower current marginal rates. This opportunity for do-it-yourself averaging seems a positive gain; the penalisation of those with uneven incomes is essentially an accidental inequity which arises from a progressive annual tax.

Thus the structure of the tax is as shown in Fig. 1. It is those transactions which cross unbroken lines in Fig. 1. which are monitored; those which cross

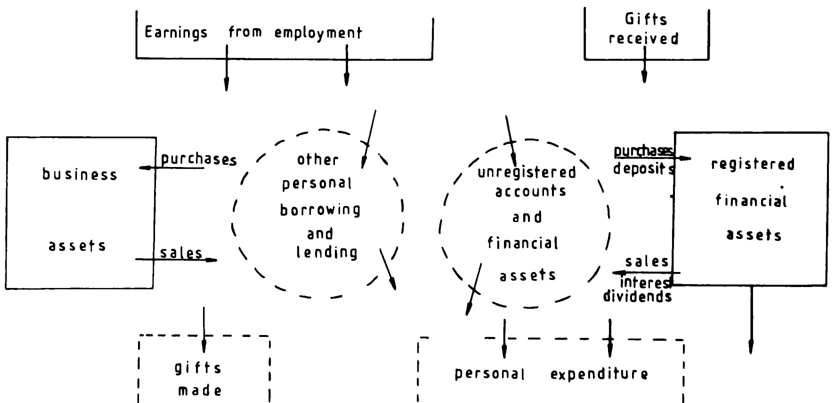

Fig. 1 : The sources of personal expenditure

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the broken lines do not interest the taxman. Assume that the present value of what goes into the broken circles is equal to the present value of what comes out — as it must be if returns on unregistered assets are certain. Assume further that individuals use their opportunities to purchase registered and unregistered assets efficiently, so that they maintain a constant level of taxable expenditure (which need not, of course, imply a constant level of actual expenditure). Then the effect of operating the tax in this way is that an individual will, over his lifetime, pay a graduated tax on the present value of his lifetime's expenditure. If gifts are included in the tax base, this is necessarily equal to the present value of his lifetime's receipts. Seen in this light, the distinction between income and expenditure taxes which was stressed in the examples of Kaldor and Hobbes which were cited earlier disappears; and such a tax has substantial claims to be seen as based on the fairest measure of taxable capacity which can be deduced from observable magnitudes.

What would be involved in completing a tax return under such a tax — which we call a 'lifetime expenditure tax' ? The easy questions from existing tax returns would go over more or less unchanged, so that an expenditure tax return would begin by asking questions about incomes from employment. The changes appear in the more difficult questions, which relate to business activities and income from capital : and they mostly represent simplifications. For businesses, or partnerships, the return would simply ask how much the trader or partner had withdrawn from the business in the course of the year. For capital gains, there would be no need to match up this year's sales with purchases occurring in a number of different, earlier, years : it is only necessary to record this year's purchases and this year's sales, and to subtract one from the other. Thus there would be major simplifications resulting from a move to a lifetime expenditure tax. To offset these, there are two main additional complications. It would be necessary to record changes in the balances held on registered accounts, and to have procedures for verifying these. It would also be necessary to have more extensive information about gifts made or received than most countries currently require.

What then are the problems ? Although the borderline between consumption and non-consumption expenditures is very much easier to police than the line between capital and income, it is by no means totally clear. Obviously, one would want to take a hard line in excluding claims that what are prima facie consumption expenditures are in fact investment; this means no credit for educational expenditures, or health expenses, or the cost of the food I need in order to stay alive. Assets which have some of the characteristics of consumption goods and some of the characteristics of financial assets — like houses, valuable pictures, or gold coins — present more difficult issues. But in both these areas precisely similar problems of definition arise under the present income tax, and while they do represent acknowledged

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difficulties they are not I think widely regarded as being among the most serious problems confronting present-day income taxes.

The transitional arrangements present difficulties of equity and of enforcement. The ideal is that after the appointed day spending out of previously taxed income would be relieved while spending from other sources — inheritance or capital gains — would be taxed. But there is no practical mechanism by which we can decide which parts of existing wealth are attributable to one source and which to the other. What are the alternatives ? We could tax all spending, however it originated — but to do this we need to be able to compile an exhaustive inventory of wealth existing on the appointed day, in the face of rather substantial incentives to conceal it. We can reduce these incentives by some rough and ready exemptions, but it would be very difficult to make these arrangements either fair or effective. Or we can simply ignore existing wealth and thus exempt the money value of existing wealth from tax and — at least in the U.K. — rely on inflation to erode that fairly rapidly. There is little doubt in my mind that the last is the only practicable solution.

If we accept this, also, it becomes possible to propose an evolutionary, rather than a revolutionary, move towards an expenditure tax. We can envisage gradually absorbing existing tax concessions to saving into the framework of the registered asset system, and transfer business accounts to a cash flow basis by extending accelerated depreciation to wider ranges of assets and by phasing out interest deductability. During this process, registered deposit accounts can be introduced. The biggest day in the transition is the one on which negotiable securities are brought into the system. Subsequently, tax levied on unregistered accounts might be abolished — and the transition to a full expenditure tax would then have been achieved.

The use of an accruals basis for an income tax is beset by practical difficulties, and these have forced real tax systems to move a long way in the direction of an expenditure tax by adopting cash flows rather than accruals as the base for taxation. In this paper, I have suggested that the logic of these practical considerations points to the use of cash flows as the underlying principle rather than simply an unfortunate expedient which one is forced, rather frequently, to adopt. The revolution which it invites is as much an intellectual revolution as a radical change in what we actually do.

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