



book reviews

edited by Robert J. Wells

Fair Not Flat: How to Make the Tax System Better and Simpler

Reviewed by Laurence Seidman

Fair Not Flat: How to Make the Tax System Better and Simpler, by Edward S. McCaffery. Published by University of Chicago Press, 2002. Price: \$28. To order, phone 773-568-1550 (AD #2500) or go to <http://www.press.uchicago.edu>.

This is an important book. It is written in a lively conversational style, addressed to the intelligent layman, with colorful characters like Rich Dad, Poor Dad, the Flintstones, the Ant and the Grasshopper, and King Lear and his three daughters (Regan, Goneril, and Cordelia). But the tax specialist will also learn much from it, and, one can hope, the makers of tax policy will give it serious consideration. It makes a persuasive case for replacing both the personal income tax and the estate tax with a progressive spending (consumption) tax, which McCaffery calls "The Fair Not Flat Tax."

McCaffery gives a concise statement of his proposal:¹

My proposal is simple:

- change the inconsistent income tax to a consistent spending tax by granting an unlimited deduction for savings and making other logical corrections
- repeal the so-called death tax
- keep tax rates progressive
- reduce the paperwork burden that most Americans now face.

The result is, in essence, a progressive national sales tax. I call it the Fair Not Flat Tax.

Note that his proposal has elements that should appeal to conservatives, and elements that should appeal to liberals. Conservatives should like an unlimited deduction for savings, and the repeal of the estate tax. Liberals should like highly progressive tax rates.

How will his progressive spending tax be implemented? He writes:²

¹Edward J. McCaffery, *Fair Not Flat: How to Make the Tax System Better and Simpler*, Chicago: University of Chicago Press, 2002, p. 6.

²McCaffery, p. 6.

The Fair Not Flat Tax can take several different forms. I will emphasize one that features a broad consumption tax such as a sales or value added tax with a rebate for low-end spenders and a supplemental personal consumption tax for high-end ones. Roughly speaking, a family of four will pay no tax on its first \$20,000 of spending and a 10 percent tax on its next \$60,000. Only a minority of families, those that spend more than \$80,000 a year on themselves, will have to fill out tax forms and pay higher rates under the supplemental consumption tax.

Thus, under his proposal, the personal income tax is terminated, and everyone faces a new 10 percent value added tax (VAT) and pays it at the cash register whenever a purchase is made. But low-income people get a rebate every April 15 to offset their VAT burden, and high-income people pay an additional spending (consumption) tax every April 15.

McCaffery concedes that there are details that must be addressed. But he conveys the flavor of his book this way:³

I readily admit that my numbers are illustrative and are only estimates. I mean this book to be general and highly readable. I will not engage in long, technical discussions about precise rates and numbers, adding fuel to think-tank fires. Complexity can wait. The devil may indeed dwell in the details, but we first need to find an angel or two in the abstractions that govern tax. It's time to get the basic principles of tax down right.

Is the Fair Not Flat Tax really fair? McCaffery answers this way:⁴

The Fair Not Flat Tax is fair because it rests on a simple and consistent principle: tax people on what they spend, not on what they earn or save. The Fair Not Flat Tax sticks to this principle. It does not contain a death tax for the simple reason that dead people don't spend. The Fair Not Flat Tax instead taxes heirs when they spend inherited wealth. It is a far better, far more consistent tax on the wealthy, of both the first and later generations, than the ineffective system we now have.

The Fair Not Flat Tax is fair because it assigns a lower rate of tax to spending on life's necessities — like food, clothing, shelter, medical care, and education — than to spending on life's ordinary

³McCaffery, p. 6-7.

⁴McCaffery, p. 7.

pleasures, and it assigns the highest tax rate to spending on life's luxuries."

McCaffery acknowledges the ancestry of his proposal. He writes:⁵

In 1995, then Senators Sam Nunn, a Democrat, and Pete Domenici, a Republican, following the recommendations of an extensive blue ribbon commission, introduced a tax plan known as the USA Tax. USA stands for 'unlimited savings allowances'

The USA Tax has two attributes that we should want in a broad-based tax: it is progressive and it falls on spending, not on work or savings directly. The plan also has a distinguished intellectual lineage. The idea was developed by the eminent British economist Nicholas Kaldor in the mid-1950s. It was advanced and applied to an American context by Harvard Law Professor William Andrews in the early 1970s. Later in the 1970s, David Bradford, then a member of President Ford's Treasury Department and now an economist at Princeton and New York Universities, used the progressive consumption tax as a model for the government study later published as *Blueprints for Tax Reform*.

McCaffery's Fair Not Flat Tax has much in common with the USA Tax.⁶ But there are important differences, as McCaffery explains: "The USA plan gets close to the mechanics of the Fair Not Flat Tax. It is a progressive spending tax. But the USA Tax, so attractive in theory, has its flaws in practice. It is not, in fact, a consistent spending tax; it shares some of the vices of the inconsistent income tax."⁷

McCaffery says three features of his Fair Not Flat Tax make it a more consistent spending tax than the USA Tax: (1) It terminates the estate tax; (2) For affluent households, it uses an annual (April 15) spending (consumption) tax that includes borrowing and subtracts repayments in the computation of annual consumption; (3) For nonaffluent households, it uses a value added tax (VAT), levied at the cash register with each purchase, as a substitute for an annual (April 15) tax, so that the annual tax will be paid only by affluent households; low-income households will be protected from the VAT through an annual (April 15) VAT rebate.

Consider each feature in turn. McCaffery writes:⁸

For one thing, the USA Tax supplements its consumption base with an estate tax; it is thus a progressive consumption-plus-estate tax. But . . . an estate tax isn't needed under a consistent

spending tax: dead men don't spend. The Fair Not Flat Tax, on the other hand, is a progressive consumption-*without*-estate tax.

McCaffery entitles his chapter on the estate tax, "Death to Death Taxes," a phrase usually used by conservatives opposed to all progressive taxes. But McCaffery favors progressivity and regards himself as a liberal tax reformer. He gives a liberal argument against the estate tax:⁹

Worst of all, the estate tax is unfair, because it penalizes the thrifty and ignores the spendthrift; it taxes savers, not spenders. . . . None of this means that we should let heirs, or anyone else, off the hook. Far from it. But there are better times to tax than at the grave site. The Fair Not Flat Tax consistently taxes spending, at progressive rates, regardless of how the wealth is obtained or whether the spenders are first or later generation rich folk.

Thus, whereas conservatives want to abolish the estate tax, period, McCaffery wants to replace it with high consumption tax rates on the affluent, so that affluent savers pay less tax, but affluent spenders pay more tax.

McCaffery is correct that the USA Tax bill of 1995 made a serious mistake in its treatment of borrowing, and his remedy is exactly right.

The second feature of the Fair Not Flat Tax that differs from the USA Tax is the inclusion of borrowing. McCaffery explains:¹⁰

More important, the USA Tax is inconsistent in its treatment of debt because it fails to include the proceeds of borrowing. . . . A postpaid consumption, or spending, tax that doesn't tax borrowed money spent in personal consumption leads to inconsistent results. In practical terms, a taxpayer could get a deduction for contributions made into a USA on one hand, consume out of borrowed money with the other — and pay no tax. It sounds hard to tax debt used to spend, but note that the far simpler sales tax has it right on this score: debt used to consume should be taxed, repayments of debt should not be. This is how a sales tax works. A progressive spending tax that doesn't tax the proceeds of debt used to finance consumption is an inconsistent consumption tax. But on the big questions in tax, we need consistency.

McCaffery is correct that the USA Tax bill of 1995 made a serious mistake in its treatment of borrowing, and his remedy is exactly right. McCaffery explains that to compute its consumption accurately, a household must add borrowing to incomes such as wages and salaries, interest, and dividends (before sub-

⁵McCaffery, p. 57-58.

⁶A detailed exposition and explanation of the USA Tax is given by Ernest Christian and George Schutzer in *Tax Notes, Special Supplement*, Mar. 10, 1995, p. 1481. Constructive suggestions for amending the USA Tax bill are given in Laurence Seidman, "The USA Tax: A Friendly Critique of Its Design," *Tax Notes*, Nov. 18, 1996, p. 833, (a) and Laurence Seidman, *The USA Tax: A Progressive Consumption Tax*, Cambridge, Mass.: The MIT Press, 1997 (b).

⁷McCaffery, p. 58.

⁸McCaffery, p. 58.

⁹McCaffery, p. 67.

¹⁰McCaffery, p. 58-59.

tracting saving such as the purchase of stocks or bonds). By contrast, the 1995 USA Tax bill excluded borrowing on the grounds that it is not income. McCaffery says that borrowing is negative saving so that just as positive saving must be subtracted, negative saving must be added. Just as borrowing must be included, repayments must be subtracted, because repayments are a nonconsumption cash outflow.

I have suggested another way to explain why borrowing must be included.¹¹ To measure its consumption, a household must add all cash inflows, then subtract all nonconsumption cash outflows; what's left is cash that must have gone to finance consumption. Thus, the household should add up all cash inflows regardless of whether the inflow is "income." For example, if a household borrows \$10,000 and sells stock for \$5,000, it should add \$15,000 to its cash inflows. It is irrelevant that the \$10,000 it borrows is not "income," and that the \$5,000 it receives from the sale of stock is revenue, not income (capital gain), which depends on what the household originally paid for the stock. What matters is that all cash inflows are a potential source of financing consumption, and therefore must be included.

The designers of the USA Tax compounded their mistake — the exclusion of borrowing — by adding an extremely complicated "Schedule S" that tried to prevent households from using borrowing to finance tax-free consumption. "Schedule S" gave the USA Tax a reputation for complexity. McCaffery, like other friendly critics of the 1995 USA Tax bill,¹² is absolutely right to rectify this mistake by including borrowing and omitting "Schedule S," thereby avoiding the most complex feature of the USA Tax bill.

The third difference between the Fair Not Flat Tax and the USA Tax is the role of a value added tax (VAT) as a *substitute* for an April 15 tax for nonaffluent households, and the role of an April 15 VAT rebate in the protection of low-income households from the VAT. The USA Tax bill also includes a VAT, but as a substitute for the corporate income tax, not as a substitute for the annual April 15 tax on household spending (consumption). Here is McCaffery's rationale for his VAT:¹³

OK, it's time to make things even simpler, without changing the basic nature of the Fair Not Flat Tax. The tax is a consistent, postpaid consumption tax. In chapter 3 we learned that sales taxes and VATs are also such taxes and that rebates or credits can be used to achieve the same effect as a zero bracket. These facts give us an easy way to knock the two lowest rate brackets off of the Fair Not Flat Tax so that most Americans will no longer have to fill out annual forms.

We can impose a national sales or VAT at a uniform 10 percent rate. There are, of course, numerous practical and administrative issues involved in deciding which one to use. I touched on these briefly in chapter 3. For now let's keep putting the grittiest details aside. The important point is that we can use the functional equivalence of sales taxes, VATs, and other forms of postpaid consumption taxes to simplify the Fair Not Flat Tax for most taxpayers.

Thus, only a household with annual spending above \$80,000 would have to pay the annual (April 15) "supplemental personal consumption tax." For the annual tax, the rates would be as follows (for a family of four): zero percent for annual spending from \$0 to \$80,000; 10 percent for spending from \$80,000 to \$160,000; 20 percent from \$160,000 to \$500,000; 30 percent from \$500,000 to \$1 million; and 40 percent for more than \$1 million.

How would the annual (April 15) VAT rebate work? The aim of the rebate would be to offset the 10 percent cash register burden from the 10 percent VAT for low-income households. He explains:¹⁴

To replicate the effect of a zero bracket, we can allow a credit against the sales tax or VAT. The credit will be set at 10 percent of earnings up to \$20,000 for a family of four. In other words, we give the family back \$2,000 on a showing that they earned at least \$20,000. We can do this by mailing a check; making an automatic deposit into a bank account; giving a credit along with each employee's paycheck or creating an exemption under the Social Security system, which now operates as a large flat tax on American workers without a zero bracket. However we deliver it, this rebate will offset the 10 percent sales tax on consumption below \$20,000, thereby effectively creating a zero bracket. The national sales tax or VAT will then work as a flat 10 percent tax on all consumption above that exempt level.

I fully agree with McCaffery that a VAT with an April 15 VAT rebate should be one component of a reformed tax system because it enables lower tax rates on the April 15 tax. But I don't think it will simplify things as much as McCaffery implies. Every household will still have to file an annual April 15 return to determine whether it must pay the "supplemental" tax because its spending exceeds \$80,000, or whether it is entitled to a VAT rebate because its income is less than \$20,000, and if so, how much. To show that it does not owe supplemental tax, a household must file an April 15 return reporting its cash inflows from wages, borrowing, and withdrawals from saving or investment accounts, and its deductions for nonconsumption cash outflows such as deposits into saving or investment accounts. Each low-income household must file a return to determine how much VAT rebate (and earned income tax credit) to claim. Thus, McCaffery is correct when he says that a VAT will sharply reduce the num-

¹¹See Seidman, *supra* note 6, at 835-837 (a); and Seidman, *supra* note 6, at 75-78 (b).

¹²See Seidman, *supra* note 6, at 842-843 (a); and Seidman, *supra* note 6, at 76 (b).

¹³McCaffery, p. 100.

¹⁴McCaffery, p. 101.

ber of households that have to pay a positive supplemental tax on April 15, but incorrect when he implies that many households will not have to file or fill out tax forms.

I fully agree with McCaffery that a VAT with an April 15 VAT rebate should be one component of a reformed tax system because it enables lower tax rates on the April 15 tax. But I don't think it will simplify things as much as McCaffery implies.

Nevertheless, McCaffery's VAT plus rebate is desirable not only because it sharply reduces the number of households that have to pay a positive supplemental tax on April 15, but also as replacement for the corporate income tax — the rationale proposed in the USA Tax bill. To serve both objectives, the VAT rate would need to be set higher than 10 percent (and the VAT rebate would need to be correspondingly larger). McCaffery is open to replacing the corporate income tax, but stops just short of calling for it in this book. He writes:¹⁵

The Fair Not Flat Tax as I have sketched it out doesn't call for eliminating or reducing business taxes, but there are good reasons to consider doing so. These reasons start with the common-sense principle that businesses don't really pay taxes, people do. Because a business is a fictional legal entity, the dollars it pays to the government ultimately must come from flesh-and-blood humans' pockets. . . . So although I haven't addressed business taxes in this book, there is a good case for eliminating them.

In the last chapter of his book, McCaffery addresses many of the details, such as the treatment of consumer durables and housing, that others have also addressed.¹⁶ After doing so, he draws this general conclusion:¹⁷

Isn't the Fair Not Flat Tax too complicated?

I hope not. That's why I have written this book, after all — because I believe that the American people can understand the Fair Not Flat Tax. It looks a lot like the Nunn-Domenici USA Tax, discussed in chapter 3, which was proposed in 1995 and was widely considered infeasible because of its complexity. But I have learned from the criticism of the USA plan and have tried to

fashion a tax that is less complicated and whose complexities will affect only a small minority of the public. . . .

The fact that the entire tax system will rest on a clear and consistent set of principles — tax people as they spend, not as they work or save; tax luxuries more than ordinary, and ordinary more than necessities — represents an enormous improvement over the status quo. These principles form the heart and soul of the Fair Not Flat Tax. And they are not very complicated.

The last time Congress considered fundamental tax reform, in the mid 1990s, the flat tax received the most attention. I share McCaffery's hope that the next time Congress takes up tax reform, it will be the Fair Not Flat Tax that is its central focus.

Laurence Seidman is Chaplin Tyler Professor of Economics at the University of Delaware and author of *The USA Tax: A Progressive Consumption Tax* (Cambridge, Mass.: The MIT Press, 1997).

¹⁵McCaffery, p. 125-26.

¹⁶William Andrews, "A Consumption-Type or Cash Flow Personal Income Tax," 87 *Harvard Law Review*, 1113-1188 (1974); U.S. Treasury, *Blueprints for Basic Tax Reform*, Washington D.C., 1977; Michael Graetz, "Expenditure Tax Design," in *What Should Be Taxed: Income or Expenditure?* Ed. Joseph Pechman, Washington D.C.: Brookings Institution, 1980, p. 161-276; and Seidman, *supra* note 6, chapter 4, p. 69-112 (b).

¹⁷McCaffery, p. 158-59.