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# THE ENGLER-KNOLL CONSUMPTION TAX PROPOSAL: WHAT TRANSITION RULE DOES FAIRNESS (OR POLITICS) REQUIRE?

Joseph Bankman\*

THE debate between an income tax and a consumption tax has been a primary focus of tax scholarship for nearly two decades. Recently, a consensus seems to have emerged in favor of a consumption, or cash flow, tax. A consumption tax is thought easier to administer and more conducive to productive economic behavior, with respect to both savings, and, under some lines of analysis, labor. The elusive quality of “fairness,” which at one time was thought to inhere in an income tax, is now claimed with equal ardor, and almost equal success, by proponents of each tax base. The shifting center of gravity in the debate has renewed interest in the nuts-and-bolts, real world issues involved in implementing a consumption tax.

In their article, Professors Engler and Knoll address one of the most important of these issues: the transition from the income to the consumption tax.<sup>1</sup> It is a task that requires economic sophistication and a practical bent and a task for which the authors are well suited. Michael Knoll has spent much of a career writing articles that combine those two qualities.<sup>2</sup> Mitchell Engler is newer to the academy but he, too, has shown a taste and talent for this sort of scholarship.<sup>3</sup> The result of their efforts is a delightful article. *Simplifying the Transition to a (Progressive) Consumption Tax*<sup>4</sup> is well-written and well-reasoned. The solution the article puts forward is innovative and workable. It is not, however, the solution I would choose. It is also not a solution that I think is likely to fly politically, though that may be true of all other “solutions” to the transition problem, including the one I would favor.

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1. Mitchell L. Engler & Michael S. Knoll, *Simplifying the Transition to a (Progressive) Consumption Tax*, 56 SMU L. REV. 53 (2003).

2. See, e.g., Michael S. Knoll, *Designing a Hybrid Income-Consumption Tax*, 41 UCLA L. REV. 1791 (1994); Michael S. Knoll, *An Accretion Corporate Income Tax*, 49 STAN. L. REV. 1 (1996).

3. See, e.g., Mitchell L. Engler, *A Progressive Consumption Tax for Individuals: An Alternative Hybrid Approach*, 54 ALA. L. REV. (forthcoming 2003).

4. Engler & Knoll, *supra* note 1.

## I. THE ENGLER-KNOLL THESIS

### A. THE TRANSITION PROBLEM

Engler and Knoll begin by stating the case for a consumption tax. This discussion is intended to justify their enterprise to a lay audience and to give that audience the background needed to evaluate their proposal. I will assume that audience has read and understands that portion of the article; I have nothing useful to add to their discussion.

Engler and Knoll next tackle the central problem of transition: treatment of pre-existing investment, capital or savings (these three terms are often used as synonyms in the consumption tax literature and will be so used here). Under the most straightforward version of a cash flow consumption tax, savings generate a tax deduction, while dissaving is taxed. An individual who earns a salary of \$100,000, saves \$40,000 and consumes the remainder is taxed on only the \$60,000 consumed. The \$40,000, and any interest or investment return earned therefrom, is taxed only when it is spent on personal consumption. Savers benefit from cash flow treatment through the up-front deduction in the same way that savers benefit under current law when they contribute monies to an Individual Retirement Account, or IRA. It is true, of course, that everything that comes out of savings is taxed, while under current law, only the excess of proceeds over investment (basis) is taxed. To put the matter differently, under a cash flow tax, since the entire amount saved is immediately deductible, the basis of savings is always zero. Compared to an income tax, a cash flow tax is thus better for savers at the front end and worse at the back end. The net result is a plus for savers, however, since the present value of the deduction going in more than offsets the lack of basis when the investment is liquidated. Indeed, as noted later in this essay, the value of the deduction going in is so great as to fully offset, on an *ex ante* basis and in present value terms, the tax on the back end.

What about persons who saved prior to the enactment of the consumption tax? They received no up-front deduction; their investment produced a tax benefit of sorts in the form of basis. A cash flow tax, instituted without transition relief, would eliminate that basis. As a result, any withdrawal or liquidation of investment for consumption purposes becomes taxable in full. An individual who sells stock for \$100,000 and uses the proceeds for consumption is taxed on the \$100,000—the fact that the individual paid \$100,000 for the stock and could sell the stock at no gain under current law is irrelevant. Thus, the enactment of a consumption tax without transition treats existing capital unfavorably. This, Engler and Knoll state, is a violation of an important fairness norm. For that reason, and for other reasons associated with real world politics, adoption of a cash flow tax must be accompanied by transition relief for existing assets.

Unfortunately, transition relief is expensive. Engler and Knoll believe that the combination of transition relief for existing assets and full deductibility of new assets is likely to push the government into a deficit.

The deficit may not be permanent: today's saving creates tomorrow's spending, and the latter event will generate tax revenues. Meanwhile, though, the government has to rely on the credit markets. This, Engler and Knoll argue, is a problem almost as great as a no transition rule.

#### B. THE ENGLER-KNOLL PROPOSAL

The solution Engler and Knoll propose to the above transition problems, and to other problems as well,<sup>5</sup> is somewhat ingenious. Under their proposal, which I shall simply refer to as Engler-Knoll, all existing assets are put in an asset account; the account has a basis equal to the basis of those assets. The account basis is increased each year by the risk-free rate, as defined by the government's borrowing rate. New assets purchased after enactment are placed in the account; the basis of the account is increased by the cost of those assets. Only withdrawals in excess of basis are subject to tax.

The operation of these rules for pre-existing assets that are all sold immediately after the enactment of a cash flow tax is clear enough. Gain is recognized in the amount of the excess of proceeds over basis, just as in existing law. Pre-existing savings are not treated in an unfavorable manner, and the fairness issue connected with such savings disappears.

The proposal to increase the basis of the asset account by the risk-free rate may seem a bit odd to readers, and I believe it will seem unfathomable to taxpayers. To anticipate the following discussion, this proposal leaves taxpayers and the government in the same position, at least on an *ex ante* basis, as a straightforward cash flow tax. Linking two accepted propositions can demonstrate this equivalence. The first proposition is that a consumption tax is as favorable to taxpayers as a conventional income tax with a zero-percent tax on capital income. The intuition behind this equivalence is that a cash flow tax provides a deduction for all investments, and the present value of the deduction offsets any tax due when the asset is sold and proceeds are used for personal consumption.<sup>6</sup>

The second proposition is that under an income tax only the risk-free return is actually subject to tax. This is of course tautologically true for riskless investments, which are defined by convention as investments in governmental securities. But it is also true for risky investments. The reason for this is that there is a linear relationship between the return to risk and the amount of risk. Double the risk of an investment and the

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5. See discussion *infra* Part IV.

6. The equivalence is often illustrated by the following example. Suppose in Year 1, *A* earns \$100 and (improbably) saves the entire amount left after taxes. *A* earns 10%, and spends the proceeds at the close of Year 2. Under a cash flow tax, *A* deducts the \$100 savings from her income and so is able to invest the entire \$100. That sum grows to \$110. If the rate on dissaving is 50%, she is able to consume \$55 at the end of Year 2. Suppose instead that *A* is denied a Year 1 deduction for saving but not taxed on her interest income. She now has \$50 to invest. Her \$5 interest income (at 10%) is not taxed, and she again has \$55 to consume. For a somewhat more complete discussion of this point, see Joseph Bankman & Barbara H. Fried, *Winners and Losers in the Shift to a Consumption Tax*, 86 *Geo. L.J.* 539, 540-41 (1998).

expected return to risk is also doubled. Under an income tax, risky investments that pay off are, of course, taxed. Risky investments that fail, however, generate a tax deduction. An income tax therefore reduces the expected return but also reduces the risk of the investment. Under a 50% income tax, it is as if the government is in a forced partnership with the taxpayer, taking half of the upside but absorbing half of the downside. Taxpayers can offset the effects of this forced partnership by doubling the amount of pre-tax risk. The tax, by reducing the upside and downside of the investment by 50%, will leave taxpayers in the same position as they were in the no-tax world with their initial investment.<sup>7</sup>

In sum, by increasing the basis of the asset account by the risk free rate, Engler-Knoll eliminates the tax on the asset. A regime in which investment is not deductible when made but in which no tax is levied on investment income is equivalent to a cash flow tax.

The operation of Engler-Knoll to taxpayers who hold a single asset is uncomplicated. An asset bought for \$100 is increased by the tax-free rate during the taxpayer's holding period. The difference between the basis so increased and sales price yields taxable gain. If the asset is a risk-free governmental bond, which by definition increases at the risk-free rate, the gain is zero. If the asset is risky, the sales price may be more or less than the adjusted basis, and the taxpayer will recognize gain or loss.

Things change a bit when, as will typically be the case, more than one asset goes into the asset account. Under Engler-Knoll, the taxpayer receives a single basis for the entire account. Presumably, no loss can be recognized until all assets are sold; otherwise, how do we know that proceeds fall below basis? A variant of the same result occurs with assets that have increased in value. No gain will be recognized until total outflows exceed basis. The proposal thus imposes a much different "realization" regime than present law. For taxpayers with multiple assets, gains and losses will be realized later.

As a theoretical matter, the inability to deduct a loss realized on an asset held in a multiple asset account is non-problematic. Basis increases each year by the risk-free rate. This compensates the taxpayer for the deferral. Taxpayers who wish to recognize losses currently will always have the option of selling all assets. Still, taxpayers will resent the inability to take losses when realized.

Taxpayers will like the corresponding gain rule, however. The rule is similar to that now provided for distributions from partnerships, with the first dollar out credited to basis.<sup>8</sup> As a theoretical matter, this form of deferral is also non-problematic, since the distribution reduces the account basis and "costs" the taxpayer the increase in basis attributable to the distributed funds. To restate this point in a different manner, the En-

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7. Enger & Knoll, *supra* note 1, at 55-56. See also Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter?*, 47 TAX L. REV. 377 (1992).

8. I.R.C. § 731 (2002).

gler-Knoll proposal imposes a net-zero tax on investment so that no problems are caused by early tax-free distributions of investment return.

There are complexities of Engler-Knoll that are not so easily resolved. As Engler and Knoll acknowledge, donative transfers are problematic. As a practical matter, the possibility of such transfers would require that we continue to track basis for each asset, thus reducing one advantage of the proposal. An alternative possibility, noted by Engler-Knoll, is to treat such transfers as consumption. However, this would be inconsistent with present law and, I believe, politically unacceptable. Engler and Knoll also acknowledge problems caused by progressivity and changing marginal rates. These problems, however, are inherent in present law as well. Finally, as a theoretical matter, the proposal works in the manner in which it is described to work only if the conditions are present to make a zero-rate tax equivalent to a cash flow tax and a tax with an upward adjustment to basis equivalent to a zero-rate tax.

I do not believe that any of the more theoretical complexities I have noted are that serious. The basis adjustment mechanism might not absolutely replicate a cash flow tax, but it will come close enough to meet most of the desirable qualities of that tax, and I suspect some workable compromise can deal with the problem of donative transfers. Of course, as noted elsewhere in this essay,<sup>9</sup> there are a host of real world issues that neither Engler and Knoll nor I discuss.

I suspect the major practical drawback to Engler-Knoll is its lack of transparency. Taxpayers will be perplexed by the basis account. They will not understand how or why the account increases each year. Taxpayers who hold multiple assets and sell one asset at a loss will not understand why they cannot recognize the loss. Taxpayers who sell a risky asset at a high gain and pay tax on that gain will never be convinced that the tax did not really reduce their expected or realized return, because they increased the pre-tax risk of their portfolio to offset their forced partnership with the government. All of this will make the Engler-Knolls proposal a hard sell.

I also do not believe that Engler-Knoll is the right way to move to a consumption tax. The proposal works and, in many respects, is a great improvement over present law, but as noted below, it is not the proposal I would adopt.

## II. MUST WE PROVIDE (COMPLETE) TRANSITION RELIEF?

### A. FAIRNESS

The major purpose of Engler-Knoll is to provide transitional relief for existing savers; its authors believe that without transition relief the tax is unfair to holders of capital and, perhaps in large part for that reason, politically unacceptable. I have stated the fairness argument earlier in this essay: taxpayers lose the basis in existing assets. As a result, savings

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9. See discussion *infra* Part V.

withdrawals that are tax-free under current law become taxable under a cash flow tax. Phrased in this stark form, the fairness of transition relief may seem obvious. It is not. I think fairness considerations argue against any broad-based transitional relief, and I believe my view reflects, or at least is consistent with, a prevailing strand of thinking in both economics and moral philosophy.<sup>10</sup>

The outline of the more general argument is that all government action invariably benefits some citizens and disadvantages others. A requirement that all losers are made whole would be impossible to finance unless accompanied by a rule that justified expropriation of gains to winners. This latter rule has never seriously been considered, in part, no doubt, because it would be impossible to administer. In many cases, an asymmetric rule that focuses only on losses would also lead to a suboptimal market treatment of risk. It will generally be more efficient to allow investors to take risks and realize the outcomes than to establish a rule that removes only the downside. A rule that leaves investors with the upside and downside of changes in government policy will also meet a prominent definition of fairness, at least to the extent that investors understand the risks. Risk will reduce asset prices, giving investors an ex ante positive expected return. The "option luck" investors then realize is from a gamble they have knowingly taken and have been compensated for. There is no need to provide additional compensation.

### *1. Has (and Will) Government Tax Policy Hurt Holders of Capital?*

My guess is that most readers will find the first few sentences of the preceding paragraph more convincing than the last few sentences. It is easier to see how the problems of asymmetrical compensation preclude government action than it is to treat investors as knowingly bearing the risk of every loss. Fortunately, we need not go that far to defend a general rule of no transition relief. We do not need to show that the losers have made knowing gambles because we can show that with respect to tax policy, the losers have been (and in this particular instance, are also) the winners.

Of concern here are the effects of a cash flow tax on the holders of capital. A point worth noting at the outset is that in the recent past, capital holders have been advantaged by changes in government tax policy. The rate of tax on investment income has declined dramatically, both

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10. See, e.g., Barbara H. Fried, *Ex Ante/Ex Post* (unpublished manuscript on file with the author). As noted by Fried, in moral philosophy, the proposition that we need not worry about the so-called "option luck" realized by investors is often attributed to Ronald Dworkin, *What is Equality? Part 2: Equality of Resources*, 10 *PHIL. & PUB. AFF.* 283 (1981). See also Richard J. Arneson, *Luck Egalitarianism and Prioritarianism*, 110 *ETHICS* 339 (Jan. 2000); G.A. Cohen, *On the Currency of Egalitarian Justice*, 99 *ETHICS* 906 (July 1989); Michael Otsuka, *Luck, Insurance, and Equality*, 113 *ETHICS* 40 (Oct. 2002). In tax, debate on this issue is sometimes said to stem from Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 *U. PA. L. REV.* 47, 53 (1977).

with respect to interest and so-called capital gain.<sup>11</sup> The declines in the tax rates increased the wealth of this group. These changes in rates were justified as good policy, and there has been no serious attempt to expropriate wealth added by those changes. The proposal to compensate holders of capital for changes that go in the other direction just seems odd. What principal of fairness would require compensation for losses but not expropriation of gains, when the gains and losses are suffered by members of the same group?

Of course, it might be objected that the gains from prior policy did not entirely accrue to current holders of capital. Some taxpayers have accumulated capital in the years following those changes. But it is not just past changes in policy that have advantaged capital holders. The very change at issue here—transition to a cash flow tax—will on balance advantage some capital holders and will bring some advantages to nearly all capital holders. The reason for this is that for most capital holders, the transition will have three primary effects. First, as noted above, it will eliminate basis in existing capital. Second, it will allow for tax-deferred reinvestment of income from capital. Finally, it will allow for tax-deferred investment of wage income. These effects will change behavior and that change in behavior will also affect welfare of capital holders. For example, savings may rise and labor may rise or fall, and that will affect the return to the capital holder's human and financial capital.<sup>12</sup>

The precise effect of the transition will, therefore, depend on innumerable factors, including, most notably, the earnings and consumption pattern of each individual. However, an example may illustrate some of the ways in which the switch affects welfare. Consider, for example, the 55-year-old lawyer with \$5 million in existing capital, net of a funded pension. The lawyer plans to work another ten years, to save part of her wage income, and to invest the remainder. The lawyer then plans to live off of her pension and leave her capital to her children. The lawyer has no basis in her pension so she is not disadvantaged by the treatment of the pension under a cash flow tax. Apart from the pension, the lawyer is a net saver. Under almost any assumption as to life expectancy—interest rates, discount rates, the consumption patterns of her children, or the effective tax of investment under current law—the lawyer and her family are likely to be advantaged by the change. The benefit of deferring tax on wage income and investment return will offset the loss of basis. Many other capital holders who are net savers will obtain the same result. Someone who has many years left to work and who can live in the meantime off part of her wage income will benefit; so will someone who

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11. Prior to the Tax Reform Act of 1986, for example, the maximum rate on capital gain was 20% and the maximum rate on interest income was 50%. WILLIAM A. KLEIN ET AL., *FEDERAL INCOME TAXATION* 4-7 (12th ed. 2000). The current maximum rate for most forms of capital gain is 20% and for interest income is 38.6%. I.R.C. § 1(g)-(i) (2002).

12. For a discussion and study of these effects, see David Altig et al., *Simulating Fundamental Tax Reform in the U.S.* (Sept. 29, 1999) [hereinafter *Tax Reform*], at <http://emlab.berkeley.edu/users/auerbach>.



has enormous capital and can live off part of her capital income. More typical, perhaps, is the holder of capital who saves for a period and then spends down her savings. The advantage of deferral on future savings may not offset the disadvantage of the loss of basis on pre-existing savings. But the loss suffered by this individual cannot be measured simply by looking at the effect of the loss of basis.

There will, of course, be some individuals whose loss is purely measured by the loss of basis. The pensioner who annuitizes her savings will fall into this category. But a blanket rule that provides transition relief to all holders of capital will not only cover this last category of persons, it will cover the first two categories as well. With respect to the first category, it would provide relief for persons who are beneficiaries of the change; with respect to the second category, it would provide relief in excess of the loss suffered.

Economists have attempted to model the distributional effects of the switch to a cash-flow tax. The results of these models show just how difficult it is to determine actual gains and losses, but support the basic intuition expressed above: those whose wealth is tied up both in wage-earning capacity and physical capital may benefit from the switch to the consumption tax. Consider, for example, the model developed by Altig, Auerbach, Kotlikoff, Smetters and Walliser.<sup>13</sup> The model divided the population into twelve wealth brackets. The model shows that the enactment of the flat-tax form of consumption tax, proposed some years ago by Representative Armey, would slightly reduce the welfare of those in the wealthiest bracket who were over age seventy at the time the proposal was enacted, but it would also produce an increase in the welfare of members of this group who were between thirty and seventy.<sup>14</sup> Adding transition relief would produce a gain in welfare to members of the wealthiest group who were over seventy and more substantial gains in welfare to members of the wealthiest group who were between thirty and seventy. Increasing the progressivity of the tax would make the case for transition relief somewhat more appealing. Under a more progressive "X" tax alternative, members of the wealthiest group who were sixty-five or over at the time of enactment suffer a decline in welfare. However, members of that same group who were under sixty-five realize an increase in welfare.<sup>15</sup> The model defines wealth as human and physical capital and so does not specifically isolate the effects of the change on holders of physical capital. As a practical matter, however, we can assume that a cohort of the wealthiest 1/12 of the population that is age sixty-four is a cohort whose wealth consists largely of physical capital. The fact that under the model such a cohort generally benefits from a switch to a consumption tax should make us think twice about the necessity of transition relief.

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13. *Id.* See also Kenneth L. Judd, *The Impact of Tax Reform in Modern Dynamic Economies*, in *TRANSITION COSTS OF FUNDAMENTAL TAX REFORM* (Alan Auerbach et al. eds., 2001), available at <http://bucky.stanford.edu>.

14. *Tax Reform*, *supra* note 12, at 27 fig.4, discussed at 26-28.

15. *Id.* at 30 fig.6.

## 2. *Transition Relief for Whom? The Relationship Between Wealth and Fairness*

Wealth may be defined, generally, as the sum of personal and real property (financial assets, land, and the like) and human capital. Some would go farther and include qualities such as health; others would go even farther and include or simply define wealth as utility. That said, for most policy purposes, property is a pretty good proxy for wealth. Transition relief for holders of all existing capital is transition relief for the wealthy. That itself does not mean that relief may not comport with an important notion of fairness. If transition relief for actual losses was feasible and economically sensible, and if such relief were granted as a matter of course to other citizens, then denying such relief to capital holders merely because they were wealthy would strike most as unfair. But, as noted above, transition relief for losses due to changes in government policy is not the norm. Consider, for example, changes in government trade policy from protectionism towards free trade. The changes are seen by many (perhaps most) as ultimately benefitting American workers. But the changes cost some workers their jobs and reduce the wealth of others whose livelihood depends on those jobs. These transitional losses are seen as undesirable, and some ameliorative steps are taken to lessen the impact, both by increasing general need-based assistance and by gearing some programs toward impacted communities. There has never been a serious attempt, however, to compensate all losers for all their losses. Seen in this light, the proposed transition rule seems inapposite because it would apply by and large only to the wealthy, would compensate both winners and losers among that group, and would overcompensate much of that group.

There is another notion of fairness, or a related moral desideratum, implicated in the proposed transition rule. This, however, argues against transition relief. A nearly certain effect of a cash flow tax is to increase the disparity in wealth.<sup>16</sup> The intuition behind this is that the most able (or at least the most highly paid) will be able to defer taxes on savings. The effect may not be as stark as once believed: one reason for the ascendancy of a cash flow tax among academics is that earlier estimates of distributional impact were analytically flawed. Still, the tax itself will tilt the distribution of wealth; the upper few percentile in lifetime wealth will be particularly favored. Adding transition relief to the switch greatly exacerbates this effect. For some libertarians and others, this development may not be at all troublesome. For most, though, whatever fairness-as-retention-of-basis concerns remain must be balanced against fairness or other norms implicated in an unequal distribution of wealth.

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16. See Bankman & Fried, *supra* note 6.

### 3. *Fairness as (or as Opposed to) Welfare*

An important effect of virtually all taxes is to reduce welfare by distorting behavior. With wealth held constant, an income tax reduces the incentive to work and save while a consumption tax (with wealth held constant) reduces the incentive to work. Individuals who avoid these taxes by substituting leisure for labor (or in the case of the income tax, present for future consumption) suffer a loss of utility, and with respect to these substitutions, the government gains no tax revenue. A cash flow tax applies to capital that has already been saved, perhaps garnered in the first instance from labor that has already been performed. Such capital can be taxed when consumed without reducing either labor or savings.<sup>17</sup> The resultant increase in revenue and welfare from a conventional labor or consumption tax is enormous. The increase in revenue makes it possible to reduce future tax rates while still coming up with a balanced budget. Economic projections show a significant percentage of the welfare gains from adopting a cash flow tax are attributable to the taxation of preexisting capital. Transition relief, of course, forfeits these gains.<sup>18</sup>

For strict utilitarians, the loss of welfare is a fatal flaw in Engler-Knoll. The loss of welfare exists because there is no independent norm of fairness to be maximized, and only utility can be maximized. For some, fairness is defined by utility maximization. For others, the loss of utility in Engler-Knoll is a drawback to be weighed against whatever fairness concerns remain.

### 4. *The Case for Limited Transition Relief*

I believe it would be wrong to assume from the foregoing that there is no fairness issue at all—only that across-the-board transition relief is uncalled for and conflicts with other notions of fairness or related norms. A

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17. In recent years, at least one leading scholar has questioned the ability to tax existing capital without distorting future behavior. Daniel Shavero argues that there is no such thing as a one-time tax; taxpayers with rational expectations will realize that what the government did once it could do again. DANIEL SHAVIRO, *WHEN RULES CHANGE: AN ECONOMIC AND POLITICAL ANALYSIS OF TRANSITION RELIEF AND RETROACTIVITY* 227 (2000). It is difficult to know exactly what to make of rational expectations arguments. On one hand, this form of argument suggests that taxpayers already factored into their labor and savings the risk of a cash flow tax. Since we have already suffered the consequences (in the form of reduced labor and savings), we might as well apply the tax. On the other hand, investors could not expect the exact same form of loss after the enactment of a cash flow tax, since they will have already gotten a deduction for savings and have no basis in their investments. The equivalent lump-sum tax effect would require not the elimination of basis but an increase in tax rates. My own take on the unanswerable question of what taxpayers have and will assume is that taxpayers will assume that the tax will be advantageous to capital. Taxpayers will not assume that the advantage of the deductibility of zero-rates on capital income will be offset by other post-enactment changes in tax law.

18. *Tax Reform*, *supra* note 12, at 4 (“[The] capital levy [born by existing capital] is crucial to both the efficiency and long-run welfare gains from switching to consumption taxation. It permits a permanent reduction in distortionary marginal tax rates . . .”). *Id.* at 28 (“all of the salutary long-run aggregate effects of the standard flat tax are mitigated by the introduction of transition relief, which must be financed by permanently higher tax rates.”).

better idea might be a limited transition provision designed to apply to those who are most likely to be net dissavers. One might imagine a proposal that allowed anyone over seventy at the time of enactment to spend \$75,000 tax-free. This amount would be reduced by the difference between pre-enactment basis and sales proceeds of any asset sold to fund the consumption. This tax-free spending amount would decline and might phase out entirely for those who were fifty-five at the time of enactment. I would not index this amount for deferred spending.

Such a transition rule undoubtedly raises a good deal of complexity. On the other hand, it allows the imposition of a more straightforward cash flow tax and avoids the basis account, which, regardless of its virtues, is certain to confuse most taxpayers. The transition rule does not attempt to fully compensate wealthy dissavers for the loss of basis. I believe, however, that it better balances the fairness issue that occupies Engler-Knoll with other fairness issues raised above, and with the long-term increase in welfare available from a conventional cash-flow tax.

#### B. THE POLITICS OF THE CASH FLOW TAX: DO WE NEED COMPLETE TRANSITION RELIEF?

Engler and Knoll believe transition relief is required because it is fair and because a cash flow tax without relief is “politically unacceptable.” The belief that broad transition relief will be needed to pass a cash flow tax is consistent with a long strand of tax scholarship and reflects a consensus reached by most involved in tax policy. In the early 1990s, however, the impossible happened or, to put the matter more accurately, almost happened. The so-called flat tax—based on a book by Robert Hall and Alvin Rabushka,<sup>19</sup> found fertile ground in the business and conservative media and by 1995 had become a legislative proposal sponsored by Rep. Dick Armey, himself an economist.<sup>20</sup> The flat tax was, in fact, a consumption tax. One notable feature of the measure is that it provided for no transition relief, and one notable feature of the debate over the measure was the lack of attention paid to transition relief. Those of us who spoke on the measure were surprised by the support it had among elderly holders of capital—the very group that would be disadvantaged most by the loss of basis. A conventional view, expressed in policy circles at the time and that I then shared, is that members of this group would sooner or later catch on to the loss of basis, and that any eventual measure would provide full transition relief.

I now think that assumption is incorrect. Enactment of a cash flow tax may be unlikely, but enactment of a cash flow tax with full transition relief is even more unlikely. To put the issue in a positive form: a cash flow tax with limited transition relief is politically more feasible than one with full transition relief. The reason for this is four-fold.

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19. ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d ed. 1995).

20. Freedom and Fairness Restoration Act of 1995, H.R. 2060, 104th Cong.

First, as discussed at some length earlier in this essay, a cash flow tax will benefit many holders of capital by deferring tax on wages and capital income. On the whole, some holders of capital will benefit from the switch to a cash flow tax. Others will be worse off under the cash flow tax, but the decline in welfare due to the loss of basis will be offset somewhat by opportunity for deferral. Thus, fewer voters will experience losses, and the losses experienced will be less, than is apparent if one looks only at the effects on basis.

Second, some of those who will be made worse by the change will support the cash flow tax on political/ideological grounds. My guess is that holders of capital generally favor measures to encourage capital formation. Support for these measures does not hinge upon personal benefit. Thus, a retired business owner may well favor generous depreciation allowances as the right thing for the nation, even if she feels the measure will not benefit her.

Third, some might not "catch on" to the full effects of the change and may not realize they are made worse off. This is particularly true of those who will, in fact, benefit from deferral but lose more from the loss of basis. The effects of the change depend on so many variables that even sophisticated taxpayers may not judge their own situation correctly. In theory, this last point is as likely to produce false negatives as false positives—that is, it is as likely to turn taxpayers who are advantaged by the switch into opponents as it is to turn taxpayers who are disadvantaged by the switch into proponents. In practice, my guess is that taxpayers will react to this uncertainty by overweighting the most salient or publicized characteristics of the cash flow tax. By far the most publicized characteristic will be the pro-capital nature of the new tax and the opportunities for tax deferral the new regime offers.

Fourth, as noted earlier in this essay, transition relief is quite expensive. The expense translates into higher tax rates. I suspect a cash flow tax is simply not salable if accompanied by significantly higher rates. To put the matter in a positive light, a cash flow tax without transition relief can be supported with lower tax rates. For taxpayers who are hurt by the switch, the lower rates will be important for the three reasons above: they will mitigate some of the loss, will be attractive on political/ideological grounds, and will be a prominent and, therefore, overweighted factor in the personal cost-benefit calculus. The enormous attraction of lower rates for all other taxpayers is self-evident.

My guess, and it is just that, is that the limited form of transition relief I suggest earlier will satisfy or at least soften many fairness concerns. It will also mitigate the costs of the switch for holders of capital least able to bear those costs. A cash flow tax with that limited form of transition relief will be more likely to get enacted than any variant of the Engler-Knoll, which, as noted above, provides transition relief in excess of costs for most holders of capital.

### III. DOES THE PROBLEM OF DEBT MAKE THIS THE RIGHT KIND OF TRANSITION RELIEF?

I have thus far argued that broad transition relief is unfair and unnecessary. It may be that I am simply wrong in this argument; wrong because there is a more subtle form of fairness argument that I am missing or wrong because I have misjudged the electorate and its representatives. If that is the case, transitional relief will be necessary. The conventional form of transition relief, noted in Engler-Knoll, is to allow holders of capital tax-free consumption equal to the basis of their capital. This is accompanied by a cash flow regime that defers tax on amounts saved. This produces a drain on the fisc that is particularly great in the first few years. (In later years, the problem is ameliorated, since the government, while continuing to lose revenue through deductible savings, gains revenue as past savings are consumed.) Engler and Knoll assume the government will need to issue debt to fund itself during this period but conclude that “[p]olitical difficulties make the new issuance of significant government debt an unlikely solution.”<sup>21</sup> They suggest that the reason debt cannot be issued is excessive attention to current deficit or the five-year scoring window.

I do not find this argument entirely convincing. The adoption of any serious tax reform proposal is unlikely, and the adoption of a cash flow tax still more unlikely. But I do not think that sort of reform will be precluded by a five-year scoring window or our “excessive” attention to deficit spending. The forces large enough to move toward a consumption tax would be strong enough to modify current rules on deficits to account for the transition costs of such a move. These forces would have a powerful argument: that the dynamics of a cash flow tax (with a zero basis in savings that will eventually be consumed) make future growth in government revenues a certainty. Congress has shown that it is willing to base spending decisions on the assumption that revenue will increase in future years. The dollars at stake will be larger here but, perhaps for the first time, there will actually be a sound basis for that assumption.

Moreover, it is not as if Engler-Knoll resolves the shortfall in revenue; it merely transfers it in time. Recall that under Engler-Knoll, no deduction is given for investment, but investment return is taxed at an effective rate of zero. The result is a steady state reduction in revenues, at least for many years. Those who worry about fiscal soundness will (or at least should) worry just as much about Engler-Knoll as a conventional cash flow tax.

### IV. DO ENFORCEMENT PROBLEMS SUPPORT ENGLER-KNOLL?

Wage income comprises the largest source of receipts under current law, and the tax on wage income is supported by employer reporting and

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21. Engler & Knoll, *supra* note 1, at 63.

withholding requirements. Engler-Knoll would effectively tax only wage income and so could rely on those same enforcement aids. Under a cash flow tax, tax is deferred on that portion of wages that is saved. Current withholding rules would need to be adjusted for this affect. A cash flow tax would also require greater monitoring of dissaving. Under current law, the sale of an asset generates no tax liability to the extent of basis. Some forms of savings, such as bank deposits or money market accounts, are subject to current taxation. No tax is due on withdrawal. In contrast, under a cash flow tax, the basis of all savings is zero, and the entire amount of dissaving is subject to tax. A cash flow tax thus increases the incentive to hide asset sales and creates an incentive to hide savings withdrawals.

Engler and Knoll conclude from this that a conventional cash flow tax raises greater compliance issues than their alternative. I think they are correct in this claim, but I do not know how important that advantage is. Engler and Knoll touch on the enforcement issue only briefly in their article. Footnotes guide the reader to other articles on the subject; these articles do not focus on the issue and spend roughly a few pages, a few paragraphs and a footnote, respectively, on the issue.<sup>22</sup> The lack of detail on this issue should not be taken as a criticism of Engler-Knoll or of the other sources. It is instead representative of how much we do not know about the implementation of a cash flow tax. Indeed, the lack of detail here reflects the added value of their and other articles on the subject.

My own guess is that the compliance problems are not so great as to tilt the balance in favor of Engler-Knoll over the conventional cash flow tax, which would operate like a giant IRA. Deduction for savings would be available only for amounts placed with qualified intermediaries, such as banks or brokers. These intermediaries would report withdrawals (just as intermediaries who handle IRA accounts now report withdrawals) and would withhold on withdrawals. There would be added costs if real property purchases were required to be held by an intermediary, who would be required to report and withhold on withdrawals. There would also be added costs to reduce wage withholding for savings and to reduce withholding on withdrawals from one intermediary that were used not for consumption but for investment with another intermediary. Recall, however, that Engler-Knoll also adds some new enforcement costs, because we must keep an eye on the basis account increasing the account for purchases, initial transfers, and the annual risk-free rate and reducing it for withdrawals. Additional complexities and costs are imposed under Engler-Knoll if we are to retain the present treatment of gifts.

## V. OTHER ISSUES

Engler-Knoll, like all other consumption tax proposals, raises innumerable design issues. Some of the issues are particularly important, such as

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22. See Engler & Knoll, *supra* note 1, at 65 nn.62-63.

the treatment of the corporate income tax or cross-border transactions. Engler and Knoll do not discuss these issues in the accompanying article but instead concentrate on the outlines of and rationale for their proposal. I think their focus is correct and have confined myself to commenting on the rationale and design detail they have provided. There will be plenty of time to discuss these other details before Engler-Knoll or any other cash flow tax becomes a likely alternative to our present tax.

## VI. CONCLUSION

My take on transition relief obviously differs from that of Engler and Knoll. They believe full transition relief is fair and only a cash flow tax with full transition relief is politically acceptable. I believe full transition relief is unfair; it overcompensates holders of capital, exacerbates unequal distribution of wealth, and reduces welfare. I think a cash flow tax with very limited transition relief, but lower rates, is more likely to be enacted. I also think Engler-Knoll, while ingenious and superior to the conventional consumption tax in some respects, will be a tough sell. Voters and legislators just will not understand the basis adjustment process.

Suppose, though, I am wrong in my political hunches: full transition relief is required, and Engler-Knoll resonates with the public. Suppose also, that a “modified” Engler-Knoll resolved my concerns about progressivity (perhaps through rates or perhaps through the transfer side of the ledger) and that the modified proposal addressed the nuts-and-bolts concerns that are certain to be raised. I would then regard Engler-Knoll as substantially preferable to present law and would support it in a heartbeat.



