IRET Institute For Research On The Economics Of Taxation

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THE INFLOW OUTFLOW TAX — A SAVING-DEFERRED NEUTRAL TAX SYSTEM

Introduction

The tax system presented in this paper was the last major work of Dr. Norman B. Ture before his death in August, 1997. It describes his view of an ideal, highly visible, and reasonably simple income tax that is neutral in its treatment of saving and consumption uses of income. It is a simple cash flow tax imposed on individual income. The cash flow accounting used in the proposal makes it a saving-deferred tax. The multiple layers of tax on estates, gifts, and corporations are eliminated. Together, these changes eliminate the current income tax bias against saving and investment and lead to substantial tax simplification. Dr. Ture developed this tax proposal in recent years with the help of his staff at IRET.

Two purposes of a good tax system — raising revenue and "pricing" government

Any restructuring of the nation's tax system should be based on a set of clear tax principles, which should be uniformly applied to the exercise. Those who would redo the tax system should start by recognizing the two key purposes of a tax system, 1) to obtain revenue to pay for government goods, services, and activities, and 2) to let the citizen-taxpayers know how much they are paying for government, so that they may decide in an informed manner how much government activity they wish to support with their votes.

Four principles or attributes of a good tax system — neutrality, visibility, fairness, and simplicity

A good tax system should fulfill its first objective, raising revenue, in a manner that does the least damage to the economy. The attribute required to achieve that objective is "neutrality." A neutral tax must be unbiased across economic activities, and, especially, not overly penalize work in favor of leisure, nor tax income used for saving and investment more heavily than income used for consumption.

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The second objective, letting voters know the cost of government, may be achieved by a tax system with the attribute of "visibility" or transparency to the taxpayers. A very large segment of the population must be made keenly aware that government costs money if government spending is to be held to levels at which its benefits match its costs. Toward that end, taxes should be paid by individuals, not hidden away at the business level or buried in the prices of products.

Additional principles or attributes of a good tax system include fairness (properly defined), and reasonable simplicity and clarity. Simplicity and clarity, in turn should lead to easy, low cost administration and enforcement of the tax rules by the government and low cost of compliance for taxpayers.

Neutrality. Neutrality means measuring income correctly and then levying taxes evenly on all uses of income by all income producers, without bias, to avoid distorting economic activity.

A neutral, unbiased tax system would begin with a sensible definition of income subject to tax. Income is a net concept, revenues less the cost of generating those revenues. Just as a business cannot reasonably be said to have a profit until its revenues exceed its costs of production (properly measured), neither can a worker or saver be said to have income until his or her revenues exceed the amounts spent on acquiring the skills or assets that will generate the revenues. The full value of all costs of earning revenues should be subtracted from revenues before any tax is imposed.

Once income has been accurately measured and allocated among taxpayers, it should be taxed even-handedly. Neutral treatment requires that all income be taxed at the same rate. It is improper to tax some income at a higher rate than other income, either through graduated tax rates or by imposing multiple layers of tax on some types of income but not on other types of income.

No tax system can easily avoid penalizing labor relative to leisure. However, keeping tax rates as low as possible and avoiding graduation avoids the worst of this distortion.

Making the tax system even-handed or neutral across various types of saving and investment, and between saving and investment and consumption, requires several steps. Multiple layers of tax on capital must be avoided, and the basic income tax bias against saving and investment must be eliminated by correctly treating saving and investment as costs of earning income. (For greater detail, see Appendix.) In particular:

• The transfer tax on estates and gifts must be eliminated.

> Most of an estate is saving that has already been taxed. Any parts of an estate that was tax deferred saving should remain tax deferred so long as the heirs continue to save it.

• The dual taxation of Schedule C corporate income at the corporate and individual level must be eliminated.

> The extra layer of tax on corporations can be eliminated either through "integration" of the individual and corporate income taxes or the substitution of a non-income type of tax system. Integration means that corporate income is recognized as belonging to the shareholders, and is taxed either on individual tax returns or corporate tax returns, but not both. This puts it on a par with income generated in proprietorships, partnerships, and sub-Chapter S corporations.

• The tax system must either allow savers to deduct saving or to exclude the returns on saving from taxable income.

> The income tax, by taxing both income that is saved and the returns on that income, taxes saving and investment more heavily than consumption. (See Appendix.) There are two ways to restore neutrality. One approach is to exclude all saving from taxable income while taxing all returns on the saving — a saving-deferred tax. This is the treatment currently allowed to a limited degree with pensions and deductible IRAs. The other is to include saving in taxable income but impose no tax on any of the returns — a yield-exempt tax. This is the treatment currently accorded Roth IRAs and tax exempt bonds. Other costs of earning income must also be expensed as occurred. Investment outlays must be deducted in the year the outlay is made (expensed), rather than depreciated over time, or otherwise delayed or ignored. (See Appendix.)

Several types of tax systems would serve to exclude saving and investment or their returns from tax, end the bias against saving and investment, and simplify the tax system. These "neutral" taxes include the unbiased income taxes (saving-deferred and yield-exempt) described above, retail sales taxes that exempt investment goods and business supplies from tax, and value added taxes that allow expensing of investment goods and other intermediate products and services purchased from other businesses at each stage of production.

Since several types of taxes are equally "neutral", choosing among them requires an assessment of their other characteristics and how well they stack up against other important attributes of a good tax system.

Visibility. Visibility requires that the tax system reveal clearly to the citizen/taxpayer what he or she must pay for government goods, services, and activities. Taxes are the "price" we pay for government; taxes "cost out" government for the taxpayer.

Compassion dictates that the very poor should not be subject to tax. Excepting the very poor, however, all citizens should pay something to help fund the outlays of the federal government in order that they understand that the resources used by the government are not free or costless. Taxes should be levied on the largest number of people consistent with compassionate treatment of those who cannot afford to pay.

At what stage in the flow of income should taxes be collected? At the business level, after it has made its payments to other firms but before its remaining revenues are paid out to its workers, savers, and investors? When the revenues are received by the workers and owners of the capital as earnings? Or when some portion of their income is spent on consumption?

Goods and services do not pay taxes. Businesses do not pay taxes. Only people pay taxes. All taxes, in fact, are taxes on income. Sales and excise taxes either depress sales of the taxed products, reducing the incomes of the people who provide the labor and capital used to make them, or they reduce the purchasing power of that income when the workers and savers attempt to spend it. Taxes collected by businesses fall in reality on the income of the businesses' shareholders or other owners, lenders, workers, or customers in the form of lower returns or wages or higher prices.

Since taxes are really paid by people out of income, they should be collected from people out of income. People see their tax liability most clearly when they pay an individual tax on the (properly defined) income that they have received, with a clear accounting, annually, at tax time. Taxes should not be hidden from taxpayers by being imposed on businesses as either corporate taxes, manufacturers excise taxes, or value added taxes. Similarly, taxes should not be hidden by being collected in bits and pieces over the course of a year as the taxpayer goes shopping, as either sales taxes or value added taxes.

Fairness. Fairness is often stated as making the rich pay a higher share of their income in taxes than the poor. Most people would agree that there should be some amount of income exempt from tax to shelter the very poorest citizens. Such an exempt amount imparts progressivity to the tax system. However, imposing further progressivity by means of graduated rates above the exempt amount is not consistent with fairness. Income is correctly understood to be the earned reward for supplying labor and capital services to the market. Except in rare cases, income closely matches the contribution of the effort and services provided by individuals to additional output. That fact, and the notion of equal treatment under the law, strongly urge that a proportional (single rate) tax on income (above the modest exempt amount) is the fairest.

Simplicity. Much complexity in the current tax code stems from its ad hoc approach to defining taxable income. The code is not based on any clear understanding of what constitutes income, nor accurate measurement of income, nor any set of coherent principles regarding the imposition of tax. This lack of guiding principles and resulting chaotic definition of income make for difficulties in administration and compliance, because neither the IRS nor the taxpayer can figure out clearly what is in or out of the tax base.

Most complexity is found at the business level or with respect to specialized investments of individuals. Taxation of wages and ordinary individual interest and dividends is fairly straightforward. Simplification should not go so far as to eliminate tax filing by individuals, as with a sales tax or VAT; that would sacrifice visibility to an unacceptable degree, and is not necessary to achieve significant simplification.

Ideally, a tax system should be easy for the government to administer and enforce, and be easy and inexpensive for taxpayers to comply with. Simplicity and clarity are the keys to achieving these goals. A clear definition of income and elimination of multiple layers of tax would create a system that is much simpler and easier to administer, enforce, and comply with than current law.

A tax proposal that conforms to the attributes and principles of a good tax system.

As mentioned, there are several types of (largely) neutral tax systems. Most achieve varying degrees of tax simplification. Unfortunately, most fail to do a good job with respect to visibility, which is one of the most critical attributes of a good tax system. (See Appendix for a comparison of these systems.)

The following is a tax proposal that conforms to all the attributes and principles of a good tax system. It is called the inflow-outflow (I-O) tax.

Overview. The I-O tax system is an individual-based saving-deferred tax with a number of additional deductions from revenue necessary to properly measure and allocate the income for tax purposes.

Inflows — an individual's revenues from work, saving, and transfer payments received — would be taxable. Outflows associated with earning the revenues (such as net saving, investment, and some education outlays), and income transferred to others (either voluntarily by gift or as mandatory tax payments) would be deductible. Net taxable income would, in effect, consist of revenues utilized for the individual's own consumption.

For neutrality and visibility, the net labor and capital income would be taxed once and only once on individual tax returns. For fairness, there would be personal allowances to shelter the poor from tax. For neutrality and fairness, there would be a single tax rate imposed

on income above the exempt amount. The single rate would eliminate the graduated tax rate bias against work, education, risk taking, and success, and would treat all individuals alike under the law.

Income must be attributed to the correct taxpayer. For visibility, income should be taxable to the final recipient of the income. People should be taxed only on the income over which they retain control and of which they enjoy the benefit. If one taxpayer gives revenue to another, either voluntarily (as by gift or charitable donation), or due to legal obligation or government coercion (alimony, fines, taxes), the donor should deduct that revenue from his or her taxable income, and the recipient should add that revenue to his or her taxable income.

Income must be defined properly. Income is a net concept, revenues less the cost of generating those revenues. Among the costs of generating income are: training and education in the case of labor income; the cost of acquiring income earning assets (saving and investment) in the case of income from capital. Costs of generating income must be deductible in full — expensed, not deferred (unless compensated by payment of interest to maintain present value).

Details of the I-O system follow. An illustrative sample tax form is on page 8.

Labor income. Individuals would pay tax on labor income (wages, salaries, self-employment income, and the value of non-pension fringe benefits) and pension receipts. The employer would report the total to the taxpayer on a W-2 form, as it does for cash wages and pension withdrawals under current law.

Transfers received. Individuals would pay tax on the taxable portion of social security. (All payroll taxes would become deductible in this tax system; therefore, over a phase-in period equal to a full working lifetime, all social security benefits would eventually become taxable.) Individuals would also pay tax on welfare and other transfer payments received from state and local governments and charities, insofar as they exceed the exempt amounts. (In practice, those who receive charity would usually be too poor to owe tax, and would not have to file a return.)

Income from saving and the net saving deduction. Individuals would deduct their saving (a cost of earning future income) from taxable revenues, and pay tax on all returns on saving (whether principal or earnings on the principal or earnings of an unincorporated business) when withdrawn. Reinvested returns would be tax deferred.

In effect, all saving would be treated like current-law pensions or IRAs. All income individuals transfer to financial intermediaries or other businesses through lending or the purchase of shares would be deductible by the savers. Only those earnings withdrawn or received by lenders, shareholders, or owners of an unincorporated business (and not reinvested)

would be taxable, and would be reported on the individual tax returns. The "inside build-up" of the saving in saving accounts, brokerage accounts, mutual funds, corporate shares, or unincorporated businesses would not be taxable. There would be no separate calculation of capital gains; they would be covered in the proceeds from the sale of assets (whose full cost was deducted at the time of purchase). The proceeds would remain tax deferred if reinvested. For example, trades within a brokerage account would not be reportable unless money was withdrawn from the account.

Pension contributions by employers and employees currently excluded from employees' incomes would remain deductible saving. Since all saving could be deducted in this system, all current-law restrictions on the amounts allowed as contributions and withdrawals under employer-sponsored pension plans would be eliminated.

The deduction for saving would be for net saving. Borrowing would be considered "dissaving" and be considered taxable revenue to be netted against amounts saved. However, borrowing would result in an immediate tax liability only if used for consumption. Borrowing used to buy assets such as stocks or a machine for one's business would not result in more taxable income because the investment outlays would be deductible saving. Also, repayment of debt and interest paid on debt would be part of deductible saving. (But see alternative treatments of home purchases, below.)

Each financial institution with which the taxpayer had dealings would report the taxpayer's net saving or dissaving for the year as a single number on a 1099 form, like those currently in use to report interest or dividends on Schedule B. There would be no need for the taxpayer to track all of his or her deposits and withdrawals over the year to calculate the net amount. There would be no separate Schedule D for capital gains.

Deductions of transfers paid. Charitable contributions would be deductible by the donor. (As indicated above, the charitable gifts would be taxable to the ultimate recipient, who would seldom have sufficient income to owe tax. Current law simply allows the charitable deduction and ignores the other side of the calculation.)

All payroll and state and local taxes would be deductible as income over which the taxpayer has lost control and transferred to others. State and local taxes are involuntary outflows. They largely fund welfare and other aid to the poor (income transfers akin to charitable contributions to persons below taxable levels of income) or education (a transfer that pays for the cost of the recipient's acquisition of human capital), all of which could be considered to be reasonable deductions. Law enforcement and fire protection are services to the taxpayer, but constitute remedies for or protection from casualty losses, and ought not to be considered beneficial income. There are some local government services that accrue to the individual taxpayer or homeowner, such as water, sewer, and trash pick-up, but these are often billed separately, in which case they would not be deductible.

Form 1040: Individual Tax Form, Inflow Outflow Tax	
1. Sum of: Labor compensation, Pension receipts, Taxable social security, Transfer payments (from W-2 forms)	$33,000
2. Net saving (+) or net withdrawals from saving (-) (from Schedule B)	$3,000
3. If line 2 is net saving (+), subtract the dollar amount from line 1; if line 2 is net withdrawal from saving (-), add the dollar amount to line 1.	$30,000
4. Other itemized deductions from Schedule A	$10,000
5. Subtract line 4 from line 3.	$20,000
6. Personal allowance times number of taxpayers and dependents: _$5,000_ x __2__ =	$10,000
7. Subtract line 6 from line 5. This is your taxable income.	$10,000
8. Tax from table (or, line 7 times 20%).	$ 2,000
9. Amount withheld, from W-2, plus estimated tax payments.	$ 2,100
10. Amount due (+) or amount overpaid (-) (line 8 less line 9). If amount is due, pay Internal Revenue Service.	- $ 100
11. If overpaid, fill in: Amount to be refunded _$100_; or Amount to be applied to estimated tax ______.	

Schedule A, Itemized Deductions	
1. Sum of individual payroll tax (from W-2), state and local income tax withheld (from W-2) and estimated state and local tax less refunds from previous year, and local property taxes.	$ 5,000
2. Gifts, contributions.	$ 1,000
3. Qualified tuition, training expenses.	$ 4,000
4. Total. Enter on Form 1040, line 4.	$10,000

Schedule B, Saving	
List net saving (+) or withdrawals (-) from financial institutions reported on 1099 forms.	
First National Bank	-$1,000
Merrill Paine Schwab	+$4,000
Total (if greater than zero, this is net saving; if less than zero, this is a net withdrawal). Enter on Form 1040, line 2.	$3,000

Deductions of cost of acquiring human capital. Individuals would deduct some portion of the cost of training and education. Tuition and other training costs are already largely deductible in the form of property taxes at the local level that pay for primary education, and state income taxes that assist state universities. Tuition paid directly by the student could be considered for similar treatment. However, there is also a "consumption" or general living element of education; it is not all a cost of earning future income. Some rough adjustment must be made in what will always be a gray area.

Treatment of home ownership. We do not recommend "pure" inflow-outflow treatment of the owner-occupied home, which would be to treat it (as in the national GDP accounts) as an investment yielding income in the form of shelter. Pure treatment would include the imputed rent from the owner-occupied home in taxable income, plus the mortgage borrowing that financed the home; it would allow a deduction for the purchase price of the home, the repayment of mortgage principal and interest, and outlays on maintenance.

This pure approach to the treatment of owner-occupied homes is far too difficult to calculate. The alternative approach to neutral treatment of saving — no deduction for the purchase of the asset, but no tax on the returns, is an easier alternative, and the I-O tax would adopt it in this instance. Neither the imputed rent nor the mortgage borrowing would be taken into the homeowner's income. In exchange, there would be no deduction of the purchase of the home, outlays for maintenance, nor repayment of mortgage principal and mortgage interest.

Treatment of businesses. There would be no separate taxation of businesses in a saving-deferred tax. As discussed above, businesses would be treated like pensions or IRAs owned by the savers: all income individuals transfer to businesses through lending or the purchase of shares would be deductible by the savers; only those business earnings distributed to lenders and shareholders (and not reinvested) would be taxable, and would be reported on the individual tax returns. The "inside build-up" of the saving in the business would not be taxable.

The non-tax status of business in the inflow-outflow tax is not just by fiat. The normal rules of the inflow-outflow tax automatically render a business a non-taxable entity. Businesses would not be taxable because their deductible outflows would always equal their inflows.

Business inflows include the revenues from sales of goods and services and income on financial investments, plus borrowing from lenders and sales of new shares to stockholders. Business outflows include operating costs — wages, purchases of materials, inventory, outlays on research and development, rent and royalties paid, and all outlays for investment in plant and equipment, structures, and (unlike current law) land — plus state and local taxes and federal payroll taxes, interest payments to lenders and dividend payments to shareholders. These outflows are all costs of earning income or transfers of capital income to lenders and shareholders for taxation on their returns. Any left-over revenues saved by the business should

be considered tax-deferred saving by the shareholders. Nothing would remain to be taxed at the business level. Consequently, there would be no need for businesses to file an income tax return, eliminating most of the accounting, auditing, and costs of enforcement and compliance in the current tax system.

In this system, the deduction for business investment would effectively be passed along to the savers who lend money to, buy shares in, or otherwise invest in the business. Savers would fully deduct their purchases of stocks and bonds. These proceeds of stock and bond issues, plus what we now call retained earnings, would just equal the operating costs and (deductible) capital investment and net saving of the business, eliminating taxable business income. This pass-through of the deduction for investment would be an advantage for start-up businesses that have little income as yet from previous investments against which to take a deduction. It effectively eliminates the problem of net operating loss carry forwards that delay and reduce the value of deductions for investment and raise the cost of capital under current law.

Territoriality. The tax would be territorial, imposed on income generated within the United States, not on income earned abroad. There would be no deduction for saving invested abroad, and no tax on the returns. There would be no credit for foreign taxes paid on foreign income repatriated to the United States. Territorial taxation would substantially reduce the confusing treatment of foreign source income that cripples American firms attempting to compete abroad. The tax would not be "border-adjustable", that is, it would not be forgiven on exports and imposed on imports, because the producers of the exports worked and earned their income in the United States, and should be taxed just as all other U.S. producers, while the producers of imports worked and earned their income abroad, where it is subject to foreign taxes.

Conclusion

The inflow-outflow tax is a neutral, highly visible tax system. It correctly measures income, providing revenue to the government with minimal disruption to the economy. It allocates income for tax purposes, appropriately, to the final recipients of the income, thereby informing the citizen-taxpayer of the tax cost of government. The I-O tax also achieves a significant degree of tax simplification compared to current law, and reduced costs of administration and compliance. The I-O tax achieves these results in a superior fashion compared to most other major tax reform proposals. It is deserving of serious consideration by policy makers and students of political economy.

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