

USC Gould

School of Law

Paul Ryan's Roadmap to Inequality
(136 *Tax Notes* 1195 (2012))

Edward D. Kleinbard
USC Gould School of Law

**Center in Law, Economics and Organization
Research Papers Series No. C12-12**

Legal Studies Research Paper Series No. 12-18

September 6, 2012

Paul Ryan's Roadmap to Inequality

By Edward D. Kleinbard



Edward D. Kleinbard

Edward D. Kleinbard is a professor at the University of Southern California Gould School of Law and a fellow at the Century Foundation. He can be reached at ekleinbard@law.usc.edu.

The purest articulation of Republican vice presidential nominee Paul Ryan's fiscal belief system is his 2010 Roadmap for America's Future. The tax provisions of this extensive proposal would convert the current personal and corporate income taxes into two consumption taxes and repeal the gift and estate tax.

This article explains how the roadmap, like Herman Cain's 999 plan, would operate in practice like a large new payroll tax. The roadmap would immunize the highest-labor-income earners from this tax through a large reduction in the top rate of the roadmap's labor earnings tax, compared with current law or policy. Unlike the 999 plan, the roadmap further would largely immunize "old" capital from the efficient (if arguably unfair) imposition of consumption tax when that capital was consumed, by providing a write-off of existing depreciable basis. The roadmap would further reduce the tax burdens on the most affluent capital owners by eliminating the gift and estate tax.

For those reasons, it is not surprising that the roadmap contemplates an extraordinarily large redistribution of tax burdens from the affluent to middle- and lower-income Americans. For middle-income families, tax burdens would increase on the order of 50 percent. At the same time, the impact of the roadmap's reprioritization of government spending also would be regressive. Proponents of the roadmap or plans like it must explain how any projected increase in economic growth will compensate the majority of Americans for shouldering more tax burdens while receiving fewer government benefits.

Introduction

The only consolation enjoyed by the minority in the House of Representatives is that a member is

free to introduce bills representing his most idealized legislative agendas, free of any troubling compromises, because both he and potentially affected parties are secure in the knowledge that the legislation will not receive a hearing, much less become law. For this reason, it is fair to treat as the purest expression of Republican vice presidential nominee Paul Ryan's fiscal belief system his 2010 Roadmap for America's Future.¹

Ryan has a deep knowledge of federal budget arcana and equally deep convictions about the direction that long-term budget policies should take. Unlike many other politicians, Ryan has articulated those convictions in comprehensive fiscal proposals, both when he was in the minority party in the House and in his current capacity as chair of the House Budget Committee. His roadmap, prepared when he was in the minority, includes a detailed report and a 629-page legislative draft, of which the tax sections alone (titles V and VI of the draft legislation) total some 100 pages.

The roadmap contemplates a much more radical restructuring of the federal tax system than is commonly appreciated. The Ryan roadmap essentially would convert the current income tax into two consumption taxes, economically indistinguishable from sales taxes or a European-style VAT. Its economic effect and redistribution of tax burdens are broadly similar to Herman Cain's 999 plan, analyzed in a prior report.²

It is possible to implement consumption taxes without radically affecting the distribution of tax burdens, but this is not what the Ryan roadmap does. Instead, it uses the rhetoric of economic efficiency to propose the elimination of most taxes on capital income (for example, dividends, interest, capital gains, and net business profits) and the lowering of the top tax rates on labor income. The roadmap finances those goals by greatly increasing the tax burdens on labor incomes below the highest levels, which is to say the incomes of most Americans.

¹Paul Ryan, "A Roadmap for America's Future: Version 2.0" (Jan. 2010), *Doc 2010-2100*, 2010 TNT 19-31.

²Edward D. Kleinbard, "Herman Cain's 999 Tax Plan," *Tax Notes*, Oct. 24, 2011, p. 469, *Doc 2011-21789*, 2011 TNT 205-25.

Like Cain's 999 plan, the Ryan roadmap's mechanism for redistributing tax burdens down the income scale is a large increase in payroll-tax-equivalent taxes, in this case by about 50 percent for Americans under the payroll cap (currently about \$110,000). The Ryan roadmap then would immunize the very-highest-labor-income Americans from any adverse consequences by pairing that higher effective payroll tax with much lower income taxes on large labor incomes.

Because payroll taxes are the dominant federal tax burdens on middle- and lower-income working Americans,³ and because by definition capital income is a property of capital ownership, which in practice in the United States is highly concentrated, most ordinary Americans would see their tax burdens increase by about 50 percent, while the most successful individuals would see reductions in their labor income tax rates and elimination of all capital tax burdens — including the gift and estate tax.

This article briefly analyzes the most salient features of the tax system proposed in the roadmap. Because the overall economic effects of the Ryan roadmap and Cain's 999 plan are more similar than might at first be apparent, this article reprises a few paragraphs on the basics of consumption taxation from my earlier analysis of the latter plan.

The Roadmap's Tax Plan

Very generally, Ryan's roadmap contains the following tax proposals:

- eliminate all tax on capital income earned by individuals;
- reduce the top tax rate on what is left (labor income) to 25 percent;
- repeal the corporate income tax;
- eliminate gift and estate taxes; and
- introduce a new 8.5 percent business consumption tax (BCT). This has the same economic characteristics as a national VAT or sales tax.

More specifically, the roadmap would offer individual taxpayers a choice between paying tax under the current income tax and a new "simplified income tax." The detailed legislative specifications for the new simplified income tax are surprisingly ambiguous, but apparently the intention was that the definition of gross income would be modified for purposes only of the simplified income tax to exclude from gross income net capital gains, quali-

fied dividends, and interest income.⁴ Also, the alternative minimum tax would be repealed. Taxpayers could flip once in a lifetime between the two systems, or again as a result of some major life events.

The Ryan roadmap's capital income exclusion would not reach every form of nonbusiness capital income. It would not, for example, exclude from gross income rents, royalties, or net short-term

⁴Proposed section 139D in the roadmap draft legislation (Ryan, *supra* note 1, at 434). The reading of the draft legislation adopted in the text as applying only to the simplified income tax arguably is inconsistent with the actual language of the draft legislation, but follows the interpretation adopted by the Tax Policy Center, *infra* note 25, in its analysis of the *Roadmap*. The Tax Policy Center in turn had the advantage of direct conversations with the drafters in resolving some of these ambiguities.

Read literally, that proposed new code section simply modifies the definition of gross income, which in turn is the starting point for determining an individual's tax base under both the existing income tax and the new alternative simplified income tax (proposed section 5). Accordingly, a straightforward reading of proposed section 139D would have it modify both tax systems.

This literal reading is consistent with the text of the roadmap's explanation, which consistently lists the elimination of capital income tax as a separate feature from the new simplified income tax. *See, e.g.*, Ryan, *supra* note 1, at 57, which lists the first two tax components of the roadmap as "Full repeal of the AMT" and "Elimination of Double Tax on Savings." The third component, "Taxpayers Choice," introduces the simplified income tax, and it neither constrains the application of the capital income provisions discussed in the second heading to that new tax alone, nor limits the capital income provisions to the regular tax base.

On the other hand, proposed section 5 (Ryan, *supra* note 1, at 426) is oddly drafted. The tax base of the simplified income tax is "alternative taxable income," defined in section 5(c). Section 5(c)(1) provides that alternative taxable income means "(A) gross income, [sic] (B) the amount excluded from income under section 139C [sic] for capital gains, dividends, and interest, minus (C) [the standard deduction, dependent allowance, and personal exemption]."

There is no conjunction between clauses (A) and (B), and clause (B) technically is unnecessary if its purpose is to exclude capital income from taxation (for example, by assuming that there should be a "minus" after clause (A)), because that already is resolved through the definition of gross income as excluding those amounts. Nonetheless, because the entire thrust of the roadmap's explanation in this regard is to eliminate capital income taxation, the roadmap has universally been read to exclude capital income from the base of the simplified income tax, which suggests that one should not read an implied "plus" after clause (A).

For the reasons suggested at the beginning of the note, this article adopts the view that proposed section 139D was intended to apply only to the simplified income tax. Even if the proposed exclusion were to have applied to both tax systems, in practice little would have changed, as the great preponderance of owners of substantial amounts of investment capital could be expected to opt into the simplified income tax.

To add to the confusion, after the roadmap was drafted, Congress added another section 139D to the code. That section deals with Indian healthcare benefits.

³The best single overview of the relative individual tax burdens of Americans is a table prepared by the staff of the Joint Committee on Taxation in 2010. *See* JCT, "Present Law and Background Data Related to the Federal Tax System in Effect for 2010 and 2011," JCX-19-10, at Table 11 (Mar. 22, 2010), *Doc* 2010-6171, 2010 TNT 55-25.

capital gain.⁵ Nonetheless, the exclusion is sufficiently broad that for convenience I refer to it below as covering individuals' capital income, without repeating the qualifier each time.

The simplified income tax base would not include any deductions beyond personal exemptions, dependent allowances, and a \$25,000 standard deduction. Similarly, the simplified income tax system would remove all existing personal credits like the child tax credit or the earned income tax credit (but would include a proposed new medical coverage tax credit). Taxable income up to \$100,000 would be taxed at a 10 percent rate; taxable income beyond that would be taxed at a 25 percent rate.

By way of one example, in the first year of the simplified income tax a family of four would be entitled to a standard deduction, personal exemptions, and dependent allowances totaling \$39,000. If this family had gross income of \$139,000 from wages, its tax liability under the simplified income tax would be \$10,000. By contrast, if the same family in 2011 claimed the standard deduction, four personal exemptions, and no credits on its income tax return, its income tax liability would be more than double that amount (\$20,400). (Of course, actual liabilities under current law could be lower, for example by virtue of itemized deductions, but subject to the reach of the AMT.)

The most affluent Americans generally would opt for the simplified income tax, since it lowers marginal tax rates relative to the current system. (One exception might be individuals who regularly give a large percentage of their income to charity.) The principal price for doing so would be the loss of personal itemized deductions, but as one climbs to the top of the income ladder, these benefits often will be dominated by the large marginal tax rate cut. Families climbing the income ladder from a more modest base presumably would avail themselves of current law until their income rose sufficiently to warrant the one-time switch to the simplified system with its lower rates but no credits or itemized deductions.

The BCT essentially would operate as a subtraction method VAT.⁶ All outflows, including for capital improvements, would be currently expensed, other than labor costs, which would not be deductible; all inflows from sales of goods and services would be included in the tax base.⁷ Financial flows generally would be ignored, so in standard public

finance terminology, the BCT generally would operate as an "R-based" consumption tax.⁸ The BCT would be border adjustable so that it would apply to imports and essentially be refundable for exports.⁹

The BCT would apply to all businesses, including sole proprietorships and other entities not subject to tax today.¹⁰ In a move designed to elicit bipartisan support from tax students everywhere, the roadmap also would repeal the consolidated tax return rules.

Business entities today have large stocks of capital investment subject to future depreciation or amortization. Under a special transition rule, the BCT would permit corporations to write off their existing tax basis in capital investments over the shorter of their remaining depreciable lives or five years.¹¹

One important question is the revenue impact of the roadmap's tax provisions. Neither the staff of the Joint Committee on Taxation nor the Congressional Budget Office has released to the public any study modeling the projected revenue consequences of these tax provisions. Instead, Ryan directed the CBO to *assume* that in equilibrium, the new tax regime would raise revenues equal to 19 percent of GDP (a bit higher than the 1977-2007 average).¹² It can be argued that the CBO ought not to have agreed to assume conclusions that were in fact testable under its existing models, but its analysis of the roadmap does so in this regard and in several other important respects.

Income Taxes and Consumption Taxes

Income in the broadest sense comes from only two sources: labor and returns on investments (capital). Outside classrooms, we do not worry much about treasure troves or cash stuffed inside pianos bought at the flea market.

In recent years, roughly 60 percent of U.S. gross domestic income has come from labor, and 40 percent from capital.¹³ (This allocation is more

⁵Kleinbard, *supra* note 2, at 475.

⁹Technically, an exporter's cost of goods would be deductible but its export sales would be ignored. I have not found a provision allowing for cash refunds if a company is predominantly an exporter and therefore incurs a net loss from the deduction of its costs.

¹⁰Proposed section 206. Ryan, *supra* note 1, at 449.

¹¹Proposed section 290. Ryan, *supra* note 1, at 527. That proposed code section also contains a similar five-year transition rule for interest expense. *See also* proposed section 226. *Id.* at 472 (no double deduction or double inclusion for amounts deducted or included under prior law).

¹²CBO, letter to Ryan, at 4 (Jan. 27, 2010), *Doc 2010-2040*, 2010 TNT 19-17.

¹³CBO, "The Budget and Economic Outlook: Fiscal Years 2012 to 2022," Figure 2-8 (Jan. 2012), at 42, *Doc 2012-1855*, 2012

(Footnote continued on next page.)

⁵Proposed section 139D would exclude only net capital gain, which for any year is the excess of net long-term capital gain over net short-term capital loss. *See* section 1222.

⁶*See* Ryan, *supra* note 1, at 59, which describes the BCT in these terms, albeit without using the phrase "value added."

⁷Proposed sections 202-205. Ryan, *supra* note 1, at 440-449.

heavily weighted toward capital income than was true a few decades ago, when the split might better have been summarized as 65-35.¹⁴) This means that we can expect the taxation of capital income to be relevant as a matter of government revenues, as well as having important economic efficiency consequences.

Income taxes are designed to tax both labor and capital income, although often at different rates (in the case of the U.S. tax system today, at a hodgepodge of different rates on different forms of capital income). By contrast, well-designed consumption taxes exempt from tax one slice of capital income: the “returns to waiting” — the core, boring “normal” rate of return on investment.¹⁵ Well-designed income and consumption taxes thus are identical in their economic effect when applied to a taxpayer who spends her entire income on a current basis; their only economic difference lies in the treatment of the return to waiting.

The reasoning behind consumption taxes is that money’s only purpose is to fund consumption, either today or tomorrow. The “normal” return on investment is seen as the price I demand for deferring the current enjoyment of my labor income. By exempting this one slice of capital income from tax, a consumption tax preserves neutrality in my consumption decisions: If I consume tomorrow, I pay tax on my larger total consumption, but not on the internal compounding of my savings at the normal rate of return. I therefore theoretically am indifferent, as a tax matter at least, between consuming today and consuming tomorrow: In either case, the present value of my total consumption experience is the same. This is why a well-designed consumption tax is said not to “double tax” savings, once when the money is earned through my labor, and again by taxing the minimum return necessary to compensate me for deferring my consumption.

By eliminating this double tax on savings, it is argued, consumption taxes will lead to higher savings, which in turn will fund greater business

investments, leading to higher national incomes. Surprisingly, the empirical case for increased savings in response to lower capital income taxes is much more ambiguous than might be expected. The explanation for this weak response is fraught with questions and filled with conflicting theories and strongly held opinions.

A consumption tax can be implemented as a sales tax or VAT, a labor-income-only tax, or one of various forms of “cash flow” taxes. The idea in every case is the same — the tax system should not encourage current consumption over future consumption by taxing the return to waiting. All consumption taxes implement this theme in one fashion or another, offering taxpayers the opportunity to compound their returns from waiting at a tax-free rate of return.

A sales tax reaches this result directly by taxing consumption when it occurs, rather than when the income to fund that consumption is earned. (Sales taxes of course are notoriously easy to evade, which is why most countries have adopted a VAT, but this report ignores those practical issues.) For example, if the return to waiting (the normal return on investment) is 6 percent per annum, the world values \$106 of consumption next year as equivalent in value to \$100 of consumption right now. If we wish to preserve that relationship so that the tax law does not distort my decision to spend today or to wait and spend tomorrow, we theoretically can get there through a sales tax alone; because there is no income tax in this hypothetical world, interest earned on my bank account (at a compounding rate of 6 percent) while I wait to consume is not itself taxed (that is, accumulates at a tax-free return) until it is withdrawn from the account and consumed. The point is not that I escape tax in perpetuity on any of my capital income returns, but that by deferring tax I am preserving the present value of consumption at different points in time.

For example, imagine that I have \$100 to spend today, including any sales tax bills, and that the sales tax rate is 8.5 percent. With that \$100 spending constraint, I can spend \$92.17 on stuff and pay \$7.83 in sales tax. Alternatively, and again assuming that the return to waiting interest rate is 6 percent, I can invest that \$100 today and have \$133.82 to spend five years from now. If the only relevant tax is the sales tax, I would then be able to buy \$123.34 of stuff and pay \$10.48 in sales tax. As a tax matter I would be indifferent between the two scenarios, because \$92.17 of stuff today and \$123.34 of stuff in five years have identical present values to me, at a discount rate of 6 percent per annum — which by hypothesis is the fair market price for waiting.

I like to conceptualize this point as follows. When I earn \$100 in compensation income in the example

TNT 21-26 (labor income share of gross domestic income estimated to be roughly 60 percent in 2012 and 2017).

¹⁴*Id.* at 41, n.27. The CBO allocates 65 percent of proprietorship and partnership income to labor and 35 percent to returns to capital, based on this older benchmark.

¹⁵For discussions of the underlying economics, see, e.g., JCT, “Present Law and Analysis Relating to Individual Retirement Arrangements,” JCX-53-08 (June 24, 2008), at 3-7, *Doc 2008-14045*, 2008 TNT 123-15 (and articles cited therein); JCT, “Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II,” JCX-63-07 (Sept. 4, 2007), at 6-7, *Doc 2007-20256*, 2007 TNT 172-13; and Daniel Shaviro, “Replacing the Income Tax With a Progressive Consumption Tax,” *Tax Notes*, Apr. 5, 2004, p. 91, *Doc 2004-6003*, or 2004 TNT 66-48.

above, I immediately incur a contingent \$7.83 sales tax liability — that is, the \$100 of earnings can buy only \$92.17 of stuff, plus sales tax thereon. If I spend all \$92.17 immediately, the tax liability crystallizes instantly. If I defer consumption, I can understand my situation as my putting \$92.17 in the bank to fund future consumption, where it will earn 6 percent tax free until I withdraw it for consumption. At the same time, I establish a little \$7.83 rainy day tax fund, which also grows at the same 6 percent and therefore will always cover my tax liability on my growing consumption account. So in sum, a well-designed consumption tax allows me to earn a *tax-free yield* (here, 6 percent) on my *after-tax income* (\$92.17) — that is, my income after setting aside enough to cover my contingent sales tax liability.

In theory, one also can implement a consumption tax by starting with an income tax structure and then exempting capital income from tax — that is, by imposing tax only on labor income. Instead of the 8.5 percent sales tax in the example above, one can imagine a tax system that imposes an immediate 7.83 percent income tax on my \$100 of compensation income but then imposes no further tax on my investment income.¹⁶

A labor income tax gets you to the same place as a sales tax if three conditions are satisfied: (1) tax rates do not change; (2) all investments yield a normal return (that is, I earn no supersized returns, as discussed below); and (3) the tax system can easily distinguish my (taxable) labor income from my (tax-exempt) capital income. In real life, of course, tax rates change, some corporate investments in particular yield supersized returns (in more formal discourse, “economic rents”), and tax systems do a terrible job of teasing apart labor income from capital income, as the sad saga of carried interest taxation demonstrates.¹⁷ For these reasons, a labor income tax is usually thought to be a poor way of implementing a consumption tax.

A cash flow tax is the third basic way of implementing a consumption tax.¹⁸ What’s the theory of cash flow taxes? Remember that the idea of consumption taxes is to exempt from tax the return to waiting — that is, low-risk “normal” returns on investment — so that future consumption has the same present value as current consumption. The theory of cash flow taxes is that you can get to the

same point as exempting normal returns from tax simply by deducting all your investments currently. That is, deducting the cost of an investment has the same economic consequences as exempting from tax the normal yield on the investment.

How so? If you can immediately deduct the cost of the investment, you get (in this theoretical world) an immediate tax benefit, which the government hypothetically instantaneously refunds to you. You can use that refund check to buy more of the same investment and get another (smaller) check, and reinvest that, and so on. The end result is that you get enough in tax savings to “scale up” your investment to the point where your after-tax yield is the same as tax exempting the yield on your original investment.¹⁹

For example, imagine that tax rates are 50 percent, normal returns are 6 percent, and you buy for \$100 a perpetual machine yielding normal returns. An ideal income tax system would provide that you could never claim any depreciation deductions on this machine that never wears out; as a result, your returns from the machine (and more mini-machines that you buy each year with your after-tax earnings) would compound at a rate of 3 percent per annum (the 6 percent pretax rate less tax of 50 percent). By contrast, a labor income tax (or “yield exemption”) approach to a consumption tax would give you a 6 percent after-tax compounded return (by imposing zero tax on normal returns to capital); the only tax would have been collected when you earned the labor income out of which you funded your \$100 purchase.

Finally, the “deduct now, include later” model — that is, a cash flow tax — would provide that the returns on that \$100 machine are fully taxable but that you get an instant write-off when you make the investment. Then in theory you could spend \$200 on two of the machines, which would cost you only \$100 after tax (the same as the first case). You would now earn \$12 per year and pay tax at the 50 percent rate, which would yield you \$6 per year after tax.

A cash flow tax can be analogized to a regular IRA; a pure labor income tax can be analogized to a Roth IRA. The two have identical economic payoffs (for the same after-tax contributions), as long as one is talking about constant tax rates and normal returns on investment. The two differ, however, in how supersized returns (economic rents) are taxed. A cash flow tax is generally thought to tax economic rents on a current basis because the scale-up hypothesis doesn’t work here. By definition, economic rents aren’t infinitely scalable, because if they were,

¹⁶The two rates are nominally different because one is expressed as a “tax-inclusive” rate and the other as a “tax-exclusive” one. Kleinbard, *supra* note 2, at 471-472.

¹⁷On the general difficulty of separating labor from capital income, see Kleinbard, “An American Dual Income Tax: Nordic Precedents,” 5 *Nw. J. L. & Soc. Pol’y* 41 (2010).

¹⁸The following discussion of the cash flow theory comes from Kleinbard, *supra* note 2.

¹⁹This is the famous “Cary Brown theorem.” See the sources in note 15, *supra*.

everyone would have done so already. By contrast, a pure wage tax (investment yield exemption) system effectively exempts economic rents from tax.

Imagine, for example, that you sort through the coins in your pocket and discover you received as change for your last purchase a magic penny that has the unique property of throwing off \$100 a year in income. In a cash flow tax, that \$100 would be taxable on a current basis. (You would get a tax deduction for your \$0.01 investment, but that has no meaningful consequence.) In a wage tax (yield exemption) system, the full \$100 of income would escape tax permanently as a return on capital (albeit an enormous return) and therefore as outside the scope of the wage tax. For this reason, readers should hold their magic pennies in a Roth IRA rather than in a regular IRA.

Labor Income Under the Ryan Roadmap

Characterizing a given tax as an income or consumption tax is helpful because it enables an observer to fairly compare the new levy with ideal forms of the relevant tax. It also is helpful in predicting the incidence of the tax — that is, which individuals are likely actually to suffer the burden of the tax.

It follows quickly from the above analysis that the Ryan roadmap converts current law's personal and corporate income taxes (which admittedly are ragged old things, full of holes and uneven treatment of different forms of capital income) into two new consumption taxes. The personal tax would become a pure labor income tax (a yield exemption system). The corporate income tax would be replaced by a subtraction method VAT (a sales tax collected at each step along the production process, rather than just from final consumers) with a new name (the BCT).²⁰ This BCT would be payable by all businesses, corporate and noncorporate.

As in Cain's 999 plan, the real impact of the Ryan roadmap on individuals is largely buried in the operation of the BCT. The reason is that the BCT operates in part as a large hidden wage tax collected directly from employers.

The BCT is designed not to burden normal returns to capital, and to impose tax directly proportionate to wages paid. As a result, it operates in a manner that is conceptually indistinguishable from current law's employer share of payroll taxes. Economists are unanimous that an employer-level payroll tax economically is borne by the employee (or in economists' lingo, the incidence of the tax

falls on the employee). To a first approximation, therefore, the BCT also operates in economic substance as just another wage tax.²¹

To see the differing impacts of the simplified income tax and the BCT on labor and capital income and how the two taxes relate to each other, it is helpful to consider three little companies, unimaginatively named A, B, and C.²²

Company A employs no capital, but it has workers who provide services to other companies. Company A today takes in \$107.65 of fee income, pays out \$100 in wages, pays \$7.65 in the employer's share of payroll taxes, and has zero income tax liability.²³ In my terminology, to pay \$100 in wages, this employer today must set aside from gross income a wage pool of \$107.65 from which to pay both wages and the employer's half of payroll taxes.

Under the BCT, Company A will incur a BCT liability of 8.5 percent of \$107.65, or \$9.15.²⁴ Unlike the Cain 999 plan, the Ryan roadmap imposes this BCT in addition to existing payroll taxes.

If one accepts the usual economic assumptions that markets are efficient and wages are freely negotiated between employer and employee, and that the incidence of a tax that is measured by wages, which describes the BCT insofar as labor inputs are concerned, falls on employees, then the aggregate amount paid by an employer for the services of an employee (including employer taxes directly measured by wages) — that is, the wage pool — should remain constant when moving from current law to the Ryan roadmap.

If the wage pool (here, \$107.65) remains constant, wages must go down substantially. From its \$107.65 wage pool, Company A first will pay \$9.15 in BCT, leaving it with only \$98.50 from which to pay both wages and the employer's share of current law payroll taxes. Assuming the wages in question fall below the payroll wage cap (about \$110,000 in 2012), the wages that A pays to its employees will drop to \$91.50 — on which amount employees in turn will suffer the employee's half of payroll taxes and any income tax liability.

²¹The text briefly considers below the alternative possibility that the incidence of the BCT would fall on consumers.

²²Cf. Stephen Leacock, "The Human Element in Mathematics," in *Literary Lapses* (1910).

²³See Kleinbard, *supra* note 2, at 474.

²⁴Neither compensation nor payroll taxes are deductible in calculating the BCT base. Proposed section 205(a)(3) and (b)(2)(C). Ryan, *supra* note 1, at 444. By contrast, under current law the employer's share of payroll taxes is deductible as a section 162 business expense. See IRS Publication 535, *Business Expenses*, at 17, Doc 2012-5581, 2012 TNT 53-59.

²⁰Alternatively, the BCT can be described as a cash flow tax, so long as it is understood that unlike David Bradford's X tax, this cash flow tax does not permit a deduction for compensation paid to workers.

Ignoring the temporary payroll tax holiday, this means another \$7 in employee payroll taxes, bringing take-home, pre-income-tax wages down to \$84.50, against current law's \$92.35. Measured by reference to \$100 of current law wages with its attendant 15.3 percent payroll tax rate (as a percentage of wages), the new system therefore imposes total wage taxes at a rate of 23.15 percent of wages — about a 50 percent wage tax increase from current law. Like the Cain 999 plan, this is the source of the Ryan roadmap's revenue pickup and its regressivity.

It might be argued that the BCT would not burden consumers rather than workers, but that argument changes almost nothing. Workers also are consumers: If you imagine that their wages stay constant but the prices of all goods increase under the BCT tax burden, workers' effective after-tax wages would be just as burdened by the BCT as in the simpler case of ascribing the incidence of the tax entirely to wages. In either case, after implementation of the Ryan roadmap, the same worker would be able to buy fewer goods and services out of the compensation income that Company A could afford to pay than she can under current law.

Unlike current Old Age, Survivors, and Disability Insurance taxes, the BCT would be uncapped, which suggests that its distributional consequences would be less regressive than current law payroll taxes. But here the Ryan roadmap's simplified income tax would come into play to immunize the most successful workers, and only those workers. Many high-income workers would receive large income tax cuts under the simplified income tax for their labor incomes, as a result of the sharp reduction in tax rates, including the reduction of the highest marginal tax bracket from 35 percent (or 39.6 percent, under current law as scheduled to take effect in 2013) to 25 percent. Moreover, the most affluent workers would enjoy a zero tax rate on their capital incomes. The net effect of both components of the new system therefore could be expected to be very favorable to the highest-income taxpayers.

And indeed this is the case. Shortly after the release of the Ryan roadmap, the nonpartisan Tax Policy Center (TPC) performed a comprehensive distributional analysis of the plan's tax provisions.²⁵ That analysis took into account the distributional aspects of both the income tax (including the ability

of taxpayers to optimize their liability through choosing between the traditional income tax and the simplified income tax) and the BCT (which the TPC treated as burdening all individuals in proportion to their total income, not just their labor income).²⁶ The TPC distributional study reached extraordinary conclusions:

The Roadmap's tax provisions would be highly regressive compared with the current tax system. . . . [T]he top 1 percent would gain an average of 26 percent and the top 0.1 percent a whopping 36 percent. The share of total taxes paid by the bottom 80 percent would rise from 35 percent to 42 percent, while the share paid by the top 1 percent would fall by nearly half from 25 percent to 13.5 percent. Taxpayers at the top of the income distribution gain most because they get the bulk of capital income, which the Roadmap would exempt from taxation. The change in average tax rates reflects that situation. While average rates would change little among the bottom 80 percent, they would fall dramatically at the top. For example, the average tax rate for the top 0.1 percent would plummet from 30 percent under current law to just 11 percent under the Roadmap.²⁷

When the proposed tax provisions were measured against the lower tax rates in effect in 2010 (that is, "current policy") — the comparison most favorable to the Ryan roadmap — the TPC's distributional analysis concluded that the net effect of both components of the new tax system would be to *raise* taxes on average for each grouping of tax units with cash incomes in the range of \$20,000-\$200,000 — that is, most Americans.²⁸ Those earning between \$200,000 and \$500,000 would save about \$5,500 on average, although a preponderance of tax units in this range would still come out worse than under 2010 tax rules. And the relatively few tax units with cash incomes exceeding \$1 million would on average see their tax bills decline by more than \$500,000.

From the other direction, a family of four today with wage income of \$46,000 pays essentially zero in income tax, after taking into account the standard deduction, the four personal exemptions, and \$2,000 in child tax credits. But that family will have suffered FICA taxes (considering both the employee and the employer's share, since the incidence of the

²⁵The analysis is summarized in Joseph Rosenberg, "Preliminary Revenue Estimate and Distributional Analysis of the Tax Provisions in a Roadmap for America's Future Act of 2010," TPC (Mar. 9, 2010), *Doc 2010-5140*, 2010 TNT 47-40 (includes both the overview and related distributional and revenue tables).

²⁶Unlike distributional studies by the JCT, TPC analyses include the distributional consequences of existing law's corporate income tax.

²⁷Rosenberg, *supra* note 25, at 4-5.

²⁸*Id.* at 46, TPC, T10-0092.

latter unquestionably also falls on the employee) of more than \$7,000 (ignoring the temporary payroll tax holiday). For this \$46,000 family, the Ryan roadmap constitutes a pure tax increase of roughly 50 percent, to \$10,650.²⁹

These tax distributional points are incomplete in that they look only to the distribution of income and consumption tax burdens. They ignore the regressive consequences of eliminating the gift and estate tax, which is levied only on the largest accumulations of capital.

More fundamentally, the net effect of government interventions also includes how government spends those tax revenues (that is, which individuals directly benefit from given expenditures). As a result, a complete distributional picture would take into account both the tax and the spending sides of the Ryan roadmap. I do not know of such an integrated distributional analysis, but on a stand-alone basis the spending side of the Ryan roadmap is substantially more regressive than current policy, which exacerbates the distributional impact of the roadmap.³⁰

As previously described, the Ryan roadmap's simplified income tax is definitionally a consumption tax because it exempts from tax all returns on investment. Like other labor income taxes, however, it suffers from the design problems identified in the section above. It exempts supersized returns (economic rents) from tax, but in practice that actually might not be a terrible flaw if one assumes that those supersized returns come from business operations, because there is still a theoretical chance of taxing those returns under the business-level BCT, considered below. (As it happens, the BCT systematically undertaxes these supersized returns.)

What is more directly troubling is that the simplified income tax offers no mechanism for teasing apart labor and capital income when both are conjoined in the net business income of a closely held business. Under the simplified income tax, small businesses would have every reason systematically to understate compensation paid to owner-employees. Compensation income would not be deductible under the BCT, so BCT liability would be unaffected by wages paid to an owner-employee. Returns (beyond \$100,000) received by the owner-employee as compensation income, however, would be taxed at 25 percent under the simplified

²⁹For the reasons previously described, the text takes into account both sides of payroll taxes and further ascribes the incidence of the labor income component of the BCT as falling directly on workers.

³⁰Paul N. Van de Water, "The Ryan Budget's Radical Priorities," Center on Budget and Policy Priorities (Mar. 10, 2010), *Doc 2010-5109*, 2010 TNT 47-41.

income tax, while returns received as dividends or interest would be tax free.³¹

Imagine, for example, that Company A had only one owner-employee. By treating the entirety of the firm's after-BCT liability as a dividend, the owner-employee would suffer an all-in tax of only the BCT rate on the company's income, bringing his total tax rate on his personal labor income to close to 8.5 percent (as the importance of current law payroll taxes diminished with income).³²

This problem is not theoretical. It has been extensively explored in the context of Nordic dual income taxes, which impose lower tax rates on capital than on labor income.³³ Experiences there and in the United States regarding carried interest show how difficult it can be in the absence of a statutory centrifuge to disaggregate privately owned companies' net business income into labor and capital components.

The very strategy that the roadmap invites is used today to evade the payroll tax obligations of S corporation owner-managers. This often is described as the "John Edwards gambit," in homage to that former presidential candidate — although a more bipartisan name might be in order, given that the same strategy apparently has been relied on by Newt Gingrich.³⁴

³¹Interest expense would not be deductible to the company, so there is no extra incentive in that regard.

³²The roadmap appears to retain current law's uncapped Medicare tax on labor income, but as described below, this tax is routinely evaded today through exactly the strategy outlined in the text.

³³Kleinbard, "An American Dual Income Tax," *supra* note 17.

³⁴See, e.g., David Cay Johnston, "Newt and the NEWT Act" (Feb. 3, 2012), available at <http://blogs.reuters.com/david-cay-johnston/2012/02/03/newt-and-the-newt-act/> (describing the avoidance strategy and the Narrowing Exceptions for Withholding Taxes (NEWT) Act of 2012 introduced by Rep. Fortney Pete Stark, D-Calif., on Feb. 2, 2012); Shamik Trivedi, "Shades of John Edwards in Gingrich Return," *Tax Notes*, Jan. 30, 2012, p. 499, *Doc 2012-1260*, or 2012 TNT 15-2. Legislation to address this issue also was introduced in 2010. See Sam Goldfarb, "Critics Attack S Corp Payroll Tax Increase in House Extenders Bill," *Doc 2010-12544*, 2010 TNT 109-2.

John Edwards's use of an S corporation, from which he paid himself a modest salary in relation to the corporation's earnings from his personal services, spawned a large collection of articles and letters in 2004. See, e.g., Kenneth A. Gary, "Edwards's S Corporation Not an Abusive Tax Shelter," *Tax Notes*, July 26, 2004, p. 365, *Doc 2004-15186*, or 2004 TNT 144-2; Kip Dellinger, "Edwards's S Corp Can Be Abusive Even if It's Not a Tax Shelter," *Tax Notes*, Sept. 6, 2004, p. 1092, *Doc 2004-17291*, or 2004 TNT 174-40; Tom Daley, "Edwards's S Corporation, Medicare Tax, and Fair Share," *Tax Notes*, Sept. 27, 2004, p. 1577, *Doc 2004-18829*, or 2004 TNT 188-38; Dellinger, "Edwards's S Corp: The Beat Goes On," *Tax Notes*, Oct. 11, 2004, p. 253, *Doc 2004-19639*, 2004 TNT 198-49.

The basic idea is to organize one's labor-intensive business (speaking engagements, the sale of auto-graphed books, recordings of lectures, etc., in the case of Gingrich) as an S corporation and then to pay oneself as modest a salary as possible. Such an individual's current law federal *income* tax liability is unaffected by how he allocates the returns on his business between a stated salary paid by the S corporation and a distribution of the S corporation's net (after-salary) income as a dividend to himself: Both streams of income flow directly to the individual owner-manager, where they are taxed at identical rates. For payroll tax purposes, however, the distinction matters; amounts paid to the owner-manager as dividends generally are not subject to any of the social contribution payroll taxes.³⁵ Conversely, if an owner-manager operated through an entity taxed as a partnership, all of his business income would be characterized as self-employment income, regardless of whether he extracted it as compensation or as a distributive share of profits.³⁶ According to a 2009 Government Accountability Office report, "13 percent of S corporations paid 'inadequate wage compensation' in 2003 and 2004."³⁷

Notwithstanding an occasional victory by the government in this area,³⁸ we have abundant evidence of the inability of tax common law to tease apart labor from capital income, even when the stakes relate only to a 2.9 percent tax. Because the stakes would be so much higher, the problems of labor income masquerading as capital income would be greatly exacerbated by the roadmap's statutory scheme in the absence of some new statutory mechanism for distinguishing between the two.

³⁵Rev. Rul. 59-221, 1959-1 C.B. 225. Timothy R. Koski, "The Application of Employment Taxes to S Corporation Shareholders — What Is 'Unreasonably Low' Compensation?" 85 *Taxes* 19 (2007).

³⁶There is nominal ambiguity in current law regarding limited liability companies and the like, because section 1402(a)(3) provides that self-employment income does not include a "distributive share of any item of income or loss of a *limited partner*, as such" (emphasis added). The rule dates to a time when LLCs did not exist and when limited partners lost their limited liability if they performed services for their partnership. Proposed regulations would clarify that all of an LLC member's income from such an entity will constitute self-employment income, unless the member performs 500 hours or less of work per year for the entity and has no power to contractually bind the firm. Prop. reg. section 1.1402(a)-2(g) and (h).

³⁷GAO, "Tax Gap: Actions Needed to Address Noncompliance With S Corporation Tax Rules," GAO-10-195, *Doc 2010-883*, 2010 *TNT* 10-13.

³⁸E.g., *David E. Watson PC v. United States*, 668 F.3d 1008 (8th Cir. 2012), *Doc 2012-3783*, 2012 *TNT* 36-12.

Capital Income Under the Ryan Roadmap

The simplified income tax would impose no tax on the capital income of individuals.³⁹ The BCT would exempt boring "normal" returns from tax but would burden supersized returns (economic rents). The Ryan roadmap also would eliminate the gift and estate tax, which burdens only the largest accumulations of capital.

Consider Company B, which needs no employees but holds a perpetual machine that never wears out and that throws off 6 percent per year in income (the normal return). Under an ideal income tax, when Company B purchases the machine, it obtains no depreciation deductions and includes \$6 per year in income. Under the BCT, by contrast, Company B will write off its investment immediately, which, as explained above, is the economic equivalent of exempting the 6 percent yield from tax. When Company B pays that return to investors as interest or dividends, they include nothing in tax. All this is by design and is consistent with standard consumption tax principles: The normal return to capital is exempt from all tax burdens.

Finally, consider Company C, lucky owner of the one and only magic penny described earlier. It cannot scale up its investment by buying more magic pennies, and so its supersized returns would be subject to the BCT. Again, this is neither conceptually irrational nor inconsistent with consumption tax norms. Ideal consumption taxes just neutralize the consumption decision between consuming today and consuming tomorrow, and to do that only the return to waiting needs to be shielded from tax. Phrased differently, even in a high-tax environment, companies will scour the earth for magic pennies, because by definition their returns are unique, and even after tax they yield superior returns to the normal return.

But this in turn implies the problem with the BCT as it applies to economic rents: It systematically *undertaxes* those returns. There is no reason to offer these returns an 8.5 percent tax rate environment to attract investment. Companies would be thrilled to find magic pennies even if taxes were imposed at a 25 percent rate, or higher.

If you analogize (imperfectly) to current law, corporate income is taxed at a marginal rate of 35 percent. While many companies can reduce their tax rates on economic rents below that rate, particularly when global intangibles are at stake,⁴⁰ that rate is a useful starting point from which to think about the appropriate tax burden on economic rents. Even

³⁹See "Introduction" for a more technical description of what income would be excludable under this rule.

⁴⁰Kleinbard, "Stateless Income," 9 *Fla. Tax Rev.* 699 (2011).

if one treats the 15 percent long-term capital gains rate applicable to individuals as our current default tax burden on economic rents, the BCT would slash that burden nearly in half. There is no economic efficiency case for doing so.

One important economic efficiency gain usually associated with the transition from an income tax to a consumption tax is that “old” capital will be double taxed. The idea is that old capital has borne the burden of income taxation, and now, when used to fund consumption, will be subject to the new consumption tax regime. This result is “efficient” in the technical sense in that it cannot be avoided (at least if the consumption tax is enacted in the dark of night), but owners of old capital understandably have other terms for this result, of which “wholesale theft” might be the most polite.

The Ryan roadmap responds to the predictable anguish of old capital by allowing companies to write off any tax basis in their assets as of the date of conversion to the BCT over five years. This exercise in tax empathy is understandable, but it substantially undercuts the economic case for moving to a consumption tax. The “efficient” double taxation of old capital under consumption tax systems that deliberately withhold any transitional relief in fact is a large component of the predicted efficiency gains associated with moving to a consumption tax.

This article has not considered the purported growth effects of the roadmap, for six reasons. First, no one knows what the revenue consequences of the roadmap actually are; as discussed earlier, Ryan simply instructed the CBO to assume that the tax plan would raise 19 percent of GDP in equilibrium.⁴¹ Second, the growth effects claimed by proponents of tax reform along the lines of the roadmap most commonly have been presented as the implications of abstract economic models whose claims and relevance to an economy as large and complex as that of the United States are highly controversial, as the recent controversy surrounding a report prepared to support Gov. Mitt Rom-

ney’s economic plans suggests.⁴² Third, as described above, the Ryan roadmap actually forgoes one of the principal economic efficiency gains from the switch to a consumption tax, which fact is not reflected in other work modeling the advantages of consumption taxation.

Fourth, what empirical evidence there is on the growth effects of capital income tax cuts is much more ambiguous than proponents of proposals like the Ryan roadmap often acknowledge.⁴³ Fifth, spending cuts have efficiency costs as well as gains, depending on what programs are cut; many models treat all government spending as equally unproductive, which is not accurate.⁴⁴

And finally, proponents of proposals like the Ryan roadmap typically fail to specify a path by which the growth they predict will be shared by all Americans, other than vague assurances that greater national income necessarily is good for all. Since the age of Adam Smith it has been understood that greater investment leads to greater worker productivity, which, all other things being equal, should lead to higher wage rates. But whatever the merits of this proposition in general, it certainly would be tested by the Ryan roadmap, which contemplates both higher taxes for the majority of Americans and government spending reductions that when viewed by themselves would be highly regressive.⁴⁵ Proponents of the Ryan roadmap or similar proposals therefore would need to demonstrate that the growth effects they claim not only are robust to a range of reasonable parameters for the inputs in their models, and that the models themselves have some demonstrated predictive power, but also that the projected growth could reasonably be expected to compensate the millions of Americans who would face both higher taxes and fewer government benefits.

Conclusions

Many economists prefer ideal consumption taxes to ideal income taxes, but no major economy in the

⁴¹The TPC, *supra* note 25, did estimate the revenue consequences of the roadmap over the period 2011-2020. *Id.* at Table T10-0094. That revenue estimate shows the roadmap falling substantially behind the “current policy” revenue levels that Ryan directed the CBO to assume for the same period. If the TPC estimates are correct, and no further changes to the roadmap are made, the adoption of the roadmap would lead to substantial increases in the federal deficit, which would have significant adverse consequences for growth. Compare Treasury, “A Dynamic Analysis of Permanent Extension of the President’s Tax Relief” (July 25, 2006), *Doc 2006-14005*, 2006 TNT 143-16 (tax reductions must be matched by equivalent spending cuts to observe growth effects in model).

⁴²Compare R. Glenn Hubbard et al., “The Romney Program for Economic Recovery, Growth, and Jobs,” available at <http://www.docstoc.com/docs/125714335/Romney-Tax-Reform-White-Paper>, with Ezra Klein, “Economists to Romney Campaign: That’s Not What Our Research Says,” *The Washington Post*, Wonkblog (Aug. 8, 2012), available at <http://www.washingtonpost.com/blogs/ezra-klein/wp/2012/08/08/economists-to-romney-campaign-thats-not-what-our-research-says/>.

⁴³See, e.g., Chye-Ching Huang, “Plan’s Costs Far Outweigh Its Benefits,” *The New York Times*, Aug. 16, 2012, available at <http://www.nytimes.com/roomfordebate/2012/08/16/should-we-stop-taxing-capital-gains/plans-costs-far-outweigh-its-benefits-6>, and the academic papers linked therein.

⁴⁴Shu-Chun Susan Yang, “Do Capital Income Tax Cuts Trickle Down?” 60 *Nat’l Tax J.* 551 (2007).

⁴⁵Van de Water, *supra* note 30.

world today relies exclusively on consumption taxes. What is more, there are signs of revisionism within the public finance community, and the income tax is staging a bit of an intellectual comeback.⁴⁶ Regardless, the roadmap is not a well-designed consumption tax, for two main reasons.

First, as currently conceived, the roadmap's two new taxes offer an open invitation to closely held companies to disguise labor income as capital income, thereby substantially undercutting its economic rationale and damaging its prospects for raising the revenues it claims that it will. Second, while the BCT in combination with the simplified income tax would exempt "normal" returns, it also would undertax any remaining supersized returns on investment, relative to ideal consumption tax norms. In fact, the roadmap would tax economic rents at only half the rate that Cain's 999 plan would have.⁴⁷

The immunization of existing capital from the brunt of the BCT (another feature not present in the 999 plan) also undercuts the economic case for this consumption tax package. The fairness reasons for doing so are unarguable, but one must recognize that the efficiency case suffers as a result.

More fundamentally, the roadmap would shift the tax burden dramatically from America's most affluent to the working poor and middle class. It does so, just as Cain's 999 plan would have, by vastly increasing payroll-tax-equivalent taxes, in this case by about 50 percent for Americans under the payroll wage cap. The Ryan roadmap then would immunize the highest-labor-income Americans from any adverse consequences by pairing that higher effective payroll tax with much lower income taxes, so that middle- and lower-income working Americans would see a 50 percent increase in their tax burdens, while the most successful

Americans would see reductions in their labor income tax rates and elimination of all capital tax burdens — including the gift and estate tax. And these consequences in turn ignore the distributional consequences of eliminating the estate tax, which by design burdens only the estates of the wealthiest decedents.

This explains the extraordinarily regressive distributional consequences of the tax provisions of the roadmap. Tax units with cash incomes between \$20,000 and \$200,000 would on average pay more in tax, and tax units with cash incomes exceeding \$1 million would on average enjoy tax reductions exceeding \$500,000 per year.

These four things cannot simultaneously be accomplished: (1) exempting from tax much of the current capital income tax base (40 percent of national income); (2) reducing the top tax rate on the remaining individual tax base (that is, labor income) to 25 percent; (3) raising as much money as did the pre-crash tax system; and (4) maintaining neutrality compared with current law in the relative tax burdens imposed across different income levels. With the top individual rate capped at 25 percent and capital income largely untaxed, the necessary revenue can come only from the labor income of the middle class and working poor. The mechanism for doing this is the BCT's effect as a vast hidden payroll tax increase on everyone but the most successful Americans.

Even this is an incomplete picture of how the Ryan roadmap would exacerbate our country's growing income inequality, because it does not take into account the distributional consequences of the roadmap's spending policies. A sophisticated understanding of the distributional consequences of government interventions requires considering not just how tax revenues are raised, but the net effect of taxing and spending policies together. In this case it is clear that the brunt of the spending reductions contemplated by the Ryan roadmap would fall on lower-income Americans. So these individuals would be squeezed from both directions: Their tax bills would go up even as their government benefits go down. Affluent Americans, by contrast, would see much lower tax bills and would not lose nearly as much from smaller spending programs as would the poor and middle class. The Ryan roadmap is in fact a roadmap to accelerating income inequality.

⁴⁶The economic efficiency case for the income tax is offered in James Banks and Peter Diamond, "The Base for Taxation," in *Dimensions of Tax Design: The Mirrlees Review*, ch. 6 (2010); their conclusions are summarized at 634. A shorter presentation of the arguments is in James Mirrlees et al., *Tax by Design: The Mirrlees Review*, 307-317 (concluding, however, that the efficiency arguments for taxing returns to household savings are not convincing). A few of the political economy arguments are mentioned in Kleinbard, "An American Dual Income Tax," *supra* note 17, at 45-48. Among those arguments are transition concerns, immediate revenue concerns, and the risk of tax holidays along the lines of the enactment of section 965 in 2004.

⁴⁷Kleinbard *supra* note 2, at 477.