

## The New International Debate on Expenditure Tax: An Assessment

G. THIMMAIH\*

### BACKGROUND

The idea of expenditure tax is as old as the science of economics. It has been repeatedly discussed as an alternative to income tax but without any decisive impact on the policy makers. In the 1970s a new debate on the desirability of introducing the expenditure tax emerged in several developed countries notably in Sweden, UK and USA. There are several reasons for this latest revival of interest in expenditure tax. The inflationary trend which engulfed the whole western world severely affected the tax payers when the increase in their nominal incomes pushed the lower slab income tax payers into the higher slabs. Besides, the business firms and the corporate sector could not plough back savings from their own sources to undertake new investments and as a result productivity suffered. Further, the type of income tax which has been operating in most of the developed countries has its own defects which added to the dissatisfaction of the tax payers and to the frustration of the tax administrators. All these problems required not merely ad hoc tax reforms but also fundamental long-term changes in the tax structures. Perhaps the most vocal discussion on the need to reform the income tax structure and to consider the possibility of introducing expenditure tax has been going on in the USA. As far back as 1921 a US Congressman Mr. Ogden L. Mills was reported to have proposed a tax on spending. Latter, in 1942 the Secretary of the Treasury, Mr. Morgenthau proposed a spending tax in USA. In 1974 the Advisory Commission on Intergovernmental Relations (ACIR) prepared an information report on the expenditure tax.<sup>1</sup> In 1975 the Secretary of the Treasury, Mr. William E. Simon suggested basic reforms of income tax and on his suggestion Blueprints for Basic Tax Reform<sup>2</sup> was prepared in 1977 in which expenditure tax has been proposed as an alternative to comprehensive income tax in place of the presently operating income tax.

On the continent, the Swedish Government Commission on Taxation, initiated a detailed study on progressive expenditure tax as an alternative to income tax in 1976.<sup>3</sup> In England, the Institute of Fiscal Studies appointed a Committee<sup>4</sup> in 1976 under the Chairmanship of J.E. Meade to examine the structure of direct taxes and to suggest the required reforms. This Committee produced an elaborate proposal of expenditure tax in 1978. All these reports have considered expenditure tax as a feasible alternative to the existing income tax as also to the ideal but impracticable Haig-Simons comprehensive income tax.<sup>5</sup> This revival of interest in expenditure tax deserves close scrutiny to understand afresh the problems

---

\*Dr. Thimmaiah is Professor of Economics and Head, Economics Unit, Institute for Social and Economic Change, Bangalore, India.

and prospects of expenditure tax in both developed and developing countries.

#### HISTORICAL PERSPECTIVE

The idea of expenditure tax is traced to the writings of Thomas Hobbes,<sup>6</sup> though the proposal to exempt savings from income tax is found in the writings of J.S. Mill, Alfred Marshall and A.C. Pigou in England and Luigi Einadi in Italy.<sup>7</sup> However it was Irving Fisher<sup>8</sup> of United States who put forward in 1937 a proposal of a more practicable expenditure tax and his detailed proposal was published in 1942.<sup>9</sup> Till that time expenditure tax was conceived as a tax on consumption. But because of the difficulty of imposing a tax on the individuals' consumption, it was considered administratively impracticable though in terms of economic logic it was rated as a better tax than income tax. It was Irving Fisher who for the first time showed that this administrative problem could be overcome by deriving expenditure tax base from income in terms of aggregate economic entities. This was a major breakthrough in designing a practicable expenditure tax. In 1947 William Vickrey<sup>10</sup> suggested for USA a spending tax either as a supplementary tax to the then existing progressive income tax in the middle income ranges, or as a complete substitute for the income tax on all income slabs except the highest. Expenditure tax shot into academic prominence and attracted worldwide attention after the publication of Nicholas Kaldor's book in 1955.<sup>11</sup> It was from this period onwards that the expenditure tax has been seriously considered for implementation by many governments both in the developed and the developing world.

It should be mentioned here that though administratively practicable expenditure tax was expounded as early as 1937 by Irving Fisher, it could not catch the attention of the policy makers mainly because of the unfavourable economic situation of the period in the western world. During the 1930's all these countries were reeling under the impact of great depression. Depression called for expansion of aggregate expenditure and since private expenditure was considered inadequate to utilise then existing productive capacity, public expenditure was expected to be expanded to fill the gap. Expenditure tax was believed to curb private consumption and therefore it was considered as an inappropriate fiscal policy tool for initiating economic recovery during depression. Thus the first proposal for expenditure tax was born at an inauspicious time and hence it faced infant mortality. After this sad demise, the expenditure tax was reborn in 1950's when Kaldor became its foster father. Kaldor's proposal was not considered sympathetically either by the British Royal Commission on Taxation of Profits and Income, before which he presented it or by the British Government because of their ignorance about the nature of the proposed expenditure tax. Undaunted by this failure to sell expenditure tax at home, when he was called upon to advise the Governments of India and Ceylon on tax reforms, he sold his expenditure tax there. Kaldor recommended expenditure tax to be introduced as a supplementary tax along with moderate rates of income tax. He also recommended it as an integral part of an 'integrated direct tax system' to curb tax evasion and to reduce inequality of income and wealth. Thus in India he recommended a

progressive income tax to be retained with a maximum marginal rate of 45 percent, an expenditure tax, an estate duty, a gifts tax, a capital gains tax and a wealth tax, all operating simultaneously. But because the Government of India could not implement it in the way he recommended and also because the bureaucracy could not derive expenditure tax base in the way suggested by Irving Fisher, it became a consumption tax based on the declared consumption of individuals. This made the tax unpopular, administratively complicated and in terms of yield unproductive. Hence the tax was abolished in 1962 but reintroduced in 1964 and finally abolished in 1966. With this demise, the first practical experiment after its second birth came to an end. In the 1970's the American Blueprints, the Swedish proposal and the Meade Committee proposal have revived the international interest in expenditure tax. These proposals have also started an international debate which deserves a critical assessment.

#### JUSTIFICATION FOR EXPENDITURE TAX

Of several justifications<sup>12</sup> for this tax at least one is as old as the idea of expenditure tax. The oldest (negative) justification for expenditure tax is that income tax amounts to double taxation of savings and hence discourages savings. This allegation against income tax was first made by J.S. Mill though it was modified by Alfred Marshall and A.C. Pigou, and it became a very fashionable argument against income tax under the catchy phrase: 'income tax is double taxation of savings'. However on close examination this is an exaggeration, as pointed out by Raja Chelliah.<sup>13</sup> Because, income tax first taxes the income earned/received in a particular year, then out of that income if some savings are made and invested, the income which flows from those savings and/or investment will be taxed and not the original savings themselves. Therefore, it is far from true to say that income tax is 'double taxation of savings'. However, what is happening in practice is that under income tax regime if there is a wealth tax or an inheritance or gifts tax, this would amount to double taxation of past accumulated savings though not in the same year. Thus income tax taxes the savings which are already included in income, and when savings are accumulated and become wealth in future, that is taxed in later years under wealth tax or inheritance tax. But even this is not double taxation of savings in the same year. And this kind of integrated taxation is based on equity consideration which is relevant even under expenditure tax regime as will be shown below.

An important argument in favour of expenditure tax is that for the purpose of fast growth of productivity, high rates of savings and capital formation are required. Self-financing is necessary for business and corporate sectors to undertake new investment and improve productivity. In an inflationary situation the cost of borrowing becomes discouragingly high and under the income tax regime plough back of savings is made impossible and hence an expenditure tax would encourage self-financing and promote savings in the developed as well as developing countries. This is the argument put forward by American Blueprints, the Swedish proposal and the Meade Committee. Thus it is interesting to know the turn of event namely, during 1930's when the expenditure tax was proposed for the first time, over-saving was considered as an economic malady and hence expenditure tax was ruled out as an inappropriate remedy as it was feared to kill

the patient. But by 1970's lack of adequate savings became a malady and hence the expenditure tax has been advocated to encourage savings both in the household and in the corporate sectors.

Yet another argument for expenditure tax advanced in the three proposals mentioned above is that the inflationary situation has created serious problems for income tax payers and for business and corporate sectors. Income tax cuts into the capital structure of companies under capital gains tax, reduces the flow of funds in the corporate sector and imposes heavy burden of tax on individuals whose nominal incomes shift them to higher brackets on account of inflation. Therefore expenditure tax is advocated as a solution to those problems created by inflation. It is argued that expenditure tax automatically indexes incomes for inflation. This argument is open to dispute. It is possible that capital gains may get more favourable treatment under expenditure tax than under income tax in an inflationary situation. But it is difficult to believe that expenditure tax would automatically index for changes in the real value of income from other sources.

All the three proposals which have unanimously advocated expenditure tax have recommended it with a view to achieving other objectives of tax reform also. For instance, the American Blueprints emphasises three objectives of tax reform namely, equity, simplicity and efficiency. In other words, the American Blueprints has tried to examine the alternative proposals for reforming the existing income tax with a view to making the direct tax structure of USA more equitable, easier to understand and justify, and more conducive to the efficient operation of the private economy. Meade Committee has maintained that its proposals aim at providing incentives and achieving economic efficiency, distributional equity, simplicity and low cost of administration and compliance. More or less the same objectives are kept in view by the Swedish proposal also. Thus all the three countries' proposals, which have proposed expenditure tax, have examined it both as a supplementary tax and as a supplanting tax to income tax from the point of the above mentioned objectives of tax reform. Incidentally, they also happen to be the essential characteristics of any good tax system. This means in all these countries their respective direct tax systems have lost these characteristics and hence these proposals assume that, among other things, if expenditure tax is introduced the necessary characteristics will be restored to their direct tax systems.

#### SCOPE OF THE PROPOSALS

The three proposals have examined the weaknesses of the existing income tax in the respective countries, and against this background the American Blueprints and the Meade Committee have proposed comprehensive income tax and expenditure tax as alternative whereas the Swedish proposal has not directly examined comprehensive income tax and expenditure tax as alternatives. The American Blueprints has examined the comprehensive income tax and fullfledged expenditure tax as alternatives and has come to the conclusion that it is very difficult to administer the comprehensive income tax even though it is the ideal way of taxing income. Hence, the Blueprints has opted for expenditure tax. Meade Committee

has examined the relative merits of comprehensive income tax, universal expenditure tax, and two-tier expenditure tax, and has recommended two-tier expenditure tax to start with on administrative feasibility ground, and has suggested gradual switch over to universal expenditure tax in a phased manner. The Swedish proposal has recommended conversion of the present progressive income tax into a proportional income tax with 30 percent rate, and the introduction of a progressive expenditure tax (along with the proportional income tax), on expenditures which exceed 30,000 kroners. Therefore all the three proposals have opted for expenditure tax not merely as an 'economically efficient' substitute but also as an administratively feasible tax as compared to comprehensive income tax.

#### TAX BASE

Expenditure tax was originally called by different names such as 'consumption tax' and 'spendings tax'. American authors used the term 'spendings tax' and British authors used the term 'consumption tax.' But it was Nicholas Kaldor who called it an expenditure tax. There are certain valid reasons for calling the tax on consumption base as expenditure tax. Traditionally the tax on consumption has been in the form of commodity taxes which assume the form of indirect taxes. They include excise duties, turnover tax, sales tax and value added tax. Conceptually such a tax, though a tax on consumption, is not neutral between different forms of consumption as the rates of tax differ from commodity to commodity depending upon their nature and importance. Even the value added tax assumes the form of consumption base tax. Therefore, there were several problems associated with the measurement of consumption for purpose of direct taxation and it was this difficulty which led to the administrative unpopularity of expenditure tax. Realising this drawback, Irving Fisher suggested the derivation of consumption through income by deducting savings from gross income. Thus the technical aspect of consumption base tax was conceptually solved. In this form, the tax will be neutral between different commodities and different consumption units. It is universally applicable for all consumption as much as an income tax. Therefore, it was rightly designated as expenditure tax as the expenditure is derived in the aggregate sense by deducting aggregate savings from aggregate income. Consequently the total expenditure is the tax base in the case of expenditure tax. However the Meade Committee has examined different forms of expenditure tax namely, (i) expenditure tax adjustment of income base, (ii) value added method and (iii) hundred percent capital allowance method. The first form of expenditure tax namely, the expenditure tax adjustment of income base, is called universal expenditure tax and the remaining two forms are called two-tier expenditure tax. Under the universal expenditure tax, the tax base is estimated in the following way: all personal incomes such as wages, salaries, dividends, interest, rent, profits and royalties plus all capital receipts like realisation of capital assets, amount borrowed, receipt of repayment of past loans, reduction in money balances plus all windfall earnings like inheritance, gifts received, lottery earnings are all added and considered as total income. From this total income, non-consumption outgoings such as for acquisition of assets, the amount of money lent, repayment of past borrowings, increase in money balances, payment of interest on money borrowed are deducted. What remains is the tax base for the universal expenditure tax. Even in the case of

two-tier expenditure tax, though it is suggested to take the form of a surcharge on the incomes above a particular limit, the tax base would be the same except that the income tax paid will be deducted from the tax base. In the case of American Blueprints, for purpose of the expenditure tax, (which is also called consumption base tax or cash flow tax), all income minus all positive and negative changes in net-worth is taken into account. In other words, all receipts of income such as wages, salaries, gross business receipts, pension funds, gifts and inheritance, all forms of public assistance, alimony and withdrawals from qualified accounts, borrowings and proceeds from asset sales minus gross business expenses, gifts made, deposits in qualified accounts, repayments of loans, and proceeds of asset purchases makes the consumption base almost equivalent to comprehensive income tax base without requiring actual tally of the purchases of consumption goods and services. The earlier mentioned experiments with expenditure tax in India and Ceylon considered the actual amount spent by individuals on goods and services as the tax base. This required proof of purchase vouchers/bills for purpose of determining the tax base which was very difficult to obtain and hence it became administratively unpopular. Precisely for this reason namely, difficulty of tax enforcement, it could not yield adequate revenue and hence the tax became unproductive. But the proposed expenditure tax base tries to get over this problem. The Swedish proposal has worked out the tax base for expenditure tax on the basis of the cash receipts such as regular income, proceeds from the sale of investment assets, legacies, gifts, loans, lottery prizes and the like plus all dissavings such as reduction of bank deposits, reduction of claims, borrowings, minus all outgoing deductible amounts like accumulated outlays for the acquisition of income outlays of investment in income yielding activities and also new savings in bank deposits, increases of claims and repayment of loans. The net amount constitutes the individual tax base for expenditure tax. Thus, as against the existing income tax which is based on the principle of ability to pay, the progressive expenditure tax is based on the principle of standard of living of the family or the individual as the tax base. The expenditure tax, as discussed in the three proposals, becomes a tax on standard of living. Kaldor justifies expenditure as a better index of taxable capacity. This is supposed to indicate the ability to pay better than mere income. However, this argument does not stand close scrutiny in terms of economic logic as income is always a better index of economic ability by the more fact that income is a larger magnitude than expenditure at higher levels of income.

#### EXEMPTIONS AND DEDUCTIONS

All the three proposals have examined the items of savings and other allowances to be deducted from the total income to arrive at expenditure as the tax base. While all receipts of income in various forms of earnings become part of total income, all items of savings such as in bank deposits, life insurance premia, stocks and shares become part of deductions. However, ticklish problems arise in regard to assets like housing, life insurance fund, durable consumer goods, borrowing and lumpy items of expenditure such as on education and health. The amount of investment involved in housing is usually large and if it is allowed to be deducted in one year, the tax base may become negative. Similarly if the amount

borrowed for housing is added to the income base and if the tax is levied on 'lumpy' expenditures incurred on education and health, the amount of tax would be prohibitively high. Therefore, several suggestions have been made by the three proposals to get over these problems. One suggestion is to add the annuity or mortgage payments on houses each year as deductible savings. Another suggestion is to take the rental value of the house. In regard to expenditure on education if we treat it as investment in human capital formation, then it should be deducted from the tax base. This is consistent with the philosophy of expenditure tax which is supposed to exempt all savings and investment. If the same logic is used, then expenditure on health becomes a depreciation or maintenance cost of human capital. But if it is exempted on such economic theoretic ground it erodes the tax base enormously. It is precisely for this reason that the Swedish proposal has suggested that deductible items of savings should be identified purely on practical considerations and not on the basis of economic theory. So in such cases suggestions are made to allow some limits upto which they are exempted. Another suggestion made by Swedish proposal is to give allowances like child allowance for education and health so that lumpy expenditures are reduced to reasonable levels. In the case of interest, if the amount borrowed is used for capital formation, it should be treated as part of investment income and hence be exempted. But this violates the principle of equity and therefore it has to be taxed separately as income from capital. In the case of durable consumer goods, the Meade Committee has suggested that some of the smaller consumer goods of daily use may be exempted from taxation as it is administratively difficult to cover them. However other high priced durable consumer goods such as TV sets, stereo sets, refrigerators, motor cars etc., will have to be taken into account for purpose of taxation by adding the annuity payment if they are purchased on credit. If they are purchased by paying their total price, the lumpy amount may be averaged over the life span of the assets. For purpose of distinguishing items of savings and durable consumer goods which qualify for deductions, all the three proposals have suggested more or less similar administrative procedure. Meade Committee has made a suggestion to classify the assets into registered and unregistered assets. All registered assets should be included as savings deductible from income and all unregistered assets which include small cash, small household articles and the like may be left out of both tax base and tax deduction. For this purpose, Swedish proposal has suggested that items like bank deposits, financial assets, houses, motor vehicles, refrigerators etc., may be compulsorily made to be registered. The American Blueprints has made similar distinction between qualifying and non-qualifying accounts which correspond to registered and unregistered classification. However, it is necessary to recognise the practical problems involved in neatly classifying all the assets for purpose of tax deduction. Meade Committee has tried to get over this problem by suggesting a principle that all assets whose market value appreciates over time should be classified as registered assets. But this principle fails to help the tax authorities during the periods of stable and falling prices. Swedish proposal, on the other hand, has suggested that for purpose of identifying savings for tax deduction, economic logic should be relegated to the background and it should be left to be determined on the basis of administrative feasibility. The Swedish proposal has re-

commended to consider the principle of 'income yielding asset' as deductible when purchased, and to be added to the tax base when sold.

Thus the expenditure tax, while making it possible to arrive at aggregate expenditure as the tax base by deducting aggregate savings from aggregate income, creates the problem of negative tax base and excessive tax base because of the need to take into account lumpy expenditures and capital assets. The three proposals have attempted to solve these problems though not successfully. The solutions are only indicative and not conclusive.

#### UNIT FOR TAX PAYMENT

In all the three proposals the unit of tax payment is recommended to be a family. It includes husband, wife and their minor dependents. If family is considered as the tax paying unit, then unless proper provisions are made for income splitting, there will be hardship for earning couples. Therefore Meade Committee has suggested the following guiding principles for the tax treatment of individuals and families: (i) the decision to marry or not to marry should not be affected by tax considerations, (ii) families with the same joint resources should be taxed equally and (iii) tax system should be fair between families which rely upon earnings and families which enjoy investment income.<sup>14</sup> The same view is taken by the American Blueprints which has suggested two guidelines: (i) families of equal size with equal incomes should pay equal taxes, and (ii) total tax liability of two individuals should not change when they marry. Meade Committee has suggested partial income splitting and partial quotient methods to levy expenditure tax on families to satisfy these criteria.

#### EQUITY OF EXPENDITURE TAX

However, since expenditure becomes the tax base, the families having more children and other dependents are compelled to spend more and hence bigger families will be taxed higher than the smaller families, whose expenditure may be limited and who can afford higher savings. Besides, the expenditure tax discriminates against income from employment or labour and falls lightly on income from capital or wealth. This, in other words, suggests that expenditure tax discriminates against income from labour and hence fails to satisfy the neutrality criterion of optimal theory of taxation.<sup>15</sup> Thus expenditure tax creates both efficiency and equity problems. It fails to be an efficient tax because it is not neutral (i) between labour income and capital income and (ii) between consumption and saving. Furthermore, income tax is neutral between consumption and savings, both different forms of savings and different forms of consumption. Hence it can be made to satisfy at least theoretically the criterion of horizontal equity namely those who earn/receive same amount of income should pay the same amount of tax irrespective of the pattern of its allocation between consumption and saving. But expenditure tax violates the criterion of horizontal equity by taxing heavily those who spend more than those who save more, given the same level of income. It fails to satisfy vertical equity also because it falls heavily on bigger families and relatively lightly on smaller families. Since the size of the family is inversely



related to level of income, the expenditure tax makes the rich people to pay proportionately less proportion of their income as expenditure tax whereas the poor people will be compelled to pay proportionately more of their income as tax because at the lower end most part of their income is consumed. This equity problem is attempted to be solved by Swedish proposal by suggesting wealth or inheritance tax on the one hand and by fixing higher exemption limit by allowing child allowances for large families on the other. The American Blueprints has tried to solve this problem by fixing a higher exemption limit. But Meade Committee has not bothered to tackle this problem except that from the point of view of equity it has suggested a supplementary wealth or inheritance tax. This question of inequity still remains an unresolved issue as far as expenditure tax is concerned. In fact in an attempt to get over this problem by suggesting an alternative or a supplementary wealth tax or inheritance tax, the three proposals are exposed to the criticism of being inconsistent with the philosophy of expenditure tax whose main concern is encouraging capital formation by exempting savings.<sup>16</sup> Though the rate structure proposed for expenditure tax by American Blueprints vis-a-vis the existing income tax rates show that expenditure tax becomes slightly more progressive as compared to income tax, this may be due to hypothetical rate structure suggested. Therefore, the real issue is not merely to choose appropriate rate structure in order to make expenditure tax progressive but also to design the tax in such a way as to achieve horizontal as well vertical equity.<sup>17</sup>

#### ECONOMIC STABILIZATION ISSUE

It has already been mentioned above that the expenditure tax proposal was not accepted during the years of depression because of its probable anti-economic recovery impact. Similarly it became a popular tax proposal during 1970's because it has been considered as a potential fiscal tool to curb inflation by reducing consumption expenditure. This stabilisation aspect of expenditure tax has not been considered by American Blueprints. The only mention that American Blueprints has made is that since American Economy is lagging in capital formation for increasing the productivity, expenditure tax would encourage savings and capital formation. But the Swedish and the Meade Committee proposals have taken to account the stabilisation potential of expenditure tax. According to Swedish proposal, in a period of inflation a rise in the rates of expenditure tax would serve the purpose of reducing aggregate demand by reducing private consumption. Reduction of rates of tax will encourage expansion of aggregate demand in times of recession. But when the income from employment goes on losing its real value in an inflationary situation, if expenditure tax rates are raised across the board, it will impose more burden on poorer sections who depend upon income from services. This means though it is possible to use expenditure tax as an anti-cyclical fiscal tool, such use will come in conflict with vertical equity consideration. As a fiscal policy tool for stabilisation, raising of the tax rates during inflation will no doubt bring down expenditure, but if that revenue is used by the government either for its own spending or for repayment of past debt, then the contractionary effect of high tax rates will be offset by the expansionary activity of the government spending. During recession, if expenditure tax is cut to

leave more money in the hands of the people, the expansionary effect will not be as much as if the government increases the expenditure because the expansionary effect of government expenditure is much more than that of private expenditure. Therefore, the compensatory finance characteristic of expenditure tax are not all that certain. However it would help encourage savings and capital formation in the long-run.

No doubt expenditure tax may be neutral between different forms of consumption but it will not be neutral between different forms of savings. It should be mentioned in this context that none of the early proponents of expenditure tax made any distinction between productive savings and unproductive savings from the point of view of society. If such distinction is not followed, then expenditure tax becomes neutral between different forms of savings. However, in recent years such distinction has been felt desirable. Accordingly all the three proposals do suggest and rightly too, some form of discrimination against undesirable savings. If this suggestion is accepted, expenditure tax cannot be neutral between different forms of savings. This can be justified on the basis of planned non-neutrality.<sup>18</sup> Further, the expenditure tax, by substituting expenditure base for an income base at higher levels of income, reduces the disincentive effect of marginal tax rates on higher incomes. This would reduce the distortion effect of direct tax on the choice between work and leisure. However, it has been accepted now that planned non-neutrality of taxation is necessary to achieve certain broader economic and social policy goals. Hence expenditure tax cannot be disqualified on the ground of its possible allocational distortion effect.

#### REVENUE IMPLICATION

Whenever a new tax is proposed in place of the existing one, the first condition which the new tax is expected to satisfy is that it should not result in any loss of net revenue yield to the government. Keeping this revenue implication in view, all the three proposals have examined the revenue impact of expenditure tax if introduced in place of the existing income tax. The American Blueprints has contended that there will not be any loss of revenue if a progressive expenditure tax is introduced in place of the present income tax. And it even goes to the extent of arguing that the yield may increase in the long-run because savings and investment will be encouraged by expenditure tax which will generate more income and thereby enhance the tax base. But the Meade Committee, which has examined the revenue aspect in detail, has put the loss at considerable amount if housing is left out of tax base. This divergence in conclusions may be attributed to different forms of expenditure tax proposals and different forms of income tax operating at present in these two countries. However the Swedish and the Meade Committee proposals, though similar in form, arrive at different conclusions in regard to revenue impact. This would suggest that there will be loss of revenue in the immediate future if the expenditure tax replaces the existing income tax. But in the long-run the yield may increase as the administration becomes easy. If in the long-run the expenditure tax replaces income tax, and a supplementary tax on wealth or inheritance is levied, then it is doubtful that the yield could be much higher through 'Laffer curve' effect<sup>19</sup> than what would be under the present direct taxes

regime. This is mainly because, the tax base under the expenditure tax is necessarily smaller than that under income tax, unless either the expenditure rates are set higher than under income tax in the short-run and/or the tax base expands in the long run, and therefore the revenue from expenditure tax will be lower than under income tax. Therefore the revenue aspect is very much connected with both rate structure and administrative feasibility of the tax. This leads us to the problem of tax evasion under expenditure tax regime.

#### TAX EVASION

Of the three proposals, Swedish proposal has examined this issue in broader perspective. It has maintained that "the possibilities of avoidance are considerably more limited than in the case of income tax, since all income is taxed equally. The loss of revenue owing to tax avoidance should therefore be substantially reduced. Tax fraud can never be entirely prevented. But there is reason to believe that the scope for fraud is less in the case of expenditure tax than it is in income tax."<sup>20</sup> However, the scope for tax evasion is equal if not more under expenditure tax. For instance, if borrowing for investment in income yielding asset is deducted from tax base, tax payers may declare their borrowings as for investment to reduce tax liability. But in actual practice they may use it for consumption. Further, borrowing may be so 'timed' as to reduce tax liability without actually incurring any net debt liabilities. In order to avoid this possibility, tax rate should be lower than the rate of interest on borrowing. This would affect the tax yield in the short-run. Similarly, if higher exemption limits are inevitable on 'lumpy' expenditure, it is possible to convert most part of the normal expenditure into lumpy expenditure. Further, it is possible to evade expenditure tax through barter transactions of goods without subjecting them to registration transfers, and by false valuation of goods.<sup>21</sup> Hence expenditure tax in order to be evasion-proof requires full computerisation of all assets, financial transactions and capital transfers of the tax payers. Besides cross checking and updating of such information virtually every year becomes an integral part of expenditure tax administration.

#### ADMINISTRATIVE PROBLEMS

Expenditure tax has been considered as an 'utopian' idea by economists like Alfred Marshall, A.C. Pigou and J.M. Keynes mainly on the ground of its administrative impracticability. But Irving Fisher attempted to change this misconceived notion by making the base an aggregate remainder of income minus savings. Even after that simplification, the failure of expenditure tax in India and Ceylon created scepticism in the minds of otherwise supporters of expenditure tax. However, the American Blueprints has tried to convince the sceptics by suggesting the minimum necessary modifications in the existing income tax self-assessment form and in other procedures. Swedish proposal has also contended that the present procedures for income tax administration may be sufficient for implementing a progressive expenditure tax also. However, Meade Committee has raised certain doubts about the administrative feasibility of expenditure tax in U.K. The Committee has felt that the tax payers will feel the initial burden of educating themselves about two-tier-expenditure

tax. In order to make it administratively simple, the tax payers should be made to accept self-assessment procedure. This is considered as a precondition for successful implementation of expenditure tax in U.K. This may be possible in a country like England where voluntary tax compliance is surprisingly high. Even so, Professor A.R. Prest<sup>22</sup> has observed that Meade Committee has tried to justify expenditure tax by comparing its hypothetical merits with the actual demerits of the presently operating income tax in U.K.

The controversy on the administrative aspect of expenditure tax has been aptly summed up by Chelliah in the following way: "The administrators usually contend that it would be considerably more difficult to administer an expenditure tax than an income tax. In putting forward this contention, they implicitly compare the present form of income tax with the fullfledged expenditure tax. Economists favouring the expenditure tax on the other hand argue that it is almost impossible to administer an equitable form of income tax; in saying this they have in mind the comprehensive income tax which they contrast with the expenditure tax."<sup>23</sup> The compromising position which emerges from the new international debate on expenditure tax is that it is possible to combine the best features of the existing income tax with the practicable advantages of expenditure tax to improve the direct tax system in developed as well as developing countries. This would suggest the emergence of an income-cum-expenditure tax in these countries in the near future. But in countries like India, where tax evasion has become a common practice, administration of expenditure tax requires adequate preparation both for the administration and for the prospective honest tax payers.

#### RELEVANCE OF EXPENDITURE TAX FOR A DEVELOPING ECONOMY

The three international proposals which have recommended expenditure tax have not been unanimous on the pattern of its actual introduction. For instance, the American Blueprints has recommended expenditure tax as an alternative to the existing income tax in USA, whereas Meade Committee and the Swedish proposal have suggested expenditure tax to be introduced first in the form of a surcharge at higher levels of income, converting the present progressive income tax into a proportional income tax. However, Meade Committee has recognised the administrative problems involved in implementing such a proposal in the beginning and also the problem of educating the public in regard to the combined operation of a proportional income tax and a progressive structure of expenditure surcharge above a particular level of expenditure. It should be mentioned here that levying a surcharge on higher levels of expenditure by retaining moderate rates of progressive income tax at all levels was first recommended by Kaldor. Meade Committee and Swedish proposals have only revived Kaldor's proposal with certain modifications. However Meade Committee has suggested an universal expenditure tax in a phased manner, that is, it has recommended introduction of a two-tier expenditure tax to start with and then replacing the income tax by a universal expenditure tax.

Expenditure tax was introduced in India from April 1, 1958 on the recommendation of Nicholas Kaldor. It was levied along with income tax. Kaldor recommended moderate rates of income tax with a maximum rate of

45 percent on income but steeply progressive expenditure tax rates as shown in Table 1. But the government of India levied high marginal rates of income tax (upto 90 percent) and also high rates of expenditure tax. However, the expenditure tax was made applicable to only those income tax assesses whose income exceeded Rs. 60,000/- per annum. Further the administrative procedure introduced to assess expenditure tax required the spenders to declare their total consumption and submit vouchers/bills in support of it. Though the government of India accepted expenditure tax as a desirable tax policy measure for reducing tax evasion and conspicuous consumption, the Indian bureaucracy did not accept it wholeheartedly and hence throttled the experiment by creating administrative complications. Consequently the revenue yield was poor, (see Table 2), and the administration became a muddle. Hence the tax was abolished. Expenditure tax faced the same fate in Ceylon also.

However in the light of the new international debate on expenditure tax, there are suggestions in India to introduce some elements of expenditure tax into the presently operating progressive income tax. In most of the countries the income tax which is operating is a mixed form of tax on income as well as on expenditure. That is, the taxable base is income minus certain forms of savings and hence it is a tax on consumption plus on certain unapproved savings, such as bank deposits in India. The suggestion made in India is that the income tax should be converted into an expenditure tax by allowing socially desirable savings to be deducted after taking into account all forms of income. For instance, Raja Chelliah<sup>24</sup> has suggested the following tax base to make the present income tax a more comprehensive income-cum-expenditure tax: gross total income as computed for income tax plus gifts, interest received on post office savings and fixed deposits, (which are exempted now upto Rs.3000/-), plus agricultural income, (which is indifferently levied), and realised capital gains and all other casual income, minus taxable gifts made, net contributions to provident fund, compulsory deposits required to be kept by the income tax payers, life insurance premia, minus increase in net worth at previous year's prices minus taxes on capital gains, wealth and on income. The proposal does not recommend wholesale replacement of the existing income tax by an expenditure tax mainly because, expenditure is not accepted as a better measure of taxable capacity and that it has got its own administrative complications which may adversely effect the revenue yield.

In India it is easy to justify expenditure tax, as it is derived from income tax, because, some of the arguments which go against expenditure tax in developed countries may not hold good for India. For instance, the expenditure tax is opposed in the west on the ground that it would hurt the large families much more than the small families and though large families have to spend more, they spend relatively smaller proportion of their income than the poor families, and hence the tax will be regressive. But this argument does not hold good for India because the Indian national policy has been to limit the size of the family through family planning programme. If the families whose total income and expenditure exceed the exemption limit face higher rates of expenditure tax because they spend more, it will act as a disincentive for having large families in India. Further, in India concentration of wealth has

Table 1  
Rate Structure of Expenditure Tax Which Operated in India

Rate Structure Suggested by Nicholas Kaldor		Rate Structure introduced by the Government of India in			
Taxable Expenditure (Rs)	Rate of tax %	1958-59		1964-65	
		Taxable Expenditure Slab (Rs)	Rate of Tax %	Taxable Expenditure Slab (Rs)	Rate of Tax %
		Upto 10,000	10	Upto Rs. 36,000	Nil
		Between 10,001 and 20,000	20	Between 36,001 and 48,000	5
Upto 10,000	Nil	Between 20,001 and 30,000	40	Between 48,001 and 60,000	7.5
Upto 12,500	25	Between 30,001 and 40,000	60	Between 60,001 and 72,000	10
Above 50,000	300	Between 40,001 and 50,000	80	Between 72,001 and 84,000	15
		Above 50,000	100	Above 84,000	20

Note: The Bill levying expenditure tax was introduced in the Indian Parliament on May 15, 1957, the tax became operative from April 1, 1958. It was discontinued from April 1, 1962, but reintroduced on April 1, 1964 and finally abolished from April 1, 1966.

Table 2  
Revenue Yield from Expenditure Tax and Number of Expenditure  
Tax Payers in India

Year	Revenue yield (Rs. million)	Yield from Expenditure tax as percent of total tax yield of the country	No. of Expenditure tax payers
1958-59	6.9	0.10	421
1959-60	8.9	0.11	553
1960-61	10.5	0.12	789
1961-62	9.6	0.09	807
1962-63	4.2	0.04	348
1963-64	0.9	0.01	042
1964-65	3.8	0.02	367
1965-66	3.5	0.02	599

Source: O.P. Chawla, Personal Taxation in India (1947-70), Somaiya Publications Pvt. Ltd., Bombay, 1972, pp. 156.

been increasing as a result of widespread tax evasion resulting in black money operation. This has been flowing into lavish consumption, urban real estate and gold. The expenditure tax when introduced should disallow any expenditure on luxury durable consumer goods, on gold, investment in urban land (except one approved plot per family for building a house for own living), and in agricultural land (not intended for own cultivation). This would discourage socially undesirable savings. Besides these, expenditure on all durable luxury consumer goods like car, TV sets, stereo sets, refrigerators etc., should be included in tax base. The past accumulation of black money has already become a 'fund' and the future accumulation will manifest itself in 'flow'. The expenditure tax may not be able to tax the black money which is in 'fund'. This will have to be covered by estate duty, wealth tax and gift tax. However, if all gifts made in the form of jewellery, luxury durable consumer goods and real estate in the past five to ten years are included as part of the expenditure tax base by averaging the amount, even this fund part of the black money may be brought under expenditure tax. In the case of future flow of black money, all expenditure incurred on these items will automatically come under expenditure tax. To that extent expenditure tax will go a long way in reducing black money. In order to achieve this kind of tax base computation, registration of all such purchases and computerising the information will become a necessary part of tax administration.

No doubt there will be some opposition to expenditure tax in India on the ground of its past failure. The past failure, however, was mainly due to the way it was implemented by the disinterested bureaucracy. Therefore, if the expenditure tax is designed technically by deriving the expenditure from total income by deducting desirable savings, then no additional assessment authority will be required. The present income tax

department will be able to assess and collect the tax. As far as the revenue from income-cum-expenditure tax is concerned, it should be more than what is realised under income tax if it is implemented in the way it is suggested. For, Raja Chelliah has proposed a progressive expenditure tax to supplement the existing progressive income tax without reducing the present income tax rates. His proposed rate structure and my modified rate structure may be seen in Table 3. It may be observed that

Table 3.  
Chelliah's Rate Structure and My Modified Rate Structure of Supplementary Expenditure Tax for India

Slab of taxable Expenditure	Raja Chelliah's suggested rate. (% of taxable expenditure of family)	My modified rate on individual assesses. (% of taxable expenditure)
First Rs. 20,000	Nil	Nil
Next Rs. 20,000	7.5	Nil
Next Rs. 20,000	10	10
Next Rs. 20,000	15	15
Next Rs. 20,000	20	20
Next Rs. 50,000	30	25
Next Rs. 50,000	40	35
Above Rs. 200,000	50	40

Source: Op. cit., p. 171.

he has treated family as the unit for expenditure tax payment without making provision for splitting the expenditure of married couples. This would impose undue hardship on married earners. Hence, it would be better to treat individuals as tax unit for tax payment though common exemption limit may be fixed for individual as well as for family. Further, Chelliah has suggested a very low exemption limit for a family. I would suggest that the exemption limit should be fixed at Rs. 40,000 in view of inflation factor and not at Rs. 20,000 as suggested by Chelliah. In fact the income tax exemption limit itself has been raised to Rs. 15,000 in 1981-82. Since the expenditure tax has been suggested by the international proposals to come into operation at higher levels of income tax, its exemption limit may be fixed at two and half times the exemption limit of income tax. Also the overall rates should increase moderately and not steeply because of the operation of a progressive income tax. Confiscatory rates do not work in practice as they would create tax resistance and hence evasion, through 'vicious circle of tax evasion' as pointed by Kaldor.<sup>25</sup> Besides, it is necessary to decide what forms of savings and investment should be encouraged and what forms of savings should be discouraged. In the west the proponents of expenditure tax did not bother to distinguish between socially desirable and socially undesirable savings.



It was only Kaldor who mentioned this distinction in passing. Such a distinction may not be relevant in developed countries but it is relevant in a developing country like India where scarce resources have to be suggested above that investment in gold and real estate should not be considered as deductible investment.

Expenditure tax will go a long way in meeting the social need of reducing lavish consumption of a few, and wide inequalities of property and wealth in India. Wide inequalities of consumption and wealth are increasing in the urban area and if a tax on expenditure is introduced it will tend to minimise them and the original integrated direct tax system will come back to its effective operation in full swing to reduce widespread tax evasion and thus reduce wide inequality of income and wealth.

Time is opportune now to bring the expenditure tax back to the direct taxes armoury in India. It has got the support of intellectuals and policy advisers of the leading democratic countries of the west. Incidentally, this was absent when the expenditure tax was introduced in 1958, and in fact policy advisers were antagonistic to the very idea of expenditure tax. Hence, expenditure tax needs only the acceptance on the part of policy makers in India. For, bureaucracy can be roped in once the government makes up its mind.

#### FOOTNOTES

1. The Expenditure Tax: Concept, Administration and Possible Applications, ACIR, Washington, D.C., March 1974.
2. Department of Treasury, January 17, 1977.
3. Progressive Expenditure Tax - An Alternative ? Stockholm, 1978. Professor Sven-Olof Lodin, the author of this Swedish study, has also published an authentic summary of the Swedish proposal in Inter-tax, Nos. 11-12, 1978 and No. 1, 1979.
4. The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Prof. J.E. Meade, George Allen and Unwin, London, 1978.
5. It is called 'Comprehensive income tax', because Robert M. Haig defined taxable income as "the money value of the net accretion to one's economic power between two points in time", (in his paper "The Concept of Income -- Economic and Legal Aspects", printed in his (edited) book: The Federal Income Tax, Columbia University Press, New York, 1929), and Henry Simons also defined it as "the algebraic sum of (1) the market value of rights exercised in consumption; (2) the change in the value of the store of property rights between the beginning and end of the period in question." Personal Income Taxation, Chicago, 1938, p. 128. Hence the concept has come to be associated with their names.
6. Nicholas Kaldor, An Expenditure Tax (George Allen and Unwin, Ltd., 1955), pp. 11-15.

7. Ibid., pp. 11, and 79-80.
8. "Income in Theory and Income in Taxation in Practice", Econometrica, January 1937, and "A Practical Schedule for an Income Tax", The Tax Magazine, July 1937.
9. Irving Fisher and Herbert W. Fisher, Constructive Income Taxation, New York, 1942.
10. Agenda for Progressive Taxation, The Ronald Press Co., New York, 1947. However, he has slightly modified his suggestion in a subsequent paper and has recommended ".....to reform the income tax at least as applied to upper bracket tax payers, so as to provide full inclusion of capital gains and losses and some form of averaging and ..... to adopt a spendings tax for upper bracket tax payers". "Expenditure, Capital Gains and the Basis of Progressive Taxation", The Manchester School of Economic and Social Studies, January, 1957, p. 24.
11. Op. cit., Footnote No. 6.
12. They are mainly peace time justifications. It is interesting to know that Milton Friedman justified expenditure tax, (spendings tax), during World War II to achieve (i) maximum total output as well as that required for war, (ii) efficient allocation of scarce consumer goods available for civilian consumption and (iii) smooth economic transition to post-war situation by using accumulated savings. See "The Spendings Tax as a Wartime Fiscal Measure", American Economic Review, March 1943, p. 62.  
  
William Vickrey also justified a spendings tax during war for the following reasons: "There is a case of a different order to be made, not discussed by Kaldor, for a temporary expenditure tax to be applied at a time of great general shortage of consumer goods, as during a war, or other emergency period. In this case the tax is specifically not expected to continue after the emergency is over, or at least only defers the tax, but reduces the applicable rate, and the incentive for individuals to save, at least temporarily is greatly enhanced. In such contexts the argument for the expenditure tax is much stronger than it is for a permanent tax; indeed it can be considered as a form of graduated generalized rationing. One could even argue that the possibility of such emergency use would be a reason for using the tax in normal times in order to have the administrative machinery ready for the emergency", "Expenditure, Capital Gains and the Basis of Progressive Taxation", The Manchester School of Economic and Social Studies, January 1957, pp. 7-8.
13. "Case for an Expenditure Tax", Economic and Political Weekly (Bombay), January 26, 1980, pp. 158-174.
14. Op. cit., p. 377.

15. Theory of optimal taxation is a new attempt to design income tax (and also commodity taxation) with a view to achieving both economic efficiency, (or neutrality or absence of excess burden), and equity, simultaneously by deriving appropriate rate schedules. According to this theory, income tax in order to be efficient should have linear rate schedule (moderately progressive rates). This requirement makes income tax an ineffective tool of achieving equity in tax burden. Therefore, it is suggested that "it would be good to devise taxes complementary to the income tax, designed to avoid the difficulties that tax is faced with". J.A. Mirrlees, "An Exploration in the Theory of Optimum Income Taxation", Review of Economic Studies, April 1971, p. 208. Hence, expenditure tax may be considered as one of such complementary taxes to achieve equity. But expenditure tax itself creates problems of 'excess burden', and inequity. See David F. Bradford and Harvey S. Rosen, "The Optimal Taxation of Commodities and Income", American Economic Review, May 1976, and Sandmo A, "Optimal Taxation - An Introduction to the Literature", Journal of Public Economics, January 1975.
16. Mr. Barry Bacewell-Milnes has maintained in this context that "There is a contradiction at the heart of the Meade Report, because the Committee could not decide whether, how or where saving should be taxed more or less heavily than spending". "The Meade Report and the Taxation of Capital", British Tax Review, No. 1, 1979, p. 40.
17. However, as compared to indirect taxes on commodity consumption, direct tax on expenditure is considered a better way of achieving equity. In this context Chellaiah has observed that "It would be a far better method to restrict the consumption of the rich through a direct tax on expenditure and simultaneously reduce the rates of taxes on commodities in general, so that many of them would come within the reach of the common people", Op. cit., p. 169.
18. G. Thimmaiah, "Tax Reform in India - An Evaluation of the Indirect Taxation Enquiry Committee (1977-78)", Bulletin for International Fiscal Documentation, February 1979.
19. This refers to the incentive effect of tax rate cut on private sector, which will generate higher GNP which in turn expands the tax base and enables the government to collect more revenue even at lower rates of tax. This 'Laffer curve' effect has been advanced in U.S.A. as a part of 'Reaganomics'.
20. Sven-Olof Lodin, Intertax, No. 1, 1979, p. 37.
21. Kenyon E. Poole, "Problems of Administration and Equity under a Spendings Tax", American Economic Review, March 1943, pp. 63-73.
22. He has observed that "the Committee is a little inclined to play the old game of comparing an imperfect present (income tax) with a perfect future (expenditure tax) without the comparison to be valid". "The Meade Committee Report", British Tax Review, No. 6, 1978, p. 191. However, Alan T. Peacock has given just the opposite interpretation for

the Committee's justification of expenditure tax. He has observed that "In fairness to the Committee, however, it must be emphasised that it has not committed the fallacy of comparing an imperfect existing income tax with some ideal hypothetical alternative". "Do we need to Reform Direct Taxes". Lloyds Bank Review, July 1978, p. 36. But in all fairness to both, A.R. Prest's statement is nearer truth. In fact Nicholas Kaldor also resorted to the same old game when he advocated expenditure tax. Professor R.A. Musgrave in his review of Kaldor's book: An Expenditure Tax, observed that "Kaldor holds that it is much simpler to devise a proper concept of spending than a proper concept of income. However, in his highly stimulating discussion, he seems to overstate the difficulties of the income tax and to understate those of the spendings tax. ... The proof of the pudding of course, is not in comparing a perfect income tax with a perfect spendings tax, but in comparing both as they turn out in practice. Again Kaldor tends to overstate the administrative difficulties of improving the income tax while understating those involved in the spendings tax." American Economic Review, March 1957, pp. 201-202.

23. Op. cit., p. 163. In this context William Vickrey has rightly observed that "In this area, more than in most, there is a sharp distinction to be drawn between considerations that would apply to the comparison of theoretically perfect taxes of the various types and those that would apply to the taxes as actually administered. ... On the other side even less tolerable is the reverse error of ignoring the difficulties of the present system merely because they are somehow being lived with, while making the most of all of the difficulties, real or imagined, associated with the new.

Evenhanded comparison of two taxes in terms of imperfect practice is difficult, however, not only because imperfection is always more complex than perfection but because the nature of the imperfections to be encountered in practice are difficult to predict, particularly with respect to the new law. As a first approximation, therefore, it is helpful to compare a reasonably perfected income tax with an equally idealized expenditure tax." The Manchester School of Economic and Social Studies, January, 1957, pp. 1-2.

24. Indian Tax Reform: Report of a Survey, The Department of Economic Affairs, Ministry of Finance, Government of India, New Delhi, 1956, p. 5.