From D. Bradford, Untangling the Income Tax

Income, Consumption, and Wealth

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The income tax is not a tax upon income but a tax upon persons according to their respective incomes; and, subject to the requirement of adherence to simple, general rules, the objective of policy must be fairness among persons, not fairness among kinds of receipts (whatever that might be construed to mean).

Henry C. Simons, *Personal Income Taxation*

THE CONCEPT of *income* is obviously central to the discussion of income tax policy, yet advocates of income tax reform rarely attempt to state their objective with any precision. Interestingly, there is a considerable degree of consensus among tax scholars as to what the term "income" means.[1] That view of income takes as its starting point the idea that income is what is received in payment for services rendered. I am going to call this the "factor payment" view of income. Reflection on why a person who has more income than another should pay more in taxes suggests that the critical issue is not payments received, but what the individual can buy in the way of consumption or additions to wealth. The implied "uses" view of income as the basis for taxation is generally accepted.

Since what goes out (in expenditure on consumption and assets) must first come in, the two views of income are close relatives, and in some simple worlds they lead to exactly the same practical tax rules. In more complicated worlds, however, they may not. In this chapter I elaborate on the uses definition of income and explain how it relates to the factor payment view. I conclude with a quick scan of the existing income tax in relation to the various concepts discussed. Appendix 2–1 focuses on an often-controversial question, the place of gift and bequest transactions in defining income. All of this is a prelude to a closer look in subsequent

1. There is a large literature on the definition of income for tax purposes. An excellent overview is provided by Richard Goode (1977, pp. 1–30). I draw here heavily on a previous paper of mine on this subject (1983), which in turn draws on the treatment in *Blueprints*, chap. 2.

chapters at a whole series of issues in the design of taxes based on income and consumption.

The Definition of Income: Uses and Factor Payment Views

An income tax is a levy based on a particular aggregation of transactions according to a complicated set of rules laid down in statutes, regulations, rulings and court decisions, and the like. In one sense that set of rules *defines* income for tax purposes: income is what the law says it is. But those rules are motivated by some sort of ideal or target concept. Thus while a tax on income is really a complex set of taxes on particular transactions, such as the receipt of wages or interest, what makes that complex set of taxes halfway understandable is the underlying notion of a certain flow of purchasing power. Indeed, the key to making the income tax more understandable is bringing about greater consistency between the definition of income implicit in the law and a clear underlying idea.

Most discussions of tax policy build on what is called in the jargon the "Haig-Simons" definition of income, a label derived from the names of two influential writers on income taxation (Haig, 1921, and Simons, 1938). According to this definition, an individual's income is the sum of what he consumes during the year and the increase in his wealth.[2] This is the *uses* view of income that I have mentioned. Most people are at first puzzled by it. They not unreasonably think of income as something that comes in, such as wage or interest receipts. But the concept of income appropriate for tax purposes is supposed somehow to be related to the well-being of the person receiving it, and that depends on what the person obtains with purchasing power, not where he got it.

Information about sources of purchasing power is, however, essential in the practical accounting methods by which to measure the sum of consumption and the increase in wealth. Income accounting has to be based on transactions that we can observe—usually an exchange of something for money. Such transactions as the receipt of wage and interest payments form the basis for income accounting. Although the layman tends to identify these receipts with income, they are actually just the starting point for measuring income. Cash receipts as such do

2. I regret that the English language makes it necessary to choose between masculine and feminine pronouns; in most cases I have chosen to use the generic "he" and "his" as the least unsatisfactory option among stylistic possibilities.

not provide a good measure of a person's consumption or change in wealth. Consider, for example, the cash inflow that results when a person sells an asset such as a share of stock. A transaction of this sort is not necessarily associated with any change in the seller's position. One minute he has a stock of wealth that includes some shares with a certain money value. The next minute, after the sale, he has one less share of stock and more cash, but the money value of his wealth, including both shares and cash, has not changed at all. The sale of stock involves simply a reallocation of the individual's portfolio and provides no measure of an improvement in position. (Presumably both the buyer and the seller of stock prefer the postsale position to the presale position. Otherwise the transaction would not have taken place. However, there is no objective way to measure the improvement perceived by the two parties. The net improvement, or surplus, attributable to the transaction is not necessarily related to the value of the assets changing hands.)

A similar problem arises in ordinary business accounting. It is taken for granted that income is somehow to be defined *net* of the cost of obtaining it. But which outlays are to be subtracted from receipts during the year? A little thought on what it is that makes various cash inflows and outflows different from the receipt of salary leads one to look for a bottom line against which to judge the appropriate treatment of different transactions. We subtract the cost of materials and other inputs from receipts from sales because we want to know what is left over to spend. Ultimately our interest is in changes in a person's consumption or power to consume. It therefore follows that an individual has experienced income to the extent that he has either undertaken consumption or added to the stock of potential consumption we call his wealth.

According to the uses view, then, income is defined as the sum of consumption and the change in wealth during the year. An increase in wealth during the year is, furthermore, what we mean by saving during the year, so income is equivalently defined as the sum of consumption and saving. This will be a critically important point to keep in mind when we come to the question of taxing on the basis of consumption rather than income. The difference between a consumption-based tax and an income-based tax is entirely in the treatment of saving.

Two related aspects of this definition should be particularly stressed. First, in an accounting sense it is possible to start with a measure of income and reach a measure of consumption for purposes of taxation by *subtracting* amounts saved. If income is the sum of consumption and saving, then consumption is the difference between income and saving. Sometimes the saving is negative; that is, in some periods people draw on their savings. In such periods consumption will exceed income. The second point is that a tax based on consumption is in an important sense a tax on wealth: under a consumption approach, amounts withdrawn from past accumulation are subject to tax. This fact makes a consumption approach an attractive one from the point of view of taxing according to ability to pay. It also draws attention to the potential difficulty in making a transition from a tax based on income to one based on consumption, since there is a danger of unfairly subjecting individuals to a double tax on their past saving. But as we shall see, the difficulty of surmounting this problem is often exaggerated.

The uses view of income can be contrasted with the factor payment view. People typically think of income as what they are paid for rendering services — for example, wages earned for working, interest received for lending money, or profit made from producing a product for sale. In the economist's technical language, these are examples of factor payments; thus in the factor payment view, income is conceived of as the sum of wages, interest, and the like. The factor payment view is closely related to the uses view of income. Factor payments must be used for something. If the only sources of purchasing power were factor payments and the only uses of purchasing power were consumption or saving, then the factor payment view of income would be identical to the uses view. Whether either condition holds depends on how one defines factor payments, consumption, and saving.

But the practical policies that flow naturally from a factor payment view of income do differ from those that flow naturally from the uses view. Practical policies specify what is included in the receipts side of an income measure and what is to be deducted. Sources of purchasing power other than factor payments include transfers of various kinds, both private and public. Gifts, bequests, scholarships, Social Security, welfare benefits, and unemployment compensation are examples of sources of purchasing power that are, to one degree or another, distinct from payments for services rendered. They would arguably be excluded from a factor payment measure of income, and U.S. income tax practice has been to exclude some of them.

Deductions, too, are likely to differ between factor payment and uses views. We take it for granted that the costs of earning factor payments should be deducted from receipts (although there are difficult borderline cases). But the uses view implies that deductions should be allowed as well for uses of purchasing power that are neither consumption nor saving. State income taxes provide an example. While one can make a case for treating state income taxes as consumption, for example, many would regard it as stretching the concept. State income taxes, however, do not represent a cost of earning factor payments. State income taxes might thus seem more obviously deductible under a uses view than under a factor payment view of income.

The attraction of a uses view of income derives from its focus on what is left for the individual. In a sense it follows to its logical conclusion the netting out of expenses that is so obvious in the deduction of the cost of goods sold from sales receipts in determining the income of the owner of a retail store. The object is to obtain a measure of what is effectively available for the owner to spend on good things. A running theme of this book is that the test of a tax base is what it implies for the distribution of burdens among individuals, taking into account its effect on economic efficiency. Like most other commentators, I find the uses definition of income superior to the factor payments view for deciding how tax burdens should be distributed. I therefore take it as the basic notion of income throughout the book.

Jargon can be tiresome, but we need a label for this income concept to suggest that the term is being used in a technical, well-defined sense. The tax theorist's "Haig-Simons" is too academic. Because of the accounting ideal that is characteristic of the concept and also responsible for many of the problems it poses, I have instead chosen the term *accrual income* for purposes of this book.

The Concept of Consumption

Translating the concept of income as the sum of consumption and saving into practical rules requires attention to the definitions of the two components. While people probably share a rough idea of what constitutes consumption, as with income there are many gray areas in the definition. Like income, consumption is in the nature of a flow measured, for example, in dollars per year. And like income, it must, as a practical matter, be described in terms of transactions. Some transactions seem to fit naturally under the label of consumption. For example, we know we are enjoying consumption when we attend a movie or dine at a restaurant. But other activities are not so easily classified. Should we, for example, describe the purchase of medical treatment for a painful disease as consumption? What about the case, already mentioned, of taxes we are obliged to pay to our state governments?

The answers to these questions can be found not by referring to some abstract standard, but by referring to the function we want the aggregation of transactions called consumption to serve. For example, national-income accountants divide the expenditure of a country into three categories: investment, consumption, and government purchases of goods and services. Their object is to describe the overall composition of the nation's expenditure to assist in determining its level. The concept of consumption implicit in the definition of income to be taxed, as in the case of the definition of any tax base, has a quite different role to play: its purpose is to discriminate among taxpayers.

If an income base is defined as the sum of consumption and saving, an income tax will vary tax burdens positively with consumption, other things (including saving) being equal. This being so, the definition of consumption for purposes of taxation is inevitably an ethical and political matter. Medical expenses provide an example. For purposes of national-income accounting the services of physicians are regarded as part of national consumption. But when it comes to setting tax burdens, there is a reasonable argument that medical expenses serve to make up for unfortunate differences among taxpayers. Two taxpayers whose outlays would be the same except that one has larger medical bills than the other might reasonably be described as enjoying the same level of consumption. Thus one might want to exclude medical expenses from the transactions that make up a person's consumption.

That the definition of consumption is a matter of policy finds expression in hundreds of interpretations of the law by the tax authorities. Consider, for example, commutation expenses. The person who commutes to the city does so mainly because it is a necessary condition of employment; it is in an obvious sense a cost of earning income. On the other hand, how much commuting expense one has depends on where one chooses to live, and this is clearly a consumption choice. (Present tax policy is based on the second view: commuting expenses are not deductible.)

The preceding example well illustrates the basic approach employed to measure individual income for tax purposes: the use of subtraction. Individual income tax accounting works by keeping track of a person's receipts and then allowing various deductions. One way of interpreting many deductions is as allowances for outlays deemed not to constitute consumption or saving. Clear costs of earning income are obvious among these. But as the cases of medical expenses and state income tax payments show, there may be other outlays that are not considered consumption; deductions for them are also implied by the accrual-income concept.

The treatment of gifts and bequests in an income tax provides an interesting application of this idea. It often comes as a surprise that tax theorists are divided on whether money an individual gives away or bequeaths at death should be regarded as consumed by the giver. The usual intuitive argument is that it should not: an individual who gives money away transfers potential consumption to the recipient of the gift. This would imply that in determining income, the amount should be deducted from the donor's income and added to the donee's income.

The counterargument, that making a gift or bequest is a form of consumption, is based on the observation that the individual can choose between spending on consumption goods and services (as ordinarily conceived) or spending on a gift or bequest (see Simons, 1938, chap. 2). The choice is thus similar to any other decision about how to allocate purchasing power. If the individual favors a gift or bequest, it must be because a value is placed on the action at least equal to the value of the ordinary consumption that might alternatively have been chosen. In this view, although the recipient of a gift should include it in income, the donor should not deduct amounts given away.

Gifts and bequests also provide an instance in which the factor payments and uses views of income tend to lead to different results. Although it may be argued that the person who is good enough to accept a gift renders a service to the donor (so that a gift received can be regarded as factor payment), most people would probably regard this as considerably stretching matters. Therefore the factor payment view would ignore gift transactions, neither including amounts received in the income of the recipient nor allowing a deduction on the accounts of the donor.

As in the case of other decisions about what constitutes consumption, the preferred policy is to be sought not in abstract reasoning but in concrete comparisons of the effect on tax burdens and other characteristics of the tax system, when one definition or the other is used for tax purposes.

The Concept of Wealth

The concept of wealth also presents problems. In a general way, it refers to the total purchasing power a person commands at a given time. It is thus a *stock*, measured in dollars (with a date specified if the general price level is variable). Wealth thus contrasts with the flow character of income and consumption. The *change* in wealth during the year (or other accounting period), which enters the definition of income, is a flow, typically measured in dollars per year. For example, a savings account balance would normally be counted as part of wealth, because the owner of the account could withdraw the full amount at will and spend it on goods and services.

An asset consists essentially of a claim to future returns, that is, to future payments of money or future delivery of goods and services. Where the returns are in the form of goods and services, it is typically possible to place a money value on them. Thus the bank account asset gives its owner a claim to payment of the balance on demand. The owner of a bond has a claim on periodic interest payments plus repayment of the face amount at maturity. The owner of a share of stock has a claim on a proportionate share of dividends declared by the firm (plus certain rights upon dissolution of the firm). The owner of a pension has a claim against his employer or an insurance company to certain payments during retirement. The owner of a machine has a claim to its rental or to the value of the extra production it permits. The owner of a personal residence has a claim to the housing services provided by the residence.

Because the future services or payments that can be claimed by the owner of an asset are of potential value to others as well, an asset generally can be converted to some positive amount of current purchasing power. Conceptually, an individual's wealth is the maximum amount of present consumption he could finance currently by selling or otherwise committing all of his assets (withdrawing funds from a bank account is an example of "otherwise committing" an asset; a much more important example is borrowing against the security of an asset).

People rarely appreciate the degree to which wealth is a *psychological* phenomenon. The value of assets depends on what we believe is going to happen in the future. It is entirely possible that beliefs could change autonomously. For example, a spread of general pessimism might occur. As a consequence, a given physical collection of assets might fall in value and a loss in wealth occur, even though nothing has "really happened." Such wholesale shifts in value can be observed daily on stock markets. It cannot be emphasized enough that such changes in wealth are genuine and that a tax system based on the uses concept of income would recognize them.

Because wealth is a phenomenon of expectations and beliefs, it is also a function of information. One of the properties of information is that it need not be generally shared; it is, however, the generally shared part that determines the market values on which the uses definition of income depends. For example, if I am told on good authority that a meteor is going to fall on my house in one year, I will reevaluate the house. Perhaps, after a struggle with my conscience, I will put my house on the market without telling anyone about the meteor. I will then have suffered no loss in wealth because of the arrival of information about the meteor. When the meteor does land on the house, it will be an unpleasant surprise for the person who then owns the house, who will suffer a loss in wealth, that is, experience some negative income.

On the other hand, if the information about the meteor is revealed to everyone else at the same time that I learn about it, the market value of my house will fall to reflect the fact that in a year the house will be damaged or destroyed. I will then be the one to suffer the loss in wealth, to experience negative income. In a year, when the meteor hits, there will be no resulting decline in the value of my assets—that will have taken place in the past—no loss in wealth, no negative income.

Actually drawing the lines to produce a practical measure of wealth is difficult and inevitably somewhat arbitrary. Typically we do not even think about valuing the average person's most important asset, his "human capital," his earning power. It must be said, though, that if wealth is understood as the current purchasing power an individual can obtain by committing the future inflows from an asset (as by selling a share of stock or by pledging the profits of a business as collateral for a loan), the omission is sensible for most people. Anyone who has tried to borrow against future earning power will know that its current market value is quite limited.

Human capital is not alone in being difficult to value or, indeed, in having different values for different owners. In particular, an asset is often of much less value to others than to its current owner. For example, a house may be on the market for some time before it is sold, and the price at which the sale will take place is hard to predict. Furthermore, most houses are not on the market at all, for the simple reason that they are of much greater value to their current owners than to others. The built-in cold room of the neighborhood fish store is quite valuable to its owner; but it is of less value, or even of negative value, to another user of the same space, as would become clear should the proprietor of the fish store decide to sell his assets. The market value of an individual's claim to a pension, especially under a defined-benefit plan (under which retirement benefits depend on such things as earnings during the years immediately preceding retirement), is difficult to establish and no doubt quite limited, for much the same reason that one's human capital has limited current value to anyone else. (Frequently the value of a pension claim is intentionally reduced via limits in the extent to which it can be pledged as loan collateral.)

An individual's claim on a pension plan is one of many examples of claims on what might loosely be called "trusts." These are arrangements under which someone is committed to making payments to individuals under various contingencies. In the case of the pension, an insurance company may be committed to pay certain amounts to a person under the contingency that the person is retired. Another example that is important less for its quantitative significance than for its contribution to the complexity of the tax law is a legal trust in which assets are held for the benefit of a particular individual. The contingencies might be the earnings performance of a portfolio or the economic success of a business. The payments may depend on events relating to the beneficiaries, as when a trustee pays a young person's college bills. In view of the contingent nature of the claim of any given beneficiary, it may be very difficult to establish its contribution to his wealth. Elaborate rules have been devised to settle this matter by convention in the case of trusts that are part of the estates of wealthy people. Most of these rules are related to the taxation of gifts and bequests. An example is the convention that taxes generation-skipping trusts, whereby wealth is passed from a grandparent to grandchildren without having given rise to wealth in the hands of the children.

The most significant example of what I am calling trusts is the business corporation. The Federal Reserve Board estimated the total net worth of the United States at $11,376 billion as of the end of 1983. Of that total, a little over one-quarter ($3,259 billion) was estimated as the net worth of financial and nonfinancial corporations (Board of Governors of the Federal Reserve System, April 1984). The net worth of these corporations is, in turn, owned by the various claimants on corporations. Important among the claimants are stockholders, some of which, such as pension plans, are also trusts. Tracing through these linked claims to the individual owners and attributing an appropriate value to the claims present difficult accounting problems. Thus the apparently simple concept of wealth presents numerous challenges to policymakers who would base tax liabilities on it or its derivative, income.

Realization Income

Income tax practitioners are accustomed to thinking of income as a "realization" concept (see Simons, 1938, chap. 3). This refers to the procedure whereby the change in value of assets held over more than one period (which is an element of accrual income) is recognized on the books only when there is a transaction with respect to the asset. Present treatment of capital gains, which is based on a realization principle, provides an example. The change in value of a share of stock held

throughout the year will not be counted in the stockholder's income for that year under the accounting practices followed in the U.S. income tax. In general, the changing value of the share will be taken into account only when it is sold or otherwise exchanged. Sale triggers a calculation of gain or loss that is counted as part of the income of the year in which the sale takes place. Income calculated in this way is sometimes referred to as realization income.

The need for a realization concept of income arises because of the difficulty of valuing assets on an annual basis. Rather than representing an independent definitional concept, realization income is a term describing the practice of income measurement. It is more reasonably described as the accountants' refuge from the requirement of excessive reliance on judgment than as a definition; and rather than offering insights into desirable tax structures, it draws attention to the limitation of the income concept as a guide to policy.

Illustrative Individual Income Accounts

To fix these ideas, especially the somewhat backward-sounding notion of income as, in effect, outlay, it will be helpful to work through an example of an individual's income accounts for a particular year.[3] As the purpose of the example is to illustrate concepts developed above, the details have been chosen for simplicity and clarity rather than for realism. Assume, then, that the individual — call him Peter — is a worker whose only sources of funds are wages and an accumulated savings account balance. The possible applications Peter can make of these funds may be divided into the purchase of goods and services for immediate use and additions to or subtractions from the accumulation of savings. Thus an account of the situation for the year might be the following:

Sources	*Uses*
Wages	Rent
Interest	Clothing
	Food
	Recreation
Balance in savings account at beginning of year	Balance in savings account at end of year

3. The material in this and the following sections draws heavily on U.S. Treasury Department (1977).

The two sides of this account must balance. Of the uses, the first four are generally lumped under the concept of consumption; the fifth constitutes the individual's net worth. Thus the accounts may be schematically written as:

Sources	*Uses*
Wages	Consumption
Interest	
Net worth at beginning of year	Net worth at end of year

The concept of income concerns the *addition,* or *accretion,* to sources and the application of that accretion during the year. This information can be found by subtracting the accumulated savings (net worth) at the beginning of the year from both sides, to give:

Additions to sources	*Uses of additions to sources*
Wages	Consumption
Interest	Saving (equals increase in net worth over the year; may be negative)

Accrual income is *defined* as the sum of consumption and the increase in net worth during the year. With this *uses* definition of income, Peter's situation may be represented by:

Additions to sources	*Uses of additions to sources*
Wages	Income
Interest	

This version of the accounts makes clear the way in which information about sources is used to determine the individual's income. To calculate income for the year, Peter would not need to add up the outlays for rent, clothing, food, and recreation and the increase in his savings account balance. Instead he would simply add together his wages and interest and take advantage of the accounting identity between this sum and income.

The classification of uses into consumption and increase in net worth is not sufficient, however, to accommodate distinctions commonly made by tax policy. Suppose, for example, that during the year Peter spends some money to rent tools required on the job. These outlays do not fit the category of consumption, nor do they represent an addition to net worth. It is helpful, therefore, to refine the accounts as follows:

Additions to sources	*Uses of additions to sources*
Wages	Consumption
Interest	Cost of earnings
	Certain other outlays
	Saving (increase in net worth)

The outlays to rent special tools needed on the job would reasonably fit the category "cost of earnings" in the new scheme. These outlays will be netted out in defining income. Note that, as emphasized earlier, the decision about which outlays to include in this category is a social or political one. Thus under existing tax rules the expense of purchasing specialized work clothes for the job is deductible, but commuting expenses are not. There is no unambiguous standard to which one can appeal to determine whether such outlays are consumption, and hence a part of income, or work expenses, and hence excluded from income.

Similarly, a judgment may be made that some outlays, while not costs of earning a living, are also not properly classified as consumption. The category "other outlays" is introduced to the accounts above for want of a better label for such transactions. For example, as discussed earlier, state income taxes would not be an application labeled "consumption," nor, clearly, do they reflect "increase in net worth." Thus, using the definition of income as the sum of consumption and saving, we now have:

Additions to sources	*Uses of additions to sources*
Earnings (wages + interest)	Income (consumption + saving)
	Cost of earnings
	Certain other outlays

As before, to *measure* income it is generally convenient to work from the left-hand, sources side of the accounting relationship. In this case,

$$\text{Income} = \text{Earnings} - \text{Cost of earnings} - \text{Certain other outlays}$$

In a similar way—and the fact is of great importance in implementing a tax based on individual consumption—consumption may be calculated by starting with sources data, including saving among the subtracted items:

$$\begin{aligned}&\text{Consumption}\\&\quad = \text{Earnings} - \text{Cost of earnings} - \text{Certain other outlays} - \text{Saving}\end{aligned}$$

Character of the Current U.S. Income Tax

While the present income tax system lacks a clear rationale, we can see in it elements of both income-base and consumption-base accounting. Thus, for example, the two items that represent the bulk of savings for most Americans, pensions and owned homes, are treated by the tax code in a way that is closer to the consumption model than to the income model. Retirement saving financed by employer contributions to pension plans (or made via Individual Retirement Account or Keogh Plan for the self-employed) is treated as it would be under a consumption tax. Additions to an employer-funded pension plan are not included in the tax base, but retirement benefits from those plans, which represent negative saving much like withdrawals from a bank account, are included. Contributions to Individual Retirement Accounts or Keogh Plans represent deductible saving, while subsequent benefits are treated as taxable dissaving.

If we were to design accounting rules to measure the accrual income attributable to an owner-occupied house, we would treat it like a business, in which the owner rents the house to himself. The result would be a certain amount of annual income. The amount would consist partly of consumption services provided to the occupant (these are the services that the renter buys with a monthly payment), and partly of the changing value of the house, viewed as an asset (accruing capital gain or loss). We might do something very similar to measure the flow of consumption from the house, first calculating the flow of annual income and then subtracting, as saving, any part of it due to an increase in the value of the house.

In actual practice nothing like either of these devices is employed in determining income subject to tax, and it may therefore be thought that owner-occupied housing represents a departure from both accrual-income and consumption approaches. The owner-occupied home is clearly not correctly dealt with as a matter of accrual-income accounting. Furthermore, its treatment seems exactly backward as a matter of consumption accounting, since no deduction is allowed for the purchase of the asset and no effort is made to measure and tax the returning flow of consumption services. In effect, the entire purchase price of the house is treated as consumption (since no deduction is allowed). Remarkably, however, this backward treatment — no deduction for an act of saving, but no inclusion of the subsequent dissaving — can be regarded as prepayment of tax on the consumption generated by the home. The resulting tax burden is equivalent to that which would result from actually measuring annual consumption services.

In addition to these examples of consumption-type base measurement rules under the existing income tax are others relating to specific assets, both financial (for example, the treatment of ordinary life insurance) and real (for example, the expensing of research and experimentation outlays). Moreover, numerous provisions of current law are designed to reduce the taxation of investment, and in effect are much like allowing immediate deduction. At the same time, of course, many rules in the existing system are those one would expect in an accrual-income tax. Perhaps most important is the taxation of interest receipts and the deduction of interest expenses. The coexistence of consumption-type and accrual-income-type rules gives the existing tax its hybrid character and accounts for many of its least satisfactory aspects.

The income concept implicit in current law has elements of both the factor payment and the uses concepts. The uses view of income seems to underlie several important deductions in the existing tax. Most obvious are the personal deductions for medical expenses, charitable contributions, and state and local taxes. While these deductions can be rationalized as (rather odd) matching grant subsidies to the activities in question, they can more naturally be explained as decisions about the consumption component of an accrual-income base. (My choice of terminology is a bit misleading in this instance. The factor payment view of income implies an accrual-type accounting just as much as does the Haig-Simons view of income as the sum of consumption and saving.) Yet many other provisions of the tax law seem explicable only on the basis of a factor payment view of income. The tax-free character of gratuitous transfers, such as gifts, inheritances, prizes (provided the recipients have not pursued them), and welfare benefits (including food stamps), as well as of the less gratuitous (because paid for with payroll taxes) transfers in the form of unemployment insurance benefits, and the partially tax-free character of the partially gratuitous (because partially paid for with payroll taxes) Social Security benefits, indicate that the income concept implicit in the law adopts to some degree the factor payment view.

With a bit of license the treatment of gifts and bequests under the current income tax rules can be interpreted as implementing a uses view of income in which these outlays are *not* regarded as a type of consumption. The uses view always calls in principle for inclusion of gifts and bequests received in the receipts part of the income calculation. If amounts given away are not regarded as consumption, a deduction would be allowed for them. However, not allowing a deduction while not requiring inclusion produces the same tax result as allowing a deduction and requiring inclusion if donor and donee are in the same tax bracket. Thus the present tax treatment has a certain equivalence with a uses approach that excludes gifts and bequests given from the donor's consumption. (There is, of course, in addition a specific tax on gifts and bequests that exceed certain amounts on a cumulated basis over the donor's lifetime.)

Appendix 2–1. Accounting for Gifts and Bequests

The illustrative income accounts presented in this chapter can be applied to the alternative treatments of gifts and bequests. Gifts and bequests received enter the accounts on the sources side, while gifts and bequests given represent uses of spending power. With these additions the accounts become:

Additions to sources	*Uses of additions to sources*
Wages	Consumption
Interest	Gifts and bequests given
Gifts and bequests received	Cost of earnings
	Certain other outlays
	Saving

Some argue that gifts and bequests given should be considered a form of consumption in defining income for tax purposes. Others contend that making a gift or bequest simply transfers the power to consume to others and should not be included in the income concept. We may give the label "bestowal-inclusive" to the consumption concept that treats amounts given away as consumed, and "bestowal-exclusive" to the concept that does not. (It is difficult to find terms for these consumption concepts that convey their respective contents. Readers of *Blueprints* will recognize them as "ability-to-pay" and "standard-of-living" consumption.) To each consumption concept corresponds an income concept, which can be derived from sources-side information as before. The two accounting equivalences for the consumption concept that includes gifts and bequests given are:

Bestowal-inclusive income
= Earnings + Gifts and bequests received
− Cost of earnings − Certain other outlays

Bestowal-inclusive consumption
= Earnings + Gifts and bequests received
− Cost of earnings − Certain other outlays − Saving

The difference between consumption and income is saving, or the increase in net worth, over the period. Thus, equivalently,

Bestowal-inclusive consumption
= Bestowal-inclusive income − Saving

The bestowal-exclusive consumption and income concepts, under which gifts given are not regarded as consumption, give rise to a deduction from the sources side:

Bestowal-exclusive income
= Bestowal-inclusive income − Gifts and bequests given

Bestowal-exclusive consumption
= Bestowal-exclusive income − Saving

Varying the treatment of gifts and bequests and of saving gives rise to four possible tax bases: bestowal-exclusive consumption and income, and bestowal-inclusive consumption and income. Going from income to consumption in either case means subtracting saving; going from bestowal inclusive to bestowal exclusive in either case means subtracting gifts and bequests given.