GETTING SCHOOLED BY THE HYBRID-BASED TAX: EQUITY AND EFFICIENCY IN THE FEDERAL TAX TREATMENT OF DEBT-FINANCED POST-SECONDARY EDUCATIONAL EXPENDITURES

ADAM HIME*

I. INTRODUCTION

The design of the tax system and substance of tax laws have an effect on nearly every economic decision made by individuals.[1] Whether to invest or consume, buy or sell, and what forms of consumption or savings in which to engage are all issues that are influenced by the design of the tax system and the substance of tax laws. The tax treatment of debt in the U.S. hybrid-based income tax system generates inequities and inefficiencies that result from both an inconsistent base and failures in timing. Americans with high net wealth and sophisticated tax advisors can strategically use the inconsistent base and timing problems associated with debt to avoid, delay, or shift tax burdens.[2] Unfortunately, for lower- and middle-class

* Class of 2004, University of Southern California Law School; B.A. 1998, University of California, Los Angeles. I would like to thank my wife Stacey, daughters Emily and Anabelle, Mom, Dad, Alex, Jennefer, Shawn, Rebecca, Craig, and Travis for their love and support over the years. I would also like to thank Edward McCaffery for his superb guidance as I wrote this Note and for his wise advice as I prepare for my future as a lawyer and as a taxpayer. Finally, I would like to acknowledge my friends and colleagues on the *Southern California Law Review* for their hard work and thoughtful additions as this Note was prepared for publication.

1. *See* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE GREAT DEBATE OVER TAX REFORM 4, 102–12 (1996) (describing how tax is one of the major factors influencing individual economic decision making, including investment and voting strategies). When economic decisions are made for reasons other than market forces, such as tax, such decisions may be inefficient. *See id.* at 103.

2. Edward McCaffery describes a basic tax avoidance scheme he calls "Tax Planning 101" that can be utilized only by high net wealth individuals who can borrow against appreciating assets and

avoid tax liability. He describes a hypothetical high net wealth individual, called "Artful Dodger," who utilizes Tax Planning 101 as follows:

> Meet Artful Dodger, a master of Tax Planning 101. Mr. Dodger is fortunate enough to have $1 million at his disposal. . . . [N]ow that he has his million dollars, Dodger is through with his days as an ordinary taxpayer. Here is how he manages never to pay taxes again. Dodger invests his million in a portfolio that gains 10[%] in value every year. In Year 1, Dodger's portfolio rises in value from $1,000,000 to $1,100,000. Dodger borrows $100,000 at 10[%] interest (leaving his net wealth at $1,000,000). In Year 2, he owes $10,000 in interest, but his portfolio has gone up by another 10[%], or $110,000, so it is now worth $1,210,000. He borrows $110,000 more (leaving his net wealth at $1,000,000). He uses $10,000 to pay off the interest on his Year 1 debt and spends the remaining $100,000 . . . .
>
> Dodger will always have $100,000 to spend, and his net wealth will always stay at $1,000,000, as long as the interest rate on his debt matches the yield to his portfolio . . . .
>
> The game can go on forever. As long as Dodger plays it, he will pay no income tax, no capital gains tax, no payroll tax, and no gift and estate tax. When he dies, his heirs can use their inheritance with its stepped-up basis to pay off his debt. They will pay no income tax, and . . . [no] death tax.

EDWARD J. MCCAFFERY, FAIR NOT FLAT: HOW TO MAKE THE TAX SYSTEM BETTER AND SIMPLER 33–34 (2002). Under any tax on income, whether it is consistent or inconsistent, borrowing cannot be taxed because it is not an accretion to wealth. *See* 26 U.S.C. § 61 (2000). The realization requirement dictates that the appreciation of assets will not be taxed until a sale or other realization event. *See* Eisner v. Macomber, 252 U.S. 189, 209–14 (1920). Artful Dodger can postpone paying federal income tax by borrowing against his appreciating property, consuming the borrowed money, and never realizing the appreciation in his stock. This delay is worthwhile, even if his heirs receive a carryover basis and have to pay tax on the appreciation of his stock, because he is able to take advantage of the time value of money. *See* FREDERIC S. MISHKIN, THE ECONOMICS OF MONEY, BANKING AND FINANCIAL MARKETS 71–72 (4th ed. 1995) (providing a simple introduction to the concept of the time value of money). Given that death is not a realization event and that heirs receive a stepped-up basis in appreciated assets on death, Artful Dodger and his heirs avoid paying income tax altogether, despite the fact that he lives with a six-figure consumption power. *See* 26 U.S.C. § 1014(a)(1) (describing the stepped-up basis for appreciated assets on death). The total number of tax advisors in the United States has grown dramatically in recent years from 120,000 in 1970 to 325,000 in 1990. *See* B. GUY PETERS, THE POLITICS OF TAXATION: A COMPARATIVE PERSPECTIVE 256 (1991). In recent years, tax advisors and accountants have begun working on contingency fee bases, "creat[ing] for themselves a vested interest in the proliferation of tax shelters." *See* Ben Wang, Note, *Supplying the Tax Shelter Industry: Contingent Fee Compensation for Accountants Spurs Production*, 76 S. CAL. L. REV. 1237, 1238 (2003). Less sophisticated tax dodgers who save in ordinary savings accounts will pay tax on the interest generated by such accounts. *See* 26 U.S.C. § 61. *See also* MCCAFFERY, *supra*, at 35–37. Scholars have argued that taxation of the yield on ordinary savings accounts is unfair because, considering the inflation rate, there is no real economic return from ordinary savings accounts. *See* Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?*, 47 TAX L. REV. 377, 391 (1992) (arguing that when inflation is taken into consideration, there is no real return on risk-free investments such as traditional savings accounts). *See also* MCCAFFERY, *supra*, at 35–36 (indicating that when federal income taxes are imposed on the yield to ordinary savings accounts, there is an actual economic disincentive to save). The story of Artful Dodger is one of inequity and inefficiency. Although unsophisticated high net wealth individuals may pay tax on the yield to their ordinary savings account, those with no real savings have no choice but to pay high income tax rates on their wages. The fact that the tax system requires Artful Dodger to pay no income tax regardless of his annual consumption power of $100,000 is inequitable considering that wage earners who earn and spend $100,000 in a year would find themselves in a marginal tax bracket of 31%. *See* 26 U.S.C. § 1(a)–(c). From an economic perspective, the tax avoidance scheme that is made possible because of the inconsistent tax base and timing failures that characterize our current tax laws encourages people with highly appreciated assets to retain their assets rather than sell them. Normally, efficiency in the free market depends on the free alienability of

Americans without the benefit of tax advisors, the inconsistent base and timing problems associated with debt in our tax system can be economically detrimental.[3]

One major type of debt that is disproportionately held by lower- and middle-class Americans under thirty-five years of age is debt accumulated to finance post-secondary education and other similar personal investments in their human capital.[4] The unfair and inefficient tax treatment of debt that is acquired to finance post-secondary education is the focus of this Note. These inequities and inefficiencies can be resolved, in whole or in

assets. *See generally* R.H. COASE, *The Nature of the Firm*, *in* THE FIRM, THE MARKET, AND THE LAW 33 (1988) (providing a rigorous argument for the free alienability of assets). For Artful Dodger to avoid paying tax on the appreciation of his portfolio, he must die with it, so his heirs will receive a stepped-up basis. This lock-in effect that is imposed by the federal income tax system can be seen as inefficient because it interferes with the free alienability of assets. If he sells the stock during his lifetime, the gain will be realized and a substantial tax will be imposed. *See Eisner*, 252 U.S. at 212. *See also* ALAN J. AUERBACH, *Should Interest Deductions Be Limited?*, *in* UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 195, 198 (Henry J. Aaron et al. eds., 1988) (discussing timing problems associated with the treatment of debt).

3. Total individual debt has grown dramatically in the United States since the 1980s. *See* ROBERT H. FRANK, LUXURY FEVER: MONEY AND HAPPINESS IN AN ERA OF EXCESS 46 (1999) ("Total household debt grew from 56[%] of disposable personal income in 1983 to 81[%] by the beginning of 1995 . . . ."). Robert Frank describes how the vast majority of this debt is not the result of strategic tax avoidance, but is, instead, generally lower- and middle-class consumer debt generated by the societal deficiency he terms "luxury fever." *See id.* at 45–49. For a discussion of strategic tax avoidance, see MCCAFFERY, *supra* note 2, at 33–34.

4. "[S]tudents from lower-income households are . . . more likely to graduate from college with debt. In 1999–2000, 71[%] of students from households making less than $20,000 [per year] graduated with debt, compared to 44[%] of students from households making more than $100,000." *See Student Debt on the Rise*, CNNMONEY, Mar. 8, 2002, *at* http://money.cnn.com/2002/03/08/college/q_studentdebt. *See also* Christine Dugas, *Debt Smothers Young Americans*, USA TODAY, Feb. 11, 2001, at 1 (finding that, in 2001, Americans thirty-five to fifty years old were almost twice as likely as Americans under thirty-five to have home mortgage debt, whereas those under thirty-five were twice as likely to have student loan debt). One study found that, in 1999–2000, almost two-thirds of students graduated with student loan debt. *See* TRACEY KING & ELLYNNE BANNON, STATE PIRGS' HIGHER EDUC. PROJECT, THE BURDEN OF BORROWING: A REPORT ON THE RISING RATES OF STUDENT LOAN DEBT 2 (2002) (indicating that, in 1999–2000, 64% of students received federal student loans, compared to only 42% in 1992–93). Furthermore, this study found that between 1992–93 and 1999–2000, the average total student loan debt doubled and that six times as many students completed their undergraduate education with federal student loan obligations over $20,000. *See id*. It also found a correlation between an unmanageable debt burden and the ethnicity of individual students. *See id*. at 3–4 (finding that over half of African-American and Hispanic students graduate with unmanageable debt burdens, while only 37% of Caucasians graduate with unmanageable debt burdens). These circumstances have been exacerbated by the fact that over the past twenty years, the amount of loans as a proportion of total student financial aid has increased substantially as the relative availability of grants has diminished. *See* Tracey Wong Briggs, *Financial Aid System Crams More Costs onto Collegians*, USA TODAY, Oct. 24, 2001, at 7D ("In 1980–81, grants accounted for almost 55% of financial aid, with about 41% in loans. [In 2000], the percentages had nearly reversed, with loans accounting for 58% and grants 41%.").

part, by tax reform. This Note discusses three alternative tax reform proposals, focusing on how each may impact the tax treatment of student loan debt. One of these reform proposals functions within the context of a hybrid-based tax, defining debt accumulated to finance post-secondary education as an amortizable investment and generating deductions for taxpayers in later years when their investments provide a higher salary than they would have had without this additional education.[5] The other two reform proposals require fundamentally redefining the tax base and moving toward a pure, consistent income tax or a pure, consistent consumption tax.

Part II provides a foundation for analysis by highlighting, through a story, the fundamental problems with the tax treatment of student loan debt under the United States' progressive hybrid-based tax system. Part III describes different systems of taxation, generally defined by their base, and provides background regarding the evolution of the taxation system currently employed in the United States. Part IV applies the rules of taxation that impact the accumulation and repayment of student loan debt under our hybrid-based tax system and analyzes whether the normative objectives of equity and efficiency are adequately achieved. Part IV also discusses some potential improvements in tax laws within the student loan context that do not involve a fundamental redefinition of the tax base. Part V analyzes whether the problems of student loan debt taxation would be better solved under a consistent, progressive income tax; a consistent, progressive, prepaid consumption tax; or a consistent, progressive, postpaid consumption tax. Finally, Part VI concludes that while no particular tax system completely satisfies the objective criteria of equity and efficiency in the context of student loan debt, a progressive, postpaid consumption tax most reasonably comports with these normative standards.

5. This is the solution proposed by Loretta Collins Argrett in her seminal article on the inequity of the current tax treatment of student loan expenses. *See* Loretta Collins Argrett, *Tax Treatment of Higher Education Expenditures: An Unfair Investment Disincentive*, 41 SYRACUSE L. REV. 621 (1990) (discussing the tax treatment of student loan expenditures, whether paid at the time the education is received or on a loan basis, and arguing that the amortization of student loan expenditures is one solution to the problem addressed in this Note). *See also* Hamish P.M. Hume, Note, *The Business of Learning: When and How the Cost of Education Should Be Recognized*, 81 VA. L. REV. 887 (1995) (describing the evolution of section 1.162-5 of the U.S. Treasury Regulations, the regulation that distinguishes educational expenditures incurred prior to entering a trade or business—for which no deduction is allowed—and those incurred to maintain or improve skills related to the individual's current occupation).

II. A TAX TIMING TRAGEDY: THE STORY OF ANDY AND BETTY

Imagine two friends, Andy and Betty, sitting in their high school library debating whether it is more beneficial for them to enter the workforce immediately after high school or to pursue higher education. Andy decides that he will begin working as a plumber immediately after graduating from high school. Betty dreams of being a dentist; her parents and teachers have told her that the surest path to success and wealth is via a college and graduate school education.

Betty listens to the advice of her elders and decides to enter a private university. Like an ever-growing number of college students, she is forced to finance her post-secondary education through debt.[6] Her parents and teachers advise her that a college education is a sound investment that will pay off many times over. Andy agrees with Betty that, in the long run, he too would probably be better off going to college than entering the workforce immediately after high school—but are they correct? Andy and Betty part ways.

At age eighteen, Andy gets married and begins working as a plumber. He joins the local union and earns $55,000 per year.[7] Assuming he forgoes any exemptions or credits, aside from his personal exemption,[8] and takes the standard deduction,[9] as is the case with most middle-class wage earners,[10] his taxable income is $46,000.[11] Each year he pays about $8000 in federal income tax[12] and has about $47,000 to spend.[13] Even assuming that he does not get a raise between the ages of seventeen and thirty, he receives about $600,000 in after-tax dollars[14] during those thirteen years.

At age eighteen, Betty goes to college. After college, at age twenty-three, she takes a year off to study for the Dental School Admissions Test and file applications for dental school. She is admitted to a private dental school where she spends four years earning a degree. After spending

6. *See* Briggs, *supra* note 4, at 7D.

7. The City of Los Angeles hires plumbers at a starting salary of $58,500. *See* L.A. Pers. Dept., Career Interests, *at* http://www.lacity.org/per/career.htm#Skilled (last visited Apr. 13, 2004).

8. The personal exemption given to each taxpayer is $2000. 26 U.S.C. § 151(d)(1) (2000).

9. The standard deduction for a married couple filing jointly in 2003 is $5000. *Id.* § 63(c)(2)(A)(i).

10. *See* MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 191 (9th ed. 2002).

11. The text contains rounded numbers for clarity, but this and subsequent footnotes will contain calculations yielding exact values. $51,000 – $5000 = $46,000.

12. 26 U.S.C. § 1(a)(2). The exact amount Andy will pay in tax is $8083.

13. $55,000 – $8083 = $46,917.

14. $46,917 x 13 = $609,921.

another year studying for her Board exams and seeking employment, she gets married and begins working as a dentist at age thirty. Betty went through college and dental school financing her education primarily through loans—accumulating $300,000 in debt[15] over thirteen years. Although Betty's parents and teachers tell her that spending time, energy, and money in school can be thought of as an investment, the U.S. tax system tells her otherwise.

After thirteen years of work, Andy gets a raise—he is now making $74,000 per year. He and his wife take their personal exemptions[16] and standard deduction,[17] giving them taxable income of $65,000 per year.[18] They pay about $13,000 in federal income tax[19] and are left with about $60,000 of disposable after-tax income.[20] This continues for thirty years, until Andy retires at age sixty. During his lifetime, Andy, a productive citizen, earns almost $2,500,000 in after-tax disposable income[21] and pays about $500,000 in federal income tax.[22]

Meanwhile, Betty is ready for the big payoff from the investment she has made in her human capital. Although at age thirty she faces $300,000 in educational debt, her job as a dentist pays $109,000 per year.[23] After she and her husband take their personal exemptions[24] and standard deduction,[25] they are left with $100,000 in taxable income.[26] Because she entered a relatively high marginal tax bracket[27] during her first year in the workforce,

15. Although it is admittedly unusual that a given student would receive neither any federal student grants or any assistance from family, $300,000 can be considered a conservative estimate of the total costs of undergraduate and professional school education for a dentist. For a sampling of the actual cost of dental school approaching $250,000, see N.Y. Univ., Coll. of Dentistry, Costs and Financial Aid, *at* http://www.nyu.edu/Dental/academicprograms/dds/costs.html (last visited Apr. 13, 2004); Univ. of S. Cal., Sch. of Dentistry, Financial Aid Information, *at* http://www.usc.edu/hsc/dental/financial_aid/dds.htm (last visited Apr. 13, 2004).

16. *See supra* note 8 and accompanying text.

17. *See supra* note 9 and accompanying text.

18. $74,000 – $9000 = $65,000.

19. *See* 26 U.S.C. § 1 (a)(2) (2000). The exact amount Andy pays in tax is $13,403.

20. $74,000 – $13,403 = $60,597.

21. ($46,917 x 13) + ($60,597 x 30) = $2,427,831.

22. ($8083 x 13) + ($13,403 x 30) = $507,169.

23. According to the National Council on Economic Education, the average dentist can expect to command a starting salary of $110,600. *See* Nat'l Council on Econ. Educ., The Mint, Careers: Starting Salaries, *at* http://www.themint.org/earning/startingsaleries.php (last visited Apr. 13, 2004).

24. *See supra* note 8 and accompanying text.

25. *See supra* note 9 and accompanying text.

26. $109,000 – $9000 = $100,000.

27. Betty is taxed at a marginal rate of 31% in her first year. 26 U.S.C. § 1(a) (2000). As Graph 3 illustrates, the marginal tax rate that is imposed on Betty during the first year she works does not take into account the substantial amount of borrowing that was necessary to acquire the skills that make her

she pays about $24,000 in federal income tax,[28] leaving her and her husband about $85,000 in disposable after-tax income[29] to spend and pay off debt. If she makes the same amount of money until she is sixty and then retires, even assuming that her school loans were interest free,[30] she will have earned a little over $2,500,000 of after-tax income during her lifetime[31] and will pay a little over $700,000 in federal income tax.[32] Her educational loans must be satisfied with after-tax dollars[33] and she is left with a cumulative lifetime after-tax spending money of about $2,220,000.[34]

When Andy and Betty reunite at their fortieth high school reunion, both are shocked to learn that Andy's lifetime after-tax spending power is higher than Betty's.[35] By the time Betty is able to crawl out of her debt-financed consumption of post-secondary education, she is never able to recover financially, and the tax system does not help her. Her lifetime consumption power is lower than that of Andy's,[36] but her lifetime federal tax payments are almost 40% more.[37]

This story demonstrates two points. First, our current federal tax system treats educational expenses as consumption, rather than as an investment, and this is inequitable. Second, our tax system discourages and punishes those who invest time, energy, and money into post-secondary education, and this is inefficient. A discussion of the inequity and inefficiency associated with the current tax treatment of post-secondary educational expenses is the focus of Part IV.

---

labor relatively valuable or the fact that her net wealth will remain negative for a relatively long time. *See* Graph 3 *infra* Part IV.

28. *See* 26 U.S.C. § 1(a). The exact amount Betty pays in tax is $23,528.50.

29. $109,000 – $23,528.50 = $85,471.50.

30. Of course, the acceptance of both federal student loans and private student loans requires the acceptance and repayment of relatively reasonable interest payments. For an interesting analysis of the tax treatment of student loan interest and the Taxpayer Relief Act of 1997, see generally Jacqueline T. Albus, Comment, *The Deduction for Interest on Student Loans: Relief Is on the Way*, 42 ST. LOUIS U. L.J. 591 (1998).

31. $85,471.50 x 30 = $2,564,145.

32. $23,528.50 x 30 = $705,855.

33. Post-secondary educational expenditures incurred to prepare students for jobs, unlike educational expenses incurred to improve skills for a current job, are nondeductible. *See* 26 U.S.C. § 1.162; 26 C.F.R. § 1.162-5(b) (amended 1967). For a discussion of the history of this distinction, see generally Hume, *supra* note 5.

34. $2,564,145 – $300,000 = $2,264,145.

35. Andy's actual after-tax spending power is $2,427,831 and is greater than Betty's actual after-tax spending power of $2,264,145. *See supra* notes 21 and 34 and accompanying discussion.

36. *Id.*

37. $507,169 x 1.391755 = $705,855.

III. TAX BREAKS IN THE TAX BASE: THREE SYSTEMS OF TAXATION

A civilized society with the objectives of functioning as a cohesive unit, enforcing laws, and promoting commerce needs taxes to support the infrastructure necessary to accomplish these tasks.[38] Unfortunately, designing an equitable and efficient tax system has proven to be an elusive goal for the U.S. government since the inception of the hybrid-based tax after World War II. Most of the modern tax debate and reform proposals center around two forms of taxation: income taxes and consumption taxes. The tax system currently employed in the United States is most accurately described as a hybrid, containing both income and consumption tax elements.[39]

Designing an equitable and efficient tax system requires consideration of the rate structure, relative consistency of the tax base, and issues of timing. Although many people believe that progressivity in the rate structure is sufficient to achieve an equitable tax system, as the story of Andy and Betty from Part II demonstrates, inequity will occur, even in a tax system characterized by a progressive rate structure, if the tax base is inconsistent or presents timing problems. The remainder of this Note will discuss the timing of taxation and focus on issues of equity and efficiency in the tax base, operating under the assumption that progressivity in the rate structure is a desirable and necessary attribute of any tax system, regardless of base.

A. THE ECONOMIST'S CHOICE: A CONSISTENT, PROGRESSIVE TAX ON INCOME

A pure, consistent definition of income was first developed in 1938 by University of Chicago economist Henry Simons.[40] Simons defined income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights

38. *See* MCCAFFERY, *supra* note 2, at 2–3; PETERS, *supra* note 2, at 81–90.

39. *See* Yoram Margalioth, Student Paper, *The Case for Tax Indexation of Debt*, 15 AM. J. TAX POL'Y 205, 246 n.141 (1998).

40. Henry Simons is often credited with developing the definition of income that will be discussed throughout this Note. Tax historians contend that Simons may not have actually been the first to develop the Haig-Simons definition of income. For purposes of clarity, however, I will refer to a pure income tax as a Haig-Simons income tax. *See* R.A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 47 n.7 (1967) (explaining that the concept of income in the Haig-Simons sense was first proposed in 1896 by Georg Schanz and first introduced into the American discourse on tax policy in 1921).

between the beginning and end of the period in question."[41] Modern tax experts have simplified this equation:

Income = Consumption + Savings.[42]

Theoretically, a consistent Haig-Simons income tax seems fairer,[43] simpler,[44] and more efficient[45] than the current tax system because it closes many of the loopholes that can be exploited only by those with the means and the motivation to hire tax planners and advisors.[46] The practical effect of a pure income tax system would be a broader tax base[47] than would be possible under either a consistent consumption tax or the current U.S. tax system.[48] Assuming revenue neutrality, a broader tax base usually translates into lower marginal tax rates.[49]

---

41. HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938).

42. MCCAFFERY, *supra* note 2, at 12.

43. *See* Edward J. McCaffery, *The Missing Links in Tax Reform*, 2 CHAP. L. REV. 233, 240 (1999) ("[T]he middle and lower-middle classes are hit hard by what is increasingly a wage tax system, looking at both the 'income' tax per se, and the large and important payroll tax system."). *See also* RONALD PASQUARIELLO, TAX JUSTICE: SOCIAL AND MORAL ASPECTS OF AMERICAN TAX POLICY 65 (1985) ("Due to exclusions and deductions, taxpayers with essentially similar incomes can end up paying quite different amounts to the government tax collector. . . . This would happen if the income of one family was exclusively from wages . . . and the other was from wages and from capital income.").

44. *See* PASQUARIELLO, *supra* note 43, at 102–03. *But see generally* Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform,* 80 HARV. L. REV. 925 (1967), *reprinted in* BORIS I. BITTKER, COLLECTED LEGAL ESSAYS 295, 302 (1989) (demonstrating that a pure Haig-Simons income tax would be impossible to achieve and administratively complex because of problems with accounting for the market value of rights exercised in consumption and the change in the store of property rights).

45. *See* SLEMROD & BAKIJA, *supra* note 1, at 181 ("Except in special cases, tax preferences are inefficient, because they create an incentive to engage 'too much' in the lightly taxed activity, and too little in other activities, relative to what the free market would dictate.").

46. For a description of one major loophole that results primarily from the realization requirement, which would be eliminated under a pure Haig-Simons income tax, see *supra* note 2. One former congressman recognized the inequities that result from specific deductions under the hybrid-based federal tax as the fundamental problem leading to the Tax Reform Act of 1986:

> [T]he ultimate measure of tax policy, on Capitol Hill and along Main Street, is fairness. . . . It wasn't low tax rates or larger paychecks that brought working men and women behind [the Tax Reform Act of 1986]. It was fairness: knowing they were not subsidizing a loophole for the guy down the street or the corporation across town.

Dan Rostenkowski, *A View from the Ways and Means Committee*, *reprinted in* THE CONSUMPTION TAX 25, 26 (Charls E. Walker & Mark A. Bloomfield eds., 1987).

47. A consequence of this broader base, assuming revenue neutrality, would be that "all marginal tax rates could be reduced by about one-third." *See* SLEMROD & BAKIJA, *supra* note 1, at 181. *See also* MCCAFFERY, *supra* note 2, at 46–47 (explaining how the effect of a pure income tax is a broader tax base).

48. *See infra* Part III.B–C.

49. As Joel Slemrod and Jon Bakija explain, "Every preference is a penalty for someone else, because it requires tax rates to be higher than otherwise." SLEMROD & BAKIJA, *supra* note 1, at 181.

Politicians, both Democratic and Republican, with the goal of lowering marginal tax rates, are not adverse to broadening the tax base through the elimination of deductions or other preferences. The last successful fundamental tax reform, implemented by Republican President Ronald Reagan in 1986, was a move toward the Haig-Simons definition of income.[50] The result was a drop in all marginal tax rates, with the top rate dropping from 70% in 1980 to 28% after the 1986 reform.[51] More recently, former Democratic House Minority Leader Richard Gephardt proposed tax reform by way of a purer income tax with a broader base and lower tax rates.[52] Under his broad-based income tax plan, the vast majority of taxpayers would pay only 10% annually in federal income taxes.[53] In support of his plan—and recognizing the inequities that result from an inconsistent tax base—Gephardt argued that "average taxpayers will know that everyone else is paying their fair share: high-priced lawyers and accountants won't help the privileged reduce their tax bill."[54]

Other developed nations, such as the United Kingdom, allow far fewer tax deductions than the United States, providing for a broader tax base that has the effect of bringing down marginal tax rates.[55] Tax experts and academics have also supported broadening the tax base through the elimination of certain deductions, arguing that a broader tax base will allow a reduction in marginal tax rates.[56]

One way to implement a consistent tax on income that is substantially similar to the Haig-Simons definition of income would be to eliminate all personal deductions and to tax accretions to wealth annually.[57] The first step would be to discard any deduction, exemption, or credit that would

See also MCCAFFERY, *supra* note 2, at 11 (discussing the effects of a broader tax base on marginal interest rates).

50. *See* FRANK, *supra* note 3, at 231.

51. *Id.*; MCCAFFERY, *supra* note 2, at 46–47.

52. *See* SLEMROD & BAKIJA, *supra* note 1, at 13.

53. *Id.*

54. *Id.*

55. "[I]n the USA . . . the individual can claim a variety of deductions, whereas for employees in the UK very few expenditures can be deducted. . . . Examples of common personal deductions allowed in the US are home mortgage interest and state income taxes." PAUL WEBLEY, HENRY ROBBEN, HENK ELFFERS & DICK HESSING, TAX EVASION: AN EXPERIMENTAL APPROACH 27 (1991).

56. *See, e.g.*, PASQUARIELLO, *supra* note 43, at 102–03.

57. Boris Bittker has demonstrated that elimination of all deductions for nonprofit-motivated transactions coupled with an elimination of the realization requirement would provide a tax system that does not completely encompass the Haig-Simons definition of income because it does not include personal labor expenditures within the definition of the market value of rights exercised in consumption. For purposes of the discussion of debt treatment in the tax system, however, this definition is sufficiently consistent with a pure income tax. *See* BITTKER, *supra* note 44, at 350–51.

alter gross income as defined by 26 U.S.C. § 61(a). Once gross income is defined, deductions would be subtracted only for profit-motivated transactions.[58] Under this simplified[59] system, the only relevant sections of the current tax code with regard to calculating taxable income would be §§ 61(a), 162, 165–67, and 212.[60] Aside from the elimination of all nonprofit-motivated deductions and of all exclusions and credits, a consistent income tax would tax accretions to wealth, even if the increase in the value of the assets was not realized by the taxpayer through sale or other disposition.[61]

Most tax experts and politicians agree that the implementation and administration of a consistent income tax would be difficult if not impossible for four reasons. First, it is argued that elimination of the realization requirement in favor of an annual taxation on the appreciation of assets would be unworkable.[62] Second, eliminating popular deductions like the home mortgage interest deduction or the deduction for state income taxes would be too politically unpopular.[63] Third, implementing a consistent income tax would entail many changes in existing laws outside

---

58. *See id.* at 301–02.

59. Slemrod and Bakija identify as one of the five major complaints about the current income tax system the belief that it is too complicated. They have also found that

> [l]iterally billions of hours are spent every year in the United States on fundamentally unproductive tax activities such as recordkeeping, wading through instructions, hunting for deductions and credits, and arranging one's financial affairs to take advantage of tax preferences. . . . Individual taxpayers spend as much as three billion hours of their own time on tax matters, or about [twenty-seven] hours per taxpayer on average.

SLEMROD & BAKIJA, *supra* note 1, at 2 (citations omitted) (emphasis omitted).

60. Bittker, *supra* note 44, at 302. This dramatic simplification of the tax code presumably would also result in a reduction in the transaction costs normally associated with filing tax forms for many individuals. For a guide designed for use as a companion in filing federal income tax forms after the 1986 tax reform, see PRICE WATERHOUSE, THE PRICE WATERHOUSE PERSONAL TAX ADVISER (1987).

61. *See* Deborah L. Paul, *The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?*, 76 N.C. L. REV. 151, 189 (1997).

62. *See* Bittker, *supra* note 44, at 337 ("None of the proponents of a [comprehensive tax base], so far as I know, wants to substitute an annual net worth computation to take account each year of the taxpayer's increase or decrease in wealth.") (citation omitted). *See also* Alvin C. Warren, Jr., Essay, *Three Versions of Tax Reform*, 39 WM. & MARY L. REV. 157, 159–60 (1997) (arguing that the elimination of the realization requirement is not "directly translatable into an operational income tax [system]").

63. Slemrod and Bakija argue that "the political system is incapable of distinguishing legitimate arguments [in favor of tax preferences] from illegitimate ones, and often succumbs to the political clout of powerful pleaders." SLEMROD & BAKIJA, *supra* note 1, at 182. *See also* PETERS, *supra* note 2, at 176 (providing empirical data that suggest "when citizens are asked about specific loopholes, there are often majorities in favor of theirs being retained"). The politics of taxation are intriguing indeed, but are beyond the scope of this Note. For an overview of some of the most comprehensive analyses of tax politics, see generally PETERS, *supra* note 2; SLEMROD & BAKIJA, *supra* note 1.

the tax context.[64] Fourth, a pure income tax will incentivize consumption and provide a disincentive for savings because there would be no savings vehicle in which wealth could be accumulated tax-free,[65] causing a depletion of the capital stock and resulting in adverse economic consequences.[66]

Assuming that a consistent tax on income without the realization requirement is administratively and politically possible, Part V demonstrates some of the ways in which the tax treatment of post-secondary educational expenses would be impacted by shifting to a consistent income tax base.

B. THE SAVER'S CHOICE: A CONSISTENT, PROGRESSIVE TAX ON CONSUMPTION

A consumption tax is any tax that does not tax savings.[67] In comparison to a pure Haig-Simons income tax, a consumption tax has a smaller tax base and would necessarily require higher marginal tax rates.[68]

64. *See* Bittker, *supra* note 44, at 350–51. Bittker states that

> [a]mong the areas that would be drastically affected by a whole-hearted use of the Haig-Simons definition are: mortality gains on life insurance; governmental benefits furnished in kind or in services; recoveries in suits for personal injury or death; charitable gifts to individuals; personal and dependency exemptions; tax-exempt organizations; the investment credit; deduction or rapid amortization of business assets; depreciation below market values; inventory pricing; accounting methods; and tax-free exchanges.

Id. Bittker's discussion of a theoretically perfect, pure income tax illustrates the impossibility of its implementation. For purposes of simplicity in this Note, however, I refer to a pure Haig-Simons income tax as one that provides no deductions except for profit-motivated transactions and implements an annual taxation on unrealized appreciation.

65. McCaffery has identified the virtues of saving and has argued that tax systems that punish saving are bad for the economy. *See* MCCAFFERY, *supra* note 2, at 37–38.

66. *Id.* at 38.

67. *See generally* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974) (describing how the consumption tax model computes tax only on a cash flow basis as opposed to taxing both personal consumption and accumulation). According to McCaffery, "Any 'income' tax that systematically deducts savings from income is in fact a consumption tax." *See* MCCAFFERY, *supra* note 2, at 15. He also illustrates the problematic nature of describing the current federal income tax in the United States as an income tax given the broad deductions that are available. *See id*. I refer to the current federal income tax as a hybrid-based tax. *See infra* Part III.C.

68. *See supra* Part III.A. A consistent postpaid consumption tax would not, however, necessarily have a smaller tax base than our inconsistent income tax. *See* MCCAFFERY, *supra* note 2, at 92–93. McCaffrey provides four arguments for why the difference between a consistent consumption tax base and our current tax base would not be very dramatic: First, we do not have a consistent income tax; second, the base-broadening feature of debt under a consistent consumption tax does not exist under our current tax system; third, there is no need for a capital gains preference under a consistent consumption tax that does not tax savings; and fourth, consumption tax engineers are able to increase the top marginal rate. *Id.* at 92–93.

Whereas the consistent income tax model includes in its base both consumption *and* accretions to wealth,[69] a consistent consumption tax model includes only consumption.[70] There is, however, one primary tax-broadening feature of a consistent consumption tax that would not be included in either a consistent income tax or our inconsistent hybrid-based tax—the direct taxation of debt-financed consumption.[71]

With the exception of the Gephardt proposal,[72] all serious tax reform proposals since the 1986 overhaul have been by way of a consumption tax. President Bill Clinton was an architect and supporter of several alterations in the tax law that had the effect of providing tax benefits for certain savings vehicles. The vast majority of the Clinton-era targeted tax cuts can be thought of as movements toward a consumption tax base because they included deductions for certain specified savings vehicles. These included the reduction of capital gains rates, the nontaxation of appreciation in family homes, and the expansion of tax benefits for Individual Retirement Accounts ("IRA") and college savings accounts.[73] President George W. Bush has also demonstrated an affinity for tax reform that has the effect of benefiting savers. President Bush's most recent proposals, in 2003, to expand the utility of IRAs and eliminate the taxation of capital gains, can be seen as fundamental moves toward a consumption tax system.[74] One of the most recent congressional proposals for fundamental tax reform was the USA Tax. The proposed USA Tax, which allowed for unlimited deductions for savings in specific accounts, can be considered a postpaid consumption tax.[75]

Other developed nations, particularly those that find it difficult to administer an inconsistent income tax, rely more heavily on consumption taxes than on income taxes.[76] For example, France, Greece, Italy, and Portugal rely more substantially on consumption taxes than the United States, primarily for administrative reasons.[77] Overall, the United States relies on a consumption base as a means of generating government revenue

69. *See supra* note 41 and accompanying text.
70. *See generally* Andrews, *supra* note 67.
71. *See* MCCAFFERY, *supra* note 2, at 92.
72. *See* SLEMROD & BAKIJA, *supra* note 1, at 13.
73. *See* MCCAFFERY, *supra* note 2, at 49.
74. *See* Peter G. Gosselin, *Bush Proposes New Tax-Free Savings Plans,* L.A. TIMES, Feb. 1, 2003, at A1.
75. *See* MCCAFFERY, *supra* note 2, at 57–58.
76. *See* PETERS, *supra* note 2, at 63.
77. *Id.*

only about half as much as the average Organization for Economic Cooperation and Development ("OECD") country.[78]

Supporters of a consumption base are among the most well-respected economists and academics the world has ever known. Adam Smith, Thomas Hobbes, John Stuart Mill, Milton Friedman, Martin Feldstein, Kenneth Arrow, and Laurence Summers are among those who have advocated the implementation of a consumption tax on theoretical and philosophical grounds.[79]

There are two basic models of consumption taxation: the prepaid consumption tax and the postpaid consumption tax. These two models have bases that are substantially identical and differ primarily in the timing of collection.[80] The practical effect of this difference depends on how progressive the tax rate structure is and can be quite significant with regard to issues of the tax treatment of debt.

---

78. The OECD is an organization of twenty-eight developed countries. *See* Warren, *supra* note 62, at 157–58.

> [L]ooking at 1994, income taxes provided a comparatively high 44.6% of all American government revenue. . . . Most other developed countries rely significantly less on income taxes and significantly more on consumption taxes. On average . . . consumption taxes constituted 31.9% of the tax revenue of OECD countries in 1994, almost twice the 17.9% in the United States.

See id. at 158 (internal citations omitted).

79. *See* FRANK, *supra* note 3, at 223. *See also The Role of Federal Tax Policy in Stimulating Capital Formation and Economic Growth: Hearings Before the Subcomm. on Econ. Growth and Stabilization of the J. Econ. Comm. Cong. of the U.S.*, 95th Cong. 178 (1977) (statement of Martin Feldstein) [hereinafter Feldstein]; John H. Makin, *Income Tax Reform and the Consumption Tax*, *in* THE CONSUMPTION TAX, *supra* note 46, at 87, 87; MCCAFFERY, *supra* note 2, at 97–100.

80. J. Clifton argues:

> Example 1: Individual A wishes to engage in $100 of debt-financed consumption on 1/1/1. The loan principal and 10% interest will be due on 1/1/2. A 40% flat-rate cash-flow consumption tax is applicable. . . . Illustration 1A—Inclusion/Deduction: A's borrowing goes into the tax base on 1/1/1 so that a 40% tax is immediately due. Thus A must borrow $166.67 on 1/1/1, pay a $66.67 tax . . . and consume the remaining $100. On 1/1/2, A earns $183.34 of wages and pays off the lender ($166.67 of principal and $16.67 of interest). Because A is allowed a full deduction for this payment, no tax is due on 1/1/2 wages. . . . $183.34 of earnings has been required to support $100 of debt-financed consumption and $66.67 of tax has been paid.
>
> Illustration 1B—Exclusion/No Deduction: A's borrowing is excluded from the tax base so that she needs to borrow only $100 which she immediately consumes on 1/1/1. Since her 1/1/2 $110 payment . . . to the lender is nondeductible, she must earn $183.34 of taxable wages on 1/1/2, pay a $73.34 tax . . . and pay the remaining $110 of after-tax wages to the lender. . . . The difference [between the two scenarios] is illusory . . . because the $66.67 [in Illustration 1A] is due on 1/1/1 while the $73.34 [in Illustration 1B] is paid on 1/1/2. Applying our 10% interest assumption, $66.67 is simply the 1/1/1 cost of a $73.34 payment on 1/1/2.

J. Clifton Fleming, Jr., *The Deceptively Disparate Treatment of Business and Investment Interest Expense Under a Cash-Flow Consumption Tax and a Schanz-Haig-Simons Income Tax*, 3 FLA. TAX REV. 544, 548–49 (1997).

1. The Prepaid Consumption Tax

A prepaid consumption tax model taxes income when it is earned from labor but not when it is earned from capital.[81] A prepaid consumption tax model would be the ultimate result of the ongoing trend toward selective deductions for particular savings vehicles that has occurred over the past fifteen years under both Democrats and Republicans.[82] The elimination of tax on all forms of savings could be accurately described as a consistent, prepaid consumption tax.

The two most commonly discussed forms of prepaid consumption taxes are wage taxes[83] and yield exemption consumption taxes.[84] The practical effect of either of these taxes is to exempt from taxation all forms of savings and yields to savings, but to include in the tax base money earned through wages.[85] All forms of payroll taxes, such as Social Security and Medicare contributions, are wage taxes because they systematically exclude from taxation yields to savings. Part V discusses the tax treatment of debt within the context of a consistent, prepaid consumption tax and compares it to the tax treatment of debt under our current system.

2. The Postpaid Consumption Tax

In contrast to a prepaid consumption tax, the postpaid consumption tax taxes consumption directly—anytime a taxpayer purchases a consumable item. The most common examples of postpaid consumption taxes are sales taxes[86] and value-added taxes ("VATs").[87] The practical effect of each of these taxes is to allow the tax-free accumulation of capital through savings.

Most of the OECD countries, aside from the United States, rely heavily on VATs in comparison to income taxes.[88] Many tax experts and

---

81. *See* MCCAFFERY, *supra* note 2, at 164.

82. *See supra* notes 72–75 and accompanying text.

83. *See* MCCAFFERY, *supra* note 2, at 164.

84. *See* Bankman & Griffith, *supra* note 2, at 379.

85. *See supra* notes 69–70 and accompanying text.

86. *See* MCCAFFERY, *supra* note 2, at 54–57. *See generally* Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax,* 70 TEX. L. REV. 1145 (1992) (discussing the differences between income and consumption taxes).

87. For a discussion of the similarities and differences between sales taxes and value-added taxes, see PETERS, *supra* note 2, at 35–37; THE VALUE-ADDED TAX: LESSONS FROM EUROPE 7 (Henry J. Aaron ed., 1981).

88. *See generally* THE VALUE-ADDED TAX: LESSONS FROM EUROPE, *supra* note 87 (providing a comprehensive accounting of the European experience with the value-added tax).

economists in the United States have suggested the adoption of VATs as a supplement to or replacement for the inconsistent income tax.[89]

As Part V demonstrates, the consistent, postpaid consumption tax most effectively implements the normative objectives of equity and efficiency in the context of post-secondary education-based debt. Although a consistent tax base is of critical importance for issues of equity and efficiency, the timing of taxation is also important. This is particularly true in a system characterized by a progressive rate structure; only the postpaid consumption tax is collected at the time of spending rather than at the time of earning, and it more accurately predicts an individual taxpayer's ability to pay.[90]

C. THE UGLY DUCKLING: AN INCONSISTENT, PROGRESSIVE HYBRID-BASED TAX

The Ugly Duckling—the title character of Hans Christian Andersen's classic fairy tale[91]—is not unlike the current U.S. tax system. Political opportunism and greed have transformed the current tax system into a jumbled mix of inequitable, inefficient, and ugly rules of taxation. In years to come, however, with an understanding of what the tax system exactly is and where it came from, it can be transformed into a beautiful swan of a tax system, embracing the objectives of equity and efficiency through the elimination of tax on all investments, no matter what form they take.

The current federal tax base in the United States is most accurately described as an inconsistent hybrid of a consistent income tax and consistent consumption tax.[92] The fundamental difference between our current tax system and a consistent Haig-Simons income tax is that our

89. Martin Feldstein was one of the first American tax experts to argue in favor of the adoption of a VAT in the United States. Feldstein, in a 1977 statement before a congressional subcommittee, opined:

> I think we ought to strengthen the existing tax laws which now emphasize taxing consumption rather than saving. . . . I think we should consider a value-added tax. All of our European competitors are currently relying to a greater and greater extent on a value-added tax. . . . [I]f we adopt this VAT, we would be taking the burden off savings and putting it on consumption.

See Feldstein, *supra* note 79, at 178.

90. *See infra* Part V.

91. *See* HANS CHRISTIAN ANDERSEN, THE UGLY DUCKLING (Jerry Pinkney ed., Morrow Junior Books 1999).

92. *See, eg.*, Margalioth, *supra* note 39, at 246 n.141. *See generally* McCaffery, *supra* note 86 (describing the differences between our tax system and a pure income tax system and discussing how our tax base can be more accurately described as a wage tax).

income tax system allows for deductions,[93] exemptions,[94] and credits[95] and employs the realization requirement[96]—all of which have the effect of narrowing the tax base and causing an increase in marginal tax rates.[97] The fundamental difference between our current tax system and the pure consumption tax model is that only some savings vehicles receive favorable tax treatment—not all of them. For example, in the context of post-secondary educational expenses, debt accumulated for education that increases the skills in a taxpayer's current profession is deductible, but debt accumulated to reach the minimal requirements for the taxpayer to begin a new profession is not.[98]

The tax treatment of certain investment and savings vehicles in the United States is similar to the treatment all savings and investments would receive under a consistent, prepaid consumption tax. Among these are family residences,[99] municipal bonds,[100] and IRAs.[101] Other savings vehicles are taxed as income, such as the yield to ordinary savings accounts.[102] A third class of savings and investments is given mixed treatment, such as gains realized by virtue of increased value in capital assets[103] that meet certain other requirements, in which the taxpayer pays tax at a special capital gains rate[104] rather than at the normal marginal tax rate.[105] Post-secondary educational expenses, accumulated when the taxpayer is seeking to enter a new profession, are not considered investments and receive no favorable tax treatment.

93. *See generally* CHIRELSTEIN, *supra* note 10, at 101–208 (describing the various business and personal deductions allowed by the tax code).

94. *See id.*

95. *See id.* at 193–96.

96. *See* Eisner v. Macomber, 252 U.S. 189, 189 (1920).

97. *See* SLEMROD & BAKIJA, *supra* note 1, at 36 (reporting that the average tax rate on what is counted as taxable income is 20%, and that with a comprehensive income tax base it would be only 8%).

98. *See supra* note 5 and accompanying text.

99. 26 U.S.C. § 163(a), (h)(2)(d) (2000).

100. *Id.* § 103.

101. *Id.* § 408(a).

102. *Id.* §§ 61, 163(h).

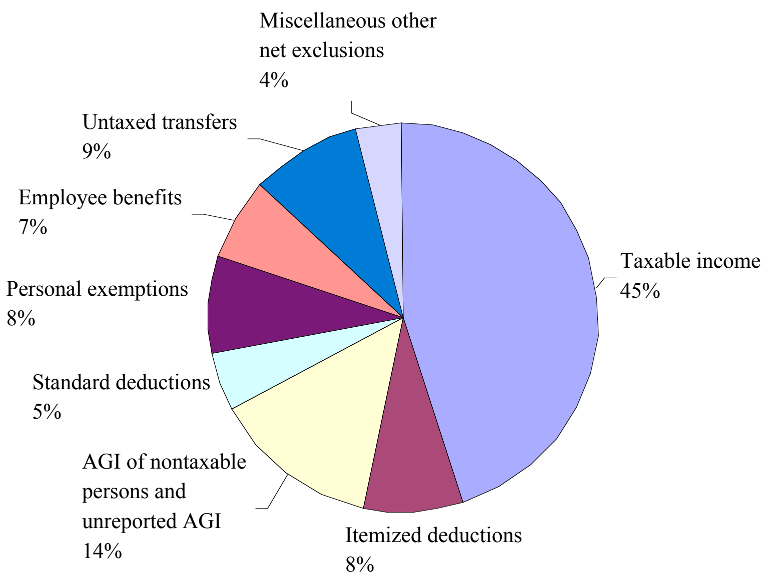
103. *Id.* §§ 1221–1224.

104. *Id.* § 1(h).

105. This is true only if the capital gains tax rate is lower than the taxpayer's marginal income tax rate. *See id.* This is the case with most taxpayers who find themselves calculating their capital gains tax liability.

It is clear that when the U.S. tax system is described as having a Haig-Simons tax base, that characterization is inaccurate.[106] In fact, when all the deductions, exclusions, exemptions, and credits that are allowed in our system materialize, only about 40% of Haig-Simons income is actually collected by the government.[107] Based on these numbers, our income tax system is actually 60% consumption tax and only 40% income tax.[108]

GRAPH 1. Taxable income as a proportion of total personal income, exclusive of untaxed appreciation (1995)[109]



106. *See, e.g.*, Jerome Kurtz, *The Interest Deduction Under Our Hybrid Tax System: Muddling Toward Accommodation*, 50 TAX L. REV. 153, 158–60 (1995); McCaffery, *supra* note 86, at 1149–55.

107. *See* PASQUARIELLO, *supra* note 43, at 42–43. *Cf.* SLEMROD & BAKIJA, *supra* note 1, at 36 (arguing that 45.5%, rather than 40%, of personal income ends up as taxable income because of the various exclusions, deductions, and exemptions).

108. When payroll taxes are included in the calculation, it is clear that our tax base can be most accurately described as a wage tax. A wage tax is a form of prepaid consumption tax, and it is therefore clear that our tax system can generally be thought of as primarily a consumption tax system. The failure of our system to tax debt, however, is the major difference between our system and a consistent consumption tax. *See* MCCAFFERY, *supra* note 2, at 4, 19–20. For a more thorough discussion of the inequities generated by the payroll tax system, see generally Dan Seltzer, Note, *Attacks on a Tax: An Alternative to the Earned Income Tax Credit to Remedy the Unfairness in the Payroll Tax System*, 77 S. CAL. L. REV. 187 (2003).

109. *See* SLEMROD & BAKIJA, *supra* note 1, at 36.

D. The Tax Treatment of Debt Under the Three Systems

1. The Treatment of Debt Under a Consistent, Progressive Tax on Income

A Haig-Simons income tax does not present problems of inconsistency in the tax base, but does retain the same timing problems associated with debt that the current U.S. hybrid-based tax has. A consistent income tax would not tax debt when the transaction between debtor and lender first occurs because debt itself does not represent an accretion to wealth.[110] Borrowing results in no net change in the taxpayer's balance sheet because, although the taxpayer receives some cash through borrowing, it incurs an immediately offsetting obligation to repay the debt. Debt, of course, under a pure, consistent Haig-Simons income tax is paid back with after-tax dollars, so a consistent income tax levies a tax on borrowing indirectly when the income is eventually earned to pay off the debt. In the context of debt accumulated by Betty to finance college and dental school, under a consistent Haig-Simons income tax she would not pay tax on the money she borrows at the time it is borrowed, but would be required to repay her loans with after-tax dollars. This timing problem is minimized under a flat tax[111] or in a situation in which the particular taxpayer is in the same marginal tax bracket at the time of borrowing and the time of repayment;[112] but, as the story of Andy and Betty demonstrates, this is often not the case.

2. The Treatment of Debt Under a Consistent, Progressive Tax on Consumption

Under either a prepaid or postpaid consumption tax, borrowing is taxable as negative savings.[113] Any tax system that rewards savings must penalize negative savings or there is an opportunity for tax arbitrage.[114]

110. *See* 26 U.S.C. § 61 (2000).

111. Discussion of the practical and normative implications of a flat tax is beyond the scope of this Note. For an enlightened and informative discussion of flat taxes from two of its foremost proponents, see generally ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (1985).

112. *See infra* Part IV.

113. Jerome Kurtz has argued that

> [w]hen an investment is deductible, as is the case under a consumption tax, it follows that borrowing related to that asset should be treated as it would be under a consumption tax, that is, the loan proceeds ought to be included as income. Otherwise, a taxpayer would have the option of reducing his tax obligation without changing his economic well-being. All that would need to be done would be to borrow and save the borrowed funds. Including borrowing in the tax base is necessary to arrive at a measure of consumption.

See Kurtz, *supra* note 106, at 163–64.

114. *See* MCCAFFERY, *supra* note 2 and accompanying text.

Under a consumption-based tax, money used to repay loans is not taxed because loan repayment is not consumption.[115] In the context of debt accumulated to finance post-secondary education, Betty would pay tax on the borrowed funds at the time she incurs the obligation, but would pay no tax on the money she uses to repay the debt during her high earning years after she graduates from dental school.[116]

The base-broadening feature of debt-taxes under a consumption tax base offsets some of the base-narrowing results of tax-free savings.[117] The net change in the tax base that results from this offset and the market effects that may result is a matter primarily of macroeconomics[118] and is beyond the scope of this Note, but there are three reasons to believe it is considerable. First, recent historical trends have consistently indicated low rates of savings and high rates of indebtedness. Therefore, the base-narrowing feature of tax-free savings would not be as substantial as it would be in a society characterized by high rates of savings and low rates of indebtedness.[119] Second, the tax arbitrage available in our current federal hybrid-based tax system through the nontaxation of debt combined with the realization requirement—aside from unfairly benefiting those individuals who hold large quantities of appreciating capital—[120]narrows the tax base in a way that is not possible under a consistent consumption tax that includes borrowing in its base.[121] Finally, debt-financed luxury consumption that results in insolvency escapes immediate taxation under our current income tax system while it would be taxed under a consumption tax system.[122]

3. The Treatment of Debt Under an Inconsistent, Progressive Hybrid Based Tax

Just as our tax system generally can be considered to have a hybrid base, so too does our tax system borrow from both the consistent income tax and the consistent consumption tax in its treatment of debt. In general, our tax system treats debt as it would be treated under a consistent income

115. *See* Kurtz, *supra* note 106, at 162–63.

116. As Part V demonstrates, only a consumption tax solves the timing problem that is the primary basis of the inefficiency and inequity illustrated in the story of Andy and Betty.

117. *See* MCCAFFERY, *supra* note 2, at 92.

118. *See id.*

119. *See* FRANK, *supra* note 3, at 46.

120. *See* MCCAFFERY, *supra* note 2 and accompanying text.

121. *See id.*

122. *See* 26 U.S.C. § 108(b) (2000).

tax—because there is no accretion to wealth it is not taxable.[123] Our hybrid-based tax suffers from the same timing problems that exist under the consistent income tax, but is characterized by the additional problem of an inconsistent tax base, which adds complexity and raises marginal tax rates.[124] After-tax dollars used to pay off debt are taxed unless there is a specific applicable deduction. In Betty's case, there is no specific applicable deduction, so she pays tax on the dollars used to pay off her student loan debt. She also pays a higher rate than she is likely to pay under a consistent income tax.[125] This fundamental timing problem that results from the inconsistent hybrid-based tax is the focus of Part IV.

IV. THE LIFE-CYCLE HYPOTHESIS: WHAT WENT WRONG FOR BETTY UNDER OUR PROGRESSIVE HYBRID-BASED TAX?

Taxes imposed on income create distortions in timing that may result in an inequitable and inefficient distribution of tax burdens. Combining such timing problems with the relatively narrow tax base that has resulted from selective deductions and the realization requirement in the hybrid-based tax system has resulted in perverse incentives with regard to the decision to pursue post-secondary education.[126] Financing post-secondary education for most lower- and middle-class students is a major investment that is given no favorable tax treatment whatsoever.[127] This results in behavior that might otherwise be beneficial to society being inequitably punished and inefficiently discouraged. As the story of Andy and Betty demonstrates, the choice by potential students to make the investment in post-secondary education may do more harm than good in terms of the long-term financial freedom and consumption power of the student

123. *See id*. § 61.

124. *See supra* Part III.A, C.

125. *See supra* Part III.A.

126. *See infra* Part IV.B.

127. Of course, as discussed previously, 26 U.S.C. § 162 and its subsequent interpretive case law make clear that educational expenses incurred to improve job skills are deductible. *See* Argrett, *supra* note 5, at 630. It is only educational expenses incurred to prepare students to acquire the skills for a new profession that receive no tax benefit under section 1.162-5 of the U.S. Treasury Regulations. *See id*. at 631–32, 635. Additionally, selective credits and deductions for post-secondary educational expenses, such as the Hope Tax Credit, Lifetime Learning Tax Credit, and Higher Education Tuition and Fees Deduction, do not benefit typical students such as Betty. For a description of these credits and deductions, see DEP'T OF THE TREASURY, I.R.S., PUB. NO. 970, TAX BENEFITS FOR EDUCATION, *available at* http://www.irs.gov/pub/irs-pdf/p970.pdf (last visited Apr. 13, 2004). Given Betty's peaked lifetime earning profile, she loses any benefit from these deductions and credits because she has no positive income during the years in which she is financing her education. *See infra* Graphs 3 and 4 and accompanying text.

taxpayer. Disincentivizing the pursuit of post-secondary education may be detrimental to the long-term economic health of our country.

The life-cycle hypothesis of savings and consumption behavior, first introduced by Milton Friedman,[128] presents a model demonstrating the importance of timing issues in taxation. This model predicts that consumption patterns over a lifetime are more static than earning patterns.[129] Generally, the earlier and later years in a given taxpayer's life are years in which consumption is greater than income, whereas the middle years of a taxpayer's life are years in which income exceeds consumption.[130]

128. *See* Joseph Bankman & Barbara H. Fried, *Winners and Losers in the Shift to a Consumption Tax*, 86 GEO. L.J. 539, 547 (1998).

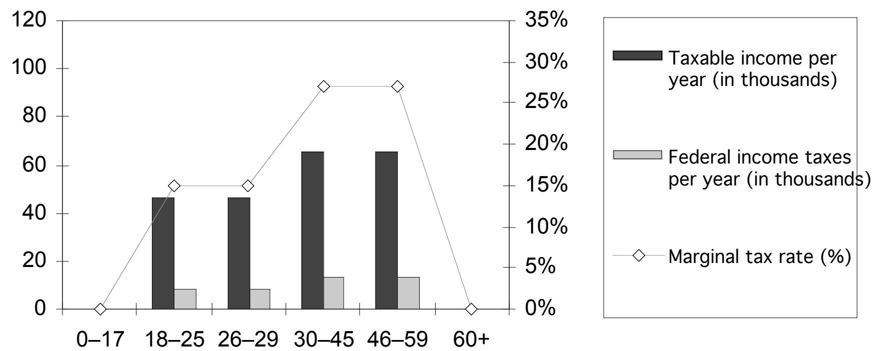
129. Slemrod and Bakija claim that

> for most people there is a natural life-cycle pattern of earning and saving. In the early years of working life, family expenses are pressing and income fairly low, so savings are minimal or even negative, as families borrow to finance consumption. In the later working years, incomes have grown to the point where many families begin to save for their retirement and higher education for their children. In retirement, the pattern reverses again, as people live off their accumulated savings.

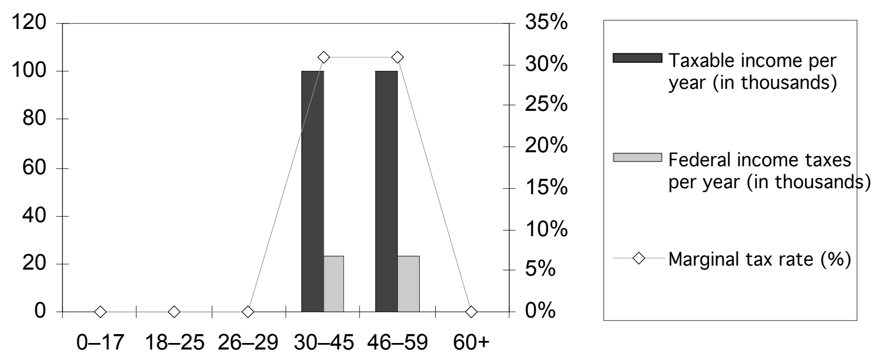
SLEMROD & BAKIJA, *supra* note 1, at 172.

130. *Id.*

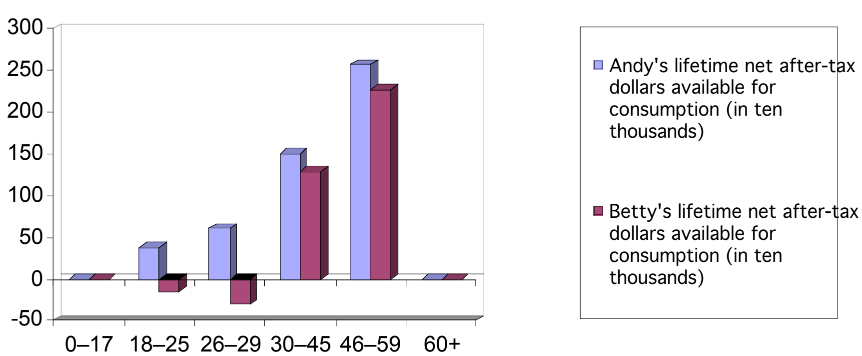
GRAPH 2. Lifetime income and tax profile for Andy



GRAPH 3. Lifetime income and tax profile for Betty



GRAPH 4. Lifetime net after-tax dollar comparison for Andy and Betty



One substantial difference between a tax that includes savings in its base and one that excludes savings from its base is when the taxes are paid. The life-cycle model predicts that any tax that includes savings in its base will fall on individuals in their high-earning years[131] and will disproportionately punish those individuals with more peaked earning profiles,[132] like Betty. This effect will be substantial, especially if the tax system is characterized by a progressive rate structure.[133] As an analysis of the lives of Andy and Betty as taxpayers illustrates, this tax treatment fails on both equity and efficiency grounds.

A. INEQUITY

One generally accepted formulation used to determine the appropriate distribution of tax burdens is the "ability to pay" principle.[134] This principle, which measures annual income alone—that is, without consideration of net wealth or debt—leaves much to be desired in terms of its core goal: equity. Under our current hybrid-based tax system, there is no consideration of the fact that those with debt accumulated during previous years may not have consumption power that is equivalent to their income. This situation, faced by young would-be dentists, like Betty, is also faced by young would-be doctors, lawyers, nurses, teachers, professors—anyone whose profession requires him to pursue any form of post-secondary education. The bottom line of the story remains the same. Andy ended up with more after-tax dollars to spend over the course of his lifetime,[135] and Betty paid 40% more in federal income taxes.[136]

131. Bankman & Fried, *supra* note 128, at 548.

132. *See* MCCAFFERY, *supra* note 2, at 17; SLEMROD & BAKIJA, *supra* note 1, at 172.

133. SLEMROD & BAKIJA, *supra* note 1, at 172.

134. "According to the ability-to-pay principle, tax burdens should be related . . . to [a family's] ability to bear the tax burden or, in other words, to tolerate a sacrifice." *Id.* at 54. Some scholars argue, however, that the federal income tax law actually favors investments in human capital, such as post-secondary education costs, because one major cost of post-secondary education is the opportunity cost associated with forgoing career opportunities during the period of years in which the education is received. According to this argument, because the value of those forgone opportunities is not taxed, it is a major tax benefit to those who invest time and money into post-secondary education. For a general description and economic analysis of this argument, see generally L.G. Sgontz, *Does the Income Tax Favor Human Capital?*, 35 NAT'L TAX J. 99 (1982). In the context of this Note, the earning years between the ages of eighteen and thirty—when Andy earned $500,000 while Betty went to school—represent years in which, under the above referenced argument, Betty benefits from her lack of federal tax obligations. *See supra* Part II. As the story demonstrates, however, even this apparent benefit to Betty, given the progressive rate structure, is not enough to compensate her over a lifetime of earning and consumption when compared to Andy. *See id.*

135. *See supra* Part II.

136. *See supra* Part II.

Horizontal equity can be seen as measured in either annual or lifetime terms. Our system chooses to measure ability to pay annually. This punishes those earners, like Betty, who have more peaked earning profiles over the course of their lives and gives a windfall to those earners who, like Andy, have a steady flow of income over a longer period in their life.

B. INEFFICIENCY

In order to maximize economic efficiency and overall social welfare, the free market should determine how many people are needed in each occupation and how the wealth of society should be distributed among members of each occupational subgroup.[137] Whether Andy's job or Betty's job is more important and should be more highly compensated should be determined by the free market. Any law that distorts individual wealth-maximizing choices of whether to engage in some activity is inefficient.[138] If people make choices in life that they otherwise would not make because of the tax system, it is considered inefficient.[139] If education is discouraged and punished by our tax system, the results are potentially devastating.

Law school studies indicate that the cost of post-secondary education has a profound effect on job choices among students.[140] Students who

137. "[Economists] believe that firms and individuals . . . are generally the best judges of what goods . . . should be produced, and how resources should be allocated. . . . [A]n unfettered free-market economy . . . tends to organize itself . . . so as to make efficient use of the country's physical and human resources." SLEMROD & BAKIJA, *supra* note 1, at 103.

138. *See id.*

139. "Taxes interfere with . . . natural efficiency, causing economic choices to be distorted away from taxed activities to relatively untaxed ones, keeping us from making the best use of our resources." *Id*. *But see* Argrett, *supra* note 5, at 628–29 (describing several tax laws that have been enacted specifically to provide incentives for post-secondary education, including the exclusion from income of certain scholarships under 26 U.S.C. § 117).

140. A 1991 study indicated that law students with little or no debt were much more likely to accept lower paying jobs than those with high debt. About 39% of students with relatively low debt ($1000 to $14,900 in 1991 dollars) took jobs in lower paying settings, such as government, public defenders offices, and public interest and small law firms, as opposed to only 17% of those with high debt ($50,000 or more in 1991 dollars). Alternatively, those with high debt were almost twice as likely to take jobs in firms of twenty or more lawyers (69%) than those with relatively little debt (37%). *See* DAVID L. CHAMBERS, JOINT AALS-BBA-LSAC TASK FORCE ON STUDENT FIN. AID, DEBTS, JOB CHOICES, AND FINANCIAL BURDEN: EDUCATIONAL DEBTS AT NINE AMERICAN LAW SCHOOLS 21 (1991). *See also* Garance Franke-Ruta, *The Indentured Generation: How Debt Stunts Young People's Dreams*, AM. PROSPECT, Apr. 16, 2003, *available at* http://www.prospect.org/print/V14/5/franke-ruat-g-sr.html (describing the impact of the "staggering run-up in law school tuition costs" on decisions by recent graduates with regard to employment). Considerations of debt also impact the career decisions of those completing their undergraduate education. According to a study by Collegiate Funding Services in 2003, 30% of college graduates took higher paying jobs over ones they would have preferred in order to make more money. *See With College Loan Bills Coming Due, Not All Graduates*

graduate with large amounts of debt are more likely to choose jobs in larger law firms than those who graduate with little or no debt and who are free to work in public interest or government jobs.[141] To the extent that the tax system forces students to choose a course of action that they otherwise would not, it is inefficient. Combining the adverse tax consequences of debt-financed educational expenses and life-cycle predictions about consumption and earnings, it may not be advantageous for young adults contemplating a college or graduate school education to pursue one.

C. Potential Solutions Within the Context of the Hybrid Base

One way to solve the horizontal equity and economic inefficiency problems within the confines of the hybrid-tax base would be to permit taxpayers to offset the costs of post-secondary education against their earnings after graduation, just as investors in nonhuman capital are permitted to subtract basis from the fair market value of an asset on sale or other realization event.[142] Under normal circumstances, expenditures on intangible assets can be amortized over the useful life of the asset if it has a reasonably determinable life.[143]

Under our current tax system, investment in an asset with after-tax dollars gives the investor basis in the fair market value of the amount paid for the asset.[144] This is true even if the purchase of the asset is financed through debt.[145] Debt is paid back with after-tax dollars, so the tax treatment of investments is theoretically and practically the same, whether it is financed through debt or through positive wealth.

Are Prepared to Pay According to a Survey Released Today by Collegiate Funding Services, COLLEGIATE PRESSWIRE, Aug. 27, 2003, *available at* http://www.cpwire.com/archive/2003/8/27/1364.asp. According to the CEO of the organization that authored the study, "These young people are increasingly entering the job market heavily encumbered with student loan and credit card debt . . . . [M]any feel they have no choice but to take a better paying job just to meet basic expenses." *See id.*

141. *See* CHAMBERS, *supra* note 140, at 21.

142. *See* Eisner v. Macomber, 252 U.S. 189, 209–14 (1920). Current tax law distinguishes between educational expenditures incurred prior to entering a trade or business, for which no deduction is allowed, and those incurred to maintain or improve skills related to the individual's current occupation. *See* 26 U.S.C. § 162 (2000); C.F.R. § 1.162-5(b) (amended 1967). "[T]here is no authority for amortization of these expenditures under section 167 . . . once the taxpayer begins a new trade or business." Argrett, *supra* note 5, at 622.

143. *See* 26 U.S.C. § 167. Loretta Argrett has argued that the recovery period should begin when the taxpayer starts earning income at an occupation related to the degree the taxpayer receives and would end at a normal retirement age or on the taxpayer's death. *See* Argrett, *supra* note 5, at 623.

144. *See* 26 U.S.C. § 1012.

145. *See id.*

If educational expenses were considered an investment in human capital for tax purposes,[146] then students would have basis in the amount spent for the education.[147] As these students entered the workforce after completing their post-secondary schooling, they would be permitted to amortize the amount of their educational expenses before determining their taxable income—just as those who invest in capital assets are permitted to depreciate or amortize the expense over the useful life of the assets. In short, investment in human capital should be treated as just that—an investment.[148]

There are two major disadvantages to this approach in comparison to the postpaid consumption tax treatment that is discussed in Part V. First, the recategorization of educational expenses and subsequent deductibility of such expenses has the effect of narrowing the tax base.[149] Assuming revenue neutrality, narrowing the tax base in one particular area requires either an expansion of the tax base in some other area to offset it or an increase in one or more of the marginal tax rates.[150] The second problem is that allowing taxpayers to offset an investment in human capital against wages, absent substantial reform of the tax base, attacks the foundation of our current system—the consistent taxation of wages.[151]

146. Nobel Prize-winning economist Theodore Schultz demonstrated the economic benefits of treating educational expenditures as investments in human capital. *See generally* Theodore W. Schultz, *Capital Formation by Education*, 68 J. POL. ECON. 571 (1960) (describing how education should be defined as an investment in human capital because it provides tangible value to the economy). "[S]tudents incur expenditures of higher education principally to enhance their ability to increase earning power. Also, many people believe that increased investment in education is crucial to the economic future of our country." Argrett, *supra* note 5, at 623–24 (internal citations omitted). In 1986, the median annual income of year-round full-time female workers twenty-five years old or older with five years or more of higher education was $27,279 as compared to $15,947 for female workers with four years of high school. The comparable figures for male workers were $39,592 and $24,701, respectively. *See id.* at 636.

147. Although the 1986 Act made interest on student loan debt nondeductible, section 202 of the Taxpayer Relief Act of 1997 restored the deductibility of interest on student loan debt under most circumstances. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997).

148. The seminal article supporting this position advocates a legislative rather than a judicial solution. *See* Argrett, *supra* note 5, at 651–59.

> Capital cost recovery of Expenditures for Certain Post-secondary Education is appropriate because these expenditures are an investment in human capital and are a significant factor in the production of income over a determinable period. Although it is possible that a court might . . . allow amortization under section 167 of all or a portion of these expenditures, this problem should be resolved legislatively for public policy and fiscal reasons.

Id. at 659. *See also* Hume, *supra* note 5 (advocating the deductibility of post-secondary education expenses).

149. *See supra* Part III.A, C.

150. *See* SLEMROD & BAKIJA, *supra* note 1, at 35–36.

151. *See* MCCAFFERY, *supra* note 2, at 4–5.

V. SAVING FACE WITH A CONSISTENT BASE: HOW THE CONSISTENT CONSUMPTION TAX OR CONSISTENT INCOME TAX WOULD SUCCEED WHERE THE HYBRID BASE HAS FAILED

The preceding discussion should make the following point clear: The failure of politicians and tax experts to agree on whether the tax base should include savings has resulted in an inefficient and inequitable hybrid-based Ugly Duckling tax system. The Tax Reform Act of 1986 seemed to be characterized by a move toward a more consistent tax on income.[152] Since 1986, however, our tax system has crept slowly but consistently toward a prepaid consumption tax base.[153] Clearly, the fact that this progression toward consumption tax treatment was inconsistent and incremental rather than consistent and fundamental has benefited certain classes of savers more than others.[154] Whether a consistent tax on income or a consistent tax on consumption would reduce or eliminate the inequities and inefficiencies caused by the timing problems that characterize debt treatment under an inconsistent hybrid-based tax system is the subject of Part V.

A. THE CONSISTENT, PROGRESSIVE TAX ON INCOME

The taxation of post-secondary education, as illustrated through the analysis of the taxpaying lives of Andy and Betty, is primarily a problem caused by the timing of any income tax and the relatively high marginal rates necessary to support an inconsistent tax base. With regard to the problem of timing, any income tax base would impose a tax on Betty when she earns her money, not when she spends it, and would therefore evaluate her ability to pay based on her income in any given year, regardless of what proportion of that income is tied up in debt repayment, and thus unavailable for consumption.[155]

A consistent tax on income, however, would be characterized by a broader base and is likely to bring down Betty's marginal tax rate during

152. *See id.* at 46–47.

153. *See id.* at 48–51.

154. *See supra* Part III.C.

155. This argument assumes that under a consistent tax on income, post-secondary education expenses are not considered profit-motivated transactions. This assumption is not without controversy. *See supra* Part IV.C. Of course, the distinction made in the tax code—discussed above in the context of the inconsistent hybrid-based tax—between the deductibility of different types of post-secondary education as business expenses would no doubt be equally important under a pure income tax, given the deductibility of profit-motivated transactions under the Haig-Simons model. *See supra* Parts III.B, IV.C.

her peak earning years. The result of a broader tax base, assuming revenue neutrality, would be a reduction in marginal tax rates.[156] Although progressivity in the rate structure, as described earlier, can be determined independently of the tax base, it is likely that Betty's income would be taxed at a lower marginal rate under a consistent income base than under an inconsistent hybrid base.

B. The Consistent, Progressive, Prepaid Consumption Tax

A wage tax, absent a fundamental redefinition of post-secondary education as an investment, would suffer from the same timing problems that plague both our current hybrid-based tax and the consistent Haig-Simons income tax. A wage tax would not tax Betty on the initial acquisition of the loan proceeds because that acquisition would not represent wages. Under a wage tax, Betty would have to pay back the debt with after-tax dollars that would otherwise be available for consumption. Although the base is the same under a consistent, prepaid consumption tax and a consistent, postpaid consumption tax,[157] the timing issues associated with the repayment of debt under a tax system with a progressive rate structure create substantial differences for an individual, like Betty, with a peaked lifetime earning profile.[158]

There is reason to believe that this timing problem would cause an even greater distortion under a consistent wage tax than under the current system or a system characterized by a pure Haig-Simons income tax base. A consistent wage tax, assuming revenue neutrality, would have an even narrower base than our current hybrid system and a substantially narrower base than the pure Haig-Simons income tax.[159] This narrower base would require higher tax rates and, therefore, would increase the distorting effects that contributed significantly to the inequity and inefficiency illustrated in the tax-paying lives of Andy and Betty.

C. The Consistent, Progressive, Postpaid Consumption Tax

A consistent, progressive, postpaid consumption tax would not fail Betty in terms of horizontal equity as do the pure income tax and the inconsistent hybrid-based tax. As the life-cycle model predicts,

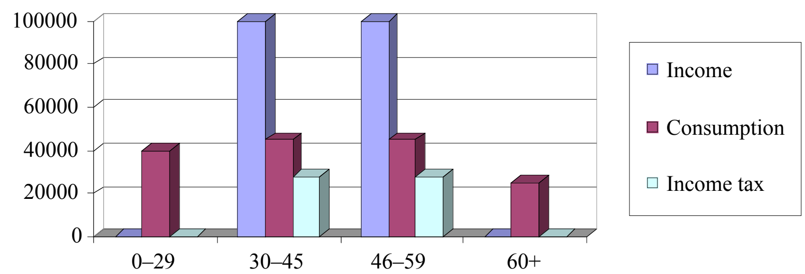
156. *See* SLEMROD & BAKIJA, *supra* note 1, at 35–36.
157. *See supra* Part III.B.
158. *See supra* Part IV.A.
159. *See supra* Part III.B.

consumption patterns are more constant throughout a person's lifetime than earning patterns.[160] Considering this empirical reality, only the consistent, postpaid consumption tax does not have a timing characteristic that results in distortions in individual taxpayer liability, such as the one seen in the comparison of the relative lifetime federal tax liability of Andy and Betty.

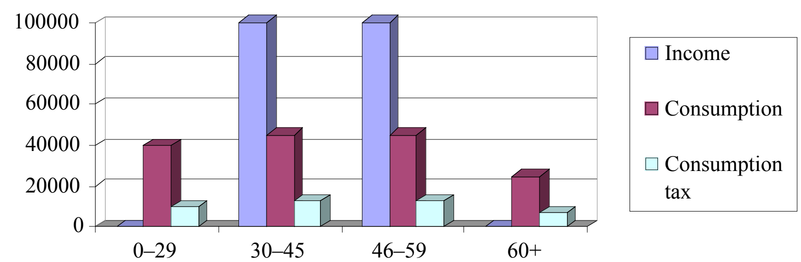
Under a consistent, postpaid consumption tax, the repayment of debt during Betty's earning years between ages thirty and sixty would not be taxed because the repayment of debt is not considered consumption. Betty would be taxed during the initial acquisition of the loan proceeds (assuming that post-secondary education were still categorized as consumption) and would pay tax at the marginal rate she found herself in at that time. Presumably, Betty would be in a lower marginal tax bracket when she is borrowing than when she is repaying her student loan debt.

160. *See supra* Graphs 2, 3, and 4 and accompanying text.

GRAPH 5. The life-cycle curve of income, consumption, and tax for Betty under the inconsistent hybrid-based tax



GRAPH 6. The life-cycle curve of income, consumption, and tax for Betty under a consistent, postpaid consumption tax



In sum, just as consumption is more static during the course of a person's lifetime than earnings, consumption tax rates are more static than income tax rates over the course of a given taxpayer's lifetime, assuming consistency in the progressivity of the rate structure. Although Betty would still be forced to pay tax on her "consumption" of post-secondary education, it would be at a lower marginal rate.

VI. CONCLUSION

Our inconsistent hybrid-based, Ugly Duckling tax system leaves much to be desired in terms of the equity and efficiency of laws governing the taxation of debt acquired to finance post-secondary education. Scholars have proposed that the simplest solution to the problems associated with the tax treatment of student loan debt is to include education as an amortizable investment in human capital. This solution admittedly achieves a better balance of equities than the current system's nondeductibility of expenses associated with post-secondary education, but it also results in a narrower tax base and higher marginal rates. Furthermore, this solution does not adequately address the underlying cause of the problem—the timing deficiencies inherent in any system that purports to tax income. Similarly, the transformation to a consistent income tax base or a consistent, prepaid consumption tax base would not truly achieve the goals of equity and efficiency in the context of debt-financed post-secondary educational expenses. Betty's misfortune, caused by a combination of the timing problems inherent in any tax on income and the narrow base that accompanies any inconsistent income tax, can only be resolved by the implementation of a consistent, postpaid consumption tax. As this Note explains, such a tax system could easily be implemented without necessitating the sacrifice of our progressive rate structure.

Just as the Ugly Duckling eventually became a beautiful swan in the Hans Christian Andersen fairy tale, the U.S. tax system's only hope of achieving substantial equity and efficiency in the context of educational expenditures depends on transformation into a system characterized by a pure, consistent, postpaid consumption tax base. With regard to the tax treatment of debt, a postpaid consumption tax will depart from our current hybrid tax system in significant ways. With regard to debt accumulated to finance post-secondary education, such expenditures would be taxed at the time of the borrowing, not at the time of repayment, imposing on Betty taxation at her marginal tax rate during the early years in her life in which she is earning relatively little money, rather than her high-income years.

Overall, the complexity of the tax system is a product of timing problems and its inconsistent base. Complexity may be tolerated, however, if it exists for good reason. The problem with the hybrid-based tax is not its complexity, but the fact that it generates inequity and inefficiency. Tax laws should be structured to distribute tax burdens equitably while not creating distortions in the market. With regard to educational debt our current hybrid-based tax fails in both regards.