

**The Fair Timing of Tax**  
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# THE FAIR TIMING OF TAX

Edward J. McCaffery\*

## Abstract

The traditional understanding of broad-based tax systems contrasts an income tax with all forms of a consumption tax. The income tax, alone, includes the yield to capital in its base; consumption taxes do not. Simple financial analysis demonstrates the equivalence of the two most common classes of consumption taxation—prepaid, or wage-based, and postpaid, or sales taxes—under certain assumptions, most importantly including constant tax and interest rates between the periods in the model. Advocates of redistributive taxes insist on both progressive rates and an income base, in large part to tax the yield to capital; opponents clamor for flat-rate consumption taxes, often invoking Mill’s celebrated argument against the income tax’s “double taxation” of savings to support their case.

Once progressivity is presumed, however—as its enduring popular appeal suggests it ought be—the traditional understanding is flawed. Asking a different timing question,

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**PRELIMINARY DRAFT: PLEASE DO NOT QUOTE CITE OR CIRCULATE**

“when, in a taxpayer’s flow of funds, ought progressive taxes be imposed?,” casts tax systems in a new light. The present tax system emerges as an onerous wage-based one. A progressive cash-flow consumption tax, in contrast, emerges as the best—most consistent and principled—tax on the yield to capital, under just the conditions in which it is fair and appropriate to tax such yield. This gives a further reason to support a progressive cash-flow consumption tax, sounding in reasons familiar to *income* tax supporters. A consistent progressive cash-flow consumption tax will lower the burden of taxation when capital transactions (borrowing, saving, and investing) are used to *smooth* labor earnings within or between lifetimes (or taxpayers), and will increase the burden of taxation when capital transactions are used to *enhance* labor earnings within or between lifetimes (or taxpayers). Critical reflection based on a near century of experience reveals such a tax to give form to attractive normative ideals.

The new understanding helps to show that the traditional and most common arguments for consumption taxation are not compelling. The best, most appealing case for a consumption tax does not rest on “horizontal equity” models, nor on claims about the economic, consequentialist importance of savings on an individual or an aggregate social level. Rather it is claims of fairness, in a social contractarian sense in the manner of John Rawls and other liberal theorists, that argue for a properly designed consumption tax—in part precisely because of the way such a tax sometimes but not all the times burdens capital and its yield, and in greater part because such a tax points the way towards greater, more meaningful progressivity in tax.

The new understanding of tax yields important insights into pressingly practical matters of tax policy and design, and opens up an important window to critique contemporary trends in tax reform. The battle in tax policy should not be over income versus consumption taxation—as it has been for centuries—but rather over what kind of consumption tax to choose. Failure to address this question head-on has led tax policy to move, seemingly inexorably, towards the wrong choice, with the fate of progressive, redistributive taxation hanging in the balance.

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To tax the sum invested, and afterwards tax also the proceeds of the investment, is to tax the same portion of the contributor's means twice over. The principal and the interest cannot both together form part of his resources; they are the same portion twice counted; if he has the interest, it is because he abstains from using the principal; if he spends the principal, he does not receive the interest. Yet because he can do either of the two, he is taxed as if he could do both, and could have the benefit of the saving and that of the spending, concurrently with one another.

**John Stuart Mill, *Principles of Political Economy* <sup>1</sup>**

## **I. Introduction**

### **A. Loomings**

**P**erhaps we should blame it all on Mill. A great deal and possibly all of the mind-numbing complexity of America's largest and least popular tax follows from the decision to have a progressive personal *income* tax.<sup>2</sup> Proponents wanted an individual income tax notwithstanding—indeed, in large part because of—such a tax's “double taxation” of savings. This double-tax argument is an analytic point generally attributed to Mill's classic 1848 treatise *Principles of Political Economy*. Historically, much of the support for the Sixteenth Amendment, ratified in 1913, came from southern and Midwestern, progressive, agricultural

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<sup>1</sup>. Book V., ch. II, § 4, at 814 (W.J. Ashley, ed., Logmans, Green & Co. 1909) (1848).

<sup>2</sup>. See Greg M. Shaw and Stephanie L. Reinhart, *The Polls---Trends: Devolution and Confidence in Government*, 65 PUB. OPINION Q. 369, 382, Question 11 (2001) (poll results from 1972 to 1999 showing plurality choose the “federal income tax” as the “worst” tax, “that is, the least fair.”)

interests, who wanted in general to implement a redistributive tax, and in particular to collect some tax from East Coast financiers.<sup>3</sup> After all, the Supreme Court had ruled that the income tax of the late nineteenth century was unconstitutional only insofar as it fell on the fruits of capital; no constitutional amendment would have been necessary to retain or implement a national wage or sales tax.<sup>4</sup> The legal *raison d'être* of the income tax was to get at such returns to savings as dividends and interest.

To this day, liberals and moderates insist on retaining the structure of an income tax precisely because it does get at the returns to saving in addition to labor earnings.<sup>5</sup> Consumption taxes of all sorts are set in contrast to the income tax, on another side of a great divide, as taxes that fail to effectively get at the yield to

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<sup>3</sup>. For some among several good sources of the political history, see SHELDON D. POLLACK, *THE FAILURE OF U.S. TAX POLICY* 45-53 (1996) [hereinafter POLLACK, *FAILURE*]; ROBERT STANLEY, *LAW IN THE SERVICE OF ORDER*, Steven A. Bank, *The Progressive Consumption Tax Revisited*, 101 MICH. L. REV. 2238 (2003). See also KEVIN PHILLIPS, *WEALTH AND DEMOCRACY* (2002). Another and somewhat related reason to go with an individual income tax was the failure to think through the possibilities of a progressive consumption tax; this failure of imagination was understandable, given the relatively low dollar stakes involved, and the lack of both theory and real-world experience pertaining to large comprehensive tax systems. Erik Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of "Incomes"*, 33 Arizona State Law Journal 1058-1158 (2001); STEVEN WEISMAN, *THE GREAT TAX WARS* (2002).

<sup>4</sup>. *Pollock v. Farmer's Loan & Trust Co.*, 157 U.S. 429c (1895); 158 U.S. 601 (1895).

<sup>5</sup>. See e.g., LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* (Oxford University Press 2002) [hereinafter MURPHY & NAGEL]; Anne L. Alstott, *The Uneasy Liberal Case Against Income and Wealth Transfer Taxation: A Response to Professor McCaffery*, 51 TAX L. REV. 363 (1996) [hereinafter Alstott, *Uneasy Liberal Case*]; MICHAEL J. GRAETZ, *THE DECLINE (AND FALL?) OF THE INCOME TAX 1997* [hereinafter GRAETZ, *DECLINE*]; Michael J. Graetz, *100 Million Unnecessary Returns*, YALE L. J. 19xx. See also BILL BRADLEY, *THE FAIR TAX* (1984) [hereinafter BRADLEY, *FAIR TAX*]. U.S. Department of Treasury 1992, cited in Gentry and Hubbard.



capital—that deliberately avoid Mill’s “second” tax.<sup>6</sup> Prominent commentators on the case for consumption taxation—both those in favor and those opposed—continue to cite as the “best” or “most sophisticated” argument for adopting a consumption base the analytic facts that consumption taxes do not overly burden capital or its yield and as such do not distort the savings-consumption decision, or, equivalently, do not favor present over deferred consumption.<sup>7</sup> The literature for and against consumption taxation is strewn with stock “horizontal equity” models, comparing savers and spenders, Ants and Grasshoppers: the idea is that income taxes punish savers like the

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<sup>6</sup>. See, e.g., Noel B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX LAW REV. 17 (1996) (“Both bases include consumption; the difference is that an income tax also includes changes in wealth, or savings. Whether or not it is appropriate or desirable to tax savings has been at the core of the debate.” (footnote omitted)); Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. LAW REV. 961 (1992) (“Under a plausible set of assumptions, the two forms of consumption tax—a tax on consumption only and a tax on wages only—impose an equivalent tax burden in present value terms” (footnote omitted)). A particularly clear statement of the traditional view comes from the recent philosophical tract by Liam Murphy & Thomas Nagel:

This equivalence allows us to say, furthermore, that any consumption tax scheme, in taxing not accretions to wealth as such, but rather only consumption, exempts from taxation the normal returns to investment.

THE MYTH OF OWNERSHIP, *supra*, at 101 (footnote omitted). See also JOEL SLEMROD AND JON BAKIJA, TAXING OURSELVES (1996). Of course, most of these fine scholars note the assumption of flat, constant, or proportionate rates somewhere, as in the omitted footnotes. A way to understand the present article is that it takes seriously the idea of *non-constant* tax rates, and attempts to build a normative theory around them, taking the tax rates themselves as the prior, foundational commitment of tax. This proposed rearrangement in the political epistemology of tax is a central theme of this article.

<sup>7</sup>. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974) [hereinafter Andrews, 74]. See also Mark Kelman, *Time Preference and Tax Equity*, 35 STAN. L. REV. 649-80 (1983), Fried, US Treasury, BLUEPRINTS FOR BASIC TAX REFORM (2d ed.), Arlington, VA: Tax Analysts, 1984, herein referred to as “Blueprints (2d ed)” quotation.

mythical Ant vis a vis spenders like Grasshopper.<sup>8</sup> On the other side of the divide, supporters of redistributive taxation argue that retaining an income tax base is a central task of maintaining or obtaining fairness in tax in large part because it, alone, gets at the return to capital, the nearly exclusive province of the economically fortunate.<sup>9</sup>

The idea that income taxes and only income taxes effectively get at the yield to capital, and that consumption taxes of either of two broad types, prepaid and postpaid, as explained further below, do not—that the difference between an income and a consumption tax base is that the former includes the yield to capital in its base and the latter does not—constitutes the traditional view of tax.<sup>10</sup> The traditional view has extended well beyond the academy to influence the popular understanding of tax and its possibilities as well as practical political decision-making. This traditional view has generated an impoverished choice set for tax, consisting of a badly flawed status quo on the one hand or a flat consumption tax of some sort on the other.

The traditional view is wrong.

The key insight is that the canonical understanding of consumption taxes changes under consistently and principled progressive tax rates.<sup>11</sup> No longer are

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<sup>8</sup>. See e.g., Slemrod & Gale. For deep critiques of the horizontal equity norm, See Louis Kaplow, *Horizontal Equity: Measures in Search of Principle*, 42 NAT'L TAX J. 139 (1989) [hereinafter Kaplow, *Horizontal Equity*]; and Griffith.

<sup>9</sup>. See e.g., Bank, *The Progressive Consumption Tax Revisited*, *supra*.

<sup>10</sup>. At least the “traditional view” within the mainstream of legal academic discourse, and in the law school classroom. The economics profession has typically had a more sophisticated, nuance perspective. See, e.g., Gentry and Hubbard, 1997, Kaplow 1994. However even the economics literature refers to the prevalence of the standard view (see, e.g., Gentry and Hubbard, referring back to Mill), and also typically suffers some limitations in its analysis and recommendations on account of the continued prevalence of this view.

<sup>11</sup>. A word is in order on terminology. What matters for most purposes for claims of justice is progressive average or (equivalently) effective tax rates, wherein taxes as a percent of total income (or consumption, or wealth, or whatever the base might be), rise in  
(continued...)

prepaid and postpaid consumption taxes—taxes on wages and taxes on spending, respectively—equivalent. Postpaid consumption taxes can and do burden the yield to capital, and not in an arbitrary, random way. Far from it: a progressive postpaid consumption tax emerges as the fairest and least arbitrary of all comprehensive tax systems, precisely because it chooses to make its decisions about the appropriate level of progressivity at the right time. In doing so, it burdens some but not all uses of capital and its yield, and for normatively attractive reasons. These points follow from a simple statement of the analytics of tax.

Why then has the traditional view persisted for so long, virtually unchallenged? It is true that an ideal income tax, as including all sources of income—both labor earnings or the yield to human capital and the yield to savings or financial capital—is a “double tax” on savings that burdens savers relative to spenders. This is true both within the income tax’s own framework, where savers are treated more harshly than spenders, and also compared to a hypothetical no-tax world, with the income tax destroying the pre-tax financial equivalence between present and deferred consumption. It is also true that a prepaid, yield-exempt or (all equivalently) wage tax categorically exempts the yield to savings, preserving the pre-tax relation whereby savers and spenders under normal circumstances have equal material resources in present value terms. But under progressive tax rates, a postpaid, cash-flow or (all equivalently) spending tax is *not* equivalent to a yield-exempt or wage tax; it is not equivalent, that is, to an “income” tax with a zero rate of taxation on savings

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<sup>11</sup>. (...continued)

that base. See Joseph Bankman and Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk?*, 47 *Tax Law Rev.* 377-406 (1992) and/or *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 *Cal. Law Rev.* 1905-1968 (1997); Mirrlees, Berliant & Rothstein (forthcoming), Atkinson. The United States tax system relies and has always relied on progressive marginal tax rates. This is one but not the only means to progressive average taxation; a better way, per the optimal tax tradition, is to rely on relatively flat, even declining marginal tax rates, coupled with a “demogrant” or lump sum transfer to effect progression. Bankman & Griffith, Mirrlees, Slemrod. For the most part, this Article, following traditional tax policy discussions, shall conflate progressive marginal and effective taxation; later it shall comment on how the new understanding of tax ought to change the analysis of progressivity, too.

(itself a semantic paradox).<sup>12</sup> This is a point that the traditional tax policy literature has sometimes stated, but it has only mentioned it in passing.<sup>13</sup>

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<sup>12</sup>. William A. Klein, *Timing in Personal Taxation*, 6 J. LEGAL STUD. 461 (1977) [hereinafter Klein, *Timing*].

<sup>13</sup>. An especially good statement of the qualification in the traditional view comes from Anne Alstott, in her response to some of my earlier work. See Alstott, *Uneasy Liberal Case*, *supra*. Alstott first sets out the traditional view in the text:

The defining characteristic of a consumption tax is that it removes from the tax base income that is saved or invested (for example in financial instruments like stocks or bonds or in real investments like plant or equipment). A consumption tax, by definition, taxes only income spent on current, personal consumption (for example, in cars, food and travel). By deferring tax on saved income until the money is spent, a proportional consumption tax essentially exempts the earnings on investment from taxation. A progressive consumption tax of the kind Professor McCaffery advocates would offer significant tax benefits to savers while penalizing those with high levels of consumption spending.

Id at 364-365 (footnotes omitted). Professor Alstott adds a footnote explaining (in more detail than typical of the literature) the relevance of rates:

A *proportional* consumption tax exempts from tax the income from savings. . . . This familiar “yield exemption” result holds only if tax rates are constant, however, and under a *progressive* consumption tax, the exclusion may save tax at a rate that is higher or lower than the subsequent tax rate paid on consumption . . . . In general, the tax rate on investment income will be positive where the saver faces a lower marginal tax rate than the consumer, negative where the saver faces a higher marginal tax rate than the consumer and zero where the two marginal rates are equal.

Id at 365. (For a related point, see Joel Slemrod, *Optimal Tax and Optimal Tax Systems*, 4 J. ECON. PERSP. 157-178 (1990); see also Eric Rakowski, *supra*, *Can Wealth Taxes Be Justified*, 53 Tax L. Rev. 263-376 (2000). Professor Alstott wrote these thoroughly correct analytic words on the occasion of a symposium on some of my earlier articles, and after

(continued...)

On the occasions when scholars have paused to reflect over the idea that varying progressive rates destroy the equivalence of pre- and postpaid consumption taxes, they have taken one of two subsequent turns. One, some point out that the potential non-equivalence of the two consumption taxes leads to an argument for flat or proportionate consumption tax rates, because—they presume, or presume that consumption tax supporters presume—the best argument for a consumption tax is one of preserving the “neutrality” between savers and spenders, or of avoiding Mill’s second tax, or, other times, of promoting savings on an individual or a social

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<sup>13</sup>. (...continued)

considering my own reply to various criticisms, in which I wrote, in part:

Professor Alstott likes income taxes because they capture the yield to savings. But so does a back-ended progressive consumption tax. The equivalence of the yield-exempt and the cash-flow consumption tax models depends on constant marginal rates; as I point out in my articles, this fact has led many to advocate flat-rate consumption taxes. But a progressive cash flow or (equivalently) back-ended consumption tax consciously hits at wealth that is spent as it is spent, whether it is taken out of earnings or capital. There is no reason, dictated by political liberal theory alone, to link flat rates with consumption taxes. A progressive consumption-without-estate tax is not a consumption tax in the sense that a consumption tax never taxes the yield to capital. But I do not necessarily care about that, because no part of my analysis turned on prior definitions.

Edward J. McCaffery, *Being the Best We Can Be (A Reply to My Critics)*, 51 TAX L. REV. 615, 630-31 (1996) (footnotes omitted). The present article grew out of my continued thinking about the relevance of variable and progressive rates to the income-versus-consumption debate. Not only did I notice the continued iteration of the view that consumption taxes do not reach the yield to capital in the popular political culture and in tax policymaking circles, but I also came to see that my own earlier work was incomplete in that I had not developed a suitably general theory of how, precisely, varying rates affected the choice of tax base, and of the normative bases for the argument. In time I came to see that the reason for the repetition of the traditional view was having the wrong argument structure in place for supporting a consistent consumption tax, a theme throughout this article. Working on these issues over several years led to the present article.

aggregate level.<sup>14</sup> But this move puts the cart before the horse: it rests the case for consumption taxation on weak normative foundations. Two, other scholars simply note that the interaction of progressive rates and a postpaid consumption tax is more or less random: taxes will go up, and hence there will be a “penalty” for savers, if consumption occurs in a higher rate bracket than initial earnings; taxes will go down, and hence there will be a “subsidy” for savers, if consumption occurs at a lower level than initial earnings.<sup>15</sup> In this second move, the language of subsidy and penalty is not helpful: it tends to confuse matters, perhaps because of an innate or intuitive aversion to non-neutral sounding rules, a belief that neutrality *per se* is an end.<sup>16</sup> In fact, each of the three major comprehensive tax alternatives—income, prepaid consumption, and postpaid consumption—has a plausible claim to neutrality of some sort. The challenge for policymakers is to decide which is the best sort. More important, there is nothing random about when savings, or the yield to capital, will decrease or increase a taxpayer’s burden of taxation under a consistent progressive postpaid consumption tax. The burden of taxation will fall when a taxpayer uses capital transactions (borrowing, saving, investing) so as to smooth out the pattern of her lifetime labor earnings, and thereby to consume in any given year at the level of her average annual lifetime labor earnings in constant dollar terms. The burden will also fall when capital transactions result in diminished consumption, again measured against the average annual labor earnings baseline. The burden of taxation will increase—the yield to capital will bear an effective positive tax burden—when capital transactions are used to finance enhanced, or greater, consumption than this level.

Put in other terms, a consistent, progressive postpaid consumption tax stands between an income tax, which double taxes all savings by including all of the yield to capital in its base, and a prepaid consumption or wage tax, which never taxes the

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<sup>14</sup>. Warren 75 responding to Andrews 74 is a good example of this.

<sup>15</sup>. Alstott, *Uneasy Liberal Case*, *supra* note --.

<sup>16</sup>. See e.g. Edward J. McCaffery & Jon Baron, *Framing the Family: Normative Evaluation of Tax Policies Involving Household Composition*, USC Olin Research Paper 00-18 (2000). See also Michael Livingston’s critique of naive neutrality norms in tax policy scholarship.

yield to capital. A consistent progressive postpaid consumption tax burdens some but not all of the yield to capital, and does so in a principled way, by design: there is no need for ad hoc deviations from an analytically sound understanding of the comprehensive tax ideal to achieve the result, as there is, for an important example, under the “income” tax so as to remove the double-tax sting from retirement (or medical or education-related) savings. Rather than look to the sources of private wealth directly, as the income and prepaid consumption taxes do, a postpaid consumption tax looks consistently to the uses of such wealth. It is here, in regard to uses, that the tax makes its distinctions. A progressive postpaid tax relatively lightens taxation on the use of capital transactions to move uneven labor market earnings into even cash flows, in constant dollar terms. But the very same tax falls more heavily on the use of capital transactions to increase one’s lifestyle above this level. There is nothing arbitrary about this level of average annual labor market earnings: we might take it, provisionally, as reflecting a certain self-sufficiency norm, in the spirit of Nobel Laureate William Vickrey—an important player in the intellectual history of tax, to whom we shall return.<sup>17</sup> In sum, the yield-to-capital *is* taxed under a progressive postpaid consumption tax, except for ordinary savings bearing normal rates of return that are used to smooth out uneven labor earning flows.<sup>18</sup>

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<sup>17</sup>. WILLIAM VICKREY, *AGENDA FOR PROGRESSIVE TAXATION* (1947); see also *Cumulative Income Averaging*, *Law & Public Policy*.

<sup>18</sup>. Note that this is not the same point made by Warren, Bankman & Griffith, Weisbach, and others [such as Schizer and Zelenak], which is that the postpaid consumption tax can at least capture some of the yield to savings, whereas a prepaid consumption tax captures none of it. Those points are made out under the assumption of constant tax rates, and look to potential variation in the rate of return. The point of this article is that under intentionally non-constant rates—under consistently progressive rates—a related (but distinct) effect takes hold. Windfall or super-normal returns to capital are captured by a constant rate postpaid consumption tax under plausible assumptions; because these are sources of “enhancement” in lifestyle in the terms of this article, that gives another, convergent reason for the postpaid model, which always, and by design, burdens the yield to capital when used to elevate lifestyle. Note too that the focus of the normative grounding of the postpaid model is consistently on the use of resources, not their source. This will all become clearer in due course.

So much is analytic, or descriptive: the facts of the matter for tax. An income tax doubly taxes all savings, by design. A prepaid consumption tax systematically exempts all of the yield to capital, again by design. A consistently progressive, postpaid consumption tax splits the difference, in a systematic way. It exempts the normal yield to capital when it is used to translate an uneven pattern of labor earnings into a constant pattern of consumption in real-value terms; the new understanding of tax calls this *smoothing*. A consistent progressive postpaid consumption tax does not exempt this yield to capital when the yield finances a “better,” more expensive, lifestyle; the new understanding calls this *enhancing*. These results obtain within and across individuals, and within and across generations. These points form the core analytic theme in this article.

The analytic theme in turn opens the way for a rethinking of the normative grounding of tax. A consistent progressive postpaid consumption tax is appealing, in part precisely because it maps up with widely held and independently reasonable ordinary moral intuitions in regards to the *taxation of capital and its yield*. To be clear, this is not the only or even necessarily the best argument for a consistent progressive postpaid tax: writing on a blank slate, one might well cut straight to the chase, and argue that such a tax is the fairest, most efficient, and simplest to administer of any comprehensive tax plan.<sup>19</sup> But history and a considerable amount of tax policy scholarship at least since Mill have conflated the case for consumption taxes of any sort with the case against taxing some or all of the yield to capital. Given that this is where matters stand, it becomes important to see that a progressive postpaid consumption tax best gets at the yield to capital, of all the major alternatives, in just the way that ordinary moral intuitions seem to want to get at such yield. The most decisive evidence for this claim comes from an examination of a near century of experience with tax. The actual income tax is not an income tax at all, because it is inconsistent in its taxation of the yield to savings. But this inconsistency is not without principle. We can see the income tax attempting to differentiate between “ordinary” savings that effect smoothing and all else. Coining two further normative terms, the new understanding refers to the idea that those savings that are used to

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<sup>19</sup>. This is what I have attempted to do in FAIR NOT FLAT.



even out cash-flows, such as retirement savings, should not be double-taxed as the *ordinary-savings norm*, and the idea that the yield to capital is an increment of value that ought to bear some tax as the *yield-to-capital norm*. The uneasy coexistence of these two norms under the income tax has led to incoherence, inefficiency, and unfairness. But the two norms come into perfect harmony under a consistent progressive postpaid consumption tax, by design.

There is more to the analysis. For example, we can see through the new lens that the analytic misunderstandings led to and were in turn informed by a limited normative argument structure for tax—the intellectual history is vitally relevant to understanding the present and the best potential futures for tax. The best argument for a postpaid consumption tax is *not* about the “horizontal equity” of savers and spenders, or about the principled non-taxation of the yield to capital. It is not an argument about the aggregate capital stock, or even about the importance of savings, on individual or national levels: depending on the choice of tax rates, we can have more, less, or the same amount of savings under a consumption as under an income tax. Rather the best argument for a consistent progressive postpaid consumption tax is that actual consumption represents the best—fairest and most efficient—time to make the decisions about the appropriate level of taxation, in large part because this allows us to get to some but not all of the yield to capital: that yield which enhances lifestyles, but none other. In other words, the best argument for the postpaid consumption tax as the right base for taxation is an argument, not about the tax base at all in the first instance, but rather about progressivity and timing in tax — a postpaid consumption tax is the fairest, most efficient, best way to implement a progressive individuated tax. A consistent postpaid consumption tax takes average lifetime earnings as the baseline for measuring “equals,” not the morally arbitrary particular pattern of human-capital realizations.<sup>20</sup> A consistent progressive postpaid consumption tax is “source neutral” in the best—most normatively compelling—sense of the term; it captures returns from labor, capital, and beneficent (or altruistic) markets. These are arguments about fairness, first and foremost, predicated on individuals, as befits a comprehensive individuated tax system.

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<sup>20</sup>. Vickrey, Blueprints.

In all this I more or less simply posit that progressivity—getting the better-able to pay to pay more, to some degree, than the less better-able—is an attractive end for tax. I shall say a few words about this end later. But for the most part I presume that we want a progressive, redistributive tax system.<sup>21</sup> Partly this is a matter of ordinary moral intuitions and our collective history, as I read them, as well as independent political and moral theory. But it is also analytic. Under a flat tax rate, prepaid and postpaid consumption taxes are indeed largely equivalent, and neither reaches the yield to capital. If we do not want progressive tax rates, many far simpler alternatives to the status quo are available; if we do not want to reach the yield to capital, ever, then we can choose a prepaid or a flat-rate postpaid consumption tax. I proceed on the assumption that “we”---at least a good many contemporary citizens and readers---do want these things, progressivity and some taxation of the yield-to-capital, and indeed that these ends are prior to any preference over more particular forms of taxation. I write to show that a postpaid consumption tax is the best---indeed, the only practicable---way to obtain these goals.

The new way of thinking about tax paves the way for extensive tax reform and opens up an important line of critique on current political proposals. The real, pressingly practical question for tax is not whether to have an income or a consumption tax, but what form of consumption tax to have. The stakes in this battle are clear and dramatic: the fate of progressivity in tax. Contemporary conservative leaders have signaled a desire to move tax towards a prepaid consumption tax. Such a tax, falling exclusively on wages, jeopardizes America’s historic commitment to at least moderate progression in the distribution of tax burdens. The path towards maintaining that commitment lies in taxing at the opposite time, of ultimate outflow, not inflow—which the postpaid consumption tax model, alone among major

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<sup>21</sup>. There are of course compelling moral and political theoretic arguments for progressivity. See Harvey Rosen, Bankman and Griffith, Barbara Fried. I also largely accept the argument of Louis Kaplow and Steven Shavell, tracking the two welfare theorems, that the general legal system should be evaluated vis a vis the goal of welfare-maximization or allocative efficiency, leaving the tax system to redistribute wealth. See LOUIS KAPLOW AND STEVEN SHAVELL, *FAIRNESS VERSUS WELFARE* (2002). But this sensible bifurcation of normative labors puts more pressure on getting progressivity in tax down right. See Baron and McCaffery, *Unmasking Redistribution*.

alternatives, does. It is time to get the fair timing of tax down right.

The rest of this article makes good on these opening claims.

## **B. The Road Ahead**

I wrote this article for a general audience interested in law reform but without necessarily an extensive familiarity with the tax policy literature. As it turns out, reconsidering tax policy more or less from the ground up has its advantages, for the traditional view has made certain wrong turns along the way. Thus an intellectual history merges with an analytic discussion of tax to generate a critique of the status quo on the way to a specific programmatic proposal for normative improvement. Here is a brief summary of the path through the argument.

Part II sets out the traditional understanding of income and both forms of consumption taxes.

Part III begins to translate the analytic facts of tax into a normative theory. It explores some of the intellectual history of tax, to lay the foundation for a reconceived normative argument structure.

Part IV introduces a new vocabulary and analysis to support the new understanding of tax. Most important, it develops more formally two norms about the taxation of capital: the yield-to-capital norm, which holds that the return to capital is an increment of value that ought to be taxed, and the ordinary-savings norm, which holds that savings that merely move around labor earnings within a lifetime ought not to be excessively burdened. These two norms are in fatal tension under an income tax; a postpaid consumption tax accommodates them by design.

Part V begins a look at and critique of contemporary practice by explaining that in reality the so-called income tax is effectively a prepaid consumption or wage tax.

Part VI continues the examination of tax practice beyond the income tax. The overall skew of the present system towards wage and away from capital taxation becomes more dramatic when the increasingly important payroll tax is added to the mix. Gift and estate or so-called death taxes are meant to alleviate the problems, but,

for the most part, they are inadequate for the task. So too for the corporate income tax, in both theory and practice. Finally, Part VI notes that there is no real, meaningful, political possibility of “fixing” the income tax to conform it to its ideal. The real choice is between prepaid and postpaid consumption taxes, that is, between taxes on wages or taxes on spending.

Part VII looks to the future, to the possibilities for tax.

Part VIII chronicles some popular misconceptions about income and consumption taxes, hoping to better inform public political opinion and discourse about tax, and concludes by underscoring why it all matters.

## II. In theory: Three forms of tax

There are three major choices of broad-based tax systems in ideal theory: the income, prepaid and postpaid consumption taxes.<sup>22</sup> The traditional view of tax has contrasted the income tax with both forms of consumption tax, which two forms it has equated. But the traditional view has gone awry in overlooking some of the lessons from the analytics of tax; the new understanding turns on the uniqueness of each of the three forms of tax. It is worth beginning with the basics.

### A. An example

A simple numeric example helps to illustrate the more technical discussion to follow.

Suppose that Ant and Grasshopper each earns \$200 in wages, the tax rate is 50 percent (for simplicity), and the interest rate on savings is 10 percent. Grasshopper, as is his way, spends all of his available money at once. Under any tax—income, prepaid or postpaid consumption—the government takes its 50 percent cut, or \$100, and Grasshopper consumes the remaining \$100. This illustrates an

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<sup>22</sup>. This is before bringing transaction costs into the story, which push the income tax to an income-with-realization tax, and generate other types of “hybrid” taxes. Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1149 (1992) [hereinafter McCaffery, *Hybrid*].

important point: a good deal of this discussion has no direct impact on most Americans, for the simple reason that they do not save. *Income equals consumption for those who do not save.*

Ant, in contrast, does save, as is her way, and so the choice of tax does matter to her. Suppose Ant saves for two years, at the conclusion of which she consumes all that she has amassed. How do the three different taxes treat her? An income tax reduces Ant's \$200 to \$100 right away, which she puts in the bank. Ant earns 10 percent on her savings, or \$10, in Year 1, but the income tax taxes this, too—Mill's double tax—taking away \$5, leaving her with \$105 at the end of Year 1. In Year 2, this \$105 again earns 10 percent, or \$10.50; again the income tax strikes, taking \$5.25; this leaves Ant with \$110.25 to consume at the end of Year 2. If the 10 percent interest rate simply compensated Ant for inflation—if the cost of goods were rising at 10 percent per year—Ant would be losing real value, actual purchasing power, over time under the income tax: \$110.25 at the end of two periods of 10 percent inflation is worth—has the same real purchasing power as—\$91 at the start of the two periods.<sup>23</sup>

Consider next the two forms of consumption tax. First, the prepaid model: Ant is taxed right off the bat under this system, reducing her \$200 to \$100. But she is not taxed again: consumption taxes are *single* taxes, escaping Mill's double-tax label. The \$100 grows by the full 10 percent interest rate, to \$110, after Year 1. In Year 2, the \$110 earns another 10 percent, or \$11, to \$121, and Ant is left to consume this much at the end of Year 2. Unlike the case with the income tax, this end of Year 2 consumption is worth the same as \$100 at the start of Year 1, under a 10 percent inflation rate.

Under the postpaid consumption tax model, Ant pays no tax up-front and so can save her entire \$200. This grows by 10 percent, or \$20, in Year 1, to \$220. The \$220 grows by another 10 percent, or \$22, to \$242 in Year 2. When Ant goes to consume this, the government collects its 50 percent share, leaving Ant with \$121 to consume. This is just as under the prepaid model. And it is more than the income

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<sup>23</sup>.  $110.25/1.21$ .

tax. There is no smoke and mirrors here. There are only two critical assumptions needed to make out the equivalence of prepaid and postpaid consumption taxes: that the interest and tax rates have stayed constant in the two periods.

Table 1 summarizes the example. Grasshopper's consumption from the start of Year 1, set out in the first column, is constant at \$100. Ant's consumption at the end of Year 2, set out in the middle column, is \$110.50 under an income tax and \$121 under either form of consumption tax. The final column converts these values back into constant starting Year 1 dollars, at a 10 percent discount/interest rate. This conversion makes clear that, under constant rates, savers lose real value under a true income tax, whereas a constant-rate consumption tax is "neutral" as between savers and spenders, present and deferred consumption.

	<b>Grasshopper</b>	<b>Ant</b>	
<b>Tax</b>	<b>Year 1 \$</b>	<b>Year 2 \$</b>	<b>Year 1 \$</b>
Income	\$100	\$110.50	\$91
Prepaid Consumption	\$100	\$121	\$100
Postpaid Consumption	\$100	\$121	\$100

**Table 1:** Income, prepaid and postpaid consumption taxes compared

The Ant-Grasshopper example stands at the center of the traditional view of tax policy. The income tax is a double tax on value that is not immediately consumed, which has led many conservatives to oppose it as an unfair burden on the noble Ant, but liberals to support it as a necessary means of capturing some of the return to capital, the nearly exclusive domain of the wealthy. Both forms of consumption tax get put on the other side of a divide, as not reaching the yield to capital. It becomes a matter of either indifference or administrative convenience which of the two forms is chosen.<sup>24</sup>

### **B. The income tax**

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<sup>24</sup>. Like many elements in the traditional view, Andrews was among the first best spokespersons for this idea. See Andrews 74. See also Slemrod & Bakija, Blueprints.

This and the following sections present the analytics of the income and consumption taxes more formally than the numeric example of Ant and Grasshopper. The more formal analysis helps to reveal some more subtle points. Traditional income tax theory begins, and sometimes ends, with the Haig-Simons definition of income. Simons took many more words to get the idea across, but his definition is a very simple identity, stating in essence that:

$$\text{Income} = \text{Consumption} + \text{Savings} \quad [1]$$

This is no more and no less than the accounting truth that:

$$\text{Sources} = \text{Uses} \quad [1a]$$

or, even more simply, the truism that:

$$\text{All Income is either spent (Consumption), or not (Savings).} \quad [1b]$$

This is not profound. But simple principles often underlie complex structures. The Haig-Simons definition of income has been enormously influential in analyzing tax. Perhaps most important, the definition has been turned into a “norm” of “source neutrality,” echoing the language of the Sixteenth Amendment that Congress shall have the power to tax “all incomes, from whatever source derived.”<sup>25</sup> An especially common use of the Haig-Simons definition of income has been to show, by rearranging its terms, that a consumption tax does not, while an income tax does, capture the yield to savings:

$$\text{Consumption} = \text{Income} - \text{Savings}. \quad [2]$$

The idea here is simple. Since all you can do with your available wealth is spend it or not ([1b]), and since what you do not spend you save—by the semantic definition of “saving”—the government can come up with any particular taxpayer’s consumption for any given period by subtracting savings from income. If you know two components of an identity relationship involving three terms, the third follows. This leads to the important practical point that a postpaid consumption tax need not proceed along an administrative line requiring tallying up precise consumption items;

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<sup>25</sup>. Citation.

subtracting savings from income will do the trick perfectly well. Hence, a postpaid consumption tax is sometimes called a “consumed income tax,” blurring the ideal distinctions while attempting to mute opposition to the “consumption” tax label.<sup>26</sup> Traditional individual retirement accounts (IRAs) and qualified pension plans work this way: as subtractions from (or non-inclusions in) what would otherwise be “income.”<sup>27</sup> The unsaved portion of income is—by definition—consumed.

The Haig-Simons definition and its manipulation to show the essential structure of a consumption tax was central to two important articles by William Andrews, each published in the *Harvard Law Review* in the early 1970s. In the first, from 1972, Andrews used the relationship to suggest that while source neutrality was indeed a compelling norm, use neutrality was far less obviously so.<sup>28</sup> Features of the “income” tax such as deductions for extraordinary medical expenses<sup>29</sup> or charitable contributions<sup>30</sup> could be understood as appropriate normative refinements of the right-hand side of the Haig-Simons identity. In other words, not all “consumption” *ought* to count equally, at least in accordance with well settled practices in tax. This is an important insight, and one that I believe should be extended to differentiating among the uses of *savings* as well as the uses of consumption.<sup>31</sup> that is a principal aim of this article.

Andrews’s second article, published in 1974, profoundly changed the course of tax scholarship and tax policy. Again looking to the right-hand side of the Haig-Simons definition, Andrews generalized an important real-world observation: what we call an “income tax” does a very poor job of getting at savings or, in Simons’

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<sup>26</sup>. Citations.

<sup>27</sup>. Citations. Explain non-inclusion.

<sup>28</sup>. Andrews 1972.

<sup>29</sup>. I.R.C. § 213.

<sup>30</sup>. I.R.C. § 170.

<sup>31</sup>. McCaffery, Hybrid, *supra*.



actual words, “the change in value of the store of property rights between the beginning and end of the period in question.”<sup>32</sup> Andrews argued that we ought systematically to give up the attempt to tax the yield to capital, subtracting savings from income to generate a postpaid consumption tax, on the model of Equation [2]. Andrews’s article drew on Nicholas Kaldor’s important work on consumption or expenditure taxation,<sup>33</sup> and it opened a floodgate for reconsideration of the case for adopting a consumption tax. An influential Treasury Department study, *Blueprints for Tax Reform*, largely authored by the public finance economist (and later co-author with Andrews) David Bradford, sketched out two routes for tax: perfecting the nominal income tax, and adopting a progressive postpaid consumption tax, ala Andrews 1974.<sup>34</sup> By the mid 1990s, the latter idea had ripened into a full-scale legislative proposal, the Nunn-Domenici USA (for “unlimited savings allowance”) Tax, which made it to the House floor in 1995.<sup>35</sup>

For all its power and influence, however, the reformulated Haig-Simons definition of “consumption” taxation has led to an analytic confusion. It is true that a postpaid consumption tax does not tax the act of savings, or the *use* of available resources to save. But a progressive postpaid consumption tax can, and—this article argues—*ought* to, under the appropriate circumstances, tax the yield to capital as the *source* of present consumption. It is all a matter of the fair timing of tax. This was an insight that Andrews himself made, in passing, in his 1975 reply to Alvin Warren’s critique of his 1974 article.<sup>36</sup> But by then, perhaps, it was too late. As with the Haig-

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<sup>32</sup>. Simons 38.

<sup>33</sup>. NICHOLAS KALDOR, AN EXPENDITURE TAX (1955) [hereinafter KALDOR].

<sup>34</sup>. Blueprints, first and second editions. US Treasury, BLUEPRINTS FOR BASIC TAX REFORM (2d ed.), Washington D.C., herein referred to as “Blueprints”; US Treasury, BLUEPRINTS FOR BASIC TAX REFORM (2d ed.), Arlington, VA: Tax Analysts, 1984, herein referred to as “Blueprints (2d ed)”.

<sup>35</sup>. USA Tax Act of 1995, S. 722, 104<sup>th</sup> Cong. (1995). Citations, and to LAURENCE S. SEIDMAN, THE USA TAX: A PROGRESSIVE CONSUMPTION TAX (1997).

<sup>36</sup>. Andrews 75, Warren 75.

Simons definition, the analytics had morphed into a norm: an *is* had become an *ought*.<sup>37</sup> Andrews, like Mill in the prior century, had grounded the case for consumption taxation on the principled ground that the yield to capital should not be taxed, and had chosen a postpaid as opposed to a prepaid tax model largely on the grounds of administrative concerns—*Blueprints*, like Andrews, was content to stick with a prepaid consumption tax model when it was more convenient to do so. This was, quite simply, the wrong reason (the principled nontaxation of the yield to capital) for the right tax (the postpaid consumption tax); advancing it has had a harmful influence on the development of tax policy.

These more contemporary intellectual historical notes shall recur. But first let us turn the clock back to Mill, to continue to understand the analytics of tax.

#### 1. *Mill's double tax critique*

The income-versus-consumption debate and the traditional view that consumption taxes do not tax savings has permeated discussions of tax at least since Thomas Hobbes,<sup>38</sup> most famously captured in Mill's criticism of any income tax as a "double" tax on savings.<sup>39</sup> To understand Mill's classic insight, it is necessary to set the problem in a dynamic context. There is after all only a difference between consumption and savings when time is present: Savings mean presently unconsumed wealth, as the Haig-Simons definition and Equation 1 illustrated.

Consider the basic financial equation defining the future value (FV) of a present one (PV) invested over time (n) at any given interest rate, (r):

$$FV = PV (1 + r)^n \quad [3]$$

This is a simple relation. Recall the case of Ant. She saved the sum of \$100 for two periods at an interest rate of 10 percent, 0.10, per period. After one period, the \$100 grew to  $(100)(1 + .10)$ , or \$110. In the second period, this \$110, that is  $(100)(1 +$

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<sup>37</sup>. Hume, Rakowski, Murphy.

<sup>38</sup>. *Leviathan*.

<sup>39</sup>. *Principles of Political Economy*.

.10), again grew by 10 percent, becoming  $(100)(1 + .10)(1 + .10) = (100)(1 + .10)^2 = \$121$ . And so on.

A fundamental principle of economic “neutrality” is that tax should not distort the non-tax allocation of resources or—what is the same thing—the relative price system.<sup>40</sup> So we would expect, in a “neutral” tax world, equation [3] to become:

$$(1 - t) FV = (1 - t) PV (1 + r)^n \quad [4]$$

where  $t$  is the tax rate. A taxpayer sends in  $-t$  (PV) to the government and keeps the balance,  $(1 - t) (PV)$ . Suppose that the tax rate were 30 percent, to make the math clearer. Equation [4] illustrates the fact that a taxpayer keeps 70 percent of her initial income, the other 30 percent going to the government.

The problem that Mill identified was that an income tax, because it falls *again* on the yield to capital,  $r(PV)$  in Equations [3] and [4]—because two  $-t$ 's appear on the right hand side of this equation—is not neutral. An income tax looks like the right-hand side of the equation below:

$$(1 - t) FV > (1 - t) PV (1 + (1 - t) r)^n \quad [5]$$

The left-hand side of this equation, that imposes a single tax on the FV of Equation [3], is no longer equal to the right-hand side, as it had been under the “neutral” tax system posited in Equation [4]. What is actually left by the income tax—the right-hand side of Equation [5]—is less than this amount. This is what Table 1 had shown, setting out the canonical Ant-Grasshopper example.

This analysis leads to the criticism that an income tax favors present consumption over deferred consumption (that is, savings), which formed the basis of Andrews's “most sophisticated argument” for consumption taxation, articulated in his 1974 article:

the lesser burden of a deferred tax is more appropriate because it ultimately imposes a more uniform burden on consumption, whenever it may occur, than does an

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<sup>40</sup>. Fullerton on neutrality.

accretion-type tax. . . . Neutrality with respect to consumption is important not only because it promotes efficiency in the allocation of income, but because it keeps the tax from bearing more heavily on one person than another on account of differences in need or taste for particular goods or services, now or in the future.<sup>41</sup>

There is no denying the sophistication of this argument, or of Andrews's elegant formulation of it. Ultimately, it is its rightness—its claims to being foundational for the argument for consumption taxation—that is in question.<sup>42</sup>

## 2. *Responses to Mill*

There is also no denying Mill's facts of the matter: an income tax falls twice on wealth that is saved; a consumption tax falls once. But there is, of course, much room to argue about the normative consequences of this analytic fact: Is Mill's second tax a good or a bad thing?

Alvin Warren answered Andrews's 1974 article arguing for a postpaid consumption tax in a tremendously influential fashion. Warren's first response was a brief comment, in 1975, later expanded in a 1980 article.<sup>43</sup> A major part of Warren's effort was to turn Mill on his head. Yes, an income tax imposes a second tax on savings, Warren conceded, but that was a *good* thing: the yield to capital was an additional increment to wealth that differentiated its recipients from those who did

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<sup>41</sup>. Andrews 74 at 1167-68.

<sup>42</sup>. Actually, in its final clause, this quotation gets close to the argument of Vickrey, and this article: tax should not fall more heavily on any person on account of the morally arbitrary time-path of her *earnings* pattern. But under a progressive postpaid consumption tax, tax does fall more heavily on taxpayers with higher *tastes* for goods and services; that is the very thing being taxed, and progressively.

<sup>43</sup>. Alvin C. Warren Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931-58 (1975) [hereinafter Warren, 75]; Alvin C. Warren Jr., *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L. J. 1081 (1980) [hereinafter Warren, 80].

not get it. Andrews had made a “horizontal equity” argument in defense of the postpaid consumption tax, arguing that the “most sophisticated” argument for a consumption tax was to preserve the pre-tax equality of savers and spenders. This argument was to get Andrews—and the case for consumption taxation generally—in significant trouble. Warren rightly pointed out that its logic led to a case for flat, or nearly flat, rates, a point to which we shall return.

Warren’s principal response to Andrews was to make a *vertical* equity argument to Andrews’s horizontal equity (“most sophisticated”) argument. Warren also importantly shifted the analysis from the *ex ante* equality of present and deferred consumers (spenders and savers, like Ant and Grasshopper) to *ex post* outcomes.<sup>44</sup> The saver has more than the spender in the second time period; it is thus fair and appropriate to tax her more. This was an argument whose roots could be found in the writings of prominent public finance economists.<sup>45</sup> More important, it resonated with popular sentiment and the very reason for the income tax in the first place. Only wealthy persons have the capital to generate any significant yield at all. The vast masses of people living from paycheck to paycheck are hard pressed to understand an argument of *ex ante* equality suggesting that this yield should escape tax altogether when it comes to their distant, rich fellow citizens. Much less could ordinary citizens understand or accept arguments such as that the stream of value had already been taxed (as Mill would have it) or that the lingering psychic benefits of present consumption—the memory of things past—was not being taxed, so they had no real complaint vis a vis the savers.<sup>46</sup> In siding with popular morality and common sense, Warren was invoking the yield-to-capital norm.

Meanwhile, Andrews’s argument for horizontal equity haunted the consumption tax crowd, although Andrews himself tried, tentatively, to back off from

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<sup>44</sup>. See KAPLOW & SHAVELL, *supra* (on *ex ante* versus *ex post* perspectives); Barbara Fried, *Ex Ante/Ex Post*, Stanford Public Law and Legal Theory Working Paper Series, Research Paper No. 54 (2003).

<sup>45</sup>. Fisher, Kaldor.

<sup>46</sup>. Discuss this argument, in Warren, Kelman et al.

it in his 1975 reply to Warren's critique. Warren's argument for vertical equity was more powerful than Andrews's horizontal equity defense of consumption taxation: suggesting that attitudes towards progressivity, towards the redistributive force of tax, drive conceptions of "fairness" more than the always tricky semantic or rhetorical comparisons of putative equals.<sup>47</sup> The proposed new understanding of tax involves putting the commitment to progressivity front and center: the central commitment of any broad-based tax is to effect some redistribution of material resources. While the case for a postpaid consumption tax has an element of horizontal equity within it, as seen by the Ant-Grasshopper example, even that element is far better understood as specifying the appropriate basis of comparison for the more fundamental vertical equity judgments.

In the intellectual back and forth over the income-versus-consumption debate, something important had been lost. Andrews had begun his 1974 article with a critique of the current "income" tax as not getting at the yield to capital at all: most of the article is concerned with a careful, critical analysis of the status quo in tax, with the claims for the "fairness" of a postpaid consumption tax more or less tacked on at the end. Warren had counterpunched with a defense of an income *ideal* against an *ideal* argument for a consumption tax based on the principled nontaxation of the yield to capital, Andrews' "most sophisticated argument." This left open the intriguing possibility that Andrews was right, for the wrong reason—for Warren's reason. A consumption tax, of the right sort, is the best practical, real-world tax precisely because it does, and the so-called income tax does not, get at the yield to capital.<sup>48</sup> In ideal theory, the income tax "double taxes" all savings, whereas a postpaid consumption tax burdens some but not all savings, and in just the right cases—those where capital and its yield are elevating lifestyles (a vertical equity norm), and not those where capital and its yield are compensating for arbitrarily uneven labor market earnings (a horizontal equity norm). A consumption tax, of the

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<sup>47</sup>. Kaplow, Griffith against HE, generalized.

<sup>48</sup>. That the actual income tax does not get at the yield to capital at all was hinted at in Andrews 74; I make the argument stronger in McCaffery, A Voluntary Tax? Revisited. See *supra* Part V.

right sort, best upholds the principles of source neutrality and vertical equity, all the while making a better use of the ordinary moral intuitions about horizontal equities in comprehensive tax system design. This is so both in ideal or first-best and non-ideal or second-best theory.

### C. Two forms of consumption tax

The same equations set out above that helped to explain Mill's critique of the income tax lead to a further, and perhaps more surprising, insight: the broad equivalence of the two basic forms of consumption taxation. Consider again Equation [4]:

$$(1 - t) FV = (1 - t) PV (1 + r)^n \quad [4]$$

This equation had set out the “neutral” or, in Mill's parlance, one-tax condition: in order to maintain the equivalence of present and future values for a given increment of wealth, a single tax ought to be levied on the flow, however long the underlying wealth persists in the taxpayer's hands. It does not matter, under the commutative principle of multiplication (which holds that  $ab = ba$ ), where, or, better put, *when*, one levies the consumption tax's single tax. That is:

$$(1 - t) FV = \{(1 - t) PV\} (1 + r)^n = \{PV (1 + r)^n\} (1 - t) \quad [6]$$

The middle form of consumption taxation in Equation [6], where the  $-t$  is levied up-front, is the prepaid or yield-exempt model.<sup>49</sup> It is, in essence, a wage tax, like social security. The single tax is levied when dollars are first earned—the  $(1 - t)$  is applied to the  $PV$ —and never again: one does not pay a “second” social security tax on dividends and interest, the yield to capital is exempt. The recently added “Roth” IRAs work this way, and contemporary proposals from the Bush Administration would move tax policy decisively in this direction.<sup>50</sup>

The second form of consumption tax, where the  $-t$  is levied on the back-end,

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<sup>49</sup>. Blueprints for Tax Reform, 2d ed.

<sup>50</sup>. Citation.

is the postpaid, qualified account, or postpaid model.<sup>51</sup> This is how traditional IRAs and qualified pension plans are taxed under the so-called income tax. More simply, it is like a sales tax. You do not pay taxes when money is first earned: the  $(1 - t)$  lies in wait, to apply to a bigger nominal sum later on down the road. Under the current income tax, you get a deduction (or non-inclusion) for contributions to an IRA or a pension plan (or for the employer's contribution thereto). You pay the single tax when the money is withdrawn, in the case of a pension plan, or actually spent, in the case of a literal sales tax.

The dramatic insight is that the two taxes are—or can be—the same, as in the simple Ant-Grasshopper example summarized in Table 1. Equation [6], relying only on the commutative principle of multiplication, shows this fact more formally.

#### **D. Two conditions of equivalence**

Equation [6], and thus the equivalence of the prepaid and postpaid consumption taxes—of wage and sales taxes—holds under just two seemingly innocuous conditions, constant tax rates and constant rates of return.

##### *1. Constant tax rates*

The tax rate,  $-t$ , must be the same in the two possible periods of taxation—the period of first labor market earning, and the period of subsequent (in the case of any savings) consumption. To help make this clearer, Equation [7] simply restates Equation [6], showing the equivalence of the prepaid and postpaid models under the traditional view, with subscripts on the two  $t$  terms:

$$(1 - t) FV = \{(1 - t_1) PV\} (1 + r)^n = \{PV (1 + r)^n\} (1 - t_2) \quad [7]$$

This form makes more transparent the mathematical fact, typically assumed, that  $t_1$  must be equal to  $t_2$  in order for the general equivalence of prepaid and postpaid consumption taxes to hold. In the Ant-Grasshopper example, the same 50 percent tax must apply at the start of Year 1 as at the end of Year 2.

This insight, set in the context of Mill's double-tax criticism, has been

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<sup>51</sup>. Id.



enormously influential: it has led to support for flat taxes of two sorts, payroll and sales. Even Rawls endorsed a proportionate consumption tax, as a matter of ideal theory.<sup>52</sup> For under progressive or variable tax rates, as a descriptive, analytic matter, the equivalence of the prepaid and postpaid consumption tax models can be destroyed, and the yield to capital can bear some tax. We should ask, however, echoing Hume,<sup>53</sup> about how this *is* (the mathematical fact of the equivalence of prepaid and postpaid consumption taxes under constant tax rates) became an *ought* (the idea that tax rates *should* be constant or, better yet, flat). Here again the intellectual history matters to present understanding. Simply put, the nearly universal assumption that a consumption tax of any sort ought to have constant tax rates followed from having the wrong argument structure in place supporting such a tax in the first place. Both Mill, in his double-tax argument, and Andrews, in his most sophisticated argument, rested the case for a consumption tax on the preservation of the pretax equality of saver and spender—making essentially a horizontal equity argument. In order to preserve this pretax equality, a postpaid consumption tax *must* work like a yield-exempt or prepaid one:  $t_1$  must equal  $t_2$ . In much the same way that the simple analytic fact of the Haig-Simons definition of income morphed into a “norm” at some point—the argument for source neutrality in taxation (a norm misapplied in the particular instantiation it has taken on, as a defense of the income tax)—the equally simple analytic fact that tax rates must be constant to uphold the equality of prepaid and postpaid consumption taxes, and thus keep a postpaid consumption tax effectively exempting the yield to capital, took on normative force. Warren pointed out that the normative logic of Andrews’s case for consumption taxes suggested flat or at least constant rates;<sup>54</sup> Andrews protested a bit,<sup>55</sup> but there the matter lay at rest, more or less, for decades.

The new understanding of tax turns on what happens when  $t_1$  does *not* equal

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<sup>52</sup>. Theory of Justice at --.

<sup>53</sup>. A Treatise on Human Understanding at.

<sup>54</sup>. Citation, Warren 75.

<sup>55</sup>. Andrews 75.

$t_2$ , by design. At a crucial minimum, the argument structure for tax changes. Prepaid and postpaid consumption taxes are no longer automatically equivalent. Only the prepaid model features yield exemption by design. Postpaid consumption taxes sometimes burden the yield to capital and other times do not. The case for choosing a progressive postpaid consumption tax must therefore rest on arguments different from Mill's "double tax" point or Andrews's "most sophisticated argument," or, for that matter, arguments about the appropriate levels of individual or aggregate social savings. Indeed, they do.

The result of the intellectual history of tax has been, from a public policy point of view, unfortunate. Both canonical forms of consumption tax have been linked, viewed as broad equivalents, and tethered to both flat tax rates and the principled argument for the total nontaxation of the yield to capital. The case for consumption taxation has suffered on the altar of our prior commitment to progressivity. In the traditional view, the progressive income tax stands alone against the barbarian non-redistributive flat consumption taxes at the gates, and doubly so: both because the income tax features progressive rates whereas there is a (wrongheaded) tendency to pair flat rates with consumption taxes, and because consumption taxes are assumed to exempt all or most of the yield to capital, and on purpose. This has put liberals and progressives in the intellectually and politically untenable position of defending a highly flawed, highly unpopular status quo in tax, against any and all reform. Yet, ironically, once we accept progressivity in the rate structure as the first commitment of a comprehensive tax system, the very equivalence of yield-exempt and postpaid consumption taxes no longer holds. Our eyes can open: the case for consumption taxation need not be about the importance of capital in the small or large at all.

## *2. Constant rates of return*

Just as the  $t$  in Equation [6] must be constant, so must the  $r$ . This second condition, a more technical one than the first, is that there not be "windfall" or "infra-marginal" returns to capital disproportionate to the net amount of capital invested—that the rates of return do not change between the second and third terms

in Equations [6] and [7].<sup>56</sup> It may at first seem intuitive that a prepaid consumption tax does not capture a windfall or lucky return in the capital markets at all, and hence a simpler statement of this second condition—that postpaid consumption taxes get at windfalls, prepaid ones do not—is all that is needed. But under a prepaid model, there is less to invest in the first place. If the windfall returns shrink down proportionate to the reduced private capital stock occasioned by the tax, there is no technical difference between the two models, hence the added nuance. Macroeconomic or micro-level individual behavioral changes can alter the equivalence, as well.<sup>57</sup>

A simple numerical example again helps to illustrate these technical points. Suppose that there are some investments that will yield staggering returns—say that they will double one’s money in a Year, a 100 percent  $r$ . Under a prepaid consumption tax model, recall that Ant will earn \$200, pay \$100 in taxes right away, and have \$100 to invest. With the 100 percent  $r$  available, this can grow to \$200 in a single year. Under the postpaid consumption tax model, Ant will have the full \$200 to invest initially, to pay tax later. The question raised by this second condition is simply this: Can Ant’s \$200 grow to \$400? If so—this is a case where the windfall return possibilities expand with the private capital stock—the postpaid tax will collect its 50 percent on withdrawal, leaving her with \$200, just as under the prepaid model with the supranormal 100 percent return. Or will instead Ant’s “first” \$100 of savings double, to \$200, and her “second” return the “normal” 10 percent, growing to \$110, leaving her with \$310? This is the case where the opportunities for windfall returns either go to the public sector, or are in any event invariant to the net amount

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<sup>56</sup>. Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 Yale L. J. 1817-1911 (1990) and/or Jeff Strnad, *Taxation of Income from Capital: A Theoretical Reappraisal*, 37 Stan. L. Rev. 1023-1107 (1985); Graetz; McCaffery Hybrid.

<sup>57</sup>. See Louis Kaplow, *Taxation and Risk Taking: A General Equilibrium Perspective*, 47 NAT’L TAX J. 789 (1994); Bankman & Griffith, *Is The Debate?*, supra; David Weisbach, *The (Non)Taxation of Risk*, University of Chicago John M. Olin Program in Law & Economics Working Paper No. 203 (2004); Larry Zelenak, *Taxing (or Not) The Returns to Risk-Taking*, draft on file with author; David M. Schizer, *Inconsistencies, Imbalances, and the Taxation of Derivative Securities: An Agenda for Reform*, draft on file with author. Weisbach, National Tax Journal.

of private capital invested: there was just one lucky opportunity to be had, for \$100, whether Ant had \$100 or \$200 to invest. If that is the case, the postpaid tax will collect \$155, leaving her with a like amount. If this later case obtains, then the postpaid consumption tax—but not the prepaid one—will have captured at least some of the high or “windfall” returns from the capital markets.

Much tax policy literature of late has been breaking down the analytics of the return to capital, and exploring the related empirical and macro-economic issues.<sup>58</sup> Scholars have analyzed the different components of the yield to capital—compensation for risk, infra-marginal returns, the pure riskless rate of return<sup>59</sup>—with the income-versus-consumption debate in mind, showing how different tax systems, with and without certain technical features (such as full loss offsets under an income tax), affect each.<sup>60</sup> It seems that the better evidence suggests that windfall returns are disproportionately to be found in private markets, even if not fully so; things are more like the second numeric example, where the postpaid model captured some of Ant’s return.<sup>61</sup>

This is all interesting and important work. The central message of this descriptive, analytic traditional literature is that a postpaid consumption tax, even with constant tax rates, most likely captures some or all of the supra-normal returns to capital, whereas a prepaid consumption tax by design captures none of it.<sup>62</sup> The traditional view has often left it at that; with Andrews’s “most sophisticated” argument haunting the consumption tax, the facts of the matter might even suggest a prepaid

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<sup>58</sup>. Most recently Weisbach. Citations.

<sup>59</sup>. Gentry and Hubbard, and note on vocabulary.

<sup>60</sup>. Bankman & Griffith. Precursor in Kelman. Followed by Warren. Explain loss offset stuff.

<sup>61</sup>. Citations.

<sup>62</sup>. Actually in general equilibrium may get some. Kaplow 1994.

consumption tax from this analysis.<sup>63</sup> Within the new understanding of tax, in contrast, where the commitment to progressivity comes first, the possibility that even a constant rate postpaid consumption tax gets at some of the extraordinary returns to capital offers yet another reason to prefer the postpaid model over the prepaid, yield-exempt one. The analytics normatively suggest a prepaid model *only if* (1) the reason for adopting a consumption tax is to preserve the pretax equality of present and deferred consumers (Mill's insight and Andrews's most sophisticated argument, again), *and* (2) the proper moment for deciding on that equality is *ex ante* to the distribution of returns from the capital market. If these two conditions held, it would be "wrong"—non-neutral—to burden any of the windfall return with a "second" tax. But both prongs are normatively dubious at best. The horizontal equities of Ant and Grasshopper are *not* the best reasons for adopting a consumption tax. And an *ex post* perspective more befits a social concern with individuated justice, given the moral arbitrariness of varying returns to capital. This latter point, which echoes a strong theme of Warren's—namely, that tax policy should take an *ex post* perspective<sup>64</sup>—is, in essence, the yield-to-capital norm.

Once we have rearranged our thinking about tax, to put a commitment to progressivity first, things change. A progressive prepaid consumption tax is not an attractive normative ideal, because it burdens uneven labor market earnings, and altogether ignores what happens in capital and what we might call beneficent or altruistic markets, the latter referring to gifts and bequests.<sup>65</sup> A progressive postpaid consumption tax *is* an attractive normative ideal, however, because it allows for capital transactions to smooth out arbitrarily uneven labor market earnings, while increasing the burden of taxation when (but only when) capital or beneficent market transactions elevate individual lifestyles. The analytic insights about supra-normal capital market returns being developed by contemporary scholars are a *subset* of this broader

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<sup>63</sup>. Warren.

<sup>64</sup>. Warren 75 and 80.

<sup>65</sup>. These are not necessarily "markets," of course, with buyers and sellers setting prices, by the locution includes all sources of wealth, labor, capital or beneficent, especially if the latter includes manna, or pure windfalls (found money).

phenomenon, now made normative: other means, such as gifts and bequests, non-capital market windfalls (manna), and imperfect smoothing, can effect enhanced lifestyles, too. The new understanding of tax picks up on the analytic insights of the emergent view, generalizes them, and, most importantly, situates them in a compelling normative framework for the taxation of capital and its yield.

A final and related point: In the grip of both the income-versus-consumption debate and Andrews's (and many others') horizontal equity argument for consumption taxation, the analysis of the yield to savings has been source driven. The literature at least implicitly looks to the left side of the Haig-Simons equation, Equation [1], and asks from whence a particular return to savings came. Was the return to capital mere compensation for inflation, the real riskless rate of return, compensation for risk, a windfall, or yet something else? These are questions and classifications based on the nature of the input. The new understanding of tax firmly shifts the analysis—as Andrews generally had begun to do, in both 1972 and 1974—to the use or right-hand side of the Haig-Simons identity. A postpaid consumption tax consistently finesses questions of where, exactly, the funds for private preclusive use or (equivalently) consumption come from: it is source neutral in this important sense. What matters—all that matters—is how the returns are used: what level of lifestyle they finance.<sup>66</sup> The focus is on outputs. This is best interpreted as a matter of vertical equity—part of a prior commitment to effecting progression in the distribution of

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<sup>66</sup>. For example, a taxpayer who engages in high risk investments might indeed receive some high or supra-marginal returns, but this same taxpayer is likely to lose on other investments so that, on balance, he or she will not “beat the market.” See BURTON MALKIEL, *A RANDOM WALK DOWN WALL STREET* ( ) (popular account of the “efficient market hypothesis”). A tax system designed somehow to isolate supra-marginal returns faces a practical problem. To be fair, it ought to allow loss deductions as well. But loss deductions under an income-with-realization tax are problematic; see *infra* Part V. Even an ideal income tax, without realization, and with some kind of inflation adjustment, to isolate out high investment returns, faces a temporal problem under progressive rates: what if the supranormal high and low returns occur in different taxable periods? These problems are all solvable, of course, in theory, but at the price of considerable real-world complexity. Meanwhile, a postpaid consumption tax gets this all right, as a matter of design. Since the tax only falls on actual expenditures, and since such expenditures, across a lifetime, can only be financed by net capital market returns (as well as labor market returns and beneficent transfers), the net yield to capital will be taxed.

individuated tax burdens. The better able to pay pay more, all measured in a suitably wide lens of timing.

### **E. The treatment of debt**

How the two forms of a consumption tax and the income tax treat savings are widely noted and reflected in traditional tax policy doctrine, now set out in basic tax textbooks. But there is far less discussion and hence less understanding of the proper analytic treatment of debt. This is unfortunate, as a practical matter, because debt is of enormous consequence both in everyday life and in understanding the appeal of different tax systems. The failure to get the tax treatment of debt down right led to an analytic mistake in the design of the Nunn-Domenici USA Tax, the one progressive postpaid consumption tax, in the manner of Andrews's 1974 article or the Treasury's landmark *Blueprints* project, that almost became American law. The misunderstanding is also unfortunate, for the proper analytic understanding of debt is simple enough, if one merely considers debt as a form of negative savings, or dissavings.

An income tax ignores debt, under the Haig-Simons definition of income, Equation [1]. There is no genuine accession to wealth when one borrows. The proceeds of debt will be put to one of the two basic and mutually exclusive uses of income, or some combination thereof—the money will be spent (consumed) or not (saved). In any event, the consumption, savings, or combined consumption and savings is precisely offset by the *dissavings* that the debt itself represents, a  $-S$  on the right-hand side of Equation [1]. Borrowing is a “wash,” as tax lawyers say. Consistent with the ignoring of the initial incurring of debt, there is no general deduction for the repayment of the principal of debt: material resources are diminished by the payment, but savings or net wealth is increased by the elimination of the liability, another “wash.” The deductibility of interest is a separate and more complicated matter. A case can be made for deducting all interest under an income tax, because interest payments reflect neither present period consumption nor savings,

but rather the compensation for consuming or saving in some other time period.<sup>67</sup> This was indeed the law prior to the Tax Reform Act of 1986.<sup>68</sup> But because the “income” tax is not really an income tax—it looks more like a prepaid consumption tax, as we shall see—an unlimited interest deduction could literally obliterate the tax. Hence the current law in regard to the deductibility of interest, as in many other areas, is rife with uneasy compromises.

A prepaid consumption or wage tax systematically ignores debt. This is because such a tax only falls on labor earnings. Prepaid consumption taxes ignore all savings, negative savings included. There is no deduction for the repayment of principal and interest. One’s credit history is irrelevant to the social security or payroll tax taxing authority.

A postpaid consumption tax, in contrast, includes debt as a taxable inflow. Recall Equation [2]:

$$\text{Consumption} = \text{Income} - \text{Savings} \quad [2]$$

A postpaid consumption tax allows a general, unlimited deduction for present savings. Borrowing is negative savings. Subtracting a negative means adding it. So debt comes into the postpaid consumption tax base in the first instance. Debt that is used to finance present period savings, however, will come out as a wash: an inclusion *qua* negative savings, an exclusion *qua* positive savings. Debt that is used to finance consumption, on the other hand, will trigger tax in the year of consumption: only the negative savings will appear on the right-hand side. In a later period, repayments of principal and interest are fully deductible from the consumption tax base. These repayments do represent positive savings.<sup>69</sup>

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<sup>67</sup>. Alan J. Auerbach, *Should Interest Deductions Be Limited?*, in UNEASY COMPROMISE 195 (Aaron, Galper & Pechman, 1988) [hereinafter Auerbach, UNEASY COMPROMISE].

<sup>68</sup>. See prior law IRC § 163, note on 263.

<sup>69</sup>. I suspect that much of the misunderstanding of the tax treatment of debt follows from a failure to understand that 0 is simply a number, one point on the scale of possible  
(continued...)



This sounds odd and unfamiliar, but it need not. Consider a routine sales tax, the most common form of a postpaid consumption tax. Grasshopper pays sales tax when he purchases an item, even if he is using borrowed funds to do so, as by putting the purchase on his credit card. Later when Grasshopper pays off his credit card balance, including any interest that he may have accumulated by then, he does not pay another round of sales taxes on the payment. So it would work under a broad-based, comprehensive, and progressive postpaid consumption tax.

It may seem as if a postpaid consumption tax is to be disfavored on this score. Certainly law students, when first told that they would have to pay tax on the money they borrow to go to school, in the year in which they borrow it, tend to think so. But the fact of the matter is that, under progressive tax rates, these students are wrong, on their own lights. The problem comes once they have graduated, and their good fortune and education allows them to enter the high tax brackets reserved for the relatively affluent. Then they will have to pay off their student loans—principal, interest and all—with after-tax dollars.<sup>70</sup> If they are fortunate enough to be in a 50 percent bracket, all taxes considered, they will have to earn \$40,000 at the margin to pay off a \$20,000 loan, with Uncle Sam (and his relatives in state and local governments) getting paid first. The students would have been better off paying their one tax during their school days, at modest tax rates, and getting a deduction later, when their presently high labor market earnings had pushed them into a higher marginal rate bracket. I present this more formally, and graphically, later.

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<sup>69</sup>. (...continued)

wealth. Moving from a negative net wealth to 0, or from a deeply negative position to a less deeply negative one, is an accession to wealth. So if a taxpayer is \$5,000 in debt, and she pays off \$1,000 of this, she has “saved” by increasing her net worth from negative \$5,000 to negative \$4,000. This is not analytically different from saving \$1,000 to increase one’s bank account from \$4,000 to \$5,000. But it seems a fairly durable feature of most of our thinking about financial matters that strange things happen to our understanding around zero. See Kahneman & Tversky, Prospect Theory, 1979 *Econometrica*; McCaffery, Cognitive Theory and Tax; Levin et al.

<sup>70</sup>. I am ignoring for these purposes such limited provisions as the lifetime learning credit and so forth, which tend to have phase-outs making them unavailable for law students, at least, and of limited help for others, at most.

Within the new understanding of tax, borrowing or negative savings has an important symmetry with positive savings. Both typically effect the ordinary-savings norm. Just as savings allow the wage earner to shift some of her labor earnings backwards in time, to finance her retirement, so borrowing allows her to shift her labor market earnings forward in time, to finance her youth and education. Progressive income and prepaid consumption taxes burden these shifts—they disfavor smoothing transactions—because the tax falls, and hence the appropriate level of progressivity is set, at the moment of labor market earnings, which is arbitrary and uneven. (Income taxes further burden shifting transactions by the double taxation of savings used to effect smoothing). A postpaid consumption tax, in contrast, accommodates these shifts, because the moment of private use is the moment when decisions about rate progression are set. On the other hand, savings that finance enhanced lifestyles or debt that enables taxpayers to live “beyond their means” are disfavored by the ordinary operation of the tax: the former phenomenon effecting the yield-to-capital norm, the latter creating a “paternalistic push” to even out lifestyles within the structure of a progressive postpaid tax.

#### **F. The battle, in theory: Three neutralities**

The three forms of taxation—income, prepaid and postpaid consumption taxes—do not map up as traditional tax theory would have them do under progressive tax rates. Each tax is unique. But each tax does correspond with a particular instantiation of a “neutrality” norm. It is worth considering these norms. But first it is worth considering why we should care about neutrality at all.

##### *1. Why even care about neutrality?*

Neutrality—of the right sort—is an attractive feature of tax law design. Neutrality is an important element of fairness to political theorists such as Rawls, even though all thoughtful theorists are now aware that social institutions inevitably have disparate impacts on differing conceptions of the good.<sup>71</sup> Rawls reconciled this apparent dilemma by insisting, with others, on “justificatory neutrality”—the idea that social institutions must be justified by appeal to reasons not sounding in the

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<sup>71</sup>. Citations – Kelman & Rorty and so forth.

advancement of any particular comprehensive doctrine.<sup>72</sup> Neutrality in such a sense is a constitutive element of the fairness and legitimacy of state action.

Tax policy typically invokes neutrality in a specifically economic sense. First-best economic efficiency is obtained when tax systems are neutral relative to a hypothetical no-tax world.<sup>73</sup> This means that taxes do not distort the relative prices that emerge from such a no-tax state; it is those prices that operate to make for a competitive general equilibrium achieving first-best, pareto optimal, aggregate social welfare, as proven many years ago by the seminal work of Kenneth Arrow and Gerald Debreau. As long as any tax equally impacts all pretax prices, there is no relative change in prices, and hence no distortion in the allocation of resources, the exclusive concern of economic efficiency.

An attempt to obtain neutrality in this sense suggested Andrews's "most sophisticated" argument for consumption taxation, for the preservation of the pre-tax equality of savers and spenders. A consumption tax of any form—with the critical assumptions of constant  $t$  and  $r$ —preserves the pretax equality of future and present values, and hence is "neutral" in regard to the decision to save or spend. The income tax, in contrast, double taxes savings and thus hurts savers vis a vis spenders, both within the income tax regime and relative to a hypothetical no-tax world.

This is true so far as it goes. But there are serious challenges in moving from the *is* generated from these analytic facts to any compelling *ought*.

One such challenge derives from the simple economic fact that all real-world taxes distort.<sup>74</sup> Avoiding a distortion to the saving-spending decision runs the risk of skewing the work-leisure tradeoff, for example, as Warren and others pointed out in response to Andrews. Any move from an ideal income tax to an ideal consumption tax would have to raise tax rates to keep revenues constant, on account of the principled omission of an element of the tax base, the yield to capital. Tax because

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<sup>72</sup>. Larmore, Rawls.

<sup>73</sup>. Fullerton on neutrality, etc.

<sup>74</sup>. Slemrod, Optimal Tax and Optimal Tax Systems, *infra*.

of its incentive effects and the limited information of government policymakers—not to mention administrative concerns<sup>75</sup>—is in a deeply “second best” situation. There is simply no *a priori* way to say that welfare would improve, *ceteris paribus*, by moving from an ideal income to a consumption tax. The increase in tax rates would compound other distortions of tax, principally the labor-leisure tradeoff. This is not however to say that a move from the actual income tax to a consistent consumption tax would work this way; the current tax is not an ideal income tax or anything too close to it. Adopting a consistent postpaid consumption tax would have very important base-broadening features, including the inclusion of debt-financed consumption, and the elimination of preferential capital gains rates and the “stepped-up” basis for assets transferred on death.<sup>76</sup> Tax rates might well decrease in any conversion to a consistent postpaid consumption tax. But in ideal theory, an income tax distorts both the labor-leisure and the savings-consumption decisions; an equal revenue consumption tax, in a static setting, would have to exacerbate the labor-leisure distortion on account of its elimination of the savings-consumption one.

What to do? The general problem of maximizing social welfare or economic efficiency in tax is best solved by the highly intricate, sometimes counter-intuitive, optimal tax literature, begun by Frank Ramsey in 1927 and importantly extended to income taxation by the Nobel Laureate James Mirrlees in 1971.<sup>77</sup> This literature—and this literature alone—points the way towards a welfarist conception of tax. Under such a conception, the question of the appropriate timing of tax—as of the appropriate tax base, and the appropriate rate structure, and so on—is a technical one for the experts. There is certainly no *a priori* reason to favor the neutrality of any one tax over the neutrality of another, on economic grounds at least.

But, two, adding to the difficulties with Mill’s and Andrews’s particular “neutral” argument for a consumption tax, and complicating the economics-based first

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<sup>75</sup>. Slemrod.

<sup>76</sup>. Cite to Fair Not Flat, A Voluntary Tax? Revisited, on point. Statutory citations to IRC §§ 1 (capital gains), 1014 (stepped up basis), etc. Cross refer *infra*.

<sup>77</sup>. Citations.

objection, neutrality as a construct of fairness is a different matter from the narrowly economic welfarist perspective just discussed. There are two large reasons for this. First, judgments of fairness need not take the pretax status quo as normatively appropriate, as the standard economics or welfarist account, with its paretian constraint, typically (though not universally or necessarily) does.<sup>78</sup> Second, and more important, the “optimal” welfare-maximizing tax answer may clash with ordinary moral intuitions and reflective normative commitments. A quick example helps to illustrate this latter point. The core insight of the Ramsey-Mirrlees optimal tax/optimal income tax literature is the “inverse elasticity” rule. The government should tax goods in inverse proportion to the elasticity of demand for them. The economic intuition for the rule is straightforward: the demand for goods that are inelastically desired is less distorted by a tax, and hence pretax prices are less affected by that tax.<sup>79</sup> In terms of “neutrality,” Ramsey taxation aims for equal and minimal distortion in the pretax competitive general equilibrium allocation of resources. Moving the Ramsey rule over to the case of income or labor taxes, as Mirrlees did in 1971, the principle becomes that we should tax inelastic suppliers of labor more than elastic ones. This is one among several reasons to consider more tax breaks for working married women, who tend to be more elastic suppliers of paid-market labor than their husbands.<sup>80</sup> But such is a case where the precepts of fairness and efficiency happen to converge (making it all the more puzzling that real-world tax policy has gone in the opposite direction).<sup>81</sup> Convergence will not always obtain so felicitously, however, so that we cannot avoid a more finely tuned moral reasoning in tax—we cannot turn the tax system over to a computer responding to elasticity data alone.<sup>82</sup> The theory of optimal-income tax suggests, for example, isolating out persons with especially high work ethics, such as recent immigrants or, perhaps, members of

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<sup>78</sup>. This is a central theme of Murphy & Nagel’s in *THE MYTH OF OWNERSHIP*, *supra*.

<sup>79</sup>. *Taxing Women*.

<sup>80</sup>. *Taxing Women*.

<sup>81</sup>. *Id.*

<sup>82</sup>. Slemrod.

certain cultural groups placing a high value on work. Ordinary moral intuition—here supported by liberal and social contractarian political theory—should revile the thought.

The analysis shows that “neutrality” is not itself a trump, but rather a claim to be investigated, empirically, and a call, but not a necessarily decisive call, on our reflective normative judgements. With these thoughts as background, another large and disturbing feature of the landscape emerges: all comprehensive and comprehensible tax systems have a claim to “neutrality” of some sort. Any consistently applied tax system is neutral in regards to its intended base. A tax on apples, after all, would (or should) tax all apples. A tax that only fell on MacIntosh, or Golden Delicious, would violate this neutrality norm—unless it could be restated as a normatively appropriate tax on MacIntosh apples alone. And so on.

We thus cannot avoid considering the neutrality of each of the three principal taxes under consideration.

## 2. *Three taxes, three neutralities*

The neutrality of an ideal income tax is familiar: it falls on all inflows, of whatever the source. Broadly speaking, the sources of present or future consumption (consumption plus savings) are the returns to labor or capital, one’s own or another’s. Thus gifts are certainly “income” in a Haig-Simons sense: they are resources available for consumption or savings.<sup>83</sup> Add in windfalls, or manna—found value—and the ideal income tax base is more or less complete. Any resources available for a taxpayer’s personal use, whether they are presently consumed or saved, are taxed, and at the moment of inflow. We can hereafter refer to labor and capital market returns and beneficent transfers as the three primary sources of wealth. An ideal income would attach to all three.

This is a general norm of source neutrality. But it is also—a point far less noted in the traditional tax policy literature—one of use neutrality. Since sources equal uses (Equation [1a]), taxing all sources *means* taxing all uses. While Mill and

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<sup>83</sup>. Income tax has never taxed them, though; § 102.

Andrews each point out that an ideal income tax is not neutral relative to savers and spenders, that observation obtains in a dynamic, or two-period, model. An income tax is use neutral in a static, one-period model: it simply does not matter, in the Haig-Simons definition, what one does with her available resources, any more than it matters from whence these resources came—you need not tell the government what you do with your income under an ideal income tax.<sup>84</sup> But as Andrews pointed out in his 1972 article, it is far from clear that we ought to have use-neutrality in taxation: medical expenditures and charitable contributions may not strike us, for example, in reflective equilibrium, as the kind of uses we ought to be taxing.<sup>85</sup> So, too, not all uses of capital transactions are created equal. While the income tax is use-neutral in a one-period setting, it is not neutral in a multi-period one: savers are “double taxed,” whereas present consumers need not pay again on any lingering psychic yield from their pleasures past.<sup>86</sup>

Prepaid consumption or wage taxes apply to all of one’s own labor earnings, period. The yield to savings is never taxed, in the spirit of Mill’s anti-double tax argument. Nor are other people’s capital, or manna, taxed: all value must trace back to someone’s labor earnings, at some point in time, when (and only when) it was taxed. A prepaid consumption tax puts pressure on sorting out the labor/capital (as well as the labor/beneficent) distinction, which can get tricky in hard cases. But it, too, is neutral, in theory, relative to its intended base: All and only all labor earnings get taxed.

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<sup>84</sup>. Of course, you would need to tell the government what of your *gross* receipts were spent on generating income, so that you would be taxed on your *net* income (the movement from IRC § 61 to § 62, in sum), and therein many difficult issues of mixed business-personal expenses, timing, and so on would remain. But once we have gotten to this net figure, the resources available to you to save or consume, the government would be indifferent to your particular mixture of savings and consumption activities under a pure income tax.

<sup>85</sup>. IRC §§ 213 (extraordinary medical expenses); 170 (charitable contribution deduction). See generally Andrews 1972.

<sup>86</sup>. Warren, Kelman.

A prepaid consumption tax is not, therefore, source-neutral; it ignores all sources other than own labor market earnings. But a prepaid consumption tax is even more use neutral than an income tax, because it is *dynamically* as well as statically use neutral, avoiding Mill's and Andrews's criticism of the income tax. It simply and consistently never matters what one does with her resources under a prepaid consumption tax, whether within a one or a multi-period model. Even under variable and progressive effective or marginal tax rates, a prepaid consumption tax is "neutral" as between savers and spenders—Andrews's most sophisticated argument again—because of its consistent yield-exemption. It preserves the pre-tax equality of present and deferred consumers, *ex ante* to the actual distribution of capital market returns for savers.

There is an important caveat to be made at this point: under progressive rates, neither the prepaid consumption nor the income tax is neutral as to the *time-path of labor market earnings*. Taxpayers who earn their wages—or, under the income tax, receive any inflow—in relatively small, concentrated bunches will be hurt by progressive tax rates, vis a vis lower but steadier earners.<sup>87</sup> Artists, athletes, doctors, lawyers, and others with skills of limited temporal duration, high human capital requirements, or that are dependent on whimsical consumer demand markets, will suffer on account of the interrelation between their patterns of labor market realizations and progressive marginal rates.<sup>88</sup> Most generally, any gap between inflows and outflows in constant real terms will increase one's average annual effective tax rate. This becomes a central theme in the new understanding of tax.

Finally, postpaid consumption taxes are neutral, too, in a morally significant regard: they are neutral relative to the source of funds for financing present consumption. Since all that matters is the use—the fact of spending, of "private preclusive use," as Andrews called it—postpaid consumption taxes are not use-neutral, statically *or* dynamically, under progressive rates. They are not statically use neutral because savings are not taxed at all in the period of initial savings. They are not

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<sup>87</sup>. Klein, 1977.

<sup>88</sup>. Klein, Vickrey, Blueprints.



dynamically use neutral once we have relaxed the assumption of constant tax rates, by design. Some acts of savings will result in higher tax burdens than if they had not been engaged in; others will lower the burden of taxation. But in giving up use neutrality, postpaid consumption taxes find a genuine *source* neutrality. Whether consumption is funded by labor or capital market returns, or by beneficent transfers, it is taxed, and at the same rates as all other consumption at the same level.

Postpaid consumption taxes are also neutral as to the time path of labor (or capital) market earnings. It does not matter when a taxpayer *earns* or receives her lifetime resources; it matters only when she *spends* them. Thus the person who earns a high salary over a short period of time—like the well-educated but highly worked lawyer—is not burdened vis a vis the slow but steady earner, given equal lifetime aggregate earnings and the equivalent use of capital market transactions to balance out the books.

In sum, an ideal income tax is both source and use neutral, although the use neutrality wanes in a dynamic setting, leading to Mill's critique. A prepaid consumption tax is not source neutral, as it ignores all but own labor earnings—it ignores all capital market earnings and beneficent transfers—but it is use neutral, both statically and dynamically. A postpaid consumption tax is not use neutral, because it differentiates between savings and consumption, but it is source neutral, because it includes all sources of financing present consumption, from labor, capital markets, and beneficence. Adding progressive rates into the mix adds an important dimension to neutrality analysis. Progressive income taxes are not neutral as to the time path of inflows (earnings) or outflows (consumption); the former on account of the interaction between progressive rates and the base, the latter because of the double-taxation of savings needed to effect certain patterns of consumption flows. Progressive prepaid consumption taxes are neutral relative to the time path of outflows (consumption) but not inflows (earnings). Progressive postpaid consumption taxes reverse this dynamic neutrality: they are neutral as to the time path of earnings but not of consumption. It does not matter under a progressive postpaid tax when or how one earns or receives her wealth; what matters—all that matters—is when and how she spends it.

The question for the fair timing of tax turns critically on these facts: When

ought the system make its judgments about individuals' varying abilities to pay—at the time of their economic inflows or outflows? This question has relevance both to the internal fairness of the tax system, and to the very design of the system. Getting the fair timing of tax down right means allowing for better, fairer determinations about the appropriate degree of progression in the tax system.

### III. A Problem of Understanding

**T**he traditional view of tax opposes income to consumption taxation. A better understanding of the facts of tax shows that, under progressive rates, three distinct forms of tax emerge: income, prepaid consumption, and postpaid consumption, each with unique positive and normative properties. This Part, still situated in the domain of ideal theory, begins translating the new, better understanding of the analytic facts into a normative argument structure; it helps lay the foundations for moving from an *is* to an *ought*.

#### A. Means and ends

A proper normative argument structure for tax ought to begin with a clear statement of the goals to be pursued, setting the ends for tax, at least provisionally, first.<sup>89</sup> Broad-based, comprehensive tax systems finance the provision of public goods, the central activity of the modern democratic state, including, possibly, the distribution or redistribution of income itself.<sup>90</sup> But, on reflection, there must be more to tax than that, for a printing press—or any of a number of far simpler taxing systems—could raise the finances needed for public goods. In moving to individuated tax systems such as the income tax, society must desire individuated justice. On further reflection, this individuated sense of justice must stem from a desire for some progression in the allocation of tax burdens, that is, from some sense that the better-able or more fortunate should pay more, in percent terms—the latter provision because a flat percent tax can be more readily obtained, too—than the less able or less fortunate. “Genuinely

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<sup>89</sup>. KAPLOW. “Provisionally” because subsequent analysis might reveal that the ends are not obtainable, or stand in some tension with one another.

<sup>90</sup>. RICHARD MUSGRAVE, *THE THEORY OF PUBLIC FINANCE* (1959) [hereinafter MUSGRAVE]; Thurow 1975 on *The Income Distribution as Public Good*.

progressive taxation is necessarily personal taxation,” as Vickrey began his 1947 *Agenda for Progressive Taxation*.<sup>91</sup> It is simply not compelling, normatively, as a matter of first best theory, to impose progressive taxes on entities, where the ultimate incidence of the tax burden is apt to be uncertain at best, and quite possibly regressive relative to individuals, at worst.<sup>92</sup>

This, then, leads to the central question for tax justice: On what grounds should we determine each individual’s fair share of the tax burden? The principal argument of this article is that this question should run out, ultimately, to a *timing* question—that is, to asking when, in an individual’s flow of funds, is it fair and appropriate to levy progressive tax rates, to make the social judgments necessary to and inherent in a system of individuated progression. In the domain of first principles, we want to know on what philosophical bases we should predicate the decisions of individual “fair shares.”

In the classic language of tax policy, we look to levy taxes on individuals based on the benefits they receive from the state, their ability to pay, or both.<sup>93</sup> Adam Smith famously combined the two, reasoning that those who have more ability to pay are, on that account, more benefitted by the very existence of the state:

The subjects of every state ought to contribute towards the support of government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.<sup>94</sup>

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<sup>91</sup>. VICKREY, *supra*, at 3.

<sup>92</sup>. But cf. Reuven Avi-Yonah, *Corporations, Society & The State: A Defense of Corporate Taxation*, draft on file with the author.

<sup>93</sup>. Musgrave, Murphy & Nagel.

<sup>94</sup>. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS, Book V, Chapter II, Part II.1, p. 777 in the Modern Library Edition (Edwin Canaan, editor, 1937).

The first clause points to “ability to pay;” the second clause conflates this with the benefits received view, by implying that the revenue enjoyed “under the protection of the state” is precisely the measure of one’s ability-to-pay. One has the ability to pay, in other words, precisely because one benefits from the very existence and structure of society, a point that echoes with Amartya Sen’s argument that all “individual” wealth is in fact a joint product of self and society.<sup>95</sup> However we come out on the semantics, note that both “ability to pay” and “benefits received” are, in traditional tax policy terms, largely vertical equity norms: those with more ability, and/or those who benefit more from the state, ought to pay more.

The central end of modern, comprehensive, individuated tax systems is to finance the modern state in a fair manner, that is, by expecting the better-able to pay somewhat more than the less better-able. Progression in effective burdens is a central end for tax, well justified within several philosophical traditions—utilitarian, liberal, and social contractarian—as well as by ordinary moral intuitions.<sup>96</sup> Certainly, without such an end, much easier possibilities exist for public finance. Such an end has long existed—and in fact informed the very choice of an income tax nearly a century ago. In 1913, the primary means to advance the socially desired end of progressive effective taxation lay in the choice of tax base, an income over a consumption one.<sup>97</sup> As the tax expanded far beyond its initial scope, however, things changed. Today it is the rate structure—not the choice of an income tax—that has become the most important means to the end of effective progressivity in tax. This has changed the facts of tax, too.

### **B. The traditional normative logic of tax**

Who? What? When? How much? are the questions that lie at the foundation of all practical tax systems. Each must be answered sooner or later, actively or by default, to get a tax system in place. How we answer these questions—and

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<sup>95</sup>. Sen.

<sup>96</sup>. Murphy & Nagel; Bankman & Griffith; Markovits (recent); Joseph Bankman & Barbara H. Fried, *Winners and Losers In the Shift To a Consumption Tax*, 86 GEO. L.J. 539 (1998) [hereinafter Bankman & Fried, *Winners and Losers*].

<sup>97</sup>. See Bank, *A Progressive Consumption Tax Revisited*, supra.

particularly, I am suggesting, in what order we answer them—turns out to matter a great deal to thinking about tax.

It is logical enough to begin with the *what* question—about the appropriate tax base—and, indeed, much of the intellectual history of tax has been consumed with asking just this.<sup>98</sup> This has meant, when it comes to broad-based, comprehensive tax systems, the celebrated income-versus-consumption debate. There are important roots of this debate in the writings of Hobbes and Smith, both of whom came down on the side of consumption taxes, for rather different reasons.<sup>99</sup> Then came Mill and his analytic critique of the income tax as a double tax on savings, and the seemingly concomitant argument for a proportionate consumption tax. Within the domain of political theory proper, this argument has been enormously influential: Rawls has accepted the argument for consumption taxation (indeed, *proportionate* consumption taxation), at least in ideal theory, citing to Mill,<sup>100</sup> and the “ultra liberal” thinker Roberto Unger has also recently endorsed consumption taxation as well.<sup>101</sup> Practical politics have come down decisively on the other side of the great divide. Having experimented with income taxation in the nineteenth century, America made a firm commitment to the idea by ratifying the Sixteenth Amendment, in 1913, and implementing a statute months later, all motivated, at least in large part, by a

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<sup>98</sup>. BORIS BITTKER, *FEDERAL INCOME TAXATION OF INDIVIDUALS*, 1995, p. 2-1; MARVIN A. CHIRELSTEIN, *FEDERAL INCOME TAXATION*, 1999, p.1; KLEIN, BANKMAN, SHAVIRO, *FEDERAL INCOME TAXATION*, 12<sup>TH</sup> EDITION, 2000, p.7; JOHN McNULTY, *FEDERAL INCOME TAXATION OF INDIVIDUALS* xi (1999); BARTON, CAMPFIELD, COVEN, DICKINSON, GUSTAFSON, *TAXATION OF INCOME 1992-1993*, p.4.

<sup>99</sup>. Citations. Hobbes on the “common pool” and responses in Warren, Fried. I pick up Smith’s argument—the greater degree of “volition” in consumption taxes, and their more palatable time of burden—later.

<sup>100</sup>. A Theory of Justice round 278. Rawls was quick to add that, in practice, “even steeply progressive income taxes” may be the right answer, and here he joined with his fellow practical political liberals.

<sup>101</sup>. Democracy.

progressive desire to get at the fruits of capital.<sup>102</sup> Policymakers at the time rejected a wide range of consumption tax alternatives, both because these tended to be flat, and because of the fact that consumption typically forms a higher percent of disposable income for the lower and middle-income classes than it does for the upper-income ones: because, in other words, the rich save more.<sup>103</sup> The base question predominated early on in the public political thinking about tax, because the question was intimately connected to the *ends* of tax, specifically its redistributive, progressive ends. The income-versus-consumption tax debate rages on in academia to this day, felling countless trees in its wake.

The *how much* question has been a distant second—in terms of quantities of ink expended—to the *what* question, but much important work has been done on point of late. The reasons for the historical neglect are not hard to come by: Significantly high tax rates are a distinctly modern creature, not present until the twentieth century and not widespread until the latter half of that century, at that. Smith and Mill discussed taxes in the range of 5 to 10 percent.<sup>104</sup> The initial “progressive” income tax of 1913 had featured a top marginal rate, including a surcharge, of 7 percent, and it had applied to far less than 5 percent of all adult Americans.<sup>105</sup> It was the very existence of an income tax—supplemented by a corporate income tax and, later, in 1916, an estate tax—with its deliberate inclusion of dividends and interest, that furthered the

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<sup>102</sup>. See Jensen. Note arguments against consumption tax and naivete of economic understanding.

<sup>103</sup>. Slemrod. Citations to history, including Stanley, Jensen, Pollack. The equivalence of the formulations follows from the Haig-Simons “definition” or identity, discussed below, that holds, in short, that Income + Consumption + Savings. See *infra*. Savings is, in other words, non-consumption; if one consumes more, she saves less, if one saves more, she consumes less, all as a percent of income, or available resources. See Fair Not Flat.

<sup>104</sup>. Adam Smith, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS, p. 782, Edwin Cannan ed., The Modern Library, 1965, 1776; John Stuart Mill, PRINCIPLES OF POLITICAL ECONOMY, p. 172, Jonathan Riley ed., Oxford University Press, 1998, 1848.

<sup>105</sup>. Witte; W. ELLIOT BROWNLEE, FEDERAL TAXATION IN AMERICA (1996).

progressive cause. But again things changed. World War I changed the rate schedule, ratcheting it up; World War II changed the breadth of the tax's application, expanding it enormously once the practical expedient of wage withholding was discovered.<sup>106</sup> The top marginal rate bracket under the income tax rose above 90 percent during World War II, and stayed at 90 percent throughout the 1950s, until John F. Kennedy cut it—to 70 percent—in 1963. Dramatic expansions in scale and scope triggered the perceived need for some previously scarce thought, reflection, and justification: Why such steep progressivity in tax rates?

Walter Blum and Harry Kalven, writing in full view of extremely high nominal rates, set the tone for post war scholarship by sounding a skeptical note, sketching out the “uneasy case” for progressivity.<sup>107</sup> Later the case was made to seem far less uneasy by the economic analysis of optimum income taxation most famously made out by the Nobel Laureate James Mirrlees, and subsequently brought into a wide tax scholarly readership by Joseph Bankman and Thomas Griffith—the latter pair writing after Ronald Reagan, America's second great income-tax cutting President, had slashed the top marginal rate all the way down to 28 percent.<sup>108</sup> Mirrlees, Bankman and Griffith, and the wider welfarist or utilitarian turn in law and economics theory lent a strong hand to the arguments for progressivity in tax; given any form of diminishing marginal utility of wealth, social welfare could improve, under specified conditions, by taking proportionately more from those who have proportionately more material resources.<sup>109</sup> Further, the theory of optimal income tax gave prescriptive advice for how to effect progressivity in tax, without relying excessively—and perhaps counterproductively—on steep *marginal* tax rates.<sup>110</sup> Such rates are, again, only a

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<sup>106</sup>. Pollack, Brownlee, Jones.

<sup>107</sup>. Blum & Kalven.

<sup>108</sup>. Mirrlees. Bankman & Griffith. See also Marjorie Kornhauser.

<sup>109</sup>. Kaplow & Shavell, Bankman & Griffith.

<sup>110</sup>. Citation and explain. The important distinction between marginal and average or (equivalently) effective tax rates shall factor in to the new understanding of tax.

means to an end of redistribution.<sup>111</sup>

Predictably enough, opposition to progressivity has never really died. Progressivity in tax is a topic that breeds intense political passions: it was one of Madison's great fears, after all, in *The Federalist No. 10*, at the dawn of the new republic.<sup>112</sup> Not content with the historically low marginal rates of the 1980s, conservatives spawned a "flat tax" movement, somewhat fueled by academics such as Robert Hall and Alvin Rabushka, but more so as a matter of popular political culture.<sup>113</sup> It is, however, highly significant that the flat-tax idea, initially highly popular, lost its appeal further down the campaign trail, as ordinary Americans came to see that a flat rate for all meant a tax increase for most. Still, what is significant for the new understanding of tax, and why the history is relevant, is that neither the facts nor the persistence of widespread, at least moderately progressive marginal tax rates have led to a re-examination of the base question. They should, for the continued confusion is opening a back door to the very flat tax that could not come in the front door of tax reform.<sup>114</sup>

The *what* and *how much* questions, asked in that order, have dominated discussions of tax policy, inside and outside the academy. Combined, they have left real-world tax policy with two stark classes of answers: flat consumption or progressive income taxes. Meanwhile, the relative neglect of the *who* question has been unfortunate. Deep issues of justice lie buried in both the seemingly arcane questions of attribution, that is, of the appropriate taxable unit, and of the equally arcane questions of incidence, that is, of who really, ultimately, bears the burden of

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<sup>111</sup>. Part of Mirlees's brilliance was to show convincingly how progressivity in effective rates could be obtained without progressivity in marginal ones.

<sup>112</sup>. Citation, and to Tax's Empire.

<sup>113</sup>. Robert E. Hall & Alvin Rabushka, *Putting The Flat Tax Into Action*, FAIRNESS AND EFFICIENCY IN THE FLAT TAX, p.3-41 1996 AND/OR... ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d. ed. 1995), etc.; Amity Shlaes.

<sup>114</sup>. Grover Norquist piece, cross refer infra.



various alternative taxes.<sup>115</sup> After all, if the central aim of tax as an instrument of social justice is to get citizens to share in the burdens of their society in proportion to something—their ability to pay, their benefits received, or some combination thereof—it matters, and critically, who is in fact bearing the burden of any particular tax. The *who* question also factors in, in interesting ways, to the discussion of the fair timing of tax, and so we shall return to it in due course.

This then leaves the *when* question, to which the title of this article harkens. It is hardly the case that matters of time and tax have been understudied.<sup>116</sup> But the questions of time have been asked in the context of—have been framed by—the seemingly prior and foundational *what* or tax base question. There have been two large and persistent themes.

One, principles of timing have been used to help inform the fundamental tax base debate, that is, to illustrate the difference between income and consumption taxes. Under the traditional view, timing principles have been used to show the equivalence of prepaid and postpaid consumption taxes in present value terms, and, in the same terms, the differences between an income and any consumption tax.<sup>117</sup> There are only differences over time, after all—savings, which is analytically the same thing as non-consumption, only exists in what an economist would call a “two period model,” the setting where Mill made his point.<sup>118</sup> The initial mapping between an income tax as a double tax on savings, on the one hand, and both forms of consumption tax as involving no effective taxation of the yield to savings, on the other, was made out in simple, partial equilibrium models. Since then, more sophisticated financial analysis has suggested that some but not all of the yield to capital is taxed under a postpaid, but not a prepaid, consumption tax—the “supra-normal” or “infra-marginal” returns, in

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<sup>115</sup>. Taxing Women, Grace Blumberg.

<sup>116</sup>. Klein, Kelman, Cunningham, Strnad, Warren, Halperin, Fellows, Shuldiner among others.

<sup>117</sup>. See note 6, *supra*.

<sup>118</sup>. Strnad quote.

some specifications, the return to risk, in others.<sup>119</sup>

Two, principles of timing have been brought into play in the context of what is wrong with the “income” tax—how its failure to currently tax all of the yield to capital leaves it short of its animating ideal—and how to cure this defect.<sup>120</sup> Tax policy scholars have analyzed how and when to tax capital appreciation—or “ordinary” appreciation masquerading as “capital” appreciation—so as to effect a practicable income tax. Some scholars for example have considered a form of “taxation on realization,” or “retrospective capital gains,” to make up for the deferral of taxes created by an income-with-realization-requirement tax;<sup>121</sup> others have explored questions of “original issue discount” and similar mechanisms for disguising the risk-free ordinary return to savings as capital appreciation.<sup>122</sup> All these technical questions have been framed by the income-versus-consumption debate: they arise out of an attempt to ensure that the “income” tax is in fact an income tax.

These timing matters are important questions, to be sure, and the tax policy literature has generated valuable insights into matters of tax policy design by asking them. But they are not the central questions of the fair timing of tax. A different question waits to be asked, one that promises new, and pressingly practical, insights into matters of tax policy design. Asking it lies at the core of the new understanding of tax.

### C. Two political takes

The traditional way to think about tax begins with the base question and proceeds to the rate question as a separate matter. Timing, when discussed at all, comes up in the context of the base matters, specifically the income-versus-consumption debate. The fault lines in that debate have been set at least since the time

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<sup>119</sup>. Gentry and Hubbard, Warren, Bankman & Griffith, and cross refer *infra*.

<sup>120</sup>. Halperin, Shakow, Shuldiner, Strnad, Fellows etc. – realization and periodicity lit.

<sup>121</sup>. Auerbach, Fellows, Shakow, Strnad.

<sup>122</sup>. Halperin, etc.

of Mill, and further hardened by recognition of the equivalence of both major forms of consumption tax under simple assumptions. An income tax is a double tax on savings, which some scholars think appropriate; a consumption tax is a single tax that exempts the yield to savings from Mill's double tax, which other scholars think appropriate.

Today's political world follows the academy's lead precisely on this issue. Crudely, most tax politics have come down to a battle of liberals versus conservatives, with the vast moderate middle holding the all-important swing vote. Liberals support a progressive income tax. They are very much concerned with both the base or *what* and the rate or *how much* parts of tax policy design, following the logic of tax set out above. A good deal of liberal energy has been exerted arguing for an income base, as well as for other taxes on wealth and capital—such as a separate wealth transfer, or gift and estate tax; a corporate income tax; and, sometimes, a direct tax on wealth<sup>123</sup>—in order to get at capital or its yield. Liberals of various stripes have also advocated progressive rates, to further advance the cause of redistribution.

Conservatives, meanwhile, have taken to arguing for flat consumption taxes.<sup>124</sup> *Flat* consumption taxes of various types are, indeed, broadly equivalent in their economic effects: all work to exempt all or most of the yield to capital under plausible assumptions. The choice between wage taxes, sales taxes, value-added taxes, and flat “income” taxes that exempt all capital gains, interest, and dividends comes down to, in good faith, matters of administration and, in less good faith, whatever the public will buy.<sup>125</sup>

An important practical fact of the matter is that conservatives—after scoring important victories in the 1980s, under Ronald Reagan, to bring progressive marginal

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<sup>123</sup>. Liberal arguments for gift and estate tax: Graetz, Ascher, Alstott, Rakowski; work on wealth tax, Ackerman & Alstott, *Tax Law Review*.

<sup>124</sup>. Robert E. Hall & Alvin Rabushka, *Putting The Flat Tax Into Action*, FAIRNESS AND EFFICIENCY IN THE FLAT TAX, p.3-41 1996 AND/OR... ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d. ed. 1995); etc.

<sup>125</sup>. See Slemrod & Bakija, among other sources; Weisbach.

rates down—seemingly lost the battle to go all the way to flat.<sup>126</sup> And rather decisively, in both politics and the academy. While several *candidates* for the Republican presidential nomination, most prominently Steve Forbes and Jack Kemp, have championed the idea, none have been able to translate its initial popularity into any enduring appeal. Indeed, Kemp had to back off from the idea when he became a vice-presidential candidate under Bob Dole, who, like George W. Bush, was to advocate an across-the-board income tax rate cut that would dampen, but significantly not eliminate, progressivity in the tax. Meanwhile, inside the academy, critics of “flat” have scored decisive intellectual victories, virtually unopposed by reasoned argument on the other side.<sup>127</sup> The idea of progressivity in tax burdens appears here to stay.

Still, this popular center may not hold. Incremental reform within the so-called income tax, by moving the tax system towards a prepaid consumption tax model, has also been flattening tax, and tying the hands of future generations that might want to restore more meaningful rate progression.<sup>128</sup>

How can this be—that progressivity is desired and disappearing, at one and the same time? The answer to the apparent paradox lies in the choice of tax base. Although the base and rate structures are logically, analytically distinct matters,<sup>129</sup> they are of course politically and economically connected. This is so, not simply in the sense that Stanley Surrey was fond of pointing out, namely that any shrinkage to the tax base, *ceteris paribus*, has to lead to an increase in tax rates.<sup>130</sup> On a deeper, more fundamental level—at the stage of initial tax system design—the nature of the tax base shapes and constrains the practical, political possibilities for progression in the rate

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<sup>126</sup>. See Edward J. McCaffery, *The Missing Links in Tax Reform*, 2 CHAPMAN L. REV. 233 (1999) [hereinafter McCaffery, *Missing Links*]; Cognitive Theory and Tax, *supra*; Forbes, *supra*, etc.

<sup>127</sup>. Fried, Bankman & Fried, etc.

<sup>128</sup>. Norquist and *infra*.

<sup>129</sup>. Zelenak.

<sup>130</sup>. Citations to Surrey.

structure. Taxes on wages are especially constrained, because high tax rates, especially high marginal tax rates, deter the socially important and morally unobjectionable activity of working. In the new understanding of tax—contrary to the traditional opposition of income and consumption taxes—income and prepaid consumption taxes stand on one side of a divide, as taxes on in-flows, which means principally taxing labor market earnings.<sup>131</sup> Postpaid consumption taxes stand on the other side of the divide, as taxes on outflows. It is far easier, and better, in both theory and in practice, to predicate progressivity on outflows than on inflows. High marginal tax rates on spending deter only high-end spending, but this pattern of disincentives can be good for a liberal society.<sup>132</sup> Today, the principal challenge to progressivity comes not from the movement away from the income tax—which, we shall see, has been too long in coming to question seriously now, even if one wanted to—but rather from the movement to the wrong kind of consumption tax base. Conservatives have shifted their attention to this critical battlefield, and are diligently working to create a prepaid—and, not coincidentally, relatively flat—consumption tax.

Liberals for their part have failed to think through the ramifications of their victory on the *how much* front. They continue to fight for an income tax and its traditional adjutants, the gift and estate and corporate income taxes. In all this, liberals have been ill served by the traditional understanding of tax. It turns out that there is more than one way to skin the capitalist cat. Given progressive rates, an income tax, per se, is no longer needed to get at the yield to capital in theory. Further, in practice, the actual income tax is not good at all at doing the very thing that liberals insist on retaining it to do—namely, getting at the yield to capital—and it is highly unlikely ever to improve in that regard. There are deep, structural reasons for this failure, sounding not just, or even primarily, in practical or administrative concerns—though these are profound—but, far more so, in ideal, normative reasons. To wit, most liberals do not

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<sup>131</sup>. A prepaid consumption tax only taxes labor earnings, by design; an ideal income tax is meant also to tax the yield to capital, but this is far smaller in magnitude than labor market earnings. The failure of the so-called income tax in practice to reach much of the yield to capital makes it an effective wage tax

<sup>132</sup>. Robert Frank, *Luxury Fever*. See Edward J. McCaffery, *Must We Have the Right to Waste?*; quotations from *Uneasy Case* and *Being the Best We Can Be*.

want to perfect the income tax, for they do not want to get at the yield to capital in all instances: tax-favored savings plans have been as much if not more a feature of Democratic than Republican tax policy for many decades by now.<sup>133</sup>

In the language introduced above, the coexistence of the ordinary-savings and yield-to-capital norms under the income tax has wrecked havoc on practical tax politics. It has left us with a confused and confusing hybrid. A progressive postpaid consumption tax—not a pure income tax, and not a hybrid income-consumption of the present form—does *exactly* what liberals want a tax system to do, in terms of getting at the yield to capital in the right cases.

#### **D. A different way to look at it**

Traditional tax policy begins with the *what* or base question; treats the *how much* or rate progressivity question as a separate, stand-alone topic; and gets to the *when* question late in the day, as an after-thought to the still lingering debates over what to tax. Beginning with the *what* question is logical, and we can understand the historical roots of this epistemic stance in the early twentieth century progressive movement to reinstate an “income” tax, at a time when tax rates, by twenty-first century standards, were minimal. But it is not necessary to start with the *what* question. In fact, doing so has been harmful to the practical understanding of tax systems.

A powerful alternative analytic is to begin with the *how much* or *at what rate* question. As we have seen, and as Vickrey put the matter, progressivity is the very reason to have an individuated tax system.<sup>134</sup> Once we have posited progressive rates, and further given that these rates and the breadth of the tax have ascended far beyond their humble beginnings in 1913, a timing question ought to come next, for the answer to it will—perhaps counter-intuitively—shape the still bracketed *what* question. This timing question is different from the ones sounding in discounted present value, original issue discount, and so forth now asked in tax policy, and framed by the

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<sup>133</sup>. McCaffery, *Missing Links*, *supra* note 151. See recent stories on Lieberman and Edwards’ tax proposals.

<sup>134</sup>. Vickrey

prior—under the traditional view of tax—income-versus-consumption debate. The new timing question sounds in a commonsensical morality, and follows from the first commitment of the tax system, to having at least moderately progressive rates:

When, in a taxpayer’s flow of funds, is it fair and appropriate to levy progressive taxes?

This is an altogether different question from traditional ones of timing, and the answers it leads to—the ways it leads us to think about tax—are fundamentally different, as well.

#### IV. Towards a New Understanding of Tax

The critical step in reaching a new understanding for tax is realizing that things change once we presume progressivity in tax—once we no longer assume that the tax rate will be the same at the moments of first earning and of subsequent use. No longer are a prepaid and postpaid consumption tax equivalent, even given constant rates of return and the relatively simple behavioral assumptions of the traditional view. The tax designer now faces three choices, of income, prepaid, and postpaid consumption taxes, each with fundamentally different properties. Under this view, the fact of the matter is that at least part of the “best, most sophisticated argument” for a consumption tax—of the right sort—is that such a tax is a far better, far more consistent tax on the *yield to capital*, under just the conditions in which it is fair and appropriate to tax such yield, than any other broad-based tax, certainly in practice and almost as certainly in theory.<sup>135</sup> An ideal income tax double taxes all savings, whatever their use. A prepaid consumption tax never taxes savings, whatever their use. A consistent, progressive postpaid consumption tax—a progressive sales tax, in short—burdens capital when savings and investments are used to enhance lifestyles (one’s own or another’s); it does not burden capital when savings and investments are used to smooth out lifestyles (one’s own or another’s). A close, reflective reading of our practices in tax reveals that this is what the actual tax system has been trying to do, but under the ill-fitting guise of maintaining an income tax: the nonideal income tax is a mishmash in regards to the taxation of capital

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<sup>135</sup>. Andrews and *infra*.

and its yield. Theory and practice happily converge under a consistent progressive postpaid consumption tax.<sup>136</sup>

This argument structure stands the traditional view on its head: it argues for a consumption tax for the very reason that the traditional view clings to an income tax—to get at the yield to capital. The argument proceeds on both first best grounds, namely that an ideal consumption tax is preferable to an ideal income tax, as a matter of fairness—specifically for purposes of the argument of this article, in terms of its fairness at getting at the yield to capital—and on pragmatic or second best grounds, namely that the best obtainable real-world tax is a consumption not an income-based one, again specifically insofar as the taxation of the yield to capital is concerned.

#### A. Two norms

The new timing question changes the understanding of tax's possibilities. By asking it, we can come to see that our actual practices, read in their best lights, argue for one particular route, that of a progressive postpaid consumption tax, precisely because it levies progressive rates at the right—fair—time and, relatedly, because of

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<sup>136</sup>. This is an important point, that answers an important question, of whether the critique of the income tax and the argument for a progressive postpaid consumption tax is ideal, or first-best, as opposed to non-ideal, or second-best, a confusion rampant in tax policy. My answer is both. The argument is that the problems with the actual income tax flow in large part from the failure of ordinary moral intuitions to support the income ideal; the inequities and distortions noted by Andrews 74 followed from an unwillingness to tax all savings. In keeping to the form of an income tax while implementing the ordinary-savings and yield-to-capital norms, we created an incoherent non-ideal system. A progressive postpaid consumption tax, on the other hand, implements the first-best ideals of the ordinary-savings and yield-to-capital norms, and so its non-ideal, real-world instantiation will not be in conflict with its animating ideal. Now, it is true, as some commentators have pointed out, that we may continue to want deviations from the taxation of all *consumption* under a postpaid consumption tax: there will continue to be arguments for medical expense and charitable contribution deductions and so on. But recall that *these* arguments must be had out under an income, tax, as well, which aims to tax all consumption and all savings. See e.g., BLUEPRINTS, *supra*. There is no change, *ceteris paribus*, in the analysis of consumption terms. The progressive postpaid consumption tax simply puts the taxation of capital or savings on a more principled footing, implementing the yield-to-capital and ordinary-savings norms, and by design. Both the first best and second best arguments for such a resolution are compelling.



the way that it gets at the yield to capital. This yield is, after all, a function of time.

Critical reflection reveals two seemingly conflicting norms about the taxation of savings. In some cases we desire to get at the yield to capital, *contra* Mill, because we do indeed view such yield as the domain of the socially fortunate. Those with more capital have more ability-to-pay, and more benefits received from the state, than those without capital. In other cases, *pace* Mill, we do not want to “doubly” tax savings, because savings is a normal, even laudable activity in the course of an ordinary life, and it seems unfair to “penalize” savers over consumers, Ants over Grasshoppers. These two norms, introduced above as the ordinary-savings and yield-to-capital ones, are in tension—fatal tension—under an income tax, which is committed to double-taxing all savings. Neither is met under a prepaid consumption tax, which ignores all savings. But the two norms come into perfect harmony under a progressive postpaid consumption tax, which can be understood precisely as implementing them simultaneously. This is not the only, or even necessarily the best, reason to favor such a tax,<sup>137</sup> but it furthers the main point at hand: how putting a commitment to progressivity in tax first changes the traditional analysis of tax policy, and how most advocates of an income tax should instead prefer a suitably designed consumption tax for the very reasons leading them presently to think otherwise.

*1. A note on reflective equilibrium*

This is an argument and an argument structure that appeals to our enlightened common sense, that can result in a reflective equilibrium, in Rawls’s helpful epistemic term. Such an equilibrium occurs when we have gone back and forth between relatively abstract political and moral theorizing, on the one hand, and paying close attention to our actual practices and ordinary moral intuitions, on the other; theory is checked by practice, and vice versa. This style of thinking looks to our actual practices for source material to interpret on the way to a better—fairer—set of rules.<sup>138</sup> It is a mode of analysis familiar to lawyers and law students reasoning in the domains of common and constitutional law—where practitioners of the method read cases to

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<sup>137</sup>. Other arguments in *The Uneasy Case, Fair Not Flat, a Reply to My Critics*.

<sup>138</sup>. Keating, McCaffery, Dworkin.

try to discern principles within them that they then endeavor to render consistent from a theoretical point of view—but curiously absent from our thinking about tax.<sup>139</sup> Yet precisely the same style of analysis can open up promising avenues for reform obscured by more conventional approaches. Consider the following abstract and stylized account of where we are in tax, and how we got here.

Theory at first suggested some form of redistributive taxation to help effect social justice while financing important public goods—including possibly the redistribution of income itself. This is a plausible, compelling end for tax. But a commitment to progressive or redistributive taxation is not nearly specific enough. Society still must answer each of the inevitable questions of tax: what, when, whom, how, and how much. Theory then suggested an income tax as the best vehicle for redistribution, precisely because such a tax reaches the yield to capital, the nearly exclusive domain of the socially fortunate; theory had read Mill.<sup>140</sup> And so at an early historical moment where theory dominated—there was after all a paucity of practice at the time to refute theory—the United States adopted an income tax. It was a limited tax, with modest, and modestly progressive, rates on the economically privileged few.

Practice grew up in the shadows of this prior theory. But over time these practices—nearly one hundred years of them by now—began to show an unease with the very idea of an income tax, especially as both tax rates and the breadth of the tax's

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<sup>139</sup>. In all this I am following a methodology I have laid out elsewhere, one that consciously draws on a model of normative constitutional and common law argument. McCaffery, *Tax's Empire*. This ought come as no great surprise. Tax is a very important subject of law, after all—it gets right to the heart of what is and is not ours, what we owe others and what we do not, traditional subjects of public political morality. There is no especially good reason we should think about tax any differently than we think about questions of property, say. Public attitudes towards “fairness” in tax generate a significant constraint on potential reform, but it is more than that: the consensual approval of enlightened individuals is largely *constitutive* of fairness in tax. Today one can see bits and pieces of a fair tax system—once again, the best reasons to have a progressive income tax in the first place sound in fairness—but there is confusion in the analytic muddle of tax. My aim is to shed some light on what we are doing, and what we could do, to bring our actual tax system into the better lights of a fully informed public reason.

<sup>140</sup>. Here or better elsewhere, Jensen history on desire for progressivity in tax.

application increased far beyond their initial bounds. As the tax grew from its humble roots, compromises and deviations piled on each other, generating over time a badly flawed tax, with multiple holes in its commitment to taxing the yield to capital. Unreflectively, as is its way, practice tried to patch up these holes, adding on corporate income and wealth transfer taxes to the income tax, as “backstops” to its inherent commitment to get at the yield to capital. The system attempted to close some of the widening loopholes to clamp down on certain attempts to avoid its theoretical commitment to taxing the yield to capital, such as through complex rules regarding “original issue discount” and so on,<sup>141</sup> while at the same time widening the holes in other cases, as through provisions for tax-favored savings accounts.<sup>142</sup>

Confronted with practical incoherence and conflict, we return to theory. Theory sees that something has gone badly awry in the progressive income tax—that is why we are where we are, reflecting over what to do next. Some take this as an occasion to argue against progressivity itself. Theory will soon see that this is mistaken. For one thing, rather little of the practical morass of tax is traceable directly to the decision to have progressive tax rates.<sup>143</sup> More important, our normative commitment to at least moderate progressivity in tax burdens remains as solid as ever: indeed, a large part of the disillusionment with tax relates to the sense that the rich are in fact not paying their fair share, that the burdens of tax fall all too heavily on the middle, laboring classes of the not-rich.<sup>144</sup> Progressivity is an end, ill-served by the means of the present tax system—and we have not changed our ends. Further, this sense of unease with the status quo, however inchoate it is, is right in its factual predicates, and directly related to deep structural features of the so-called income tax—this is a lesson that theory can learn from a detailed consideration of our practical tax system, as considered further below. Clinging to a commitment to progressivity is not a scholarly fiat: political attempts to cash in on disdain for the progressive

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<sup>141</sup>. O.i.d. rules, IRC § 1274, etc.; Halperin.

<sup>142</sup>. Pension and IRA rules, etc.

<sup>143</sup>. Bankman & Griffith make this point well.

<sup>144</sup>. Recent NPR poll. Graetz, Decline and Fall.

income tax with a flat tax of some sort have not, in fact, resonated with the people.

If progressivity is to remain, theory next considers whether something is wrong with the “income” part of the progressive income tax. Here, indeed, things have gone amuck, and the practical mess relates almost entirely to the erratic treatment of savings or accumulation, a point that Andrews had seen and made forcefully nearly three decades ago; theory reads law review articles.<sup>145</sup> We are not, in fact, taxing all savings equally.<sup>146</sup> Worse, the practical compromises we have made are theoretically incoherent, leading to the sorry state of affairs in which we fail to tax *consumption* financed out of the yield to capital, and cannot even predictably induce more savings, on an individual or an aggregate social level, when we try.<sup>147</sup>

And so theory asks an obvious question: *should* we be taxing the yield to capital? This is the question at the core of the income-versus-consumption debate, which has been needlessly, and unfortunately, all-or-nothing. Theory sees that a prepaid consumption tax, a wage tax, can never get at the yield to capital, within or between generations. This bothers theory; it seems to violate a core reason to want progressive individuated taxes in the first place. But theory also sees Mill’s point, and the practical resistance against a willy-nilly double taxation of all savings. Theory sees much principle in the income tax’s consumption tax provisions, and so becomes disenchanted with the extremes in the debate. Should we be taxing the yield to capital

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<sup>145</sup>. Andrews 74 (“the worst distortions and inequities . . .”).

<sup>146</sup>. We are not taxing savings “favored” under various forms of tax savings accounts, such as IRAs and pension plans, but also—and far more importantly to the argument of this article—savings favored by the “realization requirement” and other related tax-planning techniques equally with savings taxed (doubly) under the pure income tax model. In practice, aside from certain types of consumption expenditures (as on extraordinary medical expenses or charitable giving) specifically blessed under the income tax by virtue of deductions, exclusions, or credits, we are also—again far more importantly for the purposes at hand—not taxing consumption financed by tax-favored capital equally with consumption taxed under the traditional single tax approach to the taxation of consumption under a pure income tax.

<sup>147</sup>. The reason is that it is possible to save on the one hand and borrow on the other, resulting in a deduction with no net savings, or to move existing savings into tax-favored accounts, thereby obtaining much the same bottom-line result.

everywhere the same? Is it the case that all savings is created equal? That we are equally normatively committed to double taxing—or altogether exempting—all forms of savings, as the stark income-versus-consumption tax debate would have it?<sup>148</sup> If not, is a principled middle ground practically obtainable?

## 2. *The norms of capital*

Asking just these questions brings theory to a critical epiphany. It leads abstract theory to understand what practice has been trying inchoately and imperfectly to express. We do in fact want to burden some but not all savings. Further on reflection, we see that our best normative judgments and ordinary moral intuitions flow naturally to the *uses* and not to the *sources* of such savings.<sup>149</sup> It is not, that is, that our reflective judgments counsel for taxing those savings that come from stocks versus bonds versus real estate and so on differently. Here I put aside the far lesser, in magnitude, and more technical, or economic, question of whether or not in some special instances, because of market failures or for some other reason, we actively want a tax-based policy of inducing capital to flow to certain areas, such as “empowerment zones.”<sup>150</sup> These are technical questions best left to technical experts. Theory is in contrast crafting the broad contours of a socially just comprehensive tax system; we are getting the individuation of tax down right, in the spirit of Vickrey. Of course tax can do other things, such as correct for market failures here and there. But the task of the major comprehensive individual tax system as a central component of a just social structure is wider, and deeper, than ad hoc corrections for market failures.

Back to the broader strokes of comprehensive tax policy, it strikes our ordinary moral intuitions that some *uses* of savings—paradigmatically, for retirement, but also for medical and educational needs and so on—are appropriate on an individual and perhaps a social level and if anything ought to be encouraged, certainly not “double”

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<sup>148</sup>. Note that this is the question Andrews can be seen to be asking about consumption in his 1972 article, *supra*.

<sup>149</sup>. McCaffery, Hybrid. This article cashes out the promise of that early piece.

<sup>150</sup>. Citations and explanation.

taxed. Other uses of savings—as to enable grander lifestyles, in this or later generations—strike us as not deserving of our sympathies in the same regard. How can theory reconcile these seemingly opposing intuitions? To further advance its practical project, theory needs a better, more specific, understanding in regard to the competing ideas about savings manifest in today’s tax system. On critical reflection, the two distinct norms anticipated above emerge. Note that these are norms about the taxation of the activity of savings, that is, about the flow of funds going into and out of a taxpayer’s household, as befits Mill’s focus on such flows, and Andrews’ focus on uses. Different norms might apply to the *stock* of capital, that is, to the very possession of wealth—to how and where the value is invested. I shall revisit these concerns later.

One norm is that capital and its yield as a general matter ought to bear some tax; that those fortunate enough to be able to live off interest, dividends, capital gains, and so forth ought not be further privileged by way of exemption from the public-regarding burdens of tax. This is the yield-to-capital norm. This norm is related to the principle of “source neutrality” often invoked in traditional tax policy terms, but we have already seen that source neutrality is a more complex, nuanced idea, susceptible of differing meanings and, best understood, supportive of a consumption tax of the right sort. Indeed, there is an urge to tax the yield to capital more than the yield to labor, if anything. The general intuition behind the yield-to-capital norm is reflected in the very choice of an income tax, as we have seen, and in the periodic attempts to plug up certain “loopholes” in the actual income tax’s commitment to taxing the yield to capital; as well as in the misguided, if understandable (given the traditional view of tax), categorical resistance to any comprehensive conversion to a consumption base. The yield-to-capital norm is also manifest in the insistence on maintaining separate gift and estate and corporate income taxes: an insistence that may well also be misguided, on the better view of tax’s possibilities. The more particularized intuition that the yield to financial capital ought if anything to bear a higher burden than labor earnings, or the yield to human capital, reflects an ordinary moral intuition that such financial yields come more easily, without the psychic disutility of physical work. These attitudes were widespread at the time of the

adoption of the modern income tax, and they sensibly fit with the choice of that tax.<sup>151</sup>

We can understand the yield-to-capital norm as a vertical equity one: it reflects an intuition that the yield to capital is a privilege of the economically fortunate.

A second norm, seemingly inconsistent with the first, is also evident in our practices of tax. This is the ordinary-savings norm. This norm rests on an intuition that some savings are different. Broadly, these are the savings that take place—or ought to—in the ordinary course of an ordinary life. Savings for one’s own retirement, for one’s children’s education, for medical and other sorts of emergencies, fit into this norm. There is a strong and again widely held intuition that such savings should not be subjected to Mill’s double tax, whether or not proponents of the norm are aware of the canonical mappings of traditional tax policy. Such savings should be encouraged, if anything, and certainly not discouraged. To reconcile the ordinary-savings norm with the yield-to-capital norm, in theory, we can understand ordinary savings as moving the yield to human capital—that is, labor earnings, wages—evenly through time. The ordinary moral intuition to burden the yield to financial capital more than the yield to human capital, as the latter involves psychic disutility to work (and so on), does not so compellingly extend to labor earnings that are simply saved, at a normal rate of return, for some later day. This distinction will become clearer in the next section, with a practical analytic vocabulary regarding the uses of capital transactions before us.

In any event, the ordinary-savings norm is of course reflected in the many provisions of the law that favor (or do not disfavor) such savings: pension plans such as 401(k) plans, IRAs of various types, medical and education savings accounts. A large and very important trend of the 1990s was the expansion of such pro-savings provisions. The fact that some such provisions are structured along a prepaid model, as in the “Roth” IRAs, while others continue to come in a postpaid fashion, as with “traditional” IRAs, is yet another sign of the analytic muddle of tax. This move towards prepaid and away from postpaid consumption taxation has also characterized the contemporary conservative assault on progressivity in tax. In the traditional normative language of tax policy, we can see this second norm as a horizontal equity

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<sup>151</sup>. Jensen etc.

one. “Ordinary” savers are not the privileged elite, to the manor born. Rather, they are regular workers choosing to do a perfectly sensible—indeed, admirable—thing with some of their earnings: save them for a later, perhaps rainy, day. Here the familiar pair-wise comparisons carry normative force: why should the thrifty Ant be taxed more heavily than the spendthrift Grasshopper, when both have the same resources as of a critical moment in time, and when Ant is actually doing what a reasonable society should want her to do at that time?

There is another and important sense in which this ordinary-savings norm reflects a horizontal equity perspective. It is that the vertical equity judgments made by the basic rate structure—and the choice of an income tax, with its yield-to-capital norm—ought not properly to fall on individuals only temporarily elevated into the higher “ability to pay” or high tax-rate regions because of morally arbitrary patterns of labor market earnings. In order to make sure that we are taxing equals equally under the progressive rate structure—in order to best (most fairly) determine who are indeed “equals”—we need a wider time-frame than the arbitrarily chosen twelve calendar month one of practical tax administration.<sup>152</sup> It is, once again, a matter of timing.

The yield-to-capital norm was present at the dawn of the income tax: it was a large part of the reason for such a tax. The ordinary-savings norm favoring—or, perhaps better put, opposed to disfavoring—certain classes of savings, in contrast, became apparent much later, after income tax rates had risen and the tax’s breadth had expanded to reach the majority of adult Americans.<sup>153</sup> It was then that the horizontal equity issues became problematic; it was then that the call to escape Mill’s curse became more clarion. But herein seemingly lay a rub: the ordinary-savings norm is inconsistent with the choice of income tax, made to further the yield-to-capital norm. As a practical matter, the coexistence of the two norms about capital and its yield

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<sup>152</sup>. Vickrey; Blueprints; DAVID BRADFORD, *UNTANGLING THE INCOME TAX* (1986) [hereinafter BRADFORD, *UNTANGLING*]; Graetz; Bankman & Fried; Daniel Shaviro, *Endowment and Inequality*, in *TAX JUSTICE: THE ONGOING DEBATE* 123 (Joseph J. Thorndike & Dennis J. Ventry Jr., 2002) [hereinafter Shaviro, *TAX JUSTICE*].

<sup>153</sup>. Jones, *From a Class Tax to a Mass Tax*, and explain.



under a nominal income tax has generated a highly flawed status quo. As an analytic matter, it has left us in the grip of incoherence. The particular center we have chosen cannot hold.

Now theory has a sharpened practical question to ponder: is it possible to design a tax system that gets at some but not all of the yield to capital, in just the way we want it to? That does consistently and logically what our imperfect real-world tax system attempts to do inconsistently and illogically? That is, a tax system that implements the yield-to-capital and ordinary-savings norms concurrently?

Surprisingly—especially to those in the grip of the traditional view—the seemingly inconsistent popular attitudes towards savings can be rendered perfectly coherent and consistent under a properly designed tax system. Those forms of savings that ordinary moral intuitions favor are precisely those that smooth out life-cycle consumption: that move wealth from high-earning periods into lower-earning ones, such as retirement, or into those of greater urgency or objective need, such as times of increased education or medical expenses.<sup>154</sup> At the same time, the urge to tax some of the yield to capital plausibly relates to material resources used to finance higher standards of living, namely greater discretionary expenditures, within or between individual lifetimes. How can we relatively favor the one form of savings, which smooths out labor earnings, while not favoring the other, which enhances lifestyles? It turns out that a progressive postpaid consumption tax does exactly this. It is the mechanism of progressivity under the tax that does the bulk of the normatively desired work.

### **B. Two uses of capital**

The analysis of the prior section suggests an analytic distinction not presently drawn in the tax policy literature. Capital transactions—borrowing, savings, investing—can in fact be put to two broad (and analytically exclusive) uses within a taxpayer's lifetime. One is to *smooth* out one's labor earnings, which first obtain over a limited period of years, into a steady consumption pattern over one's entire life. This smoothing perspective solves a certain personal financial equation: it sums up an

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<sup>154</sup>. Scanlon, Preferences and Urgency.

individual's earnings in constant dollar terms, and then divides this total by the years in one's life. The result of this exercise is to generate the same level of consumption, in real dollar terms, for each year of life; it balances out an individual's books, so to

### Typical lifetime labor earnings and consumption



Figure 1

speak, as if her life were self-contained and devoid of any windfalls, gifts, and the like. Smoothing effects the ordinary-savings norm.

The other use of capital transactions is, in short, to do anything other than smooth out earnings. In other words, capital transactions can *shift* consumption patterns: to make one better (or worse) off than she could be on the basis of labor market earnings alone, for periods of her life or throughout her entire life. Consumption shifting corresponds to the yield-to-capital norm.

A simple graphical example helps to see these points.

#### 1. *An untypical picture of a typical life*

Figure 1 shows, in stylized and financial terms, how many of us live. The solid line shows labor earnings, the dotted line spending or consumption. Simply to

get an easily tractable example, Figure 1 reflects a world with no inflation, which solves the problem of translating fluctuating nominal dollars into constant real ones.<sup>155</sup> There are also no taxes—yet—in the story.

The hypothetical taxpayer in the figure lives for 80 years. She works for 40 of those years, from age 20 to age 60, but of course she consumes for all 80 years. Assume that she has no benefactors, such as parents, and no beneficiaries of her largesse, such as children; she acts as a self-contained financial unit, balancing her books of inflows and outflows within her lifetime alone. Later I shall relax this assumption, with a corresponding expansion in generality of the normative points. In any event, during her labor market earnings years, the taxpayer makes a constant

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<sup>155</sup>. The assumption does not materially affect the analysis. Inflation can be generally accounted for by indexing the rate brackets, which is how progressivity will be achieved: fully indexed, the system maintains a constant effective tax rate on constant real value dollars, as the no-inflation assumption also effects. Further, under a progressive postpaid consumption tax, the full deductibility of principal and interest washes out the time value effects at least at the normal rate of interest.

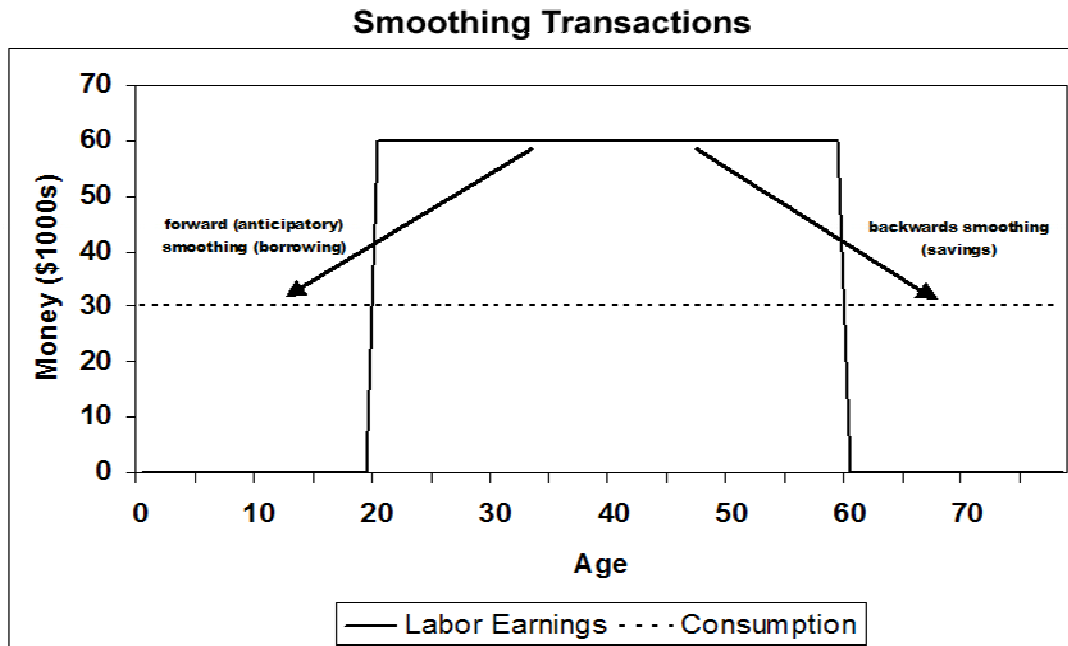


Figure 2

\$60,000; throughout her life, she spends \$30,000 annually. In such a fashion can she balance the books, with her \$2.4 million of lifetime earnings and spending.

## 2. *Smoothing transactions*

The stylized picture of Figure 2 adds onto Figure 1 to show one very important use of capital: to smooth out consumption patterns over a lifetime. The hypothetical taxpayer effects this smoothing by capital transactions. She borrows \$30,000 a year for the first quarter, or twenty years, of her life, at 0 percent interest.<sup>156</sup> For the second quarter, the first twenty years of her working life, from age 20 to 40, she pays

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<sup>156</sup>. This is of course a simplifying assumption to be sure, but it does not affect the analysis. Recall the zero percent inflation in the story; at a positive rate of inflation, the wages are higher to reflect the inflation in the principal of the debt. Consider also that many loans are intra-family transfers, as I shall discuss below. Any real interest in fact reduces the amount of lifetime consumption (below the posited \$2.4 million in the example), but then any real positive rate of return on the savings in the third and fourth quarters of the taxpayer's life increase it.

off this debt at the rate of \$30,000 a year, living on her remaining \$30,000 annually. For the third quarter, the final twenty years of her working life, from age 40 to 60, she sets aside \$30,000 a year for her retirement, once again, in the simplifying assumptions of the story, at no nominal interest, and spends the remaining \$30,000. When she retires at age 60, she draws down her retirement savings to finance continued consumption during her last quarter of life, once again at the rate of \$30,000 a year.

In this stylized example, we see that both “normal” borrowing and savings transactions—those that carry a normal rate of interest, principally (and in the simplified example, exclusively) compensating for inflation—help the taxpayer to smooth. Borrowing shifts labor earnings forward in time, so that one can consume before she earns; savings shift them back, so that one can continue to consume after she ceases to earn. In Figure 2, with no inflation, the taxpayer will simply borrow \$30,000 a year for the first 20 years of her life, pay this debt off over the next 20, save \$30,000 for the next 20, and draw this down for the final 20.

In a simple setting with perfect knowledge, no transaction costs—and no other humans in the picture—the smoothing of Figure 2 can be achieved by well functioning

### Intergenerational Smoothing

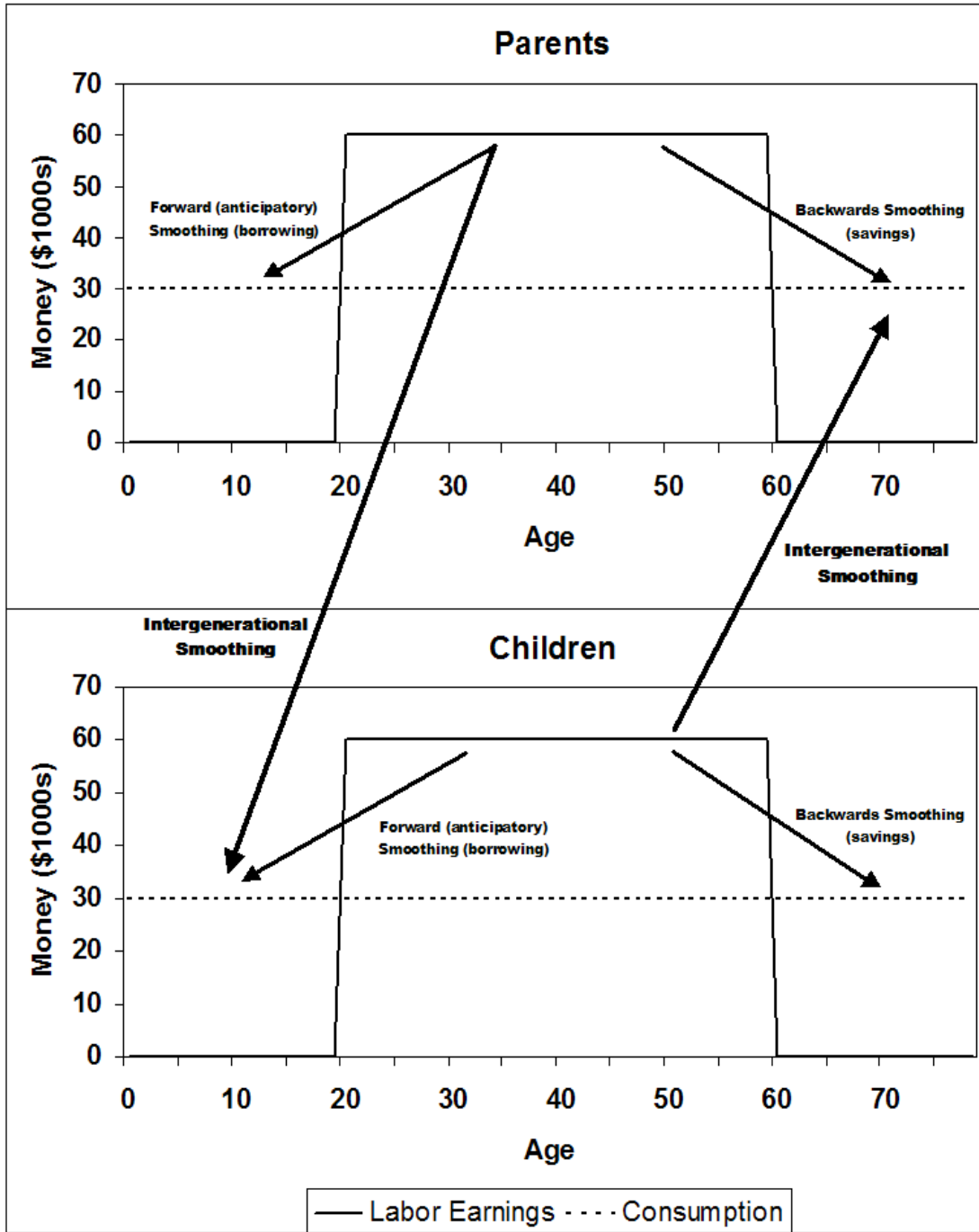


Figure 3

financial capital markets. Of course the world is not so perfect. In its imperfection, smoothing does not obtain so precisely. In practice, families often function as annuities, insurance, and other capital markets.<sup>157</sup> By social norm or otherwise, our parents pay for our consumption in our youth; we may or may not pay them back in later years, but in any event we are expected to pay for the consumption of our children in their early years. Families also provide important mortality insurance should grandparents outlive their finances, and so on. In such a fashion, the smoothing of Figure 2 obtains inter-generationally, in an “overlapping generations” model, as Figure 3 illustrates.<sup>158</sup> This Figure adds a second generation to the smoothing transactions of Figure 2. The darkened arrows indicate transfers across generational lines, from parents to children, or vice versa. The story behind Figure 3 is a common one, where parents help their children in their youth, and then these same children help their parents—paying them back, in essence—in their old age. Another familiar story of inter-generational annuities markets is where parents continually help their children, so the support received from one’s parents is turned over to the third generation, as it were, in an infinitely overlapping generations model. The idea here is to sketch out rough possibilities; these between-generation transfers can be smoothing or shifting.

Smoothing is simply an analytic possibility that almost all wage earners engage in to some extent: one has to smooth, somehow, if a limited period of labor market earnings is to make do for a full lifetime of consumption, unless one is a significant beneficiary of some sort (more on this, which affects the yield-to-capital norm, anon). What is morally significant to theory is that smoothing strikes our ordinary moral intuitions—as reflected, in fact, in the practices of the actual income tax—as a perfectly normal and appropriate thing to do. Smoothing effects the ordinary-savings norm. A reasonable political and moral theory can certainly accept this norm revealed from practice, effecting a reflective equilibrium; Mill and Rawls seem to have done so, for example. Smoothing balances out the morally arbitrary ups and downs of labor markets.<sup>159</sup> Adding progressivity into the mix—as the first, foundational commitment

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<sup>157</sup>. Kotlikoff, Kotlikoff & Spivak, etc.

<sup>158</sup>. Barro.

<sup>159</sup>. Vickrey; Blueprints; Bradford, Untangling. Of course, the position that these ups and downs are indeed morally arbitrary requires argument, which this article does not provide in any length or depth. Suffice it to say that it is hard to imagine a compelling moral argument that a putative taxpayer should pay more taxes strictly on account of her uneven  
(continued...)

of the comprehensive tax system's claim to justice—makes this critically important. Income and prepaid consumption (wage) taxes fall on the unsmoothed lines of Figure 1-3; postpaid consumption (spending) taxes fall on the smoothed lines. Under progressive marginal or effective rates, taxpayers pay more tax based on the particular pattern of their earnings profile under prepaid consumption or income taxes, but not under a postpaid consumption tax when they engage in ordinary smoothing activities.

It is for these reasons that many scholars have long advocated taking a “lifetime” perspective on the imposition of tax burdens: this is an idea advanced by Vickrey, through a very clever proposal for the lifetime averaging of tax burdens, and picked up in recent years by those, such as David Bradford and Daniel Shaviro, discussing “endowment” taxes.<sup>160</sup> The smoothed perspective looks to this lifetime average: what is significant is the \$2.4 million of lifetime consumption spread over 80 years, not the particular—and generally morally arbitrary—pattern of earning it. Any tax on inflows, such as a prepaid consumption or an income tax, that does not somehow allow for smoothing is penalizing those whose human capital gets realized in short periods, and in bunches—artists, athletes, doctors, and lawyers—vis a vis more regular, steady lifetime earners. This point was anticipated, in traditional horizontal equity terms, by Andrews, and developed by William Klein.<sup>161</sup> Indeed, Mill's double tax critique is most compelling when a taxpayer is simply trying to break even, within her lifetime, and so too with Andrews's “most sophisticated” argument for consumption tax.

By moving to a lifetime perspective, allowing smoothing to lower tax burdens reflects as much a “vertical” as a “horizontal” equity norm. If we base a tax on outflows, thereby allowing people to smooth, and assume (only for now) no net transfers in or out of the taxpayer's combined, total pool of resources available for her

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<sup>159</sup>. (...continued)

pattern of labor market earnings vis a vis an equal but steadier earner, yet a system of progressive average rates has precisely this effect under a prepaid consumption or income tax. The practical prevalence of the ordinary-savings norm—the widespread allowances under the “income” tax for backwards smoothing—further testifies to the moral insignificance of particular patterns of labor market realizations.

<sup>160</sup>. Bradford, *Untangling*; Shaviro, *Tax Justice*. Note that these ideas on predicated on individual levels; a somewhat parallel macroeconomic idea can be found in Laurence Kotlikoff's and others' writings on “generational” accounting. Citations.

<sup>161</sup>. Andrews<sup>74</sup> and <sup>75</sup>. Klein 1977.



own personal lifetime consumption, then a taxpayer can solve a personal tax minimization problem by perfect smoothing. (Note that rough or imperfect smoothing comes out much the same way, on account of the width of the progressive marginal rate brackets: there is no need for taxpayers to be precise actuaries.) Taxes are then set—equals are then measured—on the basis of this smoothed consumption line, reflecting a sustainable standard of living across a lifetime. Rather than a single year, or a short period of years, of high earnings elevating one into higher tax brackets, it is this smoothed, sustainable pattern of consumption that sets one's level of taxation. Then those who, after smoothing their labor earnings, are able to live a more costly lifestyle, are taxed more than those who not: these are, necessarily, people who have enhanced their consumption by capital market returns or beneficent transfers. "Equals" are measured by their lifestyles; lifestyles are financed by labor, capital, and beneficent transfers, and the consistent postpaid consumption tax does not mark the distinctions among sources.

The smoothed perspective as a measure of taxable ability is appealing to ordinary moral intuitions and in reflective equilibrium: it happens to map up perfectly with a postpaid consumption tax, but the argument is not a matter of semantic definitions. It is not, that is, the case that a postpaid consumption tax is independently desired for some reason and therefore that smoothing becomes the appropriate normative baseline against which to discuss increasing or lowering tax burdens. It is, rather, that smoothing strikes us as an appropriate normative baseline, because it does not take into account the morally arbitrary pattern of labor market earnings on a year-to-year basis, but rather rests its decisions about taxability on a sustainable lifetime pattern of consumption. A postpaid consumption tax implements the norm.

### 3. *Shifting or enhancing (diminishing) transactions*

A second use of capital and its yield, already anticipated, is to *change* one's average level of lifetime consumption: to enhance or increase one's lifestyle, by spending out of "surplus" capital funds, or to diminish it, by being a net saver throughout one's life, or by transferring wealth to others---personal or institutional

beneficiaries.<sup>162</sup> Shifting is the complement to smoothing. Smoothing takes the taxpayer's average labor market earnings in constant real dollar terms as its baseline. Shifting moves this baseline up or down.

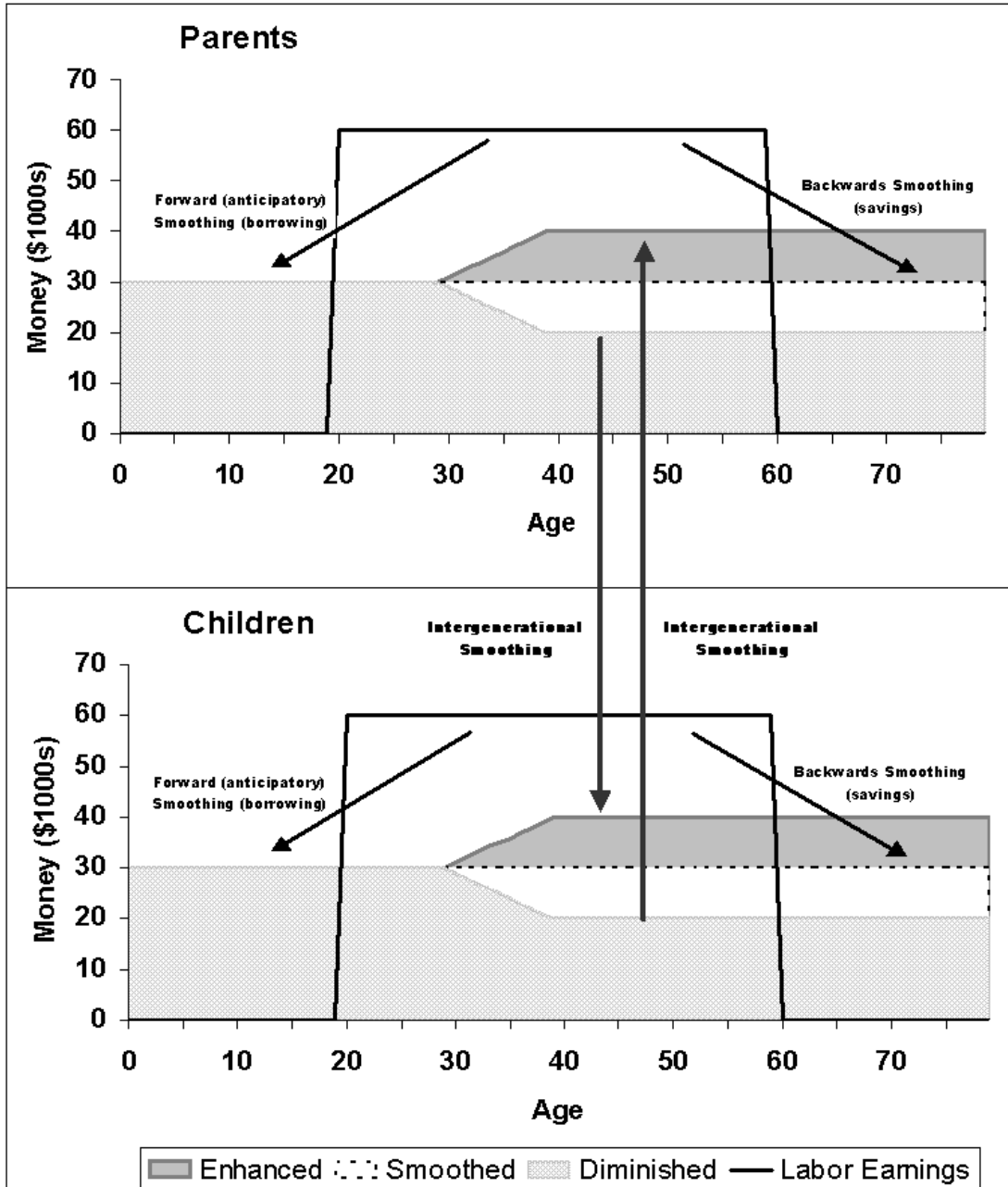
In moving from a description of capital transactions to a normative position, a norm of self-sufficiency emerges: capital transactions that are "simply" and "normally" translating uneven (by time) labor market earnings into even, smooth cash flows should not bear the sting of Mill's double tax, or indeed any positive tax burden at all. In the simple smoothed profile, there is no "luck" in the capital markets, no largesse from or to any other individual. Smoothing is what an ordinary person can do, with the fruits of her own labor, and access to normal, well functioning capital markets with little or no risk. But capital transactions can change things, too. One can do better or worse than the smoothed profile, by being the beneficiary of good luck or somehow else's largesse, or by being the recipient of bad luck or a net benefactor to others.

Figure 4 presents a simple picture to illustrate this. Figure 4 adds onto Figure 3's intergenerational example the possibility of taxpayers, within or across generations, living on more or less than their average annual labor market earnings in constant dollar terms would allow. Beginning at age 30 in each generation, the Figure shows "enhanced" consumption, where a taxpayer is living at \$40,000 a year, more than her average annual labor market earnings, in constant dollar terms, and a "diminished" consumption pattern, where the taxpayer is living at \$20,000 a year, below her average annual labor market earnings. The inter-generational setting helps to illustrate that there are several sources of this enhanced or diminished consumption

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<sup>162</sup>. Note on charitable giving, Andrews 1972.

**Intergenerational Smoothing, Enhanced & Diminished Consumption**



**Figure 4**

profile. Good fortune in the capital markets—supra-normal returns, in the language

of recent tax policy analysis<sup>163</sup>—is one. Inter-generational transfers can also either elevate or diminish consumption patterns, and altruism—transfers to charities—can diminish them.<sup>164</sup> Diminished consumption might result from a simple “mistake,” a failure to “die broke” out of an excess of caution and/or a failure of annuities markets.<sup>165</sup> It could also result from “bad luck” in the capital markets: from a failure to earn even normal returns on savings, or excessive payments for the use of capital early in life.

A compelling case can be made that the enhanced lifestyle profile is “vertically” above the smoothed one: anyone who has received additional resources to consume, one way or another, is in fact more “able to pay” than someone who has not. Indeed, this is an animating norm of an ideal income tax, a logical concomitant of Henry Simons’ (and many others’) “source neutrality” norm. It is more arguable that the “diminished consumption” profile represents a lower rung on the vertical equity or “ability to pay” ladder; an ideal income tax generally treats people on the basis of their potential to consume or, somewhat equivalently, treats savings, gifts, bequests, and even many capital market losses as instances of consumption. But note that, under a consistent progressive postpaid consumption tax, the diminution in private consumption must be permanent, across generations, to result in a lesser tax burden. In lying in wait, for ultimate private preclusive use, the progressive postpaid tax holds out the possibility—by design—of an increased tax burden on certain patterns of intergenerational transfer.<sup>166</sup> The parent who self-sacrifices to enable her child to live

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<sup>163</sup>. Warren, Bankman & Griffith, Weisbach.

<sup>164</sup>. All this depends, of course, on supporting the semantic claim that such personal or institutional (charitable) giving is not “consumption”; a position that the present income tax takes, at least relative to charitable giving Andrews 72.

<sup>165</sup>. Cite to Die Broke, also Spivak et al on annuities markets.

<sup>166</sup>. In this way, the progressive postpaid consumption tax acts as an accessions tax, falling on heirs. See McCaffery, *Being the Best We Can Be*, supra. Of course, this might not address all of the concerns of advocates of wealth transfer taxation, because the postpaid consumption tax can facilitate greater stores or stocks of private wealth. See *infra* Part VII.E..

an enhanced lifestyle is *not* solving an intergenerational tax minimization problem; she is like the intra-generational taxpayer who fails to smooth. Her family's total tax burden will go up, in constant dollar terms, on account of her financial behavior. Put another way, the progressive postpaid consumption tax—consistent with its focus on uses, or the right-hand side of the Haig-Simons identity—differentiates among the reasons for diminished lifestyles. Those who have had bad luck in the capital markets, or who are benefactors of qualified institutional charities, say, will see their and their family's tax burdens go down; those who are building private dynasties will see their familial tax burdens increase. While an ideal income tax would also adversely affect private dynasty creation, it is worth noting that neither the actual income tax, where we are, nor a prepaid consumption tax, where we are heading, would.

### C. Progressivity

The key insight of the new understanding of tax is that, in devising a just and practicable comprehensive tax system, the commitment to progressivity in individuated tax burdens ought to come first, be foundational. Once we have posited progressive rates, the next question is to what should we apply them: a question that can be restated in the temporal terms used above, namely as asking when, in a taxpayer's flow of funds, is it fair and appropriate to levy progressive taxes. Under progressive rates, the traditional view of the mapping between income and consumption taxes, and between types of consumption taxes, is wrong. Each tax has very different properties. These properties can be understood as effecting capital smoothing and shifting transactions differently: as, that is, differentially implementing the yield-to-capital and ordinary-savings norms.

The mechanism for implementing progressivity in the income tax—for effecting the vertical equity norm—has always been a system of progressive marginal rates. Such progressive marginal rates work like a ladder. As one ascends into the higher rate brackets or rungs of the ladder, she does not lose the benefit of the lower rate brackets or rungs. Consider the very basic marginal tax rate schedule set out in Table 2. The first \$10,000 of income (or whatever is being taxed in the base) generates no tax. The *next* \$20,000—the dollars that take one from \$10,000 to \$30,000 of total income—are taxed at a 15 percent marginal rate. Thus by the time a taxpayer has made \$30,000, she has paid \$3,000 (*not* \$4,500) in tax: 0 on her first \$10,000, and

\$3,000, or 15 percent, on her next \$20,000. Once one exceeds \$30,000, the next dollar is taxed at 30 percent. So a taxpayer making \$30,001 is taxed at \$3000.30 (*not* \$9000.30): the \$3,000 paid on her first \$30,000, as calculated above, plus \$.30 on her last, or marginal, dollar.

Income	Marginal Tax Rate
\$0 - 10,000	0 percent
\$10,000 - 30,000	15 percent
over \$30,000	30 percent

**Table 2:** Illustrative Marginal Tax Rate Schedule

Marginal tax rates are important for their marginal incentive effects.<sup>167</sup> Social justice, however, is more concerned about *average* or (equivalently) *effective* tax rates: with making sure that the more able-to-pay in fact pay a higher percentage of their wealth in taxes than the less-able to pay. Average tax rates are simply the total tax paid divided by the total income (or alternative base). Thus in our running example, using Table 2, the taxpayer who has made \$30,000 and paid \$3,000 in tax—while she stands on the brink of entering the 30 percent marginal rate bracket—is paying 10 percent taxes on average. (It is a very common mistake to confuse average and

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<sup>167</sup>. Fair Not Flat, Bankman & Griffith.

marginal tax rates; this explains the emphasis on “not” numbers in the parentheses in the prior paragraph).<sup>168</sup> While progressive marginal rates necessarily lead to

### Effective Tax Rates Under Progressive Marginal Rate Brackets

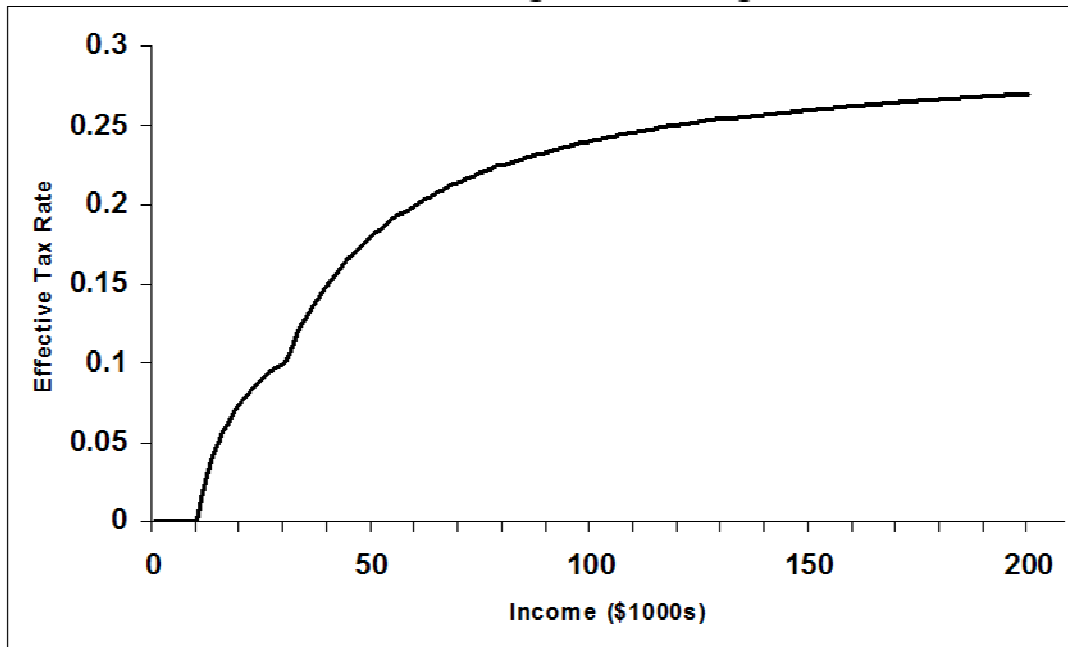


Figure 5

progressive average tax burdens, the converse does not hold: we can achieve progressivity in effective burdens with a combination of lump sum grants and declining marginal tax rates, a key insight of Mirrlees and the optimal income tax literature.<sup>169</sup>

Figure 5 translates the simplified marginal rate schedule of Table 2 into effective tax rates. Having a progressive tax system however achieved means that such a figure, plotting income (or any alternative tax base) along the X axis against effective tax rates on the Y axis, will show a constant increase. That is, higher levels of income, or labor wages, or consumption—in each of the three taxes we are considering—will be taxed higher, on average.

<sup>168</sup>. McCaffery, *Cognitive Theory and Tax*, Baron, etc.

<sup>169</sup>. Citations, including Berliant & Rothstein.

The central argument of this article can be seen by superimposing Figures 1-4, onto Figure 5, as Figure 6 does. Now it can be hard, for macroeconomic reasons, to compare rates *across* tax systems. As a descriptive matter, rates might have to be different under an income, prepaid, or postpaid consumption tax in order to raise the same amount of revenue; this depends on the breadth of the base, and so on, and is a complicated empirical project. (It is worth pointing out, however, that it is yet another common mistake to assume that rates would have to go up under any conversion from the current “income” tax to a postpaid consumption tax, because the latter does not include savings; this is only true of a move from an ideal income tax, which we do not have.<sup>170</sup>) Further, and very importantly, as a normative matter, the case for progression changes with the nature of the base; this is another central insight of the new understanding of tax, obscured by the traditional view. But fortunately it is not necessary to make the rates comparable. Figure 6 illustrates how capital smoothing and shifting transactions are taxed *within* each tax system, against a backdrop of not engaging in them. This is especially important, for we shall see—contrary to the traditional view of tax policy—that the case for progressivity changes, and generally *improves*, under a postpaid consumption tax.

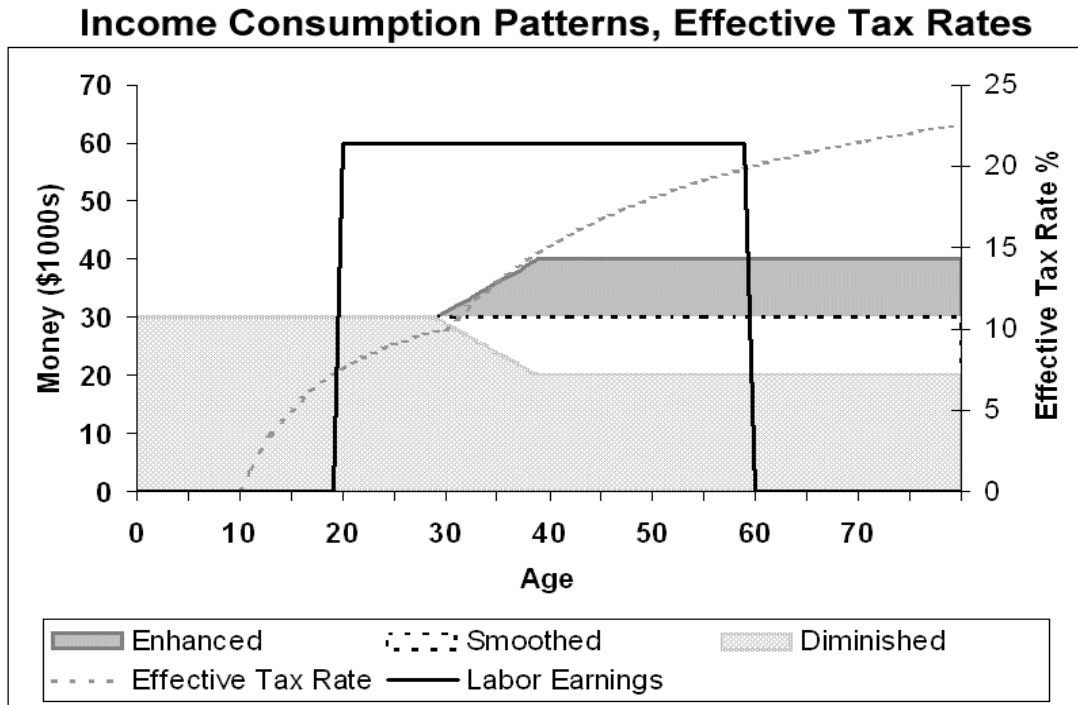
A prepaid consumption tax taxes along the solid labor wage line and ignores all variations. Under the tax rates of Table 2, this means that the taxpayer in the running example will pay \$12,000 a year for 40 years, a 20 percent average rate over her lifetime (\$480,000 out of \$2.4 million). Such a tax ignores all shifting, upwards or downwards, and smoothing.

An ideal income tax would also tax on the basis of this labor market earnings line, and would add a further tax—Mill’s second—for any positive returns to the savings needed to effect a constant lifestyle going forward. In general, a progressive income tax burdens both shifting and smoothing capital transactions. Compare a taxpayer under an income tax who in fact earns and spends \$30,000 a year with one

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<sup>170</sup>. More specifically, the move in reality would have at least two important base broadening features: the inclusion of debt-financed consumption and the repeal of any preferential rate for capital gains. The “zero basis” for inherited assets would also most likely generate more, not less, tax revenues from later generations. Bradford, *Untangling*, makes some similar points, but curiously adds some details.





**Figure 6**

who earns \$60,000 over 40 years and spreads it across 80. The latter, smoothing, taxpayer is hit hard by progressive rates: she pays \$480,000, as under the prepaid consumption tax example of the prior paragraph, on account of her bunched labor market earnings, which are all taxed at a 20 percent effective rate. The naturally smoothed taxpayer in contrast pays \$240,000 in lifetime taxes; her labor market earnings fall in a 10 percent effective tax rate. The smoother is also hurt by the double taxation of savings needed to effect her forwards smoothing: any positive interest here will bear Mill’s double tax. She is also harmed by the tax treatment of debt in effecting her backward or anticipatory smoothing, given the limitation on the deductibility of interest.<sup>171</sup>

<sup>171</sup>. IRC §§ 163(a), (d), (h).

A postpaid consumption tax, in contrast, applies to the actual consumption line. The perfect smoother, living at \$30,000 a year, would pay \$3,000 a year, a 10 percent rate across her entire life (\$240,000 out of \$2.4 million). The enhanced consumption profile would pay more: under progressive tax rates, a postpaid consumption tax does get at the yield to capital, as well as beneficent transfers, when these are used to upward shift. The diminished consumer would pay less. But if the diminished consumption was due to the transfer of resources to another taxpayer, the tax will lie in wait, to fall on this heir's enhanced consumption.

In sum, an income tax double taxes both shifting and smoothing capital transactions; a prepaid consumption tax ignores both; and a postpaid consumption tax accommodates smoothing but differentiates between upward (which lead to higher taxes) and downward (which lead to lower taxes) shifting transactions. By ignoring smoothing, progressive income and prepaid taxes make the time path of earnings economically significant. By accommodating smoothing, a postpaid consumption tax does not.

#### **D. Debt, again**

Debt, or borrowing, is critical to smoothing, and also to the distinctions among the three types of ideal taxes.<sup>172</sup> Positive savings allow an individual to defer the enjoyment of labor-market earnings, to push them backwards in time. Borrowing, as negative savings, serves a symmetric function: it allows one to shift forward her labor market earnings, to consume before earning, as Figure 2 and subsequent figures had shown. An income tax is inconsistent in its treatment of debt and savings, because it “double taxes” the latter but not the former, although the technical analysis depends on the deductibility of interest or not.<sup>173</sup> Both prepaid and postpaid consumption taxes are consistent: the former ignores all savings, the latter deducts all savings—which leads to the inclusion of debt as a taxable inflow (as negative savings), and a deduction for all repayments of principal and interest.

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<sup>172</sup>. See Adam Hime note, *Southern California Law Review* 2004.

<sup>173</sup>. Auerbach, *Uneasy Compromise*.

All this takes on significance when progressive rates are in play. By ignoring both the initial incurring of debt and its subsequent repayment, the prepaid consumption and income taxes each penalize those whose uneven pattern of labor-market earnings require them to borrow in their youth to finance their lifestyles. An important class of taxpayers in this situation are students, of course. The postpaid consumption tax, in contrast, solves this problem by including debt as a taxable inflow and allowing a systematic deduction for all repayments of principal and interest; it allows a taxpayer to smooth forwards in time, just as retirement savings provisions under the so-called income tax allow her to smooth backwards. Students often recoil at the notion that the proceeds of their borrowing will be included in their tax base, as would be the case under a consistent postpaid consumption tax. But such an inclusion, logically followed by a deduction in the year of repayment, in fact effects the ordinary-savings norm going forward; it is IRA or qualified pension plan treatment in reverse. Given progressive rates, the difference is significant. In the running example, the student borrower will pay a 10 percent effective tax on her loans under a postpaid tax, while she would pay 20 percent under an income or a prepaid consumption tax model. In practice, today, law students must earn twice their student-loan balances in order to payoff their debts, because Uncle Sam comes, first.

#### V. In Practice: The Mess We've Made, Part One: The Income Tax

**T**he key insight of Andrews's 1974 article was that the income tax was badly deficient when it came to getting at the savings component of the right-hand side of the Haig-Simons definition of income,

$$\text{Income} = \text{Consumption} + \text{Savings}. \quad [1]$$

"If we think about the personal income tax in real terms, as a tax on accretion, and of accretion as consumption plus accumulation (or minus disaccumulation)," Andrews wrote, "reflection will show that its worst inequity, distortion, and complexity arise out of inconsistency in the treatment of accumulation."<sup>174</sup> In short, the "savings" term on the right-hand side of the Haig-Simons identity gives the real world most of its

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<sup>174</sup>. Andrews 74 at 1115.

troubles.

Andrews, following Kaldor on this point, used his practical observation and criticism as a springboard to argue for a more consistent treatment of savings, in the form of its systematic exclusion, on essentially second-best grounds: even if we should tax all savings, as a matter of ideal theory, the fact that we do so only erratically, as a practical matter, suggests that we abandon the attempt in the name of consistency and fairness. Andrews ran into trouble when he tried to superimpose a possible first-best justification for the logically concomitant shift to a consumption tax, in his “most sophisticated argument;” here Warren, and Kaldor too, took offense.<sup>175</sup> Resting the ideal-theory defense of consumption taxation on the grounds of the horizontal equity of savers and spenders, the principled nontaxation of the yield to capital, or the individual or aggregate level benefits of a greater capital stock has harmed the evolution of tax policy: these are not compelling arguments for a normatively compelling tax. Whatever the sense of the appropriate ideal, almost all tax policy since Andrews has taken his practical critique as a given: the income tax is not successful in getting at capital or its yield. Those who lament this state of affairs call for an invigorated income tax, often supplemented with gift and estate or corporate income taxes, to get at capital. Those who applaud the practical insight call for a complete conversion to a consumption tax, typically any consumption tax, so as never to tax capital or its yield.

The new understanding of tax shows that the conflation of prepaid and postpaid consumption tax models has unduly hindered the descriptive or analytic—as well as the ideal theoretic—understanding of the status quo. The nonideal critique of the income tax has failed to consider the difference between the two consumption taxes. Thus, Andrews’s practical recommendations—as with the later and highly influential *Blueprints* study—vacillated between prepaid and postpaid models, as matters of administrative convenience and transaction-cost minimization. Andrews saw that the income tax was inconsistent in taxing savings and recommended that we not tax savings at all; we might as well go all the way, to remove the “worst inequity, distortion, and complexity” in the reigning tax system. Further, there were good

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<sup>175</sup>. Warren 75 and Kaldor in *Uneasy Compromise*.

reasons—going back to Mill, again—not to tax savings as an ideal matter. Within the traditional view, any form of a consistent consumption tax, prepaid or postpaid, would get us there. So the difference is a matter of mere practicality, and the seeds were planted for the replacement of one uneasy compromise (the hybrid income/consumption tax) with another (the hybrid pre and postpaid consumption tax).

Once we have come to understand that pre- and postpaid consumption taxes are not equivalent under progressive tax rates, the practical critique begun by Andrews is incomplete. We want to know, specifically, what kind of consumption tax we have and should have. Andrews and *Blueprints* preferred the postpaid model—although each were willing to mix and match readily enough—but much of tax policy since the 1970s, and especially in the last few years, has involved a steady drift towards a specifically prepaid consumption tax. Tax falls fully on labor earnings as they come into households, but any subsequent taxation on accumulated financial capital or its yield is easily avoided. Over time, the real fault line in practical income tax policy has become to preserve the tax as an effective wage tax, while making sure that the gaps on the capital side—holes that the system seemingly lacks the will, the way, or both to stop up—do not spill over to engulf the labor side. The Tax Reform Act of 1986, considered at some length below, is the grand example of this phenomenon.

Our tax system writ large—adding the increasingly important payroll tax system to the income tax—taxes labor earnings, and heavily so. Taxes on the yield to capital have become voluntary in important ways.<sup>176</sup> This is a fact, and one we ought to be confronting far more forcefully in our practical as well as normative tax policy. The traditional view of tax, content to fight out a battle in theory that the real world of practice has long since forgotten, continues to argue for an “income” tax, as if we ever have had, have now, or will ever have one, in opposition to the movement towards a prepaid consumption tax. But the real choice—the only real choice—is what kind of consumption tax to have. The traditional view of tax has ignored this choice as largely irrelevant, a matter of second-best administrative or transactions costs. Under progressive rates, however, the choice of when to impose the single tax of the

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<sup>176</sup>. McCaffery, A Voluntary Tax? Revisited, *National Tax Journal*; also Rich Dad/Poor Dad.

consumption tax model is the most important choice of all. A postpaid consumption tax is the last best hope for maintaining some meaningful commitment to real progression in effective individual tax burdens. Yet we are slowly, seemingly inexorably, drifting towards a prepaid consumption or wage tax. We will wake up soon with a flat tax, seemingly against our very own wishes.<sup>177</sup>

This Part canvasses what is wrong with the actual income tax as a practical matter. There are both structural and seemingly ad hoc deviations from the income tax's commitment to taxing savings. Ironically, it is the ad hoc deviations that point the way towards a better future for tax; the structural gaps, nightmares of tax past, haunt its present. I start with them.

#### A. Structural gaps

The problems with the “income” tax begin—and to some considerable extent, end—with *Eisner v. Macomber*, a 1920 decision of the United States Supreme Court that dealt with the timing of taxation, although the Court itself and the parties before it were slow to see the true stakes involved.<sup>178</sup>

The facts of the case were simple. Mrs Macomber, a shareholder in Standard Oil, had received a “stock on stock” dividend. To simplify the actual math of the matter, assume that this was a one-for-one stock “split.” In other words, Mrs. Macomber, who one day held 100 shares of stock, found herself owning 200 shares the next day. Since every other shareholder received the same split, the occasion was not itself an accession to wealth. The number of outstanding shares of stock had simply doubled across the board and—minor frictions aside—the value of each share of stock, necessarily, fell in half. If each of Mrs. Macomber's 100 shares had been worth \$10 each before the split, she would have had 200 shares worth \$5 each after it. Mrs. Macomber's total value of Standard Oil stock holdings would be \$1,000 before and after the paper transaction.

The much watched case made it all to the Supreme Court. It was clear that the

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<sup>177</sup>. Norquist.

<sup>178</sup>. Citation, and tax stories volume.

government was having a hard time articulating its reasoning for imposing a tax on the unlucky Mrs. Macomber, and the case actually went through two hearings before the Court.<sup>179</sup> Finally, the government got to the crux of the matter. Conceding that the actual stock dividend was not an accession to wealth, and that it was not the “new” shares of stock, per se, that it was attempting to tax, the government argued instead that the “income” had come from the antecedent rise in value of Mrs. Macomber’s shareholdings, which the government could have taxed whenever it chose to; the moment of the stock on stock dividend was merely a “convenient” time to do so. This argument sounds in Haig-Simons income. The words Simons actually used to describe the savings component of income were after all “the change in value of the store of property rights between the beginning and end of the period in question.” Suppose Mrs. Macomber had purchased the stock some years ago for \$200. It was now worth \$1,000. Mrs. Macomber had “income” of \$800 in the Haig-Simons sense—at some time—because of the “change in value of the store of her property rights.”

Unfortunately for the government, by the time it got around to making its argument, the Justices rejected all of its claims by a five to four count. Mrs. Macomber would have no taxable income until and unless she “realized” the gain in her stock. The “realization requirement” announced in *Macomber* is simple enough to understand. Its logic is compelling, even: Why should taxpayers pay a tax without a transaction generating the cash with which to pay it? Why not wait until a sale or other disposition to get at the gain? Unfortunately, the answers to these rhetorical questions, in the context of an income tax, are devastating. The time value of money suggests that a tax paid later is better, to a taxpayer, than the same tax paid sooner.<sup>180</sup> Worse yet, the confluence of the realization requirement with two other structural features of the income tax combine to make *any* tax on the yield to capital, however and whenever used, voluntary. *Macomber* marked the end of the income tax, still in its first decade of existence; as Andrews later put the matter, the realization

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<sup>179</sup>. Bankman, Klein text.

<sup>180</sup>. Andrews 74, Halperin, Chirelstein.

requirement was “the Achilles heel of the income tax.”<sup>181</sup> As with Achilles himself, the seemingly minor flaw proved fatal.

### *1. Tax Planning 101*

The realization requirement has a simple, intuitive appeal: indeed, a postpaid, consumption tax operates much along a realization model, deferring the time of tax until capital is converted into cash for consumption.<sup>182</sup> The problem is that the realization doctrine given birth by *Macomber* did not spring into existence under a postpaid consumption tax. It was engrafted onto a theoretical income tax. This is a fatal flaw.

Recall the income tax’s principled nontaxation of debt. Combined with *Macomber’s* realization requirement, this means that one can borrow—directly or indirectly using appreciated assets like Mrs. Macomber’s stock as collateral—and consume, tax-free. In other words, consumption financed by debt backed by capital assets falls out of an income-with-realization tax’s base. Far from simply missing an element of savings, or the yield to capital, the actual income tax fails to reach the *personal spending* of the propertied classes. In such a case, there is in fact no savings: if the borrowing to consume precisely offsets the rise in value of the assets—as it will in the numeric example set out below—there is no net accretion to wealth. This is simply consumption without taxation. The perverse result obtains from the conjunction of two timing rules under the flawed income tax: one, the “wait until realization” doctrine of *Macomber*, and, two, the “wait until debt is repaid” doctrine inherent in Haig-Simons itself. By using unrealized assets to help obtain debt financing now,<sup>183</sup> the savvy taxpayer gets to have her cake and eat it, tax-free.

Eventually, it would seem, things must work out, and the books become

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<sup>181</sup>. See William D. Andrews, *The Achilles of the Comprehensive Income Tax*, in NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980'S 278, 280-85 (Charles E. Walker & Mark A. Bloomfield, 1983).

<sup>182</sup>. Chorvat on realization.

<sup>183</sup>. Note that the result does not turn on any literal pledging of assets as security, though this might lead to more favorable credit terms.



balanced: the debt must be repaid, with nondeductible or after-tax dollars from fresh labor-market earnings or realized capital transactions, and a tax will be paid. Later is better than sooner, so the taxpayer has still gained an advantage from holding and borrowing, but at least a tax will get paid, eventually. Yet “later” may never come when we add a third doctrinal feature of the status quo, not unrelated to the *Macomber* story: the “stepped-up basis” for assets acquired on death.<sup>184</sup> This statutory doctrine provides that assets acquired from a decedent shall have a taxable “basis”<sup>185</sup> equal to the fair market value of the property on date of death.<sup>186</sup> This means that an heir, who acquires the property itself tax-free,<sup>187</sup> can sell it the next day, also tax-free.<sup>188</sup>

The stepped-up basis rule structurally follows from the realization requirement. *Macomber* alone gave taxpayers an incentive to acquire the kind of assets that rise in value without producing taxable cash, in the form of interests and dividends: such disfavored assets walk head-on into Mill’s second tax, whereas the realization requirement gives a way to defer the government’s second bite at the apple for non-cash-generating property. In short, the realization requirement destroys the source neutrality of an ideal income tax. Assets that go up in value via price appreciation alone, such as growth stocks, land, art, and so on, have an advantage over simple bonds and bank accounts that produce readily observable cash flows to their holders.<sup>189</sup> In the wake of *Macomber*, the rich and well advised could be expected to acquire capital assets; the financial markets could be expected to generate such assets. And indeed they did. Further, *Macomber* gave wealthy taxpayers an incentive to hold onto

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<sup>184</sup>. IRC Section 1014, and discuss.

<sup>185</sup>. See definition in *Fair Not Flat*. I prefer this to the often used “cost,” for precisely this reason.

<sup>186</sup>. IRC §1014. Note 6 month later rule.

<sup>187</sup>. IRC § 102.

<sup>188</sup>. The stepped up basis under IRC §1014 means that the gain calculated under IRC § 1001 will be 0.

<sup>189</sup>. See *Rich Dad/Poor Dad*, and explain.

their “winners,” even as they could sell their “losers.”<sup>190</sup> The ability to borrow tax-free meant that holding onto appreciated assets need not entail any personal sacrifice in consumptive lifestyle. And so it came to pass, predictably enough, that the economy became full of assets with “built-in gain:” that is, assets that had a tax “basis” equal to their initial cost, but a fair market value far in excess of this historic figure.<sup>191</sup> Just like Mrs. Macomber’s stock, in the numbers given above, had a basis of \$200 and a fair market value of \$1,000.

This built-in gain had to be preserved in the case of gifts among the living, or any taxation on capital assets would be trivially avoided. Mrs. Macomber could simply give her stock to her husband or child, who could sell it, tax-free, and perhaps later gift the cash back to her. Hence the law instituted a “carryover” basis regime for gifts, preserving the donor’s basis in the donee’s hands.<sup>192</sup> But what of assets passed on after death? Heirs complained that it was unfair to saddle them with the inherent tax liability; it was also a practical nightmare to figure out the basis of assets in some one else’s—now dead—hands. The tax system compromised by putting in place a separate gift and estate tax to get at the net wealth of the truly rich decedents, and allowing everyone else to acquire assets from a decedent with a basis equal to their then fair market value—the stepped-up basis rule.

As with the realization requirement, the stepped-up basis rule—for those who can understand it at all—makes a certain sense, in isolation.<sup>193</sup> Yet when put together with the realization requirement and the nontaxation of debt, one has all that she needs to understand “Tax Planning 101.” This is the simple tax planning doctrine that tax

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<sup>190</sup>. Subject to capital loss offset rules, discussed *infra*.

<sup>191</sup>. Explain basis, with citations, Fair Not Flat glossary.

<sup>192</sup>. IRC § 1015, *Taft v. Bowers*.

<sup>193</sup>. Indeed, a large part of the practical problems in tax seem to follow from the tendency to make decisions in isolation, without integrating the effects of each. This is a tendency that might be rooted in cognitive heuristics and biases. See Edward J. McCaffery & Jonathon Baron, *The Humpty Dumpty Blues: Disaggregation Bias in the Evaluation of Tax Systems*, 91 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 230-42 (2003) [hereinafter McCaffery & Baron, *Humpty Dumpty Blues*].

students can learn on the first day of a course in basic federal income taxation, to underscore how easy it is for those with stocks of financial capital to avoid all federal taxation.<sup>194</sup> Tax Planning 101 is elegantly simple:

- Buy
- Borrow
- Die.

That is it. By buying capital assets that appreciate without producing taxable dividends; selling one's losers and holding one's winners; borrowing to finance present consumption; and continuing the game straight on to death, the rich and well-advised can avoid *all* federal taxes. Tax Planning 101, as just set out, avoids the income tax to the spender and to her heirs. It avoids the increasingly important social security or payroll tax system, discussed below, by the simple expedient of never actually working. It avoids the estate tax because that is a net tax, on assets minus liabilities held at death. But if Tax Planning 101 is taken to its limits, there is no net estate. Tax Planning 101 means no taxes, notwithstanding a comfortable lifestyle for those with the assets in hand to play it.

## 2. *An example*

To illustrate Tax Planning 101, consider the curious case of Artful Dodger.<sup>195</sup> Imagine that Dodger has \$1,000,000, somehow, after taxes. How he got it does not really matter, although it is worth noting that he could have gotten it, tax free to him, from his parents.<sup>196</sup> With this stock of cash, Dodger buys assets. Not just any assets, but the kinds of assets that rise in value without producing taxable cash dividends: growth stocks, say, or land, art, sports franchises even. Dodger sells any assets that go down in value, taking tax losses when he can, carrying them forward when he cannot.

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<sup>194</sup>. See FAIR NOT FLAT, *supra*, at .

<sup>195</sup>. This example is borrowed from FAIR NOT FLAT, *supra*, at.

<sup>196</sup>. IRC § 102.

Suppose that the general return on investments is 10 percent. Dodger's \$1,000,000, prudently invested, rises in value to \$1,100,000 after one year. He pays no tax on this "mere appreciation," under *Macomber*. This might appear to be all fine and good, because Dodger is continuing to save, and so should not be taxed under the logic of a consumption tax, and can await taxation on realization, under the logic of an income-tax-with-realization. The trouble is, Dodger need not be saving, at all. In fact, he is consuming away.

Dodger borrows \$100,000. He pays no tax on this, because borrowing is not income under the Haig-Simons definition. Dodger can spend away, living as well as a wage earner making \$200,000, but subject to 50 percent combined federal, state, and local income and payroll tax burden. At the end of Year 1, Dodger's net worth is \$1,000,000: his \$1,100,000 portfolio minus his \$100,000 principal debt balance.

Dodger must pay interest on his debt. But he also has his assets, which he has maintained by borrowing.<sup>197</sup> So, in Year 2, the \$1,100,000 portfolio goes up by another 10 percent, or \$110,000, to a net of \$1,210,000. Dodger promptly borrows this \$110,000. He uses \$10,000 to pay off the interest on his Year 1 debt, and \$100,000 to consume. At the end of the Year, his net wealth is \$1,000,000: a portfolio of \$1,210,000 minus \$210,000 in debt.

As long as his portfolio rises by the same amount as the interest on his debt, Dodger *never* pays tax, *always* has \$100,000 of consumption, and *always* maintains his \$1,000,000 net wealth. If he can borrow less principal than the rise in his portfolio—live at a \$50,000 level, say, or, in the case of Bill Gates, a *few* billion—and if the appreciation in his portfolio exceeds the interest rate on his debt, over time, he keeps getting richer. If he needs to diversify his portfolio, not to worry: clever tax lawyers and accountants have devised ways to do just that, as by various "mixing bowl" transactions, tax-free.<sup>198</sup> Too much risk? Not to worry: various financial

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<sup>197</sup>. Explain

<sup>198</sup>. Citations.

instruments, such as “cuffs” and “collars” come to the rescue.<sup>199</sup> Much simpler devices, such as universal life insurance policies, can do the trick as well.<sup>200</sup>

Neither Dodger nor his estate in this example will ever pay any gift or estate tax. When he dies, his heirs will inherit his assets, income-tax free. They can sell them off, for no gain, because of the stepped-up basis rule. Then they can pay off Dodger’s debts, and keep whatever cash is left over. As long as Dodger has borrowed enough to bring his net estate down below \$1,000,000 or so—actually, under \$3.5 million, under current law, by 2009<sup>201</sup>—no estate tax will be due.

This is all, of course, nice work---if you can get it. One can indeed get it—if she has wealth to start—under today’s tax laws.

### 3. *The practical facts of the matter*

How many rich Americans take Tax Planning 101 to its limits, avoiding all taxes, is an empirical question, rather hard to answer, because the very rich are relatively few, and their ways more or less secret.<sup>202</sup> Certainly, plenty do; the advice is available enough.<sup>203</sup> It is also apparent, from the facts that some estates pay estate taxes, and that some among the living do indeed pay capital gains taxes, that not all who could take the game to its limits do so. Quantifying the narrow bottom-line consequences to the fisc is elusive, but these questions form the analytic basis for a consequentialist objection to any conversion to a systematic consumption tax or, what is the same thing, a consequentialist defense of maintaining the status quo, with its porous income tax. If few individuals actually take Tax Planning 101 to or near to its limits, perhaps things are not so bad at all, contra Andrews and other critics of the way things are.

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<sup>199</sup>. Citations.

<sup>200</sup>. Citations and explanation.

<sup>201</sup>. EGTRRA.

<sup>202</sup>. *Being the Best We Can Be*, and sources cited therein.

<sup>203</sup>. *Die Broke*, etc.

But things in tax today are bad, and for several reasons notwithstanding the intractability of the empirical questions over Tax Planning 101's actual breadth. One, there can be no doubt—certainly none of the critics calling for more empirical analysis, or pressing the consequentialist objection, raise any—about the analytic facts of the matter, that is, about the legal steps in Tax Planning 101's buy/borrow/die advice. This is basic tax. Yet the mere existence of this legal structure raises troubling questions of both equity and efficiency. If some but not all who have capital take advantage of Tax Planning 101, in whole or in part, what does this tell us about the fairness of the tax system? The essence of the claim that tax for those with capital is voluntary is not that no one with capital pays taxes—people do voluntary things, even pay voluntary taxes, after all—it is that no one with capital *has* to do so.<sup>204</sup> There are perfectly legitimate ways for people with property to avoid paying any federal taxes. This is not so—it is dramatically not so—for people earning labor wages, as we shall see. A system of tax that marks radical distinctions between the sources of present consumption, and that turns further on wealthy taxpayers' varying degrees of tax aversion and access to information—not even terribly sophisticated information, for the basics of buy/borrow/die are fairly basic, indeed—is a highly suspect system, at best.

Two, and central to the analysis to follow in this subsection, the mere analytic facts of Tax Planning 101—and not the breadth of their actual incidence—constrain important matters of practical tax design. In the language of economics, features such as low tax rates on realization are “endogenous” to an income-with-realization regime. There is simply no very good way, under an “income” tax with the realization requirement as now construed, to heavily burden capital: if taxpayers are not flocking to advisers to avoid a 15 percent capital gains tax, might they not do so at a 40, or 50 percent level? Evidence that some taxpayers pay some capital gains taxes at the favorable rates that persist today does not contradict the fact that there are, indeed, favorable capital gains rates. The present structure of tax haunts the possibilities for tax's better future.

Three, the discussion might be effete, lacking in practical urgency, if the

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<sup>204</sup>. See A Voluntary Tax? Revisited.

present regime, with its income-plus-estate taxes, held out the only meaningful promise of getting at capital and its yield at all. The most strident critics of any form of consumption tax insist on the yield-to-capital norm, though they do not use this language.<sup>205</sup> To such critics, getting some tax on some capital is better than getting no tax on any capital, which is what they take the consumption tax to offer. But this false dichotomy follows only from the flawed traditional view of tax. Once we understand that a progressive postpaid consumption tax gets at some of the yield to capital, and in just the cases in which it is most compelling to do so—and also as we come to see that the structure of a postpaid consumption tax changes the nature of the arguments over the rate structure, allowing for more, not less, progression in them—we are no longer left clinging to a porous income tax as the only hope for reaching capital and its yield. On ideal terms, an income tax overshoots its mark, by double-taxing all capital, willy-nilly; in non-ideal terms, the income tax fails minimal standards of fairness and rationality, by taxing the yield to capital only among those most willing to pay it. A better way exists.

To cash out this second response to the consequentialist objection to tax reform—that structure constrains design—the balance of this subsection traces out a few of the analytic elements of the present income tax regime that have followed in the structural wake of *Macomber*.

*a. Capital gains preferences*

The leading example of a provision in current law that follows from *Macomber*—a practical concession to the fact that we have an income-with-realization tax—is the preferential rate for capital gains.<sup>206</sup> This is the tax rate that gets imposed when and if a taxpayer sells or otherwise disposes of her assets. This rate has long been set at a fraction of the “ordinary” tax rates that fall on labor and the regular yield to capital in the form of interest and dividends. It is now capped at a maximum 15

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<sup>205</sup>. Alstott, Rakowski, Murphy and Nagel, Graetz, Geier.

<sup>206</sup>. IRC § 1(h).

percent, having been reduced from 20 percent in the 2003 tax legislation.<sup>207</sup>

Of all the arguments mustered in favor of a capital gains preference, the only truly compelling one is brute necessity in the face of Tax Planning 101: who would ever sell an asset and incur a 90 percent, or 70 percent, or even 40 percent tax when she could borrow against it instead?<sup>208</sup> The realization requirement generates a so-called lock-in effect, set in motion by *Macomber*: a wedge between an owner's willingness to sell a given asset and a buyer's willingness to pay for it, on account of the built-in tax liability. Suppose, for example, that Mrs. Macomber had a personal, subjective valuation in her stock of \$800; a third party buyer would willingly pay her \$1,000. This is a deal that wealth (and welfare) maximizing suggests ought to happen. But if, on sale, Mrs. Macomber would have to pay \$400 in taxes, her personal gain from the exchange would be only \$600, less than her subjective valuation. Since Mrs. Macomber quite rationally cares only about her after-tax return, the deal does not transpire. At high enough tax rates, there are many deals that do not take place. The resulting "lock-in" effect threatens to shut down the economy: assets will not trade, will not go to their highest and best use and users. This problem, in simple terms, is

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<sup>207</sup>. The Jobs and Growth Tax Relief Reconciliation Act of 2003, H.R. 2, 108th Cong. (2003) (enacted) [hereinafter, JGTRRA].

<sup>208</sup>. Other common arguments for a capital gains preference are simply not convincing. For example, there is an argument that much of the gain from the sale of an asset reflects compensation for inflation. This argument, made before general rate-bracket indexing, lacked fairness, because much of the return to *human* capital, too, compensated for changes in the inflation or monetary rate; after rate-bracket indexing became fully effective the capital gains argument lacked force. Further, indexing of an asset's basis for inflation is a far better reaction to the "problem" of inflationary gain than a crude discount to all assets held a year or more. Another argument is that capital gains can result in "bunching," or the temporary elevation of a taxpayer into a higher rate bracket; in fact, the evidence on bunching of capital realizations is slim, capital market transactions (such as installment sales, see IRC § 453) can deal with the problem, as could a more targeted averaging mechanism in the tax laws. And, again, it is unclear why there should be a solicitude for the taxpayers with financial capital who suffer this problem, when there is no adjustment for those with human capital who have it (the law did have income averaging for times ----). This article is an attempt to make the smoothing phenomenon general, and indifferent to the financial/human capital source of the problem. All that said, however, the lock-in effect *is* a compelling argument for a capital gains preference. See Edward J. McCaffery, Tax Notes.



a function of the timing of tax: by making sales and exchanges trigger tax, an income-with-realization requirement deters sales and exchanges. This is not the case under a consistent postpaid consumption tax: sales or exchanges of any investment asset followed by reinvestment of the proceeds in other assets do not trigger tax; think of making adjustments inside an IRA or 401(k) plan. All and only what triggers tax under a postpaid consumption tax is the decision to spend resources on private preclusive use.

Under an income-with-realization tax, some preference for capital gains is needed to lubricate the wheels of commerce, to keep the game going. All that is left is to haggle over the price, as the saying goes, and the political system is indeed constantly flirting with lowering the rates further. By deferring Mill's "second" tax, *Macomber* moves the system toward a prepaid consumption tax; by lowering the magnitude of the ultimate second tax hit, capital gains preferences—which follow from *Macomber* and the lock-in effect that a realization requirement generates—take us further in that direction. Of course, holding assets until death in the manner of Tax Planning 101's buy/borrow/die strategy is the limiting case: Here the second tax, like Beckett's Godot, never comes.

Capital gain preferences are a microcosm of what is wrong with the status quo. We have seen, with Vickrey, that the principal reason to have a comprehensive individual tax system is to make individuated judgments of the appropriate progressivity of effective tax burdens. But the low rate on capital gains, dictated by the flaws of an income-with-realization tax, is a crude and across-the-board affair. It is also *source* driven, a distinction based on the type of asset held and sold. It does not matter how one uses the proceeds, to smooth or to enhance, for one self or some other. Progressivity suffers, and individuation suffers, on the altar of the practical constraints of analytic tax system design.

*b. Corporate dividend preferences*

The 2003 tax act—one of several leading exhibits in making out the case that practical tax policy is moving towards a flat wage tax—not only lowered the capital gains rate to 15 percent, as discussed above, but it also extended this rate to corporate

dividends, which had traditionally been taxed at ordinary income levels.<sup>209</sup> The lowered or non-taxation of corporate dividends is an intricate economic matter that turned out to be an intricate political one, as well. For present purposes, two themes are important.

One, this development, too, plausibly follows from the structure of an income-with-realization tax. Just as *Macomber* generated a lock-in effect at the level of individual asset-owners—generating a disincentive for them ever to sell their holdings—so too did it generate a lock-in effect, dubbed a “retained earnings trap,” at the corporate level. Focusing solely on the individual tax consequences, a wealthy investor like Dodger would understandably look askance at a corporation’s paying him large cash dividends, taxable at ordinary rates that hit 90 percent and higher in the 20<sup>th</sup> Century. Better for the corporation to keep the cash itself, and reinvest, so that the value of Dodger’s shares would grow tax-free, like Mrs. Macomber’s, until and unless he decided to trigger a realization event, as by sale, at which time the tax would fall due at the much lower individual capital gains rates. The retained-earnings trap gave American corporations a good reason to hoard cash; at one point recently, Microsoft had nearly 50 *billion* in cash on-hand. One way to get corporations to disgorge their cash holdings—making stocks easier to value, and companies smaller, in the process—is to lower or eliminate the tax on corporate dividends at the individual investor level.

Two, the corporate dividend tax rate reduction is yet another step towards a relatively flat prepaid consumption tax. Tax Planning 101 points the way for those with capital to avoid paying any further federal tax whatsoever. But for those with stocks of capital unwilling or unable to take this advice, life continues to get better, tax-wise, in any event. Virtually all subsequent taxes on capital are being eliminated or reduced. And as with the capital gains preference, an argument for the normative propriety of a corporate dividend preference is not an *individuated* argument at all: any one who owns corporate stocks will see her dividends taxed at 15 percent,

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<sup>209</sup>. Citation.

however wealthy she is, and for whatever use she puts the cash.<sup>210</sup>

*c. Other consumption-tax elements*

Preference for those capital gains actually realized and corporate dividends received are just two tips of a large iceberg. As Andrews was well aware, consumption tax elements abound in the so-called income tax. But what has not been generally noticed, on account of the continued hegemony of the traditional view of tax, which has equated all forms of consumption tax, is how much of the current income tax is in fact a specifically prepaid consumption or wage tax model. Consider a few more doctrinal matters.

In cash-value life insurance, a taxpayer overpays for the pure actuarial or “term” component of insurance. The insurance company then invests the excess, on her account. The taxpayer pays no tax, basically because of *Macomber*, on the “inside build up” of appreciation, even if the insurance company buys assets that would produce ordinary income in her hands, such as bonds. When she dies and her heirs get the proceeds, these are income tax-free to them,<sup>211</sup> and with trivial planning, the policy’s value will not count in her estate for federal tax purposes.<sup>212</sup> As with most instances of clever tax planning, this device does not work only for the altruistic, or inter-generationally minded; taxpayers are free to borrow against the cash value of their policy, tax-free. In such a case, when the insured dies, the insurance company first pays itself off, and her heirs—if she has taken this game to its limit—get nothing.<sup>213</sup> This is simply a one-stop shopping way to play Tax Planning 101, buy/borrow/die. It is also prepaid consumption tax treatment: the taxpayer pays taxes on her wages, uses them to pay insurance premia, and never again pays tax.

For a good many Americans, their major asset is a house, specifically, their

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<sup>210</sup>. See story, in USA Today January 2003, on the Walton heirs and corporate dividend preference.

<sup>211</sup>. IRC § 101.

<sup>212</sup>. IRC § 2038.

<sup>213</sup>. Knetsch.

home equity. Although home mortgage interest is deductible, principal payments are not. The economics of home ownership work under a prepaid consumption tax model. One buys the asset with after-tax funds, but does not pay tax on its yield—the very important opportunity cost benefit of not having to pay rent. Further, today when a married couple sells their house, they get to take away up to \$500,000 of gain, tax-free.<sup>214</sup> That will cover most homeowners, of course; for those with larger shares of appreciation, there might be a 15 percent capital gains tax on the excess of gain over \$500,000. The saga of the taxability of home sales under the income tax, like so much of tax today, owes much to *Macomber*. The realization requirement means that capital appreciation in personal residences gets ignored as it accrues, awaiting an ultimate sale or disposition. But here too there is a lock-in effect, deterring families from “trading up” to get larger homes, or moving to a different area for job or other reasons. To deal with these problems, the law employed a “rollover” provision for many years, allowing the built-in tax gain to follow the family’s real estate moves.<sup>215</sup> But then the elderly had a problem: once the kids had left the nest, and they wanted a smaller home, or to relocate to a less expensive area, they faced an exploding tax time-bomb. So Congress dealt with their problem, excluding gain when taxpayers older than 55 sold a residence.<sup>216</sup> Perhaps mercifully, President Clinton swept away many of the subtleties, allowing the \$500,000 per couple exemption discussed above. Each step in the story made some sense. But, sweeping all details aside, what we are left with is an important asset fully taxed for most taxpayers on the prepaid consumption tax model: houses are bought with after-tax dollars, their yield is never again taxed.

Retirement savings are a final, and very important, example of consumption-tax treatment. I shall discuss them below, as an ad hoc deviation from an income tax. For these provisions follow not so much from the structure of an income-plus-realization tax, as from conscious decisions to deviate from either an income or an income-plus-realization ideal. It is noteworthy, however, that there has been a trend

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<sup>214</sup>. IRC § 121.

<sup>215</sup>. IRC § 1034, and discuss.

<sup>216</sup>. IRC § 125.

in the retirement savings area, which began on the postpaid consumption tax model, towards the prepaid one. Together with the basic tax planning of buy/borrow/die, lower tax rates on capital realizations and corporate dividends, cash-value life insurance, and the taxation of home-ownership, the new developments in retirement savings help to move tax towards a world in which citizens will pay taxes on their wages, under a compressed rate structure, and never again. This is the world of prepaid consumption, or wage, taxation.

### **B. Ad hoc deviations**

This section discusses the variety of more conscious, deliberate pro-savings provisions, such as pension plans and IRAs, that have been features of the income tax since the 1950s. Unlike the structural elements just canvassed, which followed from the working out of an income-plus-realization tax in the wake of *Macomber*, these pro-savings mechanisms have resulted from a deliberate rejection of the income-tax model. Policymakers wanted to encourage savings, wanted to avoid Mill's double tax. They added statutes to achieve the effect.

Significant technical problems follow from engrafting pro-savings provisions onto an income tax, however, on account of the analytic inconsistency. Because one can borrow tax free under an income tax, there is no logical assurance that savings will in fact increase with any nominal pro-savings provision within such a tax: a taxpayer can open up an IRA with \$2,000, using one hand, and borrow \$2,000 on a credit card, using the other. The evidence is mixed in terms of the empirical questions, how much various retirement and other savings provisions actually increase savings.<sup>217</sup> But the claim that the center we have chosen cannot hold is not a narrowly empirical one; it is not based on aggregate macroeconomic statistics and our varying, imperfect understanding of them.<sup>218</sup> The critique is based instead on the analytic structure of tax, and what this says about tax's fairness, efficiency, complexity, and possible reform. It is simply a difficult and scattershot affair to try to encourage and

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<sup>217</sup>. Venti and Wise, etc; current JPE.

<sup>218</sup>. Imperfect, because the problems are intractably hard: there is too much joint causation, too much noise in the economic statistics.

reward savings within a tax system designed to double tax them.

Still, the mere presence and persistence of the ad hoc deviations from an income tax, however ineffective, underscore the appeal of the ordinary-savings norm. The structural gaps followed, more or less from brute necessity, after *Macomber*. The ad hoc deviations in contrast have been repeatedly chosen, consciously and deliberately, by tax policy-makers. This makes their implicit norms all the more compelling to the interpretive theorist.

### 1. *Retirement savings*

Retirement savings—which, with home equity, are the major assets for most Americans who have any assets at all (most Americans do not)<sup>219</sup>—are taxed primarily on the postpaid consumption tax model; a taxpayer gets a deduction when she puts money into a tax-favored account, and she pays tax when she withdraws funds from the account. A growing trend in tax is to allow an option for taxpayers to choose a retirement savings plan structured under the prepaid consumption tax model, such as the Roth IRA, instead of the traditional postpaid approach. Under these variations, there is no tax deduction up-front, and there is no back-ended tax on withdrawal: this is an equivalent matter, given constant tax rates, as Ant and Grasshopper helped us to see.

The proliferation of retirement savings provisions resulting from the addition of a prepaid track to the longstanding postpaid one is another side effect of the influence of the traditional view, equating prepaid and postpaid consumption taxes, and it has added considerable complexity and confusion to tax. It is also not irrelevant that Congress gets its one tax *today* under the prepaid, Roth-style account model, and thus it has a short-term incentive under contemporary budgeting rules to prefer this approach.<sup>220</sup> Prepaid consumption tax savings plans also avoid the arbitrage problem noted above: there is no reason to borrow funds with one hand in order to “save” with the other under a prepaid consumption tax model, since there is no immediate tax

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<sup>219</sup>. Statistics, modal net wealth is zero.

<sup>220</sup>. See FAIR NOT FLAT, *supra*; Elizabeth Garrett.

benefit to savings in the first place. There is also no reason to borrow in lieu of making withdrawals from a qualified account (or in lieu of realizing gains), as Artful Dodger might do, because there is no tax on withdrawal from a prepaid tax. And yet moving towards a prepaid consumption tax model has a cost, one hidden by the traditional view but one that the new understanding of tax helps us to see. Recall Figures 1-3, above, representing the typical pattern of earnings and spending in a taxpayer's life. The single tax under the prepaid model falls due at the time of labor market earnings, typically in a worker's peak income—and hence most highly taxable—years; the model does not allow for smoothing. As such—because there is no way to escape the burden of wage taxation—prepaid consumption tax savings plans are in tension with highly sloping marginal tax rates. It is thus not surprising that the contemporary conservative tax reform movement has seemingly chosen this form, of moving towards prepaid consumption tax savings plans—as a step on the path towards flat taxes.

The general tax treatment of retirement savings, under traditional IRAs and pension plans such as 401(k)s, reflects the appeal of the ordinary-savings norm and the appeal of favoring (or not disfavoring) capital smoothing transactions. The original idea was to take some otherwise taxable income out of a worker's high-earning, middle-aged years, and move it backwards, to the time of retirement: backwards smoothing, in the manner of Figure 2. As noted above, these structures under an income tax lack coherence. When a taxpayer borrows and also opens an IRA, there is no net saving, just a tidy tax deduction. This is yet another instance where we can now understand that the true problem with the status quo, which seems as if it lies in the inconsistent treatment of savings—where Andrews had seen its “worst inequity and distortion”—actually relates to the inconsistent treatment of *consumption*. The taxpayer who both borrows and opens a deductible IRA is able to consume today, without any savings, and pay tax tomorrow; so too with the taxpayer who borrows in lieu of withdrawing from her tax-favored account. In both cases, there is a deferral, and a possible lowering of the ultimate tax rate. It is worth noting, however, that the taxpayer who plays this game, using traditional IRAs or pension plans, cannot escape tax altogether, as can the taxpayer with financial capital who plays Tax Planning 101: some tax must be paid on the withdrawal of funds from the

IRA or qualified pension account, even if the taxpayer dies before the withdrawal.<sup>221</sup> This is yet another example of the system's far greater solicitude for taxing wages than the yield to capital.

## 2. *More and more*

There have been two important recent developments in the field of ad hoc, pro-savings deviations from the income tax. One, these accounts have extended beyond retirement uses. There are now medical and educational savings accounts,<sup>222</sup> and the Bush Administration has proposed further savings accounts unlimited as to their use.<sup>223</sup> Two, the accounts are more and more likely to be structured on the prepaid consumption tax model.

Consider, for two important examples of both trends, the Coverdell Educational Savings Accounts (ESAs), formerly known as the Education IRAs, and the Section 529 Qualified Tuition Plans (QTPs). The former works along an IRA model, but one of the Roth or prepaid variety. An ESA can be set up for each "qualified beneficiary," or child, and persons can contribute up to \$2,000 per year per account. There are, of course, the usual array of mind-boggling provisions, such as ceilings for those who make too much income, and rules for coordination with other pro-education features, such as the "Hope" or (not equivalently) "Lifetime Learning" credits. QTPs are more complicated still: they must be maintained by a state or a "qualified educational institution," and their coordination provisions are intricate. Still, at the end of the day, QTPs have more generous contribution limits than ESAs. QTPs too work along the prepaid consumption tax model: taxpayers can put in large sums of money, with after-tax dollars, and rest assured that the investment yield will not be subject to any second tax on withdrawal, provided that the formidable terms and conditions of the statutory grant are met.

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<sup>221</sup>. Income in Respect of Decedent rules.

<sup>222</sup>. See IRS Publication 969, Medical Savings Accounts (MSAs) and IRS Publication 970, Tax Benefits for Education, both available online at <http://www.irs.gov>.

<sup>223</sup>. Citations.



An interim bottom line is that the model of allowing savings to escape double-taxation, begun in the 1950s for retirement savings, has continued to grow and develop under the so-called income tax, by conscious government policy. The theme now extends beyond retirement savings to medical and educational related savings. And there has been a dramatic shift, barely noticed by those working under the traditional view of tax, towards having the single tax of the one-tax model fall at the time of initial labor market earnings, not the time of ultimate use.

### **C. Tax shelters and the noble failure of TRA 86**

Both the deep structural gaps and the increasing ad hoc, pro-savings provisions move the income tax towards a consumption tax, as Andrews and others have long pointed out.<sup>224</sup> Further, in a distinction made salient by the new understanding of tax, the law is increasingly moving towards a specifically prepaid consumption or wage tax. All “second” taxes on the yield to capital are voluntary, under Tax Planning 101; those that do fall are deferred and come due at low marginal rates—rates whose very existence owes to the presence of the structural gaps themselves. More and more ad hoc savings provisions add to the trend, especially as they are created more and more frequently on the prepaid consumption tax model.

The other side of the coin in tax is what has been happening with labor market returns, or wages. The income tax per se makes no attempt to reach beneficent market returns,<sup>225</sup> and we have just considered its seriously porous commitment to taxing capital market returns. If the taxation of wages were porous, too, there would be nothing left to tax. It is not porous. Even as the so-called income tax system has weakened in its taxation of capital market returns, it has strengthened its commitment to taxing wages. Ad hoc savings provisions along the prepaid model do exactly this, of course: by denying any current deduction, they insure that wages are taxed, and taxed now; by not taxing withdrawals, they assure that the yield to capital is never taxed. On the structural other hand, nothing in Tax Planning 101 is relevant to citizens who must live off the yield to their human capital, that is, off of their labor

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<sup>224</sup>. Andrews 74, Hybrid, etc.

<sup>225</sup>. IRC § 102.

market wages, often paycheck to paycheck. Indeed, for many who are building up such human capital by borrowing and schooling themselves—law students, say—a depressing reality lies in wait. These unlucky wage-earners-to-be will have to pay off their student loans with after-tax dollars drawn from their high bracket years ahead. Their chosen path through life makes them income bunchers, who must rely on capital transactions to smooth—which neither an ideal income tax nor a prepaid consumption tax accommodates their doing. The actual income tax, meanwhile, accommodates smoothing only erratically, allowing backwards smoothing to some extent, at a price of the complexity of the retirement and other ad hoc savings provisions, but not forward or anticipatory smoothing at all. And as the actual income tax moves ever closed to a prepaid consumption or wage tax, even this accommodation is at risk.

Much of the history of tax planning in the United States has been concerned with the situation of high wage-earners; with their search for “tax shelters.” The general strategy of a tax shelter (at least before 1986<sup>226</sup>) is to get some of the benefits that the propertied classes have long enjoyed under the basic structure of an income-with-realization tax as a wage-earner: to hide or “shelter” one’s wages from the tax collector. The propertied classes do not need shelters, by and large, because the realization requirement, and the simple steps in Tax Planning 101 that follow from it, serve to keep their material resources from the tax collector perfectly effectively and legally. It is those with large labor market gains who need help. Prior to the epochal Tax Reform Act of 1986, sheltering for such wage-earners had become almost as easy as avoiding taxes for property owners: it was simple enough to play the game with other people’s money, or, indeed, with no money at all. The gaps in tax opened up on the capital side had leaked over to the labor-market side as well, threatening the entire system as a revenue-raising vehicle. But slowly, systematically, as marginal tax rates have come down (a top rate of 70 percent when Ronald Reagan took office in

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<sup>226</sup>. In the 1990s, a new generation of “corporate tax shelters” arose, to offset corporate income taxes, but also to shelter the large capital gains occasioned by the boom time 1990s. In the latter case, the corporate form exploited a gap in §469’s coverage. See symposia in SMU, *Tax Law Review*.

1981 has now been cut in half<sup>227</sup>), and as the structural and ad hoc opportunities to avoid “second” taxes on the yield to capital have expanded, the means for sheltering *wage* income have dried up. This continues the central theme of the practical critique of the status quo: the so-called income tax system has morphed into an effective wage, or prepaid consumption, tax. To understand this point fully, consider the shelter game, then and now.

1. *Some quick and dirty examples*

I begin with the way things were, prior to the 1986 Act, in order to understand where we are, and where we are heading. Consider, simply to make the point, four fairly basic tricks of the ancient trade of tax sheltering, here given evocative names and hypothetical taxpayers to illustrate.

**The interest dodge:** Susie, who has no capital, is about to earn \$100,000 a year as an associate in a large law firm. She borrows \$1,000,000 at 10 percent interest. With an unlimited interest deduction,<sup>228</sup> she offsets her \$100,000 salary completely on her tax return. With her \$1,000,000 in cash, she plays Tax Planning 101, just like the Artful Dodger. Susie buys capital-appreciating assets, such as growth stocks, and borrows against the appreciation to get cash to consume. She has no net assets, because her liability offsets them. She consumes \$100,000. She pays no income tax.

**The simple straddle:** Joe is in the same boat as Susie: about to make \$100,000 a year as a lawyer, with no cash in his pocket. He borrows \$200,000 on a margin account, and buys perfectly offsetting stock positions—in essence, he puts \$100,000 on each side of a “heads or tails” coin flip. (He can do this with a put and a call option on the same commodity, or by going long and short on the same stock.) One position is guaranteed to double in value; the other to become worthless. Joe sells and then writes off the worthless one, claiming a \$100,000 loss that, with

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<sup>227</sup>. JGTRRA, etc.

<sup>228</sup>. Prior law IRC § 163.

unlimited loss offsets,<sup>229</sup> wipes out the tax liability on his salary from the law firm on his tax return. Joe holds his \$200,000 winner, which precisely offsets his loan balance. Like Susie, Joe has no net assets. Also like Susie, he pays no income tax on his \$100,000 salary. He too can consume away, tax-free.

**The classic shelter:** Sara is graduating from medical school, about to start earning \$100,000, no assets in hand. She buys an old hotel in Arizona for \$3,000,000, giving the owner a non-recourse note for virtually the whole amount (no money down!).<sup>230</sup> Sara leases the hotel back to its owner, setting the rent she is owed on the hotel equal to the interest she owes on the note, which has a balloon payment due and payable in 30 years. Meantime, with a 30 year depreciation schedule, Sara gets \$100,000 in ordinary income deductions each year.<sup>231</sup> Sara, too, like Susie and Joe, has no net assets; the liability offsets the gross value of her holdings. Like her friends, she also pays no tax on her \$100,000 salary. She will worry about what happens in Year 31 much later.<sup>232</sup> For now, she consumes away, tax-free.

**The kiddie shift.** Tom is about to become a doctor, too, earning \$100,000. He has four young children. Tom decides to buy a small office building, perhaps using debt financing, which would generate a nice tax deduction<sup>233</sup> to sweeten his basic plan, and then gifts fractional shares of the building to his children. Tom then pays

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<sup>229</sup>. See IRC § 1211, capital loss offset rule, put in place in —.

<sup>230</sup>. Facts based on Estate of Franklin, which did not work; but see Tufts, which illustrates a simple case that did work.

<sup>231</sup>. IRC §§ 167, 168.

<sup>232</sup>. Under Tufts, she'll have capital gains of \$3,000,000—small prince to pay for 3,000,000 worth of tax free ordinary income for 30 years. And, in any event, she can always find another shelter, holding them until she dies (see Tax Planning 101).

<sup>233</sup>. IRC § 163, and see “the interest dodge,” above. Under an unlimited interest deduction, as generally obtained prior to 1986, even a loan to finance a gift would generate deductible interest. But see IRC § 263.

each of his offspring rent. The rent is a business deduction for Tom,<sup>234</sup> bringing his taxable income down, and just so happens to fall in each of his children's "zero bracket." Tom and kin pay no tax on the transferred amounts, which Tom directs his children to use for their basic food and clothing—indeed, he can do this himself, as their natural guardian.<sup>235</sup>

More elaborate examples of the ancient sheltering art could be put forward, but these four simple tax-planning strategies serve to illustrate the point perfectly well. All were alive and flourishing, in one form or another, for long periods in American tax law. The interest dodge, the classic shelter, and the kiddie tax were in full flower coming into the 1986 Act; either of the first two alone were sufficient, taken to their limits, to make the entire income tax voluntary, even for those without their own financial capital stakes to play Tax Planning 101.

## 2. *What TRA 1986 did, and did not do*

The traditional view of tax sees the choice of broad-based systems as one of income versus consumption. Andrews's important articles from the 1970s had opened up an attractive avenue for tax reform, in the form of a progressive postpaid consumption tax. The influential *Blueprints for Tax Reform* had traced out the two perceived forks in the road, perfecting the income tax or moving towards a consistent consumption tax. The Tax Reform Act of 1986 ostensibly took the income-tax path.<sup>236</sup> This epochal legislation's general strategy was to widen the income tax base, by eliminating scores of exemptions, exclusions, and deductions, in order to bring tax rates down. In particular, TRA 86, as it came to be known, shut down all the shelters mentioned above, with the exception of those already shut down.

There is thus no longer a general deduction for personal interest, and

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<sup>234</sup>. IRC § 162.

<sup>235</sup>. See Brooks.

<sup>236</sup>. See BRADLEY, FAIR TAX, *supra* note 5.

investment interest is subject to a “netting” rule:<sup>237</sup> the interest dodge is dead. Susie can still borrow money, but she cannot use the interest to offset her salary for tax purposes. Pure straddles had already been attacked, and the capital loss offset rules generally limit the usefulness of Joe’s simple straddle idea.<sup>238</sup> The sweeping passive activity loss rules of Section 469 effectively shut down the classic shelter in most of its incarnations.<sup>239</sup> Susie can still run a rundown hotel, but she cannot use the tax losses generated thereby to subtract from her salary as a doctor on her tax forms. The “kiddie tax” killed Tom’s clever idea, again in most instances, by putting children in the same marginal tax bracket as their parents for unearned income. Tom can still give his office to his children and pay them rent, but he will find them paying the same tax he otherwise would. In sum, the Tax Reform Act of 1986 was systematic in curtailing tax shelters, thereby stopping the bleeding in tax and enabling lower tax rates on a broader tax base.

But—and herein lies the rub, still—the watershed TRA 86 did *nothing* about Tax Planning 101 or any of its three simple steps. TRA 86 did not touch the realization requirement of *Macomber*, although Congress clearly has the power to do so.<sup>240</sup> TRA 86 did not make debt taxable, or a deemed realization event for people with appreciated assets. TRA 86 did not alter or repeal the stepped-up basis rule for assets acquired on death. It is true that TRA 86 repealed the capital gains preference, which resulted in an interim rise in its rate. Capital gains had for a significant period of time been set at 40 percent of the ordinary income tax rate; thus the top capital gains rate was 28 percent when Reagan took office with a 70 percent top ordinary rate bracket. When Reagan oversaw his first major tax-cutting bill, the Economic Recovery Tax Act (ERTA) of 1981, the ordinary rate fell to 50 percent. The capital gains rate fell in step, to 20 percent. TRA 86, which instituted a marginal rate bracket

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<sup>237</sup>. 163, especially 163(d).

<sup>238</sup>. 1211, anti-straddle provisions.

<sup>239</sup>. IRC § 469 and explain.

<sup>240</sup>. Explain, as with consideration of o.i.d. rules, IRC §§ 1271-74, and so forth.

of 28 percent on the highest incomes,<sup>241</sup> eliminated any further and specific capital gains rate preference, thus, in essence, restoring the pre-ERTA rate of 28 percent on capital gains. Interestingly, this created a natural experiment to see if capital transactions were elastic to the tax rate; there was, indeed, a spike in sales under the outgoing 20 percent regime.<sup>242</sup> But recall that the capital gains rate, as argued above, is a reaction to the very existence of Tax Planning 101. Since TRA 86 left Tax Planning 101 unchecked, its elimination of the capital gains preference was fragile from the start. Indeed, a preferential rate soon enough reappeared, with the elder George Bush maintaining the top rate at 28 percent when ordinary income tax rates went up; Bill Clinton reducing it first to 20 then later to 18 percent; and the younger Bush bringing it down to its current 15 percent. As this saga of capital gains preferences played itself out, the simple advice of buy/borrow/die lived on.

What the Tax Reform Act of 1986—one of the most sweeping acts of tax legislation ever passed, and the subject of laudatory volumes from the popular press—did was simple. It shored up the status of the “income” tax as a prepaid consumption or wage tax. Shelters for *wage* earners were shut down or drastically curtailed. Yet people with capital could still buy, borrow, and die to their heart’s content; tax remained voluntary for those with financial capital.

## VI. The Mess We’ve Made, Part Two: Beyond The Income Tax

**T**ax policy typically suffers from blinders when it comes to taxes other than the income tax.<sup>243</sup> The personal federal income tax is, indeed, the largest American tax. The income tax also features relatively high marginal tax rates and rewards at least some sophisticated planning, even after the Tax Reform Act of 1986 put a lot of tax shelters out of business, at least for the time

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<sup>241</sup>. Confusing with the bubble, See Cognitive Theory and Tax.

<sup>242</sup>. Slemrod etc.

<sup>243</sup>. Beginning to change. Geier et al.

being.<sup>244</sup> The income tax's size and malleability warrant its status as a relative staple in American law school classrooms. Yet large as it is, the federal income tax accounts for less than one-half of all federal government revenues, and less than one-third of all taxes in America, state, local, and federal combined.<sup>245</sup> Other taxes must be factored in to any general theory about fairness in tax today.

When we widen the lens of our inquiry to consider the state of tax generally in the United States, a surprise awaits: the principal theme advanced in the last Part only deepens. The American tax system, writ large, is moving, seemingly inexorably, towards a consumption tax—and specifically towards a prepaid consumption tax—at relatively flat rates. What capital taxes remain are erratic in their operation, unprincipled in their conception, and—not unrelatedly—fragile in their vitality.

This Part explains these comments, beginning with the critically important payroll tax system.

#### **A. Payroll taxes**

No normative analysis of tax today should ignore the payroll tax system. To begin with, the combined social security and medicare system is, indeed a tax: not only are the exactions from wages mandatory (the classic hallmark of a tax), but they are also untethered from any precise benefit or payback system—social security has long been on a “pay as you go” basis.<sup>246</sup> To continue the analysis, the payroll tax is a big tax. The employee pays 7.65 percent of her pretax wages: 6.2 percent for social security, up to a ceiling presently approximately \$87,000, plus 1.45 percent for

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<sup>244</sup>. See articles on the new corporate tax shelters, in SMU, *Tax Law Review*, and so forth.

<sup>245</sup>. In 2002, federal personal income taxes raised just over \$858 billion, 46.3 percent of total federal receipts of \$1.853 trillion, and 30 percent of total government receipts of \$2.847 trillion. See BUDGET OF THE U.S. GOVERNMENT, HISTORICAL TABLES, FISCAL YEAR 2004, Tables 2.1, 2.2, and 5.1.

<sup>246</sup>. See Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1 (2002) [hereinafter Geier, *Integrating*]; McCaffery, *Benefits of Burdens*, *supra*.



medicare, with no ceiling.<sup>247</sup> The employer pays a matching share, but the real incidence is all on the employee: this is an employee-specific cost, one that a rational employer must factor into account when considering whether to hire, and how much to pay, an employee. Consider for example an employee earning \$10,000. She must pay \$765 out of her wages in payroll taxes, and her employer must pay a like amount. This means both that her employer considers her labor to be worth \$10,765, and that \$1,530 has gone to the government on account of her paid work.<sup>248</sup> The full amount of \$1,530—the total tax, including the employer’s share—could go to the employee if Uncle Sam released his hold on it. (The self-employed see this all much more directly, as they must themselves pay 15.3 percent of their wages up to \$87,000, and are allowed an income-tax deduction only for one-half of the total payroll taxes they pay.) The net result is a flat, 15.3 percent tax on labor earnings, starting in with the first dollar earned, and extending upwards to \$87,000, after which the social security tax ceases and the payroll tax rate drops down to the 2.9 percent (two times 1.45 percent) of medicare alone.

Table 3 puts together this rate structure with the basic income tax one, using 2003 rate brackets after tax reform.<sup>249</sup> Such tables are difficult to construct with any precision, on account of the considerable complexity within the income tax: varying

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<sup>247</sup>. See Social Security Administration, *Understanding the Benefits*, SSA Publication No. 05-10024, available online at <http://www.ssa.gov/pubs/10024.html>.

<sup>248</sup>. Since the employee never sees the employer’s share in her paystub, it is in some ways more accurate to “gross up” her salary, and see that she has paid \$1530 out of \$10,765, a 14.2 percent rate. See, e.g., Daniel N. Shaviro, *Effective Marginal Tax Rates on Low-Income Households*, Employment Policies Institute, available online at [http://www.epionline.org/study\\_shaviro\\_02-1999.pdf](http://www.epionline.org/study_shaviro_02-1999.pdf). On the other hand, the \$10,000—without any deduction for her share of payroll taxes paid—is what the employee must report to the IRS for income tax purposes, so the 15.3 percent figure used in constructing Table 3, below, is also accurate. On reported wages of \$10,000, \$1530 goes to the government. Table 3 thus does reflect the taxes paid on reported wages, although it does not precisely track take home pay: this is set at 1 - the tax rate net of the employer’s share of the payroll tax (so a taxpayer making \$30,000, say, faces a marginal rate of 22.65 percent and gets to take home 77.35 percent of her next dollar in reported wages, considering the payroll and income taxes alone).

<sup>249</sup>. Up-to-date tax rate tables can be found at <http://www.irs.gov>.

“zero brackets” based on whether a taxpayer itemizes or not,<sup>250</sup> and how many personal exemptions she has;<sup>251</sup> infra-marginal rate changes brought on by the earned-income tax credit and its phaseout;<sup>252</sup> the loss of personal exemptions;<sup>253</sup> the alternative minimum tax;<sup>254</sup> and so forth. The table nonetheless gives the basic rate structure facing a single individual taking the standard deduction.<sup>255</sup> It ignores the important EITC available for low-income taxpayers,<sup>256</sup> and so understates the degree of progression in total tax system.<sup>257</sup> Still it gives a basic sense of the matter, while helping to illustrate why the EITC is so important. Most important, Table 3 shows how big the payroll tax system is, relative to the income tax.

<b>Income</b>	<b>Payroll Tax</b>	<b>Income Tax</b>	<b>Combined</b>
\$0 - 8,000	15.3	0	15.3
\$8,000-15,000	15.3	10	25.3
\$15,000-36,400	15.3	15	30.3
\$36,400-76,800	15.3	25	40.3
\$76,800-87,000	15.3	28	43.3

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<sup>250</sup>. IRC § 68.

<sup>251</sup>. IRC § 152.

<sup>252</sup>. IRC § 32

<sup>253</sup>. IRC § 68(c).

<sup>254</sup>. IRC § 57.

<sup>255</sup>. Using \$5000 for the standard deduction and \$3000 for personal exemption, creating an effective “zero bracket” of \$8000.

<sup>256</sup>. Benefits of Burdens, Anne Alstott.

<sup>257</sup>. Actually, including the EITC would create a “hump” in the lower to middle regions, because the EITC benefit is taken back by a phaseout that begins at xxx. See generally Shaviro.

Income	Payroll Tax	Income Tax	Combined
\$87,000-151,500	2.9	28	30.9
\$151,500-319,500	2.9	33	35.9
\$319,500 and above	2.9	35	37.9

**Table 3: Payroll, Income and Combined Tax Rates, Single Person, 2003**

An individual taxpayer begins to pay 15.3 percent in payroll taxes right away on her first dollar of wages, with no accommodation for family size, medical needs, or anything else. Thus over the range from \$0 to \$87,000, a taxpayer's average or effective payroll tax rate—as well as her marginal one<sup>258</sup>—is 15.3 percent. In contrast, a single person under the income tax would have to earn over \$53,000 before her average income tax rate was as high as 15.3 percent.<sup>259</sup> Given that the average annual pay in 2000 was slightly over \$35,000 per worker,<sup>260</sup> it should not be surprising to learn that nearly 80 percent of Americans pay more in payroll taxes than in income ones.<sup>261</sup> Yet the payroll tax, alone among major federal taxes—the personal and corporate income and gift and estate taxes—has never been cut.<sup>262</sup> In any event, it is the aggregate of payroll and income taxes that matters to a rational taxpayer. Table 3 shows the rather compressed rate structure under the payroll plus income taxes combined. It starts at 15.3 percent, quickly hits 30 percent, peaks at \$76,800 at 43.3 percent, and then declines precipitously, although it never falls below 30 percent or rises above 40 percent. Anyone who earns between \$15,000 and infinity in wages pays

<sup>258</sup>. See above for effective and marginal defined.

<sup>259</sup>. The solution to the problem of  $\$0 + .10(\$15,000 - 8,000) + .15(\$36,400 - 15,000) + .25(x - 36,400) = .153x$ , where  $x$  is the income, is \$53,505.

<sup>260</sup>. 2002 STATISTICAL ABSTRACT, Table 611.

<sup>261</sup>. See Andrew Mitrusi & James Poterba, *The Distribution of Payroll and Income Tax Burdens, 1979-99*, 53 NAT'L TAX J. 765 (2000).

<sup>262</sup>. McCaffery & Baron, *Humpty Dumpty Blues*, *supra* note 237.

taxes in this narrow band, between 30.3 and 43.3 percent, with the top endpoint at 37.9 percent.

Most important for the central purpose of rethinking the fair timing of tax, the social security or payroll tax is a canonical instance of a prepaid consumption tax. Its single levy is applied up-front, as money is earned in labor markets, and never again: no social security “contribution” is asked of returns in the capital or beneficent markets. Combined with the understanding that the nominal income tax is largely now a prepaid consumption or wage tax, too—the theme of the prior Part—this gives a dark spin to Table 3: the United States is evolving a steep wage tax, one that falls especially hard on the middle classes, at compressed rates.

### **B. Death, to the rescue?**

The payroll tax makes no effort to collect any tax on the yield to capital or from beneficent transfers. The income tax also ignores beneficent transfers to the transferee, and, although it is intended to fall on the yield to capital, the actual income-plus-realization tax is erratic at best in living up to its theoretical commitment, and altogether voluntary at worst. In large part for this reason, defenders of the idea that capital ought to bear some positive tax burden—that is, supporters of what the new understanding of tax refers to as the yield-to-capital norm—have long advocated other, supplemental taxes to “backstop” the income tax, specifically in regard to the yield to capital.<sup>263</sup> Chief among these addenda has been the gift and estate tax.

There has been much debate of late about the estate tax, whose supporters seem to be losing: EGTRRA, the 2001 tax act, gradually weakens the tax, then altogether repeals it for the single year 2010, then brings it back in full force.<sup>264</sup> Congress has repeatedly considered extending the repeal, to make the elimination of the tax permanent.<sup>265</sup> There is no need to rehash the basic arguments over repeal, reform, or

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<sup>263</sup>. Most prominently, see Andrews 74.

<sup>264</sup>. Citation to EGTRRA.

<sup>265</sup>. See Linda Cohen, Edward J. McCaffery, and Fred McChesney, *Shakedown at* (continued...)

status quo, here. The main practical, descriptive point, for the new understanding of tax and the question of the fair timing of tax, is simply to understand that the estate tax has been a very porous backstop to the income tax, indeed.<sup>266</sup> The main theoretical, prescriptive point to see is that a gift and estate tax is not needed to backstop a consistent, progressive postpaid consumption tax, which tax better effects the fair timing of tax.

Although, as with capital taxes under the income tax, decedents' estates do pay some tax, the yield is consistently small.<sup>267</sup> Tax Planning 101, discussed above, provides a roadmap for readily avoiding the estate tax, by dying with net assets under its generous exemption level: spending it all and dying broke being the limiting case.<sup>268</sup> This is morally problematic, because it is far from obvious that the spending of the rich is to be encouraged, or is any less harmful than their passing on of wealth—and shortly we shall see that Tax Planning 101 can be used to pass on wealth, as well, if the wealthy person so desires.

The use of Tax Planning 101 to avoid all federal taxes—the estate tax in particular by dying broke—shows once more that the deep problem with the status quo is not, as Andrews would have it, with its inconsistent treatment of savings or accumulation. Rather it is with the use of capital transactions to finance *consumption*, tax-free. This allows a restatement of a central theme: All capital is not the same, from the perspective of the quest for individuated justice in tax. What matters, morally, is the *use* that individuals make of their capital, not the source of the yield to capital. Andrews saw the “worst inequity, distortion, and complexity” in the income tax's treatment of accumulation, or savings. Not seeing—or not wanting to see, under the influence of Mill—any way to split the difference, to make distinctions among the

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<sup>265</sup>. (...continued)

*Gucci Gulch: A Tale of Death, Taxes & Money*, draft on file with author.

<sup>266</sup>. See McCaffery, *A Voluntary Tax? Revisited*, *supra*.

<sup>267</sup>. Stats, Martin Sullivan in Tax Notes, Cooper, McCaffery, *A Voluntary Tax? Revisited*.

<sup>268</sup>. FAIR NOT FLAT and *A Voluntary Tax? Revisited*, *supra*.

uses of capital (as he had made among the uses of consumption in his 1972 article), Andrews recommended going all the way, to the total nontaxation of capital. Under the new understanding of tax, a surprising insight arises. What is problematic about the status quo—what is its “worst inequity”—is not the treatment of accumulation or savings, in and of itself; it is, rather, the inconsistent treatment of consumption, the other term on the right-hand side of the Haig-Simons identity. Through its structural problems, beginning—but not ending—with its inconsistent taxation of accumulation, the income-plus-realization tax allows the consumption of the wealthy to escape taxation altogether. The estate tax is not a “backstop” to this problem—of consumption financed by capital—at all, because its mere existence *encourages* it. A potential taxpayer who has amassed or acquired significant portions of capital need not pay any further tax, whatsoever, within her lifetime, no matter what her lifestyle. This is problematic.

Still, one might support the estate tax, within the context of a basic consumption tax—even a prepaid consumption tax—model, as ensuring that a tax gets levied at least once per generation.<sup>269</sup> (Another, different, way to support an estate tax under a consumption tax model is as a corrective to the large accumulations of “private” capital that a consumption tax allows, and even encourages; Andrews followed this rationale.<sup>270</sup> I shall address this argument later.) The idea is that wealth coming into an individual’s possession—via labor market earnings or beneficent transfers—should be taxed, once, and then all second taxes at the individual’s level should be avoided, in the spirit of Mill. If such a system were to work, the pressure on the choice of prepaid versus postpaid consumption tax would lessen, because the greatest problems of socio-economic inequity tend to take place, as both Rawls and Robert Nozick, in their different ways, noticed, with a problem of iteration over time.<sup>271</sup> The more generations go by without the corrective of a tax, the more the unfairness compounds. But so long as each generation is taxed once—the estate tax serving as a proxy for an

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<sup>269</sup>. Aaron and Galper, etc.

<sup>270</sup>. Andrews 74, etc.

<sup>271</sup>. Rawls, *POLITICAL LIBERALISM and A THEORY OF JUSTICE*, supra; ROBERT NOZICK, *THE EXAMINED LIFE*, and explain.

accessions tax,<sup>272</sup> making sure that a tax is paid before the receipt of beneficent transfers—the problem of iteration is held in check. If the gift and estate tax worked as planned, it would put labor market and beneficent market resources on the same footing—taxed once each generation of beneficial users—with only capital market earnings free of taxation, the latter in accordance with Mill’s principle.

The practical problem with this happy possibility is that the gift and estate tax does not work as planned. Even without further weakening—which seems all but certain to happen<sup>273</sup>—the estate tax is simply not a very effective mechanism for levying a tax on second or subsequent generations. It has too many holes, and of such a sort, as to make it inherently defective for the task. Consider but two.

One is the basic exemption amount, or so-called unified credit, now set at \$1.5 million per person on death, \$1 million for inter vivos gifts. A married couple, with proper planning, has \$3 million—scheduled to rise to \$7 million by 2009 and infinity, briefly at least, in 2010—to pass on death, altogether tax-free. The \$1 million amount can be given by any person, at any time, to any other person, without triggering a gift or estate tax.<sup>274</sup> Simple planning allows a basic leveraging of the value, as by placing assets in a family limited partnership form.<sup>275</sup> Wealthy parents with two children can transfer up to \$2 million of pre-discounted property to each child, altogether tax-free, and the children—or their financial advisers—can play the Tax Planning 101 game to their heart’s content. If the wealth is transferred when the parents are 50 years old, and invested at an 8 percent rate of return, it will grow to being worth over \$20 million per child by the time the parents reach 80.

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<sup>272</sup>. Andrews, Rawls.

<sup>273</sup>. It seems highly unlikely that the exemption level, set to reach 3.5 million dollars per person in 2009, will return to its pre EGTRRA levels. Not only has the exemption level never been raised in the history of the tax, but all current Senators except for Russell Fiengold (D-Wi) are on record as supporting at least a heightened exemption level. See Cohen, McCaffery & McChesney, *supra*.

<sup>274</sup>. EGTRRA keeps the gift tax exemption level at \$1 million per person, so the higher numbers in later years refer only to the estate tax, as things now stand.

<sup>275</sup>. Citations, Martin Sullivan. But see recent Strangi case and so on.

Two, in addition to this unified credit or exemption amount, there is the “annual exclusion amount,” presently \$11,000.<sup>276</sup> This is a per donor per donee per year amount that can be given, altogether tax-free. Once again, simple planning allows the values to be doubled, with two parents, and perhaps quadrupled, with fractional share discounts. So two parents can give each of their children \$30,000 or more worth of value each year—altogether apart from the exemption amount, just discussed, and also not including qualified medical and tuition expenses—tax free. A pattern of such annual giving, begun at birth, can easily result in each child’s having \$8 million, tax free, at her fortieth birthday: a good stake to play the Artful Dodger’s game. Skillful use of perfectly legitimate estate-tax planning advice can get tens or even hundreds of millions of dollars out of one’s estate, tax-free. So much for the once-per-generation norm.

These problems with the estate tax follow from its structure; it is a back-ended wealth tax, typically imposed when someone dies, on the wealth she has left over on her deathbed. But death is not a very sensible or efficient time to tax. Given the incentives generated by the tax’s high marginal rate structure, wealthy patrons can and do plan ahead to avoid it, making it the original “voluntary tax.”<sup>277</sup> Tax Planning 101 combines with Estate Planning 101—give early, often, and in trust<sup>278</sup>—to eviscerate the tax. It is a mistake to think that Tax Planning 101 need be practiced by narrowly selfish individuals. While dying broke is the simplest and surest way to avoid the estate tax, the borrowing in buy/borrow/die can be used to transfer wealth down to the next generation, as well. In such a case, there is no tax at all in the second (or later) generation(s). The problems of iteration can become severe. A dramatic illustration of the stakes and problems has been the recent trend, initiated by estate-planning practitioners, to have states repeal the hallowed Rule against Perpetuities, so as to allow wealthy benefactors to set up “dynastic”—that is, potentially infinitely

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<sup>276</sup>. IRC § 2503.

<sup>277</sup>. Cooper and my NTJ.

<sup>278</sup>. See Fair Not Flat at.



lived—trusts.<sup>279</sup>

Now it still may, and has, been argued that an estate tax, with all of its holes, is better than nothing. This is parallel to the consequentialist objection to income tax reform, considered above: the income tax may be rather ineffective at getting at capital, but at least it tries, and so we must retain it in the name of fairness. The support for the estate tax similarly follows from the implicit acceptance of this yield-to-capital norm: any taxes that get at capital are better than nothing. Within the traditional view, a consumption tax is the “nothing” in this choice set, because it does not get at the yield to capital at all, and so advocates of the yield-to-capital norm cling to whatever is left of the income and estate taxes.

Fortunately, we do not have to face the choice of an ineffective estate tax or nothing. The new understanding of tax changes things. When we get the fair timing of tax down right, we will see that there is a better way—and time—to tax than either the moment of initial earnings, or the time of ultimate death.

### C. Corporate taxes too

The corporate income tax, like the gift and estate tax, has been defended as an important “backstop” to the personal income tax.<sup>280</sup> The argument is that the corporate income tax gets at wealth that is left in the corporation—a tendency aggravated by *Macomber*—and so cuts against the deferral of the realization requirement. The desire to have a backstop to the basic income tax reflects the normative commitment to taxing capital and its yield, and an understanding that the actual income tax falls far short of implementing this goal. Yet, even less so than the gift and estate tax, the corporate income tax is not a satisfactory backstop to the income tax. Like the gift and estate tax, the corporate income tax is porous and avoidable.<sup>281</sup>

But there is a much deeper problem with the corporate income tax. It is the

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<sup>279</sup>. Citations.

<sup>280</sup>. Citations, including *Avi-Yonah*, *supra*.

<sup>281</sup>. Citations, statistics and analysis.

problem of incidence—of who, really, bears the burden of the tax. Corporations are legal fictions; only real people pay real taxes. Thus the dollars remitted to the government on account of corporate taxes must come out of someone's pockets, somewhere along the line. There is a great deal of uncertainty on this matter among sophisticated public finance economists. There are two broad candidates, and each is problematic in terms of the fairness of tax. Some models suggest that some or all of the real burden of the corporate tax falls on wages or consumption, adding to—not counterbalancing—the general bias of the status quo, towards a prepaid consumption tax.<sup>282</sup> The corporate tax becomes a wage tax in drag. Other models suggest that some or all of the corporate tax falls on capital. This cannot be specific, however, as in a naive partial equilibrium model: it cannot be the case that the particular owners of particular corporations see the corporate income tax come out of their pockets. Capital is capital, and it seeks a competitive rate of return. Thus pricing or capitalization effects equilibrate the markets after the corporate tax falls, so that all capital bears a competitive after-tax rate of return. In other words, the incidence of the corporate income tax, to the extent it falls on capital at all, must be felt rather generally in all accessible capital markets.<sup>283</sup>

In this very generality lies a problem. Those who see the corporate income tax as an important “backstop” to the income tax see it as an important tax on capital. Yet the new understanding of tax has shown us that we do not want to tax all capital, all the time. This leads to a particular critique of the corporate tax: to the extent it falls on capital at all, it is not an individuated tax—it fails Vickrey's (and out) test for progression. The burden on capital makes it just as hard to engage in the kind of ordinary savings, smoothing transactions that ordinary moral intuitions favor, as well as in the kind of elevating, shifting transactions that these intuitions want to reach—it does not split the ordinary-savings and yield-to-capital norms. It also does not make any differentiation based on the level of the beneficial owner's income, consumption, or wealth: it is a crude one-size-fits all, a flat tax in essence, like the current capital

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<sup>282</sup>. Arnold Harberger, an early advocate of the view that some or all of the burden is borne by taxes, now feels it is mostly borne by labor. See article in Bruce email file.

<sup>283</sup>. See most recent Harberger, etc.

gains or corporate dividend tax.

If corporate taxes are to be justified, it must turn on the political economy, or the psychological political economy, of hidden taxes,<sup>284</sup> and not on the principled taxation of capital. Corporate taxes are simply far too crude a mechanism to effect individuated fairness in getting at the yield to capital or anything else.

#### **D. State and local taxes**

Roughly one-third of all taxes in America are collected at the state and local level.<sup>285</sup> These, too, ought to play a role in any general theory about the fairness of tax.

The three largest state and local taxes are sales (36 percent of total), property (29 percent) and income (27 percent) taxes.<sup>286</sup> State and local income and property taxes are itemizable deductions under the federal personal income tax, somewhat lessening their sting, both in terms of bottom-line dollars and their contribution to the overall progressivity of the system.<sup>287</sup> The largest state and local tax in the aggregate are sales taxes. At first glance, sales taxes are paradigmatic of the postpaid consumption tax, the point towards which the fair timing of tax is headed. But here is a place where the traditional view of tax still holds. Because state and local sales taxes are *flat* taxes, they are indeed equivalent to wage or yield-exempt taxes, as the

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<sup>284</sup>. Cognitive theory etc.

<sup>285</sup>. In 1999, state and local governments collected approximately \$816 billion in taxes (STATISTICAL ABSTRACT OF THE UNITED STATES 2002, Table 420), whereas the federal government collected \$1.828 trillion (Id at Table 454). Of the \$2.644 trillion total, state and local taxes accounted for just over 30 percent.

<sup>286</sup>. STATISTICAL ABSTRACT 2002 at Table 420 (the figures for income taxes seem to include corporate as well as individual, and so overstate the effect of the latter. Compare Id at Table 417).

<sup>287</sup>. IRC § 164. See Stark, UCLA Law Review (forthcoming); McCaffery and Baron, Uncovering Hidden Taxes.

traditional view, and Ant and Grasshopper, helped us to see.<sup>288</sup> The reason to care about the fair timing of tax—the reason to push this concern up in the epistemology of tax—is to preserve and indeed strengthen the tax system’s commitment to progressivity in effective tax burdens.<sup>289</sup> State and local sales taxes more or less moot the point.

The remaining state and local taxes do not offer much of an antidote to what is happening on the federal side. State and local income taxes tend to simply and by rote track the federal income tax, and thus contain all of the holes in the commitment to taxing savings we have been exploring. This leaves state and local property taxes, which do indeed effect some degree of progressivity, being based on the assessed value (or initial purchase price)<sup>290</sup> of real or personal property. But real property taxes, by far the major part of property taxes, tend to finance local public goods,<sup>291</sup> and often get “capitalized” into the values of homes. Not even factoring in the income tax deductibility of these payments, the equities of state and local property taxes are rather crude, at best.

#### **E. Summing up: A voluntary tax**

Add together the so-called income tax, considered in the last Part, and the panoply of taxes considered in this Part, and this is what we have in America in the early years of the 21<sup>st</sup> century: a highly burdensome wage tax, at compressed tax rates. The major tax is the federal personal income tax, but this is increasingly equivalent to a prepaid consumption or wage tax, at historically (and relatively) flat rates. The payroll tax is by far the second biggest tax in the landscape, and it does not even pretend to be anything other than a wage tax. State and local taxes scarcely even try to posit a counter-trend, and indeed tend to rely on flat sales taxes. The two federal taxes that aim at capital—the gift and estate and corporate income taxes—are

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<sup>288</sup>. Of course could reach the supra-normal returns, Gentry and Hubbard, Warren, Weisbach et al.

<sup>289</sup>. See *infra* Part VII A. and I..

<sup>290</sup>. As in California, under Prop 13, explain.

<sup>291</sup>. Tiebout etc.

scattershot affairs at best, small in their magnitude, fairly easily avoided, and in any event crude in their ultimate equities.

In sum: Taxes on beneficent transfers scarcely exist. Taxes on capital are easily avoided, virtually voluntary. Taxes on wages are high and inescapable. This is where we have come, guided by the traditional understanding of tax. Where to, next?

### VII. The Fair Timing of Tax

**T**raditional tax policy endlessly debates the income versus consumption tax. It equates both forms of consumption taxes, which it sees as exempting the yield to capital (or, sometimes, falling arbitrarily on it) by design and on principle. Under the traditional view, the only hope to satisfy both an ideological and an ordinary moral intuition to tax the yield to capital—to see this source of value as an appropriate, indeed compelling, object of taxation, as the domain of the economically fortunate—is to cling to an income tax. Faced with various flaws and gaps in the actual income tax, the traditional view nonetheless insists on retaining its form, shoring it up wherever and whenever possible, and backing it up catch as catch can with such supplemental taxes as the gift and estate and corporate income ones. Meantime, consumption tax advocates, standing on principle and on the other side of a perceived great divide, clamor for flat-rate consumption taxes, holding true to Mill's anti-double tax argument.

While theory fiddles with the same old debates, the tax system burns. The practical income tax is a practical failure. It is too complicated, inefficient and, worst of all, unfair. While some of this failure can be blamed on special interest politics and other ills of modern life, another culprit lies close at hand, like Poe's purloined letter: theory, most importantly the traditional view of tax itself. The practical failure of tax relates in considerable part to its analytic structure, which is not that of an ideal income tax at all. What we have in tax is instead a hybrid income-consumption tax, an incoherent income-plus-realization tax. This structure is not simply random, a function of forces external to tax. It relates rather to deep and persistent doubts about the income ideal, with its pervasive double taxation of any and all savings. When we take a closer look at the analytic muddle of tax, we understand that we do not have, have

never had, and will never have a pure income tax, largely for the reason that we do not want one. The Tax Reform Act of 1986 provided the ultimate proof of this pudding: a systematic, comprehensive attempt to restore an “income” ideal that touched none of the planks in what I have identified as Tax Planning 101, the basic buy/borrow/die tax avoidance advice for those with stores of financial capital. Whereas the traditional view of tax holds up the Tax Reform Act as a shining light on the income side of the great divide, the new understanding of tax casts a clearer light. The law left us with a prepaid consumption tax. The succeeding years have brought us closer still to a flat wage tax.

The traditional view of tax would have us be forever doomed to some such uneasy compromise. For we are—it would seem to the traditional view—of two minds when it comes to the taxation of savings. With one mind, we want to tax the yield to capital, and hence we cling to the forms of income, corporate income, and gift and estate taxes. But with the other mind we do not want to tax savings, and hence we riddle the so-called income tax with exclusions and deductions, and lack the will to strengthen the structural flaws applying to the taxation of the yield to capital. The realization requirement alone is more than sufficient to doom the whole enterprise, but the plethora of ad hoc, pro-savings devices confirms the theme. We live with the practical incoherence, patching it up here and there. We fail to see an emergent forest, so consumed are we with the trees and even the shrubs and the weeds of tax, and so ill-suited are our maps to any better future.

The new understanding of tax liberates our minds from the grip of theoretical incoherence that dooms the present practice of tax. Under progressive marginal rates—the most important element of a comprehensive individuated tax system, its foundational commitment, its *raison d’etre*—the two forms of consumption tax are not equal. A progressive postpaid consumption tax does fall on the yield to capital, and not arbitrarily. Its judgments turn consistently and on principle on the use of capital transactions. Normative reflection first identifies and then reconciles the ordinary-savings and yield-to-capital norms. It turns out, *mirabile dictu*, that the people are of one, not two minds—with two norms, not one—when it comes to the taxation of capital and its yield. It seems fair and appropriate to burden capital transactions when these facilitate or enable a better lifestyle, reflecting a greater “ability to pay” or more

“benefits received” from the social compact. But it does not seem fair and appropriate to burden capital transactions when they are used simply and sensibly to move around in time uneven labor market earnings. These are ordinary moral intuitions that theory can easily accept, in a Rawlsian reflective equilibrium.<sup>292</sup>

The real, practical choice in broad-based tax design is not between an income tax, with its theoretical double taxation of any and all savings, and a consumption tax, with its yield exemption of any and all savings. The real, practical choice is to retain the status quo, with its uneasy compromises, slouching ever further towards a prepaid consumption tax; to move consciously and explicitly towards a prepaid consumption tax, including by means of a flat-rate sales tax, its rough equivalent; or to change direction, and move consciously and explicitly towards a progressive—even a *more* progressive—postpaid consumption tax. Sweeping aside once and for all the intellectually and ethically untenable first option, this is a choice of when to impose a single tax. Notwithstanding the traditional view, which had equated pre- and postpaid consumption taxes, the choice matters—critically—under progressive rates. And the battle—the challenge of the fair timing of tax—is all about progressivity.

Now we can get back to the basic question for the determination of the fair timing of tax:

When, in a taxpayer’s flow of funds, is it fair and appropriate to levy progressive taxes?

We can see more clearly what the phrase “flow of funds” means, and what the choices are. We can tax people as they earn or as they spend, on in-flows or on out-flows. The question becomes, under progressive rates, what difference it all makes. This penultimate Part takes what has preceded it—a new, better understanding of the analytics of tax, of where we are and why—and moves it into the normative; it attempts to extract an *ought* from the nightmarish *is* of tax today. It answers, in a moral and political fashion, the question of the fair timing of tax.

#### **A. A better, if less sophisticated argument**

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<sup>292</sup>. See RAWLS, A THEORY OF JUSTICE and POLITICAL LIBERALISM, *supra*.

Andrews's "best, most sophisticated argument" for a consumption tax tracked Mill's earlier observation about double-taxation, which in turn had roots as far back as Hobbes.<sup>293</sup> Andrews's was primarily a horizontal equity argument, about preserving the pretax equality between present and deferred consumption, between spenders and savers, Ant and Grasshopper. Mill had elegantly made the point at a time when taxes were few and rates were low.

A century and a half after Mill, things have changed. We have a better understanding of capital markets. More important, tax has expanded greatly in scope, and high tax rates—certainly compared to any Mill himself contemplated—are here to stay. These changes ought to lead to a rethinking of the grounds for consumption tax. Under progressive marginal rates, a postpaid consumption tax does not feature yield exemption. Nor does such a tax operate randomly. Capital market transactions that elevate lifestyles bear a higher burden of tax; those that smooth or diminish lifestyles lower the burden. This pattern of effect on the yield to capital is not a reason to abandon postpaid consumption taxation or progressive rates. Far from it: on the better understanding of tax, it gives a reason to support each. It is the argument structure for a consumption tax, of the right sort, that needs repair. A progressive postpaid consumption tax need not preserve the pretax equality of savers and spenders, and need not increase savings or the aggregate capital stock at all. The tax needs a better if less sophisticated argument to justify it. Fortunately, this lies at hand, in common sense and ordinary moral intuition.

The answer falls not far from the right question: in the fair timing of tax. Under the new understanding of tax, the great divide is between taxes on inflows and taxes on outflows. The income and the prepaid consumption taxes stand together on one side of this divide, opposed by the postpaid consumption tax. Prepaid consumption and income taxes each make their decisions about the fair burden of tax at the time of inflow into a household; the difference is that an income tax includes capital market yields (as well as, possibly, beneficent transfers<sup>294</sup>) whereas the prepaid consumption tax includes labor market earnings alone. But as Figures 1-6 illustrate,

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<sup>293</sup>. Citations, to LEVIATHAN and so forth.

<sup>294</sup>. Kahn & Kahn.



and common sense confirms, the pattern of inflows is, from a moral point of view, arbitrary. Predicating progressivity on inflows means that one's effective tax burden turns on matters of luck and whim vis a vis the timing of inflows. This affects choices of life plans—it discriminates based on patterns of study, work, and leisure, having little or nothing to do with command over material resources, ability to pay, or benefits received. At the same time, the income tax constrains the progressivity in the design of the tax system, the very thing an individuated tax system ought to be facilitating. Progressive wage taxes can only be avoided by not working, which imposes a cost to the wider society without apparent benefit.<sup>295</sup> There is no way out.

A consistent progressive postpaid consumption tax in contrast makes its decisions about the appropriate degree of progressivity at the right—fair—time. It falls on outflows, on spending. Such a tax favors (or does not disfavor), capital *smoothing* transactions, but imposes a tax—in the form of the higher effective progressive rates—on lifestyle enhancing or capital upward *shifting* transactions. There is luck in what happens in capital markets—as there is luck, too, in labor market earnings and beneficence<sup>296</sup>—but, importantly, this is luck that relates to the very reasons for deciding on the appropriate burden of taxation, luck that goes to command over material resources, ability to pay, benefits received. It is not the morally insignificant luck over the timing of the receipt of material resources; it is the morally significant luck that goes to the extent of that very control.

A consistent postpaid consumption tax is source neutral in an appealing sense; it falls equally on labor market, capital market, and beneficent transfers, provided that they are used to elevate a taxpayer's lifestyle. It does not matter what, exactly, supports an individual's standard of living. All that matters is that something did. Hence the animating norm of the tax is solidly a *vertical* equity one, looking to a consistent, meaningful, observable, and comparable measure of inter-personal well being. Among many other practical virtues, the tax can finesse questions of the precise

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<sup>295</sup>. I have speculated elsewhere that a society that wished to reduce its citizens' working might indeed welcome such an incentive. McCaffery, *Being the Best We Can Be*, supra. But this does not strike me as a compelling reading of contemporary American norms.

<sup>296</sup>. Rawls natural lottery of talents and so on.

source of wealth or income—whether it was derived from labor, capital, or beneficence. This is a significant improvement on the status quo, in both theory and practice. Within lifetimes, much effort today goes into dressing up labor earnings in capital clothing: through the use of stock options, say. A consistent postpaid consumption tax does not mark the distinction. Across lifetimes, wealth can be transferred either by financial and physical capital, or by human capital—the children of the wealthy tend to get better (more expensive) education, better networks, more job connections and so forth.<sup>297</sup> Again, the postpaid consumption tax does not mark the distinctions. Financially privileged lives are taxed, on account of the privilege, however financed.<sup>298</sup> The practical virtues coincide with a moral, theoretical appeal.

For the most part, taxpayers do smooth. But a consistent progressive postpaid consumption tax as I have described it (that is, without a mechanism such as Vickrey’s cumulative lifetime averaging to modify or define it)<sup>299</sup> determines its level of progressivity on the basis of taxpayer’s actual consumption patterns, whether taxpayers have smoothed or not. Just as such a tax system allows taxpayers to lower the burden of taxation by smoothing, it penalizes them, at the margin, for not smoothing. The next section shall consider the question of why the tax system should expect a taxpayer to actually smooth, as opposed to performing the smoothing by operational fiat, in the manner of Vickrey’s cumulative lifetime averaging. This is a practical question, with practical issues being paramount in its answer: a postpaid consumption tax with cumulative lifetime averaging is, after all, a postpaid consumption tax. But first there are questions at the level of ideals: what is morally compelling about one’s spending level, in general, and, in particular, about average annual labor market earnings, in constant dollar terms? A consistent progressive postpaid consumption tax makes its decisions of the appropriate level of taxation on the basis of the former, and allows

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<sup>297</sup>. See John Langbein, *The Twentieth Century Revolution in Wealth Transmission*, Mich. L. Rev., and explain.

<sup>298</sup>. In this regard, a consistent progressive postpaid consumption tax operates as a better, more practical “privilege tax” than the specifically designated tax discussed by Bruce Ackerman and Anne Alstott in *THE STAKEHOLDER SOCIETY*.

<sup>299</sup>. See Vickrey, *Cumulative Averaging*, *supra*.

capital transactions that effect the smoothing to the latter to lower the burden of taxes. Why?

One, spending, as already suggested, reflects a fair and objectively observable measure of a taxpayer's standard of living, command over material resources, ability to pay, and benefits received. Spending turns on importantly voluntary, autonomous decisions, as Adam Smith suggested, rather than the impersonal, external factors that affect the timing of inflows.<sup>300</sup>

Two, and related, capital transactions that smooth uneven labor market earnings do not reflect greater ability to pay, benefits received, or command over resources. They are simply the means by which one finances her lifestyle through time, dealing with the particular patterns of human and financial capital realizations. Using a smoothed consumption line as an analytic baseline allows us to see two effects of a consistently progressive postpaid consumption tax in its interaction with capital market transactions. First, taxpayers who fail to perfectly smooth can pay a price for their uneven spending profile; this is discussed, as the "paternalistic push" of the system, in the next section (though, again, it can be eliminated through cumulative averaging within the postpaid consumption tax system). But, second, and much more important, taxpayers who can do better, in material terms, than their average annual labor market earnings will see the value that enables them to do so—whether from capital market or beneficent transactions—taxed at a higher rate. If the combined present value of one's lifetime annual consumption exceeds that of one's aggregate lifetime earnings, something has happened to allow the taxpayer to elevate herself, in material consumption terms. The smoothed consumption line accepts the best lights reading of Mill's argument against "double" taxation, and Andrews's case for preservation of the pretax equality of savers and spenders, while at the very same time conceding the most powerful criticism of Warren and others, namely that those who receive a return to capital are better off, in terms of their command over material resources, than those who do not. If capital has made one richer, viewed in a wide lens of time, the yield-to-capital norm (and vertical equity generally) demands that we tax the yield; if capital

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<sup>300</sup>. Citations, including Smith, and my own discussions of voluntary, beginning with Cognitive Theory, also Lotteries and Voluntary tax? Revisited.

transactions have merely moved resources around in time, the ordinary savings norm (and horizontal equity generally) demands that we not burden its yield. The smoothed consumption line as a baseline for choosing the *level* of progressivity imposed is a principle imperfectly reflected in our present practices, most importantly in regard to retirement savings.

The bottom line, normatively, is what strikes us all as fair.<sup>301</sup> A prepaid consumption tax—like the current “income” tax—makes its judgments on the appropriate level to tax on the basis of labor earnings alone. It would ignore all the sources of enhanced lifestyle from capital markets or beneficent transfers and penalize those with temporally uneven labor market earnings. A progressive postpaid consumption tax makes its decisions about the appropriate level of taxation on the basis of outflows. This means that capital transactions that smooth out uneven labor market earnings will lower the burden of taxation; both capital market and beneficent transactions that finance greater lifestyles than own-earnings would allow raise the burden.

Thus the best, most sophisticated argument for a consumption tax, of the right sort—a progressive postpaid consumption tax—is that this tax makes its judgments about the appropriate level of taxation at the right time, allowing for a fairer, more enduring degree of progression in tax burdens in both theory and in practice, and differentiating between savings and investment activities that simply move around labor earnings in time and those that facilitate greater levels of consumption, alone among major comprehensive tax options. This is not as neat and elegant an argument as Andrews’s “most sophisticated” one. It does not pivot on any simple, handy turn of phrase. But it is a better argument. It connects the fairness of the tax base question—income versus consumption, of both forms—to the issue of progressivity by means of the fair timing of tax. It thus not only reconciles the two appealing norms about the taxation of savings—the ordinary-savings and yield-to-capital norms—but it also allows for a better, fairer, more meaningful and enduring progressivity in tax burdens. This is true both internal to the tax system or base in question, and external to it. Internally, a consistent progressive postpaid consumption tax tethers its decisions

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<sup>301</sup>. See McCaffery, *Being the Best We Can Be*, supra.

on the appropriate level of taxation to the objective, observable, meaningful variable of personal spending. Externally—as a matter of tax system design—a postpaid consumption importantly allows for more progressivity in tax burdens.

We can continue to understand this better if less sophisticated argument by looking at four tax systems: an ideal income, an income-with-realization, a prepaid consumption, and a postpaid consumption tax. Let us consider each in terms of how they interact with two phenomena: first, the various sources of wealth, second, the various uses of capital transactions. In all cases, we are concerned with two factors: what is included in the base, and when. But we should also have in mind at all times the how much question, for the decisions about what and when to tax have a decisive impact on the possibilities for the rate structure.

#### 1. *Sources*

We have considered the three principal (and exclusive) sources of inflows into a household: labor market earnings, capital market returns, and beneficent transfers.

An ideal income tax includes both labor and capital market returns in the base, and possibly also beneficent transfers,<sup>302</sup> and all at the time of inflow.

An income-with-realization tax also includes labor and capital market returns, and possibly also beneficent transfers, but it postpones the timing of the taxation of capital returns until the moment of realization—a gap that we have seen can lead to the effective evisceration of all taxes on capital, making an income-with-realization tax into an effective prepaid consumption tax. It relaxes the time for the inclusion of the returns to capital, fatally to its basic commitments in regard to the tax base.

A prepaid consumption tax includes only labor market returns, and at the time of initial earnings.

A postpaid consumption tax, in contrast, falls on ultimate outflows. Thus it includes labor and capital market returns and beneficent transfers to the extent these are used to finance consumption, but all at the moment of spending. This means that

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<sup>302</sup>. Kahn & Kahn and Simons and note, cross refer.

capital market transactions that are used to smooth out labor market earnings reduce taxes, under progressive marginal rates; capital market transactions that lead to greater expenditures—capital returns above the “opportunity cost” of capital or its inflation-adjustment<sup>303</sup>—increase taxes. Similarly, beneficent transfers that flow downstream, as it were, reduce taxes; those that flow upstream increase them.

## *2. Uses of Capital Transactions*

Consider next how the four possible tax systems impact the uses of capital market transactions.

An ideal income tax doubly taxes all the yield to capital, from whatever source and however used. It thus burdens both capital shifting and smoothing transactions.

An income-with-realization tax slips into being a prepaid consumption tax, which ignores all uses of capital. The actual income tax accommodates some backwards smoothing through its ad hoc savings provisions, as for retirement, medical, and educational savings accounts, but does so inconsistently.

A consistent prepaid consumption or wage tax, like the payroll tax system, ignores all capital transactions.

A consistent progressive postpaid consumption tax, in contrast, differentiates among capital market transactions. Capital transactions that smooth uneven labor market earnings, backwards or forwards in time, consistently reduce the burden of taxation under progressive rates. That tax differentiates among capital transactions that shift consumption patterns obtainable on the basis of labor market earnings alone on the basis of whether these are upwards or downwards shifting: the tax increases on upward shifting transactions, and diminishes on downward shifting ones.

### **B. Vickrey’s cumulative lifetime averaging, compared**

A consistent postpaid consumption tax is not the only means of effecting smoothing or averaging to avoid the problem of the uneven time-path of labor market (and other) earnings. Vickrey proposed a mechanism of smoothing by accounting

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<sup>303</sup>. Gentry and Hubbard and note and explain.

conventions, a “cumulative lifetime averaging” technique that helped to put tax burdens on what Vickrey took to be a normatively appropriate lifetime basis.<sup>304</sup> *Blueprints* also contained some discussion of the idea.<sup>305</sup> Despite Vickrey’s frequent protestations to the contrary, the idea is complicated in practice. It entails choosing a certain period for smoothing, adding up cumulative income (or consumption) within the period, subtracting previously taxed income (or consumption) and then applying a rate structure, which could lead to negative taxes (refunds) as well as positive taxes (payments) in the immediate period of the return. Human events such as marriage, divorce, and death were subjects of some concern. And so on. A consistent progressive postpaid consumption tax without cumulative smoothing is far easier to implement.

Let us set aside, however, these practical or second-best concerns for a moment. For present purposes, imagine that Vickrey’s proposal could be implemented seamlessly, by summing up lifetime income, dividing by the years of the taxpayer’s life, and basing a payment (annual or lump sum) on the average annual income level. So stated, there are two issues at the level of first-best or ideal theory to differentiate the proposal I am pressing, for a consistent progressive postpaid consumption tax, from Vickrey’s proposal for cumulative averaging—though we importantly share the end of effecting meaningful progression in the allocation of tax burdens, and hence have much more in common than sets us apart.

One, Vickrey’s plan is set in the context of an *income* tax, where the problem of uneven earnings is made more acute by arbitrary patterns of financial capital realizations. Taxing the yield-to-capital consistently throughout a lifetime, however, effects a smoothing in it, by design, such that an income tax with cumulative averaging begins to resemble a consistent postpaid consumption tax. The simplest way to see this point is that if a taxpayer balances her books within her lifetimes—neither leaving nor receiving any net beneficent transfer—then lifetime income equals lifetime consumption

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<sup>304</sup>. See William Vickrey, *Tax Simplification Through Cumulative Averaging*, 34 *LAW & CONTEMP. PROBS.* 736 (1969) [hereinafter Vickrey, *Cumulative Averaging*].

<sup>305</sup>. See *BLUEPRINTS*, *supra* note --. [work in Bradford cites here]. Thanks to David Bradford and Jim Hines for a discussion of this and related points.

(consider the Haig-Simons definition, across a lifetime, with no net savings), and Vickrey's averaging mechanism effects smoothing by fiat. So there is no difference between a Vickrey-income tax and a postpaid consumption tax for those who do not save; the choice—again all in first-best theory—turns on what we think of inter-generational smoothing activity. Certainly here reasonable minds can differ. I think the point is largely moot, because it is the practical difficulties of Vickrey's proposal that doom it. But, in theory, one could certainly argue that an incentive to transfer wealth across generations in a smoothing fashion—or, equivalently, the absence of an incentive to consume excessively in the present generation—is a good thing.<sup>306</sup>

Two, a difference between the proposal for a consistent progressive postpaid consumption tax and Vickrey's cumulatively averaged income tax relates to the taxation of consumption itself. A move to a consistent postpaid consumption tax avoids the problem of having the morally arbitrary pattern of labor market (or, under the income tax, labor and capital market) returns dictate the level of progressivity. But it only does so if the taxpayer actually does smooth. Vickrey might well ask, here, why the *actual* pattern of consumption should matter, as opposed to an average lifetime measure that would reflect the vertical equities of the wider view without the happenstance of uneven earnings or spending patterns.<sup>307</sup> In other words, even if Vickrey or a disciple should concede the first point, that consumption, and not income, is the right thing to cumulatively average, why should we not do the averaging within a consumption tax design? Why, that is, should the government differentiate between someone who spends an even \$30,000, every year, and someone who alternates years of spending \$40,000 with years of spending \$20,000? The Vickrey lifetime averaging mechanism, applied to a consistent consumption tax base, would alleviate this problem.

Now as with the first point, reasonable minds can certainly differ, and there is nothing in the new understanding of tax that would or should reject a cumulatively averaged consumption tax out of hand. Far from it: this is a serious idea, and an attractive means to a meaningful progressivity in tax, where the new understanding of

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<sup>306</sup>. Kaplow, *A Framework for Evaluating Gift and Estate Taxation*, McCaffery, *Uneasy Case*, supra.

<sup>307</sup>. I thank David Weisbach for his persistence in pressing this point on me.



tax aims. Once again, however, I suspect that the practical answers are decisive: cumulative averaging is too complex, and its benefits over a non-averaged postpaid consumption tax are too minor, to mandate it. But we can also proffer several arguments suggesting that an averaging mechanism is not needed, and that the relatively simple, unadjusted progressive postpaid consumption tax model is indeed an attractive ideal.

First, it is important to note that a taxpayer's smoothing need not be precise to effect lifetime tax-minimization, on account of the marginal rate bracket mechanism. The very width of the rate brackets can be set to mitigate the effect. Consider again the marginal rate structure set out in Table 2. A considerable part of the virtue of a consistent postpaid consumption tax is that there can continue to be rate brackets at higher levels of consumption, because the disincentive effects do not fall on work effort per se.<sup>308</sup> Suppose, for example, that there was a 40% bracket extending from \$100,000 to \$200,000. A taxpayer who spent \$120,000 in one year and \$180,000 in the next would bear no burden on account of not consuming an even \$150,000 in each year.

Second, capital market mechanisms can easily and effectively deal with many consumption-smoothing problems, such as consumer durables, an issue that haunted Andrews and *Blueprints*.<sup>309</sup> The problem here is that a taxpayer who makes a large purchase in one year, say of a house or a car, will show a certain "lumpiness" in her consumption, which might indeed trigger higher taxes under a consistently progressive postpaid consumption tax. But capital transactions, such as leasing or buying over

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<sup>308</sup>. This is a point I have made elsewhere. See Edward J. McCaffery, *The Tyranny of Money*, 98 MICH. L. REV. 2126 (2000). See also ROBERT FRANK, *LUXURY FEVER* (1999). It also relates back to the first argument contra Vickrey, specifically his use of an income tax base as default. A well-designed tax system, I have and am arguing, should allow an "escape valve" for excessive lifetime earnings—it should allow and perhaps even encourage the wealthy to continue to work and save, hoping that they *not* spend their "surplus" funds on themselves. A tax system that taxes spent and unspent resources does not do this; it disincentives work effort by those who have already funded their own generation's needs and wants.

<sup>309</sup>. Citations.

time, can fairly readily solve these problems—in a manner that self-help labor market averaging is not always possible.<sup>310</sup> Rather than spending \$20,000 on a car in a single year, for example, a five-year payment plan will effect a \$4,000 annual charge. And housing, which is a complex item to tax under any broad-based tax, because of its mixture of consumption and savings elements, can be handled in several different ways to avoid the specifically lumpy consumption problem.<sup>311</sup>

Third, once the modifications suggested by the first two points (wide rate brackets and capital market transactions) are understood, a strong argument exists that the pattern of household consumption is *not* morally arbitrary. Spending level is importantly a matter of choice, and one that affects the wider body politic.<sup>312</sup>

Fourth, and related, there are paternalistic reasons to try to get individuals actually to smooth their consumption—certainly a good deal of current American social economic policies are designed with this goal in mind, not the least being the forced retirement savings effected by the social security system.<sup>313</sup> Whereas Vickrey, as a classical economist, was drawn to the neutrality of the income-averaging scheme—it does not matter whether a taxpayer does smooth; all taxpayers with equal lifetime material resources, measured in constant dollar terms, pay the same lifetime tax, however they choose to spend their wealth—ordinary moral intuitions may question this. It is prudent and good to live within one’s means, to borrow sensibly in youth and to save responsibly in mid-life.

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<sup>310</sup>. See MCCAFFERY, FAIR NOT FLAT, *supra* note --.

<sup>311</sup>. See BLUEPRINTS, ignoring the imputed income of home-ownership “for reasons of simplification” (citation and explain); FAIR NOT FLAT, *supra*, etc.

<sup>312</sup>. Tyranny of Money, Right to Waste. Curious that some, Rakowski and now Geier, argue against this moralism, while advocating, explicitly or implicitly, progressive income tax rates. It is difficult to see why the harm from unequal earnings is greater than the harm from unequal spending, especially when a tax system can constrain what can be done with the earnings. See also Sen. The problem of the accumulated capital itself is, of course, a different matter, that I have addressed elsewhere (Political Liberal Case, Being the Best We Can Be), and which I address again *supra*.

<sup>313</sup>. Weiss, Fried.

Once again, to be clear, and fair: these various arguments against Vickrey's very clever cumulative lifetime averaging proposal, at least when set in the context of a consumption tax (that is, after the first point, on the income-versus-consumption difference, is set aside) may be more a matter of making a virtue out of a near-necessity, for Vickrey's proposal is complicated, and would make annual tax reporting more burdensome and counter-intuitive. Still it does appear as if a compelling case can be made that what the progressive postpaid consumption tax does simply, by design, is also the right thing to do.

### **C. Notes on gift and estate and corporate taxation**

One considerable practical advantage of a consistent progressive postpaid consumption tax is that it at least lessens the need for both gift and estate and corporate income taxes. These taxes have been perhaps best justified as being important "backstops" to the actual income tax's flawed instantiation of the income ideal. Both taxes reflect a desire to get at some capital; the gift and estate tax might also reflect a norm to get at at least extraordinary, large amounts of beneficence. Under the traditional view of tax, the gift and estate tax in particular is often thought to be important in any movement towards a consumption ideal: either because a consumption tax enables second and later generations to live off the fruits of a prior generation's capital, altogether untaxed,<sup>314</sup> or because a consumption tax facilitates the building up of large stocks of private capital, as Andrews maintained.

Under the new understanding of tax, things change. A consistent progressive postpaid consumption tax does fall on the yield to capital, under the right circumstances, and at a compelling time. Such a tax is also individuated, meeting Vickrey's test. Thus second and later generations are taxed, at the moment of expenditures, and the tax burden on the family will have increased if these descendants are in fact consuming at a higher level than their ancestors, although it will have lowered if the heirs are at a lower level. Arguably, this incentive to redistribute wealth

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<sup>314</sup>. Hence the "once per generation" norm of Aaron and Galper, *supra*.

within extended families is a welfare-improving one.<sup>315</sup> In any event—and this is important—a consistent postpaid consumption tax would impose a far greater, far more systematic and principled burden on inherited wealth than what obtains today, under the flawed income-plus-estate tax regime. As things now stand, under the effective prepaid consumption tax model, both present and future generations living off the yield to capital need pay *no* tax. Relatedly, I shall consider below the theoretical issues involved with large stocks of private capital, which a postpaid consumption tax might be thought to make more likely and prevalent.<sup>316</sup> But it is again worth pointing out, however, both that such large stores of capital can and do easily arise today, under the essentially “voluntary” tax on capital imposed by the income tax, and that stocks of private capital might well *decrease* under a conversion to a consistent postpaid consumption tax, because under it—unlike the status quo—consumption financed by capital will bear a positive burden of tax.

A compelling case can be made, then, to replace the current income, corporate income, and gift and estate taxes with a consistent postpaid progressive consumption tax—and all to get at the yield to capital in a better, fairer, more individuated and progressive way. Such a tax consistently taxes people, including heirs, when they spend, not when they work or save. Aside from consistency, this principle comports with ordinary moral intuitions about fairness in tax. Still, justice might be thought to require some additional tax on inherited wealth, as a freestanding matter,<sup>317</sup> either at the time and level of the transferor or in the hands of the transferee. It is worth noting, as a practical matter, that the latter might be effected by allowing earned-income allowances under the postpaid consumption tax, in effect isolating out those who live solely off of financial capital for higher tax burdens.<sup>318</sup> This adds complexity to the simpler proposal for a consistent progressive postpaid consumption tax, and is perhaps inconsistent with its best spirit, but it can be done. Similarly, untethered from the idea

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<sup>315</sup>. See Kaplow, *supra*; see also Stiglitz, as cited in *Uneasy Case*.

<sup>316</sup>. Andrews thought so; see Andrews 74.

<sup>317</sup>. Compare Rawls.

<sup>318</sup>. Compare Andrews 74, McCaffery Yale 1994.

that an estate tax is somehow needed to “save” the income tax, with its realization requirement and all, a wealth or wealth transfer tax, with a broader bases and a much reduced rate structure, can isolate out some of the perceived harms of transferred wealth without the steep distortions of the status quo.

Part of the new understanding of tax, however, is to argue for a more compelling instantiation of a source neutrality norm, as argued above. Persons with high *salaries* are benefitted in many ways, by the natural lottery of their talents, education, connections, luck, and so on. A consistent, progressive postpaid consumption tax does not differentiate between and among sources of good fortune — own or other’s labor market earnings, own or other’s capital market yields. All that matters is how one lives, in material terms. That is a fairly simple norm to implement. It is also compelling.

#### **D. The new Achilles heel**

To Andrews, and within the traditional view of tax, the realization requirement of *Macomber* was the Achilles heel of the income tax. And so it is, from the perspective of an ideal income tax. The realization requirement is the first and most important step in converting the so-called income tax into a wage tax. But from the vantage point of a consistent postpaid consumption tax, the realization requirement gets it right: there is no need to tax until and unless savings or investments are cashed out and consumed on private preclusive use. Under such a tax, and the new understanding of tax, a new Achilles heel arises: the tax treatment of debt.<sup>319</sup> It is the “borrow” part of Tax Planning 101’s buy/borrow/die that is problematic. For this is the step that allows *consumption* to escape, tax-free.

The point is especially important, because it is so poorly understood. Thus the USA Tax, the practical variant of a postpaid consumption tax that received serious legislative consideration in the mid 1990s, tragically neglected to include debt in its base.<sup>320</sup> Theoretically, the treatment of debt is essential to the fair timing of tax, to

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<sup>319</sup>. Compare argument of Calvin Jones on tax shelters, Adam Hime student note.

<sup>320</sup>. Seidman, *The Tyranny of Money*.

providing symmetry to the taxation of capital market transactions by allowing forwards as well as backwards smoothing, in the manner of Figure 2. Practically, any postpaid consumption tax that does not include debt in its base is doomed to failure, on account of the ease of the arbitrage to avoid it.

Hence it is imperative that any real-world postpaid consumption tax tackle the issue of debt. This is the single biggest practical challenge facing the tax. I believe that other perceived obstacles, such as the problem of “pre-enactment basis,” consumer durables, housing, and so on tend to be overstated.<sup>321</sup> The proper treatment of debt is essential to getting tax right.

### **E. Capital as power**

This section picks up an important and long bracketed issue. The capital norms central to the new understanding of tax are norms about cash flow—they are about how to account for the yield to capital as it comes into and out of a household, or a taxpayer’s control. But capital has another dimension as well: its mere presence, and the power and pleasure that this presence brings. What should the tax system do about the stock of wealth? It was this concern that led Andrews to recommend adding on a gift and estate tax to a consistent postpaid consumption tax, out of worries that private accumulation would grow unbearably great under a consistent consumption tax.<sup>322</sup>

I believe that there are compelling reasons, of both a practical, nonideal and an ideal nature, why this concern against a consistent postpaid consumption tax is mistaken, and that in fact such a tax can adequately meet all of society’s reasonable concerns over the private capital stock.<sup>323</sup> But it is also important to see that these are, indeed, logically distinct arguments. A tax on, or regulation of, private stocks of

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<sup>321</sup>. Citations to literature on pre-enactment basis, define, also FAIR NOT FLAT.

<sup>322</sup>. Andrews 1974.

<sup>323</sup>. These were arguments I first pressed in *Uneasy Case*, supra, and *Political Liberal Case*, supra, which I attempted to reprise in *Being the Best We Can Be*. As time has gone on I now realize that this argument should not derail the case against comprehensive tax reform; a separate argument can be had out over wealth taxes, which can as easily accompany a so-called income as a postpaid (or, for that matter, prepaid) consumption tax.

capital, at some quanta or in some cases, can accompany any comprehensive tax plan, income, prepaid or postpaid consumption. I believe that this is an argument worth having out, but it need not derail the larger debate over comprehensive tax system design.<sup>324</sup>

The practical arguments begin with the fact that the present income tax is not working well, at all, to monitor the situation of private stocks of wealth. The new understanding of tax gives a precise reason to understand why this is so: the current system is largely a prepaid consumption or wage tax, which makes little serious attempt to fall on capital or its yield. It is therefore a mistake to consider that private stocks of capital will necessarily increase under any conversion to a consistent, progressive postpaid consumption tax. Such a tax will have two large and important base-broadening features. One, there will no longer be any need for special capital gains rates, or lower rates on corporate dividends and the like. Wealth that is consumed will all be taxed at a uniform rate, just as now obtains, for example, for withdrawals from traditional IRAs and 401(k) plans. Two, consumption that is financed buy debt backed by capital will now bear a tax. I have no ready way of quantifying the magnitude of this effect, but I suspect it to be large.<sup>325</sup> Finally, too, as I shall argue more specifically below, the rate structure can increase in its slope under a consistent postpaid consumption tax. One of the animating goals of the getting the fair timing of tax down right, after all, is to increase the level of progressivity in the tax system, reversing a seemingly irreversible trend under the status quo, witnessed over a half century of tax policy changes.

These practical advantages of a postpaid consumption tax over the status quo add to the practical difficulties with any separate wealth tax, one that would apply to stocks of capital alone. Such taxes encourage consumption, of course, which seems inconsistent with the spirit of a consumption tax, but the new understanding of tax helps to show that things are not so simple. A consistent progressive postpaid consumption tax is a tax on capital in important cases, after all. But taxes on static

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<sup>324</sup>. See the Tax Law Review Symposium on wealth taxes.

<sup>325</sup>. I thank Bill Gale for related discussions.

sources of wealth are problematic, difficult and costly. Postpaid taxes are simpler.<sup>326</sup>

None of these practical, nonideal concerns would carry much weight, however, if theory suggested a large and persistent problem with private stocks of capital. As I have suggested, this is not a concern that ought either to favor the status quo, or to prevent a conversion to a more principled and progressive postpaid consumption tax. Rather it suggests possibly adding a wealth tax onto whatever major comprehensive tax system we have. Here, in the domain of theory, however, I believe that the concern over capital as power is mistaken. This is a concern, after all, best understood as going to the use of capital. A consistent postpaid consumption tax already chills the use of “private” capital to fund private preclusive use at any point in the future, through its tax rate mechanism: the future tax operates as a present lien against potential consumption. Tax rates can—and, I believe, should—increase under the more principled tax system design. The further use of private capital to achieve private benefit can be effected far more by the regulation of private capital than by its taxation. A consistent postpaid consumption tax provides a mechanism to regulate wealth. As I have written elsewhere, a postpaid consumption tax importantly redefines property rights: it changes what it means for wealth to be one’s own.<sup>327</sup> Society has a stake in the private savings accounts, and is justified in regulating them, just as it does now, with IRAs and pension plans. Simply forbidding monies in tax favored savings accounts from being used to finance personal political pursuits would go a long way—farther than the current tax system, and farther too than the current regulation of campaign financing—toward curtailing the power of private capital.

In short, the problems of private capital as private power, far from posing objections to a consistent progressive postpaid consumption tax, offer a powerful set of reasons for such a tax.

#### **F. Taking progressivity seriously**

The income-versus-consumption debate has been stuck in an all-or-nothing

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<sup>326</sup>. See Andrews 1974, BLUEPRINTS but see also Tax Law Review symposium.

<sup>327</sup>. See McCaffery, *Must We Have the Right To Waste?*, *Political Liberal Case*.



understanding of the taxation of capital and its yield, with income tax advocates wanting to tax it, and consumption tax advocates seemingly wanting to ignore it. A close and careful look at our practices in regard to tax suggests that the people do not cling to either extreme. Sometimes capital and its yield does indeed seem to provide an additional increment to value, appropriate to tax; other times it does not. The new understanding of tax shows that a consistent progressive postpaid consumption tax gets matters right, by design: it burdens capital shifting transactions, reflecting the yield-to-capital norm, but accommodates smoothing transactions, effecting the ordinary-savings norm. By getting the fair timing of tax down right, such a tax also gets the taxation of capital and its yield down right.

But the question of the fair timing of tax is more important than cleaning up the intellectual history of tax, or getting the analytics of the taxation of capital and its yield down better. Why is it important to get the fair timing of tax down right? And why in particular is a postpaid consumption tax the most attractive ideal? In the end, both these base and timing questions serve another master: that of progressivity, the first commitment of the normative, individuated tax system.

Once again the better divide is between taxes on inflows and those on outflows. Here the income and prepaid consumption or wage tax share a spot on one side, with the postpaid consumption or expenditure taxes on the other. By falling on inflows, progressive income and prepaid consumption taxes deter inflows—which mainly means labor (and, in the case of a true or ideal income, savings). But these are socially good activities, and so the tax policymaker is put to a hard choice between progressivity and efficiency. Efficiency generally wins. Thus we are slouching towards an ever-flatter wage tax system. On the other side of the divide, progressivity interfaces differently with taxes on outflows. Progressive expenditure taxes deter high-end expenditures. Individuals can escape these disincentives by saving, or by giving their wealth away to less fortunate people, institutions, family members. While I do not mean to overstate the case,<sup>328</sup> I also do not mean to understate it. Getting the timing of tax

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<sup>328</sup>. Thus, as I have addressed elsewhere, it is true that a progressive postpaid consumption tax deters the initially productive activities of those whose motivation is to one day spend it all on themselves, in a form of backwards induction. See *Being the Best We Can* (continued...)

down right opens an important avenue to rethinking and restructuring the progressivity of our tax system, the only major vehicle of redistribution left standing in our society.<sup>329</sup>

Thus, under a consistent progressive postpaid consumption tax, we should rethink the analysis of optimal taxation.<sup>330</sup> It is not optimal income tax that we should model, but optimal postpaid consumption taxes. Of course, for most Americans, living from paycheck to paycheck, the two converge, because income equals consumption for those who do not save. And in all cases, the social-welfare maximizer will still be concerned with the elasticity of labor, a productive input — especially as tax rate adjustments can keep the capital stock constant, so that the conversion to a consistent consumption tax is not about an increase in social savings, a point that the new understanding of tax helps us to see. But under a consistent postpaid consumption tax, the nature of this input ought to change, at least on the behaviors of the economically important upper classes. High marginal tax rates on high-end consumption need not deter labor efforts, as opposed to spending decisions. Such taxes will deter those who earn only to ever spend on themselves—such people will rationally backwards induce, and stop working today—but they need not deter those building up wealth for other reasons, including inter-generational altruism (yet another reason not to engraft a wealth transfer tax onto a consistent postpaid consumption tax model, or to choose Vickrey’s cumulative lifetime *income* averaging over a cumulative lifetime *consumption* averaging or the simpler general tax outlined here). The questions are technical, empirical ones, beyond the scope of the present effort. But they hold out an intriguing possibility—the very spirit behind the project of ascertaining the fair timing

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<sup>328</sup>. (...continued)

*Be, supra.* But two important points oppose this insight. One, this does not seem a compelling portrayal of most wealthy Americans. See *THE MILLIONAIRE NEXT DOOR*, and so on. Two, if society must deter some people—and large tax systems must—the challenge is not necessarily to minimize net distortions, as it is to get the right distortions. Deterring only those narrowly selfish persons bent on spending every last possible penny on themselves strikes me, on balance, as not a bad thing to do.

<sup>329</sup>. Kaplow and Shavell

<sup>330</sup>. Mirlees, Atkinson, Bankman & Griffith, explain.

of tax. If we get the form of tax right—its timing and its base—we can, at long last, get its redistributive functions down right. The embarrassments of today point us to hope for a better tomorrow.

### **VIII. The difference it all makes**

We have come a long way, using many words, covering the intellectual history of tax, the status quo, tax theory and practice, in the income and other taxes, and more. Now it is time to be brief, to list some lessons and final thoughts.

#### **A. Common errors about income and consumption taxes**

Before concluding, this section simply lists and comments on some common mistakes in the popular understanding of tax systems that have been impeding better, more fruitful discussion about tax reform.

##### *1. We have an income tax*

As the growing cognitive psychological literature abundantly well shows us, labels matter. The major comprehensive tax system in America is officially termed the “income” tax, and virtually all political discourse about it takes it as such. Yet the tax system we have is far closer to a consumption tax, because of its many omissions of taxing capital and its yield. More specifically, we are moving ever closer to a prepaid consumption or wage tax.

##### *2. The principal choice in comprehensive tax policy is between an income and a consumption tax*

A central goal of this article has been to argue that the classic income-versus-consumption debate is moot. We do not have, have never had, and will never have an income tax. The real choice is and ought to be over what form of consumption tax to have. Here the stakes are large and dramatic.

##### *3. Consumption taxes are flat taxes*

This is a confusion only really present in certain popular political discourses, but one that conservative politicians have used to their advantage. Further, it relates back to Mill, and an important theme in the tax policy literature. If the *reason* for

supporting a consumption tax is to preserve the pretax equality between savers and spenders—to effect yield exemption—then there is indeed something compelling about a flat-rate structure. That is why a large ambition of this article was to argue that this is not the right reason for a consumption tax.

*4. All consumption taxes are created equal*

All flat consumption taxes are indeed largely equal, except for the important points about infra-marginal returns to capital. But, more important, progressive consumption taxes vary greatly. A prepaid consumption or wage tax, even at progressive rates, features yield-exemption, by design; a postpaid consumption tax most decisively does not.

*5. Consumption taxes do not reach the yield to capital*

The dominant analytic point of this article is that, under progressive rates, a postpaid consumption tax reaches the yield to capital when such yield is the source of enhanced lifestyles, but not otherwise.

*6. The best argument for a consumption tax is one of horizontal equity between present and deferred consumption (that is, spenders versus savers)*

Here is where we can blame Mill, again, and take objection to Andrews's "most sophisticated" argument. Indeed and ironically, a very good reason for consumption taxes, of the right sort, is that they fall on the yield to capital under just the circumstances in which ordinary moral intuitions suggest that this is the right thing to do. But there are other good reasons for a consumption tax, of the right sort, most importantly including that a consistent postpaid consumption tax opens the door to deeper, more lasting progressivity in the allocation of tax burdens.

*7. The case for consumption taxation is a case about the importance of capital, on the individual or aggregate level*

Depending on the rate structure, there can be more, less, or the same amount of capital under a consumption as under an income tax. Indeed, in part because a consistent postpaid consumption tax facilitates more progressivity—a steeper slope in the rate structure—than we now have, it is possible that tax rates could decrease on the

lower income classes while increasing on the upper ones. In such a case we might get less savings among the poor, and more savings among the rich, which is a compelling normative endpoint (especially given a basically just society that provides basic needs and goods to all its citizens.<sup>331</sup>)

*8. Rates would have to increase under a transition to a consumption tax*

The standard income-versus-consumption debate assumes that rates would have to increase under any conversion to a consumption tax, at constant revenue needs, because the consumption tax fails to reach an element of the income tax's base, namely savings. In fact, we do not have an income tax. In moving from the status quo—the flawed income-with-realization tax—to a consistent postpaid consumption tax, there would be two large base broadening features. One, we could repeal the special rate preferences for capital gains and corporate dividends. Two, we would have a mechanism for picking up debt, and thus would add debt-financed consumption to the base. These two provisions could well offset the greater allowance of deductions for savings, especially as so little savings is taxed today.

*9. The gift and estate and corporate income taxes are important backstops to the individual income tax*

The traditional view of tax sets an income tax against all forms of consumption taxes. Most tax policy scholars and makers through the years have favored the former, for they ascribe to the yield-to-capital norm. But the status quo individual income tax disappoints, for it fails to get at the yield to capital in many and many of the most important cases. Thus the gift and estate and corporate income taxes are desired as “backstops” to the income tax, as some way of getting at the yield to capital. But in practice, these taxes are porous in the application, and unfair in their incidence. Under the new understanding of tax, we can see that a consistent progressive postpaid consumption tax does get at the yield to capital, in the right cases, in a principled and individuated manner. Thus, under it, and putting aside the analytically separable question of the problems of capital-as-power, these two further taxes are not needed.

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<sup>331</sup>. Rawls, *A Theory of Justice* and elsewhere.

### 10. *Adopting a consumption tax would be a radical change*

If one believes that the great fault line in tax policy is between an income and a consumption tax, and that we have the former, then a change to a consumption tax seems radical. But it is not. We do not have an income tax, and the only real question is what kind of consumption tax to have. Adopting a consistent, postpaid consumption tax would entail only two major steps: (1) institute an unlimited deduction for savings, along the lines of traditional IRA plans; and (2) include debt as a taxable input. At the same time, we could repeal: (1) all preferences for capital gains, corporate dividends, and the like; (2) all rules relating to “basis” (as assets would have no basis, not having been taxed); (3) the corporate income tax; and (4) the gift and estate tax. While there are important transitional concerns, such as those over “pre-enactment basis,” these tend to be overstated.<sup>332</sup>

### **B. Last Words: Tax matters**

These are dark times for the great progressive spirit in America. We have, perhaps wisely, rooted out many vestiges of inefficient and haphazard redistribution from our general social-economic laws and regulations, persuaded by a welfarist economic argument that such redistribution is best left to the tax system.<sup>333</sup> But when we look at that tax system, whose very design once served as a shining light of progressive liberalism, we see a steady retreat towards something very different from where we started. More darkly still, we seem ill-served by our intellectual armament to halt the retreat. Most people pay little or no attention to the frightening details of tax, deterred and dismayed by its dizzying complexity. Those who do know, and care, are trapped in the traditional income-versus-consumption debate. Progressives fight to maintain whatever vestiges of an income tax we have, and defend its adjuncts, the corporate and gift and estate taxes, as the last best hope for justice in tax and, by extension, in society at large. Yet these very choices are giving comfort to the enemies of redistribution, for the income, corporate, and gift and estate taxes are wildly unpopular. The tax system is drifting, seemingly inexorably, towards a flat wage tax.

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<sup>332</sup>. See Warren, Kaplow, Fair Not Flat.

<sup>333</sup>. See LOUIS KAPLOW AND STEVEN SHAVELL, FAIRNESS VERSUS WELFARE (2002).

All hope for effecting redistribution from rich to poor may soon be lost. Amidst the darkness, dramatic change seems beyond the pale; the very tinkering that has gotten us into the state of tax we are in seems to be the only procedure for going forward. “People treat a plan as realistic when it approximates what already exists and as utopian when it departs from current arrangements. Only proposals that are hardly worth fighting for—reformist tinkering—seem practicable.”<sup>334</sup>

But perhaps it is indeed darkest before the dawn. By rethinking first principles in the analytics of tax, we can come to a new understanding. An income tax is not needed to advance the progressive cause, and in fact its very structure impedes it. But all consumption taxes are not created equal. While a prepaid consumption or wage tax does indeed let capital off the social hook altogether, a consistently progressive, postpaid consumption tax gets matters just right, by design. It comports with compelling ordinary moral intuitions about the taxation of capital and its yield, and it allows for a structure in which a deep and meaningful progressivity in the allocation of tax burdens can flourish. It is not where we are headed, now, but it could be where we end up—if we get the fair timing of tax down right.

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<sup>334</sup>. ROBERTO MANGABEIRA UNGER, *FALSE NECESSITY: ANTI-NECESSITARIAN SOCIAL THEORY IN THE SERVICE OF RADICAL DEMOCRACY*, PART I OF *POLITICS*, A WORK IN CONSTRUCTIVE SOCIAL THEORY (1987) at 6.