

# TOWARD TAX REFORM

Recommendations for  
President Obama's  
Task Force

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## Where Can We Stand to Gain Perspective?

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The difficulty in tax reform lies not in finding good ideas, but in articulating principles and processes for choosing among them. Traditional concepts like equity (horizontal and vertical), simplicity, or efficiency often are reduced in practice to truisms or implicit value-laden decisions. Before debating which substantive proposals it prefers, the Volcker task force would do well to think about the tools and metrics of its decision-making process.

If one accepts as a postulate that the task force's goal is to revisit the income tax, then some important but underappreciated consequences necessarily follow that can inform the task force's thinking. Most fundamentally, income comes in only two flavors: returns to labor and returns to capital.

Tax policies typically do not break down labor income into smaller groupings. For example, we do not distinguish manual labor income from returns to the application of intellect, at least in our tax rate structures.<sup>1</sup> Moreover, we actually know a good deal about how to tax labor income, given the constraints of a

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<sup>1</sup>The literature addressing the taxation of human capital has pointed out that the tax system advantages education-intensive labor in at least two respects. First, under realization principles, the enhanced earnings potential attributable to a degree is not taxed when the degree is awarded, but only in the future as income is earned. Second, students pay for higher posteducation incomes in part through forgoing current taxable income (to attend school), thereby providing a tax subsidy to the cost of education. Those sorts of arguments leave most nonspecialists baffled. The analyses arguably also understate the tremendous variety of individual career paths — high-skill crafts can require years of apprenticeship, and many students work full time while attending school. The literature might be said also to ignore the fragility of life itself, both regarding its span and an individual's ability to capitalize on her acquired skills. In practical terms, those arguments probably will have little impact, except perhaps to point toward increasing the ability of students from lower-income households to pay tuition costs with pretax dollars, to minimize differences in outcomes attributable to differences in starting wealth.

practical tax system. Of course, there are profound questions as to the degree of progressivity that the tax rate schedule should reflect, but those are issues probably best left to the political process rather than expert advice — that is, the very purpose of the political process in this context is to serve as the mechanism through which we discover our appetite for progressivity.

Practical tax policy debates about labor income usually turn on when we should construct exceptions to the general rule, typically to serve social objectives. We can improve those decisions by turning to tax expenditure analysis. In the broadest terms, tax expenditure analysis provides a practical tool for observing when specific tax rules work to give certain taxpayers an effective government subsidy (or, in the rarer case of negative expenditures, impose a double tax on a taxpayer). The social and economic objectives and consequences of the subsidy can then be explicitly analyzed, relative to its cost. Further, policymakers can consider whether the tax system is the appropriate vehicle for that subsidy.<sup>2</sup>

Given that there is little theoretical disagreement about how to measure labor income in a practical income tax system, tax expenditure analysis is a particularly useful tool in this context. By using it, the Volcker task force can address those cases that are susceptible to straightforward cost-benefit analysis (where, for example, a subsidy is mistargeted in practice because of poor design), and it can more explicitly present to the political process the choices that lie buried in those cases that involve the weighing of intangible social values.

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<sup>2</sup>Tax expenditure analysis fell on hard times for many years, because it was widely perceived as resting on a false premise. To use this analysis, one compares current tax rules with some more comprehensive alternative measure of income. If (as was widely suspected in the past) the alternative income base itself could not be derived from universally accepted first principles, tax expenditure analysis could fairly be criticized as simply promoting the alternative base as a reform agenda, rather than communicating anything objectively helpful about current law. The Joint Committee on Taxation's staff addressed those concerns in a series of pamphlets in 2008 that proposed a comprehensive new tax expenditure taxonomy. See "A Reconsideration of Tax Expenditure Analysis," JCX-37-08 (May 12, 2008). That work is briefly summarized in my 2009 Woodworth Lecture, at *Tax Notes*, May 18, 2009, p. 925.

Most of the difficulties in designing a practical income tax relate to how to tax capital income, and in turn how to distinguish labor from capital income. Here the Volcker task force can make real conceptual progress. The fundamental insight that can guide the work is that one must take a holistic view of capital income.<sup>3</sup> The corporate income tax, capital gains tax, taxes on dividends and interest income, and even the estate tax are all taxes on capital income, not separate taxes. The goal should be to tax capital income consistently, but that cannot be achieved until these separate categories are revealed as simply empty legal artifacts of 19th-century trust law, company law, and financial accounting, not anything based on economics.

As one simple example, consider interest income. If an individual owns a Treasury bond, and interest rates decline, the future interest income is taxed as ordinary income, just as would have been the case had rates remained stable. But if the individual sells that Treasury bond in the new lower-rate environment at a gain, that gain is taxed at advantageous capital gains rates, even though it represents just the discounted present value of the same stream of future ordinary interest income. The artificial label of “capital gain” has obscured the identity in economic returns.

On the other side, if the corporate income tax in fact fairly measures and collects tax on capital income where that capital is held in corporate form, what justification is there for any CGT on the sale of corporate stock? And if the answer is that the corporate tax base is defective, is there not another more straightforward response than the rough justice of CGT on corporate stock, with all its mismeasurements and lock-in problems?

Modern finance theory teaches us that returns to capital can be divided into three species: normal returns (the basic time value of money returns that compensate an investor for deferring consumption), risky returns (the individually uncertain returns attributable to taking on uncertainty), and rents (the supersized returns attributable to a unique asset or position, such as a

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<sup>3</sup>Edward D. Kleinbard, “A Holistic Approach to Business Tax Reform,” *Tax Notes*, Jan. 8, 2007, p. 90.

valuable patent). One can debate whether all three should bear the same tax rate or whether that rate should be the same as the rate imposed on labor income, but what is important is that we move beyond the empty formalities of our inherited legal labels and begin to think in these terms.

It is possible to do so in an implementable tax system. One admittedly ambitious approach is the business enterprise income tax, which basically divides up the taxation of capital income into two responsibilities: Individual owners of capital are charged with paying current tax on normal returns (the basic time value of money returns) on their investment capital, and firms of all legal sorts (including sole proprietorships) are charged with paying tax on risky returns and rents.<sup>4</sup> The sum of the two represents a single comprehensive accounting for capital income. Another approach is the Nordic “dual income tax” structure, in which all capital income (including imputed rents on owner-occupied housing!) is taxed at a single low rate, relative to the rate imposed on labor income.

Finally, if it proposes a holistic approach to the taxation of capital income, the Volcker task force must also address how to distinguish labor from capital income. The carried interest debate of 2007 was one example of the problem. Here again good work has already been done — for example, in the Nordic structures referred to above. ■

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<sup>4</sup>Edward D. Kleinbard, “Rehabilitating the Business Income Tax” (Hamilton Project, 2007).