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TOWARD A THEORY OF FEDERAL TAXATION:
A COMMENT

Daniel Q. Posin*

SUMMARY OF THIS ARTICLE

The American income tax has come under increasing criticism because of its complexity. Various alternatives to the American income tax have been suggested, the most prominent of which is the consumption tax. This Article discusses the consumption tax and the other alternatives. This Article concludes that the reasons for the complexity of the tax system transcend the particular type of tax which is imposed. The roots of complexity of the tax system lie in the complexity of the economic system that is to be taxed, the variety of non-revenue raising uses to which the tax system is put and in the inevitable political pressures that are brought to bear on Congress as the tax-creating entity. This Article concludes that the federal income tax should be seen for what it is: an inevitably complex tax that is a mixture of an income tax and a consumption tax. This Article argues that a wealth tax should be added to the already mixed system. The wealth tax adds balance to the mixed system and taps a legitimate base of taxation which is not now subject to tax. The Article explains how a wealth tax would work in conjunction with the present system and discusses the fiscal and economic implications of it.

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COMPLEXITY OF THE PRESENT INCOME TAX

The American income tax has come under major criticism for its great complexity. The criticism has ranged from the occasional exegesis in the popular press to more scholarly critiques. Various alternatives to the income tax have been suggested in response to these criticisms. The major alternative considered first in the scholarly journals and more lately by policy makers in Congress and in the Administration is the consumption tax. Therefore it is useful first to consider the consumption tax, both as a possible alternative to the present tax and to see what insight it may provide into the present income tax.

BACKGROUND OF THE CONSUMPTION TAX

Generally, taxes can be divided into two categories: taxes that are levied on persons (including corporations and other entities as well as natural persons) and taxes that are levied on transactions. Taxes levied on persons would include such taxes as the income tax, the consumption tax, estate and gift taxes, the wealth tax, and the head tax (flat amount of tax on each person). Taxes levied on transactions would include sales taxes, stamp taxes, and the value added tax.

Taxes levied on transactions have the great virtue of being simpler to administer. Primitive societies tend to rely on transaction taxes. However, in modern, complex societies where it is necessary to raise greater amounts of revenue, and where wealth is unevenly distributed, it is generally deemed necessary to tax people based on their ability to pay. The society must keep track of individuals and the society must have a scale for measuring ability to pay.

There are three major ways to measure the ability to pay. The measure can be made according to income, consumption, or wealth. The income tax has long been regarded as an outstanding measure of ability to pay. Generally speaking, the greater the net income, the greater the ability to pay and the greater the tax that can
be extracted. The greater tax is extracted from those with higher incomes for two reasons: (1) to effectively raise additional revenues, and (2) to bring about some redistribution of wealth in the society. These two reasons have been the basis of the American income tax throughout its history. Taxing people by their ability to pay does not necessarily imply a progressive rate schedule. A proportional tax on income—everyone paying 10% of his or income—will of course cause those with higher incomes to pay more. The question of progression in rates is a somewhat separate issue which I do not address directly at this time.

The second possible way to tax by ability to pay is the consumption tax. The consumption tax should not be confused with a sales tax, which is a tax on transactions. In the consumption tax, the amount of tax levied depends on the total of the dollar value of the consumption transactions. In the consumption tax, the amount of the tax that is levied depends on the total of the dollar value of the consumption transactions in which the taxpayer engages during the tax year. Thus record is kept of the dollar value of the consumption transactions of each individual. The tax rate is then applied to this total dollar volume. The tax rate can be either proportional—10% on everybody—or, as is usually suggested, the tax rate can be steeply progressive, applying a higher and higher rate to incrementally larger amounts of consumption. Various technical reasons, discussed below, argue for a progressive rate schedule.

The consumption tax is not a recent gimmick as far as tax reform is concerned. On the contrary, the idea of taxing people on their consumption is one of the oldest and most distinguished ideas in the tax law. Thomas Hobbes, writing in Leviathan, 300 years ago, stated:

. . . the equality of imposition consists rather in the equality of that which is consumed, than of the riches of the persons that consume the same. For what reason is there, that he who labours much, and sparing the fruits of his
labour, consumes little, should be more charged, than he
that living idly gets little, and spends all he gets; seeing the
one has no more protection from the Commonwealth than
the other? But when the impositions are laid upon those
things which men consume, every man pays equally for
what he uses; Nor is the Commonwealth defrauded by the
luxurious waste of private men.

Note that one of Hobbes' great concerns was with the
man who lives off his capital. This situation carries over
to the present day as a concern with the U.S. income tax.

Over one hundred years ago John Stuart Mill argued
for a consumption tax before a committee of Parliament.
A distinguished group of economists followed Mill in sub-
sequent years in supporting the consumption tax—Alfred
Marshall in England, Pigou in France, Irving Fisher in the
United States, and Luigi Einaudi in Italy. More recently
in 1955 the British economist Nicholas Kaldor argued for
the tax most effectively in his book entitled "An Expendi-
ture Tax."

The first statement of the case for a consumption tax in
the modern American setting was by Professor William D.
article sparked a vigorous debate that continues in the law
reviews and the economic journals down to the present
time.

Thus, the consumption tax has an outstanding pedi-
gree. It is indeed an aristocrat of ideas in taxation.

HOW THE CONSUMPTION TAX WORKS

The first issue with regard to the consumption tax in-
volves keeping track of each person's consumption during
the year. Indeed the practicalities of implementing a con-
sumption tax were of great concern to many of the early
economists who were writing on this subject.

But keeping track of everyone's consumption is not as
hard as might first appear. It is generally agreed that the
way a consumption tax would work would be that account
is first kept of each individual's income. This of course is
something that taxpayers or their advisors do now. Having ascertained everyone's income, the next step is to determine what each person has saved or invested during the year, if anything. Saving or investing generally occurs in discrete blocks, for which the taxpayer gets records, so accounting for saving or investing is not particularly difficult. Then the equation is set up: Income - Saving = Consumption. It is assumed, with justification, that everything that the taxpayer received in income that he did not save he consumed. Furthermore, if the taxpayer does not save but in fact consumes some of his capital, i.e., engages in dissavings, that is charged to consumption. Dissaving, or reducing capital, is also something that can be easily kept track of. Thus the true equation for the consumption tax is: Income - Saving + Dissaving = Consumption. To the dollar amount of consumption is applied a progressive rate structure.

Comparison of the Consumption Tax and the American Income Tax

One of the insights that emerges upon consideration of the consumption tax is that the present American income tax is not really an income tax at all. Economists and students of the tax law generally agree that a true income tax would measure income according to the following formula: Income equals consumption plus saving. This is the well-accepted definition of income first propounded by the economist Henry Simons in 1938.

When viewed in that light it is clear that the American income tax is not a pure income tax. While the American system does prima facie tax income, it contains very many of the elements of a consumption tax. Consider again the formula for income: Income = Consumption + Saving. For the man who consumes everything he earns, the income tax comes to be the same as the consumption tax. The two bases are the same in that case. This is the situation indeed for a great many people in the American economy. For those who do manage to save a little, the
amount of saving is small compared to the amount of consumption. Once again, in such cases, the income base and the consumption base come to about the same thing.

But consider the people who can save a great deal. Much of the saving in the American economy is not taxed. Unrealized appreciation in the value of assets held is not taxed. If the stock market goes up 20% in one year, the increased value in the stocks held is not taxed until the stocks are sold (and even then the tax is likely to be at the low capital gains rates). The increase in value of homes is not taxed. (Even on the sale the increase in value of the home is not taxed if various rules are complied with). The increase in value of retirement plans, IRA's, Keogh Plans, life insurance, and annuities is not taxed. Taxpayer contributions to many of these savings media are deductible and hence not taxed. Income from state and local bonds is not taxed. Favorable depreciation schedules and investment tax credit rules in effect allow income from depreciable business or investment assets not to be taxed.

What is the consequence of this? Consider again the theoretical formula for an income tax. The taxpayer is taxed on Income = Consumption + Saving. To the extent that in the American tax system savings are not taxed, the savings factor in that formula drops out. That formula then approaches Income = Consumption.

Thus it is clear that the American income tax is a mixed tax—it is partly an income tax but is also partly in important respects a consumption tax. Recently literature that has debated the relative merits of an income tax versus a consumption tax has tended to lose sight of the fact that the present-day American system is already in large measure a consumption tax. Thus most of the debate has been wide of the mark.

**REPLACING THE AMERICAN INCOME TAX WITH THE CONSUMPTION TAX**

I have thus far described the history of the consumption tax and discussed how it works in theory and practice.
The discussion has also established that the American income tax is not a pure income tax but is a mixture of an income tax and a consumption tax.

The next issue fairly addressed is: Why scrap our present mixed tax system and replace it with a pure consumption tax? I would assert that the burden of proof lies with the advocates of a consumption tax. After all, our present tax is in place and it would be disruptive to change it. Thus the advocates of a consumption tax would have to show that the consumption tax has a clear superiority over our mixed tax for them to make a case for the consumption tax being adopted.

A rich variety of reasons have been advanced to assert that the consumption tax would be a better tax than the income tax. I have alluded to some of these reasons already.

1. **Hobbes' Moral Reason**

Hobbes in the quote set forth above really suggested a moral reason, namely, that when a man saves, his capital is still in the pool of the society's capital; it is helping the society's capital to grow, and therefore to the extent that a man saves the state should not tax him. It is only, according to the Hobbesian view, when a man has drawn some resources for purely private consumption that he has actually deprived the society of capital. Only then has he benefited in some way, and only then should the state tax him.

There are several answers to this theory. First, it is inaccurate to say that amounts in saving confer no benefit on the saver. Great amounts of saving stashed away in the form of real estate or financial assets certainly do confer a benefit—the benefit of economic security. Thus there is a benefit and thus morally it could be taxed.

There is a second answer also to this Hobbesian approach. It is by no means clear that all savings build up the society. If a man buys and holds gold bars that does nothing to increase the productivity of the society. Or
suppose a man buys for $300,000 a stamp in which an airplane was printed upside down. In what way does such an investment build the wealth of the society? Such investments do not go to increase the wealth of the society. They just involve speculators moving sums of money around among themselves. Why should we allow a deduction for such investments? Yet this is what the consumption tax allows.

Perhaps a deduction should not be allowed for such non-productive investments, only productive investments. However, recall that the formula for imposing the consumption tax is as follows: Consumption (the thing to be taxed) = Income − Savings. Thus taxpayers want things to be denominated saving as much as possible. If we start splitting hairs as to what kind of saving gives rise to a deduction and what kind does not, we start to lose one of the presumed virtues of the consumption tax: its supposed simplicity, a matter about which I will have more to say presently.

2. Noncomparability of Income

One of the major arguments in favor of the consumption tax over the income tax is that when the state taxes income, it is not taxing comparable units. Consider a tenured professor of law who makes $40,000 a year. Compare him to a plumber who also makes $40,000 a year. Should these two gentlemen really be taxed the same? Might not the plumber be well advised to save some of his income, in case the demand for housing declines and he cannot find work? This has been known to happen. Whereas the tenured professor of law is free to spend everything he makes in full confidence that his income is assured for the balance of his career.

In terms of ability to pay taxes, who really has more income here—the free-spending law professor or the frugal plumber? A compelling case can be made that the law professor’s income is really worth more than the plumber’s and so the professor should pay more taxes.
The same point can be made about a variety of other sources of income. $50,000 of net rental income from a choice piece of real estate is worth more than $50,000 of salary income to a corporate executive who may have a tenuous grasp at best on his job because his company is about to be taken over.

The income tax is blind to this problem. It taxes all these people as though their dollar had equal worth. Indeed, it would be impossible to do otherwise with an income tax, impossible to make comparisons of the value of individual dollars of income based on the likelihood that such payments will continue in the future.

But the proponents of the consumption tax assert that the consumption tax sorts all this out automatically. If a plumber is worried about his future he will spend less and save more than the free-spending law professor. And so the free-spending law professor will wind up paying more taxes on a consumption base. All the varieties of security of income get washed out and we let the taxpayers themselves decide how secure they feel, how much they will spend on consumption and therefore how much tax they will pay.

It seems that the advocates of the consumption tax score a point here. The consumption tax does account for the noncomparability of income units in a way that the income tax cannot (although differences in personality will also play a role in amounts saved versus amounts spent in consumption). It is questionable whether the non-comparability of income is enough of a point in itself to cause us to scrap our present income tax, but it must be conceded that it is a point for the consumption tax. Although non-comparability is a good argument, it is questionable whether it is sufficient to effect a change in our tax system.

3. Effect on Investment

One of the earliest criticisms of the income tax as compared to the consumption tax was that the income tax dis-
couraged investment. John Stuart Mill first enunciated this criticism in his Principles of Political Economy. Indeed, Mill went so far as to suggest that the Income Tax caused savings to be taxed twice. That extreme position has been largely discredited. However, even in the present time a lively debate continues in the literature concerning the extent and the way in which the income tax discourages saving and the consumption tax encourages saving.

My response to this is what difference does it make? The significance of this criticism depends on whether the circumstances are such that savings are desirable. Sometimes it is desirable to encourage savings and sometimes it is not. For example, the U.S. economic recovery of 1982-1983 was led primarily by consumer spending. Presumably a tax which discouraged spending and encouraged savings would have dampened this recovery.

Furthermore, as discussed above, the American income tax is a mixed system where a number of things are done to encourage savings in the areas of pension plans, failure to tax unrealized appreciation, favorable treatment of capital gains, interest-free state and local bonds, accelerated depreciation, investment credit and IRA's. Congress frequently adds provisions to encourage savings.

Arguably, an ideal tax should be neutral on the matter. We want, so the argument goes, people to make decisions as to whether to save without regard to tax considerations. But neither tax is neutral on the matter. Both influence behavior in one direction or the other.

So I do not see that the consumption tax scores any great points on this issue.

**Idiosyncratic Examples: The Miser and the Spendthrift**

The proponents of each of these taxes can advance examples as to how the other tax would fail under certain sets of facts.

The supporters of the income tax can assert, for exam-
pie, that the consumption tax fails to reach the hard-working miser; i.e., the man who works and accumulates great amounts of wealth but lives very modestly. His wealth will give this man great security and indeed may even confer upon him great economic and political power. Yet this process of accumulation of wealth is only lightly taxed by a consumption tax if the man lives modestly.

The advocates of the consumption tax have several answers to this, however. Although they concede that the income tax would reach the miser on this set of facts, the income tax does nothing about already established wealth that may be inherited or that is otherwise of long standing.

Furthermore, the proponents of the consumption tax can argue that the income tax totally fails to take account of the spendthrift. Recall that Hobbes was worried about the spendthrift in the quotation set forth earlier. The man who owns vast amounts of capital and consumes it on a grand scale is taxed very lightly, if at all, by the income tax whereas the consumption tax would fall on him heavily. The most brilliant example of this is given by British economist Nicholas Kaldor, discussed above as one of the early advocates of the consumption tax. He gives the example of a man who owns millions of dollars worth of gold and sells it off a little at a time to live in a grand scale being taxed the same as a beggar, under an income tax.

Based on this discussion of idiosyncratic examples, the arguments seem to be of equal weight. Both the consumption tax and the income tax fail to reach people that, based on some standard of ability to pay, one would think should be heavily taxed. The consumption tax fails to reach the miser, and the income tax fails to reach the spendthrift.

I have the temerity to note at this point that the reason we feel that it was unjust, under the examples given above, for the miser and the spendthrift not to be taxed heavily was because they were both wealthy! I will discuss
the possibilities and limitations of a wealth tax later in this article.

4. SIMPLICITY

One of the strongest points argued for the consumption tax by its supporters is that a consumption tax would be simpler. If this were true it would be a major point, probably the most important one in favor of the consumption tax. The complexity of the Internal Revenue Code that would presumably be avoided arises from provisions dealing with the treatment of such items as corporate reorganizations, capital gains and losses, retirement plans and installment sales.

Although I agree that the complexity of the American income tax referred to certainly exists, I believe that the complexity results from the fact that the American income tax is not a pure income tax. The American income tax, as discussed above, is a mixed tax, and this contributes strongly to its complexity. For example, consider two (out of many) significant contributors to the complexity of the American income tax, which are somewhat related: (1) The favorable treatment of capital gains, and (2) the requirement of a realization in order to tax appreciated gains on property.

With respect to the first of these, if capital gains ceased to be given favorable treatment but were just taxed at the same rates as all other forms of income, then we would be spared the many agonizing definitions and rules in the Internal Revenue Code and its associated Treasury Regulations used to determine whether a particular transaction qualifies for capital gains treatment. It has been reliably estimated that if the favorable treatment of capital gains were eliminated from the Internal Revenue Code, its size would be reduced by one-third to one-half. A pure income tax would not have any favorable treatment for capital gains and therefore would be much simpler than the present American income tax on that ground alone.

With respect to the second of these contributors to
FEDERAL TAXATION

complexity, if the increase in the value of property held were taxed on an annual basis regardless of whether it was sold or otherwise disposed of, a great deal of complexity would drop out. The whole area of pension and deferred compensation tax law would drop out, as the value of amounts put aside by the employer for the employee's later use would simply be taxed in full to the employee. The whole raft of rules of tax-free exchanges on individual and corporate transactions would drop out as taxpayers would simply be taxed on the increase in value of property in their hands independent of whether they had sold or exchanged it. There are a variety of other special exclusions and deductions in the American income tax that would have no place in a theoretically pure income tax. All of these special provisions contribute greatly to the complexity of the American income tax.

Thus, as this discussion indicates, the theoretically pure income tax is a great deal simpler than is the American income tax. Moreover, the consumption tax is not without its complexities. While the formula, Consumption = Income - Saving, looks simple enough, what is to be done with the purchase of a major capital asset, such as the taxpayer's home? The proponents of the consumption tax generally agree that when such a massive amount of savings is made in one year, the appropriate approach would be to spread the deduction for such savings out over more than one year to more accurately reflect the consumption tax base. Providing rules for such a spread out, of course, involves complexity. When account is taken of matters such as this it seems fair to say that the theoretically pure consumption tax is not especially more simple than the theoretically pure income tax.

Therefore, from the point of view of complexity it might just as easily be argued that we should do away with the various imperfections in our income tax and get back to a theoretically pure income tax as that we should go to a consumption tax. When put in that light it becomes clear that we are not going to get rid of the complexity in
our tax system any time soon. The same forces that give rise to complexity in the income tax will give rise to complexity in the consumption tax, if it is enacted. These forces arise from the pervasive nature of the federal tax system. In a sense it can be said that the federal tax system reaches everyone, every year, on every financial transaction.

The complexity of the tax system, therefore, arises from causes that run deeper than the type of tax that we have. The complexity arises from the complexity of the society to be taxed, the tendency to try to make up for the failure of national policies in other areas, such as the complex favorable tax treatment of employee accident and health benefits because we do not have a system of national health insurance, and the use of the tax system as an instrument of national economic policy. As long as the tax system continues to be subject to these powerful and important forces, we are going to continue to have a complicated tax system, whether the tax is an income tax or a consumption tax.

Can the proponents of the consumption tax plausibly assert that the consumption tax will be more immune to these deep-seated reasons for complexity than the income tax has been? This does not seem likely. The roots of complexity go beyond the nature of the particular tax imposed. There is no "quick fix" for the problem of complexity of the federal tax system.

Moreover, enacting a completely different tax such as the consumption tax would create a great deal of confusion and complexity as people were getting used to it.

Therefore, although the issue of eradicating complexity is one of their strongest arguments, I do not believe that the proponents of a consumption tax overcome the income tax on this issue.

Summary of the Comparison of the Consumption Tax and the Income Tax

I have discussed the history of the consumption tax and
how it works. I have compared it to the income tax using a variety of measures. I believe I have shown that the advocates of the consumption tax do not appear to have carried their burden of showing that the tax would be so far superior to the mixed type of income tax that we have now that we should undergo the great inconvenience of abolishing our present tax and acquainting the public with an entirely new type of tax. Nevertheless, the debate has been exceedingly useful in helping us to understand our present mixed tax and why it works the way it does. This has been the assertion of supporters of the consumption tax who have always agreed that, although it might not be feasible to do away with the present income tax, the debate would help to understand the present tax system better.

**Other Alternatives to the Income Tax**

While the consumption tax is the major alternative that critics have offered as a replacement for the American income tax, other possibilities have been advanced as well. The two other major possibilities are the so-called flat rate tax, and the value-added tax. Neither of these can be considered a realistic substitute for the present American income tax.

The flat rate tax is not really intended as a full-scale substitute for the present American income tax but is merely a variation — and a minor variation at that — of the present American income tax. While there are several different proposals offered by academians and politicians, the same theory underlies each. That theory is that the system of graduated income brackets should be compressed into just a few brackets. In its most extreme version the system of brackets is eliminated entirely and there is only one proportional tax on income, hence the term "flat tax." In addition most proposals eliminate some deductions such as the casualty loss deduction or the deduction for medical expenses (both of these were in
In the end the flat-tax proposals, therefore, change relatively little of the present American income tax. They simply tinker with it. Adoption of any of the current flat tax proposals would not materially simplify the Internal Revenue Code, since the complexity of the Code stems not from the existence of a substantial number of graduated brackets but from questions of what to properly include in the tax base (i.e. the variety of deductions, credits, and exclusions) against which the brackets are applied. The problem of the tax base is not addressed in any comprehensive fashion by any of the flat-tax proposals. The recent proposals of the Treasury Department, which have been adopted in modified form by the Reagan Administration, offer some simplifications but do not substantially simplify the Internal Revenue Code.

The value-added tax (VAT) is a form of sales tax in which a tax is imposed on a product at each stage in its production, from raw material to finished product. As such, VAT is a form of sales tax and is therefore a tax on transactions rather than on individuals. VAT therefore suffers from the two major drawbacks of sales tax: (1) The amount of revenue it can raise is limited in comparison with the income tax or the consumption tax and (2) it is regressive. The regressive nature of VAT can be mitigated somewhat by excepting from its reach necessities such as food. Nevertheless the economists’ consumption function demonstrates the fact that lower income people spend a greater percentage of their income than higher income people. Thus VAT will inevitably extract a higher percentage bite from the income of lower income people than from the income of higher income people.

For these reasons, neither the flat rate tax nor the value added tax is a realistic alternative to the present American income tax.
The Theory of Federal Income Taxation

The discussion has lead to several conclusions. It has shown that the present American income tax is not really an income tax at all, but rather a combination of both incomes and consumption tax components. The discussion has also demonstrated that the arguments for replacing the present mixed tax with a pure consumption tax or any other kind of tax are not persuasive. Also, and significantly for the purposes of this discussion, it has been shown that the American federal tax system, whether it be fundamentally based on income or on consumption, is going to remain complex.

Out of this discussion emerges the theory of federal income taxation:

The American federal income tax is a combination of both income tax and consumption tax concepts. It is made further complex by a variety of powerful political and social forces. None of this is going to change in the foreseeable future. Suggested changes in the system should be developed in recognition of these circumstances.

This discussion further demonstrates that continually attempting to develop major sweeping changes that will drastically simplify the system is an exercise in futility. [The monster has come to dinner and is staying.] Once we have reconciled ourselves to living with the ungainly tax system we and our forebears have created, perhaps then we can initiate some ad hoc ideas that will make the ungainly system work just a little bit better.

The Wealth Tax

Introduction

An element that could be usefully hammered onto the federal tax system is a wealth tax. As demonstrated in the preceding discussion, the American income tax is really a combination of income and consumption tax elements. It has thus long since surrendered any claim to theoretical purity and any accompanying advantages of simplicity. Moreover, we are not, as stated previously, likely to de-
velop a theoretically pure tax any time soon. Thus, initiating improvements to the present tax system must involve making *ad hoc* changes to what is already an *ad hoc* system. A wealth tax added to the present system would tap an additional legitimate tax base and add balance to the system. Its contribution to the tax revenues would be substantial. As will be discussed below, a wealth tax would probably increase tax revenues by at least $20 billion annually. This amounts to over 10% of estimated annual federal budget deficits over the next several years. At the same time a wealth tax would not misallocate resources, or be unduly burdensome to any group. It is a logical and effective *ad hoc* addition to our already *ad hoc* system of federal taxation. The wealth tax is widely used in Europe and the Indian sub-continent with significant success.

**HOW A WEALTH TAX WORKS**

The wealth tax is levied as a percentage of the taxpayer’s net worth. For reasons that I will discuss below, the wealth tax should provide a credit for income taxes paid. The literature on this subject describes two forms of the wealth tax. I believe, however, for reasons set forth below, that the two forms are really one and the same. Before setting forth my own critique, I will describe the two forms of the wealth tax, as seen in the traditional literature.

The two forms of the wealth tax have various names. I will call them for convenience the weak form and the strong form. The weak form of the tax is limited to a relatively small percentage of the taxpayer’s net worth. It is designed to exact a tax of less than a normal rate of return from the taxpayer’s capital. Rates for this weak form of wealth tax generally hover around 1% or less of the taxpayer’s capital subject to the tax.

The strong form of the tax is designed, according to the traditional view, to take more in tax from the taxpayer’s capital than is produced by a normal rate of return less income taxes paid. The rate for the strong form is there-
fore significantly higher than the rate for the weak form. The strong form is said to be a tax directly on capital, according to the traditional view.

My position is that there is in fact no strong form of the wealth tax—no wealth tax is imposed on capital. This is because when a high rate of wealth tax is imposed, the value of capital subject to the tax drops. This in turn decreases the amount of tax that can be collected by the wealth tax to an amount that can be paid out of income.

Some numerical examples may serve to illustrate:

Example (1) Let us say T has capital subject to the tax of $100,000. If this $100,000 is invested in high-grade corporate bonds paying 10% interest, T's annual income from this capital will be $10,000. Let us assume further that T is in the 50% marginal income tax bracket. Therefore on T's $10,000 interest income, he must pay income tax of $5,000. Let us say also that T is subject to a "weak" form of the wealth tax, which is imposed at the rate of 1% on his investment. By virtue of this tax, T must pay an additional $1,000 in tax. Thus T's income after the income and the wealth tax is $4,000. The tax has been paid out of the income from the bonds. On this set of acts, a wealth tax has operated like an additional income tax on investment income.

Example (2) The facts are the same as in Example 1, except that T is now subject to a "strong" form of the wealth tax. In this case let us assume that the wealth tax is at a rate of 7% of capital. Once again, T has interest income from his corporate bonds of $10,000. Being in the 50% bracket, he pays income taxes of $5,000. However, on account of the strong form of the wealth tax, he now also owes $7,000 of wealth tax (7% of $100,000). His total tax is $12,000, which he cannot pay solely out of income. Thus he must dip into capital to come up with the extra $2,000. He now has only $98,000 invested. This is the confiscatory aspect of the strong form of the wealth tax, according to the literature.

This analysis, however, is flawed. The day a 7% wealth
tax is imposed the value of T's corporate bonds will drop. By how much will they drop? Assume for simplicity that all potential buyers of these bonds are also in the 50% marginal income tax bracket. The bonds continue to pay their fixed amount of $10,000 per year. The income tax on that amount continues to be $5000. However, no one would pay $100,000 for those bonds if the net after tax return was a negative $2000. Therefore the bonds must drop in value by enough to lower the wealth tax to $5000. The bonds will then drop from $100,000 to a value of $71,428. (7% of $71,428 equals $5000). This is a one-time drop. Thereafter, the bonds will continue to trade at around that price and move up and down according to market factors, such as changes in interest rates. In reality, the price will not drop all the way down to $71,428, because some of the potential purchasers of these bonds are not in the 50% marginal bracket. Thus, a taxpayer in the 30% marginal bracket might find these bonds attractively priced at or near $100,000. This would be so because his income tax would be $3000 and his wealth tax would be $7000, if the bonds had a value of $100,000. The bond would not have to drop very much in value for them to have a net positive return to this taxpayer.

What this discussion demonstrates is that there is no such thing as the "the strong form" of the wealth tax. There is no such thing as the wealth tax actually being a tax on wealth. The wealth tax, no matter what its rate, will always be payable out of income from the taxpayer's capital subject to the tax, because the property will drop in value to reflect the imposition of the tax.

Of course, in the case of a wealth tax with a relatively steep rate, such as the 7% in the example above, taxpayers in the 50% marginal bracket have undergone a relatively stiff "tax" on their capital in the sense that their capital has undergone a one-time drop in value on the occasion of the first imposition of the tax. That is a different matter entirely, however, from saying that a wealth tax of relatively high rate is paid out of capital. It is erroneous
and leads to incorrect policy decisions to maintain that a wealth tax of relatively high rate is paid out of capital.

Consider, for example, X, an individual, whose wealth is entirely tied up in $10 million worth of undeveloped forest lands. These lands generally appreciate 10% every year. X has no salary and owns no income producing assets. X occasionally sells off some land to meet his modest living expenses. On these facts X has little income (only what may be realized on his occasional land sales). Therefore X pays an inconsequential amount of income tax (assume for simplicity that he pays no income tax). Assume X is subject to a 7% wealth tax. On these facts X has unrealized appreciation on the value of his land of $1 million (10% of $10 million) and pays a wealth tax of $700,000 (7% of $10 million). Thus where X pays little or no income tax, the wealth tax even at a relatively high rate does not cause the value of his assets to fall (at least not to him or others not paying much in income taxes). Indeed, the wealth tax has led to a relatively reasonable result, that a taxpayer of great wealth who would not have otherwise paid any taxes at all, in fact paid some taxes. Note that X in the example given above is a miser with established wealth. Therefore X in the example above would not be significantly reached either by an income tax or a consumption tax.

This discussion leads to the conclusion that a reasonable way to impose a wealth tax of some significant rate is to allow a credit or a partial credit against the wealth tax for income taxes paid with respect to the capital involved. If that were done, then in our Example 2 above, T, having paid $5000 in income taxes on his investment income, would only pay $2000 more in wealth taxes to reach his 7%. That would still leave him with a $3000 after tax return. However, the taxpayer X, above, who owned the forest land, would derive no benefit from the credit for income taxes paid, since he pays no income taxes. As we have discussed, it is appropriate that the wealth tax reach him more heavily.
This discussion has assumed a wealth tax of 7%, which is very much higher than what I would propose or than is in use in Europe or the Indian sub-continent today. Yet even with this relatively high rate, the tax, when combined with a credit for income taxes, works effectively and in a non-confiscatory manner, not overtaxing those who are already paying substantial taxes on income from their capital and yet reaching those who are not otherwise taxed.

While it is not presently on the horizon, the wealth tax may become a useful complement to other methods of federal taxation, in the era of very high budget deficits.
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