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INCREMENTAL VERSUS FUNDAMENTAL TAX REFORM AND THE TOP ONE PERCENT

*Deborah A. Geier**

A variety of evidence, both qualitative and quantitative, strongly suggests that people at the top end of the wealth and income distribution behave in ways that are substantially different from the behavior of most of the rest of the population.

—Christopher D. Carroll¹

[R]ecent press accounts have estimated Bill Gates's net worth at \$100 billion. Assuming a 10 percent annual rate of return, Gates would have to spend \$10 billion a year, or over \$25 million a day, on nondurable goods and services simply to avoid further [wealth] accumulation.

—Christopher D. Carroll²

[A]ny departure from equity must have clear justification in terms of probable effectiveness with regard to growth.

—Richard Musgrave³

Introduction

IN his 1985 book, John Witte sought to explore the “long-term consequences of incremental politics” by studying the incremental changes made to the income tax over the years.⁴ Not surprisingly, his study concluded that “in the area of taxation a highly incremental process has produced radical policy changes over time.”⁵ That is to say, incremental change over time has already resulted in fundamental shifts in both what is taxed and who is taxed.

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1. Christopher D. Carroll, *Why Do the Rich Save So Much?*, in DOES ATLAS SHRUG?: THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 465, 481 (Joel B. Slemrod ed., 2000) [hereinafter ATLAS].

2. *Id.* at 476-77.

3. Letter from Richard Musgrave (a leading tax expert) to Walter Heller (later head of President Kennedy's Council of Economic Advisors), reprinted in JOHN F. WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX* 159 (1985).

4. WITTE, *supra* note 3, at xxii.

5. *Id.* at 19.

Until the twentieth century (except for a brief period of income taxation to fund the Civil War), the federal government raised virtually all of its revenue through various forms of consumption taxes, such as tariffs. Those who debated whether or not to enact an income tax at the end of the nineteenth century and beginning of the twentieth century showed a sophisticated understanding of the difference between consumption taxation and income taxation and of the regressiveness of consumption taxes. Supporters of income taxation argued that it would more fairly apportion the tax burden by shifting it away from consumption to capital income. Erik Jensen, for example, has compiled a host of provocative quotations by legislators of the day that show such an appreciation, some of which follow.⁶ Ohio Senator John Sherman said:

A few years of further experience will convince the body of our people that a system of national taxes which rests the whole burden of taxation on consumption, and not one cent on property or income, is intrinsically unjust [T]he consumption of the rich does not bear the same relation to the consumption of the poor as the income of the one does to the wages of the other.⁷

Representative Benton McMillan of Tennessee, chairman of the Ways and Means Subcommittee on Internal Revenue, stated:

I ask of any reasonable person whether it is unjust to expect that a small per cent of this enormous revenue shall be placed upon the accumulated wealth of the country instead of placing all upon the consumption of the people And yet when it is proposed to shift this burden from those who can not bear it to those who can; to divide it between consumption and wealth; to shift it from the laborer who has nothing but his power to toil and sweat, to the man who has a fortune made or inherited, we hear a hue and cry raised by some individuals that it is unjust and inquisitorial in its nature⁸

He added: "The taxes having continually increased upon consumption, and no corresponding increase having been placed upon accumulation, we see such colossal fortunes amassed as were never accumulated in any other age or in any other country of the world."⁹ Senator Henry M. Teller of Colorado posited that the rich who spent little would be taxed the same as the poor who spent the same amount: "The man who holds millions of dollars' worth of property pays no more, perhaps, under the general taxes levied upon consumption than the man who has not any property."¹⁰ A House Ways and Means Committee Report also stressed the shift from consumption taxation to taxation of income from capital

6. See generally Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of "Incomes,"* 33 ARIZ. ST. L.J. 1057 (2001) (questioning whether a federal tax on consumption only could be imposed under the authority of the sixteenth amendment without apportionment among the states).

7. *Id.* at 1094 (quoting JOHN SHERMAN, SELECTED SPEECHES ON FINANCE AND TAXATION, FROM 1859-1878, at 336, 348-49 (1879)).

8. *Id.* at 1096-97 (quoting 26 CONG. REC. app. 413 (Jan. 29, 1894)).

9. *Id.* at 1098 (quoting 26 CONG. REC. app. 415 (Jan. 29, 1894)).

10. *Id.* at 1097 (quoting 26 CONG. REC. 6692 (June 22, 1894)).

when it stated: “The wealth of this country amounts to more than \$65,000,000,000, and the question arises whether it is not just and fair that a portion of this money should be raised by a tax on the earnings of wealth instead of imposing it all, or nearly all, on consumption.”¹¹ Missouri Representative Uriel S. Hall argued for an income tax so that “the wealth of this country should help to bear the burden of national taxation,” which didn’t occur “[u]nder our tariff system [where] its burdens are put upon consumption.”¹² Arkansas Representative Hugh A. Dinsmore phrased it: “We propose to tax the accumulated wealth of the country rather than the consumption. . . .”¹³ Representative Josiah Patterson of Tennessee:

I have heard it said [the income tax] would be a discriminating tax. This can only be so on the assumption that it would be class legislation to tax property, and that taxes to be just ought to be imposed exclusively on articles of consumption. Such an assumption is revolting alike to every sentiment of humanity and justice.¹⁴

Representative Elijah V. Brookshire of Indiana: “[The income tax] relieves consumption, and therefore gives relief where it should be given in fact.”¹⁵ Representative Clifton R. Breckenridge of Arkansas:

You can tax, as we do under our existing tariff and excise system, the consumption of the people, the necessaries of life, and the luxuries of life, and if a man be but a farthing above the point of starvation, under a system which taxes consumption we impose a burden upon him. But under this system what a man has above what he spends pays no Federal tax at all. In taxing incomes we pursue a far more enlightened policy.¹⁶

Senator Henry M. Teller of Colorado: “It has been asserted here and it has been asserted elsewhere that a tax upon consumption and consumption alone does not properly distribute the burdens of taxation among the people.”¹⁷ Senator Bailey of Texas: “Under any circumstances, an income tax is more equitable than a tax on consumption. It is more just as between the different classes”¹⁸ And:

I believe not that wealth ought to supplement the tax which consumption pays, but I believe wealth ought to bear it all. I think it is a monstrous injustice for the law to compel any man to wear a suit of clothes and then tax him for buying it I believe that all taxes ought to be laid on property and none of it should be laid upon consumption.¹⁹

11. *Id.* at 1099-1100 (quoting H.R. REP. NO. 53-276, at 3 (1894)).

12. *Id.* at 1100 (quoting Uriel S. Hall, An Income Tax: Reasons in Its Favor, 17 FORUM 14, 14-15 (1894)).

13. *Id.* (quoting 26 CONG. REC. app. 275 (Jan. 29, 1894)).

14. *Id.* at 1100-01 (quoting 26 CONG. REC. app. 76 (Jan. 23, 1894)).

15. *Id.* at 1101 (quoting 26 CONG. REC. app. 315 (Jan. 31, 1894)).

16. *Id.* (quoting 26 CONG. REC. app. 439 (Jan. 30, 1894)).

17. *Id.* (quoting 26 CONG. REC. 6692 (June 22, 1894)).

18. *Id.* at 1124 (quoting 44 CONG. REC. 1538 (Apr. 26, 1909)).

19. *Id.* at 1124 n.343 (quoting 44 CONG. REC. 1702 (May 4, 1909)).

Representative Ollie M. James of Kentucky: “[N]o tax was ever more unjust . . . than a tax upon consumption”²⁰ Representative De Armond of Missouri:

There is no good reason why taxation should not be according to ability to pay—according to wealth, according to income. Your tariff tax is a tax upon necessity, a tax in proportion to the amount you buy, a tax in proportion to what you must have, not a tax in proportion to what you possess.²¹

Representative Martin Dies of Texas: “What form of taxation could be more unjust than to tax a man in proportion to what he eats, wears, and uses?”²² Representative Cyrus Cline of Ohio: “I believe in an income tax because it taxes what a man really has. It taxes wealth, not want; accumulated possessions, instead of consumption.”²³ As Professor Jensen pithily put it: “And so on. Trust me, there are many, many more examples. I’m not making this up.”²⁴

The income tax that was eventually enacted in 1913 was thus specifically aimed at income from capital by establishing personal exemption amounts that were high enough to free most labor income earned by most workers from taxation. So, although it was denominated a tax on “income,” it’s not too far-fetched to say that it acted primarily as a tax on the capital income of the wealthy.²⁵ Even Treasury Secretary Andrew W. Mellon, no knee-jerk liberal,²⁶ argued in the 1920s that earned income ought to be more lightly taxed than capital income. (And, as described below, a tax on earned income only is, in essence, a consumption tax.)

The fairness of taxing more lightly incomes from wages, salaries and professional services than the incomes from business or from investments is beyond question. In the first case, the income is uncertain and limited in duration; sickness or death destroys it and old age diminishes it. In the other, the source of the income continues; the income may be disposed of during a man’s life and it descends to his heirs.

Surely we can afford to make a distinction between the people whose only capital is their mental and physical energy, and the peo-

20. *Id.* at 1125 (quoting 44 CONG. REC. 4398 (July 12, 1909)).

21. *Id.* (quoting 44 CONG. REC. 4420 (July 12, 1909)).

22. *Id.* at 1126 (quoting 44 CONG. REC. 4426 (July 12, 1909)).

23. *Id.* (quoting 44 CONG. REC. 4436 (July 12, 1909)).

24. *Id.* at 1102.

25. Fewer than 2% of workers filed income tax returns between 1913 and 1915. See WITTE, *supra* note 3, at 78.

26. Al Gore, Sr., criticized the post-WWII income tax rate decreases proposed by the Republicans as “right out of the Andrew Mellon primer on special privilege.” *Id.* at 132. Michael Graetz refers to William Simon—President Ford’s Treasury Secretary—as “probably the most conservative Treasury Secretary since Andrew Mellon.” MICHAEL GRAETZ, *THE DECLINE (AND FALL?) OF THE INCOME TAX* 224-25 (1997). Mellon was the first to argue adamantly in the political arena for supply-side reductions of high marginal rates on the wealthy as the “scientific” way to raise revenue through a growing economy. He analogized the “right” tax rate to the right “price” charged by a business to maximize overall profit. See ANDREW W. MELLON, *TAXATION: THE PEOPLE’S BUSINESS* 93-107 (1924).

ple whose income is derived from investments. Such a distinction would mean much to millions of American workers and would be an added inspiration to the man who must provide a competence during his few productive years to care for himself and his family when his earning capacity is at an end.²⁷

A credit for earned income was thus introduced in 1924. While it waxed and waned over the years, the idea was reinvigorated in 1969, when the top rate for “earned income” was capped at 50%, while the top rate for other (capital) income was 70%. The rate preference for labor income was maintained until the 1981 Reagan-era tax act, when the top marginal rate was reduced to 50% for all income, whether from labor or capital.²⁸

The labor income of the lower and middle classes was not taxed at the federal level to any real extent until the Social Security Act was enacted in 1935, which imposed a tax on wage income only, up to a certain ceiling, with no exemption amount.²⁹ No capital income was (or is) taxed under the payroll taxes, and the first dollar earned was (and is) taxed. From 1939 through 1949, for example, the tax was imposed at a rate of 1% on both the employer and employee on wages up to \$3,000.³⁰

Because of the generous personal exemptions under the income tax—\$2,500 for married couples and \$1,000 for single taxpayers, along with \$400 for each dependent, at a time when few households earned as much each year—the 2% payroll tax was the only tax paid by the vast majority of lower and middle class workers By 1939, only about 5 percent of the population paid income taxes.³¹

The year 1935 also saw the introduction of an undistributed profits tax on corporations, a form of capital taxation, though rate reductions for capital gains also were enacted.³² Nevertheless, I think it a fair generalization to say that, prior to World War II (WWII), almost all income was taxed at the federal level once, with the labor income of the poor and middle class taxed primarily under the Social Security tax and the capital income of the wealthy under the income tax.

WWII changed all that. The income “class tax” became a “mass tax” with the drastic lowering of exemption amounts to tax the labor income of the lower and middle classes. The labor income of the lower and middle classes was thus taxed both under the income tax and again under the payroll tax. This represented a paradigm shift in both what was taxed and

27. MELLON, *supra* note 26, at 56-58. E.R.A. Seligman, of Columbia, an influential early commentator on income taxation, also supported “differentiating between earned and unearned income, on the grounds that unearned income is a reliable symptom of greater freedom to choose how the income will be used.” Stephen Utz, *Ability to Pay*, 23 WHITTIER L. REV. 867, 913 (2002).

28. See WITTE, *supra* note 3, at 168, 192-93.

29. See generally Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1 (2002) (describing the development of the federal payroll taxes on labor income).

30. See *id.* at 24.

31. *Id.*

32. See WITTE, *supra* note 3, at 100-03, 108.

who was taxed, though the rates for the lower and middle classes were still low (by today's standards) under both the income and payroll taxes. And the top marginal rates under the income tax were high, topping out at greater than 90% in the 1940s.

The top income rate was reduced to 70% during the Kennedy administration, where it remained until Ronald Reagan took office. In 1981, the top income tax rate was reduced to 50% (and, as noted before, the separate, lower rate for "earned income" disappeared). In 1986, it was nominally reduced to 28%. Though increased in 1993 to 39.6%, the top rate stands at 38.6% today and is scheduled to be reduced to 35% in 2006 (though, without legislative action, it will go back up to 39.6% in 2011).³³ Moreover, the value of the personal exemptions, which were not indexed for inflation, deteriorated over time, and rates rose for the lower and middle classes over time as well (through so-called bracket creep), so that the income tax became significant for the poor and the middle class by the 1970s.³⁴ "By the end of the 1970s, nearly 80% of Americans were paying higher taxes because of bracket creep."³⁵ Between 1964 and 1980, inflation alone increased the percentage of income taxed at 35% or more from 8% (and only 1% of returns had income taxed at these rates) to 31% (and more than 10% of returns had income in these brackets).³⁶ The introduction of the earned income tax credit for the working poor (aimed initially at "rebating," in effect, the payroll taxes but expanded since then to provide transfer payments in excess of that rebate) has effectively taken the working poor off the income tax rolls,³⁷ but the average wage earner continues to pay income tax (as well as payroll taxes).

At the same time that the top income tax rates were being slashed to historically low post-WWII levels in the early and mid-1980s, the burden of the payroll taxes, which now included not only the Social Security tax but also the Medicare tax (introduced in 1965), was being significantly increased through both increases in the tax rates and expansion of the tax base (by increasing the wage ceiling in step with average wage increases in the economy). For 2002, the first \$84,900 of wages or self-employment income is subject to a 12.4% Social Security tax.³⁸ While 6.2% is collected from each of the employer and employee (in the employment context), economists generally agree that the economic incidence of both the employer and employee portions of the payroll taxes is borne by the employee.³⁹ All wages and self-employment income, without a cap, are subject to an additional 2.9% Medicare tax (1.45% on each of the em-

33. See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001).

34. See generally GRAETZ, *supra* note 26, at 52-67 (describing the effects of inflation on the personal exemptions and tax brackets).

35. *Id.* at 54.

36. *Id.*

37. See Geier, *supra* note 29, at 25, 59.

38. See *id.* at 16-17.

39. See *id.* at 17.

ployer and employee).⁴⁰ “Thus, wages and self-employment income up to \$84,900 (as of 2002) are taxed at a total combined flat rate of 15.3%, with no exemptions or deductions, while wages and self-employment income above that ceiling continue to be taxed at a flat rate of 2.9%.”⁴¹ As implied by the term “payroll taxes,” these taxes continue to apply only to labor income, not capital income of any sort.

Provocative work by Andrew Mitrusi and James Poterba has documented the increasing burden of the payroll taxes on the labor income of the poor and lower middle class since the late 1970s.⁴²

As of 1999, nearly two-thirds of families pay more in payroll taxes than they do in income taxes, while fewer than one-quarter of families pay more in income taxes than they do in payroll taxes. By comparison, in 1979, only 44% of families paid more in payroll taxes than income taxes. Moreover, the families that pay more in payroll taxes than in income taxes are overwhelming low- and middle-income families. Mitrusi and Poterba showed that an overwhelming majority of families with adjusted gross income of \$100,000 or less in 1999 paid more in payroll taxes than in income taxes, with very few families with adjusted gross income of more than \$100,000 paying more in payroll taxes than income taxes. Mean income taxes do not reach approximate parity with mean payroll taxes until one reaches \$75,000 to \$100,000 of adjusted gross income (AGI), increased by certain items of untaxed income (adjusted AGI). “At income levels below \$50,000, more than three-quarters of families have payroll tax bills that exceed their income taxes. At adjusted AGI levels above \$200,000, income taxes exceed payroll taxes for virtually all families.”⁴³

Almost as much revenue is now raised under the regressive payroll taxes as is raised under the individual income tax, whereas until 1963 the individual income tax raised more than twice as much revenue as the payroll taxes.⁴⁴ Between 1965 and 1999, payroll taxes nearly doubled as a percentage of GDP (from a little more than 3% to nearly 6.5%)⁴⁵ while individual income taxes rose much more slowly, from nearly 8% of GDP to nearly 12%,⁴⁶ and corporate taxes declined from about 4% of GDP to about 2.5%.⁴⁷

40. *See id.*

41. *Id.* at 17-18.

42. *See* Andrew Mitrusi & James M. Poterba, *The Changing Importance of Payroll and Income Taxes on U.S. Families*, in 15 *TAX POLICY AND THE ECONOMY* 95 (James M. Poterba ed., 2001); Andrew Mitrusi & James M. Poterba, *The Distribution of Payroll and Income Tax Burdens, 1979-1999*, 53 *NAT'L TAX J.* 765 (2000) [hereinafter *Distribution*]. *See generally* Geier, *supra* note 29, at 19-23 (summarizing their work).

43. Geier, *supra* note 29, at 19-20 (footnotes omitted; quoting *Distribution*, *supra* note 42, at 765, 771).

44. *See* Geier, *supra* note 29, at 23.

45. *See* John Buckley & Al Davis, *Extraterritorial Income/Corporate Inversion Debate: Will Myths Prevail?*, 96 *TAX NOTES* 289, 294 fig.3 (2002).

46. *See id.*

47. *See id.*

This evolution has produced a federal tax system that is, today, a consumption tax in many respects for the poor and middle class (actually, a system that provides them *better* than consumption tax treatment, for reasons discussed shortly), at a combined tax rate under both the payroll and income taxes that is higher than commonly perceived, and an income tax (albeit with some consumption tax features) for the wealthy, with marginal rates under the income tax at comparatively low levels for the post-war period. To see why this is true, I need to very briefly describe the forms of consumption tax that various supporters argue should entirely replace the income tax, returning us to a pre-16th amendment world by taxing only consumption, not returns to capital. (My description will be brief, as I believe that most readers of this essay will likely be familiar already with the various forms of consumption tax proposals.)

A tax imposed on retail sales—a sales tax—is the most easily understood consumption tax. Because of serious enforcement difficulties, the regressiveness inherent in a single, flat rate, and the high rate that would have to be imposed to raise the same revenue that is collected under the income tax, however, a sales tax is not a serious contender as a form of consumption tax that could replace the income tax. A value-added tax (VAT) is essentially a sales tax that is collected piecemeal at each stage of the manufacturing process, rather than all at once at the retail sale (and for that reason is more difficult to evade). For example, under a subtraction-method VAT, each merchant in the chain from raw materials to finished product pays tax on a base equal to the sales price she gets in the market for her goods less any purchased inputs (except wages paid to employees) and thus pays a tax on the “value added” at that stage. The aggregate amount collected by the time the product is sold to the consumer should be the same as that collected under a retail sales tax. Many European countries have VATs, as well as our neighbor to the north, though no country relies *solely* on consumption taxes. These countries typically impose a VAT in *addition* to income taxes.⁴⁸

In an effort to introduce some progressivity into a VAT, Robert E. Hall and Alvin Rabushka advocate what they call the “flat tax,”⁴⁹ which is a business VAT with the exception that wages would be permitted to be deducted (unlike under a traditional VAT), and the employees would be taxed under the same VAT tax rate on wages received above a basic exemption amount. At the individual level, in other words, only labor returns (wages) would be taxed. Capital returns (interest, dividends, capital gains, etc.) would not be taxed.

A wage tax, including the individual portion of the so-called flat tax, can produce the identical result to another kind of consumption tax, usually called a cash-flow consumption tax. Under a cash-flow consumption tax, all cash flows (and, presumably, consumption received in kind that would be included in the tax base under current law, such as free housing

48. See *id.* at 293.

49. See ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d ed. 1995).

and meals that are not excludable under § 119 and fringe benefits that are not excludable under § 132) are generally included in the tax base. For example, all the following would be initially included: wages, borrowed money, the entire “amount realized” on the sale of business and investment assets, as well as “gain” realized (the amount over basis) on consumption assets sold for more than they cost the taxpayer.⁵⁰ Any amount that is not spent on consumption is then deducted from the tax base, including repayments of principal and interest on loans and the purchase of investments, leaving only amounts spent on consumption in the tax base. Of course, there are sticky questions of categorization. (Is the purchase of a durable consumer asset that maintains or even increases in value, such as a home, an “investment”? What about human capital outlays, i.e., education outlays? Would students be taxed on the amount borrowed for college in the year of receipt, with no offsetting deduction for the tuition paid? How could students pay the resulting tax bill?) But the intent is, generally speaking, to tax only amounts spent on consumption and not amounts added to savings.

While they look superficially quite different, a wage tax on labor returns and a cash-flow consumption tax can reach the same results (under certain—admittedly improbable—conditions, such as identical investment returns, no significant inflation, and no change in tax rates over time). The only difference is that the tax comes at the front end under a wage tax and at the back end under a cash-flow consumption tax.

To illustrate, assume that Jane has \$100,000 from her wages to invest, that the interest (and discount) rate is 10% compounded annually, that the tax rate is 30%, and that Jane holds the \$100,000 investment for one year, at which time the total net return (income and principal after tax) is consumed. Compare the results below under both a cash-flow consumption tax and a wage tax.⁵¹

50. The original purchase price of the consumption asset, if not considered an investment purchase, would not have been deductible in the year of purchase (and thus would have been taxed by virtue of remaining in the tax base), but any appreciation in value will not have been taxed to the taxpayer. Thus, it would be necessary to retain the concept of “basis” for personal consumption assets that are later sold, with the appreciation entering into the tax base at that time.

For example, assume that a diamond engagement ring purchased for \$20,000 is classified as a “consumption asset,” since it is used primarily for personal purposes. The \$20,000 purchase price would be nondeductible and thus would be taxed in the year of purchase (by remaining in the tax base). If the marriage goes sour and the ring later sold for \$30,000 because of appreciation, \$10,000 would have to be included in the tax base in the year of sale. Thus, the concept of “basis” would have to be retained for consumer assets that might be later sold for more than their purchase price.

Compare this to the purchase of stock for \$20,000, which is later sold for \$30,000. The \$20,000 purchase price would be deductible in the year of purchase, since stock is clearly an investment asset, and thus there would be no basis. When sold for \$30,000, the entire \$30,000 would enter the tax base.

51. JOSEPH M. DODGE ET AL., *FEDERAL INCOME TAX: DOCTRINE, STRUCTURE & POLICY* 473-75 (2d ed. 1999).

Cash Flow Consumption Tax

Gross Wages Invested (fully deductible)	\$100,000
Tax on Invested Wages (30%)	0
Net Investment After Tax	100,000
Gross Return (\$100,000 + [.10 x \$100,000])	110,000
Tax (30%)	33,000
Net Return	\$ 77,000

Wage Tax

Gross Wages Available for Investment	\$100,000
Tax on Wages (30%)	30,000
Net Investment After Tax	70,000
Gross Return (\$70,000 + [.10 x \$70,000])	77,000
Tax (30%) on Gross Return	0
Net Return	\$ 77,000

They are the same.⁵² Therefore, one way to think about the difference between pure consumption taxation and pure income taxation is that consumption taxation effectively taxes labor returns but frees capital (which is heavily concentrated in the top 1%, as discussed in the next section) from taxation, whereas income taxation taxes both returns to labor and returns to capital.

This brief exercise illustrates how any provision in our so-called income tax that *either* allows the immediate deduction of a capital expenditure *or* exempts the return to savings from tax is a consumption tax feature of our hybrid income/consumption tax, and there are many significant ones. Some of the most important include: the deferral of tax on unrealized appreciation (which is economically equivalent to including the appreciation in the tax base and allowing an immediate offsetting deduction, as under a cash-flow consumption tax), § 219 traditional IRA contributions, § 401(a) qualified pension plan contributions, § 408A Roth IRA contributions, the deferral of life insurance inside buildup, the § 121 exemption on home-sale gain, the § 103 exemption for state and local bond interest, and § 179 expensing. More subtle consumption tax features include accelerated depreciation and the reduced tax rate for net capital gain (which would be wholly tax free under a consumption tax, if attributable to an investment asset).

52. And they result in a lower tax than under a pure income tax, under which capital expenditures for the purchase of an investment are nondeductible:

Income Tax

Gross Wages Available for Investment	\$100,000
Tax on Wages (30%)	\$ 30,000
Net Investment After Tax	\$ 70,000
Gross Return (\$70,000 + [.10 x \$70,000])	\$ 77,000
Tax on \$7,000 "Income" (\$77,000 - \$70,000 basis)	\$ 2,100
Net Return	\$ 74,900

Id. at 472.

Some of these features have income limits that preclude the very wealthy from sheltering all of their savings from taxation. “Because the large majority of low- and middle-income taxpayers can shelter most of their savings from tax through qualified pension plans, IRAs, homeownership, and life insurance, it is not farfetched to say that a majority of Americans already operate under a consumption tax regime, while the affluent, whose savings exceed the limits allowed under (some of) the tax-preferred vehicles, operate under an income tax.”⁵³ Actually, since the lower and middle classes can shelter their savings from taxation *without* including borrowed money in the tax base (and then deducting repayments), one could say that they get *better* than consumption tax treatment under current law (though, again, at a higher tax rate than is commonly perceived when payroll taxes are considered). Should we extend *full* consumption tax treatment to the very wealthy? That’s the billion-dollar question.

This essay serves as a brief book review, of sorts, of two books written by respected tax academics⁵⁴ for the general population, each of which advocates fundamental tax reform of different sorts. I first discuss Edward J. McCaffery’s *Fair Not Flat* and then turn to Michael Graetz’s *The Decline (and Fall?) of the Income Tax*. In brief, McCaffery advocates replacing the income tax, as well as the estate and gift tax, with a cash flow consumption tax with graduated rates. He would maintain the payroll taxes, and though he mentions retaining business taxes (of some sort, not detailed) in his book, he has since advocated simply repealing the corporate tax as well.⁵⁵ My concerns with his proposal are many, but I focus here chiefly on the undocumented (and potentially dramatic) nature of how a cash flow consumption tax—even one with graduated rates—could affect the amount of tax paid (and the wealth accumulated) by the top 1% of wealth owners. Focusing on the top 1% might seem myopic—after all, the number “1%” seems so picayune—but that small segment of the population pays more than 33% of the tax collected under our hybrid income/consumption tax, and it owns nearly 40% of the private wealth in this country. The top 1% is tremendously important for a myriad of reasons, much more so than the number “1%” might suggest. They are different from the rest of the population in critically important ways that should be considered in any discussion of replacing the current tax system with a cash flow consumption tax. (As a subsidiary issue, I can’t help also criticizing the manner in which McCaffery tries to sell his proposal to the public, painting fantastic (and misleading) pictures of who pays tax in this country, which can do more harm than good in the long run.)

53. *Id.* at 482 n.14.

54. Edward J. McCaffery is the Maurice Jones, Jr., Professor of Law at the University of Southern California Law School. Michael J. Graetz is the Justin S. Hotchkiss Professor of Law at the Yale Law School.

55. See Edward J. McCaffery, *Remove a Major Incentive to Cheat*, WALL ST. J., July 9, 2002, at B2.

Michael Graetz focuses on removing a large number of income tax filers from the system by enacting a VAT and retaining the income tax only for those earning above \$75,000 to \$100,000 or so (depending on how the numbers crunch out). I think his idea of removing the average wage earner (the median household income in this country is about \$50,000)⁵⁶ from the burdens of filing is terribly important, but I have serious qualms about his suggested method of doing so. For reasons I'll detail later, I think it is important to maintain a *single* tax system applicable to all taxpayers. (Indeed, I have advocated integrating the existing payroll tax burden on labor income with the income tax burden on labor income.)⁵⁷ But his fundamental objective is a sound one, and we ought to further explore ways of removing large segments of the lower and middle classes from the burden of filing a tax return under a single (or at least integrated) tax system, even if the tax paid by them remains unchanged.

I. STATISTICS ON THE TOP ONE PERCENT AND THE DISTRIBUTION OF THE TAX BURDEN

To place my most pressing qualms about McCaffery's book into context, I need to convey important information about the top 1% of households in terms of wealth and income, as well as describe my personal tax "ideology." I'll return and discuss evidence regarding the behavior of the top 1% in Part II, below.

A. THE TOP ONE PERCENT IN VARIOUS SNAPSHOTS

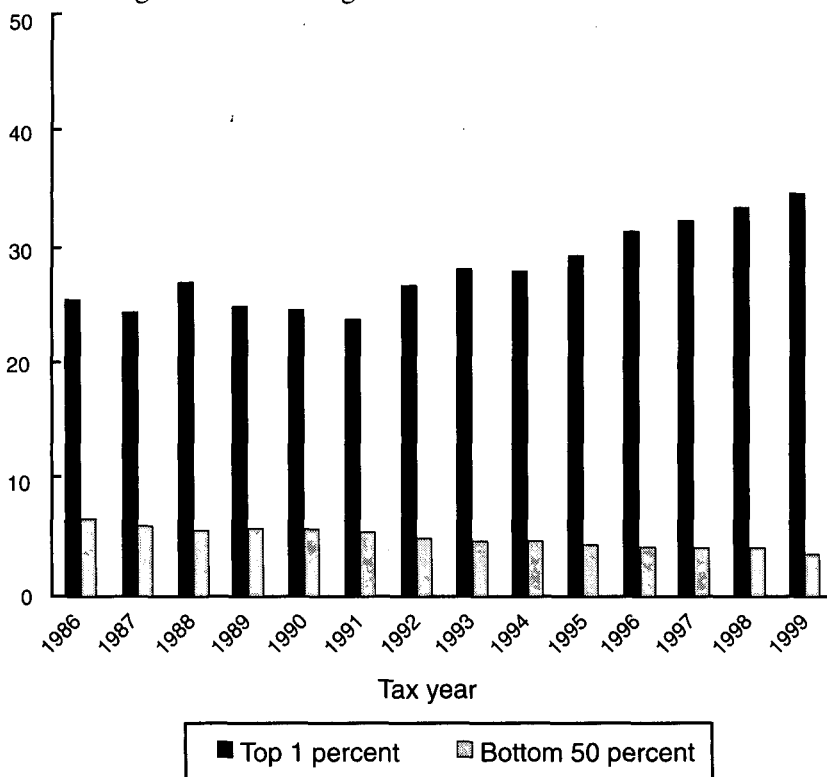
The top 1% is incredibly important, because this segment paid more than a third of the personal income tax in 1999, as shown in *Figure 1*.⁵⁸ The bottom 50% paid less than 5% of the total.

Figure 1 illustrates that the income tax share of the top 1% has increased between 1986 and 1999, but—to place that information into context—*Figure 2* depicts the percentage share of income of the top 1% and the bottom 50%, respectively, and shows how the increased tax share was accompanied by an increased share of income, while the percentage income share of the bottom 50% decreased. The year 1999

56. See Peter T. Kilborn, *Mobile Home Owners Remain House Hungry*, N.Y. TIMES, July 11, 2002, at A19.

57. See Geier, *supra* note 29.

58. To be precise, the returns in the top 1% paid 36.2% of total income tax. Michael Parisi & Dave Campbell, *Individual Income Tax Rates and Shares 1999*, in 21 STAT. INCOME BULL. 6, 14-15 (2002).

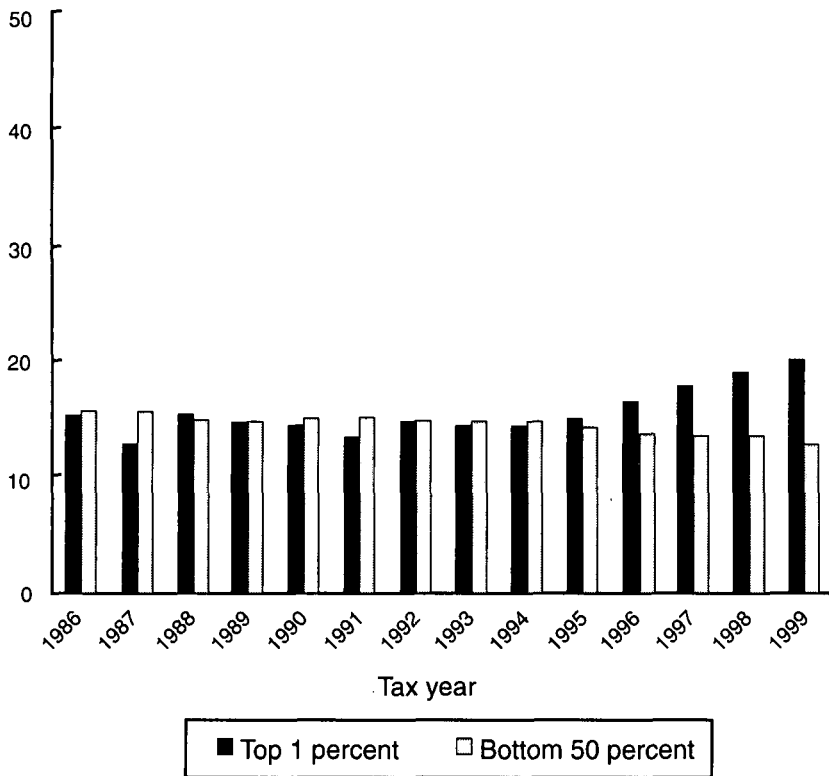
Figure 1: Percentage Share of Total Income Tax⁵⁹

marks the fifth consecutive year that the income shares of the top 1 percent of taxpayers were higher than the corresponding shares of the bottom 50 percentile. The income share for the top 1 percent of taxpayers grew to the largest it has been in the previous 13 years, reaching 20.3 percent for 1999, while the bottom 50 percent of taxpayers reported the lowest share of income over the corresponding period at 13 percent. This constitutes the largest difference in income shares between the two percentile groups over the previous 14 years, 7.3 percentage points.⁶⁰

59. *Id.* at 16.

60. *Id.* at 15.

Figure 2: Percentage Share of Income⁶¹



Moreover, even though the amount of income tax raised from the top 1% increased over this term, the *average income tax rate* (tax paid divided by total income) of the top 1% decreased from 33.13% in 1986 to 27.53% in 1999 (though higher than the 1990 low of 23.25%).⁶² Finally, as *Figure 3* shows, the *after-tax* share of income between 1977 and 1999 increased for the top 1% by 115% and decreased for the bottom 20% by 9%.

Figure 3: Change in After-Tax Family Income, 1977-99⁶³

Bottom 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%	Top 1%
-9%	+1%	+8%	+14%	+43%	+115%

61. *Id.* at 16.

62. *Id.* at 35.

63. Inequality.org, *Facts and Figures*, tbl.2.2, at <http://www.inequality.org/facts3.html> (citing the Center on Budget and Policy Priorities, *The Widening Income Gulf*, Sept. 4, 1999, at <http://www.cbpp.org/9-4-99tax-rep.html>, which cites Congressional Budget Office data).

So even though the absolute percentage of revenue raised under the personal income tax from the top 1% has increased, its share of after-tax income has increased even more. In other words, both pre-tax and after-tax income disparity has increased. Edward N. Wolff, an economist at New York University who has done much valuable work in documenting these trends, put it this way:

[T]he greatest gains in real income over the period from 1982 to 1997 were households in the top one percent of the income distribution, who saw their incomes grow by 44 percent. Mean incomes increased by 21 percent for the next highest four percent and by 10 percent for the next highest 5 percent. Groups in the bottom 80 percent of the income distribution all experienced less than 6 percent real growth in income. Of the total growth in real income between 1982 and 1997, 47 percent was received by the top one percent and 88 percent by the top quintile, with [the] remaining 12 percent distributed among the bottom 80 percent.⁶⁴

Using projections for 2000, the Staff of the Joint Committee on Taxation estimated that the percentage of federal revenue paid by the top 1% plummets from about a third to about 18.6% when *all* federal taxes are considered, including the regressive Social Security and Medicare taxes.⁶⁵ Since almost as much revenue is raised under the payroll taxes as under the personal income tax,⁶⁶ this comparison makes plain that it is the personal income tax (as well as, I would add, the estate tax) that clearly is responsible for the progressivity of the federal tax burden.⁶⁷ Therefore, any income tax proposal that would significantly affect the top 1% can significantly affect the distribution of the aggregate tax burden and can—perhaps more important—significantly affect the disproportionate accumulation of wealth (and its power) in a tiny minority.

How much income do you need to be in the top 1%? Are members of that group really that much apart from the median household income of about \$50,000? The answer is yes. Not only does the top 1% earn far more than the median household, but the top 1% looks very different from even those in the next richest 4%. The “typical” American probably lives down the street from someone in the 95th percentile of income earners. The top 1% is truly a class unto itself. To be in the richest 5% in 1996, you needed an income of at least \$145,412—your average successful doc-

64. EDWARD N. WOLFF, RECENT TRENDS IN WEALTH OWNERSHIP, 1983-1998, at 5-6 (Jerome Levy Economics Institute, Working Paper No. 300, 2000), at <http://www.levy.org/docs/wrkpap/papers/300.html>.

65. See STAFF OF J. COMM. ON TAX'N, DISTRIBUTION OF CERTAIN FEDERAL TAX LIABILITIES BY INCOME CLASS FOR CALENDAR YEAR 2000, 3, JCS-45-00 (2002). McCaffery does not propose any changes in the payroll taxes.

66. See Geier, *supra* note 29, at 23.

67. It's worth noting here that, in the 1990s, the states significantly decreased the percentage of revenue collected through progressive income taxes and significantly increased the percentage collected through regressive sales taxes (i.e., consumption taxes). See Nicholas Johnson & Daniel Tenny, *The Rising Regressivity of State Taxes* (Center on Budget and Policy Priorities, 2002), at <http://www.cbpp.org/1-15-02sfp.pdf>.

tor or lawyer—but to be in the richest 1%, you needed a threshold income of more than twice that amount—at least \$349,438, by one measure published in 1997.⁶⁸ By another measure published in 2001: “[A] family of four would these days need an income of more than \$400,000, and average income of all families in this category is over \$600,000 in 1999 dollars.”⁶⁹

A pungent anecdotal example of this phenomenon is the radically divergent rates of pay increase between the average worker and the average Chief Executive Officer (CEO) of a publicly traded corporation over the last 30 years.

Over the past 30 years most people have seen only modest salary increases: the average annual salary in America, expressed in 1998 dollars (that is, adjusted for inflation), rose from \$32,522 in 1970 to \$35,864 in 1999. That’s about a 10 percent increase over 29 years—progress, but not much. Over the same period, however, according to *Fortune* magazine, the average real annual compensation of the top 100 CEOs went from \$1.3 million—39 times the pay of the average worker—to \$37.5 million, more than 1,000 times the pay of ordinary workers.⁷⁰

Even those within the top 1% itself saw increasing income concentration. Using data examining the last 30 years, Thomas Piketty and Emmanuel Saez reported that

60 percent of the gains of that top 1 percent went to the top 0.1 percent, those with incomes of more than \$790,000. And almost half of those gains went to a mere 13,000 taxpayers, the top 0.01 percent, who had an income of at least \$3.6 million and an average income of \$17 million. . . . That meant that the 13,000 richest families in America had almost as much income as the 20 million poorest households; those 13,000 families had incomes 300 times that of average families.⁷¹

And this is a recent phenomenon. “[I]n 1987 the top 0.01 percent earned only about 40 percent of what they do today, and top executives less than a fifth as much.”⁷²

“Wealth and income are strongly correlated . . .,”⁷³ and the dramatic difference in income thresholds between the top 1% and even the top 5% corresponds to an even more dramatic difference in wealth accumulation (assets less liabilities). As shown in *Figure 4*, the top 1% owns nearly 40% of private wealth in this country, while the bottom 40% owns a mere 0.2%. Remember that most, if not all, of the savings of the lower and

68. See LAURENCE S. SEIDMAN, *THE USA TAX* 35 (1997).

69. JOEL SLEMROD & JOHN BAKIJA, *TAXING OURSELVES: A CITIZEN’S GUIDE TO THE GREAT DEBATE OVER TAX REFORM* 58 (2d ed. 2000).

70. Paul Krugman, *For Richer*, N.Y. TIMES, Oct. 20, 2002, at Magazine, 62, 64.

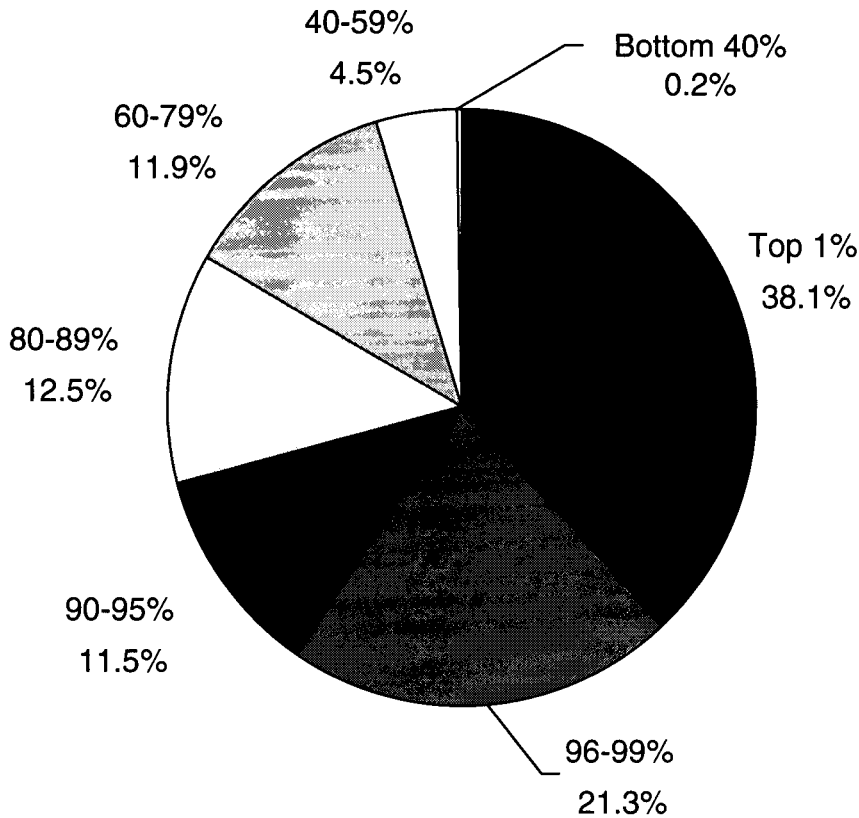
71. *Id.* at 65.

72. *Id.*

73. WOLFF, *supra* note 64, at 11.

middle classes are already exempt from taxation under the consumption tax features of our hybrid income/consumption tax.

Figure 4: Distribution of Net Worth, 1998⁷⁴



Moreover, as Figure 5 shows, the top 1%'s share of wealth increased from 33.8% in 1983 to 38.1% in 1998, while the bottom 40%'s share decreased from 0.9% to 0.2% during the same period.

Figure 5: Distribution of Net Worth, 1983 to 1998⁷⁵

Wealth Class	1983	1989	1992	1995	1998
Top 1%	33.8	37.4	37.2	38.5	38.1
Next 4%	22.3	21.6	22.8	21.8	21.3
Next 5%	12.1	11.6	11.8	11.5	11.5
Next 10%	13.1	13.0	12.0	12.1	12.5
Next 20%	12.6	12.3	11.5	11.4	11.9
Middle 20%	5.2	4.8	4.4	4.5	4.5
Bottom 40%	0.9	-0.7	0.4	0.2	0.2

74. Inequality.org, *Facts and Figures*, tbl.1.1, at <http://www.inequality.org/facts2.html> (citing WOLFF, *supra* note 64, at tbl.2).

75. *Id.*

In other words, the top 1% owns about the same amount of wealth (38.1%) as the bottom 95% (40.6%). And the *changes* in marketable wealth accrued disproportionately to the top 1%. Between 1983 and 1998, “the richest one percent received 53 percent of the total gain in marketable wealth. The next 19 percent received another 39 percent, so that the top quintile together accounted for 91 percent of the total growth in wealth, while the bottom 80 percent accounted for 9 percent.”⁷⁶ Displayed more graphically, *Figure 6* shows changes in net worth in percentage terms between 1983 and 1998.

Figure 6: Change in Average Household Net Worth, 1983-1998⁷⁷

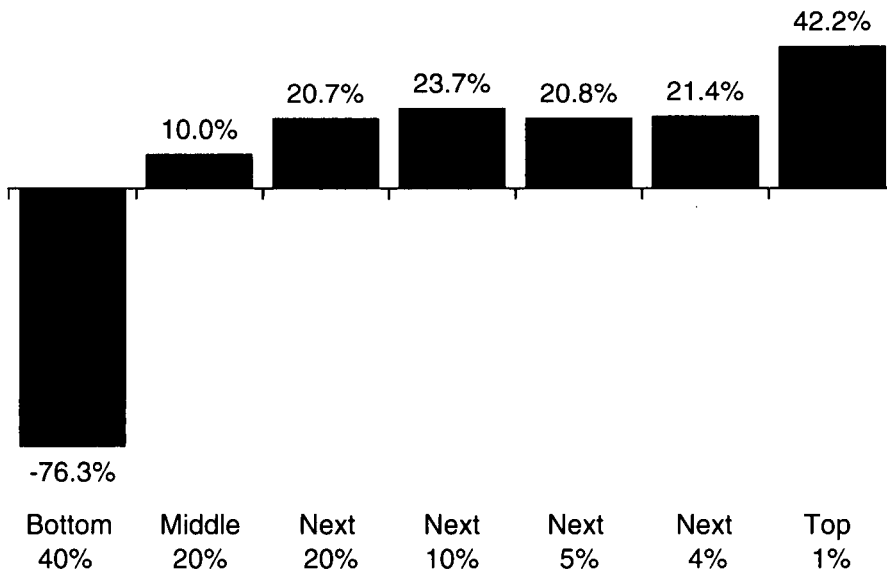
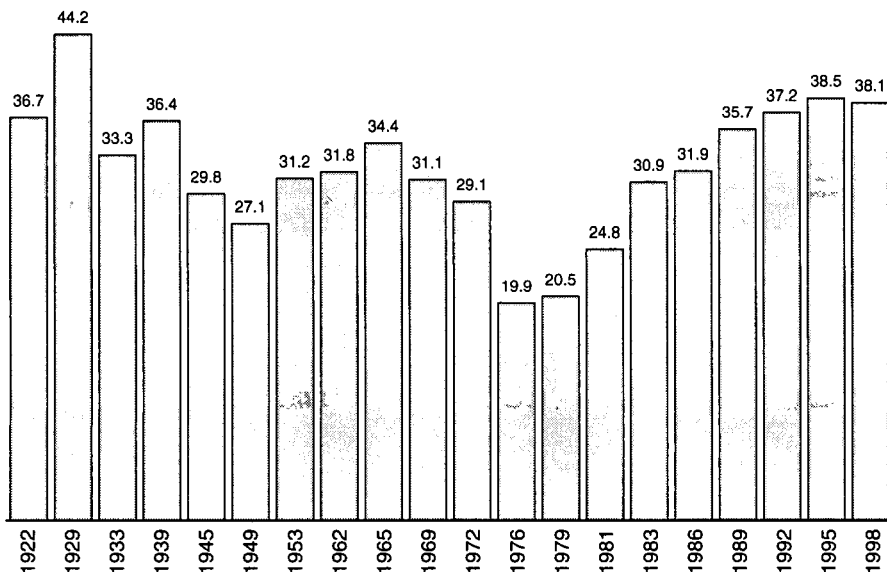


Figure 7 shows changes in wealth concentration in the top 1% since the high of 1929 and the lows of the mid-1970s.

76. WOLFF, *supra* note 64, at 5.

77. *Id.* at tbl.3.

Figure 7: Percentage Share of Household Wealth Held by Top 1%, 1922-1998⁷⁸



Though *Figure 7* goes only through 1998, Wolff confirmed in 2002 that “wealth in America is more highly concentrated today than at any time since 1929”⁷⁹

How much wealth (assets less liabilities) did one need to make the top 1% in 1998? The threshold was \$3,352,100, while the average was \$10,204,000; the average net worth of the bottom 40% was \$1,900 (while the threshold was, of course, negative, with many in the bottom 40% owing more in debts than they owned in assets).⁸⁰ Median household wealth was either \$71,600 or \$60,700, depending on whom you ask,⁸¹ while mean wealth was about \$270,000, which “implies that the vast bulk of household wealth is concentrated in the richest families.”⁸²

Finally, any proposal to free entirely from taxation the returns to capital (unless spent) requires that we consider how concentrated the ownership already is of stocks, mutual funds, and retirement accounts. After all, we are not starting from a clean slate, with every taxpayer starting out

78. Inequality.org, *Facts and figures*, tbl.1.4, at <http://www.inequality.org/facts2.html> (citing information in Edward N. Wolff, *New Series Household Data*, 78-79, for years 1922-1989, and WOLFF, *supra* note 64, at tbl.2, for years 1992-1998).

79. See David Cay Johnston, *More Get Rich and Pay Less in Taxes*, N.Y. TIMES, Feb. 7, 2002, at A17.

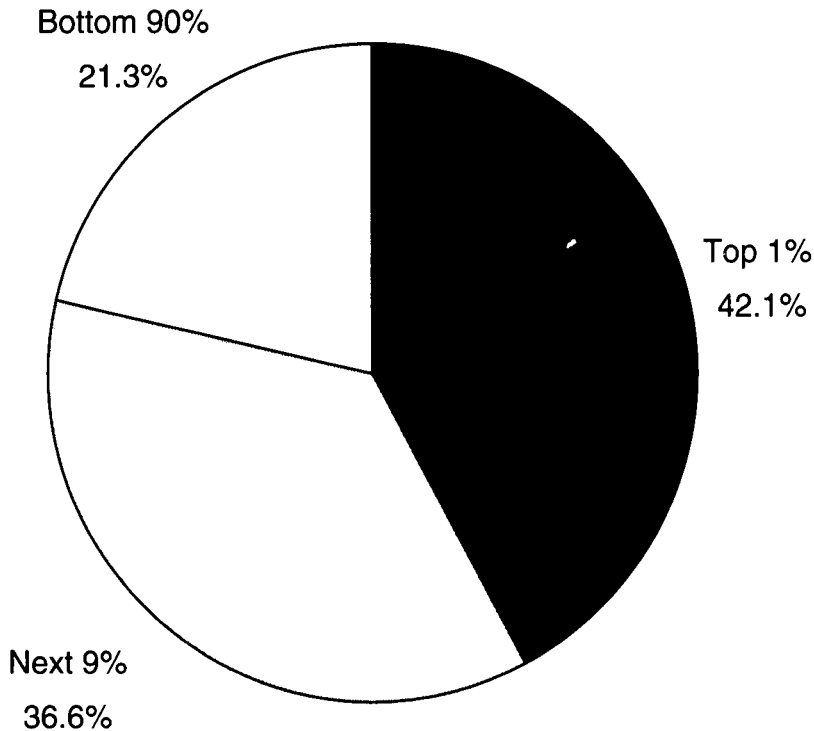
80. See WOLFF, *supra* note 64, at tbl.3 and note to tbl.5.

81. The \$60,700 figure comes from WOLFF, *supra* note 64, at tbl.1. The \$71,600 figure was computed by Arthur B. Kennickel of the Federal Reserve Board. See *Recent Changes in Family Finances: Results from the 1998 Survey of Consumer Finances*, FED. RESERVE BULL. (Jan. 2000), at <http://www.federalreserve.gov/pubs/bulletin/2000/0100lead.pdf>.

82. WOLFF, *supra* note 64, at 4.

with a proportionate amount of such assets. Once again, the top 1% owns the lion's share, 42.1% as of 1998, as illustrated in *Figure 8*.

Figure 8: Share of Total Ownership of Stocks, Mutual Funds, and Retirement Accounts, 1998⁸³



“Between 1989 and 1998, nearly 35 percent of all stock market gains went to the top 1 percent of shareholders.”⁸⁴ Moreover, “[m]iddle-class families enjoyed 2.8 percent of the stock market gains between 1989 and 1998, but accounted for 38.8 percent of the increase in household debt.”⁸⁵

As Wolff summarized the data, “[t]hese results indicate rather dramatically that the growth in the economy during the period from 1983 to 1998 was concentrated in a surprisingly small part of the population—the top 20 percent and particularly the top 1 percent.”⁸⁶ During this time period, “the top one percent received 53 percent of the total growth in net worth, 56 percent of the total growth in financial wealth, and 47 percent of the total increase in income.”⁸⁷ “There has been almost no trickle down of economic growth to the average family: almost all the growth in house-

83. *Id.* at tbl.6.

84. Inequality.org, *Facts and Figures*, note to tbl.1.13, at <http://www.inequality.org/facts2.html> (citing the Economic Policy Institute).

85. *Id.*

86. WOLFF, *supra* note 64, at 6.

87. *Id.* at 15.

hold income and wealth has accrued to the richest 20 percent.”⁸⁸

B. MY PERSONAL IDEOLOGY

In his wonderful book, *The Ideologies of Taxation*,⁸⁹ Louis Eisenstein warns us that, “like all ideologies, [ideologies regarding the distribution of the tax burden] are presented as bodies of objective truth which only the prejudiced or benighted can fail to approve.”⁹⁰ Certainly, Edward McCaffery comes across as such a true believer, as I’ll describe in the next part. But perhaps I really shouldn’t be too hard on him, as I (no doubt) am guilty of the same failing. I have my own ideology regarding the just distribution of the tax burden, which is that the top 1% ought to bear a goodly portion of the tax burden—even if they don’t spend a lot—because they benefit disproportionately (as measured by dollars) from the regulated capitalist system paid for by tax revenue.

Of course, we can all disagree about what a “goodly portion” means, but for present purposes, my concern is that the income tax burden on the top 1% not be diminished from its present levels, accepting it as the “right” benchmark. Perhaps it should be higher, with some of the burden of the squeezed middle class shifted to it, but it should not be lower. When both payroll taxes and income taxes are considered, those households with income below \$50,000 per year (approximately the median income) have seen their aggregate federal tax burden increase between 1979 and 1999, while upper-income households experienced a tax decrease.⁹¹ These numbers will become even more pungent when the phase-in of the 2001 tax act, which decreases marginal income tax rates for the wealthy and repeals the estate tax, is complete. While the top 1% of wealth holders now owns nearly 40% of the private wealth in this country, it pays less than 20% of the aggregate federal tax burden, when all taxes are considered (including the regressive payroll taxes).⁹²

At bottom, I believe that someone earning \$500,000 of income and saving \$400,000 while spending \$100,000 on personal consumption in a year should not pay merely the same federal tax as someone earning \$100,000 who spends it all on personal consumption. (Actually, if the \$500,000 and \$100,000 consists entirely of labor income, the payroll taxes add an additional 15.3% tax to the first \$85,000 *only* of each taxpayer, with earnings above that amount taxed at only a 2.9% rate, which makes the lower earner even worse off, comparatively speaking.)

To me, the bottom-line question is: *How should the costs of maintaining a regulated capitalist economy, with its laws of supply and demand that create wealth, be allocated among the members of the population?* In my view, essentially all tax revenue goes toward paying the costs of maintain-

88. *Id.* at 16.

89. LOUIS EISENSTEIN, *THE IDEOLOGIES OF TAXATION* (1961).

90. *Id.* at iii.

91. See Geier, *supra* note 29, at 23.

92. See *supra* note 65 and accompanying text and fig.4.

ing a regulated capitalist economy—even that tax revenue that funds transfer payments, such as Social Security payments to the elderly and Medicaid payments to the poor. (It is for this reason that I argue it would be defensible to repeal the earnings cap under the Social Security tax, coupled with a slashing of tax rates under that tax, as an alternative to full integration of the two taxes.)⁹³ Therefore, the costs of paying for that system should be allocated across the population at least in proportion to the money benefits extracted under that system.⁹⁴ The person earning \$500,000 per year is able to do so *only because* he or she lives in a regulated capitalist system and can exploit the market to sell products or services. That \$500,000 is not earned by the individual in a vacuum; it is—perhaps in very large part—made possible by our system of laws (where contracts will be enforced), our education system, a functioning court system, functioning transportation and technology systems, a military complex, etc., etc., etc. As Bill Gates’s dad said in support of the estate tax: “It is a very legitimate claim of society on an accumulation of wealth which would not have occurred without an orderly market, free education and incredible dollars spent on research.”⁹⁵

For a person who earns \$500,000 per year to be protected from paying any of the costs of the system under which such wealth accumulation was made possible, so long as he avoids spending money, seems indefensible to me. It allows the accumulation of wealth, made possible by capitalism, without paying for the costs of supporting capitalism. It is not an answer to me to say that he will pay some of the costs someday—just as soon as he spends. It is basic economic doctrine that, because of the time value of money, deferral of tax is tantamount to reduction, if not complete forgiveness.⁹⁶ Thus, delay can allow greater concentrations and disparities in wealth than would otherwise occur, since funds can grow on a pre-tax basis, as can occur in a qualified pension plan afforded consumption tax treatment for the middle class. The tax event, beyond the basic tax-deferred savings of the middle class, should ideally be at the time of wealth accumulation, in my view. Sometimes, practical considerations require delay (such as with the realization requirement), but as soon as it is possible (e.g., not later than death), that delayed tax should be paid.

I realize that this is an idiosyncratic ideology, as it, in effect, can be said to meld the “benefit” theory of tax justice with the “ability to pay” theory, when the “ability to pay” theory has traditionally been perceived as a

93. See generally Geier, *supra* note 29, at 11, 25, 42, 65.

94. I do not go so far as to say that government precedes all income earning, as apparently do Liam Murphy and Thomas Nagel. See LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP* (2002). Even in anarchy, with no structured government, people can bargain (even though without the support of a court structure to enforce contracts, etc.) and accumulate wealth and economic power to some extent.

95. Carl Huse, *Battle on Estate Tax: How Two Well-Organized Lobbies Sprang Into Action*, N.Y. TIMES, June 14, 2002, at A27.

96. See DODGE ET AL., *supra* note 51, at 467-72, 618-19.

rejection of the “benefit” theory.⁹⁷ On the other hand, it seems to be consistent with the thinking of the influential German theorist Georg Schanz, whom Utz describes as insisting “on economic power (*wirtschaftliche Kraft*) as the ultimate measure of ‘pure’ taxable capacity (*rein wirtschaftliche Vermogen*), and argued that these concepts should be understood without reference to the idiosyncratic preference satisfaction of the individual who enjoyed or wielded the economic power at issue.”⁹⁸ In other words, I (like Schanz) do not argue for allocation of the tax burden under utilitarian principles by arguing that the tax burden ought to be apportioned in such a way that utility or well-being (however measured) might be least damaged. The costs of our regulated capitalist system are measured in nominal dollars (however one perceives the utility associated with those dollars), and those costs should be allocated at least proportionately (and arguably even disproportionately) to those with greater dollars since those dollars are, perhaps to a very great extent, made possible by the economic system, the costs of which are being apportioned. In other words, you might say that I focus on economic power rather than utility. That’s why poor people don’t pay, even though they can be said to “benefit” from the system, as well. The “benefit” obtained from our regulated capitalist system is, for this purpose, measured by the economic power (i.e., dollars) created by it.

Of course, this formulation does absolutely nothing to solve the conundrum posed by utility theory itself, which is precisely “how progressive” it is defensible to make the tax system. Nevertheless, it does (at least in my ideology) support extracting a greater tax from the person who earns \$500,000 of wealth in our regulated capitalist economy (and spends only \$100,000 of it) than from the person who earns \$100,000 and spends it all. The person who is fortunate enough to earn \$500,000 rather than \$100,000 because of the laws of supply and demand ought to pay more of the cost of the system that allows the laws of supply and demand to operate (as opposed to, say, a system of central planning).

Two consequences of such an allocation are also important to me. They are the protection of regulated capitalism as well as the avoidance of plutocracy. I am a fan of regulated capitalism. I think that it is superior, warts and all, to any other economic system that humans have thus far concocted. But I do not think that it would prosper well in a country where the top 1% that profits so disproportionately from having such a system in place does not pay a disproportionate share of the costs of that system. At the other end of the spectrum, I also fear the political and democratic ramifications of further concentration of economic power in so small a portion of the population. It’s not so much that I fear that the super wealthy can buy off individual politicians in a sinister fashion (though that may happen, too). Even more insidious is their ability, as

97. “Proponents of taxation according to benefit, sometimes called the ‘equivalence principle,’ traditionally reject the ability to pay approach.” Utz, *supra* note 27, at 867 n.2.

98. *Id.* at 909.

Witte noted in 1985, to influence the terms of public debate through the “bias in favor of economic power.”⁹⁹ Even with perfect good faith and the best of intentions in trying to advance what he or she believes to be the “best” road for the country to follow, the mere fact that the person with great wealth can have a disproportionate effect on public opinion through the deployment of money (often through tax-exempt foundations) is troublesome in terms of democratic principles.

[R]ather than using coercive power, economic elites exercise power by controlling values and limiting the scope of alternatives considered in public decisions (i.e., by limiting the definition of what is politically possible). This control of the “agenda,” which serves to limit the bounds of government action, is not seriously opposed because of mass inculcation of capitalist values.¹⁰⁰

A provocative recent example is the movement to repeal the estate tax, an extremely progressive tax applicable to fewer than 2% of decedents, which reaches primarily appreciation in the value of property that is never taxed under the income tax. In other words, it’s a tax on capital that serves chiefly to prevent the realization requirement under the income tax from allowing built-in gain to go untaxed generation after generation (which, by the way, McCaffery’s tax would allow, as will be described). As recounted by Paul Krugman:

[M]uch of the general public has been convinced that the estate tax is a bad thing. If you try talking about the tax to a group of moderately prosperous retirees, you get some interesting reactions. They refer to it as the “death tax”; many of them believe that their estates will face punitive taxation, even though most of them will pay little or nothing; they are convinced that small businesses and family farms bear the brunt of the tax.

These misconceptions don’t arise by accident. They have, instead, been deliberately promoted. For example, a Heritage Foundation document titled “Time to Repeal Federal Death Taxes: The Nightmare of the American Dream” emphasizes stories that rarely, if ever, happen in real life: “Small-business owners, particularly minority owners, suffer anxious moments wondering whether the businesses they hope to hand down to their children will be destroyed by the death tax bill. . . . Women whose children are grown struggle to find ways to re-enter the work force without upsetting the family’s estate tax avoidance plan.” And who finances the Heritage Foundation? Why, foundations created by wealthy families, of course.

⋮

This obviously raises the possibility of a self-reinforcing process. As the gap between the rich and the rest of the population grows, economic policy increasingly caters to the interests of the elite, while public services for the population at large—above all, public education—are starved of resources. As policy increasingly favors the in-

99. WITTE, *supra* note 3, at 13.

100. *Id.*

terests of the rich and neglects the interests of the general population, income disparities grow even wider.¹⁰¹

The most common fairness complaint of the economic elites of progressive taxes is that they (or their ancestors)¹⁰² “earned” their money, fair and square, and thus they “deserve” to keep it at the same rate as the little guy. And apparently they are convincing some of their less-well-off brethren of this.

[I]n decades far past, one’s good fortune was taken, in part at least, as just that—as “good fortune”—in part due to luck or good genes or being in the right place at the right time in the right country in the right era. Progressive taxation . . . was not uncommonly viewed as an appropriately larger contribution to the public fisc to support the economic and social environment—a regulated capitalist system—that makes such top-heavy wealth acquisition possible in the first place. That doesn’t seem to be the case anymore. It seems to me that Americans more and more feel that whatever wealth comes under their control is attributable to their own hard work and merit, and even the wealthy are viewed by the nonwealthy as having “earned” their wealth. One recent Gallup poll, for example, found that 53% believed that the rich are rich because of “strong effort,” while only 32% credited “luck” or “circumstances beyond [their] control.” And Lawrence Lindsey . . . has said that “the envy argument . . . carries a lot less weight than it used to [because Americans] have a sense that those who have money today have earned it.”¹⁰³

But this notion that one’s returns (whether on capital or labor) is indicative of “dessert” is misguided. As Alan Gunn succinctly put it:

As a fan of a market economy, I am amazed at the number of people who think that prices (including wages) are supposed to measure what people “deserve.” Prices are determined by supply and demand, period (absent government intervention, to be sure). Markets do what they do—mainly, putting information to use—very well. But one of the things they don’t do is give people what they deserve. Complaining about this makes about as much sense as complaining that the laws of physics are unfair.¹⁰⁴

101. Krugman, *supra* note 70, at 141.

102. [N]early 40% of the Forbes 400 in 1999 achieved their wealth the easy way: they inherited it, with this 40% slice inheriting on average \$2.5 billion each. Or as the Economist magazine put it in 1998: “In many cases the rich have got richer by doing rather little. An American who had \$500,000 in shares and a \$500,000 New York apartment fifteen years ago, and has merely held on to them, is now \$5 million better off.” Wealth begets wealth, sometimes without much effort, which has perhaps contributed in part to the increasing wealth concentration in this country

Deborah A. Geier, *The Death of the “Death Tax?”: An Introduction*, 48 CLEV. ST. L. REV. 653, 656 (2000) (footnotes omitted).

103. *Id.*

104. E-mail submission from Alan Gunn, Professor of Law, Notre Dame Law School, to Taxprof, a closed Internet discussion group for tax law professors at AALS-accredited law schools (Apr. 24, 2002) (copy on file with author).

In other words, it is not at all clear that a high-school physics teacher “deserves” to be paid only, say, \$40,000 per year, while a CEO of a publicly traded company “deserves” to be paid, say, \$100 million per year. The labor market for CEOs is (apparently) very tight for them to command such stratospheric salaries. Since supply and demand—our regulated capitalist system—is what allows the CEO to command such a salary (and not necessarily “dessert”), it should not be considered unfair to demand that the CEO pay an outsized portion of the costs of that regulated capitalist system from those outsized returns. Or—even worse—these super-sized salaries may contain super-sized rents, according to Bebchuk, Fried, and Walker. According to their analysis, “many (not a few) top executives are skimming mighty rents—incomes in excess of what market efficiency and maximum shareholder value would dictate—from the people who employ them.”¹⁰⁵ It might be impossible to prevent such rent extraction, but it shouldn’t be considered unfair to more heavily tax it.

Similarly, the large salary that entertainer Jennifer Lopez (who my nieces tell me is called J.Lo by those in the know) can demand may be partly a function of the fact that all things Latina are hot right now in the cultural zeitgeist.¹⁰⁶ (I understand that even Raquel Welch has reclaimed her Latina roots.)¹⁰⁷ If that fashion should pass, J.Lo and Raquel might have to be satisfied with less pay, but their singing and acting talent (?) presumably will not have changed.¹⁰⁸ The laws of supply and demand—the capitalist economy—are surely responsible at least in part for these changes in return, both the upside and the downside. (Indeed, I believe that most people are quick to blame the economy or shifting tastes if their pay is reduced, while if their pay is increased due to the effects of supply and demand, they attribute the increase rather to their own personal effort and talent.)

This line of reasoning becomes even more persuasive in the context of what Robert Frank and Philip Cook have called winner-take-all markets,¹⁰⁹ which they contend are growing more prevalent.

105. *Economics Focus: Taken for a Ride*, THE ECONOMIST, July 13, 2002, at 64 (describing Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002)).

106. Cf. Cartoon in the NEW YORKER magazine, July 29, 2002, at 64. The scene: a fusty middle-aged couple in their living room, the husband sitting in an overstuffed armchair reading the paper, the wife, trying to get her husband’s attention, parading before him dressed in an outrageously flamboyant outfit apparently intended to be evocative of Latin America. The caption: “Just reclaiming my Latino roots.”

107. See Mireya Navarro, *Raquel Welch is Reinvented as a Latina*, N.Y. TIMES, July 11, 2002, at E1 (noting that “Hollywood . . . now considers Latinos hip and pays Jennifer Lopez up to \$12 million a picture).

108. “If public tastes shifted and demand for their services decreased, their incomes would decline dramatically without any change in their abilities or work effort.” GRAETZ, *supra* note 26, at 223.

109. See ROBERT H. FRANK & PHILIP J. COOK, *THE WINNER-TAKE-ALL SOCIETY* (1995).

As described by Frank and Cook, a winner-take-all market has several characteristics. It is one in which *relative* merit, as opposed to only absolute merit, determines who wins, where differences in absolute merit might actually be quite small. Think of the difference between the gold medal winner at the Olympics and the silver medalist. Only hundredths of a second might separate them, but the financial rewards that go to the gold medalist in endorsements, etc., are huge, while no one remembers the silver medalist only days later.

Moreover, increasingly competitive market conditions due to many factors, including increasing technology and the breakdown of loyalty within organizations, bids up the price of that relatively small group of winners to heights not commonly seen prior to the 1980s in spheres outside sports and entertainment. Today, the authors argue that winner-take-all markets “have permeated law, journalism, consulting, medicine, investment banking, corporate management, publishing, design, fashion, and even the hallowed halls of academe.” Whereas the median income in an increasing number of professions has remained relatively constant, the distributions around that median have become far more pronounced, with the winners at the top gaining a significantly higher share. The realm of pay reaped by CEOs is one much-discussed example. “Today’s average chief executive earns 475 times as much as the average factory worker, up from a ratio of forty-two in 1980.”¹¹⁰

And they, too, reiterate that the distribution of income wrought by capitalism does not necessarily reflect desert.

The economist’s theory of wages, which holds that workers are paid in proportion to the value of their productive contributions, was never intended to justify market income distributions on ethical grounds. Nonetheless, many see a certain rough justice when pay is distributed on that basis, for the system rewards not only talent but also the willingness to expend effort. In winner-take-all markets, however, pay distributions will be more spread out—often dramatically so—than the underlying distributions of effort and ability. It is one thing to say that people who work 10 percent harder or have 10 percent more talent should receive 10 percent more pay. But it is quite another to say that such small differences should cause pay to

110. Geier, *supra* note 102, at 657-58 (footnotes omitted). For 2000, it was over 500 to 1. See Q&A: *Welcome to the Working Class*, N.Y. TIMES, July 13, 2002, at A15.

In 1981, [America’s 10 most highly paid CEOs] were paid an average of \$3.5 million, which seemed like a lot at the time. By 1988 the average had soared to \$19.3 million, which seemed outrageous. But by 2000 the average annual pay of the top 10 ten was \$154 million. It’s true that wages of ordinary workers roughly doubled over the same period, though the bulk of that gain was eaten up by inflation. But earnings of the top executives rose 4,300 percent. Paul Krugman, *Plutocracy and Politics*, N.Y. TIMES, June 14, 2002, at A35 (summarizing material in KEVIN PHILLIS, *WEALTH AND DEMOCRACY: A POLITICAL HISTORY OF THE AMERICAN RICH* (2002)). Moreover, the pay of American CEOs is more than three times that of CEOs of comparable companies in Britain and more than four times that of comparable CEOs in France and Germany. See Alan B. Krueger, *Economic Scene*, N.Y. TIMES, Apr. 4, 2002, at C2.

differ by 10,000 percent or more The realization of how winner-take-all markets contribute to income inequality may affect the extent to which society tries to alter market distributions in the name of fairness.¹¹¹

In other words, the operation of the market itself is arguably increasingly responsible for the increasingly outsized rewards of the very top, not desert *per se*. And let us not forget good old-fashioned luck, patronage, and connections.¹¹²

It is time now to turn to McCaffery's book, since he, too, professes to be supportive of progressive taxation.

II. MCCAFFERY'S *FAIR NOT FLAT* TAX

In his book, which was written to convince the general public and not the specialist, Edward McCaffery proposes repeal of both the income tax and the estate and gift tax and enactment of a progressive rate, cash-flow consumption tax. As best as I can glean, he seems to rely on four main reasons in this book for selling his tax to the public: (1) to make the wealthy pay more tax; (2) possibly to encourage economic growth; (3) to have a moral tax base; and (4) to have a tax system that eliminates class conflict. Each reason is discussed in the following subparts (though they inevitably overlap here and there). But before I get there, let me describe some of his details, though they are sketchy, and I will not spend much time on them. I also will not be spending any time on other contentious issues, such as transition problems,¹¹³ the repeal of any preference for interest received on state and local bonds,¹¹⁴ and the loss of the special preference for retirement savings (as compared to other savings).

His proposed tax rate schedule on spending for a household with four people is shown below.¹¹⁵ While he advocates that his tax should apply "per household," he does not provide alternative tax schedules for, say, a single person or a married couple with no children at home—the far more common households in America today. Presumably, the thresholds for each of the tax rates below would be lower for such households, triggering the higher tax rates at lower rates of spending. While he has "tried to

111. FRANK & COOK, *supra* note 109, at 17.

112. Cf. Paul Krugman, *Steps to Wealth*, N.Y. TIMES, July 16, 2002, at A21 (charging that President George W. Bush "became wealthy entirely through patronage and connections").

113. See generally Joseph Bankman & Barbara H. Fried, *Winners and Losers in the Shift to a Consumption Tax*, 86 GEO. L.J. 539 (1998) (discussing transition possibilities and winners and losers under each with the introduction of a cash-flow consumption tax).

114. See EDWARD J. MCCAFFERY, *FAIR NOT FLAT* 99 (2002) (noting "no need for . . . tax-free municipal bonds"). The exemption for interest on state and local bonds is, indeed, inefficient, losing more money than is provided in subsidy to the states, with the difference going to the highest-bracket taxpayers. See, e.g., DODGE ET AL., *supra* note 51, at 323-27. Congress has long tried to repeal the indirect subsidy and replace it with a direct cash grant, but state and local governments have lobbied hard to retain the less efficient indirect subsidy. They fear that a direct cash subsidy from the federal government would be subject to reductions when money is short, while the indirect subsidy keeps the money coming.

115. See MCCAFFERY, *supra* note 114, at 26.

make a guess at revenue neutral rates,”¹¹⁶ he also states, “All of my numbers are rough and only illustrative.”¹¹⁷

Spending (\$)	Tax Rate (%)
0 – 20,000	0
20,000 – 80,000	10
80,000 – 160,000	20
160,000 – 500,000	30
500,000 – 1,000,000	40
over 1,000,000	50

Because he advocates repeal of the estate and gift tax, he explicitly contemplates that *Dad* should be able to transfer funds to *Daughter* to spend, and that spending will be taxed at *Daughter*'s lower marginal tax rate.¹¹⁸ (Presumably, we would have to develop a common-law “assignment-of-spending” doctrine if *Dad* attempts to give money to *Daughter*, who lives in a separate household and who then buys *Dad*'s personal consumption for him as an in-kind gift, in order to have the spending taxed at her lower marginal rate. On the other hand, since cash gifts would not trigger any tax consequences under McCaffery's plan, what is to prevent several households from lowering their aggregate marginal spending rate by making gifts of money among themselves, which is then used to fund consumption for the households at the lowest possible combined marginal rate?)

While his book “doesn't call for eliminating or reducing business taxes,”¹¹⁹ he has more recently advocated repeal of the corporate tax as well, folding that tax into the cash-flow consumption tax.¹²⁰ Since the corporate tax raises approximately 12% of all federal revenue,¹²¹ the rates above for a family of four would have to be significantly higher (or kick in at significantly lower spending thresholds) in order to be revenue neutral. This would seem to doom his “self-imposed limitation . . . never to have a marginal tax rate over 50 percent.”¹²² These rates also contemplate retention of the regressive payroll taxes,¹²³ and the burden of those taxes would not be integrated into his tax through either a credit or a

116. *Id.* at 91.

117. *Id.* Alternatively, he suggests enacting an 11% VAT, which would allow lowering the rates at each level by 10%. That is to say, the rate applicable to spending from \$0 - \$20,000 for a family of four would be negative 10% (and would be administered through sending a rebate check of \$2,000 on showing consumption expenditures for a family of four of at least \$20,000); the rate applicable to spending from \$20,000 to \$80,000 for a family of four would be zero (since they will have paid the 11% VAT, which is equivalent to the 10% rate in the table); the rate applicable to spending from \$80,000 to \$160,000 for a family of four would be 10%, and so on. *See id.* at 100-01.

118. *See id.* at 146.

119. *Id.* at 125.

120. *See supra* note 55 and accompanying text.

121. *See* GRAETZ, *supra* note 26, at 21.

122. McCaffery, *supra* note 114, at 91.

123. *Id.*

deduction, though he says that “in time it might be possible to move away from the payroll tax and to build up the progressive spending tax,”¹²⁴ presumably through higher rates or lower spending thresholds for each tax rate.

In other words, he proposes to repeal the corporate tax (which, although the evidence is ambiguous, is probably a tax borne by all capital),¹²⁵ repeal the estate and gift tax (a tax on capital¹²⁶ and clearly the most progressive element of the federal tax system, since it applies to fewer than 2% of all decedents), retain the regressive payroll taxes on labor income without change, replace the better-than-consumption tax treatment currently enjoyed by the lower and middle classes (because they can both exclude loan proceeds and exempt their savings from tax) with less-advantageous pure consumption tax treatment, and provide pure consumption tax treatment to the affluent, including the top 1%, as well.

He would categorize a personal residence as an investment, so that the inclusion of the borrowed money used to purchase the home would be offset by a deduction of the purchase price.¹²⁷ When the proceeds of the home were sold, however, the entire sales proceeds would be included in the tax base. Only if the proceeds were fully rolled over into another home or other investment property would the taxpayer escape taxation on the full amount realized.¹²⁸ Therefore, if a retiree sold the large family home and chose to rent instead of buy another home, he would be taxed on the full sales proceeds (unlike today).¹²⁹ Only if he rolled it over into another investment would he escape taxation. The same would be true of a divorcee who got the house in the divorce (and little else) and sold it, rented instead, and used the money to pay living expenses, unlike under current law. “[C]orporate shares represent, on average, less than one-fifth of the total wealth of the vast middle of the population, with accumulated net worth of less than \$250,000, Federal Reserve data indicates. Homes, by contrast, are far and away the major investment of these households.”¹³⁰ The repeal of the exclusion for realized home sale gain, unless the proceeds were rolled over into another investment, would dilute the “better-than-consumption-tax-treatment” that the broad middle class now enjoys with respect to their most significant savings.

124. *Id.* at 93.

125. See Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 *TAX L. REV.* 261, 302 n.170 (2001).

126. See James M. Poterba, *The Estate Tax and After-Tax Investment Returns*, in *ATLAS*, *supra* note 1, at 329, 335-36 (noting that estate taxes are large enough to represent a substantial component of the capital tax burden).

127. See McCaffery, *supra* note 114, at 134-35.

128. See *id.* at 135.

129. See I.R.C. § 121 (2002) (exempting from taxation realized home sale gain not in excess of \$250,000 for a single individual and \$500,000 for a married couple filing a joint return, without regard to whether the proceeds are rolled over into another home or other investment).

130. Louis Uchitelle, *Wall St. Damage Ripples Across the Population*, *N.Y. TIMES*, July 21, 2002, at 19.

There would be no exceptions to the rule that borrowed money is included in the tax base when received, offset by a deduction only if the borrowed money is used to buy an investment. (Recall that middle class households accounted for 38.8% of the increase in household debt between 1989 and 1998.)¹³¹ Therefore, a student who borrows for college would have to include the loan proceeds in the tax base when received and get no immediate offsetting deduction (unless tuition were categorized as an investment). Indeed, anyone who is in dire financial straits from a job layoff, etc., and for that reason has to borrow money to pay the rent and utilities, would have to include that borrowed money in the tax base. They would then deduct repayments, when made. In other words, the tax bill would come when they are least able to pay it, and the deductions would come in later (presumably better off) years. While some would see this timing as ill-matched to taxpaying capacity over time, McCaffery sees this as a plus. He argues that because consumption is much more level over a lifetime, while income is bunched in the high-earning middle years, the tax bill should be more level over a lifetime.

A progressive tax on inflows—like an income or prepaid consumption tax—therefore seems unfair: it heavily taxes the high midlife earner A consistent postpaid tax, on the other hand, falls on our voluntary choice of spending level, not on the much more erratic profile of our earnings—it chooses to tax at a better, fairer time. It spreads the tax burden across our lifetimes¹³²

Others might conclude that since taxpaying capacity is at its highest in the high-earning middle years, more tax should be paid then, and less tax paid in the low-earning early years and retirement years. If “bunching” is a big problem because of progressive rates, we could revive income averaging, though it does not seem to me to be a big problem with our relatively compressed tax rate schedule for the vast majority of the population.

McCaffery repeatedly stresses the “inconsistency” of the income tax to tax all income as its fatal flaw—in particular, the practical inability to tax appreciation in assets until realized.¹³³ He talks about the importance of being “consistent” a lot, referring constantly to a “consistent consumption tax” being better than our “inconsistent income tax.”¹³⁴ Indeed, it’s for this reason that he insists that all loan proceeds must be included in the tax base, because a theoretically pure cash flow consumption tax requires it. He criticizes the Nunn-Dominici version of a cash-flow consumption tax (the unlimited savings account tax, or “USA tax”) on this ground.

131. See *supra* note 85 and accompanying text.

132. McCaffery, *supra* note 114, at 17.

133. *Id.* at 29 (referring to the realization requirement as “the most fatal flaw of the so-called income tax”).

134. See, e.g., *id.* at 97 (referring to the “inconsistent” income tax and a “consistent, progressive spending tax”).

[The USA Tax] is not, in fact, a *consistent* spending tax; it shares some of the vices of the inconsistent income tax. For one thing, the USA Tax supplements its consumption tax base with an estate tax; it is thus a progressive consumption-plus-estate tax

More important, the USA Tax is inconsistent in its treatment of debt because it fails to include the proceeds of borrowing as income. The treatment of debt is critical to an effective tax: borrowing is a form of negative savings or dissaving. A tax built up on the idea of subtracting savings from income . . . must *add* negative savings, or borrowings, into its tax base.¹³⁵

So I was surprised to read later that he supports deduction of some of the personal consumption expenses that are allowed to be deducted under our hybrid income/consumption tax. For example, he would support allowing deduction of extraordinary medical expenses, charitable contributions, and perhaps some education expenses, as well as child care expenses.¹³⁶ He does not clarify to the reader why some exceptions to pure theory can be made under a cash-flow consumption tax but not others, or why some exceptions can be made under a consumption tax but not under an income tax, though perhaps he simply considers these exceptions to be *de minimis* and therefore unimportant.¹³⁷

A. TAXING THE TOP ONE PERCENT

McCaffery is very savvy in trying to appeal to the general, middle-class reader at whom his book is clearly aimed. He does so by telling them—over and over again—that they are required to pay taxes but that the rich are escaping paying any tax, that this is unfair, and that his proposal would change this state of affairs. He starts out his book, at the very beginning of the Introduction, with a quotation from a book called *Rich Dad, Poor Dad* that goes like this:

“Taxes” said rich dad. “You’re taxed when you earn. You’re taxed when you spend. You’re taxed when you save. You’re taxed when you die.”

“Why do people let the government do that to them?”

“The rich don’t,” said rich dad with a smile. “The poor and the middle class do. I’ll bet you that I earn more than your dad, yet he pays more in taxes.”

“How can that be?” I asked. As a 9-year-old boy, that made no sense to me.”¹³⁸

He does not tell his middle-class target audience that they are *not*, in fact, taxed at the federal level when they earn and again when they

135. *Id.* at 58-59 (emphasis in original).

136. *See id.* at 155.

137. *See id.*

138. *Id.* at 1 (quoting ROBERT T. KIYOSAKI & SHARON L. LECHTER, *RICH DAD, POOR DAD* (2000)).

spend¹³⁹ and taxed when they die—that they are, in fact, eligible for better-than-consumption tax treatment under current law and not subject to the estate tax, with its \$1 million exemption. He does not tell the reader that the top 1% pays more than a third of the revenue under our income/consumption tax (excluding payroll taxes), while the bottom 50% pays less than 5%, which is hardly a case where poor dad pays *more* than rich dad, as the quotation above states. He lets this misimpression fester. And then he implies, right off, that he’s going to make the rich pay more tax and reduce wealth disparity in doing so.

We need fundamental, comprehensive tax reform, not ad hoc tinkering.

[T]here is a widening gap between the rich and the not-rich in this country.

It may surprise many readers to learn that there is a deep connection between these two facts. Tax as it is today is a cause of the wealth gap. Tax as it could be tomorrow would narrow it. That’s what this book is about: a proposal to make the tax system better and fairer so that we can get to a model of class teamwork, not class conflict, in this great nation.¹⁴⁰

He goes on to tell the reader:

[O]nce you have wealth, whether you earned it or were given it, you are home—and tax—free. Life on top is very good, with ever new and ever more expensive luxuries for you to enjoy. And with very basic tax planning, you need never pay tax on your lavish lifestyle. But if you are not rich, these are difficult times. Life is stressful as you live from paycheck to paycheck, never seeming to get ahead. *And yet you are taxed at every turn.*¹⁴¹

He also says that our tax system (and since he proposes to maintain the payroll taxes, he is talking only about our hybrid income/consumption tax and the estate and gift tax) makes it hard to build up wealth. Though he directs this assertion at the middle-class reader, he does not tell him that he essentially gets better-than-consumption tax treatment under current law, with virtually all of his most significant savings given consumption tax treatment while his borrowing enjoys income tax treatment (i.e., excludable when received). Moreover, he does not tell the middle-class reader that his wealth *can* be passed from generation to generation without tax, that fewer than 2% of decedents pay estate tax.

He talks of the “surprisingly obscure fact that paying tax has become *virtually voluntary* for the growing number of Americans who have made a fortune for themselves and can comfortably live out the rest of their days on the yield from their property holdings. Meanwhile workers . . .

139. Earnings are included in gross income, and personal consumption spending is generally nondeductible, which means that amounts that are earned and spent on consumption are taxed only once, not twice.

140. McCAFFERY, *supra* note 114, at 1-2.

141. *Id.* at 2 (emphasis added).

are taxed on all sides”¹⁴²

He begins each of chapters one, two, and five with a similar quotation from *Rich Dad, Poor Dad* (with the quotation preceding chapter five saying “[t]he real reality is that the rich are not taxed”).¹⁴³ He begins chapter three¹⁴⁴ with a quotation from Joel Slemrod’s and John Bakija’s *Taxing Ourselves: A Citizen’s Guide to the Great Debate Over Tax Reform*¹⁴⁵ regarding how the U.S. income tax system is under attack, without further letting the reader know that Slemrod and Bakija actually advise *against* a cash-flow consumption tax in favor of further reform of the income tax.¹⁴⁶

McCaffery implies, again and again, that the wealthy are not paying tax. “Wealthy people and their well-paid tax advisers are even less help. These fortunate few are doing just fine under the status quo. They have no interest in change.”¹⁴⁷ He refers to “the brutally simple means by which rich property owners can live well *tax free*.”¹⁴⁸ “It hardly seems progressive to have rich spenders bear an average tax rate of *zero percent*.”¹⁴⁹ Our tax system “allows rich and clever people like Rich Dad to *pay no taxes whatsoever*. Heirs . . . can acquire massive wealth early in their lives and spend away *without ever paying any tax*. . . . The rich, clever, and well-advised win. The not-rich lose.”¹⁵⁰ And again: “[T]he inconsistent income tax that we do have is particularly bad because it falls heavily on the poor dads of the nation while the rich dads delight in their ability to evade it.”¹⁵¹

I wouldn’t be surprised if every Joe Sixpack who read this book didn’t think that he was paying more in personal income taxes than the rich. This is clearly the impression that McCaffery wants to convey. Nowhere does he even hint to his reader that the top 1% pays more than a third of personal income taxes and that the bottom 50% pays less than 5% of it and that fewer than 2% of decedents pay estate tax. It is against his interest to let them know that. He talks about the rising burden of the payroll taxes on the middle class—which I agree is egregious—but remember that he proposes no changes in them. He proposes to replace only the

142. *Id.* at 4 (emphasis added).

143. *See id.* at 9, 27, 78.

144. *See id.* at 45.

145. SLEMROD & BAKIJA, *supra* note 69.

146. *See id.* at 237-56 (advocating “building a better income tax” rather than going to a clean consumption tax).

147. MCCAFFERY, *supra* note 114, at 5. I believe he’s wrong that the wealthy like the income-and-estate-tax status quo. If it were up to them, they would go back to a world containing only consumption taxes and no estate tax. I think that, so far, it’s the middle class that has resisted the shift downward in the tax burden that a consumption-without-estate tax would likely provide, on average. This is just one of the ways that I think McCaffery misleads the general public in this book.

148. *Id.* at 32 (emphasis added).

149. *Id.* at 82 (emphasis added).

150. *Id.* at 114 (emphasis added).

151. *Id.* at 28.

progressive portions of the federal tax system with a pure consumption tax.

How do the rich avoid paying tax, according to McCaffery?¹⁵² The key is the realization requirement, which provides consumption tax treatment by failing to tax the appreciation in value of property, coupled with the failure to include debt proceeds in the tax base, as under a pure income tax. He is right that this is, of course, better-than-consumption tax treatment. It's the same kind of better-than-consumption tax treatment enjoyed by the middle class when they borrow money to invest in an IRA, which has income ceilings that limit their availability to the wealthy. He instructs his readers in "Tax Planning 101," which he teaches to his students on the first day of class and which is premised on the deferral of gain under the realization requirement, the tax-free step-up in basis at death, and the borrowing exclusion:

1. Buy
2. Borrow
3. Die

That's it. By buying appreciating assets and borrowing against the appreciation until death, the fortunate few can have the resources to live the good life tax free. Their heirs can inherit the assets with a stepped-up basis, sell them off, and pay off the debts. Neither the decedents nor their heirs will pay any income tax when using this strategy. They'll avoid paying payroll tax by the simple expedient of not working.¹⁵³

He then gives an explicit example to really rile up the reader :

Meet Artful Dodger, a master of Tax Planning 101. Mr. Dodger is fortunate enough to have \$1 million at his disposal. It really doesn't matter to us how Dodger came upon his money. Perhaps he inherited it, in which case he would never pay any federal taxes on his good fortune. Or perhaps Dodger earned his stake by working, or he won the lottery, in which cases he as already paid an initial income tax. In any event, now that he has his million dollars, Dodge is through with his days as an ordinary taxpayer. Here is how he manages never to pay taxes again.

Dodger invests his million in a portfolio that gains 10 percent in value every year. In Year 1, Dodger's portfolio rises in value from \$1,000,000 to \$1,100,000. Dodger borrows \$100,000 at 10 percent interest (leaving his net worth at \$1,000,000). In Year 2, he owes \$10,000 in interest, but his portfolio has gone up another 10 percent, or \$110,000, so it is now worth \$1,210,000. He borrows \$110,000 more (leaving his net wealth at \$1,000,000). He uses \$10,000 to pay off the interest on his Year 1 debt and spends the remaining \$100,000. In Year 3, the portfolio again goes up 10 percent, this time \$121,000,

152. I am talking about legal avoidance here. Evading tax by failing to report cash flow at all by, say, parking it offshore would be a problem under a cash-flow consumption tax as well as an income tax, since the first step is gross reported cash flow.

153. McCaffery, *supra* note 114, at 32.

rising from \$1,210,000 to \$1,331,000. He borrows \$121,000 (again leaving his wealth at \$1,000,000). He uses \$10,000 to pay off his Year 1 debt, \$11,000 to pay off his Year 2 debt, and spends \$100,000.

You get the point. Dodger will always have \$100,000 to spend, and his net wealth will always stay at \$1,000,000, as long as the interest rate on his debt matches the yield to his portfolio. And if—as one would expect—Dodger is on average earning more on his portfolio than he is paying on his debt, he is actually making money on the deal, too.

The game can go on forever. As long as Dodger plays it, he will pay no income tax, no capital gains tax, no payroll tax, and no gift and estate tax. When he dies, his heirs can use their inheritance with its stepped-up basis to pay off his debt. They will pay no income tax, and Dodger's estate will also have dodged the death tax, which is a tax on one's *net* estate, that is, assets minus liabilities. Dodger only ever has one million dollars of net wealth, the current exemption level for estate taxes.¹⁵⁴

In short, McCaffery at the least implies that the very rich do not pay tax and will pay more tax under his plan than under the status quo. But is this true? Are there really that many very rich people—those in the top 1%—who refuse to buy any investment property that pays any investment return (such as interest, dividends, rents and royalties) other than appreciation in the value of the property, who never sell any property with appreciation (thus realizing it for tax purposes), who refuse to earn any labor income, to boot, and who borrow every dollar that they spend on personal consumption? McCaffery implies to the reader that there are, and that taxes are, indeed, completely voluntary for the very wealthy.

I am not arguing that everyone who is able to do so takes Tax Planning 101 to its limit, although I can assure you that after years of advising, teaching, and lecturing I have learned that quite a few wealthy people do. Rich Dad seems to have figured it out perfectly well; there is no shortage of clever lawyers, accountants, and financiers giving advice and developing financial plans for the rich. But even if many wealth holders don't take full advantage, the very possibility of Tax Planning 101, in all of its simplicity, ought to give us pause. Any wealthy person—and America is spawning new millionaires by the minute—can avoid paying taxes for the rest of her life. If she does pay tax, it's in some sense a matter of her choice: she pays tax because she wants to keep working, or because she invests in a way that doesn't take Tax Planning 101 to the limit. Tax for the rich is voluntary: they can live perfectly well without it.¹⁵⁵

McCaffery glosses over the difficulty of legally avoiding tax. He implies that it is a piece of cake. But as Weisbach warned in a different context:

This imperfection in substitution is the reason we collect so much tax every year. Tax planning is very difficult. Although it is important to

154. *Id.* at 33-34.

155. *Id.* at 33 (emphasis added).

recognize the problems that highly liquid and sophisticated financial markets pose for the tax system, we should not assume that hypothetical equivalences mean that taxpayers can really eliminate tax by using simple methods.¹⁵⁶

The real behavior changes that are required to avoid tax as McCaffery suggests have real costs that make substitution undesirable for most people. Indeed, evidence shows that the wealthy do *not* attempt to minimize taxation of their capital income in any consistent way. Auerbach, Berman, and Siegel found that “relatively few taxpayers realizing capital

156. David A. Weisbach, *Thinking Outside the Little Boxes: A Response to Professor Schlunk*, 80 TEX. L. REV. 893, 908 (2002).

McCaffery gives the same misimpression to the middle class reader about the estate tax, claiming that it, too, is easily avoided (and thus really voluntary) because of “Estate Planning 101,” which entails giving “early” and “often.” See McCAFFERY, *supra* note 114, at 68. But, again, this is terribly overstated because it belies the behavior of real people. The very wealthy taxpayers who can afford to be (and who are) advised by the best Wall Street lawyers often pay millions in estate tax if they if want to give as much as possible to non-charitable beneficiaries other than a spouse. See generally Richard Schmalbeck, *Avoiding Federal Wealth Transfer Taxes*, in RETHINKING ESTATE AND GIFT TAXATION 113 (2001) (analyzing avoidance techniques); Richard Schmalbeck, *Does the Death Tax Deserve the Death Penalty? An Overview of the Major Arguments for Repeal of Federal Wealth-Transfer Taxes*, 48 CLEV. ST. L. REV. 749, 757 (2000) (noting that analyses of “Internal Revenue Service data on actual estate tax returns indicate that more than a third of [the \$32.3 billion in] revenue [for fiscal year 2001] will come from estates with gross values in excess of \$10 million—estates that presumably had the benefit of expert estate planning, and could not be said to have ‘volunteered’ in any meaningful sense to pay estate taxes”).

With respect to the *actual extent* of giving “early” and “often” by the top 1%, James Poterba found that “[a]lthough households that are potentially liable for estate taxes could transfer roughly one-quarter of their net worth to their heirs through a systematic program of planned giving, the observed flow of inter-vivos giving is substantially smaller than such a tax avoidance program would imply.” Poterba, *supra* note 126, at 330. “What is clear is that nearly three-quarters of the elderly households for whom the estate tax may loom as a potential burden are *not* making transfers.” *Id.* at 345. “Many analysts hold the view that the estate tax can be avoided by the use of sophisticated tax planning If the tax is easily avoided, however, it is not clear why it does raise substantial revenue” *Id.* at 328-29.

I think that everyone sees the need for serious reform of the estate tax to reduce the gamesplaying (and to limit it to the truly wealthy). Alternatively, we could replace it with a system of realization at death (as Canada has done) or replace it with an income inclusion by the donees, which I would like to see further explored, as it would eliminate the separate tax by incorporating it into the income/consumption tax. See *infra* note 272. Some form needs to be maintained, however, if we are serious about progressivity of the tax burden and taxation of capital returns. Today, the estate tax serves as an important backstop to our hybrid income/consumption tax, indirectly taxing capital returns (mainly unrealized gains) that were never taxed under the income/consumption tax. Providing a pure consumption tax that allows the wealthy to grow their holdings without contributing to the costs of government, and then to allow transfer of that wealth from generation to generation without tax, as it keeps growing over time, seems undefensible under my personal ideology, described in Part I. As Slemrod and Bakija state:

A consumption tax . . . that does not include bequests or inheritances in the tax base will lower the average tax rate over a lifetime on those (generally high-income) families who pass on wealth to their heirs For this reason some economists who favor a consumption tax do so only if a bequest is treated (that is, taxed) as if it were an act of consumption by the bequeathor.

SLEMRD & BAKIJA, *supra* note 69, at 176-77. McCaffery does not support such treatment. He wishes to allow wealth to accumulate without tax, and to be transferred from generation to generation without tax, until (and unless) it is spent on consumption, no matter how many billions are accumulated.

gains appear to utilize the avoidance strategies that theory would predict. Put simply, over \$100 billion capital gains are realized every year, and most of them face a positive rate of tax.”¹⁵⁷ Moreover, the authors recognized that their initial data applied only to realized gains, which does not take into account a reduction in effective tax rates by delayed realization. So they went further.

To gain a more complete picture of the relationship between realized and accrued gains, we look at the only available evidence on unrealized gains, from the Survey of Consumer Finances If higher-income people more successfully avoid realizing taxable gains, then accrued gains should be more concentrated among high-income people than realized gains. However, this pattern is not in evidence For corporate stock, taxpayers with over \$100,000 of income realized about 87 percent of gains in the average year of the period, whereas their accruals accounted for only 70 percent of gains. For business assets, the respective values for realizations and accruals are 76 percent and 61 percent.¹⁵⁸

They concluded: “Our findings dispel [the contention] that high-income people can avoid the tax at will”¹⁵⁹

In commenting on their work, Jane Gravelle notes that since capital gains are the type of income “thought to be most under the straightforward control of the taxpayer,” Auerbach, Burman, and Siegel’s study “is particularly significant because, if high-income taxpayers are not successfully practicing tax avoidance for this source of income, they are unlikely to be more successful with other types of income.”¹⁶⁰ She found little to criticize. “In fact, this study both suggests that the wealthy do not avoid much capital gains tax and may present more evidence that the realization response is not very powerful.”¹⁶¹ She found particularly significant the evidence that “higher-income individuals tend to have the same, or larger, shares of realizations as they have of accruals.”¹⁶²

[T]he real question is why high-income individuals realize so much capital gain when there are many sophisticated techniques to avoid tax while still obtaining cash and the risk characteristics desired The authors present some evidence on the use of these sophisticated techniques and find them not very widely used. One explanation may be that transaction costs are too large to permit the shielding of gains in this alternative way In any case, this failure to use tax-avoidance techniques tends to provide additional evidence that the realizations response is not very large.

. . . .

157. Alan J. Auerbach et al., *Capital Gains Taxation and Tax Avoidance: New Evidence from Panel Data*, in *ATLAS*, *supra* note 1, at 355, 356.

158. *Id.* at 378.

159. *Id.* at 377.

160. Jane Gravelle, *Commentary on Chapter 11*, in *ATLAS*, *supra* note 1, at 389, 389.

161. *Id.*

162. *Id.*

The apparently limited use of sophisticated techniques of capital gains avoidance, even among very high-income individuals, is further evidence of a limited sensitivity to tax factors. If individuals are not willing to take the time to arrange tax-avoidance transactions to allow them to realize without paying tax, how much less willing would they be to forgo sales altogether in order to minimize tax liability? These observations give us some reasons to believe that the realizations response is not responsive to tax considerations. If realizations elasticities are small, then much of the efficiency impetus for capital gains reductions is eliminated, and the claims that the lower rates can be adopted with little or no revenue loss cannot be true. Small realizations elasticities also suggest that the recent cuts in capital gains taxes will be much more costly than predicted by the revenue estimators at either the Joint Committee on Taxation or the Treasury, and that the efficiency benefits are less significant than the distributional consequences.¹⁶³

If there are not very many people like Artful Dodger out there, if empirical studies show that the very rich simply don't behave like that, the tax system is "voluntary" for the top 1% only in an unimportant, meaningless sense. In another context, Francis Edgeworth said: "Only a very clever man would discover that exceptional case; only a very foolish man would take it as the basis of a rule for general practice."¹⁶⁴ To fundamentally change the tax system to catch a theoretical taxpayer (or a handful of real taxpayers) is overkill, to say the least.

The empirical evidence that we do have suggests that McCaffery is wildly overstating the abundance of these wealthy tax dodgers (and then using them to get the middle class taxpayer to go along with his preferred tax system). As noted already, the top 1% pays more than a third of the personal income taxes, suggesting that they are not willing to engage in the significant behavior changes that would result in significant tax reduction. Very few taxpayers earning more than \$200,000 per year (which is a threshold well below the top 1%) pay no federal income tax, and there is no trend indicating a significant problem. As reported by the Internal Revenue Service:

For 1999, of the 2,429,942 income tax returns with AGI of \$200,000 or more, 1,605 (0.066 percent) showed no U.S. income tax liability; and 1,398 (0.056 percent) showed no worldwide income tax liability For 1998, there were 1,467 returns (0.070 percent) with AGI of \$200,000 or more with no U.S. income tax liability; and 1,283 returns (0.062 percent) with no worldwide income tax liability.

Of the 2,479,566 tax returns with expanded income of \$200,000 or more, 2,525 (0.102 percent) had no U.S. income tax liability; and 2,174 (0.088 percent) had no worldwide income tax liability Of the 2,132,301 returns with expanded income of \$200,000 or more for

163. *Id.* at 390-91.

164. Joel B. Slemrod, *The Economics of Taxing the Rich*, in *ATLAS*, *supra* note 1, at 3, 12.

1998, there were 2,224 (0.104 percent) with no U.S. income tax liability; and 1,914 (0.090 percent) with no worldwide income tax liability.

Thus, the proportion of nontaxable returns both in terms of expanded income or AGI and whether measured by absence of U.S. income tax or absence of worldwide income tax decreased slightly between 1998 and 1999.

....
The percentage of nontaxable returns are not substantially different [between 1976 and 1999] regardless of whether measured in constant or current dollars.¹⁶⁵

Of course, McCaffery might well respond that the people following his Tax Planning 101 course would not show up in these statistics, since they have changed their behavior so as to stop earning any realized income, even from their investment portfolio, while living on borrowed money secured by that portfolio. But, as noted above, other studies cast serious doubt that the behavior of the top 1% conforms to the strictures required by Tax Planning 101. Studies show that the very wealthy do not deliberately avoid all realized income. Indeed, labor earnings comprise a large (and growing) share of the top 1% picture.

Before the 1940s, the wealthiest Americans earned the bulk of their income from returns on capital; now their primary source is wages and salaries. In 1916, for example, the top 0.01 percent of "tax units" earned 70 percent of their income from capital, 24 percent from business ventures and only 6 percent from wages. By 1998, wages and salaries accounted for 45 percent of the very top group's income; business activities, 33 percent; and return on capital, 22 percent.¹⁶⁶

Finally, the repeated implications that McCaffery makes to his middle class reader that the very rich do not pay their fair share of taxes does not even suggest to the reader that the very rich may actually pay much *less* under his system than under our hybrid income/consumption tax. Because so much is at stake here—more than one-third of the total personal income tax take—I would need reassuring empirical evidence that the top 1%'s share of the tax take would not be shifted downward, even to the 95th percentile group, under his plan, for such a shift can exacerbate even further the increasing wealth concentration in the top 1% documented in Part I. But he gives us no such assurance. He states: "The Fair Not Flat Tax is roughly distributionally neutral: it doesn't significantly change the broad pattern of who bears the tax burden."¹⁶⁷ I think that this statement is very misleading to the middle class reader.

First, he doesn't define what he means by the "the broad pattern." Does he mean only that the top quintile, the top 20%, will roughly pay the same tax as it does today? If he's speaking only in quintiles, that can

165. Brian Balkovic, *High-Income Tax Returns for 1998*, in STAT. INCOME BULL. 7, 10 (2002).

166. Krueger, *supra* note 110.

167. McCaffery, *supra* note 114, at 122.

result in major shifting of the tax burden from the super wealthy to the mass affluent who are not that different from the average. The top 1% is truly different, as described in Part I—even from the next 4%. They are not just wealthier but *disproportionately* wealthier, owning nearly 40% of the private wealth in this nation.¹⁶⁸ Any proposal that can significantly reduce the tax burden on this very special group, and indeed which is aimed specially at encouraging them to increase their wealth accumulation even more through saving more, is troublesome (at least to me).

Second, he makes this claim by comparing for the reader the *marginal* rate structures of his tax plan and the current Code (even though he had previously instructed the reader on the importance of the average tax rate). “[I]f we kept revenue constant and lowered rates on the rich, we’d have to increase rates on the middle- and lower-income classes.”¹⁶⁹ By referring to a table comparing current marginal rates and the marginal rates that he proposes for a family of four, he asserts that “the burden on the lower and middle classes eases.”¹⁷⁰ At another point, he says that making rich people pay tax on their spending “would in turn lower the burden on ordinary workers,”¹⁷¹ again implying to the reader that his plan would shift more of the tax burden from the middle class to the wealthy. This, of course, is very misleading because the tax bases are different. Having a 50% marginal rate on spending at the top can extract less tax than under current law. And having a 10% marginal rate on a tax base at the bottom that includes borrowing to consume can result in a higher tax bill than under current law. We need much more evidence than he gives the reader regarding the mix of spending to realized income in the top 1%, as well as the distribution of debt to finance consumption.

With respect to the former, McCaffery is constantly giving the impression to his reader that the rich class contains many profligate spenders who must be reigned in for the good of the country. (More on his “for-the-good-of-the-country” argument in the next subpart.) He talks about “Rich Dads” as “people who are only about themselves, who look to spend every last penny on their narrowly selfish desires.”¹⁷² This is one of the ways in which he reinforces to the reader the implication that imposing a tax on spending can increase the tax burden of the rich. But the empirical evidence shows that the top 1% saves at extraordinary rates. There is “strong evidence that the higher the lifetime income, the higher the saving rate.”¹⁷³ Slemrod noted:

The distribution of net saving by wealth class is also apparently quite concentrated. . . . [T]he top 1 percent of 1983 wealth-holders did 13 percent of net saving between 1983 and 1986; when ranked by 1986

168. See *supra* fig.4, Part I.A.

169. *Id.*

170. *Id.* at 93.

171. *Id.* at 51.

172. *Id.* at 75.

173. Stephen P. Zeldes, *Commentary on Chapter 14*, in *ATLAS*, *supra* note 1, at 485, 486.

wealth-holders, the top 1 percent did 53.7 percent of net real saving! The striking difference in results is due to the endogeneity of 1986 wealth to realized savings between 1983 and 1986—those who successfully saved are, other things equal, bound to become wealthier.¹⁷⁴

The super rich save so much that one academic recently sought to explain precisely *why* they saved at rates so much higher than the middle class. In *Why Do the Rich Save So Much?*,¹⁷⁵ Christopher Carroll finds that the typical “life cycle” model of saving, under which people save primarily to finance their own future consumption, is persuasive for the median income earner but not for the super wealthy, the top 1%. “[T]he richest households [the top 1%] are saving more than can be justified even in a version of the Life-Cycle model that allows for very patient consumers with a strong precautionary saving motive.”¹⁷⁶ So he next models a “dynastic model,” under which people save “mainly for the benefit of their heirs,”¹⁷⁷ but finds this model lacking explanatory power as well. He found that “only 5 percent of the total population, and 4 percent of the wealthy households, indicated that providing an inheritance was one of their *top five* reasons for saving.”¹⁷⁸ There is also no evidence that the wealthy childless elderly dissave.¹⁷⁹ Evoking Weber’s argument that the “pursuit of wealth for its own sake was the ‘spirit of capitalism,’”¹⁸⁰ Carroll finally turns to what he calls a “capitalist spirit” model and concludes that “the wealthy save because, either directly or indirectly, they obtain greater pleasure from possessing an extra dollar of wealth than they would get from an extra dollar of consumption”¹⁸¹ The “essential insight” of this model is that “consumers with permanent income below a certain threshold behave like standard life-cycle consumers and try to spend all their assets before death; consumers with permanent incomes above the threshold save at ever increasing rates as lifetime income rises.”¹⁸² He notes that informal evidence is also consistent with the notion that “wealthy people derive utility either directly from the ownership of wealth, or indirectly, either from the activities that lead to wealth accumulation or from a flow of services that is closely tied to the ownership of that wealth.”¹⁸³ “The view that all wealthy people are motivated solely by a love of wealth for its own sake is surely extreme. A variety of other plausible, and apparently very different, motivations are commonly proposed, ranging from job satisfaction to status-seeking, to philanthropic

174. Slemrod, *supra* note 164, at 6.

175. Carroll, *in* ATLAS, *supra* note 1, at 465.

176. *Id.* at 469.

177. *Id.* at 465.

178. *Id.* at 472 (emphasis in original).

179. *See id.* at 473.

180. *Id.* at 474.

181. *Id.* at 466.

182. *Id.* at 475.

183. *Id.* at 476.

ambitions, to power lust.”¹⁸⁴ But although these are very different psychological motivations, some benign and some perhaps not, they lead to behavior that is indistinguishable from the “wealth-in-the-utility-function model.” This means that, whatever the motivation of the super rich to save, taxing the top 1% only on what they spend, and not taxing them on what they save, can lead to a lower tax burden than what they endure today. This can be the case even with quite progressive rates at the top. A very high earner, who is subject to the 38.6% bracket today, can lower his tax bill substantially under McCaffery’s system by buying a huge house and a stock portfolio with his earnings, behavior that apparently he is already predisposed to engage in.

Moreover, since McCaffery effectively would not tax debt used to purchase investment assets, I would predict that it is almost a certainty that wealth disparities would accelerate, since money could be borrowed on the strength of existing wealth to purchase more assets, and the return on those assets would not be taxed, even the capital gains when sold, so long as it was not consumed. Since only so much can be spent on consumption, and since apparently the utility of further wealth accumulation exceeds that of further consumption for the super wealthy, I suspect that this would likely lead to even further wealth disparities and concentration of wealth. At the least, I need to see better empirical evidence. McCaffery explores none of this with his middle-class reader.

At bottom, McCaffery tries to convince his reader that his plan would be significantly progressive by focusing only on his progressive tax rate structure—devoting an entire chapter to it—while ignoring the effects of his consumption tax base on the distribution of the tax burden. While at first he tells the reader that he disagrees with the “flat tax” proponents who seek to tax only labor income, not capital income,¹⁸⁵ because taxing only labor income would be unfair, he finally concedes to his reader that the flat tax base is essentially the same as his proposed base when he says: “[T]he Fair Not Flat Tax agrees with conservatives [who support the flat tax] about the tax base and with liberals, or at least moderates, about tax rates.”¹⁸⁶ The fact that one has a progressive marginal rate on spending does not mean that you have a progressive tax as measured by realized income. Especially in view of the evidence that savings rates increase (and consumption rates decrease) as income rises, it could result in a flat or even regressive tax when the tax paid on spending is placed in the numerator and realized income placed in the denominator. We simply do not have this evidence.

In a few places, McCaffery acknowledges to the reader that his proposed tax could decrease—not increase, as he repeatedly implies elsewhere—the tax burden on the super wealthy. At one point, he slips in that “the rich will benefit most from the repeal of the gift and estate tax

184. *Id.* at 477.

185. *See supra* notes 49-52 and accompanying text.

186. MCCAFFERY, *supra* note 114, at 95.

and the systematic nontaxation of savings under the Fair Not Flat Tax”¹⁸⁷ in defending the use of progressive rates. He also says: “While certain rich savers will win by repeal of the death tax, their good fortune will inure to the benefit of all. When the wealthy save, they help society.”¹⁸⁸ (Again, I’ll address his implicit argument that decreasing the tax burden on the wealthy will help the economy in the next subpart.)

Moreover, in the back of the book, in a question-and-answer section, he poses two questions and answers on this count, which are worth quoting in full. This is what he says in response to the question: “If we don’t tax savings at all, won’t private capital build up and up, making the distribution of wealth more uneven than it is today?”

Not necessarily, and probably not. Remember that the inconsistent income tax already fails to tax most savings. The estate tax is easily avoided by those so motivated. Worse, the rich today can consume free. Under a consistent spending tax, this will no longer be possible. A billionaire spending \$10 million a year will now have to pay taxes on \$10 million a year. The consistent progressive tax on spending will reduce the accumulated wealth of those rich people living the good life.

Here’s another, more technical way to make the point. People often assume that tax rates will have to go up under a consumption tax, because the tax base will shrink when we systematically exclude savings. That would be true if we were starting from a consistent income tax. But of course we are not. The inconsistent income tax already misses most savings. And a consistent consumption tax would have two major base-broadening features compared to the status quo: the inclusion of debt-financed consumption in the tax base, and the repeal of a special preference for capital gains. These changes would diminish, not enhance, the privileges of the rich.¹⁸⁹

Notice that when he says that “the inconsistent income tax already fails to tax most savings,” as though his plan wouldn’t change much, he does not qualify that statement by income distribution. It is absolutely true that the savings of the lower and middle classes are protected from taxation through pension plans, IRAs, life insurance, and home sale gain that goes untaxed on sale, even if the proceeds are not rolled over into another house but rather spent on consumption in retirement. (Indeed, they get better-than-consumption tax treatment, since their savings are untaxed while their borrowings are also excluded from the tax base, unlike under a pure consumption tax.) But he neglects to mention that the earnings of the top 1%, which I am most interested in and which pays more than a third of the tax, exceed the income limits for some of the most important consumption tax features aimed at the lower and middle classes. The chief consumption tax feature for the top 1% is the realization requirement, which shelters unrealized appreciation in property from tax.

187. *Id.* at 124.

188. *Id.* at 110.

189. *Id.* at 151.

But we have seen that the wealthy consistently realize these gains,¹⁹⁰ contrary to McCaffery's Tax Planning 101 instructions. Moreover, his assumption that inclusion of debt-financed consumption in the tax base would hurt the super rich more than the middle class is not backed up by any empirical evidence. As noted earlier, the super rich save at extraordinary rates, and the middle class has seen the greatest rise in debt.

McCaffrey asks, "But how can you just ignore the pleasure and power that large amounts of savings would bring?"¹⁹¹ This is what he says in response:

This comment gets back to a basic liberal misconception: that fairness dictates taxing savings. I believe that the liberals are wrong.

For one thing, capital helps us all—perhaps especially the lower and middle classes. Rich people who save are contributing to society's overall well-being. They are not being selfish, spending every last penny on themselves in order to go broke. It's backward to have a tax policy that punishes rich people for saving and encourages them to spend—encourages them, that is, to pursue a lavish and luxurious lifestyle. High-end consumption, not the accumulation of capital, should be the liberal's true concern.

Let's take the liberal objection more seriously for a moment. It is true that large sums might build up in private Trust Accounts under a consistent consumption tax. But what is wrong with the mere possession of large amounts of wealth?

Two answers spring to mind. One, people who have wealth will one day be able to spend a lot of money on themselves and live luxuriously. The possession of wealth confers the right to future consumption. But a consistent progressive spending tax such as the Fair Not Flat Tax checks this problem. When holders of large Trust Accounts go to spend down their wealth, they will be taxed. If they make large withdrawals to spend lavishly on nonurgent needs, they will be taxed at the highest marginal rate level. The Fair Not Flat Tax gets at both actual consumption and future consumption. In fact, it does so far better than the inconsistent income tax system, notwithstanding the latter's seeming concern with capital as a source of potential consumption. Recall that when Ross Perot spent \$60 million running for President, he saved \$33 million in today's taxes [not because his expenses were deductible under the income tax—they were not—but on McCaffery's theory that spending the money before he died removed the money from his estate and thus avoided tax under the estate tax]. Under the proposed consistent consumption tax he would have to withdraw \$120 million from his Trust Account and pay \$60 million in taxes in order to spend \$60 million on himself. Which system does a better job at getting at the pleasures that wealth bestows?

The second concern about private possession of wealth is that people who have a lot of capital will become too powerful. Large pools

190. See *supra* notes 157-63 and accompanying text.

191. McCaffery, *supra* note 114, at 151.

of private savings may indeed confer a level of power on their holders that would be troubling in a liberal democracy. If Bill Gates or Warren Buffet could use their billions of dollars to affect politics, this would be problematic. Of course, they can do that easily enough under today's inconsistent income-plus-estate tax. Wealthy, sophisticated investors like Gates and Buffet need not pay any tax on their capital if they follow Arftul Dodger's simple plan, even if they are using the money to influence economic markets or politics.

Liberals might point out that the Fair Not Flat Tax will allow even greater stores of wealth to accumulate within the Trust Accounts and hence will be more problematic than the status quo. I've already indicated my skepticism about this claim. But more important, a consistent spending tax automatically generates a mechanism to monitor and control the problem of the private abuse of wealth in a way that the current tax system does not. We can regulate the Trust Accounts to prevent their abuse just as we regulate most large pools of capital today.¹⁹²

Where to start? As noted earlier, I'll address his "the-rich-help-us-all-by-saving" argument in the next subsection, which deals more fully with his economic arguments. He also asks rhetorically what is wrong with the mere possession of large amounts of wealth and responds, first, that it confers the right to future consumption. Since a spending tax would tax that consumption, he avers that he's got that base covered. But, of course, that does not respond to the question of why the person who was able to exploit our regulated capitalist system to reap huge rewards should not have to pay any of the costs of that system *until* such time (if ever) that he spends money. Tax deferral is tax reduction in present value terms—and can be the equivalent of complete forgiveness. Moreover, it's not the spending of the money that justifies his payment of part of the costs of capitalism; it's the *earning* of the money via that system, whether by labor or capital, that justifies his having to pay part of the costs—even if he doesn't spend a dime of it. But this diverts me to his "morality" argument, which is the subject of the third subpart, below.

Let me at least say with respect to his Ross Perot example that I find it truly remarkable that he is essentially arguing that Ross Perot ran for president in order to save on his estate taxes! The rich "might as well spend their money running for high-ranking elected offices—as Perot did in 1992. He used \$60 million of his money to run for president, thereby saving over \$30 million in eventual estate taxes."¹⁹³ (I don't know if he really believes this simplistic view of incentives or if he merely wants his middle-class reader, whom he's trying to convince with this book, to believe it.) I also find it difficult to swallow the argument that we should repeal the estate tax in order to provide a disincentive for wealthy people to run for political office. It's tantamount to saying that we can prevent rich people from running for office if only we would reduce their tax bur-

192. *Id.* at 151-53.

193. *Id.* at 71.

den and thus make them even wealthier (which is what I believe a consumption tax without estate tax, in replacement for our current Internal Revenue Code, would do—even with a top spending marginal tax rate of 50%). It's a truly silly argument, in my view.

The second objection that he foresees, and addresses, is that the increased wealth accumulation that can occur in the top 1% under his plan can lead to excessive power. His answer? Regulate the savings of these wealthy people so that they don't abuse their power. He seems to be concerned only with excessive economic power (the power to control an industry, say, through concentrating investment in that one industry), because his answer is to require diversification.¹⁹⁴ He also would make sure that lobbying expenses are treated as personal consumption expenses (as they are under current law) so that they are taxed. Suffice it to say that I don't think that requiring diversification and ensuring that lobbying expenditures are taxed, as they already are today, begins to answer the myriad political, social, and economic problems that can arise with excessive wealth concentration. For example, extreme wealth concentration in a nation seems to correlate with average lower life expectancy¹⁹⁵ and slower economic growth.¹⁹⁶

Before moving on to his economic arguments, let me close with a further word on his repeated assertions, both implied and explicit, that the rich don't pay tax in this country, or can easily and legally avoid tax under current law, and that this is one of the big reasons to come on board in support of his plan. One has to read his entire book to get the full flavor of how he belabors this point as a way to sell his tax plan to the reader, whom he clearly envisions to be the average taxpayer. In my view, this does a great disservice. The average taxpayer, when polled, already thinks that the rich easily avoid taxes on a massive scale. One survey, for example, revealed that people on average believed that 45% of millionaires paid no income tax!¹⁹⁷ I understand his motivation. I understand that McCaffery wishes the reader to become so incensed at the rich not paying tax that he will sign on to his plan as a way to get the rich guy. But further nurturing these misconceptions on the part of the public in an attempt to sell his tax is simply not defensible, in my view—particularly when his plan might well end up taxing the all-important top 1% *less* heavily than under current law.

B. ECONOMIC ARGUMENTS

Most supporters of consumption taxation do so on economic grounds. They claim that if savings were freed from tax, and only personal consumption were taxed, then people would actually react to this incentive, changing their behavior by substituting savings behavior for consumption

194. *See id.* at 147-48.

195. *See generally* Krugman, *supra* note 70, at 67.

196. *See infra* notes 211-14 and accompanying text.

197. *See* Slemrod, *supra* note 164, at 8.

behavior—a phenomenon dubbed the “substitution effect.” The additional money injected into the economy from greater investment (from their new savings) by U.S. citizens and residents would increase economic growth. It might even reduce interest rates—at least if the government is not dissaving at the same time by deficit spending and foreign investors are not withdrawing their U.S. investments.

Another way that they like to say the same thing is that savings are subject to double taxation under an income tax, whereas consumption is subject to only a single tax. The argument is that when \$100 of wages are earned, and taxed, the taxation of that \$100 is also—at the same time—implicit taxation of any future investment income which that \$100 will earn (if invested), since that \$100 represents the present value of any future investment return under common valuation models. If we tax the actual investment return when earned, we’re taxing a portion of that initial \$100 a second time, or so the argument goes.¹⁹⁸ In contrast, if the taxpayer spends that \$100 on personal consumption, instead of investing it, it is taxed only once (when spent, since the amount spent is not deducted and thus is taxed by failing to be removed from the tax base). To complete the argument, they assert that people actually appreciate this and actually react to this disincentive by consuming instead of saving in order to avoid this supposed double taxation.

McCaffery repeatedly relies on such economic arguments—and then unexpectedly says “never mind.” For example, he tells his reader: “Because of the second tax on savings, all else being equal, people will save less under an income tax than they will under a consumption tax.”¹⁹⁹ The “all else being equal” must encapsulate an awful lot that he does not tell his reader, for it ignores the fact that many people are so-called target savers, who save for fixed targets, such as \$500,000 in the bank by age 65, or \$100,000 in the bank by the time that Junior reaches college age. Because of the tax preference for savings under a consumption tax, a target saver can actually *reduce* his savings rate (the percentage of his earnings that he saves) and still reach his target—a phenomenon dubbed the “in-

198. Personally, I’ve always found this “double tax” argument to be rather dubious. It’s not double taxation in “real time.” The investment return is new wealth to the taxpayer when it’s actually earned. Simply because one method of *pricing* an investment under financial theory is to compute the present value of future, expected returns does not mean that taxing the initial amount invested is tantamount to taxing all those future returns as well. And I think that Nicholas Kaldor, whose work McCaffery cites (*see* McCAFFERY, *supra* note 114, at 58), agreed with me. He said:

Some people would take strong objection to this statement on the ground that the market value of property is merely the discounted value of its expected future yield; wealth viewed as a stock and as a flow are merely two different aspects of the same thing, and not two different things; to regard the discounted value of the flow of wealth as something additional to the flow of wealth itself is counting the same thing twice over. All this may well be true from some points of view, *but from the point of view of the measurement of taxable capacity—which is the only purpose in question here—it is not correct to say that the one is just a reflection of the other.*

NICHOLAS KALDOR, *AN EXPENDITURE TAX* 31-32 (3d ed. 1955) (emphasis added).

199. McCAFFERY, *supra* note 114, at 36.

come effect.” The extent to which the substitution effect (which would increase the savings rate) and the income effect (which would reduce it) operates in the economy is unknown,²⁰⁰ but there is reason to believe that there are a lot of target savers in the middle class. As noted earlier, the evidence seems to indicate that they more often tend to be life-cycle savers, trying to save enough to meet future consumption needs in retirement but spending the rest of their money, while the super rich seem to get more utility out of an extra dollar of savings at the margin than an extra dollar of consumption, contributing to the high savings rate of the wealthy.²⁰¹ Moreover, the decrease in the savings rate of the middle class over the last twenty years or so has corresponded to the broadening of consumption tax treatment for retirement savings for the middle class, which may be indirect evidence that they are target savers. Even focusing merely on the substitution and income effects is too simplistic, since many people save for reasons that have nothing to do with tax incentives or disincentives at all. Behavioral economists admit to not knowing at all why people save. The decisions can be an amalgam of inability to delay gratification, hyperbolic discount rates (which is another way of saying the same thing, because it means that a person would require unreasonably high rates of return to make it worthwhile to save and thus delay immediate gratification), general personality traits, even the role of shame.²⁰² Since middle class savers already enjoy better-than-consumption tax treatment for the bulk of their savings, enacting a pure consumption tax might do little more than provide inefficient windfall benefits to the top 1% for the savings behavior that they would have engaged in anyway.

While McCaffery tells his reader nothing of these difficult empirical questions, he does admit that some people might actually save less under a pure consumption tax but also states that “it is . . . not necessary to be precise. Most economists agree that a consumption tax is more efficient than an income tax. If we could turn back time and start over again with a consistent consumption tax, we would be a wealthier, happier people today.”²⁰³ The thoughtful lay reader who would like to make up his own mind on the evidence is told, essentially, to take his word for it that there would be nontrivial efficiency gains and that “most economists” agree on this (and also, by implication, to exalt efficiency over all).

He also dumbs down for his reader the connection between a consumption tax and interest rates. “[H]aving money available for investment is a good thing for the economy: the more capital there is, the lower interest

200. “Economic theory is completely silent on the question of which of these two opposing effects will dominate. The case for the conventional (supply side) position must therefore be made on empirical grounds.” Robert H. Frank, *Progressive Taxation and the Incentive Problem*, in *ATLAS*, *supra* note 1, at 490, 491.

201. See *supra* notes 173-84 and accompanying text.

202. See Mary Kane, *Behavioral Economists Can't Say Why We Spend*, CLEV. PLAIN DEALER, May 21, 2001, at 4C; Jacob M. Schlesinger, *Few Americans Heed Washington's Urging for Bigger Nest Eggs*, WALL ST. J., June 29, 1999, at A1 (providing anecdotes).

203. McCaffery, *supra* note 114, at 37.

rates become. Lower interest rates help us all”²⁰⁴ And again: “[S]avings are very important. The national pool of savings helps to keep interest rates low. This in turn helps today’s homeowners, students, and middle-class consumers, as well as future generations—our children and our children’s children.”²⁰⁵ Who wouldn’t like lower interest rates? It’s another reason to sign on to his plan, he implies to his reader.

While that’s true as far as it goes, it doesn’t go very far, and again he doesn’t give any hint to his reader of the complexities inherent in such broad, sweeping, but ultimately simplistic-to-a-fault statements. Once again, I get the feeling that McCaffery is more interested in simply getting the reader on board for his plan than in truly educating him, and so he doesn’t want to introduce any complications that might undermine his case. The statement implicitly assumes so much. It assumes that private capital must come from savers in this country (rather than from savers abroad investing in this country, as occurred heavily in the 1990s), so we must increase the flow of private capital from savers in this country; it assumes that replacing our current Code *would* substantially increase the private savings rate; and it assumes that the government would not, at the same time, engage in deficit spending, which is dissaving that could offset the increase in private saving.²⁰⁶ None of this is assured, and thus interest rates could very well remain unchanged (or even rise) while the tax burden of the top 1% could well be shifted downward.

For example, Slemrod and Bakija, in their book also written for the general public, helpfully describe, in easy-to-understand terms, the difficulties of measuring whether or not a consumption tax replacement for the current Code would actually increase private savings significantly (which could lower U.S. interest rates if the savings stay in this country, there is not an exodus of foreign investment, and the government doesn’t significantly deficit spend). They conclude that any effect would likely be quite modest—whether the tax under examination is a flat-rate consumption tax (such as the so-called flat tax) or a progressive cash-flow consumption tax similar to McCaffery’s proposal (the USA tax). They also introduce the important notion that economic growth might also be had at the sacrifice of quality of life if it means more hours worked. In other words, efficiency is not, in fact, all.

The potential economic benefits of switching to a consumption tax are real, but how large would these benefits be? . . . In many cases, the best evidence suggests only a moderate effect. . . . It is clear that promises of miraculously higher growth rates forever are unjustified by the existing evidence.

204. *Id.* at 38.

205. *Id.* at 120.

206. *Cf.* William G. Gale & Samara R. Potter, *An Economic Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001*, 55 NAT’L TAX J. 133 (2002) (concluding that the deficit spending produced by the tax cuts for the wealthy in the 2001 act will increase long-term interest rates and thus dampen the projections for economic growth that were otherwise assumed to accompany the tax cuts for the wealthy).

....
 Based on historical experience, many important areas of economic behavior, especially savings rates and hours worked, appear to be unresponsive to moderate changes in incentives.

....
 According to [Alan Auerbach's] estimates, adopting the USA Tax, which has the most progressive rate structure and significant transition relief, would generate little growth in output per capita, leaving it only 1.6 percent higher than it otherwise would be after ten years Achieving these gains in the simulations requires a doubling of the saving rate. Although the model is based on a reasonable estimate of the likely saving response, the large simulated increase in saving rates suggests that a slightly different model may be more appropriate. Auerbach also concludes that introducing into the model either a reasonable cost of adjusting the capital stock or a lower responsiveness of work effort would reduce the projected growth significantly.

Other modeling changes can alter the answers a lot. For example, Eric Engen of the Federal Reserve Board of Governors staff and William Gale have constructed a model of the economy that accounts for the fact that the income tax system already lets much capital income go untaxed and also incorporates a precautionary motive for saving. Their model suggests that switching to a consumption tax would increase the saving rate by only around one-tenth of its current level, leading to a correspondingly small impact on economic well-being.

....
 [Increases in "welfare" are far more modest under consumption tax proposals.] For example, . . . some of the increased output occurs because people are projected to work a greater number of hours. Working longer hours obviously has a cost in terms of lost leisure, so the increased output is an overestimate of the net benefit. "Welfare" is the economists' term for a dollar measure of well-being that takes these factors into account. In these stylized models, increases in welfare from tax reform are considerably smaller than increases in output. For example, in Auerbach's model, welfare is estimated to increase by between 0.64 percent and 1.85 percent for future generations, depending on which consumption tax is adopted Other studies have come to similar conclusions.

....
 What can be concluded from all this? It is possible that the shift to a flat-rate, clean-base consumption tax system could eventually cause incomes to increase by a few percentage points, with some of that gain offset by less leisure time or reduced spending in the early years. Much of the potential gain from the reform plans comes from scaling back progressivity or shifting burdens onto older generations. It is not clear how the economic gains would be distributed among the population, but they would probably go disproportionately to the same people who benefit most from the tax changes even without any economic response. There is an unavoidable trade-off here, as

younger generations and higher-income people would be made better off at the expense of older generations and poorer people; it is extremely unlikely that economic growth would allow us to transcend these trade-offs entirely. Plenty of uncertainty applies to all of the predictions.²⁰⁷

Their own bottom-line, personal conclusion?

The weight of the evidence suggests private saving is probably not very responsive to the after-tax rate of return. The bottom line is that switching to a consumption tax does not guarantee a big boost in saving and investment—our best guess is that at most there would be only a small increase. Because there are more direct ways to increase national saving (for example, increasing the budget surplus), the likely but not assured prospect of a somewhat higher saving rate does not appear to be, by itself, a reason to undertake a wholesale transformation of the tax system.²⁰⁸

McCaffery provides his reader no such nuance. As a true believer, he seems interested only in preaching to his readers the salvation of his plan.

And again he seems to imply that the rich don't save now, which is why we need to provide tax incentives for them to save so that the economy can grow, which would help the middle class.

[F]or most Americans there is no real difference between an income tax and a consumption tax, because most Americans don't save.

For the most part, then, the difference between an income and a consumption tax base directly impacts only the wealthy. But this does not mean that the choice of tax is unimportant. Far from it. Savings matter. The attempt to tax savings has had major consequences for tax policy in America. What the rich do with their money is important for the rest of us mainly because it is important to our national economy. Saving is good for us all. *We ought to be encouraging the rich to save; it is exactly the same thing as not encouraging them to consume so much on themselves.* We also ought to be making it easier for ordinary working-class people to get into the savings habit. Any true income tax is backward in this regard.²⁰⁹

He neglects to say that working-class people can already shelter virtually all of their savings from tax. We don't have a "true income tax" for the middle class. (Indeed, he implies the opposite when he says that his tax "is fairer—especially to those middle-class Americans who are trying to save"²¹⁰—implying that the savings of the middle class are taxed now and would not be only under his tax.) The issue is whether we ought to extend the consumption tax treatment already enjoyed by the working class to the top 1%. McCaffery says yes, because we need to get them to save in order to expand the economy. But, as noted earlier, the rich al-

207. SLEMRUD & BAKIJA, *supra* note 69, at 232-35.

208. *Id.* at 180.

209. MCCAFFERY, *supra* note 114, at 41 (emphasis added).

210. *Id.* at 121.

ready have high savings rates, so once again, a consumption tax might do little more than provide inefficient windfall benefits to those who would have saved anyway.

More important, the logical corollary of his argument that the rich will save more than they do now if we enact a pure consumption tax is that wealth accumulation by the top 1% will grow even more concentrated. Robert Frank points out that economic inequality has historically been accompanied by *slower*, not more rapid, growth rates.²¹¹ In other words, if McCaffery is right that the wealthy would, in fact, react to the savings incentives of a pure consumption-without-estate tax to increase their savings rates even more, then the increasing wealth inequality documented in Part I could become even more pronounced. (This would seem to be particularly true if, as I will discuss below, he is right that the middle class can *increase* their consumption levels under a consumption tax, which would logically seem to decrease their savings rates even further.) Those “supply siders” who argue for lower taxation of capital, as under a consumption tax, in order to support economic growth ignore several cross-national studies described by Frank that seem to show strong negative correlations between inequality and growth rates. The “golden age” of economic growth rates of 5% per year in the U.S. and most of the rest of the industrialized world occurred between the end of WWII and roughly 1973, a time of high marginal tax rates on the wealthy and much less income and wealth inequality than the period since 1973, which has witnessed growing wealth and income inequality, accompanied by an increase in the aggregate federal tax burden on those earning less than the median income of \$50,000 and a decrease in the aggregate tax burden on the wealthy. Moreover, those countries with greater shares of national income going to the poor and middle classes had higher growth rates. He concludes that “higher growth rates are associated not with higher income inequality, as predicted by supply-siders, but with lower inequality.”²¹² While he notes that correlation is not cause and effect, and other factors may be at work, he also notes that so far they haven’t been identified. “There was never any solid theoretical support for the existence of this trade-off [between equity and efficiency], and the empirical evidence, such as it is, would never change a skeptic’s mind.”²¹³ It hasn’t changed this skeptic’s mind.²¹⁴

211. Frank, *supra* note 200, at 495.

212. *Id.*

213. *Id.*

214. Even though Frank supports progressive taxation to decrease inequality on both efficiency and fairness grounds, he supports consumption taxation over income taxation as well because he believes it would dampen consumer demand and the keep-up-with-the-Joneses mentality (what he calls “luxury fever”). *See id.* at 503. Because McCaffery’s consumption-tax-without-estate-tax plan might well increase wealth concentration and inequality, however, it seems to me that complete reliance on such a plan would be inconsistent with Frank’s concern for such inequality. Perhaps an *add-on* consumption tax for the wealthy would address his concerns. As an interesting side note, the first time that Congress considered enacting a cash-flow consumption tax was as an add-on tax to discourage consumer demand. In 1942, the Roosevelt administration wanted to raise Social

Another argument that McCaffery makes that seems to be premised—at least implicitly—on economic grounds is that if we can get the rich to save more by consuming less there will be more for the lower classes to consume.

[M]oving to a consistent consumption tax does not mean that the law will oppose consumption, which many people consider to be the “engine of the economy.” Indeed, the Fair Not Flat Tax is more pro-consumption—and more genuinely progressive [editorial comment: he provides no empirical evidence for that]—than the mess we’re in In fact, a good reason to implement the Fair Not Flat Tax is that it will achieve more equality, more fairness in consumption—it will make it *a little bit easier for the lower and middle classes to consume, in part by making it harder for the rich to consume and getting them to save more instead.*²¹⁵

He says essentially the same thing later.

A consistent, progressive spending tax ought to make it easier for the lower and middle classes to consume by putting more of the responsibility for the nation’s savings on the shoulders of the rich. And the whole society should *want* the rich to save. This moves us toward a model of class teamwork and away from class conflict.²¹⁶

And again later:

The question of providing for the nation’s total supply of savings thus becomes one of asking who should consume less in order to fund society’s reasonable capital stock requirements. The flip side to the question of what consumption should we tax is what nonconsumption should we encourage? The Fair Not Flat Tax’s answer is compelling: it is the wealthy who should consume less. “*This would free up the lower and middle classes to consume more.*”²¹⁷

Huh? How does it make it easier for the middle class to consume more if the rich consumes less? That somehow implies that there is only a limited amount of “stuff” to consume out there, and the rich are taking “too much” of it, leaving only the leftover detritus for the middle class. If he’s talking only about nonrenewable resources, such as fossil fuels, perhaps he has a point. But he certainly doesn’t tell his reader that he’s talking about that. I would think the average reader would take away the impression that he’s talking about all manner of daily consumable items. But that ignores the laws of supply and demand. If the demand is there for the stuff, it generally will be produced (again, unless we’re talking about land

Security taxes in part to combat inflation by dampening consumer demand. The House rejected that idea but essentially got to the same place through the back door by proposing to piggyback a cash-flow consumption tax onto the income tax (since, as discussed earlier, a wage tax such as the Social Security tax can be seen as a consumption tax). The tax would have been imposed on income less savings, loan repayments, and some other preference items. It got killed quickly. See WITTE, *supra* note 3, at 117.

215. McCaffery, *supra* note 114, at 43 (emphasis added).

216. *Id.* at 90.

217. *Id.* at 94 (emphasis added).

or some such limited commodity). Perhaps he means that if the rich stop buying, the *price* of stuff will go down under the laws of supply and demand, enabling the middle class to afford some items that they find too pricey now. But, again, he certainly doesn't say this. Or perhaps—as I think likely—he means that if the wealthy save more the economy will grow, which will allow the middle class to be paid higher wages, allowing the middle class to consume more. The more traditional way of phrasing what Slemrod and Bakija call this “highly controversial” argument is that taxing capital depresses wages.²¹⁸ But if that's what he means, it belies his assertion that, in fact, he's not relying on any sort of supply-side or “trickle-down-economics” argument, which he refers to as “voodoo economics.”

[T]he argument against an income tax and for a consumption tax like the Fair Not Flat Tax does not depend on any precise measurement of actual [economic] effects. It is not an argument like the supply-side supporters of Ronald Reagan and other conservative Republicans might make. I am not saying, let alone promising, that there will be X percent more work or Y percent more savings, or that GDP will increase by Z percent under a consumption tax. Washington, D.C., today is overrun with economists working in plush think tanks, cranking out “dynamic analysis” to show how much richer we would all be if we could just cut taxes their way. Most of this stuff is nothing more than “voodoo economics,” as the elder George Bush called it two decades ago. I am not relying on witchcraft. The argument for the Fair Not Flat Tax is about simplicity, efficiency, consistency and—first and foremost—about fairness. It rests on an appeal to our enlightened common sense. It is not about the total size of the nation's capital stock.²¹⁹

I have to admit that now I'm really lost. What are all the arguments that he made that I quoted above about how getting the rich to save more would help us all by injecting more capital into the economy, which would lower interest rates, etc., if not economic arguments? He explicitly argued: “What the rich do with their money is important for the rest of us *mainly because it is important to our national economy*. Saving is good for us all.”²²⁰ He also said: “The question of providing for the nation's total supply of savings thus becomes one of asking who should consume less *in*

218. They explain:

[The] argument goes as follows. Taxes on capital income . . . reduce the rate of return to saving, which in turn reduces how much people save. Because saving is what finances capital investment, a decline in saving over time means that there is a less capital-intensive and therefore less productive economy. By this reasoning, workers ultimately bear some of the burden of taxes on capital income, because their wages are reduced when the economy is less productive.

SLEMRD & BAKIJA, *supra* note 69, at 69-70. The authors go on to describe why the argument is “highly controversial.” *See id.* at 70.

219. McCaffery, *supra* note 114, at 42. He repeats himself later: “This is not a supply-side argument that depends on predictions that there will be more money for us all, that we will have a higher GDP, or anything like that.” *Id.* at 128.

220. *Id.* at 41 and accompanying text (emphasis added).

order to fund society's reasonable capital stock requirements."²²¹ But now he says that he does not rely on economic arguments or capital stock needs at all, that such stuff is "voodoo economics." It's all about "efficiency" (which, by the way, is an economic argument) and "fairness."²²² So why does he talk about how the nation will benefit, including the lower classes, if the rich save even more than they do now under their high savings rates? If it's only about "fairness," not economics, how can it be more "fair" to the middle and lower classes if the rich save more? I'm confused. Those arguments about getting the rich to save more *have* to be economic ones. I have to believe that McCaffery is hoping that his lay reader will, in fact, believe all the economic assertions and will discount the disclaimer. At the same time, he can then tell detractors (who might point out that others say that the economic effects would likely be weak) that he is not relying on any economic arguments but only on notions of "fairness." So it is to those fairness arguments that I now turn.

C. THE FAIRNESS OR MORALITY OF CONSUMPTION TAXATION

McCaffery says: "I believe that fairness is the most important element of a good tax system"²²³ He also says that he believes in the ability-to-pay norm as a norm of tax justice, but he believes that someone must *demonstrate* her ability to pay by an act of spending. Merely *having* ability to pay is not sufficient to require that person to contribute towards the cost of capitalism.

Let me be perfectly clear: I agree with "ability to pay" as a general principle informing the fairness of any tax. But the fatal flaw of even a consistent income tax is that it determines one's ability to pay at the wrong time—at the time of earning from labor or capital, rather than at the time of spending. The Fair Not Flat Tax will get at the rich—but when, and only when, they *show* their ability to pay by choosing to spend money on themselves.²²⁴

He does not say *why* it is unfair to tax the rich when they "have" ability to pay, rather than when they "show" that they have such ability, other than to say that taxing someone at the point of wealth accumulation does nothing more than attempt to tax "the sheer joy and psychological plea-

221. *Id.* at 94.

222. He also says that it's about simplicity, but Slemrod and Bakija, at least, disagree that a cash-flow consumption tax would be simple.

Unlike the other kinds of consumption tax discussed so far, the personal consumption tax would complicate tax matters for many individuals The tax affairs of the average taxpayer, . . . for whom the conceptual measurement difficulties of capital income are not of little concern, would be complicated by the addition to the tax base of borrowing and savings account withdrawals. Even credit card borrowing could have tax consequences.

SLEMRD & BAKIJA, *supra* note 69, at 221. They go on to note that it would likely be a difficult tax to enforce and would be far more intrusive into our financial affairs on a continuing basis.

223. MCCAFFERY, *supra* note 114, at 40.

224. *Id.* at 41 (emphasis added).

sure of owning capital” and that “[n]o tax tries to get at purely psychological pleasure.”²²⁵

As made clear in Part I, I argue that amassing wealth itself demonstrates ability to pay, whether or not that amassed wealth is “shown” by an act of consumption. I also argue that it is fair to tax that wealth accumulation at the time of accumulation, because those savings were made possible by our regulated capitalist system and thus should shoulder part of the costs of that system. Delayed taxation is reduced taxation because of the time value of money. And, I would add, we are not taxing the “psychological pleasure of owning capital” but rather *real dollars*. Why is it “fair” to allow one who chooses to live like a miser and amass great wealth to escape contributing toward the cost of the regulated capitalist system that made his wealth possible in the first place?

Moreover, he does not address the shift in the tax burden downward from the top 1% that I suspect would attend his consumption-without-estate tax—no matter how high the top marginal rate on big spenders—or how the increased wealth disparity that would likely accompany it would be conducive to a happy, healthy America. He acknowledges that anyone who allows the wealth they earn to accumulate is not charged any of the costs of the capitalist system in which their wealth accumulation was made possible; they are “untouched by current taxation.”²²⁶ But rather than seeing this as unfair, he argues that this person isn’t “getting away with something She is simply living a noble, prudent lifestyle and helping everyone else out in the process”²²⁷ His is a very benign view, full of stereotypes, where anyone who allows wealth to accumulate is “noble,” not power-hungry, and anyone who spends is “selfish”—“people who are only about themselves, who look to spend every last penny on their narrowly selfish desires.”²²⁸

The way I read McCaffery is that he believes a spending tax is more fair on essentially two grounds. The first is that it taxes very rich people who have no earnings and who are living off of borrowed money. The second is that saving is inherently moral behavior. Both are discussed below.

If McCaffery believes that a spending tax would satisfy the ability-to-pay norm that he says he favors, he *must* believe that there are an awful lot of people out there who are very wealthy with non-income-producing assets (i.e., which pay no dividends, interest, rents, or royalties), who don’t work, who don’t realize any of the built-in gain in those otherwise non-income-producing assets by selling them, and who are financing their personal consumption entirely with debt secured by these assets. If there really is such a large group of people, the only way to satisfy the ability-to-pay norm for this group would be to tax them when they spend, since

225. *Id.* at 153.

226. *Id.* at 105.

227. *Id.*

228. *Id.* at 75.

they have very little realized income. He says that a spending tax “would get rich people who finance a high-end lifestyle with capital to bear *some* tax, as they should *but now don’t*.”²²⁹

Such an approach would be consistent with the thinking of Nicholas Kaldor, a British economist, favorably cited by McCaffery,²³⁰ who was best known for systematically exploring the concept of a spending tax premised on ability-to-pay grounds. Kaldor was not interested in the “double-tax-on-savings” argument for consumption taxation, as he didn’t think it was double taxation.²³¹ Rather, he wrote:

[The] case [for an expenditure tax] does not really rest on the element of “double taxation” of savings involved in an income tax, but arises from more fundamental shortcomings of the concept of “income” as a measuring rod of taxable capacity. The real inequities of the system arise not so much from the failure to exempt savings out of “income,” but the failure to tax as “income” the spending power that is exercised through “dissavings” (or spending out of capital) or through capital profits or other receipts of various kinds. Since these non-taxable sources of spending power are not distributed at random, but are closely linked with the ownership of capital, taxation according to “income” introduces a bias in favour of property owners whose taxable capacity is underrated relatively to those who derive their income from work.²³²

Kaldor was influenced by the times in which he lived and worked, which was post-WWII Britain. Those were wrenching times for Britain, which struggled with a transition from a heavily class-bound society, with a land-and-capital-rich gentry, to a society with a strong middle class. The landed gentry, who typically did not work (and thus earn a labor return) and whose periodic capital income was decimated with the war, could nevertheless maintain their consumption spending either with debt (secured by their property) or by selling assets and realizing capital gains. Britain did not tax capital gains income (or any other kind of non-periodic income that was not a return to labor, such as prizes or lottery winnings, other gambling winnings, gifts and inheritances, the sale of mineral rights, premiums received on a lease, etc.) at this time.²³³ Kaldor wrote: “The net result of these exemptions is to introduce a systemic bias in taxation in favour of property owners.”²³⁴ In other words, they could maintain their consumption spending without paying any tax. This led Kaldor to argue in the 1950s that to satisfy the ability-to-pay norm in this milieu Britain needed a spending tax, not an income tax.

But he is a product of his time. “To ignore the ability to pay of those possessing large fortunes, because their fortunes did not fit the flow of

229. *Id.* at 51 (emphasis added).

230. *See id.* at 58.

231. *See* KALDOR, *supra* note 198, at 31-32.

232. *Id.* at 13-14.

233. *See id.* at 35.

234. *Id.* at 36.

income model on which earlier theorists had relied, was to misconceive the general character of the British economy at the time.”²³⁵ Are the circumstances similar in America today? Unlike Britain in the 1950s, we *do* tax realized capital gains and non-periodic receipts (except gifts). Only excluded borrowed amounts (and excluded gifts) can support consumption spending without tax in the U.S. Are there a lot of wealthy people who have decreased their realized income to paltry amounts—either intentionally (as McCaffery implies) or unintentionally (as happened in post-war Britain)—and who are living off of borrowed money? McCaffery assumes so, but we need the empirical evidence. What we do have does not seem to indicate that our society today is comparable in this respect to Kaldor’s Britain. As noted earlier, the top 1% in America today typically works for a living, realizing significant labor returns.²³⁶ Moreover, they do not seem to avoid realizing built-in gains to any significant extent,²³⁷ and (unlike Britain in the 1950s) we tax such gains, albeit at rates below that imposed on ordinary income. And my anecdotal observation is that unrented land is not a huge component of the top 1%’s portfolio. Even Kaldor admitted that “[i]t would be possible to improve the income tax system considerably from the equity point of view if the definition of ‘income’ were made comprehensive through inclusion of capital gains and other casual receipts”²³⁸

Moreover, apparently Kaldor engaged in the empirical work necessary to establish that the super wealthy would not see a tax reduction under an expenditure tax, as compared to the leaky income tax then in effect in Britain. Indeed, he was convinced that the top rates imposed on “income” would have to be significantly *reduced* if the tax base were switched to “spending” in order to avoid a massive shift in the tax burden to the wealthy. Kaldor wrote:

In fact, if the present nominal rates of taxation were rendered effective through a change-over to Expenditure as the basis of the levy, so far from making the rates *more* progressive it would be essential (as argued later) to reduce the scale of progression of the rates quite considerably if a revolutionary change in the position of different social classes were to be avoided. A change-over to an expenditure tax would undoubtedly have the most severe effect on the wealthy and not on the people who are only moderately well-off. It would be therefore rather nonsensical to suggest that an Expenditure tax would imply a less progressive method of parcelling out the burden of taxation than the present system.²³⁹

This is not surprising, considering that capital gains and other non-recurring realized property income were not taxed in Britain at the time. But that is not the case in America today. McCaffery concedes as much by

235. Utz, *supra* note 27, at 919.

236. Krueger, *supra* note 110.

237. See *supra* notes 157-63 and accompanying text.

238. KALDOR, *supra* note 198, at 14.

239. *Id.* at 50.

proposing—very unlike Kaldor—that the top tax rate on spending would have to be significantly *increased* to at least 50% (or more if the corporate tax were also repealed, as he also suggests) if we were to avoid a large shift in the tax burden, but he does not particularly address whether the top 1% would nevertheless see a decrease in its burden, as I suspect it would. We simply need to see much more empirical evidence than he gives us on the ratio of consumption spending to realized income in the top 1% in America today.

His second “fairness” ground for a consumption tax is that saving is, essentially, inherently moral behavior and ought to be rewarded and encouraged, period. He refers to the “virtues of saving”²⁴⁰ and says that the “The Fair Not Flat Tax aims to bring common-sense morality into the tax system.”²⁴¹ But saving is a social good only because of the *consequences* it can have. Saving for rainy days, for retirement, etc., can be argued to be a social good because it reduces the chances that the person will become a public charge. Indeed, that is why we encourage saving by the middle class under current law by providing it better-than-consumption tax treatment for the vast majority of its savings.

But what about the top 1%? Why is it inherently moral to encourage or reward a deca-millionaire²⁴² for further saving and accumulating even more wealth? It is highly unlikely that the deca-millionaire will become a public charge. The argument for why it is good to provide incentives to the deca-millionaire to continue to accumulate even more wealth *must* be grounded in the economic growth rationales discussed above. But McCaffery, remember, disclaimed any reliance on such economic arguments. So, beyond basic life-cycle saving, the argument becomes circular. He essentially says that further saving by the top 1% ought to be rewarded, regardless of whether or not it increases economic growth or the nation’s capital stock, because saving is inherently moral behavior, but the reason it is moral vis-à-vis others in society is because it provides economic growth and low interest rates, which helps the rest of the non-rich. It is circular. And it conflates, even equates, the moral dimension with the economic dimension for the top 1%. But they are separate issues, as Slemrod and Bakija remind us.

[E]conomists have often proclaimed at congressional hearings and in the press that one tax system is superior to another. To make such a judgment, the economist is implicitly introducing his or her own values into the choice, values that Congress or the majority of Americans may not share. For this reason, in principle any panel of economists offering their opinions on the best tax system should be followed by a panel of philosophers or ethicists who offer their views on the ethics In practice, of course, we do not convene such a panel every time an adjustment in the pattern of tax liabilities is con-

240. McCaffery, *supra* note 114, at 37.

241. *Id.* at 77.

242. Recall that the average net worth (assets less liabilities) of the top 1% is about \$10 million. See Wolff, *supra* note 64, at tbl.3 and note to tbl.5.

sidered, and we rely on the political system to make these kinds of choices.²⁴³

D. ENDING CLASS CONFLICT

Finally, McCaffery says over and over again that his tax system will encourage “class teamwork” and end “class conflict.”²⁴⁴ “I will show how a consistent, progressive consumption tax, by encouraging the rich to save, not spend, can move America to a promising model of class teamwork, not class conflict.”²⁴⁵ Indeed, his concluding chapter is entitled: “Toward Class Teamwork, Not Class Conflict.”²⁴⁶ In it he says:

We can fix our tax system and put all Americans—rich and poor—on the same side. We can have a social and economic model built on class collaboration, not class confrontation Tax today is part of the tension between economic classes, but it could help to bridge the divide. Getting our tax system right can improve our economy, our politics, and ultimately and most importantly, ourselves.²⁴⁷

But I don’t see any explanation of how his tax system can lead to “class teamwork” and not “class conflict.” I can’t see how enacting a tax system that may very well allow the top 1% to accumulate an even larger share of private wealth, and to pass it down from generation to generation, all without tax, will lead to “class teamwork” and reduce “class conflict.” He does not address that issue in his final chapter. Rather, it contains three subparts.

First, he again argues that a consumption tax will improve our economy, notwithstanding his earlier disclaimer that he is not making any economic arguments in favor of his plan.²⁴⁸ Second, he argues that a consumption tax will improve our politics. Apparently, he thinks that special lobbying interests who lobby for tax breaks under a hybrid income/consumption tax would disappear if Congress enacts a “pure” consumption tax. I have to agree with Sheldon Cohen, former IRS commissioner, that the chances of this are slim.

It amazes me that grown men and women believe that Congress will enact a pure [consumption tax] (that is one with no exceptions) and keep it that way forever This defies belief! They expect that the Congress that brings us new deductions and credits every year will suddenly reform and never amend the code to help an industry or group. . . . I believe that humans do not change behavior very much, as leopards do not lose their spots.²⁴⁹

243. SLEMROD & BAKIJA, *supra* note 69, at 53.

244. *See, e.g., supra* notes 140, 216 and accompanying text.

245. McCAFFERY, *supra* note 114, at 38.

246. *Id.* at 112.

247. *Id.* at 112-13.

248. McCAFFERY, *supra* note 114, at 42.

249. Sheldon S. Cohen, *Don't Hold Your Breath Waiting for a Flat Tax*, 86 TAX NOTES 1637 (2000).

Finally, he says that a pure consumption tax will help us to “improve ourselves.” In this regard, he says “[t]he whole system is set up against work and ordinary middle-class forms of savings . . .”²⁵⁰ without telling the reader that the vast majority of middle-class savings *already* are protected from taxation (and, indeed, get better-than-consumption tax treatment). And again he implies that the rich pay no tax while the middle class does. “The rich, clever, and well-advised win. The not-rich lose.”²⁵¹ He concludes that “the Fair Not Flat Tax will ask the nation’s most fortunate people to join the team, not set themselves up against it.”²⁵²

This last part seems to be premised, once again, on the twin notions that the rich are not paying tax because they are avoiding any realized income and living off of borrowed money and that they are big spenders instead of big savers. As addressed earlier, he documents neither of these assertions, and indeed the evidence I reviewed, though meager, seems to cast serious doubt on them.

In closing, I can’t help but also comment on McCaffery’s charge that those who disagree with him are simply being stubborn and also are simply relying on stereotypes. For example, he dismisses opposition to repeal of the estate and gift tax as nothing more than hardheadedness. “It’s time to stop the bickering, because this is an issue on which all can agree—if only they would listen.”²⁵³ Those who oppose complete repeal, instead of reform, of the estate tax are just not listening! They can’t possibly have considered objections; their objections must be frivolous. If only they would listen

He also says: “Many liberals have a tendency to demonize the wealthy, and a further tendency to lump together all members of any demonized group.”²⁵⁴ I was startled when I read this because of McCaffery’s *own* simplistic stereotyping of rich people, which had become irritating to me by that point. He invariably demonizes those who spend as “selfish,” and he canonizes those who accumulate great wealth as leading “noble” lifestyles.²⁵⁵ He views anyone with wealth as having achieved it solely “through their decisions to work hard and save well”²⁵⁶ rather than through the machinations of the marketplace. He shows no apparent appreciation that some who spend are no doubt quite noble and that some who accumulate wealth are no doubt nasty people. In fact, I have no doubt that the top 1% contains all stripe of humanity—good, bad, and banal. To decide whether or not to tax them on their accumulated wealth by determining whether they are being “selfish” spenders or “noble” savers is, itself, to act on stereotype. To treat them all the same, in recognition of the fact that whether they are nefarious or virtuous, their wealth

250. McCaffery, *supra* note 114, at 114.

251. *Id.*

252. *Id.* at 116.

253. *Id.* at 63.

254. *Id.* at 77.

255. See, e.g., *supra* notes 172, 192, 227, 228 and accompanying text.

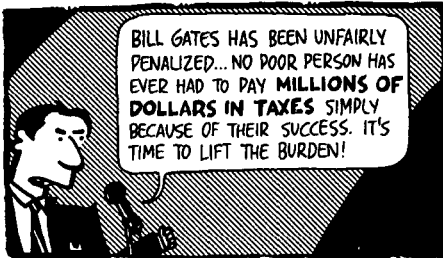
256. McCaffery, *supra* note 114, at 153.

accumulation was made possible by the regulated capitalist system in which they live, and thus they ought to contribute toward the costs of maintaining it (whether or not they happen to spend money), seems to me to be the route less reliant on stereotypes and demonization.

I can understand McCaffery's motivation in maintaining that his plan will lead to "class teamwork" and not "class conflict." I assume that he is trying to shortcut any criticism of the kind that I make throughout this article—that the disproportionately important top 1% (important both by measure of private wealth accumulation and by measure of the one third tax share that they currently pay under the hybrid income/consumption tax) would likely see their tax share drop—perhaps quite significantly. Anyone pointing that out, as I am, can be charged with fomenting class conflict, unlike McCaffery.

To that, I can only say that I am reminded of a Ted Rall cartoon.²⁵⁷

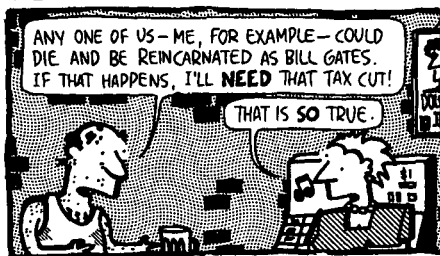
REP. NATE MORRIS (R-WA) STUNNED THE NATION THIS WEEK BY PROPOSING A TAX CUT FOR JUST ONE PERSON.



A FEW POLITICIANS OPPOSE THE TAX CUT, BUT ARE QUICKLY SHUT DOWN.



ORDINARY CITIZENS, THINKING ONLY OF THEIR SELF-INTEREST, STRONGLY SUPPORT THE GATES RELIEF BILL.



SO...WHAT DOES BILL GATES THINK?



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On a more serious note, I do believe that those who wish to significantly shift the tax burden downward from the top 1% use charges of "class warfare" against those who speak out against such plans as a mechanism simply to cut off debate. As mentioned earlier, those who earn the median income of \$50,000 saw their share of the aggregate federal tax burden (including payroll taxes) increase between 1976 and 1999, while

257. See N.Y. TIMES, July 23, 2002.

the wealthy saw a decrease.²⁵⁸ Why isn't that shift an illustration of class warfare against the middle class? Why is it class warfare only when it is suggested that those who own nearly 40% of the private wealth in this country ought to pay at least the 20% of the aggregate federal tax burden that they pay now, but it is not class warfare when the tax burden is systematically shifted downward, as happened in recent decades?

As the material at the beginning of this article indicates, the move away from consumption taxation was, indeed, a move to ensure that the rich shouldered more of the tax burden than they did under consumption taxes. In that sense, the debate over whether we ought to return to consumption taxation for all—even the top 1%—unavoidably involves a discussion of class. We should not shy away from that task. As Erik Jensen wrote: “James Carter, representing a bank nominally defending the [new income] tax before the Supreme Court [in 1895], conceded it was ‘class legislation in th[e] sense [of distinguishing between rich and poor]. That was its very object and purpose.’ It’s hard to disagree.”²⁵⁹

III. GRAETZ’S VAT-PLUS PROPOSAL

The bulk of Michael Graetz’s book is devoted to detailing some of the historical and current major problems with our hybrid income/consumption tax. Yet, in the end, he concludes that it is important to retain it (and attempt to improve it) for the wealthy, in order to maintain adequate progressivity in the tax burden.

Nevertheless, he recognizes that—as described earlier—our current tax system is essentially a consumption tax for the poor and middle class (since virtually all of their savings go untaxed) and an income tax for the more affluent (whose earnings exceed many of the ceilings limiting the savings preferences targeted at the middle class). As noted then, the most important consumption tax feature of current law available to the more affluent is the realization requirement, though apparently the top 1% does not unduly avoid realization on any consistent basis.²⁶⁰

Recognizing this, Graetz proposes that we lift the burden of having to file an annual tax return for those earning less than \$75,000 to \$100,000 or so (depending on how the numbers crunch out) by enacting a 10 to 15% VAT—a pure consumption tax—and then increasing the zero bracket amount under an improved hybrid income/consumption tax²⁶¹ to about \$75,000 to \$100,000.²⁶² To avoid imposing tax on the poor who are ex-

258. See *supra* note 91 and accompanying text.

259. Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of “Incomes,”* 97 TAX NOTES 99, 103 (2002).

260. See *supra* notes 157-63 and accompanying text.

261. He encourages simplifying and reforming the pension rules, eliminating the ability to deduct interest on debt used to purchase consumption by reforming the home-equity debt rules, integrating the corporate and individual taxes, reforming the Social Security and Medicare systems and integrating the tax burdens, and reducing complexity for small businesses. See, e.g., GRAETZ, *supra* note 26, at 244-60.

262. See *id.* at 264-66.

empted under current law, a portion of the VAT could be rebated to replicate the current zero bracket amount and earned-income tax credit (or we could create an exemption from the payroll taxes on the first chunk of wages). In this fashion, those earning less than \$75,000 to \$100,000 would be freed from the burden of having to file an annual return but would not have their tax burden materially changed, and they would continue to enjoy no tax on their savings, as today.²⁶³ Since the median household income is about \$50,000 per year, this would remove a very large portion of the population from the annual filing requirement and thus would be a major simplification. Graetz estimates that a 10% VAT and exemption of \$75,000 would have eliminated 100 million of the 107 million tax returns filed in 1993, about 93% of the total.²⁶⁴ It would, in his words, be returning the income tax to its roots “by return[ing] the income tax to its pre-World War II status, when it supplied progressivity to the United States tax system by limited application only to people at the top of the income tax scale.”²⁶⁵

He also, unlike McCaffery, would support some continuation of wealth taxation, whether it be in the form of an estate tax or a tax on inheritances. He questions

whether repeal of such an important element of progressivity without any replacement is appropriate now, given the widespread evidence that the distribution of wealth in the United States has become more unequal in recent years. Protecting family farms and businesses from having to liquidate to pay estate taxes is no reason for exempting large liquid estates from tax. Wealth inequality has always been greater than income inequality²⁶⁶

I absolutely support his idea of relieving a significant portion of the population (double the median household income is a good benchmark) from the burden of having to file returns. I believe that such a move would dilute the support of middle America for replacing the current Code with a pure consumption tax, since consumption tax supporters have used frustration with the complexity of current law for the average American as a selling tool to trumpet their proposals, which would likely shift the tax burden downward. I have grave misgivings, however, in accomplishing this salutary goal by enacting a new and separate tax and by increasing the exemption of the income tax. History teaches us that one of two things would likely happen if we have a separate tax that applies to only 7% of the richest filers. I would expect that either the exemptions

263. As noted earlier, McCaffery also advocated, as one alternative, enacting a VAT for the lower classes and a cash-flow consumption tax for those households of four spending at least \$80,000 per year. *See supra* note 117. In other words, both McCaffery and Graetz advocate removing the lower classes from the burden of filing an annual return while preserving the consumption tax treatment that they already enjoy. Where they disagree is whether the tax that applies to the more affluent should be a spending tax (McCaffery) or our hybrid income/consumption tax (Graetz).

264. *See* GRAETZ, *supra* note 26, at 264-65.

265. *Id.* at 266.

266. *Id.* at 267.

would be reduced to cover the median household again, so that such households would be pay *three* federal taxes (the VAT, payroll taxes, and the hybrid income/consumption tax) or the pressure would build to eliminate the special, “punitive” tax—imposed only on the “wealthy”—and to raise the revenue instead through increasing the VAT rates.

My concern regarding the first possibility—that the exemptions would eventually be lowered again—rises from our experience with enactment of the payroll tax in 1935. Congress could have funded the new Social Security system by lowering the income tax exemptions to bring the average wage earner into the income tax fold. As I describe elsewhere:

If that had been done, their wage income would have been taxed only once at the federal level—even as the income tax itself expanded to raise more revenue with WWII—and the increased revenues obtained under the general income tax from this expansion could have funded the payments made under the program. In other words, Social Security spending would have been simply one more government program supported by general tax revenues, but those general tax revenues would be collected from the lower and middle classes, who would benefit from the new program, as well as the wealthy.

But there were important political reasons for the separate tax. If the “tax” could be sold as an “insurance contribution” rather than a “tax,” and Social Security benefits perceived as simply the return for which prior premiums were paid, President Roosevelt believed that “by virtue of a statutory ‘compact’ between the contributors and Congress, . . . a future President and Congress could not, morally or politically, repeal or mutilate the ‘entitlement’ character of the program.” . . .

Moreover, there was simply no need at the time to expand the income tax downward, as opposed to enacting a separate tax on wages, in order to avoid a future “double tax” problem, since the income tax was itself thought at the time to be a tax that would *never* reach the lower and middle classes. It was, therefore, not likely foreseen that the labor income of these lower- and middle-class workers would soon be taxed twice—once under the new payroll tax and once under the income tax. As Professor Carolyn Jones has related:

In testimony before the Senate Finance Committee in 1932, Herbert Hoover’s Treasury Secretary, Ogden Mills, aptly described the very limited scope of the individual income tax up to that time. “We have become accustomed,” he said, “to high exemptions and very low rates on the smaller taxable incomes. That is our fixed conception of an income tax and it is very difficult as a practical matter to change fixed conceptions of this character.”

She went on to note that this “fixed conception” remained prominent through the middle and late 1930s in Roosevelt’s New Deal, when the payroll tax was enacted. “In public pronouncements, Roosevelt and prominent Congressmen linked income taxpaying to plutocracy and rejected imposition of income taxes upon ‘average’ citizens.” Moreover, Congress agreed.

Congress was . . . quite clear as to who should not be paying income taxes. When Senator LaFollette proposed reducing exemptions to \$2,000 for couples and \$800 for singles [in 1935], he was soundly defeated. At a time when three-fourths of American families were at or below the \$2,000 level at which they could live decently, Sen. Alben Barkley argued that LaFollette's measure would hurt the "average citizen" and "average families" "whether we consider the average man as one who receives less than \$5,000 a year or one who receives less than \$10,000 a year—we can make up our own average to suit our own view of what an average ought to be."

. . . This attitude toward income taxation continued through the 1930s.²⁶⁷

It took the cataclysm of WWII to lower the income tax exemptions to reach the middle class. I doubt that it would take another cataclysm to do so again. Prior to WWII, the income tax had *never* been paid by the middle class. As noted in the quotations unearthed by Carolyn Jones, there was widespread antipathy to extending the income tax to the middle class. The perception of the income tax as appropriately being limited to the wealthy was deep-seated and entrenched. It went to the very heart of what people thought income taxation was all about. But today we have lived with an income tax that has covered the middle class for literally a half century. Congress would not have the high perceptual hurdles it once had to overcome to extend the income tax downward again. It is not a common mindset today to think of income taxation as being appropriately limited to plutocracy. Something far less significant than WWII—the war on terrorism?, a prescription drug benefit for Medicare?, ensuring the solvency of Social Security?—could realistically be cited as requiring the exemption, alas, to be reduced. At the least, it would be far too easy to freeze any indexation for inflation, thus effectively reducing the exemption significantly over time, as happened in the decades following WWII.²⁶⁸

It's no answer to say that the Congress that enacts the VAT and raises the income tax exemptions can make its intention very clear that future Congresses should not reduce the exemptions. Graetz, himself, notes that Congresses cannot bind future Congresses in such a manner when he argues that no consumption tax would remain pure for long.

Our system of government, with new elections of the House of Representatives and one-third of the Senate every two years and of presidents every four years, does not give one Congress the power to prevent different legislation by a subsequent Congress. It is impossible, therefore, for any legislative body to make a viable binding political commitment to fair taxation over any person's lifetime. Indeed, as we have seen, each new Congress is tempted to change the tax

267. Geier, *supra* note 29, at 27-29 (footnotes omitted).

268. See *supra* notes 34-36 and accompanying text.

law, and all at least threaten substantial change.²⁶⁹

He's right. In another context, he writes:

Steve Forbes, Dick Armey, and the *Wall Street Journal* have all claimed that Congress will not raise tax rates under a flat tax because "everybody would have the same rate and you cannot raise it without everybody knowing and complaining." This faith that enacting a flat-rate consumption tax will hamstring the voracious appetite of the Congress for revenues seems naïve. In 1990 Democrats proposed a "millionaires surtax"—a higher tax rate on income over \$1 million. This prompted Phil Gramm to say "millionaires today, thousandaires tomorrow," The claim that moving to a flat-rate tax will guarantee the people of this nation lasting freedom from high tax rates, from narrowly targeted taxes, from special tax advantages, from unfair tax differentials is a pipe dream. It denies all historical experience.²⁷⁰

I think that Graetz's faith that Congress would both (1) index his \$75,000 to \$100,000 exemption so that its value is not reduced over time and (2) not reduce the exemption over time in order to raise revenue is similarly naïve. We simply can't bind future Congresses, and past history belies such a rosy prediction. Enacting a VAT for low- and middle-income people coupled with an income tax with a \$100,000 exemption would likely result—over time—in a lowering of that high exemption with the result that low- and middle-class workers would be taxed three times at the federal level. The fact that Mitrusi and Poterba's studies, indicating that three-fourths of households earning the median income of \$50,000 paid more in payroll taxes than income taxes, were such big news illustrates that it's easy to lose sight of the *combined* federal tax burden when focusing on proposals to change only *one* of the tax systems. We tend to focus only on one tax system at a time when measuring the tax burden. Indeed, the growth of European welfare states was fueled by adding a consumption tax—typically VATs—to income taxes.

Or—one could even envision it going the other way. The separate income tax imposed only on the "wealthy" could be seen, much like the estate and gift tax, as a "soak-the-rich" tax aimed only at the wealthy that punishes success and is thus fundamentally unfair. You could already hear the calls that the wealthy should be subject to only the same tax—the VAT—that applies to the lower and middle classes, that also taxing them under a separate income tax unfairly double taxes them. We can't ignore the potential for such political rhetoric in whatever tax design is chosen, as Graetz himself recognizes that the populace is often swayed by such rhetoric. For example, he notes that most Americans typically tend not to support VATs and sales taxes while sometimes supporting a cash-flow consumption or flat tax without realizing that they are all variations

269. GRAETZ, *supra* note 26, at 203.

270. *Id.* at 232-33.

on the same theme—consumption taxes.²⁷¹ This possibility is particularly true if the estate tax is also retained, as Graetz seems to support, which would then create “two” special taxes imposed only on the “wealthy” in addition to the VAT imposed on everyone.

For these reasons, I think that it is important to do whatever reform we do within the context of a single tax system. Indeed, I have also recommended integrating the payroll tax burden on labor income with the income tax burden on labor income.²⁷² In this way, the real distribution of the federal tax burden can be made more transparent. But Graetz’s ultimate goal of removing a large portion of the population from the burden of having to file tax returns should be pursued vigorously. It would not be easy; perhaps it is impossible in America. But this is the direction in which I would like to see intellectual energy devoted.

The vast majority of lower- and middle-class wage earners in England, for example, need not file annual returns, since all tax due is withheld at source. Only those with more complicated tax lives must file annual returns. The PAYE system²⁷³ not only applies to money benefits but also to certain benefits in kind, such as stock options, and it applies on a cumulative basis, taking into account the taxpayer’s personal exemptions. “The system can also be used to collect underpayments of tax from that or a previous year, as well as to refund overpayments.”²⁷⁴ Inland Revenue does all the work. As Slemrod and Bakija describe:

[I]n the income tax systems of the United Kingdom and Japan, the ultimate simplification is achieved—no filing at all. They manage this

271. See *id.* at 212, 216-20 (noting that since Americans tend not to support replacing the income tax with a retail sales tax or a VAT, consumption tax supporters have had to disguise their taxes with income tax garb to mask the fact that they are consumption taxes); *id.* at 189-91 (warning of the political impact of “colorful anecdotes”).

272. See generally Geier, *supra* note 29. For this reason, it might be better to replace the estate and gift tax on donors with an income inclusion under I.R.C. § 102 for donees in excess of a *de minimis* amount. With an income inclusion, the tax is integrated with the income/consumption tax. Moreover, carryover basis for any property received in kind (which I think is unworkable) could be avoided; with an income inclusion, the donee, should be entitled to a stepped-up, fair market value basis. Section 102 could be amended to provide that all gifts and inheritances above \$11,000 (indexed to inflation) per year must be included by the recipient. (The \$11,000 figure is patterned after the amount that can be given to each donee per year without owing a gift tax or reducing one’s lifetime exemption. A basic annual exclusion at this level would clearly allow the exclusion of holiday gifts and such to continue, as under current law.) As under current law, support payments to dependents (such as college tuition payments made by a parent) would not be considered to be “gifts” and would be excludable under the common law rule for support payments within an intact family. (Under current law, for example, tuition payments in excess of \$11,000 per year made on behalf of a child do not trigger a gift tax. See I.R.C. § 2503(e) (2002).) If it is desirable to recreate the \$1 million exemption under the current estate tax, amended § 102 could provide that \$11,000 per year is excluded *and* does not count toward a lifetime \$1 million exclusion for inter vivos gifts and inheritances. (This might raise less revenue than under the current gift-and-estate tax, since the \$1 million lifetime exclusion would be per donee, not per donor. A \$10 million estate, for example, could be dispersed among 10 donees and trigger no tax. The lifetime exclusion amount might therefore have to be lower.)

273. See JOHN TILEY, *REVENUE LAW* 212-17 (4th ed. 2000).

274. *Id.* at 216.

by having a very simple tax base for most taxpayers and a sophisticated system of employer withholding (called PAYE, or “pay as you earn,” in the United Kingdom) that ensures that come year-end, exactly the appropriate amount of tax has been withheld by the employer—no refund and no tax due. Interest and dividend income is taxed at the source of payment at a fixed rate. Many British taxpayers wouldn’t recognize a tax form if they saw one.

In fact, thirty-six countries use some form of no-return system for at least some of their taxpayers. Almost all use some form of exact withholding as in the U.K., but Denmark and Sweden achieve it with a tax agency reconciliation (TAR) system. Under a TAR system, taxpayers provide basic information to the tax authority, which then calculates tax liability based on this information and what is provided to it from employers and other institutions. Taxpayers have a chance to review (and contest) these calculations, after which refunds or additional tax payments are made.

The U.S. Treasury tax proposals of 1984 contained an exact withholding scheme, called the “return-free” system, which was to be available for more than half of all taxpayers. It was never enacted, though, because the system wasn’t simplified enough to make it feasible. Note that establishing a return-free system for many taxpayers accomplishes what might be called “populist simplification,” because it completely eliminates the hassle of tax filing for a large number of voters.²⁷⁵

The common denominator of any plan that would allow a return-free alternative for middle class taxpayers, however, would be the surrender of many of the special tax breaks that make each person’s tax calculation so unique (accompanied, presumably, with reduced tax rates). While that’s a tough habit to break in America,²⁷⁶ it might be doable. The average taxpayer seemed initially taken with the so-called flat tax—even though he would have had to give up most deductions and credits—until he learned that it was a consumption tax that dramatically shifted the tax burden downward. The average Joe didn’t seem to mind giving up the deductions, so long as it wasn’t accompanied by a shift in the distribution of the tax burden. Enacting a return-free system for the vast majority of taxpayers, within a single income/consumption tax that would not reduce the percentage of the tax paid by the top 1%, would itself qualify as “fundamental tax reform,” in my book. But this would be fundamental reform that I could support.

275. SLEMROD & BAKIJA, *supra* note 69, at 250-51.

276. See, e.g., The Back to School Tax Relief Act of 2002, proposed in the summer of 2002, which would “extend the present-law above-the-line deduction for higher education tuition and expenses to expenses incurred for elementary and secondary . . . education.” Description of H.R. 5193, The “Back to School Tax Relief Act of 2002” (July 24, 2002), 2002 TAX NOTES TODAY 143-45 (2002).

CONCLUSION

Everyone seems to agree that the tax system is broken. Where it's tough to find agreement is what to do about it. Under the norms of my own personal ideology of tax justice that I describe here, I think it unfair to return to pure consumption taxation, even if the rates on spending were made progressive. The shift in the tax burden away from the top 1% that would likely occur, away from those who accumulate wealth under our capitalist system, is not defensible to me. Since that wealth accumulation is made possible through taking advantage of what our regulated capitalist system has to offer, the wealth earned under it ought to be tapped to support the costs of that system, whether or not it happens to be spent.

Michael Graetz's work points to a different reform: Don't change the tax base dramatically but merely simplify it for the lower and middle classes, and make it return-free for them to boot. Since the truly poor don't owe tax, and the middle class essentially already enjoys consumption tax treatment, it ought to be possible to create a return-free tax for the middle class on consumption without reducing the tax burden on the top 1%. But, in my view, it is important that this be accomplished within a single tax system. Because of the risks that I describe here, we should avoid enacting two tax systems, such as an individual VAT coupled with an income tax with large exemptions. I simply don't believe that the resolution regarding the distribution of the tax burden would stand the test of time as well as it would under a single tax system.

