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JB McCombs

AN HISTORICAL REVIEW AND ANALYSIS OF EARLY UNITED STATES TAX POLICY SCHOLARSHIP: DEFINITION OF INCOME AND PROGRESSIVE RATES

JB McCombs*

Introduction

Tax law consistently has been an area of major political interest. Since 1969, or 1976 at the latest, it has become the subject of an ongoing mass struggle in the United States, reaching far beyond politicians and the inner circle of dedicated political spectators. The struggle intensified in the 1980s and promises to stay in the forefront of the political and popular mind. Three reasons for tax law's continued popularity as a political issue come to mind.

First, there has been a significant increase in the number of financially sophisticated people. The shift from factory worker to office worker has accelerated our move into the information age.

* Assistant Professor of Law, University of Nebraska College of Law; J.D. 1981, University of Michigan; LL.M. (Taxation) 1986, New York University. I am indebted to my colleagues Michael Chellis and Mary Lou Fellows for substantive and editorial comments which greatly improved this piece.

Financial sophistication of taxpayers increased the use of and pressure on the loopholes and preferences that had long been built into the Internal Revenue Code (the "Code") for use by a relatively small group of sophisticated, high income taxpayers.

Second, when the middle classes joined the tax preference game by the millions, and tax shelters began to be mass-marketed professionally, anti-abuse provisions in the Code grew explosively. Much of the tax legislation since 1969 has consisted of anti-abuse provisions. As used here, and in most discussions of tax legislation, an "anti-abuse provision" is a euphemism for a rule designed to keep the middle classes from obtaining a tax benefit that was intended for the rich.

The third reason for the recent mass struggle over United States tax laws is that Congress and its penumbral ring of lobbyists have turned with increasing frequency to tax law as a means of bestowing benefits on favored groups. Concern with federal budget deficits, which has been growing steadily since the late sixties, increased the attractiveness of using "expenditures" hidden in tax law rather than direct spending programs. Also, Congress has become increasingly more interested in manipulating our economy, and tax law is an attractive tool for that purpose.

The foregoing events and factors have produced a Code that is out of control, which further intensifies the mass struggle over our tax law. The time is ripe for a retrospective look at authors who wrote about basic tax issues. Although we cannot be sure what message these works conveyed to readers in their own time, in the midst of today's struggle they communicate the importance of getting back to the basics. They help us focus on the importance of theoretically sound, yet administrable definitions of gross income and taxable income. They emphasize that the rate structure should reflect reasoned thinking and conscious ethical judgments about inequality, rather than mindless manipulation to fulfill campaign promises or to revenue neutrality agreements.

This Article will not examine actual tax legislation, but only the ideas and reasoning of scholarly commentators. The earliest piece addressed was published in 1914.[1] The period under study ends with the adoption of the Internal Revenue Code of 1954,

[1] Works on United States tax policy were published prior to 1914, but those discovered were not sufficiently significant to warrant coverage here. *See* E.R.A. SELIGMAN, THE INCOME TAX: A STUDY OF THE HISTORY, THEORY AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD v (2d ed. 1914) [hereinafter E.R.A. SELIGMAN, THE INCOME TAX].

which began a new era with respect to tax legislation and tax policy.[2]

Finally, this Article will address the ideas and reasoning of the historical authors with respect to two issues: the proper definition of income, and the use of personal exemptions and progressive rates.[3] The purpose of this Article is not simple historical reporting; rather, it is hoped that writers of the past can help us better understand the problems of the future.

I. The Definition of Income

When the decision was made to include an income tax in the total tax system, a thoughtful definition of income was the next appropriate step. Unfortunately, United States income tax history did not begin this way. The nation's first income tax, in force from 1862 to 1871, was adopted as a temporary measure to finance the Civil War.[4] In 1894, Congress again adopted an income tax which the Supreme Court promptly declared unconstitutional.[5] Thereafter, the sixteenth amendment to the United States Constitution, granting Congress the power to levy an income tax, was ratified in 1913. Despite the experience gained from the 1862 and 1894 income tax laws, the first constitutional income tax act did not address the definition of income as one of its fundamental components. Complaining about this inadequacy in 1936, one scholar noted that the 1913 Tax Act left the definition of income in a state of confusion:

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[2] Although it made no changes in the substantive law, the Internal Revenue Code of 1939 was enacted in an effort to clarify the existing laws:

> The 1939 [Code] effort was largely a matter of sorting and putting together currently operative internal revenue statutes—*codification.* Even so, the result was the tax practitioner's "bible," the Internal Revenue Code of 1939. Wholesale *revision* of the internal revenue laws was first accomplished in 1954, yielding a new (King James Version?) "bible" for the practitioner.

J. Freeland, S. Lind & R. Stephens, Cases and Materials on Fundamentals of Federal Income Taxation 9 (6th ed. 1987) (emphasis in original).

[3] Two other issues of fundamental importance, then and now, are the best type of tax system (*e.g.*, income, consumption, corporate, inheritance, and property taxes) and proper tax treatment of capital and income from capital.

[4] An income tax was adopted for the year 1861, but was never implemented. Act of Aug. 5, 1861, ch. 45, §§ 49-51, 12 Stat. 292, 309-11 (1861). The 1862 tax, which officially repealed and replaced the 1861 tax, was established by the Act of July 1, 1862, ch. 119, §§ 81-83, 86, 89-93, 12 Stat. 432, 469-75 (1862).

[5] The 1894 Income Tax Act, Act of Aug. 27, 1894, ch. 349, §§ 27-36, 28 Stat. 509, 553-60 (1894), was declared unconstitutional by the United States Supreme Court in Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 448-49 (1895).

> Viewed from the vantage point of the present, the federal income tax law of 1913 seems an incredibly náive document. Today it seems astonishing that so many fundamental issues should have been so slightly considered or so blithely ignored. The law contained no precise and comprehensive description of the tax base.[6]

Because it was not adequately addressed by Congress, the process of building and shaping a definition of income was left largely to the Treasury Department and the federal courts. The judiciary is, however, distinctly ill-suited for such a role. The nature of the judicial process requires judges to address an issue piecemeal and under constraint of the particular facts of each case. The Treasury Department, although the best qualified to develop a useful, thoughtful definition of income, was, unfortunately, the least powerful of the participating entities.

Tax policy scholars have addressed the definition of income with voluminous results, but it is not clear that their suggestions have been heeded to any great extent. Some even have had the good sense to develop their own versions of the best theoretical definition of income, and then to discuss concessions to administrative and practical realities which reasonably might be made without unduly compromising the theoretical starting point.

Some scholars in tax policy might consider Professor Irving Fisher's 1906 classic, *The Nature of Capital and Income*, as the logical starting point in this discussion.[7] It is an early piece, yet more sophisticated than many of its contemporaries. Fisher attempted to convince his readers that income should be defined as consumption. He was, in fact, an early and able proponent of a consumption tax, which more commonly was referred to as a spending tax in his day. Rather than arguing directly for the adoption of a consumption tax, however, he insisted that the definition of income be revised to exclude all savings and investments.

A. *Robert M. Haig: Economic and Legal Aspects*

In developing a portrait of "income," Robert Murray Haig began by painting a face that only an economist could love[8] by pro-

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[6] Haig, *Foreword* to R. MAGILL, TAXABLE INCOME at iii (1936).

[7] *See* H. GROVES, TAX PHILOSOPHERS: TWO HUNDRED YEARS OF THOUGHT IN GREAT BRITAIN AND THE UNITED STATES 108 (1974) (net income should be defined to exclude savings).

[8] THE FEDERAL INCOME TAX (R. Haig ed. 1921). In 1921, Robert Murray Haig (1887-1953) was an associate professor at the Columbia University School of Business, having

viding us with an extremely theoretical conceptualization of the term: "Modern economic analysis recognizes that fundamentally income is a flow of satisfactions, of intangible psychological experiences."[9] If a person earns a dollar and spends it to buy dinner, he claims, income is neither the dollar nor the dinner. Income is the satisfaction obtained from eating the dinner.

Therefore, two workers, each of whom earns a dollar and spends it on an identical dinner, will have differing incomes if one enjoys the meal more than the other. Nevertheless, Haig cited the economists of his time who took the same position. For example, Harvard's Professor Frank Taussig wrote: "Now just as all production in the last analysis consists in the creation of utilities, so all income consists in the utilities or satisfactions created. . . . Our food, clothing, furniture, may be said to yield psychic income. They shed utilities, so to speak, as long as they last."[10] Professor E.R.A. Seligman, of Columbia University, whose other work is discussed below,[11] stated: "We desire things at bottom because of their utility. They can impart this utility only in the shape of a succession of pleasurable sensations. These sensations are our true income."[12] Haig, however, admitted that:

> the economist, while recognizing all this, realizes that before he can proceed far with his analysis of economic phenomena he must arrive at something more definite and more homogeneous—less diaphanous and elusive than these psychic satisfactions. . . . How impossible it is to compare one man's satisfaction with a book with another man's satisfaction with his dinner![13]

Haig's reaction appears schizophrenic. He first bemoaned the fact that moving away from "psychic satisfactions" compromises a valid and valuable theory.[14] Then, in the same discussion, he

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joined that faculty in 1912. During his career, Haig served on numerous commissions in several countries, studying primarily the tax and public finance problems of cities and states. *See* 45 THE NATIONAL CYCLOPEDIA OF AMERICAN BIOGRAPHY 265-66 (1962).

[9] Haig, *The Concept of Income—Economic and Legal Aspects*, in THE FEDERAL INCOME TAX 2 (R. Haig ed. 1921).

[10] *Id.* (quoting 1 F.W. TAUSSIG, PRINCIPLES OF ECONOMICS 134 (1916)).

[11] *See infra* note 109 and accompanying text.

[12] Haig, *supra* note 9, at 3 (quoting E.R.A. SELIGMAN, PRINCIPLES OF ECONOMICS 16 (1914)).

[13] *Id.* at 3-4.

[14] *Id.* at 4-5.

> It should be carefully noted, however, that, first, when one abandons "usances" and satisfactions and substitutes the goods and services yielding these satisfactions, he is taking a step away from the fundamentals. . . . For example,

adopted the other side of the argument. "But is there, after all, any theoretical injustice? Who, for instance, would seriously defend the proposition that taxes should be apportioned according to capacity for appreciation rather than according to the capacity to command the goods and services which are appreciated?"[15] Haig then switched from an income tax to a consumption tax analysis.

> In the words of Professor Ely: Money income should, perhaps, refer to the value of the goods consumed and the services enjoyed, although in popular speech and by many economists the word is used in the literal sense of the net amount of money that comes in, whether it is spent for enjoyable things or is saved.[16]

To a modern reader, this highlights another weakness of the satisfaction definition of income with which Haig began. If true income is satisfaction, rather than money (or money's worth) used to attain satisfaction, then money earned and saved is not income, and we transform an income tax into a consumption tax without ever admitting the fundamental change. The only reconciliation of this analysis with an income tax is to hold that the act of saving produces satisfaction that fits within Professor Haig's concept of "true income." He mentioned this idea briefly and dismissed it as "impracticable."[17]

Haig simply seemed to be struggling with the inevitable, illogical ramifications of the assertion that satisfaction is the fundamental measure of income. His commentary exemplifies the struggles of many tax scholars of his era with their insensitivity to the importance of the time value of money.[18] For example, Haig asserted that "[n]o great harm is done if the person who postpones spending his money is taxed upon it when he receives it rather than when he spends it."[19] An inability to discern the time value issues frequently has lead to erroneous theories and conclusions in tax policy.[20]

> two persons who receive precisely equal amounts of goods and services may derive therefrom very unequal "usances" and satisfactions.

Id.

[15] *Id.* at 5.

[16] *Id.* at 5 (quoting R. ELY, OUTLINES OF ECONOMICS 98 (1908)).

[17] *See id.* at 6.

[18] *See, e.g., infra* note 20 and accompanying text.

[19] Haig, *supra* note 9, at 5.

[20] For an enlightening exposure to the theory and practice of time value issues, respectively, see Cunningham and Schenk, *How to Tax the House That Jack Built*, 43 TAX L. REV. 447 (1988); Lokken, *The Time Value of Money Rules*, 42 TAX L. REV. 1 (1986).

The trek from satisfactions, to goods and services, to money left Haig with a final concern. If money was adopted literally and strictly as the form of income measurement, all of the numerous sources of in-kind benefits would be missed in the ultimate calculation of income. Haig explained:

> The economics of this situation is very clear. . . . [G]oods and services which are of significance are those which are susceptible of evaluation in terms of money. It is not necessary that they should actually have passed through the process of a sale. From the point of view of equity it is theoretically important that all goods and services received without payment should be accounted for in case it is possible to value them in terms of money.[21]

Professor Haig considered these issues because he sought a rational route from his theoretical starting point to a definition of income that could be of practical use with income tax problems. Despite the weakness of his starting point and the resulting difficulties that arise along the way, his trip, nonetheless, ended successfully. Under his analysis,

> income becomes the increase or accretion in one's power to satisfy his wants in a given period in so far as that power consists of (*a*) money itself, or, (*b*) anything susceptible of valuation in terms of money. More simply stated, the definition of income which the economist offers is this: Income is the *money value of the net accretion to one's economic power between two points of time.*[22]

Haig contrasted the satisfaction definition and his ultimate accretion definition of income. Accretion "defines income in terms of the power to satisfy economic wants rather than in terms of the satisfactions themselves. It has the effect of taxing the recipient of income when he receives the power to attain satisfactions rather than when he elects to exercise that power."[23]

However, the observation failed to identify the significance of the difference between a consumption tax (which results naturally from an attempt to apply the satisfaction theory directly) and an income tax (which results from application of his accretion definition of income). After identifying the difference between tax systems resulting from the two income definitions, Haig minimized it: "This should do no violence to our sense of equity, however. The

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[21] Haig, *supra* note 9, at 6 (footnote omitted).
[22] *Id.* at 7 (emphasis in original).
[23] *Id.*

fact that a man chooses to postpone the gratification of his desires is no sufficient reason for postponing his tax."[24] This language suggests that his choice between these two tax systems was not a fully informed one. Modern economic analysis demonstrates that a tax imposed when income is earned produces a substantially greater burden than does a tax imposed at the time of consumption.[25]

Haig's accretion definition of income led him to some interesting observations and conclusions. He maintained that an increase in the value of an asset should be considered income, so long as the increase "is sufficient in amount and definite enough in character to be susceptible of precise evaluation in terms of money."[26] This conclusion did not lead to the proposition that appreciation be measured and taxed annually; Haig realistically conceded that "the scientific economist in advising the legislator would be the last to suggest an attempt to follow the implications of his analysis without regard to the limitations imposed by the actual conditions under which the law must function."[27] He adamantly asserted, however, that administrative concessions should be identified as such, and not defended on the erroneous ground that asset appreciation is not income. Similarly, with respect to imputed income from the rental value of an owner-occupied home, the rental value is within his accretion definition of income, but the legislature reasonably might decide not to tax it due to "special circumstances" involved in the receipt of income in this manner.[28]

Haig's use of the phrase "economic power" in his definition is helpful because it focuses attention on the issue of inflation in defining and measuring income:

> If it were possible to modify the concept of taxable income so as to eliminate [the effects of inflation] it would certainly be desirable to do so. . . . [A]n approximate solution might be realized if we were able to evolve a satisfactory index of the level of prices. If

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[24] *Id.*

[25] For a further discussion and mathematical illustration of the difference between a consumption tax and an income tax, see McCombs, *Tax Incentives for Investment: A Free Market Future Versus Our Pork Barrel Past*, 64 IND. L.J. 665, 676-77 & n.47 (1989) (example shows if investment deducted initially and investment income not taxed as earned it is equivalent to zero tax rate on income from investment).

[26] Haig, *supra* note 9, at 14.

[27] *Id.*

[28] With respect to imputed income from home ownership, we are told that Wisconsin attempted to tax such income for several years, but eventually abandoned the matter. *Id.* at 14-15.

> it were accurately known what the change in price level in a given year had been, it might be possible to qualify [the measured income] in such a way as to eliminate the influence of the changing standard.[29]

One of Haig's last comments deals with the proper treatment of gifts, an issue that plagues definitional attempts of most tax policy writers. Although Haig admitted that under his definition a gift should be included in the donee's income, he rejected that result. Instead he takes the common position that most gifts are given within the family, and the family is, for many tax purposes, treated as a single economic unit. Although most noncharitable gifts probably do occur within the family, they often involve a grandparent donor and grandchild donee. The family unit recognized for tax purposes, however, includes parents and dependent children only. Thus, Haig's reasoning, which has some validity for gifts from parents to dependent children, does not go as far as he implies, and leaves grandparent-grandchild gifts and gifts from parent to an adult child unresolved. Haig's income definition is similar to the one developed by Henry Simons, whose work is discussed below.[30] Although their conceptions have come to be known jointly as the Haig-Simons definition of income, these two scholars were not harmonious in their conclusions as to gifts. Before Simons' work on this topic is analyzed, however, an intervening scholar must be considered.

B. William W. Hewett: Income as Satisfaction and the Equity Principles

In 1925, four years after Haig's definition was published, William Wallace Hewett wrote on the definition of income.[31] Professor Hewett began with a quote from Irving Fisher describing two criteria of a good definition. "It must be useful for scientific analysis; and it must harmonize with popular and instinctive usage."[32] The

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[29] *Id.* at 17. Perhaps recent experimentation by the accounting profession with financial statements that address the effects of inflation will lead to the solution of the accounting problem, thereby allowing tax law refinements needed to eliminate the influence of inflation on income taxation.

[30] *See infra* note 45.

[31] Dr. Hewett was then an assistant professor of economics at the University of Pennsylvania, having received his Ph.D. there in 1924. He moved to the University of Cincinnati in 1929, and spent the rest of his career there. *See* 4 WHO WAS WHO IN AMERICA 435 (1968).

[32] W. HEWETT, THE DEFINITION OF INCOME AND ITS APPLICATION IN FEDERAL TAXATION 10 (1925) (quoting I. FISHER, THE NATURE OF CAPITAL AND INCOME 103 (1906)).

choice of this quote is ironic because Fisher's definition of income excludes all earnings saved or invested, and, therefore, is at odds with the popular meaning of income and almost identical to the popular meaning of consumption.

While Haig began his analysis with the abstract theory of satisfaction, traveled "downstream" through goods and services, and concluded with the concept of money's worth, Hewett began at the opposite end, adopting money income as a starting point, yet perceiving real income as consisting of "those commodities and services that will satisfy the wants of men."[33] Hewett thus recognized that many commodities and services are obtained without a money transaction.

He then considered a final step, one that would place him at Haig's point of beginning: "Many economists, while agreeing that in practice the best definition of income is one in terms of commodities and services . . . feel that in the 'final analysis' the utilities or satisfactions of wealth and human beings are the true income."[34] Hewett refused to take this step, in part because it would violate Irving Fisher's criterion that a good definition remain in touch with the popular meaning of the word. Most importantly, Hewett perceived that a satisfaction definition of income would lead to a consumption tax, while a commodity and service definition of income could lead to an income tax.[35]

A close cousin to the satisfaction definition of income is the proposal that income consists of services received. This refers not only to services rendered by other people, but includes "services" rendered to the taxpayer by the physical objects he uses. The service provided by a car, for example, is transportation; the service provided by a home is shelter. Income can be defined to consist of all services received from people and things. This approach is conceptually related to the satisfaction definition because both lead to a consumption tax. Under this approach, money received and saved does not provide service to the recipient and, therefore, should not be included in income. The service definition is a practical improvement over the satisfaction definition, because it is based on money value of services received, thereby adopting a quantifiable standard which does not vary from one person to the

[33] *Id.* at 11.
[34] *Id.* at 13.
[35] *See id.* at 14.

next. Nevertheless, the service definition of income, like the satisfaction definition, was rejected by Hewett because it was too far removed from the common meaning of income, and because it inevitably would lead to a consumption tax. If we want a consumption tax, he declared, we should argue for it directly rather than trying to achieve it under the camouflage of a revisionist definition of income.

Professor Hewett also discussed the economist's concept of social income (also called national income) and related it to individual income. "All individual incomes are obtained from the social income, and the social income must therefore equal the total of all individual incomes."[36] The benefit to be achieved from establishing this equality is not clear. In fact, the correctness of the alleged equality is not clear. Hewett admitted two exceptions to his rule: first, gifts pose definitional difficulties because although they "divert a flow of commodities and services to the [recipient] . . . [they] add[] nothing to the social income, and we are faced with an example of a form of individual income which apparently is not social income; the equality principle appears to break down."[37]

Hewett's attempt to rescue the equality principle, however, is unconvincing:

> The solution to the problem rests in the fact that what really happened was a transfer of title to income—an alteration in the direction of the income flow. The father gave up a right to receive real income, equal to the gain acquired by the son. There has been no product or service added to the "national heap [of goods and services]"; the receipt of the gift is offset by the surrender of income by the giver. The equality of the social income with the total of individual incomes is therefore maintained.[38]

One inevitable ramification of the foregoing explanation is that money earned and given away, as a definitional matter, is not income to the person who has earned it. Although Hewett rejected a definitional exclusion for money that was earned and saved, he failed to object to a definitional exclusion for money that is earned and given away. Hewett's explanation would lead to the conclusion that a donor should receive a tax deduction for gifts given, and that such deduction could be disallowed only for policy or adminis-

[36] *Id.* at 23.
[37] *Id.*
[38] *Id.*

trative reasons, not for definitional reasons.[39]

Hewett also identified three categories of capital gain: (1) increases in value of stock due to retained earnings of the corporation; (2) increases in prices of specific properties as a result of changes in supply of or demand for those items; and (3) increases in prices of all or most properties due to inflation. Because retained earnings reflect real production of a corporation, Hewett concluded that the corporation's stock experiences an increase in real value and the shareholders derive income from it. Adhering to his principle of equality between social income and aggregate individual incomes, Hewett noted that equality is maintained by his conclusion because the corporate production adds to social income in the same amount that corporate earnings add to shareholder income.

In Hewett's second category, an increase in value of a particular property due to scarcity (increased demand or decreased supply) produces real income to the owner. Economic power (command over goods and services) is increased. Here, as with gifts, individual income is not paired with a corresponding increase in social income. The individual's benefit does not reflect increased production of goods or services. Hewett incorporated this exception into his equality principle, without attempting to rationalize it.

With gains derived from inflation, Hewett completed the triad of possible combinations of social and individual income. Contrary to his first two categories, neither individual nor social income is present with inflation gains. There is no social income because production of goods or services is unchanged. There is no individual income because the property owner's economic power has not increased.

Although not addressed directly, a review of his analysis of capital gain disproves Hewett's principle of equality between social income and aggregate individual incomes. His original statement of this principle was that "[a]ll individual incomes are obtained from the social income."[40] Hewett's second category (gains derived from shifts in supply and demand) illustrates that individual income can

[39] An objection to a proposition leading to a deduction for donors is that it produces a definition of income that is dependent upon the taxpayer's uses, rather than sources, of economic power. Definitional concern with uses is a trait of a consumption tax, not an income tax.

[40] W. HEWETT, *supra* note 32, at 23.

arise without additional production of goods or services. Yet, the purpose of social income accounting is to measure production. The concepts described by the terms "individual income" and "social income" are distinct and should not be linked arbitrarily.

Hewett's efforts led him to define the net income of an individual "*as the flow of commodities and services accruing to an individual through a period of time and available for disposition after deducting the necessary cost of acquisition.*"[41] This is labeled "economic income." Presumably he included money as a commodity. Failure to do so would reduce the definition to consumption, which Hewett previously had rejected.

Hewett created two alternative definitions of income. First, the "legal definition of income" is the economic definition modified to accommodate administrative problems.[42] For example, economic income would include all increases and decreases in property values accrued during the year. However, because annual appraisals of all properties are administratively cumbersome, the legal definition of income imposes a realization requirement.

Second, "taxable income" is legal income modified by concerns about ability to pay (*e.g.*, the standard deduction) and social or economic objectives (*e.g.*, tax exempt interest from municipal bonds).[43] Hewett stressed that any of these modifications should be identified explicitly as elements in the definition of legal or taxable income, and not in the fundamental definition of economic income.

C. *Henry C. Simons: Income*

Simons' work led him to an income definition very similar to that of Robert Haig.[44] Although their definitions have been labeled the "Haig-Simons definition of income," and generally accepted as the accretion definition of income upon which all subsequent discussions are based, the Simons formulation is cited far more frequently than Haig in modern tax policy literature.

In Simons' view, calculation of social income has a different purpose than calculation of personal income, and different definitions, therefore, were in order. Also, the requirement that social

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[41] *Id.* at 34 (emphasis in original).

[42] *Id.* at 79.

[43] *Id.*

[44] *See supra* note 9.

income equal the aggregate of individual incomes imposes the unpleasant restriction that gifts and certain capital gains (those based on scarcity factors) must be excluded from individual income because they are excluded from social income.

Robert Haig argued that satisfaction is the fundamental basis for the definition of income. Irving Fisher built his definition upon services, both human and those provided by use of goods. William Hewett looked to the goods themselves, plus the value of human services received. Henry Simons, however, endorsed a definitional foundation more abstract than that of Hewett and Fisher, which avoided the extreme subjectivity of Haig's initial satisfaction theory, and therefore has more practical appeal. In the words of Simon:

> Personal income connotes, broadly, is the exercise of control over the use of society's scarce resources. . . . [I]t implies [an] estimate of consumption and accumulation. Consumption as a quantity denotes the value of rights exercised in a certain way (in destruction of economic goods); accumulation denotes the change in ownership of valuable rights as between the beginning and end of a period.[45]

These comments led to his one-sentence definition of income, which has been quoted almost as a ritual litany in tax policy studies during the last fifty years: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."[46] Because this definition finds income in consumption, and in any increase in net worth, it will lead to a true income tax and not to a consumption tax.

Difficulty with in-kind and imputed income is common among those who attempt to define income. Simons addressed these less obvious forms, first in connection with his definition of income:

> [I]t raises the unanswerable question as to where or how a line may be drawn between what is and what is not economic activity.

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[45] H. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 49-50 (1938).

[46] *Id.* at 50. The phrase "algebraic sum" is used because the second item in the definition may be either negative or positive. For example, if the first item, consumption, totals $32,000, but during the same period the second item, essentially the taxpayer's net worth, is reduced by $7,000, then $7,000 of the total consumption was funded from prior accumulation and only $25,000 was funded from current income.

> . . . [T]he poorest families might be shown to have substantial incomes if one went far in accounting for instruction, nursing, cooking, maid service, and other things which the upper classes obtain by purchase.[47]

Simons observed that the definition was developed specifically for use in the taxation of income. Therefore, if a flaw in the definition causes a certain type of income to escape detection and taxation, no injustice will occur so long as people within a particular income class all have approximately the same amount of the neglected form of income, and no group is likely to have inordinate amounts of it. Thus, one can view an income tax as taxing *relative* income, and so the definition and measurement of relative incomes are all that is necessary.

> A little reflection along these lines suggests that leisure is itself a major item of consumption; that income per hour of leisure, beyond a certain minimum, might well be imputed to persons according to what they might earn per hour if otherwise engaged. Of course, it is one thing to note that such procedure is appropriate in principle and quite another to propose that it be applied. Such considerations do suggest, however, that the neglect of "earned income in kind" may be substantially offset, for comparative purposes (for measurement of relative incomes), if leisure income is also neglected. For income taxation it is important that these elements of income vary with considerable regularity, from one income class to the next, along the income scale.[48]

Similar considerations are found in the case of an employee who receives indirect benefits in addition to his salary.

> Let us consider . . . the relative incomes of an ordinary officer serving with his troops and a *Flügeladjutant* to the sovereign. Both receive the same nominal pay; but the latter receives quarters in the palace, food at the royal table, servants, and horses for sport. He accompanies the prince to theater and opera, and, in general, lives royally at no expense to himself and is able to save generously from his salary. But suppose, as one possible complication, that the *Flügeladjutant* detests opera and hunting.[49]

Though no bright line can be drawn between indirect benefits

[47] *Id.* at 51-52 (footnote omitted).
[48] *Id.* at 52-53.
[49] *Id.* at 53 (emphasis in original).

that are income and those that are not, we should attempt to include the largest of such items in the definition of income. Simons suggests that the most intangible of such benefits and pleasures probably vary positively and continuously with income, and so the failure of his definition to reach them should not cause major distortions in the measurement of relative income.

Of greatest practical significance is the case of a husband and wife who both work outside of the home, as compared to a married couple with one wage earner. Both couples might have the same total income under an exhaustive definition, but failure to tax the second couple on income received in kind from services produced by the spouse at home will cause the first couple to be taxed more heavily. Partly to deal with this discrimination, from 1982 to 1986 the Code allowed a double-income family to deduct ten percent of the lower paid spouse's earned income (five percent in 1982), up to a maximum income of $30,000.[50]

A related difficulty arises from imputed income from use of one's own consumer goods. Although not unique in principle, home ownership is the most significant example; the home is usually the taxpayer's most valuable consumer asset. Professor Simons adopted the nearly universal position of endorsing some mechanism to include the rental value of an owner-occupied home in the owner's income.

> [W]hen property is employed directly in consumption uses, there is the strongest case for recognizing an addition to taxable income. This is widely recognized in criticism of our federal tax for its egregious discrimination between renters and homeowners, and perhaps more strikingly in the almost consistently different practice among income taxes abroad.[51]
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> . . . .
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> . . . Income from consumers' capital is often a large part of total income for individuals in the upper brackets. To exclude it

[50] *See* I.R.C. § 221 (1981) (repealed 1986) (enacted by Pub. L. No. 97-34, § 103, 95 Stat. 172, 187-88 (1981)). Another intended function of the working spouse deduction was to reduce the impact of the progressive rate structure on the combined income of the two working spouses.

[51] H. SIMONS, *supra* note 45, at 112 (footnote omitted).

> At all events, the United States and Canada seem to be the only important countries not taxing rental income to homeowners. . . . Schanz (writing in 1896!) remarks that he knows of only one jurisdiction where rental income to homeowners is excluded. This is in Mecklenburg. He points out that a similar situation existed in Basel from 1840 to 1866.

Id. at 112 n.3.

> is to introduce a bias inconsistent with the system of progression and to differentiate flagrantly among persons of really similar financial circumstances. Furthermore, where such income is excluded, an attractive and easy means of evasion is made available. . . .
>
> Serious inequity arises, furthermore, from the fact that the opportunity for evasion is open to different income classes, and to members within given classes, on very different terms . . . . The real opportunity to escape tax thus varies widely, according to the consumption tastes of individuals, according to the amount of property held, and according to the character of one's occupation and investments.[52]

Although taxation of imputed income from home ownership might be criticized on the grounds of administrative difficulty, Professor Simons noted that a good approximation of rental value can be obtained by multiplying the full value of a home, as assessed for local property taxes, by a selected net rate of return percentage. Thus, taxpayers would be spared the difficulty of calculating gross rental value and subtracting actual repair costs and the statutory allowance for depreciation. He does not mention, however, that use of a net rate of return percentage would allow a homeowner to continue to deduct implicit depreciation long past the depreciable life of the home.[53] This chapter of Simons' book ends, unfortunately, without resolution of the problem: "one faces here one of the real imponderables of income definition."[54]

Regarding the proper treatment of gifts and inheritances, Simons adamantly rejected the common conclusion that gifts and inheritances should be excluded from the definition of income.[55] If Simons' general definition is accepted, gifts and inheritances clearly fit within it. The purely political step of enacting a statu-

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[52] *Id.* at 113-15 (footnotes omitted).

[53] Given the straight-line method and 27.5 year depreciation schedule provided by the Code today, only a small percentage of taxpayers would enjoy the unintended benefit of unending depreciation. *See* I.R.C. § 168(b)(3), (c)(1) (1990). In 1989, statistics indicated that the average American homeowner held her home for twelve years. Pfister, *Housing Turnover Rates: Nation Steady, but Regions Fluctuate*, THE GUARANTOR, Sept./Oct. 1990, at 10. Also, allowing continuous depreciation probably represents good social policy because it avoids potential pressure on a homeowner to move to a new home when the scheduled depreciation term expires.

[54] H. SIMONS, *supra* note 45, at 124.

[55] *See* Haig, *supra* note 9, at 26. Haig agreed on a theoretical level, but argued against his tentative conclusion.

tory exclusion, as found in current United States tax law,[56] is one possible response, but the theoretical definition should not be distorted to accomplish an exclusion. Inclusion of gifts and inheritances within the definition of income, however, highlights an important feature of the Simons definition: its blindness as to source. A review of the definition will reveal that it is equally blind to use.

Simons dispensed with the common suggestion that gifts and inheritances should not be included in income solely because they are already taxed under the gift and estate tax system.[57] Further, some writers have argued that the purpose of the income tax system is satisfied because it has taxed the gift one step earlier, when the funds were earned by the donor. But when a person earns income and then uses some of the dollars earned to pay her doctor, the income tax system is not "satisfied" with taxing those dollars only as they are earned by the patient. The same dollars will constitute income again, to be taxed again, upon receipt by the physician. As Simons says, "[t]he income tax is not a tax upon income but a tax upon persons according to their respective incomes."[58] In other words, an income tax taxes not dollars, but an event, *i.e.*, the receipt of income. The fact that the patient or donor has borne an income tax cannot logically prevent taxing the doctor or donee simply because dollars that represent the former person's income have been transferred to the latter.

There may be an important distinction between the two foregoing transactions. The payment from patient to physician is part of a bilateral exchange of money for services, while the gift from donor to donee is a unilateral transfer. The life cycle of income begins with receipt and ends with consumption, with saving as an optional interim step. The life cycle of a gift, however, can only be found by tying the donor's receipt of income to the donee's eventual consumption.

Giving a gift, however, is a form of consumption by the donor. The important question is not whether the transaction is bilateral or unilateral, but whether the transferor receives satisfaction from the transaction.[59] The voluntary nature of a gift is persuasive evidence that the donor receives satisfaction from the act of giving.

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[56] *See* I.R.C. § 102 (1990).

[57] H. SIMONS, *supra* note 45, at 128.

[58] *Id.*

[59] The word "satisfaction" is not used in the Haigian sense as a definition of income, but rather to define consumption.

The donor, like the patient, has received income and consumed it; the donee, like the physician, has received income and eventually will consume it. Both parties in each transaction should therefore recognize income.

Consider, also, that many large *inter vivos* gifts are motivated by the desire to reduce or avoid subsequent income or estate taxes. Although planned giving is not objectionable, it does remove this class of gifts from the moral high ground on which one might intuitively place family gifts. Finally, "gifts, inheritances, and bequests is a kind of accumulation which can be taxed with least adverse effect upon the morale of an enterprise economy."[60]

Simons also proposed aggressive treatment of the donor who gives noncash property. "Every transfer of property by gift should be treated as a realization, at the fair market value as of the date of transfer, by the donor."[61] He would apply the same rule to property owned at death.[62] As a result, the beneficiary's fair market value basis in inherited property[63] would, for the first time, make sense, and it could legitimately be extended to calculate the basis of property received by gift *inter vivos*.

Although most tax policy literature discussing capital gains emphasizes economic policy goals, this Article primarily concerns definitional questions. As long as adjustment is made for inflation, capital gains are properly included within a theoretical definition of income. Henry Simons commented that it is "thoroughly unsound, as a matter of definition, to set up a category of capital profits outside (or even within) the income concept."[64]

As with capital gains, the tax exemption for interest received on state and municipal bonds[65] is rarely, if ever, defended on the basis of the theoretical definition of income. Since the Supreme Court, in *South Carolina v. Baker*,[66] recently upheld the federal taxation of state bond interest,[67] the constitutional definition of income is no longer an argument.

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[60] H. SIMONS, *supra* note 45, at 144.

[61] *Id.* at 166. Simons also stated that the original New York state income tax regulations took this position with respect to both personal and charitable gifts, but the regulation was rejected by the state courts. *Id.* at 166 n.7.

[62] *Id.* at 165.

[63] *See* I.R.C. § 1014 (1990).

[64] H. SIMONS, *supra* note 45, at 150.

[65] *See* I.R.C. § 103 (1990).

[66] 485 U.S. 505 (1988).

[67] *Id.* at 524-25.

Nevertheless, Simons indicated two problem areas. First, the effects on investment policy are detrimental.

> Those who should buy nothing else are turned away from government bonds by their scarcity and low yield; and persons who, with their statisticians and professional analysts, should arbitrate the direction of new and speculative undertaking can now be attracted away from exempt investments only by prospects of fabulous yields.[68]

Second, federal subsidies to state and local governments should not be given in proportion to their borrowing. Federal grants to state and local governments on the basis of any rational criterion would make sense out of a currently senseless subsidy. Presaging Stanley Surrey's tax expenditure concept,[69] Simons noted that it would be "preposterous" for Congress to allocate direct subsidies in proportion to borrowing.

Therefore, under Simons' definition, widely adopted as the most sound theoretical approach, income consists of consumption plus net saving (or minus net dissaving). Comprehensive images of consumption and saving limit the compromise of this definition to explicit political, administrative, social, or economic decisions.

D. *William Vickrey: Agenda for Progressive Taxation*

William Vickrey has analyzed, on a fundamental level, specific items of inclusion and exclusion.[70] One disadvantage of his approach is his failure to indicate clearly whether his focus is the theoretical definition of income or a pragmatic, administrable, politically feasible definition for statutory purposes. In addition to explicitly endorsing the Haig-Simons definition,[71] Vickrey specifically addressed certain definitional proposals. He rejected Fisher's consumption definition as consisting of mere nomenclature and no substance. Vickrey also rejected attempts to develop a definition

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[68] H. SIMONS, *supra* note 45, at 178.

[69] *See* Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 706 (1970) (author describes own tax expenditure concept).

[70] William Vickrey received his undergraduate education at Yale and presumably met Irving Fisher while there. He served on the Department of Treasury's tax research staff during World War II, partaking in the unsuccessful attempt to enact a wartime spendings tax. In 1947, Vickrey received a Ph.D. from Columbia University and has been a faculty member at the university ever since. H. GROVES, *supra* note 7, at 110-11.

[71] W. VICKREY, AGENDA FOR PROGRESSIVE TAXATION 6-7 (1947).

that excludes capital gains: "[I]t appears to be impossible to produce such a definition that will be internally consistent and not require hairsplitting distinctions, nor give capricious results."[72]

Vickrey, however, endorsed the common position that gifts and bequests should not be included in the recipient's income, without indicating whether this exists as a fundamental matter of definition or as a pragmatic matter of tax law.[73] With respect to transfers which occur at death, Vickrey refuted Simons' theory by noting the difficulty of maintaining "that the testator obtains any vast satisfaction from the distribution of that which death forces from his grasp."[74] Although he seems willing to accept Simons' reasoning with respect to gifts *inter vivos*, Vickrey rejects the conclusion since "gifts and inheritances are after all mere transfers, and . . . [they] will frequently not stand up under a heavy tax assessed solely by reason of . . . [that]" transfer.[75] Vickrey depicted his concern with an illustration involving a grandparent, son, and grandchild. If giving does not generate a tax liability, in many cases the grandparent would make a gift to the son, and years later the son might give the same property to the grandchild, assuming the property had not been consumed in the meantime. With the imposition of a tax on each gift, the grandparent is more likely to make a gift directly to the grandchild, perhaps with an income interest to the son, to avoid tax on the interim transfer, thereby producing the economic inefficiencies of trust management.[76] Such an argument could be made with equal force against an effective gift tax or against any proposal to make the existing gift tax effective. Unless one is willing to abandon transfer taxation entirely, it simply goes too far.

Vickrey was correct, however, in his statement that the only practical alternative to taxing both donor and donee is to tax the donor and not the donee.[77] The alternative, which is to tax the donee and allow a deduction to the donor, presents two practical problems. First, it seriously undermines the progressivity of the system because donors are generally subject to a higher tax rate

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[72] *Id.* at 8.

[73] *Id.* at 198-99. He later stated explicitly that the theoretical definition of income includes gifts received and that the only theoretical question is whether the donor is entitled to a deduction. *Id.* at 199.

[74] *Id.*

[75] *Id.* at 200.

[76] *Id.* at 201.

[77] *Id.*

than donees. Second, there would be a revenue loss because donors would claim every available gift deduction, while donees certainly would not report all gifts received.[78]

Although he opposes characterization of gift receipts as income, Vickrey endorses the type of separate transfer tax on gifts enacted under the Code. "Succession taxes are justified primarily on the ground that they promote equality of opportunity and that they obtain revenue in a manner that has little effect on incentives."[79] This view effectively supports either an income tax or a separate succession tax on gifts. Vickrey's intended distinction remains unclear, and, in fact, he elsewhere conceded this. In a passage criticizing the idea that aggregate individual income must equal social or national income, he acknowledged the "inconsistency in condemning the double taxation of gifts under income tax and then turning around and approving an additional tax on gifts in the form of succession tax."[80] Indeed, for one who is willing to support an effective, separate, gift tax, there is no attractive argument against Simons' proposal to let the income tax fill a major part of that role.

With respect to owner-occupied homes, Vickrey took a position held almost unanimously among economists: not only is rental value included in the theoretical definition of income, but it also should be included in the statutory definition of income.[81] This goal can be achieved by imputing full rental value to the owner and allowing deductions for repairs, interest, taxes, and depreciation. As a preferred alternative, Vickrey supported Simons' suggestion of applying a net rate of return (net of estimated expenses and a constant depreciation factor) to the value of the home.[82]

As a compromise among these alternatives, Vickrey addressed the provisions which, then and now, allow deduction of property taxes and mortgage interest paid on owner-occupied housing.[83] While he asserted that no deduction for property taxes should be

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[78] *Id.* at 202.

[79] *Id.*

[80] *Id.* at 199.

[81] *Id.* at 19.

[82] *Id.* at 19-21.

[83] After decades of attack by economists, the deduction for home mortgage interest finally has some limitation. The interest on home indebtedness incurred after October 31, 1987 in excess of $1,000,000 is not deductible. *See* I.R.C. § 163(h) (1990). Obviously, this is a minimal limitation in terms of total national housing and tax policies, but it may set the stage for more meaningful steps in this direction.

allowed, he failed to consider whether federalism concerns might reasonably lead to the interpretation that deductions for sales and home property taxes follow from deduction for state income taxes,[84] even though the former two would not be deductible from a purely definitional perspective. With respect to the home mortgage interest deduction, which is often criticized unequivocally, Vickrey makes an important point.

> With interest on home mortgages the case is not quite so clear cut. While eliminating the deduction of such explicit interest without taxing the imputed interest on equities would reduce the disparity between the tenant and the home-owner with a thin equity, it will not reduce the disparity between the tenant and the owner of an unencumbered home, and it will actually introduce new disparities among home-owners having differing equities in their residences.[85]

Since the time of the first United States income tax, payments of certain other taxes have been deductible for purposes of the federal income tax.[86] A deduction for gasoline taxes was allowed until 1979.[87] The deduction for state and local sales tax payments was repealed in 1986,[88] leaving property taxes and state and local income taxes as the only non-business tax payments still allowed as

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[84] *See, e.g.*, McCombs, *A New Federal Tax Treatment of State and Local Taxes*, 19 PAC. L.J. 747, 750-51 (1988) (discusses federalism argument for applying federal tax treatment to state and local income, property, and sales tax).

[85] W. VICKREY, *supra* note 71, at 22-23. In connection with this discussion, Vickrey also made an important practical point with respect to all cases in which the definition of taxable income is narrower than the theoretical definition of net income:

> It should be noted that the elimination of the mortgage interest deduction will increase the tax base and thus permit the rates to be decreased to a corresponding degree. This may be a distinct advantage in so far as *it decreases the intensity of such other inequities as cannot be eliminated* and reduces the effect of the tax on incentives to production.

Id. at 23-24 (emphasis added). Although the language regarding reducing incentives to production has been popularized by the Reagan revolution, the language immediately preceding it has received little attention.

[86] *See, e.g.*, Act of July 1, 1862, ch. 119, § 91, 12 Stat. 432, 473-74 (1862) (local and other taxes to be deducted first).

[87] *See* Revenue Act of 1978, Pub. L. No. 95-600, § 111(a), 92 Stat. 2763, 2777 (1978) (amending 26 U.S.C. § 164(a) (1976)) (repeal of deduction for state and local taxes on gasoline and other motor fuels).

[88] *See* The Tax Reform Act of 1986, Pub. L. No. 99-514, § 134(a)(1), 100 Stat. 2085, 2116 (1986) (amending 26 U.S.C. § 164(a) (1985)) ("any tax . . . which is paid or accrued by the taxpayer in connection with an acquisition . . . of property shall be treated as part of the cost of the acquired property").

itemized deductions for individual taxpayers.[89] When Vickrey's *Agenda for Progressive Taxation* was published, the gasoline tax deduction was still allowed. He correctly argued against the deduction on the ground that gasoline taxes are an indirect form of paying for the use of public roads, because they are in the economic sense user fees, not taxes.[90]

Vickrey did not discuss the common argument in favor of a federal deduction for state income taxes—that the state income tax is an unavoidable cost of earning income. The theoretical argument for deducting state income taxes is strong, if not unassailable. State income tax liability is highly analogous to a business expense and presents the strongest case for deductibility at the federal level. Less certain is whether sales and property tax deductions (for which the theoretical argument is weaker because they arise from consumption rather than production activities) should nevertheless be allowed on the strength of the federalism concern for allowing free state choice of revenue sources.[91]

Vickrey referred to this federalism concern as "discrimination" between states, and described an alternative response to it:

> If the discrimination resulting between states using income taxes and those using other forms of taxation is deemed too great, it might be possible to provide for the deduction of only the excess of the state income tax over a given amount or over a given percentage of income. This restriction would limit the discrimination to the areas where it is needed to prevent confiscation and where it is most effective in promoting progressive taxation by the states, and would also remove one more unnecessary item from the returns of small taxpayers.[92]

If the annual or biennial ritual of massive tax reform acts is finally waning, perhaps the relative quietude will allow the tax treatment of life insurance to receive the attention and analysis it deserves. Even without a stable legislative backdrop, perhaps the revenue pressures of our current era will force life insurance to the front of the stage. Vickrey believed that the savings component of the life insurance contract is analogous to a savings account, and should be handled as other forms of savings. The interest should be included in the policyholder's income but the proceeds which

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[89] *See* I.R.C. § 164 (1990).

[90] W. VICKREY, *supra* note 71, at 94-95.

[91] *Id.*

[92] *Id.* at 100.

represent the return of principal should be excluded.[93]

Finally, Vickrey vigorously advocated the inclusion of capital gains in income:

> [U]nder any consistent form of tax based on accrued income these gains should be included in income and taxed just as heavily as any other form of income. Although it has been urged in season and out that capital gains of one kind or another should be excluded from taxable income, no method of doing this that does not involve gross discrimination, hairline distinctions, and opportunities for avoidance has been devised, short of going all the way to a spendings tax.[94]

Furthermore, in his opinion, England's declining to tax capital gains does not present an argument for the adoption of the same rule in the United States. He asserted that not only is tax law more strictly interpreted in this country, but "tax avoidance is a favorite indoor sport and regarded as a sign of business acumen and the exercise of a basic civil right, rather than as unpatriotic or bad form."[95]

Vickrey also found little merit in three arguments commonly raised in discussions of capital gains. "The first is that through postponing the realization of income generally and of capital gains in particular, the taxpayer gains to the extent of the interest he is able to earn on the amount of the tax postponed."[96] This argument would lead to a higher rate of tax on gains from assets held for a long time, but Vickrey does not endorse such a rule. "Second, under progressive rates, if a taxpayer realizes in a single year a large gain that has accrued over a number of years, his income may be pushed into higher brackets and taxed at higher rates than if he had been able to report the income gradually as it accrued."[97] Vickrey accepts this proposition as a serious concern, although it is less significant today due to the much smaller range from the lowest to highest tax rate. In a later chapter, he constructs a very complicated program for *lifetime* cumulative income averaging, including an interest factor on income earned and taxes paid in prior

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[93] *Id.* at 65 ("savings part of the life insurance contract should be treated as any other form of savings; . . . the interest should be included in the income of the policyholder . . . but proceeds representing the return of principal should not be included").

[94] *Id.* at 136 (footnote omitted).

[95] *Id.* at 137.

[96] *Id.* at 144.

[97] *Id.*

years, to avoid problems from the time value of money.[98]

Third, "if there is a general inflation or deflation of the price level, capital gains or losses will be recorded which do not represent any real change in economic power or net worth."[99] Although Vickrey notes the possibility of indexing asset bases for inflation, he is not sufficiently concerned with this problem to endorse that solution. With respect to these three concerns, Vickrey notes that "none of the treatments accorded [to capital gains and losses] bears any logical relation to any of these special problems: allowing for these factors leads to quite different schemes of taxation."[100]

Vickrey began his treatment of capital gains with the theoretical ideal that all of a taxpayer's capital assets should be appraised at the beginning and end of each year. Increases in value should be included in income and decreases should be deducted. But for many types of assets, such an appraisal cannot be accomplished accurately. Nor can it be achieved administratively, due to the enormity of the task, even for those assets whose value could be reasonably estimated. The traditional response to this problem has been to defer measurement of gain or loss from property until the property has been disposed of in a "realization" transaction. In most cases such a disposition is a sale for a stated cash price, although the payment may be made immediately or in installments. The sale price represents an arm's length appraisal in the medium by which taxes are measured and paid, without government intervention or involvement in the appraisal process.

An exchange of one item of property for another is also a realization event, but because only a small minority of property dispositions are made for noncash consideration, the category of transactions in which the government must demand an appraisal is relatively small. Vickrey was convinced, however, that "there are schemes of defining realization that will more closely approximate a proper tax base and lead to fewer discriminations than the present collection of incongruities."[101]

He was particularly dissatisfied with the complete escape from

[98] *Id.* at 164-97. "Vickrey's ingenious proposal, in spite of its undoubted merits, ranks high on the list of proposals too subtle and elaborate for Congress. . . ." H. GROVES, *supra* note 7, at 111.

[99] W. VICKREY, *supra* note 71, at 144.

[100] *Id.*

[101] *See id.* at 138.

tax of gain accrued in property held by a taxpayer at death. This escape is due to the combination of the failure to tax the decedent on the gain inherent in her property, and the allowance of a fair market value basis to the beneficiary of the estate.[102] A partial escape from tax, of a similar nature, is often achieved when appreciated property is given to another person. As in the case of death, the transferor is not taxed on gain inherent in the property. Unlike the treatment of an inheritance, however, the recipient of the gift is required to use the transferor's historical basis for calculation of gain when the property is later sold.[103] In spite of this carry-over basis rule, there is often a partial escape from tax because the donor is nearly always in a higher tax bracket than the donee. Although the difference between donor and donee tax rates is much smaller today than it was then, it is still significant. Also, although Vickrey did not mention it, even if both parties pay tax at the same rate, the failure to treat a gift as a realization event causes the government to suffer loss of the time value of money from the date of the gift until the donee sells the property.

Vickrey's solution to the problems associated with inheritance and gifts was to require realization of the inherent gain/loss at the time of transfer. There is no objective reasoning against his proposal regarding gifts. The donor can easily provide the basis for computation. Because under current law, all gifts over $10,000 in value—$20,000 if given by a husband and wife jointly[104]—have some kind of gift tax consequences, any gifted property with an estimated value close to $10,000 must be appraised. For gifts clearly worth less than $10,000 (or $20,000, where applicable), a realization requirement would mandate an appraisal where one is not currently required. If such appraisal is difficult to achieve, the donative intent usually can be satisfied by giving a different piece of property with a more easily determined market value.

The proper solution is not so clear in the case of transfers at death. The major difference is the unknown basis; the only person who reasonably can be required to know and state the property's basis is dead. It would greatly burden the personal representative of the estate to determine the basis of each item of property left by the decedent.[105]

[102] *See* I.R.C. § 1014 (1990) (basis of property acquired from decedent).
[103] *See id.* § 1015 (basis of property acquired by gifts and transfers in trust).
[104] *See id.* § 2503(b) (exclusion from gifts).
[105] *See id.* § 1023 (1976) (repealed 1980) (provided basis carry-over from the decedent

Vickrey's response to the problem of unknown basis seems eminently reasonable and theoretically sound, but is politically impossible; it would only exacerbate the protests of would-be personal representatives. Vickrey asserted that

> [i]t would seem entirely reasonable for the tax assessor to assume a very low basis in the absence of data, and place the burden of proof on the executor to show any higher basis. This would place on the decedent the responsibility for keeping adequate records, if he wished his estate to have favorable tax treatment.[106]

Where the personal representative believes that the decedent's basis was higher than the tax assessor's presumed basis, the same objectionable pressure would be placed upon the representative to struggle through piles of incomplete records to produce the necessary evidence.[107]

We can therefore see that no single definitional theory has both logical cohesiveness and acceptable political consequences. No matter the economic or policy arguments asserted, United States income tax law represents an amalgam of the various theo-

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to his estate and its beneficiaries for decedents dying after 1976) (enacted by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005, 90 Stat. 1520, 1872-79 (1976)). In 1978, the effective date was delayed to January 1, 1980. *See* Revenue Act of 1978, Pub. L. No. 95-600, § 515, 92 Stat. 2763, 2884 (1978). In 1980, the entire section was repealed, without ever having been applied. *See* Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401, 94 Stat. 229, 299-301 (1980).

[106] W. VICKREY, *supra* note 71, at 140-41.

[107] There is, however, an approach that can avoid such criticism. This alternative proposal begins, as did Vickrey's, with the observation that the burden of determining fair market value must be an acceptable one, because under current law personal representatives must value every item to establish the new basis of that item in the hands of the estate and the beneficiary. It would be a minor imposition to require the representative to multiply the fair market value of each item by, for example, 70% (0.7). If the resulting figure is *conclusively* treated as the basis for all further tax purposes, there is no "burden of proof on the executor to show any higher basis," as there is in Vickrey's original proposal. Thus, there is no requirement, or command performance "opportunity," to find and use historical basis information.

An expanded version of this proposal could be used by those who agree with Simons that inheritance constitutes income and should be taxed. Rather than multiplying the fair market value of each inherited item by 70%, as suggested above, every inherited asset could be given a zero basis in the hands of the beneficiary. Upon ultimate disposition of the asset, the entire sale price would be income. The government would suffer the time value of money burden in the meantime, but for those who consider inheritance to be income and an involuntary, noncash disposition, such as transfer at death, an inappropriate time to impose tax liability (on either party), the deferral cost will be acceptable. If the administrative burden on personal representatives is genuinely a major issue, this approach is better than the current law. In this case none of the assets of the decedent would require appraisal for income tax purposes.

ries discussed above.

II. Progressivity and Personal Exemptions

Progressivity is one of the most emotional issues addressed in tax policy. As a consequence, it has resulted in a great volume of writing and notably three classic treatises—one which endorses it enthusiastically;[108] a second which supports it if the degree of progression is moderate;[109] and the third work which adamantly opposes progressive taxation.[110]

A. E.R.A. Seligman: The Historical View

In *Progressive Taxation in Theory and Practice*, Professor Seligman set forth the history of progressive taxation in the United States. With the adoption of the 1862 Tax Act, Congress introduced a progressive rate system: three percent on incomes from $600 to $10,000, and five percent on incomes above $10,000.[111] According to Seligman, the progressive feature was a matter of some discussion:

> Secretary [of the Treasury] Fessenden, in his report for 1864, defended the progressive income tax in the following words: "The adoption of a scale augmenting the rate of taxation upon incomes as they rise in amount, although unequal in one sense, cannot be considered oppressive or unjust, inasmuch as the ability to pay increases in much more than arithmetical proportion as the amount of income exceeds the limit of reasonable necessity."[112]

Apparently, the progressive feature was considered a greater evil than income tax generally. In 1867, with the expenses of war removed from the budget, the tax was retained; the rate structure, however, was changed to a proportional one.[113] Many in Congress

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[108] H. Simons, *supra* note 45.

[109] E.R.A. Seligman, Progressive Taxation in Theory and Practice (2d ed. 1908).

[110] W. Blum & H. Kalven, Jr., The Uneasy Case for Progressive Taxation (1953).

[111] *See* Act of July 1, 1862, ch. 119, § 90, 12 Stat. 432, 473 (1862). An odd aspect of this rate structure was the provision that, upon crossing the $10,000 threshold, the 5% rate applied to the taxpayer's entire income above $600. As a result, a taxpayer with $10,000 of income would owe a $282 tax, while one with $10,001 of income would owe $470.05.

[112] E.R.A. Seligman, *supra* note 109, at 102 (quoting Report of the Secretary of the Treasury, 1864, at 15). The phrase "ability to pay" is one of many phrases, each backed by different reasoning and theories, that have developed in the centuries of discussion of progressivity.

[113] *See* Act of March 2, 1867, ch. 169, § 13, 14 Stat. 471, 477-80 (1867).

viewed this tax strictly as a war measure and called for its repeal shortly after such expenses abated.[114] Due to a revenue shortage, the tax was extended to include incomes of 1871, payable in 1872, and was allowed to expire immediately thereafter.[115]

To discuss the issue of progressive tax rates, brief comments on terminology are in order:

> A tax may be said to be *proportional* when the mathematical relation between the amount of the tax and that of the thing taxed remains the same. A tax is *progressive* when the relation varies in such a way that, as the amount taxed itself increases, the tax will represent a continually larger fraction of that amount.[116]

Seligman defined a degressive system as one having progressive rates up to a certain level and a constant tax rate thereafter.[117] He admitted, almost grudgingly, that this description fit every progressive tax system because rate increases can never continue indefinitely. But he added that a degressive tax is one in which the highest rate is considered the "normal" one.[118] The lower rates are thus considered concessions to lower income taxpayers, a middle step between the full, normal rate applied to higher incomes and the complete exemption granted to the lowest income levels.[119] Se-

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[114] In 1870, when the Civil War income tax was, by its terms, scheduled to expire, there was some support for its continuance. In response, Representative McCarthy of New York replied:

> [T]his income tax bears, what no other tax bears upon its face, the evidence that it was only considered and passed as a war tax, being limited to five years in its duration. The five years are up; the war is over; our revenue will bear the reduction, and we can afford to let it die. . . . The people demand that it shall not be renewed, but left to die a natural death and pass away into the future as pass away all the evils growing out of the civil war.

CONG. GLOBE, 41st Cong., 2d Sess. 3993 (1870).

[115] *See* Act of July 14, 1870, ch. 255, § 6, 16 Stat. 256, 257 (1870).

[116] E.R.A. SELIGMAN, *supra* note 109, at 3 (emphasis added).

[117] *Id.* at 4.

[118] *Id.*

[119] *Id.* at 5. "Degression" was a term also used by Professors Blum and Kalven in *The Uneasy Case for Progressive Taxation, see supra* note 110, with a more specific and meaningful definition. Degressive taxation in their view is a system that provides an exemption, or a zero rate of tax, to a subsistence amount of income (as provided by our standard deduction and personal exemptions), followed by a single rate applicable to all income above the exempt amount. This is not a truly proportional tax relative to total income, for it produces a modest amount of progression in the average tax rates. For example, if the exempt amount is $9,000 and the constant tax rate above that amount is 30%, a taxpayer with $18,000 of taxable income will pay a $2,700 tax, or 15% of total income; a taxpayer with $27,000 of taxable income will pay $5,400 of tax, or 20% of total income. The average rate rises even though the marginal rate is constant.

ligman concluded that the trend seemed to move toward progressive taxation.[120]

Seligman identified three major classes of theories favoring progressive taxation: the socialistic, the compensatory, and the economic. According to the socialistic theory, governments of an earlier age imposed taxes primarily for the purpose of generating revenue to pay for their operations. Although revenue continues to be important, in the modern era, governments also use taxation to achieve social, political, and economic effects. Seligman then went on to adopt a revised view of the socialistic theory which seemed like an extremist version of itself,[121] without announcing or admitting to it.

> It is not true historically that the tax policy of various nations has been adjusted *solely* with reference to purely fiscal reasons. All governments have allowed social considerations in the wider sense to influence their revenue policy. . . .
>
> But, on the other hand, it is not allowable to confound this undoubtedly social element in all fiscal policy with what [German economist Professor Adolph] Wagner calls the socio-political, or what might be termed not incorrectly the socialistic element. From the principle that the state may modify its strict fiscal policy by considerations of general social utility to the principle that it is the duty of the state to redress inequalities of fortune by taxation, is a long and dangerous step. It would land us not only in socialism, but practically in communism. If this were one of the acknowledged functions of government, it would be useless to construct any science of finance. There would be only one simple principle: confiscate the property of the rich and give it to the poor.[122]

An open-minded view of Wagner's theory would admit that it does not describe early tax policy as being *solely* fiscal, nor does it advocate that modern governments use taxation to *eliminate* inequalities of income or wealth. It would be more reasonable to say that, according to Wagner, the degree of nonfiscal considerations in taxation has increased, and that one significant nonfiscal consideration is the reduction of economic inequality. This interpretation

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[120] E.R.A. SELIGMAN, *supra* note 109, at 125.

[121] *See infra* note 122 and accompanying text.

[122] E.R.A. SELIGMAN, *supra* note 109, at 130-31 (emphasis added). "[B]ut we clearly transcend the claims of justice when we demand that the state should do away with *all* inequalities of wealth." *Id.* at 131 (emphasis added). Seligman's treatment of Wagner's theory was later criticized by Henry Simons. *See infra* text accompanying note 146.

leads to the conclusion that Wagner's theory takes a defensible view of the trend in this area, and also avoids the confusion of moderate socialism with communism.[123]

Seligman addressed the arguments of Francis Walker in a second category, which he labeled "compensatory theories."[124] Walker perceived serious flaws in the market mechanisms that lead to dramatic differences in the financial success of different individuals:

> [Walker] bases his defense of progressive taxation on two considerations: first, "the undoubted fact that differences of property and income are due, in no small degree, to the failure of the state in its duty of protecting men against violence and fraud," and secondly, "that differences in wealth are, in a measure, due to the acts of the state itself, having no political purpose, as treaties of commerce, tariffs, currency legislation, embargoes, non-intercourse acts, wars, etc."[125]

Walker proposed using progressive taxation to recapture some of these financial advantages from their undeserving owners.[126] This proposal is vulnerable, of course, because, even if one sympathized with Walker's judgment concerning the flaws of the market, there is no close correlation between total income and this particu-

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[123] Other authors Seligman discussed explicitly proposed complete economic equalization of the citizenry via taxation. For example, Guicciardini, in the early 16th century, wrote:

> Even a moderately progressive tax . . . will not suffice to bring about justice and equality, because it would not restrict the rich man in the same degree as the poor man in the satisfaction of his necessities. For since we are all citizens of the same state and each the equal of the other, there can be no true equality or justice in taxation unless the taxes reduce us all to the same economic level. For to have too much wealth does not do any one any good, but on the contrary is a dangerous thing not only for the body politic, but for the citizens at large, and even for the owners [of the wealth] themselves. If, then, we introduce the progressive principle we shall become truly equal as we reasonably ought to be.

Id. at 135-36 (footnotes omitted) (E.R.A. Seligman trans.); *see also id.* at 136-37 (equalization proponents in the French Revolution).

[124] 1 WHO WAS WHO IN AMERICA (1607-1896) 556 (1963). Francis Walker was president of Massachusetts Institute of Technology from 1881 until his death in 1897, and also taught economics at Yale.

[125] E.R.A. SELIGMAN, *supra* note 109, at 143 (quoting F. WALKER, POLITICAL ECONOMY, 479-80 (1st ed. 1883)).

[126] *Id.* at 143.

> This defense of progressive taxation is . . . not new with President Walker. Progressive taxation was first advocated at length on this ground in the remarkable work of a woman, Mlle. Royer, which was [awarded a prize] by the Council of State of Vaud, in Switzerland, at the time of the great international convention on taxation in Lausanne in 1860.

Id.

lar category of undeserved income for any particular person.

Seligman referred to this argument as the general compensatory theory. Its cousin, the special compensatory theory, springs from quite different intellectual roots but also used progressive taxation to compensate for other elements in the economy. The special compensatory theory inquires whether the net effect of all other components of national, state, and local tax systems (other than the income tax) is regressive. If it is, a progressive income tax can be added, with the degree of progressivity calculated to offset the net regressivity in the other taxes. Of course, this theory places a limit on the amount of income tax progression that can be justified. Seligman called it "only ostensible progression."[127] A different theoretical basis is necessary if one desires a total tax structure with net progressivity.

One early theory, which was developed to explain and justify taxation in general, was called the benefit theory. This is one that Seligman included in his category of "economic theories," and it adopts the simplistic view that taxes constitute payments for services provided by government to citizens.

> Since protection was generally regarded as the chief function of the state, the conclusion was drawn that taxes must be adjusted to the protection afforded. Taxes were looked upon as premiums of insurance which individuals paid to the collective insurance company—the state—in order to enjoy their possessions in peace and security.[128]

Seligman's view leads to the conclusion that if one taxpayer has twice as much property or income (whichever base is being used) as another taxpayer, the wealthier individual has twice as much to lose, thus enjoying twice the benefit of the less wealthy person. A proportionate rate structure is the inevitable result of the benefit theory.

A slightly more sophisticated version of this idea, one recognizing David Ricardo's point that "the power of paying taxes is in proportion to the net, and not in proportion to the gross revenue,"[129] applies the proportionate tax rate only to income above a certain exempt amount. The exemption might be a subsistence

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[127] *Id.* at 147.

[128] *Id.* at 150.

[129] *Id.* at 151 (quoting D. RICARDO, PRINCIPLES OF POLITICAL ECONOMY AND TAXATION ch. xxvi (1817)). Ricardo (1772-1823) was one of the leading English economists of the 19th century. *Id.*

amount or could be calculated to include some degree of basic comfort above subsistence. The meaning and effect of Ricardo's statement can best be illustrated numerically, as in the following example. If subsistence requires $1,000 per year, a taxpayer earning $1,500 has only $500 available for the payment of taxes. A twenty percent tax rate in a system that provides no exemption will claim $300, which is sixty percent of the $500 from which the tax must be paid. A taxpayer with a $5,000 income will pay $1,000 in tax, which constitutes only twenty-five percent of that person's available income. Thus, a rate structure that appears proportionate on its surface can be highly regressive in operation if a subsistence exemption is not allowed.[130]

Seligman provided a similar analysis of the effect of an exemption, although he approached it from a different direction. He stated: "[P]roportional taxation of clear income, *i.e.*, income above a fixed minimum, is actually degressive taxation of total income. Thus without being aware of it many advocates of so-called proportional taxation really favor non-proportional taxation."[131]

A constant tax rate combined with a personal exemption produces a tax that is proportionate with respect to net income above the exemption, but progressive with respect to total income. In contrast, a tax with increasing rates for increasing levels of net income above a personal exemption will be progressive with respect to both net income and total income. When Seligman claimed that supporters of a constant rate tax with an exemption are unwittingly supporting "non-proportional taxation,"[132] he has, to some extent, unwittingly classified proponents of apples with supporters of oranges.[133]

Ultimately, Seligman rejected the benefit theory:

> This whole method of [benefit theory] argument, however, is inconclusive. The question of advantages which an individual derives from governmental action is a psychological one. It does not logically lead either to proportion, or to progressive or to regres-

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[130] Similarly, a tax system that is proportionate relative to net income above the exemption will be moderately progressive, relative to total income. One must make an individual decision about which tax base is most appropriate for use as a standard in measuring progressivity or regressivity of competing proposals for tax rules and rates.

[131] E.R.A. SELIGMAN, *supra* note 109, at 151-52.

[132] *Id.* at 152.

[133] Blum and Kalven analyzed the difference between these two tax types in greater detail, but overlooked the key point, namely, the difference in the tax base used to determine progressivity or proportionality. *See supra* note 110.

> sive taxation. The degree to which a taxpayer values the public art galleries, or the public concerts, or clean streets, or the decisions of the courts, or the thousand and one other benefits conferred by state action, depends on a multiplicity of motives which may differ in every individual case.[134]

Another idea which Seligman discussed is the "faculty concept," the historical forebear of our modern concept of "ability to pay." "Faculty," however, had a distinctly proportionate flavor, while "ability to pay" is now found on the tongues of those with progressive rates in mind. A common feature is that both look to what the taxpayer has, rather than to the benefits he receives from the government. Several of the British colonies in America adopted taxes based on faculty.[135]

As the standard for measuring faculty changed from property to income, the propriety of a subsistence exemption under the faculty theory became recognized. Seligman credited this exemption with the broadening of the theoretical focus from production of income alone to the later inclusion of consumption of income. The new consciousness of consumption as a relevant matter in taxation, he maintained, then led to the idea of trying to evaluate the amount of sacrifice borne by a taxpayer.

> The original idea, as we have seen, was that of production. . . . Both property and income, as tests of faculty, had regard to conditions of production. As soon, however, as a demand was made for the exemption of the minimum of subsistence, a new factor was introduced,—namely, the conditions of consumption. What the individual received or produced in the way of income was no longer the only consideration; the ability to apply this product to the satisfaction of his necesary wants became an equally congent factor.
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> . . . Equality of pressure, or equality of sacrifice, now became a fundamental consideration; and faculty, or capacity to pay taxes, was henceforth declared to be measured by that proportion of his product or income, the loss of which would impose upon the individual an equal burden or sacrifice with his neighbor.[136]

Seligman's discussion of the faculty concept leads naturally into his analysis of the equal sacrifice theory. This theory centers around the decreasing marginal utility of money. A dollar is more

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[134] E.R.A. Seligman, *supra* note 109, at 155.
[135] *See id.* at 267-72.
[136] *Id.* at 209-10.

precious to a poor person than to a wealthy person. If the assumption that the marginal utility of money declines as income increases is accepted, it provides an irrefutable argument against a head tax. Obviously a $100 tax on a poor person imposes a much greater burden than a $100 tax on a wealthy person. Justification of proportionate taxation under this theory, however, requires the conclusion not only that a rich person values a dollar less than a poor person, but also that a person with $100,000 of taxable income places as much value on (or receives as much satisfaction from) $1,000 as a person with $10,000 of taxable income places on $100. Even if it is agreed that the wealthier person places a lower value on a dollar, there is no proof that she values a dollar only one-tenth as much as the poorer taxpayer. An economist would claim that, even though we have concluded that the marginal utility curve slopes downward, we do not know the rate or angle of that downward slope.

Under Seligman's analysis, the equal sacrifice theory gains enough strength to carry us one additional step, from simple rejection of a head tax to a confident justification of proportionate taxation. He interpreted the term "equal sacrifice" to mean, more precisely, proportional sacrifice.[137] By way of example, consider that truly equal dollar taxation imposes a tax of $100 on every taxpayer, regardless of income. Truly equal taxation based on the sacrifice theory, however, looks to each person's income, but only for the purpose of determining the amount of satisfaction that a taxpayer in a particular income bracket gets from a dollar. If one concluded that a person with a $100,000 income gets only half as much satisfaction from a dollar as does a person with a $10,000 income, then the former would pay a $200 tax and the latter, $100. In this example, the dollar amounts are not equal, although the amounts of sacrifice, or satisfaction lost, are.

Similarly, a proportional dollar tax would take $1,000 from the $100,000 per year person and $100 from the $10,000 per year person. A proportional satisfaction tax, in attempting to take satisfactions (or impose sacrifice) in the same ratio as the income of the two individuals (10 to 1), will take $2,000 from the high income taxpayer and $100 from the low income taxpayer (again, assuming that the former finds only half as much satisfaction in her marginal dollars as does the latter). Therefore, Seligman's proposal that

[137] *See id.* at 214.

the term "equal sacrifice" be interpreted to mean proportional sacrifice equips this theory with the power to justify a modest degree of dollar progressivity.

Further, a tax that is proportionate with respect to total income is regressive with respect to income above a subsistence exemption. A tax that is proportionate with respect to income above an exemption is progressive with respect to total income. Similar potential for confusion exists when we presume that satisfaction per dollar decreases as income increases. Implicitly, then, a tax that is proportionate with respect to dollars will be regressive with respect to satisfaction and a tax that is proportionate with respect to satisfaction will be progressive with respect to dollars. Selection of the appropriate tax base, for comparison and analysis of the effects of various taxes, is essential to a valid characterization and a clear understanding of the results.

Seligman also noted that various authors have concluded that the faculty theory leads to proportional taxation, degressive taxation, and progressive taxation. Professor Thomas Nixon Carver placed a different twist on the equal sacrifice theory, stating that "the really logical equality of sacrifice is the equality of marginal sacrifice."[138] Thus, achieving equality of marginal sacrifice from taxation may require the government to impose taxes only on individuals with the highest incomes. As they are "taxed down" gradually to the income level of their less wealthy, untaxed neighbors, the neighbors can be added to the taxable group. Additional revenue needs would be satisfied by this larger group. The goal is to minimize the amount of satisfaction sacrificed by the group as a whole. The government, therefore, would always take dollars that represent the lowest amount of satisfaction, namely, dollars held by those taxpayers who have the highest remaining incomes.[139] Carver concluded that this reasoning was only the first step in a two-step process. Although a truly just distribution of the burdens of taxation is "the least evil to the least number[,] . . . [t]he evils of taxation . . . are two-fold—the *sacrifice* to those who pay the taxes and the *repression* of industry and of enterprise which the taxes occasion."[140]

Seligman rejected Carver's proposition in a way that reflects

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[138] *Id.* at 287.

[139] *See id.* at 285-86. This same reasoning was developed by English economist F.Y. Edgeworth, although immediately rejected as impractical communism. *Id.*

[140] *Id.* at 287 (emphasis added).

the fact that many turn-of-the-century commentators on progressivity had not yet recognized that very high income tax rates might cause a substantial reduction in gross national product. Perhaps today we ascribe to this idea too much power, over too broad a range of rates. As one scholar has recently noted, we have had some exceedingly good economic years in conjunction with some very high tax rates.[141] In the early twentieth century, the potential economic repression from high rates was not widely acknowledged, and progressivity was addressed more frequently on purely ethical grounds. For example, Seligman refuted Carver's ingenious argument by alleging that this "repression" is not caused by progressive rates. Specifically, Seligman asserted that "[t]he repressiveness of a tax is due far more to the nature of the tax than to any scale of graduation."[142] Today, one need not be a supply-side economist to have greater concern than Seligman showed for the possible magnitude of income tax effects on saving, risk taking, and entrepreneurial efforts. More than eighty years later, Carver's analysis, combining one highly theoretical element with another very practical element, is appealing in both approach and conclusion.

B. Henry C. Simons: The Ethical View

Thirty years after Seligman wrote, Henry Simons provided a much more sensitive approach to the indirect economic costs that might result from taxation. Economist Harold Groves described Simons' view toward this issue:

> [Simons believed that government] in general, though having many benevolent potentialities, should be closely circumscribed among other reasons because taxes are costly in terms of repression.
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> Simons had a deep interest in reducing inequality, and al-

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[141] *See* Graetz, *The Truth About Tax Reform*, 40 U. FLA. L. REV. 617, 626 (1988). The author believes that dramatic reductions in the maximum individual tax rates do "not seem likely to have major *economic* significance" and while low tax rates have at times been accompanied by good times, the connection is no more than coincidental. *Id.*

[142] E.R.A. SELIGMAN, *supra* note 109, at 288. Carver stated that "[a] progressive tax is therefore to be commended unless the rate of progression is made so high as to discourage the receivers of large incomes from trying to increase them." *Id.* at 288 n.10 (quoting from Carver, *The Minimum Sacrifice Theory of Taxation*, 19 POL. SCI. Q. 66, 79 (1904)). Seligman replied that "[n]o tax short of one hundred percent would completely discourage this, and at all events it would take far more than the 'moderately progressive tax,' of which Professor Carver speaks, to accomplish this result." *Id.* at 289 n.10.

though he thought that this must be at some price in terms of aggregate output, he conceived the goal as worth the price.[143]

In days gone by, the field we now know as economics was referred to as political economy. Today, economists have dropped the term "political" from their titles in an attempt to convince the world that their arguments and conclusions are scientific, objective, and free from political bias. Simons, however, was not offended by the presence of political values in economic writing; his concern was that the political element be admitted at the outset, and identified to some extent rather than hidden under a cloak of scientific neutrality.

> It has become conventional among students of fiscal policy . . . to dissemble any underlying social philosophy and to maintain a pretense of rigorous, objective analysis untinctured by mere ethical considerations. The emptiness of this pretense among economists is notorious; yet people who cannot solve a simultaneous equation still regard "unscientific" as the ultimate in critical invective and themselves live in constant terror of that characterization. Having been told that sentiments are contraband in the realm of science, they religiously eschew a few proscribed phrases, clutter up title-pages and introductory chapters with pious references to the science of public finance, and then write monumental discourses upon their own prejudices and preconceptions.[144]

Simons, in contrast, laid his politics, refreshingly, out on the table, reflecting his views of depression-era attitudes and programs relevant to his topic:

> Taxation is the proper means for mitigating inequalities; and, confining attention to this field of economic policy, one naturally places more emphasis upon that objective than would be appropriate in a less restricted discussion. . . .
>
> . . . Fine sentiments about economic justice are now employed mainly in support of schemes which, in spite of all good intentions, must serve to aggravate inequality, to make poorer a community which at best will be poor enough, and to undermine a political system which we overwhelmingly prefer to the authoritarian alternatives. Thus, I would suggest . . . not merely that progressive taxation is a sound and promising method for mitigating inequality but that it is the only sound and promising method which has seriously been proposed and that other currently popu-

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[143] H. GROVES, *supra* note 7, at 75.
[144] H. SIMONS, *supra* note 45, at 1-2.

> lar schemes are unsound technically and incompatible with the kind of total arrangements which we wish to preserve against the recently prevailing world-trend.[145]

Earlier, we found German economist Adolph Wagner verbally flogged and labeled a communist by Seligman. Now, we find Simons coming to his rescue, and specifically defending him against Seligman. Simons supported Wagner's advocacy to recognize the effect of taxation in changing the distribution of wealth and income. He rejected Seligman's "facility," as a mere disguise for people who do not want to face directly the ethical and political questions of proper distribution of income.[146] In his treatise, Simons also revealed an analysis of taxation which builds toward Carver's two-part approach.[147] The author stated that "every increase in the degree of progression is, *with reference merely to distributional effects*, a desirable change, and without limit short of substantial equality among those taxed."[148] Shortly thereafter, it becomes clear that Simons was presenting his own case. "The case for drastic progression in taxation must be rested on the case against inequality—on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely."[149]

Finally, his reasoning crystallized, paralleling that of Carver,[150] although he did not cite or discuss Carver's work in this regard.

> Such a view obviously takes account merely of the distributional effects of progression. Indeed, that is as far as traditional discussions of justice in taxation may properly go. Yet this is obviously but one side of the problem. The degree of progression in a tax system may also affect production and the size of the national income available for distribution. In fact, it is reasonable to expect that every gain, through taxation, in better distribution will be accompanied by some loss in production. The real problem of policy, thus, is that of weighing the one set of effects against the other.[151]

The causes behind this threatened loss in production (Selig-

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145 *Id.* at v-vii.
146 *Id.* at 15-16.
147 *See supra* text accompanying note 140.
148 H. SIMONS, *supra* note 45, at 17-18; *see also supra* text accompanying notes 139-41.
149 H. SIMONS, *supra* note 45, at 18-19.
150 *See supra* text accompanying notes 138-40.
151 H. SIMONS, *supra* note 45, at 19.

man's "repression")[152] need further attention. Simons identified them as the effects of progressive taxation: "(*a*) upon the supplies of highly productive, or at least handsomely rewarded, personal services, (*b*) upon the use of available physical resources, (*c*) upon the efficiency of enterpriser activity, and (*d*) upon the accumulation and growth of resources through saving."[153] Effects of the first three potential causes of lost production are cast off as insignificant, at least within any range of progressive rates that is likely to emerge from the political process.[154]

The adverse effect on saving, however, is recognized as a significant, indirect cost of progressive taxation. As compared to a proportional tax that raises the same amount of revenue, a progressive tax takes more dollars from high income taxpayers who are most likely to have saved some of those dollars. The tax savings caused by a change from a proportionate to a progressive tax system are enjoyed by lower income taxpayers, who are most likely to apply tax savings to increased consumption. Therefore, Simons concluded that progressive taxation leads to lower savings and higher consumption rates than does proportionate taxation. He flatly dismissed the Keynesian theory that modern society suffers from oversaving, and endorsed the generally accepted economic attitude that increased saving is in most cases beneficial to economic growth.[155]

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[152] *See supra* note 142 and accompanying text.

[153] H. SIMONS, *supra* note 45, at 19-20.

[154] Simons was writing at a time (1938) when the top rate was 79% on income above $5,000,000, which was then the highest top rate in United States history, other than the 1917 rate of 82% on income above $2,000,000. *See* Roberts & Samson, *Historical Survey of the Progressivity of the U.S. Income Tax*, 12 THE ACCT. HISTORIANS NOTEBOOK 11, 13 (Spring 1989). Simons wrote:

> The attractiveness of jobs as jobs surely varies, on the whole, directly and markedly with the remunerations which they carry. What competing firms must pay to get experts away from one another is vastly different from what society would be obliged to pay in order to keep the experts from being ditch-diggers. Physical resources . . . will always be more profitable to employ than to leave idle, so long as progression falls short of 100 per cent or does not rise precipitously to that level. Our captains of industry (enterprisers) are mainly engaged not in making a living but in playing a great game; and it *need* make little difference whether the evidence of having played well be diamonds and sables on one's wife or a prominent place in the list of contributors under the income tax. Besides—and this may be emphasized—the mere privilege of exercising power is no mean prize for the successful enterpriser.

H. SIMONS, *supra* note 45, at 20 (footnote omitted) (emphasis in original).

[155] Here, Simons' comment sheds a thoughtful light on the history of industrialized nations and the possible future of less developed countries. Simons wrote:

Although he conceded that increased progression will cause reduced capital accumulation for future production, Simons paused to consider whether that might be an acceptable trade-off.

> There is, first of all, a question as to whether society should make large sacrifices to further accumulation. To stress obligations to our children's children is often a means of diverting attention from patent obligations to our contemporaries. For the future there is a responsibility of maintaining a respectable proportion between population and resources—which surely admits of more than one method. Of course progress should be encouraged; but its costs should give us pause, in a society mature enough to exercise some deliberate control. Both progress and justice are costly luxuries—costly, above all, in terms of each other. . . .
>
> There is also a difficult question, from the point of view of the economics of welfare, as to the relative importance of productional and distributional considerations. There is real point, if not truth, in the suggestion that, within wide limits, the quality of human experience would be about the same at one income level as at another if the *relative* position of persons and classes remained unchanged. Poverty, want, and privation are in large measure merely relative. Thus, something can be said for mitigation of inequality, even at the cost of reduction in the modal real income.[156]

C. Blum and Kalven: The Critical View

In 1953, Professors Walter J. Blum and Harry Kalven, Jr., wrote a short book critiquing progressive taxation. They did not quickly convert the nation to proportionate taxation, but perhaps they demonstrated that Henry Simons was right in his contention that progressivity is an issue more concerned with ethics than rationality.

Blum and Kalven seemed to prefer Simons' approach. In 1963, when the book was reprinted, they recorded some additional thoughts on the view of progressivity as an ethical issue.

> The cost of our present stock of productive instruments was, in a significant sense, decades and centuries of terrible poverty for the masses. Conversely, the cost of justice will be a slowing-up in our material advance (though this effect may be modified if and as governments assume the role of savers).

H. SIMONS, *supra* note 45, at 22.

[156] *Id.* at 24-25 (emphasis in original).

> Ten years ago we were puzzled as to why Henry Simons' bluntness had not had more impact on the tone of discussions in the United States. Writing in the late thirties, he exasperatedly asserted that the whole superstructure of sacrifice and ability-to-pay theorizing was simply nonsense and that the case for progression was no more and no less than the case for mitigating "unlovely" economic inequality.[157]

The authors claimed to have approached their topic with a bias favoring progressivity.[158] Appropriately, Blum and Kalven's *The Uneasy Case for Progressive Taxation* begins with a careful definition of the central issue, particularly with reference to the difference between progression arising from a constant rate tax with a personal exemption,[159] and the type of progression (relative to both total and taxable incomes) obtained from actually graduating the statutory marginal rates. The former is defined as degression. Based upon their conclusion that "[i]t is almost unanimously agreed that some exemption keyed to at least a minimum subsistence standard of living is desirable,"[160] the authors put aside the issue of degression and focused their attention on the latter form of progression.[161]

The authors discussed three general objections often lodged against progressivity. First, they pointed to the additional complication progressivity adds to an income tax and its administration. Income splitting and other problems related to identifying the proper taxpayer fit into this category. Progressivity also creates the problem of identifying or defining the appropriate taxable unit in family matters. With a flat tax, husbands, wives, and children can be taxed together or separately with no difference in impact or tax liability. The difference between married, single, and head-of-household taxpayers would disappear (except with respect to the appropriate size of the exemption). Splitting income among different years is the temporal equivalent of splitting income among dif-

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[157] W. Blum & H. Kalven, Jr., *supra* note 110, at xiv.

[158] *Id.* at 2-3. "Like most people today we found the notion of progression immediately congenial. Upon early analysis the notion retained its attractiveness, but our curiosity as to the source of its appeal increased." *Id.* at 2.

[159] *See supra* note 130 and accompanying text.

[160] W. Blum & H. Kalven, Jr., *supra* note 110, at 4.

[161] *Id.* "With these qualifications the question of the essay can be finally formulated: On what grounds is a progressive tax on all incomes over a minimum subsistence exemption to be preferred to a proportionate tax on all incomes over a minimum subsistence exemption?" *Id.*

ferent individuals, and it is aggravated (though not created) by a progressive rate structure. Under a flat tax, the seemingly inescapable year-end ritual of deciding whether to accelerate deductions into the expiring year and delay income into the coming year, or vice versa, becomes purely a matter of the time value of money. The question of the year in which the individual will be in a higher tax bracket drops out of the equation.[162]

> And one of the few plausible arguments, if not the only one, for special treatment of capital gains stems from this characteristic of progression. Because a capital gain may have been in the making for many years, it seems unfair to tax all of it as the income of a single year.[163]

The authors also implied that the reduced importance of timing, which would result from elimination of progressive rates, would allow repeal of the rules for the net operating loss carryback and carryforward,[164] installment sale method,[165] last-in first-out ("LIFO") inventory method,[166] and carryover of capital losses.[167] Such an implication is not sound, however, for several reasons: the installment sale method is motivated in large part by a sympathy for the taxpayer who has a realized gain that is much greater than his cash from the transaction; the LIFO method is driven by desire to reduce the effective tax rate on inflationary gain by delaying the tax as long as possible; and net operating loss and capital loss carryover provisions are primarily based on the government's reluctance to give immediate refunds for such losses.

The second general objection to progressivity is that it is "politically irresponsible."[168] This is the "tyranny of the majority" argument, which questions the right of the majority to impose such a burden on the higher-income minority. The response to this, which the authors acknowledged, is that such an objection applies to every decision made by a democratic government. The authors made reference to constitutional limitations on the power of the

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[162] For many people, perhaps the majority of those who do this type of planning, the great width of the brackets in the current three-tiered system has already eliminated this issue. The de-emphasis of this issue from the 1986 move toward a flat tax affirms the cogency of the authors' argument.

[163] W. BLUM & H. KALVEN, JR., *supra* note 110, at 16-17.

[164] *See* I.R.C. § 172 (1990).

[165] *See id.* §§ 453, 453A, 453B.

[166] *See id.* §§ 472-474.

[167] *See id.* § 1212.

[168] W. BLUM & H. KALVEN, JR., *supra* note 110, at 19.

majority in certain areas, such as free speech, which merely highlights the fact that those who framed and adopted our Constitution never deemed the upper end of a highly paid person's income to rank with the fundamental individual freedoms protected by the Bill of Rights.[169]

The third general objection to progressivity is that it reduces total national output. Blum and Kalven noted that a progressive tax is not the only type that can reduce the productivity of our economy:

> It is worth a reminder that the disadvantages of progression, as well as its advantages, in this connection and in all others, are to be assessed only by contrasting a progressive system which raises a given amount of revenue to a proportionate one which raises an identical amount of revenue.[170]

Nevertheless, the comparable progressive tax will subject the most highly paid (and therefore, arguably, most productive) citizens to a higher marginal tax rate than would the revenue-equivalent proportionate system.

One fundamental assumption that the authors made regarding productivity deserved more thought than it received. They asserted that "[i]t is not difficult to concede that money is the dominant stimulus to work in our society."[171] Others would disagree with this assumption, however, especially with respect to high income individuals. It ignored the large number of "workaholics" in higher income strata. It also gave inadequate attention to the nonmonetary rewards that often flow from highly paid positions. Simons, whom the authors quote only briefly on this point, saw money as only one stimulus at work in our society.[172]

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[169] *Id.* Their 1963 introduction paints a much more realistic picture of the history of progressivity in the United States:

> There has always been, both here and in other economically advanced societies, a large degree of official fraud in sponsoring a popular impression as to the amount of actual progressivity in the tax system. High surtax rates have invariably been accompanied by big holes in the tax base, so that the effective rates for most taxpayers are totally obscure and undoubtedly far below the published schedule of rates. . . . The classic objection about the political irresponsibility of majority vote seems almost to be turned upside down. Instead of the majority voting high taxes on the minority, the minority seems to have beguiled the majority into thinking that this has actually happened.

Id. at xx-xxi.

[170] *Id.* at 21.

[171] *Id.* at 22.

[172] *See* H. SIMONS, *supra* note 45, at 20. "Our captains of industry (enterprisers) are

It also can reasonably be argued that much of the interest of the rich in money is in having *relatively* more than their peers. This is a corollary to Simons' assertion that "[p]overty, want, and privation are in large measure merely relative."[173] Because a rational, progressive income tax will not upset the relative pre-tax order (of rich, richer, richest), this kind of egotistical stimulus to working will not be impaired by progressive taxation.

Another element in the productivity debate is the possible discouragement of saving and investing. There is widespread agreement that progressive taxation has a negative effect on capital accumulation and that such accumulation is an important element in economic growth. As mentioned above, Simons wrote that "[w]ith respect to capital accumulation, however, the consequences are certain to be significantly adverse,"[174] but that, in his opinion, the incremental loss of productivity is probably justified by the reduction of inequality. Blum and Kalven agreed with him on the first conclusion but parted company with him on the second. They identified two phases in the formation of "real capital": the decision of an individual with discretionary income to save, rather than consume, a part of it;[175] and the decision by that same, or another, person to invest those savings in a business or other venture.[176] The authors recognized that the effect of progressive taxation on the decision to save is unclear. Some people save in response to the rate of interest their savings can earn. For high income people who save for this reason, the incentive to save is reduced by the higher tax rates that accompany a progressive system (as opposed to a proportionate system that generates equal revenue). On the other hand, other people save to accumulate a specific amount of money for retirement. For them, reduction in rate of return due to the tax burden will actually force them to save more to achieve the same retirement goal. The authors recognized that, since the magnitudes of these two savings incentives are unknown, the net effect on saving of a particular tax rate is also unknown.

Blum and Kalven's analysis of the effects of progressivity on

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mainly engaged not in making a living but in playing a great game." *Id.*

[173] *Id.* at 25.

[174] *Id.* at 21.

[175] *See* W. Blum & H. Kalven, Jr., *supra* note 110, at 23; *see also* McCombs, *supra* note 25, at 673 (source-based and use-based investment schemes as investment incentives to encourage decisions).

[176] W. Blum & H. Kalven, Jr., *supra* note 110, at 23.

investment (*i.e.*, risk-taking) is not applicable under the current United States tax system with its extremely wide rate brackets. If one thinks back (or forward) to a rate structure containing a large number of relatively narrow brackets, however, the discussion is valuable. Under such a system, if an investment is successful, the profit will push the investor into a higher tax bracket and such profit will be taxed at a rate higher than the investor normally experiences. If the investment is unsuccessful, the loss will pull the investor down to a bracket lower than normal. As a result, the government takes a higher than normal percentage of investment profits, while it absorbs through loss deductions a lower than normal percentage of investment losses (assuming full deductibility of losses). Again, Blum and Kalven distinguished between high tax rates in general and high tax rates generated by progressivity. While a high tax rate itself may discourage investment, its impact is enlarged by a progressive system. Ultimately, the "relatively wealthy," a significant source of investment funds, are taxed under progression at rates higher than the single rate prevalent under a proportionate tax rate.[177]

Blum and Kalven identified the effect of progressivity on levels of saving and investment as central to the debate over progressivity, and referenced Simons' idea of government capitalism. Thus, it may be in order to consider the capital formation issue more broadly, and in a modern context. Simons did not go into much detail in his discussion of government capital formation, but he did suggest that the government might appropriately purchase all regulated utilities. This, he believed, could be accomplished without a major overthrow of our economic system.[178] If inadequate capital formation is a valid concern, however, perhaps we should be searching for possible ways to implement Professor Simons' concept of government capitalism, structured in ways and within limits that impose acceptably small costs in terms of greater government control over the private economy.

It is not at all clear that changing from progressive to proportionate taxation will increase private capital formation sufficiently to satisfy those who are concerned about it. Indeed, progressivity of federal taxes was reduced by the several tax reform acts of the

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[177] *Id.* at 24.

[178] In Nebraska, for example, nearly all electricity is produced at facilities owned and operated by public power districts. Despite this, Nebraska has avoided a reputation as a socialist state.

1980s, yet Congress is still grappling for ways to increase the United States saving rate.[179] One point remains clear—taxes are not the only significant variable in capital formation. Cultural attitudes toward consumption and saving are also important ingredients.[180]

Desire to retain progressive taxation, therefore, might not be the only force leading to endorsement of government capitalism. For example, in the United States, gradual changes in cultural attitudes could, over a span of multiple generations, produce a situation in which people save a lower percentage of their incomes than did their grandparents under otherwise identical circumstances. Furthermore, despair over the chances of economic development in the third world outstripping population growth could convince industrialized nations to assume the role of capitalists for less developed countries.

On the subject of a reduction in production caused by a progressive tax, the parallel between the Blum and Kalven team and Henry Simons continues, despite their inapposite conclusions on progression. The continuation of these diametric conclusions gives some validity to Simons' claim that progressivity ultimately rests upon an ethical judgment rather than logical reasoning.

In contrast, a number of theories have been advanced in support of a progressive income tax. One is the suggestion that a progressive tax is highly sensitive to contraction and expansion of the overall economy, and that it reacts to each in an appropriate manner. During a recession, for example, revenues produced by a progressive tax will fall faster than those from a proportionate tax, leaving more money in the private economy at a time when it is especially needed. During an expansion, revenues produced by a progressive tax grow faster than the economy, and faster than revenues from a proportionate tax, reducing the likelihood that the economy will become "overheated" and inflationary. During recession and expansion, these effects occur more quickly than federal spending changes could be made, and also reduce the amount of spending and monetary adjustments necessary to stabilize the economy.

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[179] *See, e.g.*, Davenport, *JEC [Joint Economic Committee] Considers Tax Changes To Bolster Saving Rate*, 43 TAX NOTES 1572 (1989) (JEC convened to "examine the possibility of manipulating the tax code to boost savings and investment").

[180] In my opinion, cultural attitudes are the largest factor in the saving rate, dwarfing the effects of tax structure and rate of return.

The sacrifice theory is another supportive theory.[181] According to Blum and Kalven, "[i]t ignores the benefits received from government and treats taxes as though they were a confiscation of property. The problem then becomes one of confiscating in an equitable manner."[182]

Although the term "equality of sacrifice" is often used in this context, it is used generally to describe a condition under which each person suffers a proportionate, rather than truly equal, sacrifice. If "sacrifice" is taken to mean the number of dollars surrendered, then proportionate sacrifice theory simply leads to proportionate taxation. If, however, sacrifice is to be measured in terms of potential satisfaction surrendered to the government, and if that meaning is combined with the theory of declining marginal utility of money, then proportionate sacrifice in terms of potential satisfaction will require progressive surrender in terms of dollars.[183]

Blum and Kalven separated the truly equal sacrifice idea from that of proportionate sacrifice, although the distinction is difficult to discern. They demonstrated that the truly equal sacrifice approach does not necessarily lead to progressive rates. Simons has already stated that if the utility curve for money slopes downward only gradually, a goal of equal sacrifice will produce regressive tax rates.[184] Blum and Kalven added that:

> This is an important step since it is one thing to assume that the utility of money declines but quite another to assume the rate at which it declines. Clearly, the fewer the demands the argument makes on knowledge of the slope of the curve, the stronger the argument will be.[185]

Both of these sacrifice theories involve a two-step process.

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[181] *See* W. BLUM & H. KALVEN, JR., *supra* note 110, at 32 n.100; *see also* H. SIDGWICK, PRINCIPLES OF POLITICAL ECONOMY 566 (2d ed. 1887) (equal sacrifice by all should be goal of taxation).

[182] W. BLUM & H. KALVEN, JR., *supra* note 110, at 39.

[183] *See id.* at 39-45 (arguing for proportionate sacrifice).

[184] H. SIMONS, *supra* note 45, at 7.

[185] W. BLUM & H. KALVEN, JR., *supra* note 110, at 41. In my opinion, the equal sacrifice approach must be abandoned, because, as stated by British economist A.C. Pigou, "[i]n order to prove that the principle of equal sacrifice necessarily involves progression we should need to know that the last £10 of a £1000 income carry less satisfaction than the last £1 of a £100 income; and this the law of diminishing utility does not assert." A.C. PIGOU, A STUDY IN PUBLIC FINANCE 86 (3d rev. ed. 1962). Personal reflection leads to the intuitive conclusion that the utility curve for money does not decline that steeply. At least, many reasonable people could so conclude, which takes the strength out of this theory's support for progression.

First, each must establish a normative proposition of how the sacrifice of paying taxes should be shared. Second, a tax rate structure that achieves the proposed sharing must be shown. The equal sacrifice theory is strong on the first step and weak on the second. The proposal that a sacrifice for the good of the group should be borne equally by all its members is, superficially, very appealing.[186] As discussed above, however, under this theory, support for progression depends upon the idea that the marginal utility of money decreases faster than income increases, and this supposition is subject to serious challenge.

Conversely, the proportional sacrifice theory as an argument for progression is strong on the second step, but at first glance seems weak on the first. Assuming for a moment the normative proposition that each person should suffer a proportionate sacrifice to pay for government expenditures, progressive taxation with respect to income is necessary and appropriate to achieve that goal. Any normal, declining marginal utility curve for money will support the claim for progression.[187] Under any normal, downward sloping utility curve, even a gentle slope, a tax that takes twenty percent of income from both high income and low income taxpayers will be proportionate with respect to dollars but regressive with respect to satisfaction sacrificed. Because the high income individual will pay the tax with less valuable (*i.e.*, less satisfying) dollars, that person will sacrifice a lower percentage of his satisfaction. It is very clear that progressive tax rates are necessary to achieve proportionate sacrifice.

The more difficult part of the analysis is to make a compelling argument for the first step, *i.e.*, the proposition that taxpayers

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[186] *But see* A.C. PIGOU, *supra* note 185, at 43-44 (poor people ultimately lose in equal sacrifice situation).

[187] Blum and Kalven were rather impressed by the discovery by Dutch economist Cohen-Stuart in the late 19th century of certain utility curves that decline but do not lead to progression under the proportional sacrifice theory. British economist F.Y. Edgeworth also wrote about such curves. While Blum and Kalven stated in their text that "any argument for progression based on [proportionate sacrifice] loses some of its force because of the fact that a declining curve does not always result in progression," they admitted in a footnote that:

> Cohen-Stuart and Edgeworth confine themselves to showing only that it is *possible* to find an instance of a declining utility curve which would not result in progression under the [proportionate] sacrifice formula. Neither suggests that such a curve is at all plausible. It takes considerable ingenuity to find such an instance, and the curve is eccentric.

W. BLUM & H. KALVEN, JR., *supra* note 110, at 43 n.109.

should suffer a proportionate, rather than equal, sacrifice of the potential satisfactions represented by their incomes. Surprisingly, Blum and Kalven presented a convincing argument that proportionate sacrifice is the superior choice.

> Any theory of equalizing the sacrifice of taxpayers implicitly assumes that the taxes are a necessary evil falling upon a distribution of money, and therefore upon a distribution of satisfactions, which [distributional pattern] is otherwise acceptable. With this assumption the problem is not to use the tax system to adjust existing inequalities in that distribution but simply to leave all taxpayers equally "worse off" after taxes. The vice of the equal sacrifice formula is that it is regressive when measured by satisfactions and this becomes compellingly clear if large enough sacrifices are exacted equally from each taxpayer. The corresponding virtue of the proportionate sacrifice formula is that it remains neutral as to the relative distribution of satisfactions among taxpayers. Under it they are all equally "worse off" [in terms of satisfaction, not dollars] after taxes.[188]

In *The Uneasy Case for Progressive Taxation,* one can discern strength in each of the two steps that are required to support progressive taxation with the proportionate sacrifice theory. Although Blum and Kalven were not fully convinced by their own arguments, upon close analysis their arguments on behalf of the proportionate sacrifice theory are compelling. They summarize them as follows:

> [The proportionate sacrifice theory] makes relatively few demands on knowledge about the utility curve for money, other than that it declines; and it narrows considerably the issue between progressive and proportionate taxation. As between one who favors proportional taxation on grounds of its neutrality and one who favors the proportionate sacrifice standard on grounds of its neutrality there is only the issue of whether there is a meaningful and sufficiently ascertainable money utility curve for all taxpayers.[189]

The only remaining difficulty is how to devise a specific rate schedule that implements the proportionate sacrifice theory. To remain true to the reasoning behind the theory, some estimated utility curve for money must be constructed. It seems likely that there

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[188] *Id.* at 43-44 (footnotes omitted).
[189] *Id.* at 44-45.

have been many years in which United States statutory rates have been much more progressive than could be justified under this theory, with any reasonably estimated money utility curve.[190]

[190] With the caveat that upper statutory rates are usually much higher than effective rates on true net income (due to the porous statutory definition of taxable income), the following chart lists the highest and lowest rates for each year in the history of the federal income tax.

TABLE I THE GREAT EXPERIMENT: PROGRESSIVITY FROM A HISTORICAL PERSPECTIVE

INDIVIDUAL INCOME TAX

Year	Number of Tax Brackets	Top Rate	Income Level for Top Rate	Exempt Income (Family of 4)	Lowest Rate	Top-Bottom Rate Comparison: High-Low Range	Ratio
1861	1	3.0%	$0	$600	3.0%	0.0%	1.00
1862	2	5.0%	$10,000	$600	3.0%	2.0%	1.67
1863	2	5.0%	$10,000	$600	3.0%	2.0%	1.67
1864	3	10.0%	$10,000	$600	5.0%	5.0%	2.00
1865	2	10.0%	$5,000	$600	5.0%	5.0%	2.00
1866	2	10.0%	$5,000	$600	5.0%	5.0%	2.00
1867	1	5.0%	$0	$1,000	5.0%	0.0%	1.00
1868	1	5.0%	$0	$1,000	5.0%	0.0%	1.00
1869	1	5.0%	$0	$1,000	5.0%	0.0%	1.00
1870	1	2.5%	$0	$2,000	2.5%	0.0%	1.00
1894	1	2.0%	$0	$4,000	2.0%	0.0%	1.00
1913	7	7.0%	$500,000	$4,000	1.0%	6.0%	7.00
1914	7	7.0%	$500,000	$4,000	1.0%	6.0%	7.00
1915	7	10.0%	$500,000	$4,000	2.0%	8.0%	5.00
1916	13	14.0%	$2,000,000	$4,000	2.0%	12.0%	7.00
1917	21	82.0%	$2,000,000	$2,000	4.0%	78.0%	20.50
1918	56	77.0%	$1,000,000	$2,400	6.0%	71.0%	12.83
1919	56	71.0%	$1,000,000	$2,400	4.0%	67.0%	17.75
1920	56	71.0%	$1,000,000	$2,400	4.0%	67.0%	17.75
1921	50	58.0%	$200,000	$3,300	4.0%	54.0%	14.50
1922	50	58.0%	$200,000	$3,300	4.0%	54.0%	14.50
1923	50	58.0%	$200,000	$3,300	4.0%	54.0%	14.50
1924	43	46.0%	$500,000	$3,300	2.0%	44.0%	23.00
1925	23	25.0%	$100,000	$4,300	1.5%	23.5%	16.67
1926	23	25.0%	$100,000	$4,300	1.5%	23.5%	16.67
1927	23	25.0%	$100,000	$4,300	1.5%	23.5%	16.67
1928	23	25.0%	$100,000	$4,300	1.5%	23.5%	16.67
1929	23	24.0%	$100,000	$4,300	0.5%	23.5%	48.00
1930	23	25.0%	$200,000	$4,300	1.5%	23.5%	16.67
1931	25	25.0%	$200,000	$4,300	1.5%	23.5%	16.67
1932	57	63.0%	$1,000,000	$3,300	4.0%	59.0%	15.75
1933	57	63.0%	$1,000,000	$3,300	4.0%	59.0%	15.75
1934	30	63.0%	$1,000,000	$3,300	4.0%	59.0%	15.75
1935	30	63.0%	$1,000,000	$3,300	4.0%	59.0%	15.75
1936	33	79.0%	$5,000,000	$3,300	4.0%	75.0%	19.75
1937	33	79.0%	$5,000,000	$3,300	4.0%	75.0%	19.75
1938	33	79.0%	$5,000,000	$3,300	4.0%	75.0%	19.75

Furthermore, even if it could be proven that the actual shape

1939	33	79.0%	$5,000,000	$3,300	4.0%	75.0%	19.75
1940	35	89.0%	$5,000,000	$2,800	4.0%	85.0%	22.25
1941	31	81.0%	$5,000,000	$2,800	4.0%	77.0%	20.25
1942	23	88.0%	$150,000	$2,300	6.0%	82.0%	14.67
1943	25	93.0%	$200,000	$1,900	11.0%	82.0%	8.45
1944	25	94.0%	$200,000	$2,400	3.0%	91.0%	31.33
1945	25	86.5%	$200,000	$1,500	2.9%	83.7%	30.35
1946	25	86.5%	$200,000	$2,500	2.9%	83.7%	30.35
1947	25	86.5%	$200,000	$2,500	2.9%	83.7%	30.35
1948	25	82.1%	$400,000	$3,400	16.6%	65.5%	4.95
1949	25	82.1%	$400,000	$3,400	16.6%	65.5%	4.95
1950	25	84.3%	$400,000	$3,400	17.4%	66.9%	4.85
1951	24	91.0%	$400,000	$3,400	20.4%	70.6%	4.46
1952	27	92.0%	$600,000	$3,400	22.2%	69.8%	4.14
1953	27	92.0%	$600,000	$3,400	22.2%	69.8%	4.14
1954	24	91.0%	$400,000	$3,400	20.0%	71.0%	4.55
1955	24	91.0%	$400,000	$3,400	20.0%	71.0%	4.55
1956	24	91.0%	$400,000	$3,400	20.0%	71.0%	4.55
1957	24	91.0%	$400,000	$3,400	20.0%	71.0%	4.55
1958	24	91.0%	$400,000	$3,400	20.0%	71.0%	4.55
1959	24	91.0%	$400,000	$3,400	20.0%	71.0%	4.55
1960	24	91.0%	$400,000	$3,400	20.0%	71.0%	4.55
1961	24	91.0%	$400,000	$3,400	20.0%	71.0%	4.55
1962	24	91.0%	$400,000	$3,400	20.0%	71.0%	4.55
1963	24	91.0%	$400,000	$3,400	20.0%	71.0%	4.55
1964	28	77.0%	$400,000	$3,400	16.0%	61.0%	4.81
1965	25	70.0%	$200,000	$3,400	14.0%	56.0%	5.00
1966	25	70.0%	$200,000	$3,400	14.0%	56.0%	5.00
1967	25	70.0%	$200,000	$3,400	14.0%	56.0%	5.00
1968	25	75.0%	$200,000	$3,400	14.0%	61.0%	5.36
1969	25	77.0%	$200,000	$3,400	14.0%	63.0%	5.50
1970	25	73.0%	$200,000	$3,500	14.0%	59.0%	5.21
1971	25	70.0%	$200,000	$4,200	14.0%	56.0%	5.00
1972	25	70.0%	$200,000	$5,000	14.0%	56.0%	5.00
1973	25	70.0%	$200,000	$5,000	14.0%	56.0%	5.00
1974	25	70.0%	$200,000	$5,000	14.0%	56.0%	5.00
1975	25	70.0%	$200,000	$5,000	14.0%	56.0%	5.00
1976	25	70.0%	$200,000	$5,800	14.0%	56.0%	5.00
1977	25	70.0%	$203,200	$6,200	14.0%	56.0%	5.00
1978	25	70.0%	$203,200	$6,200	14.0%	56.0%	5.00
1979	15	70.0%	$215,400	$7,400	14.0%	56.0%	5.00
1980	15	70.0%	$215,400	$7,400	14.0%	56.0%	5.00
1981	15	70.0%	$215,400	$7,400	14.0%	56.0%	5.00
1982	12	50.0%	$85,600	$7,400	12.0%	38.0%	4.17
1983	13	50.0%	$109,400	$7,400	11.0%	39.0%	4.55
1984	13	50.0%	$162,400	$7,400	11.0%	39.0%	4.55
1985	14	50.0%	$169,020	$7,700	11.0%	39.0%	4.55
1986	14	50.0%	$175,250	$7,990	11.0%	39.0%	4.55
1987	5	38.5%	$90,000	$11,360	11.0%	27.5%	3.50
1988	2	28.0%	$29,750	$12,800	15.0%	13.0%	1.87

of the utility curve for money justifies rates above fifty percent,[191] it is still possible to reject such high rates under this theory by following Carver's lead. He began with the minimum sacrifice theory, which endorses the most extreme form of progressivity, and then superimposed a rate-limiting theory that considered the burden on others from the overall productivity loss caused by the extremely high rates.[192] His second step could be added to the proportionate sacrifice theory in the same manner. In this way, with some estimates of productivity losses caused by various rates, one could construct a declining marginal utility curve for money that maps the "boundary," below which one is not willing to follow the proportionate sacrifice theory. If the utility curve for money declines so steeply that the proportionate sacrifice theory prescribes unacceptably high rates at some income levels, Carver's theory of productivity losses can be used to constrain the rates ultimately selected to more reasonable levels.

One objection to progressivity raised by Blum and Kalven was that even if these various theories have some validity as general arguments in favor of progression, none gives any hint of what the theoretically justifiable rate structure should be.[193] Properly conceived, their objection should not be used as a general argument against progressive taxes, but is valid only against highly progressive taxes. If it is agreed that the proportionate sacrifice theory demonstrates only that the ideal rate structure is progressive and nothing about the proper degree of progressivity, then it is highly likely that a moderately progressive set of rates will be closer than a strictly proportionate tax to the unknown theoretical ideal. As the proposed rate structure becomes more progressive, this likelihood is reduced. Seligman made an argument of this nature, without identifying the fact that the likelihood of being near the ideal varies when the proposed progressivity is changed.[194] As long as

Roberts & Samson, *supra* note 154. It should also be noted that even the top statutory rate can sometimes be subject to interpretation. For example, this author would list the top rate in 1988 as 33%. *See* I.R.C. § 1(g) (1990).

[191] This assumes, for purposes of discussion, that rates above 50% are objectionable on other, perhaps nonobjective grounds.

[192] *See* E.R.A SELIGMAN, *supra* note 109, at 40-122 (varied treatment of progressive taxation in foreign countries).

[193] *See* W. BLUM & H. KALVEN, JR., *supra* note 110, at 53.

[194] *See* E.R.A. SELIGMAN, *supra* note 109, at 293-94 (footnote omitted). Seligman wrote:

> It may, indeed, frankly be conceded that the theory of faculty cannot determine any definite rate of progression as the ideally just rate. To this extent there seems

the argument is restricted to the defense of moderately progressive rates, it provides the better response to this issue. With this in mind, Blum and Kalven seem almost disingenuous in their complaint that the perfect proportionate sacrifice rate package cannot be determined.

CONCLUSION

Every individual who hopes to be a scholar or preeminent practitioner in her field must understand the history of that field. For those whose professional interests lie in tax policy, the preceding authors and works stand together as a "primer" of foundation-building thoughts on fundamental issues. In some cases an author's position lent itself naturally to comparison and contrast with another author, while at other times an author stood distinctively by himself. Similarly, certain portions of the reviewed works prompted a natural response in terms of modern circumstances and debates, while other portions must be absorbed as general historical knowledge and are not directly tied to a specific current topic. Perhaps the overarching lesson is that pragmatism and ethical judgment are necessary companions to theoretical analysis in this field, and the greatest difficulty is in knowing which to apply at each point in one's analysis of these or other tax policy issues.

> to be some truth in Mill's contention that progressive taxation cannot give that "degree of certainty" on which a legislator should act; as well as in McCulloch's assertion that when we abandon proportion we "are at sea without rudder or compass." It is true that proportion is in one sense certain, and that progression is uncertain. The argument, however, proves too much. An uncertain rate, if it be in the general direction of justice, may nevertheless be preferable to a rate which, like that of proportion, may be more certain without being so equitable. . . . In truth, a strict proportional tax, if we accept the point of view mentioned above, is really more arbitrary as over against the individual taxpayers, than a *moderately* progressive tax. The ostensible "certainty" hence involves a really greater arbitrariness.

Id. (footnote omitted) (emphasis added).