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Democracy and Opportunity: A New Paradigm in Tax Equity

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Democracy and Opportunity: A New Paradigm in Tax Equity

James R. Repetti[*]

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> Any tax that produces revenue will in some way alter the social and economic order.
>
> —Randolph E. Paul[1]

I. INTRODUCTION

Academics and policymakers pay little attention to the interaction of a tax system with the objectives of a just government. For example, in the debate about whether the United States should retain an income tax or adopt a consumption tax, most discussions focus on the relative efficiency and equity of the taxes. Proponents of a consumption tax worry that an income tax is inefficient because it burdens investment income. Advocates of an income tax fear that a consumption tax is not equitable because low-income taxpayers consume a greater percentage of their income than wealthy taxpayers. These concerns date at least as far back as Thomas Hobbes[2] and John Stuart Mill[3] and continue into the twenty-first century.[4]

The difficulty in comparing these concerns is that efficiency gains can be quantified, but the benefits of tax equity appear

1. RANDOLPH E. PAUL, TAXATION FOR PROSPERITY 214 (1947).

2. *See* THOMAS HOBBES, THE LEVIATHAN 386-87 (C.B. Macpherson ed., Penguin Books 1968) (1651) ("For what reason is there for he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged . . . .").

3. *See* JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY bk. V, ch. 2 (W.J. Ashley ed., Longmens, Green & Co. 1923) (1871) ("The subjects of every state ought to contribute to the support of the government, as nearly as possible in proportion to their respective abilities: that is, in proportion to the revenue which they respectively enjoy under the protection of the state. In the observation or neglect of this maxim consists what is called the equality or inequality of taxation.").

4. *See, e.g.*, Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 STAN. L. REV. 1413, 1414 (2006) (arguing that a consumption tax is more efficient than an ideal income tax).

intangible and difficult to measure.[5] Moreover, the many different views of distributive justice obscure equity's importance because of disagreement about equity's underlying rationale. The failure to agree about a rationale for tax equity causes it to appear less well-defined and worthy than tax efficiency.

A leading tax academic has described tax policy's failed search for an appropriate rationale for equity as a search for the turtle on which all other turtles rest.[6] This Article suggests that the failure is the result of an improper method of analysis. Tax policy has ignored the necessity of first identifying equity goals appropriate for a just government and then designing a tax system to help achieve those goals. This Article proposes that the principal equity goal underlying a just government is the creation of equal opportunities for all citizens to achieve self-realization—to make the best life for themselves and their families. However, a tax system should not merely be evaluated for its contribution to achieving equal opportunity for self-realization. A tax should be *designed* to achieve equal opportunity for self-realization as one of its principal goals. Viewing equal opportunity for self-realization as a design issue leads to the identification of another principle that is foundational—the promotion of democracy. Both political philosophy and empirical literature suggest that equal access to the electoral process and participation in the community must exist in order for equal opportunity for self-realization to exist. Thus, the turtle lying at the bottom is equality of opportunity—equality of opportunity to maximize self-realization and equality of opportunity to participate in the political process.

Designing a tax system to maximize these opportunities eliminates the uncertainty inherent in prior approaches that defined equity by reference either to benefits conferred by the government on the taxpayer or to the taxpayer's ability to pay. A design focused on achieving equality of opportunity for self-realization and participation in the democratic process need not measure a taxpayer's increase in

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5. *See* Joseph M. Dodge, *Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles*, 58 TAX L. REV. 399, 410 n.40 (2005) (stating that attempts to compare efficiency to equity are similar to attempts to compare apples to oranges); *see also* CASS R. SUNSTEIN, FREE MARKETS AND SOCIAL JUSTICE 70-107 (1997) (observing that, since human goods cannot be measured using a common index, social decisions cannot be based solely on quantitative factors).

6. Daniel N. Shaviro, *Commentary: Inequality, Wealth, and Endowment*, 53 TAX L. REV. 397, 398-99 (2000) ("Inequality therefore plays an important role in a variety of views of distributive justice, although under any it rests at least one turtle from the bottom."). The "turtle" metaphor traces its roots to Hindu mythology in which the universe is portrayed as resting on the back of a giant tortoise. *See* Roger C. Cramton, *Demystifying Legal Scholarship*, 75 GEO. L.J. 1, 2 n.4 (1986) (describing the source of the "turtle" story).

utility as the result of government benefits or a taxpayer's decrease in utility in an attempt to impose equal sacrifices. Instead, the design should ensure that the tax burden on disadvantaged taxpayers is sufficiently low so that it does not harm their opportunity for self-realization. It also should ensure that the tax burden on advantaged taxpayers is sufficiently high to provide the revenues needed to permit a low burden for the disadvantaged and to burden the disproportionate political power of the advantaged.

To illustrate the importance of designing a tax system based on these principles of equity, this Article revisits the debate about the desirability of an income tax versus a consumption tax. It is well understood that democracy is an inefficient form of government in the short term, but is the most successful in the long term. The same is true for an income tax. Advocates of a consumption tax assert that investment income should not be taxed in order to maximize efficiency. However, an income tax that burdens investment income makes contributions to the effective operation of our democracy and to the creation of equal opportunity that are more important than any efficiency gains provided by a consumption tax. Indeed, as discussed in this Article, the relative efficiencies of the two types of tax systems, while clear in an idealized world, are far less clear in the real world. A tax system designed to maximize opportunities for self-realization and participation in democracy provides benefits that previously have been ignored in evaluating tax systems. In contrast, a consumption tax designed to deal with transition and distributive issues likely to arise in the real world may be no more efficient than the income tax that it would replace.

Part II of this Article reviews the debate about the appropriate design for a tax system in the United States. It explains that, although there has been broad agreement that equity is needed in a tax system, disagreement continues about the goals that equity should achieve. Part III proposes that an important goal for the design of a tax is the establishment of conditions that provide equal opportunity for all citizens to achieve self-realization. Opportunity for self-realization in turn requires that a tax system's design contribute to the creation of conditions that enable all citizens to participate equally in democracy. Designing a tax system to achieve these goals not only will increase equity, but also will provide efficiency gains that analysts have not considered previously. In Part IV, the Article demonstrates that a progressive income tax with limitations on loss deductions is better than an ideal consumption tax in establishing the conditions for equal opportunity for self-realization and democracy because it burdens investment income, which is an important source of political

power. The claim that a consumption tax can limit the excess political power of the wealthy in the same way as an income tax is incorrect because the wealthy consume only a small percentage of their income, and a consumption tax burdens investment income only in narrow situations. Lastly, Part V analyzes other aspects of the efficiency and equity claims for the two forms of taxes. It argues that the efficiency claims for an ideal consumption tax versus our existing income tax are overstated when viewed in the context of real world systems that account for taxpayer behavior and transition relief. Given the uncertain efficiency gains of the consumption tax and the potential efficiency gains of a progressive income tax, the equity goals discussed herein should govern the selection of a tax system. Such equity goals weigh heavily in favor of a progressive income tax.

II. THE DEBATE

A. An Introduction to Theories of Tax Justice

The moral aspects of various tax systems have been central to the debate about tax systems. Underlying the clash of perspectives are different value judgments about what is most important for society.[7] Thomas Hobbes advocated a consumption tax because he felt that taxpayers should be taxed on goods that they withdraw from the common stock.[8] Hobbes's view represents a value judgment that consumption should be discouraged because it withdraws resources that could be used for the common good.[9]

Similarly, Nicholas Kaldor argues that a consumption tax is fairer than an income tax because an income tax does not affect wealthy taxpayers who choose to consume principal rather than invest it and consume income.[10] This argument also reflects a value judgment about the relative merits of spending principal versus spending income generated by that principal.

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7. *See, e.g.*, Richard A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 46 (1957) ("The choice [between an income tax and consumption tax] is essentially one of value judgment.").

8. HOBBES, *supra* note 2, at 387 ("[E]very man payeth Equally for what he useth . . . .").

9. *See, e.g.*, INSTITUTE FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION: REPORT OF A COMMITTEE CHAIRED BY PROFESSOR J.E. MEADE 33 (1978) (defining consumption as personal appropriation of the community's productive resources); William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 314-15 (1972) (defining consumption as private preclusive use of resources).

10. NICHOLAS KALDOR, AN EXPENDITURE TAX 14, 53 (1955).

Others have asserted that distributive justice is an important consideration in the debate. For example, Louis Kaplow and Steven Shavell argue that our tax and transfer systems should be the principal tool for accomplishing fairness, whereas the focus of all other legal rules should be efficiency.[11] Edward McCaffery asserts that a tax system must be fair and just and that justice requires an individuated tax that is "based on ability to pay or benefits received or some such principle."[12] Professor McCaffery states:

> [A] persuasive case can be made out under both liberal egalitarian theories, such as those of John Rawls, and utilitarian or welfarist conceptions of justice, that, at least given fair and efficient markets, the tax system is the best or even the only place to redistribute material resources.[13]

This understanding has guided U.S. tax policy for the past century. A head tax would maximize efficiency in our tax system. Yet policymakers and most participants in the debate would agree that a head tax is not desirable because of its distributive effects. There was, and still is, broad agreement that using the tax system for redistribution is an important element of tax equity.[14] For example, in justifying the imposition of a heavier tax burden on the rich, President Theodore Roosevelt said, "The man of great wealth owes a peculiar obligation to the State, because he derives special advantages from the mere existence of government."[15] Similarly, polls show that a majority of respondents favor a progressive rate structure that requires the rich to pay a greater percentage of their income in taxes.[16] Unfortunately, this agreement does not extend to how to design a tax system. That debate has been vague and unproductive because of disagreement

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11. Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, 668 (1994); *cf.* William Sanchirico, *Deconstructing the New Efficiency Rationale*, 86 CORNELL L. REV. 1003, 1005 (2001) (arguing against the "practice of evaluating legal rules solely on the basis of the efficiency criterion," and asserting that "these arguments are alternatively logically flawed or reliant on untenable assumptions"); Kyle Logue & Ronen Avrahan, *Redistributing Optimally: Of Tax Rules—Legal Rules and Insurance*, 56 TAX L. REV. 157, 165 (2003) (arguing that the determination whether the tax system or legal rules should be used to achieve redistribution is a contextual inquiry).

12. Edward McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 830-31 (2005).

13. *Id.* at 831.

14. It is interesting to note that this agreement existed in the world's first democracy, Athens, which had a progressive tax. *See* Maureen B. Cavanaugh, *Democracy, Equality and Taxes*, 54 ALA. L. REV. 415, 461 (2003) ("Significant features of Athenian democracy were made possible because taxes were imposed on the property of the wealthiest of its citizens . . . .").

15. 59 CONG. REC. 27 (1906) (statement of Theodore Roosevelt). For an excellent review of the history of views on progressivity in the United States, see Dennis J. Ventry, Jr., *Equity Versus Efficiency and the U.S. Tax System in Historical Perspective*, *in* TAX JUSTICE 26 (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002) (summarizing perspectives).

16. KARLYN H. BOWMAN, AM. ENTER. INST., PUBLIC OPINION ON TAXES 2 (last updated Apr. 6, 2007), http://www.aei.org/docLib/ 20050415_TAXES.pdf.

about theories of distributive justice that justify progressivity in the tax system and the selection of a tax base. Daniel Shaviro argues that the quest for an appropriate tax base has been hampered by the fact that each base is a crude proxy for some underlying and poorly articulated theory of distributive justice. Professor Shaviro says:

> [N]either "wealth" nor "income" nor "consumption" plausibly can be what we really want to tax. Rather, the defense of any of these bases must lie in its capacity to provide a crude proxy for something else that is relevant to distributive justice but cannot be directly observed.
>
> What is this other underlying thing? While unlikely to be the subject of universal agreement, it has something to do with inequality. After all, to the extent benefit taxation is unfeasible, there presumably would be no objection to raising all government revenues through a uniform head tax but for the idea that those who are better-off should bear greater burdens. Inequality therefore plays an important role in a variety of views of distributive justice, although under any it rests at least one turtle from the bottom. The move from a description of who is better-off under some metric to the claim that tax burdens should vary by reason of the differences that this metric identifies requires motivation. . . .
>
> Writers in the income tax literature have often recognized the conceptual need for a lower-lying distributional "turtle" than the Haig-Simons (or any competing) income definition itself. The true but unobservable underlying measure that, for reasons lying at least one more turtle down, income tries to implement often goes by the name of "ability" or "ability to pay." The spirit, however, in which this hypothetical measure typically is discussed (or, rather, deliberately not discussed) was well illustrated by Henry Simons, when he argued that attempts to poke too far behind the supposed objectivity of an income definition "lead directly back into the utter darkness of 'ability' or 'faculty' or, as it were, into a rambling, uncharted course pointed only by fickle sentiments."[17]

B. The Government Benefits Principle

Academics have formulated many principles in an attempt to find the underlying rationale for tax policy. One approach has been to tax an individual based on the benefits she receives from the government.[18] The tax represents consideration provided by the

17. Shaviro, *supra* note 6, at 398-99.

18. *See, e.g.*, FRIEDRICH A. HAYEK, THE CONSTITUTION OF LIBERTY 315-16 (1960) ("[S]ince almost all economic activity benefits from the basic services of government, these services form a more or less constant ingredient of all we consume and enjoy . . . therefore a person who commands more of the resources of society will also gain proportionally more from what the government has contributed."); RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 239-42 (3d ed. 1980) ("Under a strict regime of benefit taxation, each taxpayer would be taxed in line with his demand for public services."): Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417, 452 (1952) ("The relevant question is whether, granting that most benefits from government cannot be particularized and traced, it nevertheless can be held that such benefits as a whole vary in some fashion with income.").

taxpayer for her "contract" with the government to protect her life, liberty, and property.[19] To include all of the taxpayer's well-being in the tax base (direct government benefits and taxpayer-generated benefits), we might determine that all of the taxpayer's income is attributable to the government because the government provides the infrastructure that enables the taxpayer to earn a living.[20] Alternatively, we might decide that only a portion of a taxpayer's well-being is attributable to government benefits, but that a taxpayer's amount of total welfare generally correlates with the amount of government benefits received.[21] In either case, we could use each taxpayer's current level of welfare as a measure of the benefits conferred on that individual by government and seek to assess a tax thereon.[22]

However, evaluating the degree of each taxpayer's welfare generated by the government is challenging. It requires establishing the conditions that would exist without a government—something that we have no experience with. Joseph Dodge observes:

> The problem lies in trying to prove how much private wealth is attributable to government and how much is attributable to private labor and capital. This task seems hopeless, since there would be no private wealth (and no government funded by taxes) without private capital and labor, and there would be very little lasting "property" wealth without government.[23]

Moreover, the benefits approach suggests little about the tax system's design.[24] It does not indicate the level of taxation because the appropriate level of government expenditure or redistribution that should be accomplished with the tax collected is not addressed.[25] While the contractarian nature of the benefits theory suggests that

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19. *See* Dodge, *supra* note 5, at 402, 412 ("[T]axation is the necessary 'cost' everybody pays to secure the benefits of entering into the social contract.").

20. Hobbes described a world without government as a state of nature which entailed a war of all against all. LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP: TAXES AND JUSTICE 16 (2002). Marjorie E. Kornhauser explains that "[t]he robust form of the [benefits theory] . . . states that the government plays a role—at least indirectly—in the creation of all wealth and income because all private property is a 'legal convention.' " Marjorie E. Kornhauser, *Choosing a Tax Rate Structure in the Face of Disagreement*, 52 UCLA L. REV. 1697, 1709 (2005).

21. *See, e.g.*, Blum & Kalven, *supra* note 18, at 452 (noting that "there are many instances of good correlation between a tax paid and a benefit received" but this logic extends only so far).

22. MURPHY & NAGEL, *supra* note 20, at 17. Professor Joseph Dodge refers to this type of benefit theory as the "contractarian version of the benefit principle" to distinguish it from an older benefit norm that only would have considered benefits received directly from the government. Dodge, *supra* note 5, at 402.

23. Dodge, *supra* note 5, at 424.

24. MURPHY & NAGEL, *supra* note 20, at 18.

25. *Id.*; Dodge, *supra* note 5, at 430 ("[T]he new benefit principle, being a theory of government entitlement to private wealth, cannot itself generate a top-down redistributive role for government.").

taxes should be collected commensurate to the benefits provided by the government, it says nothing about the use of a tax system to achieve distributive justice goals, except to the extent that one can view distributive justice as being necessary to permit the government to fulfill its obligations to protect life, liberty, and property. Indeed, the benefits approach conflicts with any government that provides welfare to indigents as a matter of moral policy.[26] For example, if one governmental objective is to provide minimal income support and health benefits, then the government should provide those items to the indigent.[27] But the poor would have to be taxed for such benefits.[28]

In a similar vein, the benefits approach does not provide guidance about tax rates.[29] One justification for progressive tax rates under the benefits approach is that the portion of government benefits received by high-income taxpayers increases more rapidly than their income. But it would be difficult to prove this justification. If the benefits are derived from the government's protection of property, for example, it seems unlikely that the costs of protecting property increase more rapidly than the value of the property itself.[30]

Another justification for progressive rates under the benefits theory might be based on the declining marginal utility of money. However, this justification requires additional decisions regarding tax system design that are separate from the initial benefits-based justification for the tax. One important decision would be whether the tax should account for declining marginal utility in seeking to impose equal burdens on taxpayers that receive the same amount of benefits. For example, consider benefits that will be provided equally to taxpayers and that have the same intrinsic value for each taxpayer.[31] A person who earns $10,000 per year might value one thousand units of benefits conferred on him at $1,000 ($1 per unit). However, if we

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26. MURPHY & NAGEL, *supra* note 20, at 18.

27. *Id.*

28. *Id.* Professor Dodge points out that the most recent version of the benefits theory, what he calls "the new benefits theory," eliminates this problem by defining its scope to refer to only government benefits that relate private wealth accumulations. Dodge, *supra* note 5, at 430-31.

29. MURPHY & NAGEL, *supra* note 20, at 17.

30. *See* Blum & Kalven, *supra* note 18, at 454 ("[T]he principle of progression requires not merely that the benefits increase with income but that they increase more rapidly than income."); *see also* Kornhauser, *supra* note 20, at 1708 (observing that the benefits theory lost support in the late nineteenth century because of the belief that poor individuals received many more benefits from the government than the rich). Kornhauser points out that if this were true, a tax based on benefits could never be progressive. *Id. But see* 50 CONG. REC. 3835-36 (1913) (statement of Senator Poindexter) (arguing for a progressive income tax rate on the grounds that large fortunes resulted from special favors from the government, not from individual merit).

31. This example is based on MUSGRAVE & MUSGRAVE, *supra* note 18, at 239.

assume declining marginal utility, the same person now earning $20,000 per year might value the one thousand units at $2,000 ($2 per unit) or even $3000 ($3 per unit). (Because the taxpayer has a higher income, the marginal value of each dollar has declined, and, therefore, more dollars will be assigned to each unit of value.) In designing our tax on benefits we need to decide whether our tax will impose equal burdens (taking into account declining marginal utility) on benefits received. If the tax is intended to impose equal burdens on taxpayers using the dollar value of the benefits conferred, different tax rates will be assessed depending on the taxpayer's income because of the declining marginal utilities. In the case of the taxpayer with the $20,000 income who valued the benefits at $2 per unit, we would impose a tax proportional to her income, because doubling her income caused her to double the dollar value of the benefits. If that taxpayer valued the 1,000 units of benefits at $3000 ($3 per unit) when her income was $20,000, we would impose a progressive rate that would increase as her income increased. Note that the rationale for the design of this system—the taxation of benefits—does not justify a particular rate structure.[32] The decision to impose equal burdens and the nature of the declining marginal utility determine the tax rate, not the goal of taxing benefits.

The benefits approach also fails to identify the appropriate tax base. Deborah Geier argues that income is the best measure of government-provided benefits because the government maintains and regulates the capitalist system that provides such income.[33] Professor Dodge, however, has responded that consumption may be a better measure:

> Income tax advocates sometimes argue that income is a better measure of well-being than consumption, on the theory that wealth confers utility above and beyond future consumption . . . . It is true that wealth has value apart from consumption value; for example, it can be used to influence family, friends, politicians, charities, subordinates, and business associates. It is not clear, however, that it is legitimate to add the value of such attributes to consumption value, because the consumption of wealth precludes the exercise of these other attributes and vice versa.[34]

As discussed herein, I disagree with Professor Dodge's view that it is inappropriate to add political power to consumption power in constructing a tax base. Nevertheless, I agree that the benefits theory, standing alone, does not provide a rationale for selecting one tax base over another.

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32. *Id.* at 239-40; *see* MURPHY & NAGEL, *supra* note 20, at 17.

33. Deborah A. Geier, *Incremental Versus Fundamental Tax Reform and the Top One Percent*, 56 SMU L. REV. 99, 119 (2003).

34. Dodge, *supra* note 5, at 435 n.135.

C. The Ability-to-Pay Principle and Equal Burdens

Another approach to designing a tax is to base it on each taxpayer's ability to pay.[35] Under an ability-to-pay approach, higher-income taxpayers are expected to pay higher amounts of taxes. The ability-to-pay principle overlaps with the benefits approach in that wealthy individuals who are more able to pay taxes also may be viewed as having benefited more from government programs than people who are less wealthy.[36] However, the two approaches could result in different tax bases. For example, the ability-to-pay approach exempts benefits provided to low-income individuals, whereas the benefits doctrine does not. Some suggest that an ability-to-pay tax should be based on the taxpayer's innate abilities (or "endowment"), not just the taxpayer's actual resources. The impractical nature of attempting to collect a tax based on a taxpayer's innate abilities, however, has precluded most policymakers from seriously considering such a tax base. Instead, the focus has been on whether a taxpayer's ability to pay is better captured by the taxpayer's income or consumption.

Although higher-income taxpayers are expected to pay more taxes than low-income taxpayers, the ability-to-pay doctrine does not resolve the debate about rate structure. The ability-to-pay approach raises additional issues about whether taxpayer liabilities should involve equal sacrifices and the appropriate level of such sacrifices.[37] A tax that imposes equal burdens on all taxpayers may have regressive, proportional, or progressive rates, depending on whether the elasticity of the marginal utility of income with respect to income is, respectively, less than, equal to, or greater than one.[38] In other words, not only does the marginal utility of income have to decline as income increases, but it also has to decline at a rate that is greater than the rate at which the taxpayer's income increases to justify a progressive rate schedule. Because it is likely that elasticities of the marginal utility of income differ among individuals, any attempt to design a tax system based on equal burdens is bound to be controversial.

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35. *See, e.g.*, MUSGRAVE & MUSGRAVE, *supra* note 18, at 242 (defining the ability-to-pay principle). For an excellent discussion of the history of the ability-to-pay principle, see Stephen Utz, *Ability To Pay*, 23 WHITTIER L. REV. 867, 870 (2002).

36. *See* DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 150 (1986) ("We are likely, for example, to feel that well-to-do people should pay more in taxes than poor people both because it accords with our sense of justice and because we believe that well-to-do people typically derive more benefit than poor people do from services such as national defense.").

37. *See* Blum & Kalven, *supra* note 18, at 455-65 (describing difficulties in designing a tax system based on taxpayer sacrifice).

38. MUSGRAVE & MUSGRAVE, *supra* note 18, at 251.

An alternative to imposing equal burdens is to impose proportionate burdens.[39] Each taxpayer would give up an equal portion of her income, measured in terms of the lost utility of the taxes paid. The structure of the rates, however, is again dependent on the rate of declining marginal utility. If a taxpayer's utility of income remains constant, a flat tax rate will result in proportionate burdens.[40] If marginal utility declines in a straight line, a progressive tax rate will impose proportional burdens.[41] If, however, the marginal utility decreases in a nonlinear fashion, then determining the appropriate rate structure is difficult.[42]

Like the benefit approach, the ability-to-pay principle does not recommend one tax base over another. Some argue that the ability-to-pay principle favors an income tax because a consumption tax does not tax income from capital and, therefore, does not fully reflect the taxpayer's ability to pay.[43] Others counter that a consumption tax burdens capital because the present value of capital is diminished by the consumption tax that will be imposed when the taxpayer's capital ultimately is consumed.[44] Moreover, advocates of a consumption tax argue that a certain type of consumption tax, a progressive post-paid consumption tax, is fairer than an income tax because it taxes the yield on savings only when such yield is used to elevate a taxpayer's standard of living.[45]

The result is that, although the benefits and ability-to-pay doctrines provide rationales for imposing a tax and determining whether that rationale is fair, neither gives helpful guidance for designing a tax system. This may explain why the debate about the best design of a tax system has endured. Policymakers need to look elsewhere for rationales for selecting a tax base and rates.

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39. *See, e.g.*, MURPHY & NAGEL, *supra* note 20, at 29; Blum & Kalven, *supra* note 18, at 457 (analyzing the imposition of equal burdens and proportionate burdens).

40. MUSGRAVE & MUSGRAVE, *supra* note 18, at 252.

41. *Id.*

42. *Id.*

43. *See* RICHARD GOODE, THE INDIVIDUAL INCOME TAX 23-24 (rev. ed. 1975) (arguing that income tax is preferable because it better captures the benefit from wealth that is not consumed than a consumption tax does); Alfred G. Buehler, *Ability to Pay*, 1 TAX L. REV. 243, 250 (1946) (arguing that an income tax is fairer than a consumption tax because the consumption tax ignores capital and, therefore, does not fully reflect the taxpayer's ability to pay).

44. Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, 103 TAX NOTES 91, 106 (2004).

45. *See* McCaffery, *supra* note 12, at 923 ("A consistent progressive postpaid consumption tax, in contrast, makes its decisions about the appropriate degree of progressivity at the right—fair—time. It falls on outflows, or spending. Such a tax favors (or does not disfavor) capital smoothing transactions, but imposes a tax—in the form of the higher effective progressive rates—on lifestyle enhancing or capital upward shifting transactions.").

III. A DIFFERENT APPROACH

A. The Underlying Turtle is Opportunity

As discussed above, a major concern underlying the benefits theory and ability-to-pay approach is the principle that a tax system should be fair. Neither approach helps define a tax base because the distributional concerns underlying the notions of fairness are ill defined. While the benefits approach justifies a tax based on benefits received by a taxpayer, it provides no guidance about how much tax should be collected from each taxpayer and whether different rates should be imposed. The ability-to-pay principle suffers from similar difficulties—it does not provide a normative framework for how much tax to collect or what rate structure to use. Both doctrines require consideration of another principle—the imposition of equal burdens—but that principle is not helpful because of the uncertainty surrounding the elasticities of the marginal utility of income.

Liam Murphy and Thomas Nagel argue that identifying a just tax requires looking outside the tax system and focusing on the "broader principles of justice in government."[46] They reason that the starting point of a tax, such as each taxpayer's income in an income tax, is itself the product of government policies. Analyzing an income tax based solely on the amount of taxes assessed ignores an important factor—the fairness of the incomes earned by the taxpayers. Professors Murphy and Nagel view the tax system as an instrument that helps achieve governmental objectives for justice. They assess the current state of tax policy analysis as woefully inadequate, stating:

> [The] entire [current] approach is flawed in its foundations. If the distribution produced by the market is not presumptively just, then the correct criteria of distributive justice will make no reference whatever to that distribution, even as a baseline. Distributive justice is not a matter of applying some equitable-seeming function to a morally arbitrary initial distribution of welfare. Despite what many people implicitly assume, the justice of a tax scheme cannot simply be evaluated by checking that average tax rates increase fast enough with income .... [O]nce we reject the assumption that the distribution of welfare produced by the market is just, we can no longer offer principles of tax fairness apart from broader principles of justice in government.[47]

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46. MURPHY & NAGEL, *supra* note 20, at 30.

47. *Id.* For an earlier argument that tax analysis needs to take into account the conditions that gave rise to the distribution of the tax base, see PATRICIA APPS, A THEORY OF INEQUALITY AND TAXATION 4 (1981) ("[T]ax theory remains firmly grounded upon an innate or inherited endowments theory of inequality. The aim of the analysis here is to examine tax incidence and tax distortions taking account of the way in which institutional inequality is initiated and perpetuated."). Many others also have noted that economic well being is the result of many factors, including the individual's initial starting point, the efforts of others, and merit. *See, e.g.*,

At first, it may seem that this approach increases the complexity of the problem. If it is difficult to identify objectives in taxation, will it not be exponentially more difficult to identify the broader principles of justice in government? A broad consensus exists, however, about the appropriate objectives for distributive justice in a capitalist democracy. Many have proposed that the principle underlying distributive justice for democratic governments is that "no one should have less valuable resources and opportunities available to him than anyone else, simply in virtue of some chance occurrence[,] the risk of which he did not choose to incur."[48] Others similarly have suggested that equality of "opportunities, not outcomes" should be the major concern of distributive justice.[49] Rawls asserted that "each citizen, regardless of class or origin, should have the same chance of attaining a favored social position, given the same talents and willingness to try."[50] Rawls's first principle of justice, that individuals enjoy equal rights to the most extensive liberty possible,[51] was aimed at allowing individuals to maximize self-realization.[52] His second principle of justice stated that social and economic inequalities should be arranged such that offices and positions are open to everyone under conditions of *fair equality of opportunity*.[53] A Task Force of the American Political Science Association summarizes the prevailing view:

Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259, 275-79 (1983) (questioning "those who simply assume that the market distributes rewards to people who deserve them and denies rewards to people who do not"); Sagit Leviner, *From Deontology to Practical Application: The Vision of a Good Society and Tax System*, 26 VA. TAX REV. 405, 415-18 (2006) ("[D]ifficulty with the view of the market as neutral or providing just rewards is that, in the real world, people do not enter the market with equal resources including identical or otherwise equivalent talents, skills, or backgrounds."); Amartya Sen, *The Moral Standing of the Market*, *in* ETHICS AND ECONOMICS 1, 1-19 (Ellen Frankel Paul et al. eds., 1995).

48. ERIC RAKOWSKI, EQUAL JUSTICE 1 (1991); Kornhauser, *supra* note 20, at 1728 ("What Americans do agree on . . . is that all people should have an equal chance to achieve their goals, including the accumulation of wealth and income.").

49. *See, e.g.*, BRUCE ACKERMAN & ANNE ALSTOTT, THE STAKEHOLDER SOCIETY 24 (1999) (proposing that equality of "opportunities, not outcomes" should be the major concern); Richard J. Arneson, *Equality and Equal Opportunity for Welfare*, 56 PHIL. STUD. 77 (1989) (same); Ronald Dworkin, *What Is Equality? Part 2: Equality of Resources*, 10 PHIL. & PUB. AFF. 283, 284 (1981) (discussing equality in resources).

50. JOHN RAWLS, THE LAW OF PEOPLES 115 (1999); *see also* JOHN RAWLS, A THEORY OF JUSTICE 73 (1971) (advocating equality of opportunity).

51. RAWLS, A THEORY OF JUSTICE, *supra* note 50, at 60.

52. *See* RAWLS, THE LAW OF PEOPLES, *supra* note 50, at 115 (observing social conditions should be "such that each citizen, regardless of class or origin, should have the same chance of attaining a favored social position, given the same talents and willingness to try").

53. RAWLS, A THEORY OF JUSTICE, *supra* note 50, at 73.

Americans support private property and free enterprise, and see much of the skewed distribution of wealth and income as a legitimate result of differences in individual talent and effort. But it is important to remember that Americans accept economic inequalities only when they are sure that everyone has an equal opportunity to get ahead—to make the best of life for the individual or his or her family. Government is expected to help ensure equal opportunity for all, not to tilt toward those who already have wealth and power.[54]

The broad consensus about equal opportunity for self-realization has not helped to resolve the debate about tax systems. Marjorie Kornhauser observes that although most Americans believe in equal opportunity, they disagree "on the exact nature of the steps to be taken."[55] Indeed, determining what equal opportunity for self-realization means is difficult. While there may be broad agreement that everyone should have an equal opportunity to "get ahead," this can be accomplished in many different ways. For example, does equal opportunity for self-realization require equal resources at birth or that each person possess the minimal resources needed for health, education, and housing?[56]

This disagreement suggests the need for a different method of analysis. A tax system cannot be evaluated merely for its contribution to achieving the commonly accepted, but difficult to define, goal of equal opportunity for self-realization. A tax system should be *designed* to achieve equal opportunity for self-realization as one of its principal goals. This new perspective of looking at equal opportunity for self-realization as a design issue identifies another foundational principle: the promotion of democracy. Both political philosophy and empirical literature suggest that equal access to the electoral process and participation in the community are prerequisites to equal opportunity for self-realization, regardless of the form of equal opportunity for self-realization.

Political philosophers long have understood that participation in democracy and in the community is necessary for individuals to achieve self-realization. Such participation allows all, including the least advantaged, to participate in the discussion about what equal opportunity for self-realization means and how to achieve it. Rawls believed that democracy provided an avenue for self-realization. He stated, "It is only in active cooperation with others that one's powers

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54. TASK FORCE OF THE AM. POLITICAL SCI. ASS'N ON INEQUALITY AND AM. DEMOCRACY, AMERICAN DEMOCRACY IN AN AGE OF RISING INEQUALITY 4 (2004).

55. Kornhauser, *supra* note 20, at 1728.

56. For a discussion of different types of opportunity, see Anne L. Alstott, *Equal Opportunity and Inheritance Taxation*, 121 Harv. L. Rev. 469, 476-85 (2007).

reach fruition. Only in social union is the individual complete."[57] Similarly, the philosopher John Dewey believed that democracy should encourage communication among various groups because a pluralistic conversation about differences is the best means to self-realization.[58] Dewey hoped that participation by all would lead to the identification of common interests, not merely bargaining over individual interests,[59] and that better communication would lead to understanding and to a better society.[60] He said, "Popular government is educative. It forces a recognition that there are common interests."[61] He concluded that "the very heart of political democracy is adjudication of social differences by an exchange of views."[62]

These philosophers worried, however, that economic elites could hijack the political process. Dewey said that access to participation is to be free and equal "without respect to race, sex, class or economic status."[63] In reviewing Dewey's political philosophy, William Caspary observes, "One of the chief obstacles to participation and reasonable discussion, in Dewey's view, is the social class structure which enables economic elites to dominate politics."[64] Rawls also worried about the impact that inequalities would have on "securing the fairness of elections and of political opportunities to run for office."[65] He viewed fairness in the political process as important to an ordered society.[66] Robert A. Dahl expresses a similar concern:

> Extreme inequalities in the distribution of such key values as income, wealth, status, knowledge, and military prowess are equivalent to extreme inequalities in political resources. Obviously a country with extreme inequalities in political resources stands a

57. RAWLS, A THEORY OF JUSTICE, *supra* note 50, at 525 n.4; *see* WILLIAM R. CASPARY, DEWEY ON DEMOCRACY 12 (2000).

58. *See* JOHN DEWEY, 9 THE COLLECTED WORKS OF JOHN DEWEY 107 (Jo Ann Boydston ed. 1969-1991) (discussing human interaction in a democratic society); Jim Garrison, *John Dewey*, ENCYCLOPAEDIA OF PHILOSOPHY AND EDUCATION, http://www.vusst.hr/ENCYCLOPAEDIA/john_dewey.htm (last visited Mar. 15, 2008) (describing the role and importance of communication in democracies).

59. JOHN DEWEY, THE PUBLIC AND ITS PROBLEMS 207 (1927); *see* CASPARY, *supra* note 57, at 9.

60. DEWEY, *supra* note 59, at 207; *see* CASPARY, *supra* note 57, at 9.

61. DEWEY, *supra* note 59, at 207; *see* CASPARY, *supra* note 57, at 9.

62. DEWEY, 15 THE COLLECTED WORKS OF JOHN DEWEY, *supra* note 58, at 273; *see* CASPARY, *supra* note 57, at 9.

63. JOHN DEWEY, RECONSTRUCTION IN PHILOSOPHY 186 (2d ed. 1948); *see* CASPARY, *supra* note 57, at 8.

64. CASPARY, *supra* note 57, at 12.

65. RAWLS, THE LAW OF PEOPLES, *supra* note 50, at 114-15.

66. *Id.*

very high chance of having extreme inequalities in the exercise of power, and hence a hegemonic regime.[67]

Adopting tax policies that strengthen democracy, i.e., give all participants an equal voice,[68] would improve opportunities for all citizens to maximize self-realization because it allows all, including the least advantaged, to participate in the discussion about what equal opportunity for self-realization means and how to achieve it. Empirical studies generally confirm the view of political philosophers that increased participation of non-elites in the political process results in governmental policies that improve opportunities for all citizens. Studies have found that the existence of an inclusive political system that considers the interests of all major groups in the decisionmaking process results in a high level of equality.[69] Studies also suggest that greater competitiveness in the election process increases the level of government expenditures.[70] Several explanations

67. ROBERT A. DAHL, POLYARCHY: PARTICIPATION AND OPPOSITION 82 (1971).

68. For articles asserting that an objective of democracy is to give all participants an equal vote, see, e.g., Edward B. Foley, *Equal Dollars Per Voter: A Constitutional Principle of Campaign Finance*, 94 COLUM. L. REV. 1204, 1225-26 (1994); David A. Strauss, *Corruption, Equality, and Campaign Finance Reform*, 94 COLUM. L. REV. 1369, 1382 (1994).

69. J. Corina M. van Arnhem & Geurt J. Schotsman, *Do Parties Affect the Distribution of Income? The Case of Advanced Capitalist Democracies*, *in* THE IMPACT OF PARTIES: POLITICS AND POLICIES IN DEMOCRATIC CAPITALIST STATES 283, 342, 350-51 (Francis G. Castles ed., 1982). This study found that countries in which corporatist processes exist are characterized by medium to highly egalitarian redistributive systems. *Id.* at 350. Corporatism is defined as a situation where "political elites generally accept the basic interests of the major groups in society" and "carefully work together in order not to exclude major groups from decision-making processes." *Id.* at 342; *see also* Vicki Birchfield & Markus M.L. Crepaz, *The Impact of Constitutional Structures and Collective and Competitive Veto Points on Income Inequality in Industrialized Democracies*, 34 EUR. J. POL. RES. 175, 193 (1998) ("Welfarist policies, which tend to reduce income inequalities, will increase if political institutions allow access of groups which are below the median income level.").

70. Charles F. Cnuddle & Donald J. McCrone, *Party Competition and Welfare Policies in the American States*, 63 AM. POL. SCI. REV. 858, 865 (1969); Michael Comiskey, *Electoral Competition and the Growth of Public Spending in 13 Industrial Democracies, 1950 to 1983*, 26 COMP. POL. STUD. 350, 367 (1993); Richard E. Dawson & James E. Robinson, *Inter-Party Competition and Welfare Policies in the American States*, 25 J. POL. 265, 282 (1963). *See generally* Thomas M. Holbrook & Emily Van Dunk, *Electoral Competition in the American States*, 87 AM. POL. SCI. REV. 955, 955 (1993) ("While the empirical evidence is somewhat mixed, most studies indicate that competitive political systems do produce more liberal policy outcomes, though the effects are sometimes small when compared to socioeconomic variables." (citations omitted)); *see also* Charles Barrilleaux, *A Test of the Independent Influences of Electoral Competition and Party Strength in a Model of State Policy-Making*, 41 AM. J. POL. SCI. 1462, 1464-65 (1997) (finding that state policy liberalism increases with increased electoral competition); Robert D. Plotnick & Richard F. Winters, *Party, Political Liberalism, and Redistribution: An Application to the American States*, 18 AM. POL. Q. 430, 440-41, 452 (1990) (finding evidence in a study of fifty states that electoral competition increases the proclivity of state governments to adopt redistributive policies). Other studies have shown that the view of the controlling party (liberal or conservative) also affects the distributive policies of the

account for this model.[71] One is that, in competitive elections, candidates cater to the median voter.[72] Because the median voter is less wealthy than the average voter in a society that has skewed income distribution, the median voter favors increased expenditures for redistributive policies.[73] Alternatively, increased competition may result in a higher turnout by lower socioeconomic groups, which may result in greater deference by elected officials to those groups.[74]

Such redistributive policies improve opportunities for self-realization in a number of ways. The tax system reduces the burden on the less advantaged by collecting more tax from higher-income individuals.[75] Transfer payments, which pay revenues collected from

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government which that party controls. *See, e.g.*, Charles Barrilleaux, Thomas Holbrook & Laura Langer, *Electoral Competition, Legislative Balance and American State Welfare Policy*, 46 AM. J. POL. SCI. 415, 424 (2002); Alexander Hicks & Duane Swank, *On the Political Economy of Welfare Expansion: A Comparative Analysis of 18 Advanced Capitalist Democracies, 1960-1971*, 17 COMP. POL. STUD. 81, 102-04 (1984).

71. *See* Sultan Ahmed & Kenneth V. Greene, *Is the Median Voter a Clear-Cut Winner?: Comparing the Median Voter Theory and Competing Theories in Explaining Local Government Spending*, 105 PUB. CHOICE 207, 207-25 (2000) (describing and testing various theories).

72. *See, e.g.*, Randall G. Holcombe, *The Median Voter Model in Public Choice Theory*, 61 PUB. CHOICE 115, 115, 120-21 (1989) (noting that most of the empirical evidence is consistent with the view that "the demand for public sector output in a democracy is the median voter's demand"); Alan H. Meltzer & Scott F. Richard, *Why Government Grows (and Grows) in a Democracy*, 52 PUB. INT. 111, 116-17 (1978) (discussing the correlation of median voter desires with actual expenditures). The median voter theory has been challenged in a number of articles. Some have argued that increased competition will cause parties to seek to mobilize their core constituencies rather than to appeal to the median voter in order to win an election. *See, e.g.*, Girish Gulati, *Revisiting the Link Between Electoral Competition and Policy Extremism in the U.S. Congress*, 32 AM. POL. RES. 495, 510 (2004). Others have criticized the empirical studies of the median voter theory for failure to link actual government expenditures to those predicted by the model. *See, e.g.*, Thomas Romer & Howard Rosenthal, *The Elusive Median Voter*, 12 J. PUB. ECON. 143, 144 (1979).

73. Holcombe, *supra* note 72, at 115, 120-21; Meltzer & Richard, *supra* note 72, at 116-17.

74. Holbrook & Van Dunk, *supra* note 70, at 955; Tom W. Rice, *An Examination of the Median Voter Hypothesis*, 38 W. POL. Q. 211, 218, 221 (1985) (noting that increased voter turnout resulted in redistributive policies); Evan J. Ringquist et al., *Lower Class Mobilization and Policy Linkage in the U.S. States: A Correction*, 41 AM. J. POL. SCI. 339, 340 (1997) (noting that lower class mobilization is associated with more liberal welfare policies). *But see* Elisabeth R. Gerber & Arthur Lupia, *Campaign Competition and Policy Responsiveness in Direct Legislation Elections*, 17 POL. BEHAV. 287, 288 (1995) (noting that competition results in greater responsiveness only if opponents have interests similar to the voting majority).

75. *See* Michael Strudler, Tom Petska & Ryan Petska, *Further Analysis of the Distribution of Income and Taxes, 1979-2002*, INTERNAL REVENUE SERVICE, Nov. 2004, *available at* http://www.irs.gov/pub/irs-soi/04asastr.pdf (examining the redistributive effects of federal income tax rates); Martin A. Sullivan, *Economic Analysis: Inequality, Populism, and Democratic Tax Policy*, 114 TAX NOTES 16, 17-18 (2007) (discussing impact of income taxation on distribution and inequality); Van Arnhem & Schotsman, *supra* note 69, at 292 (explaining how redistributive policies help equalize distribution of income).

high-income taxpayers to low-income individuals, increase resources.[76] Similarly, funding programs, such as public education, help the poor to compete more effectively in the market.[77] The positive effect of democratic participation on self-realization is not a one way street. Increased opportunity for self-realization also enhances citizen involvement in politics and community. This is illustrated by the U.S. experience with the G.I. Bill, a program that enabled 2,200,000 World War II veterans to attend college and 5,600,000 to attend vocational training.[78] Suzanne Mettler found that veterans who used the G.I. Bill's education benefits joined more civic organizations and participated in more political activities than veterans who did not.[79] She concluded that the program "enhanced beneficiaries' socioeconomic circumstances and skills in ways that heightened their capacity and predisposition for civic involvement."[80]

B. Efficiency Gains of Equal Opportunity

Section III.A argued that a just tax system should be designed to facilitate equal participation in the political process in order to create equal opportunity for self-realization. A utilitarian argument also supports such a system. Tax policy analysts have ignored potential benefits arising from equal opportunity for self-realization and participation in the political process, perhaps due to perceived difficulty in measuring such benefits.[81] However, a surprising amount of empirical literature suggests that these benefits may be measurable. Equal opportunities for self-realization and for participation in the political process create a sense of unity, not by

76. *See* Nathan Kelly, *Political Choice, Public Policy, and Distributional Outcomes*, 49 AM. J. OF POL. SCI. 865, 877 (2005) (discussing the effect of transfer programs on inequality); Van Arnhem & Schotsman, *supra* note 69, at 292 (assessing the equalizing impact of transfer payments).

77. Kelly, *supra* note 76, at 877. Kelly's findings suggest that the funding of programs, such as education, have a greater impact on inequality than direct transfer payments. *Id.* The efficacy of the expenditures will depend on the nature of the program and its management and staffing. *See, e.g.*, U.S. DEP'T OF HEALTH & HUMAN SERVS., STRENGTHENING HEAD START: WHAT THE EVIDENCE SHOWS, at Part III (June 2003), *available at* http://aspe.hhs.gov/hsp/StrengthenHeadStart03/index.htm (discussing the importance of coordination and the effects of fragmentation on education at the state level).

78. Suzanne Mettler, *Bringing the State Back in to Civic Engagement: Policy Feedback Effects of the G.I. Bill for World War II Veterans*, 96 AM. POL. SCI. REV. 351, 351 (2002).

79. *Id.* at 356-58.

80. *Id.* at 362.

81. *See* CASS SUNSTEIN, FREE MARKETS AND SOCIAL JUSTICE 70-107 (1997) (observing that, since human goods cannot be measured using a common index, social decisions cannot be based solely on quantitative factors); Dodge, *supra* note 5, at 410 n.40 (stating that attempts to compare efficiency to equity are the same as attempts to compare apples to oranges).

making us all alike, but by uniting us in a common goal of establishing conditions that allow all to achieve self-realization. A developing literature in psychology suggests that the ability to participate in the political process increases participants' sense of well-being.[82] This literature also suggests that a shared purpose and sense of belonging to a common enterprise motivates people to excel.[83] In addition, a shared sense of purpose may help to lubricate the wheels of commerce by reducing monitoring costs that parties might incur otherwise. Robert Putnam observes:

> A society characterized by generalized reciprocity is more efficient than a distrustful society, for the same reason that money is more efficient than barter. If we don't have to balance every exchange instantly, we can get a lot more accomplished.[84]

Equality of opportunity also may translate into productivity gains. Empirical studies suggest that equality in wealth distribution correlates with increased productivity growth in the long run. As shown in Table 1, most published studies have found a statistically significant relationship between high concentrations of wealth at the start of a period and poor economic growth in the subsequent twenty-five or more years.[85]

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82. BRUNO S. FREY & ALOIS STUTZER, HAPPINESS AND ECONOMICS 143 (2002).

83. ROBERT D. PUTNAM, BOWLING ALONE 349 (2000).

84. *Id.* at 21.

85. Alberto Alesina & Dani Rodrik, *Distributive Politics and Economic Growth*, 109 Q.J. ECON. 465, 481 (1994); Alberto Alesina & Dani Rodrik, *Distribution, Political Conflict and Economic Growth, in* POLITICAL ECONOMY AND BUSINESS CYCLES 22, 34 (Alex Cuckierman, Zvi Hercowitz & Leonardo Leiderman eds., 1992); Francois Bourguignon, *Growth, Distribution, and Human Resources, in* EN ROUTE TO MODERN GROWTH: LATIN AMERICA IN THE 1990s 43, 58 (Gustav Ranis ed., 1994); Klaus Deininger & Lyn Squire, *New Ways of Looking at Old Issues: Inequality and Growth*, 57 J. DEV. ECON. 259, 268-69 (1998); Roberto Perotti, *Growth, Income Distribution, and Democracy: What the Data Say*, 1 J. ECON. GROWTH 149, 159 (1996); Torsten Persson & Guido Tabellini, *Growth, Distribution and Politics, in* POLITICAL ECONOMY, GROWTH, AND BUSINESS CYCLES 3, 11-14 (Alex Cuckierman, Zvi Hercowitz & Leonardo Leiderman eds., 1992); Hannu Tanninen, *Income Inequality, Government Expenditures and Growth*, 31 APPLIED ECON. 1109, 1112 (1999); *see* Sugata Ghosh & Sarmistha Pal, *The Effect of Inequality on Growth: Theory and Evidence from the Indian States*, 8 REV. DEV. ECON. 164, 175 (2004) (finding that inequality in rural states adversely affected subsequent productivity growth, but that inequality in urban states had no effect); Stephen Knowles, *Inequality and Economic Growth: The Empirical Relationship Reconsidered in the Light of Comparable Data*, 41 J. DEV. STUD. 135, 151-52 (2005) (finding that inequality, measured using expenditures by individuals, adversely affects economic growth in sample consisting primarily of less developed countries).

In contrast, the results of studies that have used shorter time periods are mixed. For a survey of the studies, see James R. Repetti, *Democracy, Taxes and Wealth*, 76 NYU L. REV. 825, 831-35 (2001) and Huw Lloyd-Ellis, *On the Impact of Inequality on Productivity Growth in the Short and Long Term: A Synthesis*, 29 CANADIAN PUB. POL'Y S65, S66 (2003). As discussed in Repetti, *supra*, at 836, and Lloyd-Ellis, *supra*, at S77, it is likely that the long-term studies reflect a more accurate picture because the factors that hurt productivity growth are most likely to manifest themselves over a long period of time. *See infra* text accompanying notes 88-90.

TABLE 1

Author	Time Period	Data	Negative Correlation Between Initial Inequality and Subsequent Growth
Ghosh & Pal (2002)	35 years	States in India	X*
Tanninen (1999)	32 years	52 countries	X
Deininger & Squire (1998)	32 years	61 countries	X
Knowles (2005)	30 years	35 countries	X**
Alesina & Rodrik (1992)	25 years	24 democratic countries	X
Persson & Tabellini (1992)	25 years	80 countries	X
Alesina & Rodrik (1994)	25 years	46 countries	X
Perotti (1996)	25 years	36 countries	X
Bourguignon (1999)	25 years	35 countries	X

* Ghosh and Pal found a negative relationship between initial inequality and subsequent growth in rural states, but found that inequality in urban states had no effect.

** Sample consisted primarily of less developed countries.

These long-term studies challenge the conventional wisdom that "inequality is good for incentives and, therefore, good for growth."[86] The conventional wisdom is that inequality should increase growth because (1) the wealthy had a higher marginal propensity to save than the poor; (2) only the wealthy could make the large capital commitment necessary for industrial growth; and (3) the poor would be motivated to work harder.[87] However, the long-term studies

86. Philippe Aghion, Eve Caroli & Cecilia García Peñalosa, *Inequality and Economic Growth: The Perspective of the New Growth Theories*, 37 J. ECON. LITERATURE 1615, 1615 (1999).

87. *Id.* at 1620. The findings also challenge Simon Kuznets's theory about the role of inequality. Kuznets theorized that as a society develops from a rural to an industrial economy, inequality initially should increase due to the higher income earned by the industrial workers compared to rural workers. Simon Kuznets, *Economic Growth and Income Inequality*, 45 AM. ECON. REV. 1, 1-28 (1955); Simon Kuznets, *Quantitative Aspects of the Economic Growth of Nations*, 11 ECON. DEV. & CULTURAL CHANGE 1, 67-69 (1963). Inequality should decrease subsequently, however, as more rural workers transition into industrial jobs. The findings described above that link inequality to slow growth, therefore, may merely reflect countries transitioning from a rural to industrial economy. The difficulty with this explanation, however, is that inequality has increased in the industrial countries, contrary to the Kuznets hypothesis. *See, e.g.*, Josef Zweimuller, *Inequality, Redistribution, and Economic Growth* 3-5, (Institute for

suggest that other more powerful forces may be involved. The explanations with the most support—the failure of countries with inequality to invest adequately in education[88] and the presence of social unrest in those countries[89]—are also the explanations most likely to manifest themselves over a long period of time.[90]

Furthermore, inequality appears to impose economic costs because of its effect on health. Commentators on public health have noted that mortality rates are strongly related to the degree of inequality in a population.[91] Studies suggest that a person's relative income and status in a society are more important for a person's health than her absolute standard of living.[92] One explanation for this is that income inequality results in increased levels of frustration, which may cause harmful behavior.[93] Another explanation is that societies with large disparities in income may underinvest in education, health care, and other factors that increase health.[94] Some also have argued that large disparities in income lead to declining social cohesion, as exhibited in civic participation, norms of reciprocity, and trust in others.[95] Regardless of the explanation, it seems clear that striving to achieve equality has tangible benefits.

Studies also suggest that increased participation in democracy affects productivity, although the results are controversial because of disputes about appropriate methodology. It is clear that democracies

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Empirical Research In Economics, University of Zurich, Working Paper No. 31, 2000) (noting increased wealth concentration in industrialized countries); *see also* Deininger & Squire, *supra* note 85, at 278 (finding no support for Kuznets hypothesis). Thus, many question the validity of the Kuznet's hypothesis. *See, e.g.*, Deininger & Squire, *supra* note 85; Zweimuller, *supra*.

88. Oded Galor & Joseph Zeira, *Income Distribution and Macroeconomics*, 60 REV. ECON. STUD. 35, 35-51 (1993); Perotti, *supra* note 85, at 152-53; Kevin Sylwester, *Income Inequality, Education Expenditures and Growth*, 63 J. DEV. ECON. 379, 388 (2000).

89. Perotti, *supra* note 85, at 173-75 (finding that social and political instability decrease economic growth); Carolyn B. Rodriguez, *An Empirical Test of the Institutionalist View on Income Inequality: Economic Growth within the United States*, 59 AM. J. ECON. & SOCIOLOGY 303, 310-11 (2000) (asserting that inequality results in higher incidence of property and violent crimes).

90. Repetti, *supra* note 85, at 836; *see also* Lloyd-Ellis, *supra* note 85, at S77 (arguing that the impact of inequality on poor economic growth is likely to grow stronger in the long-term because of the delayed impact of inadequate education).

91. *See, e.g.*, Ichiro Kawachi et al., *Social Capital, Income Inequality and Mortality*, 87 AM. J. PUB. HEALTH 1491, 1491 (1997) (discussing the strong relationship between a society's income inequality and its level of mortality); Richard G. Wilkinson, *Comment: Income, Inequality, and Social Cohesion*, 87 AM. J. PUB. HEALTH 1504, 1504-05 (1997) (noting that more egalitarian countries and states have lower mortality rates).

92. Wilkinson, *supra* note 91, at 1505.

93. Kawachi et al., *supra* note 91, at 1491.

94. *Id.*

95. *Id.*

generally have higher productivity than non-democracies.[96] Studies that have attempted to analyze the impact of the *degree* of democracy on economic growth, however, have been contradictory. One study that reviewed twenty-one empirical analyses of the relationship between the degree of democracy and economic growth observed that eight of the studies found that strong democracy encouraged growth, eight found the opposite, and five found no effect.[97] Several of the contradictory studies have been criticized for their choice of parameters and methodology.[98] David LeBlang conducted a study in which he corrected for these problems and found that the greater the extent of democracy at the beginning of a period, the greater the economic growth during that period.[99]

96. *See* Pablo M. Pinto & Jeffrey F. Timmons, *The Political Determinants of Economic Performance: Political Competition and the Sources of Growth*, 38 COMP. POL. STUD. 26, 30 (2005) (noting that, on average, democracies tend to have better economic growth than non-democracies).

97. Adam Przeworski & Fernando Limongi, *Political Regimes and Economic Growth*, 7 J. ECON. PERSP. 51, 60 (1993). Another study, by Robert Barro, found the "suggestion" of a u-shaped relationship between democracy and economic growth. Robert J. Barro, *Democracy and Growth* 37-38 (NBER, Working Paper No. 4909, 1994), *available at* http://www.nber.org/papers/w4909. He observed that, as countries moved from a weak to a stronger democracy, economic growth increased, but that once a moderate level of democracy was achieved, growth decreased. *Id.* Barro cautions that these results are unreliable, however. He states, "One cannot conclude from this evidence that more or less democracy is a critical element of economic growth." *Id.* at 38.

98. David Leblang, *Political Democracy and Economic Growth: Pooled Cross-Sectional and Time Series Evidence*, 27 BRIT. J. POL. SCI. 453, 455 (1997). Most studies have used the average growth rates of several countries for the period being studied, usually 1960-1985. This has been challenged because the growth rates for shorter time spans within the 1960-1985 period vary significantly. *Id.* Using the average for the entire period masks changes occurring within the shorter periods. In addition, many of the studies may have a reverse causality problem because it is not clear whether equality is encouraging growth or vice versa.. *Id.* To avoid this, only the state or condition of democracy at the start of the period should be used. *Id.* at 457; *see also* J. Helliwell, *Empirical Linkages Between Democracy and Economic Growth*, 24 BRIT. J. POL. SCI. 225, 225-48 (1994) (evaluating the two-way linkages between democracy and economic growth).

99. Leblang, *supra* note 98, at 460. Leblang corrected the masking problem, described *supra* note 98, by using the average growth rate for ten-year periods within the period 1960-1989 for seventy countries. In addition, he corrected the causality problem, described *supra* note 98, by using the state of democracy in each country at the start of each ten year period. *Id.* at 453-57, 460. As discussed in the text, correcting these problems yielded statistically significant results that the greater democracy was at the beginning of the period, the greater economic growth would be during the period.

Another explanation for some of the contradictory results may be that, as countries become more democratic, investments in the countries shift, resulting in conflicting effects on productivity. Theorists have proposed that increased political competition (i.e., open and inclusive elections) may hurt productivity because it discourages investment in physical capital due to increased distributive policies. Pinto & Timmons, *supra* note 96, at 34. At the same time, however, there are countervailing positive forces that may improve productivity. Increased political competition encourages more investment in education, which enhances productivity. *Id.*; Leblang, *supra* note 98, at 460; William T. Dickens, Isabell Sawhill & Jeffrey Tibbs, *The Effects*

Thus, persuasive evidence suggests that equality of opportunities for self-realization and participation in democracy may provide economic gains. Achieving distributive justice has positive efficiency benefits that analysts previously have ignored and that should be considered in the debate about the design of a tax system.

IV. DESIGN OF THE TAX SYSTEM FOR EQUALITY OF OPPORTUNITY FOR SELF-REALIZATION AND PARTICIPATION IN DEMOCRACY

A. Introduction

Designing a tax system to promote democracy and equal opportunity for self-realization eliminates the uncertainties of relying on changes in marginal utility to determine the appropriate levels of tax and the rate structure. This design process also suggests an appropriate tax base. This Part begins by reviewing the basic design issues for a tax and the contributions made by the democracy and equal opportunity for self-realization doctrines to resolving these issues. Because equal opportunity for self-realization is dependent on attaining an open democracy, it is not surprising that the democracy doctrine provides the most detail about tax system design.[100]

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of Investing in Early Education on Economic Growth 5-7 (Brookings Inst. Policy Brief No. 153, Apr. 2006); Lawrence J. Schweinhart et al., *Lifetime Effects: The High/Scope Perry Preschool Study Through Age 40*, at 73 (Monographs of the High/Scope Educ. Research Found. No. 14, 2005). Moreover, in politically competitive democracies, new knowledge filters quickly through the political and economic system because the society is open, thereby increasing productivity. Pinto & Timmons, *supra* note 96, at 34. Also, democratic countries are likely to enforce antitrust prohibitions strictly. *Id.* The net effect of these conflicting forces will vary depending on their relative strengths. In analyzing data for ninety-one countries, Pinto and Timmons found that increased political competition correlates with decreased investment in capital but increased investment in education. *Id.* at 45-46. They also found an increased return on capital investment, suggesting that more democratic nations obtain more growth per unit of capital invested. *Id.*

100. Many academics, including the author, have written about the need to take into account the impact of a tax system on democracy. *See, e.g.*, Reuven S. Avi-Yonah, *The Report of the President's Advisory Panel on Federal Tax Reform: A Critical Assessment and a Proposal*, 59 SMU L. REV. 551, 556 (2006) (arguing that an income tax is necessary to prevent the accumulation of private power that is not accountable to the people); Marjorie E. Kornhauser, *The Rhetoric of the Anti-Progressive Income Tax: A Typical Male Reaction*, 86 MICH. L. REV. 465, 521 (1987) (stating that a progressive income tax contributes to stability of the U.S. government by reducing the gap between the wealthy and the poor); Martin J. McMahon, Jr. & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1, 68 (1998) (suggesting that a progressive tax helps preserve democracy by reducing inequality); Repetti, *supra* note 85, at 825 (arguing that an estate tax is necessary to prevent accumulations of wealth that otherwise would impede democracy). This Article advances our understanding by suggesting that, instead of merely recognizing the effect of a tax on democracy, the achievement of equal participation in democracy and equal opportunity for self-realization should be the principal components of tax equity that guide the design of a tax system. As discussed in Part IV,

Basic design issues for a tax include determining the appropriate amount of revenue to collect and identifying the proper tax base, rate structure, and time for assessing the tax. Both the equal opportunity for self-realization doctrine and the democracy doctrine recommend an amount of revenue to collect because both require a certain level of government expenditures to achieve equal economic and political opportunity. For example, funding of education, health care, and housing programs is necessary to establish minimal conditions to achieve equal opportunity for self-realization and to equip persons to engage in democracy.

Regarding rate structure, the opportunity for self-realization doctrine suggests that tax burdens should impair as little as possible the ability of each individual to have the same chance to succeed. Consequently, regressive rates are inappropriate because they impede opportunities for low-income individuals and counteract spending programs intended to benefit these persons.[101] The choice between proportional rates and progressive rates under the opportunity doctrine is less clear, however, because the choice is an empirical issue, not a normative question. The solution depends on the amount of revenues needed. A proportionate tax is appropriate if adequate revenue can be collected using a proportional rate without impairing the ability of the least advantaged to achieve equal opportunity. If, under a proportional tax, revenue needs require a rate that imposes too great a burden on the least advantaged, a progressive rate should be used. Resolution of this issue requires determination of the amount of after-tax income each taxpayer needs for equality of opportunity and the amount of revenues necessary to fund government.

The self-realization doctrine also does not recommend one tax base over another. The key insight from the equality of opportunity for self-realization doctrine—that a tax should not burden the less advantaged to the extent that their ability to achieve self-realization is impaired—could be accomplished with an income tax, a consumption tax, or a wealth tax. Similarly, the equality of opportunity for self-realization doctrine does not recommend the timing of the tax. Minimizing the tax burden on the least advantaged

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such recognition resolves many uncertainties about tax base, timing, and rate structure that currently exist.

101. *See generally* Kornhauser, *supra* note 20, at 1730 ("If equality of opportunity is the dominant meaning of equality, then a progressive tax system is the best structure to ensure this equality."); McMahon, Jr. & Abreu, *supra* note 100, at 70 n.267 (1998) (arguing that support for a progressive income tax can be found in its reduction of "disparities in after-tax income that dampen opportunity," but noting that further discussion of the choice between an income tax and consumption tax "must await another time").

does not require assessment of the tax at a particular time so long as the same amount of revenue is collected in present value terms.

B. Refinements to Tax Design under the Democracy Principle

The opportunity for self-realization doctrine supports a tax structure that is not regressive. Questions remain, however, about whether the rate structure should be progressive or proportional, and about the appropriate tax base and time for assessing the tax. The democracy doctrine fills these gaps and recommends a progressive income tax that taxes investment income as it accrues. To explore the normative case for a progressive income tax under the democracy principle, and to determine the best tax base and time for assessing the tax, the first part of this Section discusses the problems that impede equal participation in the political process. It demonstrates that wealthy individuals are able to influence disproportionately the elective and legislative process as well as their communities. They exert this influence through campaign contributions and investment of their wealth. This influence hurts a democracy's goals of allowing self-realization through the political process because it impedes equal access and participation in the process. As discussed above, the disruption of a democratic system also may harm economic activities. If the objective underlying the structure of a tax system is to help democracy, the tax should impose a burden on a taxpayer's ability to exert disproportionate influence on the political process. Thus, the equality of participation in democracy doctrine supports a progressive income tax that burdens investment income.

1. The Impact of Income and Wealth on Democracy

In order to glean insight into the best design of a tax system, this subsection examines the ways in which high-income individuals can distort the political process. Case studies and empirical literature have evaluated the impact of the wealthy on representative government and the communities in which high-income individuals live. They show that the wealthy exert a disproportionate influence on government and their communities.

a. Impact on Representative Government

High-income individuals have a greater influence on elected officials than middle- and low-income individuals. When Americans of different income strata disagree about appropriate policies, Martin Gilens has found that policy outcomes are consistent with the

preferences of the most affluent and bear no relationship to the preferences of the middle class and the poor.[102] In his conclusion, he speculates about the cause:

> If government policy is uniquely responsive to the preferences of affluent Americans, as the evidence above suggests, by what mechanisms do the affluent exert their influence? My data are not well suited to answering this question . . . . But the most obvious source of influence over policy that distinguishes high-income Americans is money and the willingness to donate to parties, candidates and interest organizations.[103]

In fact, a majority of the individuals contributing to political candidates have high incomes. A study of congressional campaign contributions made in 1997 found that 81% of the contributors of $200 or more to congressional candidates had annual family incomes of over $100,000.[104] Forty-six percent of the donors had annual family incomes over $250,000, and 20% had incomes over $500,000.[105]

Campaign contributions influence election results.[106] Studies have shown the major impact that campaign financing has on the outcome of U.S. Senate elections,[107] gubernatorial contests,[108] and state legislative elections.[109] For example, in elections for open Senate seats, the financial resources and relative experience of the candidates are the most important determinants of the outcome.[110] Moreover, campaign expenditures of challengers are the most important factor affecting the incumbent senator's reelection chances.[111] In state legislature elections, candidate spending is the "overwhelming"

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102. Martin Gilens, *Inequality and Democratic Responsiveness*, 69 PUB. OPINION Q. 778, 788-89 (2005).

103. *Id.* at 793.

104. John Green et al., Individual Congressional Campaign Contributors: Wealthy, Conservative and Reform-Minded, at tbl. 1 (June 9, 1998), http://www.opensecrets.org/pubs/donors/donors.htm.

105. *Id.*

106. ANTHONY GIERZYNSKI, MONEY RULES: FINANCING ELECTIONS IN AMERICA 60 (2000).

107. *E.g.*, Alan I. Abramowitz, *Explaining Senate Election Outcomes*, 82 AM. POL. SCI. REV. 385, 395-99 (1988); Charles Stewart III, *A Sequential Model of U.S. Senate Elections*, 14 LEGIS. STUD. Q. 567, 577-84 (1989).

108. *E.g.*, Sarah M. Morehouse, *Money Versus Party Effort: Nominating for Governor*, 34 Am. J. Pol. Sci. 706, 722-23 (1990); Samuel C. Patterson, *Campaign Spending Contests for Governor*, 35 W. POL. Q. 457, 475-76 (1982).

109. *E.g.* Gregory A. Caldeira & Samuel C. Patterson, *Bringing Home the Votes: Electoral Outcomes in State Legislative Races*, 4 POL. BEHAV. 33, 33-38 (1982) (discussing elections in California and Iowa); Anthony Gierzynski & David Breaux, *Legislative Elections and the Importance of Money*, 21 LEGIS. STUD. Q. 337, 351-52 (1996) (analyzing twelve state legislative elections); Michael W. Giles & Anita Pritchard, *Campaign Expenditures and Legislative Elections in Florida*, 10 LEGIS. STUD. Q. 71, 84-85 (1985) (examining Florida House elections).

110. Abramowitz, *supra* note 107, at 397.

111. *Id.*

indicator of success where the primary elections are not preceded or followed by a convention.[112]

Contributors also seek to exploit their contributions. Janet M. Box-Steffenmeier and J. Tobin Grant found that Political Action Committees ("PACs") contribute to legislators who are successful in getting a large percentage of their sponsored bills enacted into law.[113] Further, a study of the Tax Reform Act of 1986[114] found that concerned citizens significantly increased their contributions to members of the House Ways and Means Committee and Senate Finance Committee during the period preceding the Act's adoption.[115] PACs time their contributions around key votes in order to buy access to legislators and to encourage them to participate in the process.[116] This strategy appears to work; one study found a correlation between PAC contributions to senators and their participation in floor votes on roll call issues.[117] It determined that voting participation increased as the percentage of contributions senators received from PACs increased.[118] Large contributors also have more access to elected officials than other contributors do.[119] Laura Langbein found a strong correlation between contributions and the amount of time that elected officials spent with contributors.[120] Similarly, others have suggested that patterns of campaign contributions are consistent with the pursuit of access.[121]

Other evidence indicates that contributors influence how elected officials vote. Although studies have found mixed results regarding a direct relationship between contributions and the vote of senators or members of the House in highly visible roll calls on the

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112. Morehouse, *supra* note 108, at 722.

113. Janet M. Box-Steffensmeier & J. Tobin Grant, *All in a Day's Work: The Financial Rewards of Legislative Effectiveness*, 24 LEGIS. STUD. Q. 511, 519 (1999).

114. I.R.C. § 1 et seq. (2006).

115. Jeffery Milyo, *Electoral and Financial Effects of Changes in Committee Power: The Gramm-Rudman-Hollings Budget Reform, the Tax Reform Act of 1986, and the Money Committees in the House*, 40 J.L. & ECON. 93, 97 (1997).

116. Thomas Stratmann, *The Market for Congressional Votes: Is Timing of Contributions Everything?*, 41 J.L. & ECON. 85, 109-10 (1998) (concluding that PACs time their contributions in order to influence voting by legislators on important bills).

117. Peter T. Calcagno & John D. Jackson, *Political Action Committee Spending and Senate Roll Calling Voting*, 97 PUB. CHOICE 569, 582 (1998) (observing that participation in Senate votes increases because of PAC contributions).

118. *Id.*

119. Laura I. Langbein, *Money and Access: Some Empirical Evidence*, 48 J. POL. 1052, 1057-61 (1986).

120. *Id.* at 1060-61.

121. *E.g.*, J. David Gopoian, *What Makes PACs Tick? An Analysis of the Allocation Patterns of Economic Interest Groups*, 28 AM. J. POL. SCI. 259, 262-63 (1984).

floor,[122] studies show that contributions appear to influence roll call votes on issues that do not attract significant publicity.[123] For example, contributions appear to have influenced votes on trucking legislation that received little publicity.[124] Similarly, contributions seem to have influenced votes on the Bank Underwriting Bill,[125] which received less publicity than other bills affecting the financial sector.[126] Studies of state proceedings have found direct evidence that campaign contributions influence the voting records of state legislators.[127]

In addition, contributions appear to motivate greater partisan activity at the committee level. Richard Hall and Frank Wayman examined the relationship between campaign contributions and the activities of members of three House committees on three bills (the Dairy Production Stabilization Act,[128] the Job Training Partnership Act,[129] and the Natural Gas Market Policy Act of 1984[130]).[131] They found that the greater the contributions, the greater the representatives' level of committee activities consistent with the interests of the contributors.[132] The activities included attendance,

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122. *See generally* Janet Grenzke, *Money and Congressional Behavior*, *in* MONEY, ELECTIONS, AND DEMOCRACY: REFORMING CONGRESSIONAL CAMPAIGN FINANCE 143, 144 (Margaret Latus Nugent & John R. Johannes eds., 1990) (surveying studies); Richard A. Smith, *Interest Group Influence in the U.S. Congress*, 20 LEGIS. STUD. Q. 89, 89 (1995) (same).

123. *See* Grenzke, *supra* note 122, at 150-51 (summarizing studies).

124. Woodrow Jones, Jr. & K. Robert Keiser, *Issue Visibility and the Effects of PAC Money*, 68 SOC. SCI. Q. 170, 170 (1987).

125. H.R. 4040, 97th Cong. (1981).

126. Jean Reith Schroedel, *Campaign Contributions and Legislative Outcomes*, 39 W. POL. Q. 371, 373-74, 383 (1986).

127. *E.g.*, Michael Evans Begay, Michael Traynor & Stanton A. Glantz, *The Tobacco Industry, State Politics, and Tobacco Education in California*, 83 AM. J. PUB. HEALTH 1214, 1215-17 (1993) (examining tobacco industry's influence on the California legislature); Stanton A. Glantz & Michael E. Begay, *Tobacco Industry Campaign Contributions are Affecting Tobacco Control Policymaking in California*, 272 JAMA 1176, 1181-82 (1994) (same); Fred Monardi & Stanton A. Glantz, *Are Tobacco Industry Campaign Contributions Influencing State Legislative Behavior?*, 88 AM. J. PUB. HEALTH 918, 920 (1998) (examining tobacco industry's influence on state legislatures in six states). *But see* Jay K. Dow & James W. Endersby, *Campaign Contributions and Legislative Voting in the California Assembly*, 22 AM. POL. Q. 334, 348-49 (1994) (finding no effect of contributions by business groups or labor unions on California legislators).

128. Pub. L. No. 98-180, 97 Stat. 1128 (1983).

129. Pub. L. No. 96-300, 96 Stat. 1322 (1982).

130. H.R. 4277, 98th Cong. (1984).

131. Richard L. Hall & Frank W. Wayman, *Buying Time: Moneyed Interests and the Mobilization of Bias in Congressional Committees*, 84 AM. POL. SCI. REV. 797, 797-99 (1990).

132. *Id.* at 809-10, 813-15; *see also* Diana Evans, *Before the Roll Call: Interest Group Lobbying and Public Outcomes in House Committees*, 49 POL. RES. Q. 287, 287-88 (1996) (examining the relationship between interest group contributions and congressional committee activities).

voting, speaking, offering amendments, and behind-the-scenes negotiations.[133]

b. Impact on Communities

In addition to its impact on the political process, wealth affects life in the community. The placement of investments and ownership of assets in a community can exert as much political influence as direct campaign contributions. Michael Walzer succinctly describes this phenomenon:

> It would be a mistake to imagine, however, that money has political effects only when it "talks" to candidates and officials .... It also has political effects closer to home, in the market itself and in its firms and enterprises .... Even within the adversary relation of owners and workers, with unions and grievance procedures in place, owners may still exercise an illegitimate kind of power. They make all sorts of decisions that severely constrain and shape the lives of their employees (and their fellow citizens, too). Might not the enormous capital investment represented by plants, furnaces, machines, and assembly lines be better regarded as a political than an economic good? To say this doesn't mean that it can't be shared among individuals in a variety of ways, but only that it shouldn't carry the conventional entailments of ownership. Beyond a certain scale, the means of production are not properly called commodities ... for they generate a kind of power that lifts them out of the economic sphere.[134]

The famous case studies of Muncie, Indiana[135] in the books *Middletown*[136] and *Middletown in Transition*[137] illustrate Professor Walzer's point that wealthy individuals exercise disproportionate influence on their communities.[138] The accumulation of capital enables wealthy individuals to influence community affairs in ways that the

133. Hall & Wayman, *supra* note 131, at 810-11.

134. MICHAEL WALZER, SPHERES OF JUSTICE: A DEFENSE OF PLURALISM AND EQUALITY 122 (1982).

135. Though not identified at the time of publication, it was later revealed that Muncie, Indiana was the setting for the *Middletown* studies. *See, e.g.*, John Herbers, *How They're Doing in Muncie, Ind.*, N.Y. TIMES, Apr. 18, 1982, § 7 (Book Review), at 11 (reviewing THEODORE CAPLAW ET AL., MIDDLETOWN FAMILIES: FIFTY YEARS OF CHANGE AND CONTINUITY (1982)).

136. ROBERT S. LYND & HELEN MERRELL LYND, MIDDLETOWN: A STUDY IN AMERICAN CULTURE (1929).

137. ROBERT S. LYND & HELEN MERRELL LYND, MIDDLETOWN IN TRANSITION: A STUDY IN CULTURAL CONFLICTS (1937).

138. Others also have argued that wealthy individuals and corporations exert too much influence over the media in their communities. *See, e.g.*, BEN H. BAGDIKIAN, THE MEDIA MONOPOLY 5-6 (5th ed. 1977) (" 'Market dominant' corporations in the mass media have dominant influence over the public's news, information, public ideas, popular culture, and political attitudes."); MICHAEL PARENTI, INVENTING REALITY: THE POLITICS OF MASS MEDIA 33-37 (2d ed. 1993) (discussing the influence of corporate owners and advertisers over media content). Hollywood has expressed this theme, as well. Frank Capra's classic movie *It's a Wonderful Life* portrayed a wealthy miser inflicting misery on his community. IT'S A WONDERFUL LIFE (Liberty Films 1946); *see* William S. Blatt, *Minority Discounts, Fair Market Value, and the Culture of Estate Taxation*, 52 TAX L. REV. 225, 250 (1997) (discussing the movie).

less wealthy cannot. *Middletown* describes the effect that wealthy business owners have on the media through their placement of advertisements:

> The growing profit in controlling the agencies of news diffusion has developed yet another use of the press—that of buttressing the interests of the business class advertisers who buy advertising; more than ever before it is the business class advertisers who are the supporters of the newspapers, rather than the rank and file of readers of the paper. It is largely taken for granted in Middletown that newspapers, while giving information to the reading public as best they may, must not do it in any way that will offend their chief supporters. Independence of editorial comment happens to be in rough inverse ratio to the amount of advertising carried. The leading paper rarely says anything editorially calculated to offend local business men; the weaker paper "takes the stand" editorially from time to time on such matters as opposition to child labor; while the third paper, the four-page weekly Democratic sheet, carries no advertising except such political advertising as must legally be given to a rival paper, and habitually comments freely and vociferously on local affairs.[139]

Middletown also notes that the affluent exerted control over the news content of the local newspapers:

> Not only advertising and editorial comment but the actual news presented is not unaffected by Middletown's dominant interests. It is generally recognized in Middletown that adverse news about prominent business class families is frequently treated differently, even to the point of being suppressed entirely, than news about less prominent people.[140]

This control has been alleged in other contexts. The Dupont family supposedly suppressed stories and editorials when they owned the largest newspapers in Delaware.[141]

Middletown in Transition discusses the political pressure the affluent applied, not only through the press, but also through their employees:

> The . . . election witnessed perhaps the strongest effort in the city's history by the local big businessmen (industrialists and bankers) to stampede local opinion in behalf of a single presidential candidate. These men own Middletown's jobs and they largely own Middletown's press; and they made use of both sources of pressure—though not to the point of excluding summaries of President Roosevelt's speeches . . . . The pressure in the factories is reported to have been heavy and direct . . . .[142]

In summary, the evidence shows that the selection of investments and deployment of assets allow the wealthy to exert a disproportionate influence on governments and their communities.

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139. LYND & LYND, *supra* note 136, at 475 (footnote omitted).

140. *Id.* at 476.

141. BAGDIKIAN, *supra* note 138, at 42.

142. LYND & LYND, *supra* note 137, at 360-61 (footnote omitted).

2. Using the Tax System to Burden Political Power

Section IV.B.1 demonstrates that economic power distorts the political process in representative government and in the community through campaign contributions and through the placement and control of capital. Because the underlying goal of distributive justice in a democracy is to establish conditions that will provide equal opportunity for all to participate, the government's tax system should be designed to impose a burden on the taxpayer's ability to exert disproportionate influence on the political process.

The argument that a tax system should help to achieve equal participation in the democratic process is certain to be controversial. A tax system, by itself, will never achieve absolutely equal access to the political process. Doing so would require confiscatory rates above a certain level of income, which are likely to harm productivity and be politically unacceptable. But the tax system can augment other approaches to achieving equal access to the political process, such as campaign finance reform.

Campaign finance laws standing alone cannot eliminate or even significantly curb disproportionate political power, as money always finds a way to circumvent political restrictions. The relative ineffectiveness of campaign reform is illustrated by recent history. Prior to the Bipartisan Campaign Reform Act of 2002,[143] significant limits on campaign contributions existed. These limits, however, were easily circumvented. For example, individuals and the PACs that they financed could spend unlimited amounts on their own advertisements to support or defeat candidates and to advocate issues.[144] Also, Federal Election Commission advisory opinions allowed political parties to raise unlimited amounts of money from individuals, corporations, and labor unions (so-called "soft money") that parties could use to fund administrative expenses, voter registration and turnout programs, and state party organizations.[145] State organizations could use soft money for general state election campaign purposes if the contributions were legal under state law.[146] Large amounts of soft

143. Pub. L. No. 107-155 (2007).

144. Buckley v. Valeo, 424 U.S. 1, 39-51 (1976) (per curiam).

145. Op. FEC 1978-10 (Part A) (Aug. 29, 1978), *reprinted in* Campaign Practices Guide: Federal Election Commission Advisory Opinions 1975-1984 (Cong. Q., ed. 1988); Op. FEC 1976-72, *reprinted in* Campaign Finance Reform: A Sourcebook 187-89 (Anthony Corrado et al., Brookings Inst. eds. 1997), available at http://www.brook.edu/gs/cf/sourcebk/chap6.pdf; *see also* GIERZYNSKI, *supra* note 105, at 45 (noting effects of congressional amendments to Federal Election Commission Act and FEC advisory opinions).

146. GIERZYNSKI, *supra* note 106, at 45.

money were raised, and it had a significant effect. One authority described the role of soft money in the 1996 elections:

> In 1996 the Republican's national committees raised $141.2 million. The national Democratic committees raised $122 million. They used the money to run "issue ads" that benefited their presidential nominees; they distributed the rest to state party organizations that registered voters, campaigned on behalf of the parties' candidates (both state and federal), and got voters to the polls on election day.[147]

The Bipartisan Campaign Reform Act of 2002[148] made several changes that were intended to halt the influence of soft money. It banned national party committees from using soft money.[149] In addition, it prohibited state and local parties from using soft money in federal election activities.[150] The results of these reforms have been mixed. The positive benefits are that soft money has all but disappeared and the number of contributions by small donors has surged.[151] But almost half of the soft money that disappeared has been replaced by funding through section 527 organizations, a new method invented by skillful advisors to circumvent the limits. In 2002, national parties raised $591 million through these organizations. In 2004, they raised $271 million.[152] A section 527 organization is an independent political organization that is not subject to campaign contribution limitations.[153] Many of the staff members of the section 527 organizations were also staff members of the national parties.[154] The amount that wealthy individuals contributed to section 527 organizations is impressive. Twenty-four donors accounted for $142 million of contributions to section 527 organizations.[155] Among these donors was George Soros, who contributed $24 million.[156] Soros was

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147. *Id.*

148. Pub. L. No. 107-155 (2007).

149. 2 U.S.C. § 441i(a) (2000 & Supp. II 2002).

150. *Id.* § 441i(b). Another aspect of the Bipartisan Campaign Reform Act, which prohibited corporations from making any broadcast that referred to a candidate within a certain time period of federal elections, was recently the subject of a Supreme Court ruling. FEC v. Wis. Right To Life, Inc., 127 S. Ct. 2652 (2007). The Court ruled that the prohibition was unconstitutional as applied to the advertisements at issue in that case, even though they referred to a candidate, because the advertisements were not an appeal to vote for or against a specific candidate. The long-term implications of this decision are not clear.

151. Anthony Corrado, *Party Finance in the Wake of BCRA: An Overview*, *in* THE ELECTION AFTER REFORM: MONEY, POLITICS, AND THE BIPARTISAN CAMPAIGN REFORM ACT 19, 26-28 (Michael J. Malbin ed., 2006).

152. Stephen R. Weissman & Ruth Hassan, *BCRA and the 527 Groups*, *in* THE ELECTION AFTER REFORM, *supra* note 151, at 79, 81.

153. Alan J. Cigler, *Interest Groups and Financing the 2004 Elections*, *in* FINANCING THE 2004 ELECTION 208, 223 (David B. Magleby, Anthony Corrado & Kelly D. Patterson eds., 2006).

154. *Id.* at 224-25.

155. Weissman & Hassan, *supra* note 152, at 92.

156. *Id.* at 94.

clearly motivated by access to the candidate (John Kerry) in making this donation. He is quoted as saying: "I would be very happy to advise Kerry . . . . I've been trying to exert some influence over our policies and I hope I'll get a better hearing under Kerry."[157]

The influence of economic power on democracy, and the lack of success using campaign finance reform to limit that power, suggest that tax should play a role in curbing excess political power. The role of wealth in creating political power suggests two design features: (1) the tax should be applied to some measure of the taxpayer's ability to control or influence the political process; and (2) the tax should be applied at the time that control can be exercised. The measure of the taxpayer's ability to control requires some thought because it manifests itself in different ways. As discussed above,[158] a taxpayer can control the political process through placement of her wealth (i.e., the process of selecting her investments) and through campaign contributions. Persons who have insufficient resources to satisfy basic needs lack funds to invest or to spend on campaign contributions. A tax that is designed to help democracy, therefore, should not apply to persons with few resources. Rather, it should apply to persons with sufficient resources to enter the political process and to exert influence through their selection of investments.

C. The Tax Base

Wealth, income, or consumption could be used as a measure of the resources that enable a person to exert political influence. Subsection 1 considers the relationship of these potential tax bases to political power. Subsection 2 discusses the inability of either a wealth tax, an ideal income tax, or a consumption tax to burden investment income and the administrative difficulties posed by a wealth tax.

1. General Considerations

Of the three potential tax bases, wealth is arguably the most accurate measure of a person's ability to affect democracy. Persons with greater wealth have more to invest and thus can exercise greater control. As discussed above, the selection of investments can exert great influence. Similarly, persons with more wealth are able to contribute more to campaigns.

157. *Id.* at 86-87 (quoting Jane Mayer, *The Money Man*, NEW YORKER, Oct. 18, 2004, at 176).
158. *See supra* Section IV.B.1.

Alternatively, income might be used as the tax base. Concentrations of income follow the same pattern as concentrations of wealth in countries for which both sets of data are available.[159] Income, however, is not as accurate a measure of political power as wealth because income can vary from political power. For example, it is possible that a taxpayer can have high income for any given year but not be able to impact the political process because he earned low income in prior years.

Consumption bears the most remote relationship to political power. It is unlikely that amounts of consumption correlate strongly with wealth and political influence. A person with a net worth of $100 billion probably consumes a significantly smaller percentage of her income than a person with a net wealth of $1 million. For example, it has been estimated that Bill Gates would have to consume $25 million a day to avoid further accumulation of wealth, assuming that his net worth is $100 billion and that his investment income averaged 10%.[160] Recent empirical evidence suggests that wealthy individuals save a much higher percentage of their income than less advantaged persons. A 2004 study, using data from the Survey of Consumer Finance, found that taxpayers in the median quintile of income in the United States saved only 11% of their income while taxpayers in the top 1% saved 51% of their income.[161] Similarly, an analysis of data from the Consumer Expenditure Survey found that taxpayers with income over $200,000 consume only 37% of their income, while taxpayers with income below $30,000 consume all their income.[162] These studies suggest that even if progressive rates are used in a consumption tax, the rates for the wealthiest would have to be confiscatory to collect the same tax revenue as an income tax.

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159. Philippe Aghion et al., *Inequality and Economic Growth: The Perspective of the New Growth Theories*, 37 J. ECON. LITERATURE 1615, 1617 (1999); Roberto Perotti, *Growth, Income Distribution and Democracy: What the Data Say*, 1 J. ECON. GROWTH 149, 154 (1996). For a detailed analysis of wealth distribution in the United States, see Martin J. McMahon, *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993, 1017-21 (2004).

160. Christopher D. Carroll, *Why Do the Rich Save So Much?*, *in* DOES ATLAS SHRUG?: THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 465, 480-81 (Joel B. Slemrod ed., 2000).

161. Karen E. Dynan, Jonathan Skinner & Stephen P. Zeldes, *Do the Rich Save More?*, 112 J. POL. ECON. 397, 416 tbl. 3 (2004). However, prior studies, primarily from the 1950s and 1960s, have produced mixed results. *Id.* at 399-401.

162. Leonard E. Burman & Troy Kravitz, *Lower-Income Households Spend Largest Share of Income*, 105 TAX NOTES 875, 875 tbl. (2004).

2. The Problem of Investment Income and Administrative Difficulties

Despite the differences among tax bases with respect to political power, the selection of the best tax base is not clear. As discussed above, political power should be burdened by a tax at the time that power can be exercised. Because the investment of capital can be an exercise of political power,[163] a taxpayer's investment income should be burdened. However, neither a wealth tax, an ideal income tax, nor a consumption tax burdens most of the income from investments.[164]

A wealth tax faces another major problem that makes it impractical. A wealth tax must be assessed annually to burden political power at the time it is exercised. If the tax is assessed over a longer period, wealth and the accompanying political power will accrue between assessments.[165] An annual wealth tax, however, requires annual valuations that would overwhelm the IRS and the judiciary.[166] Valuation is the weakest link in our current estate and gift tax because valuations are easily manipulated and because the process of valuation is resource intensive.[167] Currently, less than 2% of taxpayers are subject to the estate tax.[168] A wealth tax requiring all

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163. *See supra* Section IV.B.1.

164. Technically, the return on an investment can be viewed as consisting of three parts: a riskless return, a risk premium, and, in some cases, an inframarginal return. Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter?*, 47 TAX L. REV. 377, 387 (1992); Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17, 29-31 (1996); Alvin Warren, *Would a Consumption Tax be Fairer Than an Income Tax?* 89 YALE L.J. 1081, 1097-99 (1980). An ideal income tax burdens only the riskless and inframarginal returns on investment, while a cash-flow consumption tax burdens only the inframarginal return, and a wealth tax only the riskless return. *See, e.g.*, Bankman & Griffith, *supra*, at 387; Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q.J. ECON. 388, 389 (1944); Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 TAX L. REV. 423, 439 (2000); David Shakow & Reed Shuldiner, *A Comprehensive Wealth Tax*, 53 TAX L. REV. 499, 517-20 (2000). Because the riskless return historically has been very low—only .06%, STOCKS, BONDS, BILLS, AND INFLATION 2006 YEARBOOK: VALUATION EDITION 93 (Ibbotson Assocs. 2006), and an inframarginal return is an extraordinary event, an ideal income, cash-flow consumption, and wealth tax fail to burden the largest portion of investment income—the risk return.

165. The same revenue derived from an annual wealth tax could be collected in present value terms by assessing a wealth tax every few years and using a higher tax rate. The difficulty is that, during the periods in between such assessments, the taxpayer still has the amounts to invest. As discussed earlier, the selection of investments is an important source of political power. *See supra* Section IV.B.1.b.

166. James R. Repetti, *Commentary: It's All About Valuation*, 53 TAX L. REV. 607, 609-12 (2000).

167. *Id.*

168. In 2002, only 1.17% of the estates of deceased taxpayers filed an estate tax return. Tax Policy Center, 1934-2002 (July 10, 2007), *available at* http://taxpolicycenter.org/TaxFacts/TFDB/TFTemplate.cfm?Docid=52&Topic2id=60.

U.S. taxpayers to file returns based on annual valuations would be too unwieldy.[169] Based on these impracticalities, this Article eliminates the wealth tax as a viable alternative and focuses on the consumption tax and income tax.

a. Consumption Tax

While a consumption tax does not have the administrative problem of a wealth tax, it cannot curb political power because it does not burden investment income. Investments are a major source of political power[170] and represent a significant portion of the receipts of wealthy individuals. For example, in 2000, capital gains accounted for over 57% of the adjusted gross income of taxpayers with $10 million or more of income and 12% of the income for taxpayers with adjusted gross incomes between $200,000 and $500,000. In contrast, it represented an insignificant amount for taxpayers with lower incomes.[171] Similarly, in 2000, capital gain, dividend, and interest income represented 76% of the adjusted gross income of the 400 taxpayers in the United States with the highest adjusted gross incomes.[172]

A review of the different types of consumption tax and their impact on investment income clarifies why a consumption tax does not burden investment income. A prepaid consumption tax (also referred to as a wage tax), taxes the taxpayer's wage income but exempts his investment income.[173] For example, a Roth IRA is a prepaid consumption tax because the taxpayer pays an income tax on the amount deposited in the IRA but does not pay any tax on the amounts withdrawn.[174] Regardless of how progressive this type of consumption tax is made, it will never burden the return on investment. Because the return on investment is never taxed, a prepaid consumption tax does not impair the taxpayer's ability to influence the political process through placement of investments and campaign contributions.

Another type of consumption tax is a postpaid tax, such as a cash flow tax where the taxpayer includes all income in the tax base

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169. *Id.*

170. *See supra* Section IV.B.1.b.

171. Leonard E. Burman & Deborah I. Kobes, *Composition of Income Reported on Tax Returns*, 101 TAX NOTES 783, 783 (2003).

172. Tax Policy Center, Tax Facts: Returns of Taxpayers with the Top 400 Adjusted Gross Income, 1992-2005 (Mar. 7, 2008), *available at* http://taxpolicycenter.org/TaxFacts/TFDB/TFTemplate.cfm?Docid=260.

173. *See, e.g.*, McCaffery, *supra* note 12, at 824 (explaining impact of prepaid consumption tax on investment income).

174. *Id.*

but is allowed to deduct amounts invested.[175] Taxation of investment income is deferred until the taxpayer withdraws the investment for consumption. At that time, the entire amount of the initial investment and the income earned thereon is taxed. A cash flow tax with a flat tax rate exempts the investment income from tax, except where the return is a rare form, referred to as an "inframarginal" return.[176]

The exemption of investment income by a postpaid consumption tax with a flat rate is illustrated by the following example.[177] Suppose a taxpayer subject to a cash flow type consumption tax with a flat rate of 50% decides to invest $200 in year one in an investment that yields 10%. Because a cash flow consumption tax allows a deduction for amounts invested, the taxpayer's investment of $200 in year one generates a $200 deduction. This deduction saves him $100 in taxes that also can be invested, which in turn will generate another deduction. If the taxpayer continues to invest his tax savings from each successive investment, he eventually will have invested an additional $200.[178] At the end of year two, he will have his investment of $400 (the investment of $200 plus the additional investment from tax savings of $200) and $40 of investment income. When he consumes his investment in year two, he will pay a tax of $220 (50% of $440), leaving him with $220 to consume. In effect, his investment income has not been burdened because his initial investment was $200 and he earned $20 thereon (a 10% return). Because the postpaid consumption tax fails to burden

175. A cash-flow tax was first discussed in legal literature in William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

176. Inframarginal returns are usually associated with new ideas, monopolies, or managerial skill. R. Glenn Hubbard, *Prospects for Fundamental Tax Reform: How Different are Income and Consumption Taxes?*, 87 AM. ECON. REV. 138, 139 (1997). Other than monopolies, inframarginal returns are usually returns on labor—the invention of a better computer operating system or the effective management of an organization represent the fruits of the labor of the inventor or manager. For a discussion of the different types of investment returns, see *supra* note 164.

177. This example is based on Example 1 in Alvin C. Warren, *How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax?*, 52 TAX L. REV. 1, 3 (1996).

178. The additional amount of the tax savings that taxpayer will be able to reinvest as a result of being able to deduct each successive amount is equal to the amount of the initial investment multiplied by $t/(1 - t)$, where t is the tax rate. *See, e.g., id.* (discussing this example). It is important to note that this formula assumes that the amount of the initial investment already has been accounted for fully in the tax base. For example, if taxpayer received wages of $100, you could not multiply that $100 by $t/(1 - t)$ to determine the additional amount of tax savings that could be invested. The taxpayer who received $100 in wages could invest only $100 because that amount already includes his tax savings attributable to deducting the $100 investment from his $100 of wages. To see this, consider that $100 of wages would have allowed taxpayer to consume $60 and pay a consumption tax of $40. The amount remaining after taxes, $60, would have generated an additional $40 of tax savings if invested, as can be seen by applying the $t/(1 - t)$ formula: $60 x .40/(1 - .4) = $40.

return on investment, it likewise fails to impair the taxpayer's influence on the political process through placement of investments and campaign contributions. As an aside, note that the taxpayer's return was not burdened because he was able to invest his tax savings in an investment that yielded the same return as his initial investment. If the taxpayer instead invested his tax savings in an investment yielding a lower amount, his return would be burdened.[179] It is thought that inframarginal returns are restricted in the amount that can be invested, with the result that inframarginal returns are burdened in a postpaid consumption tax.[180]

The foregoing example involved a postpaid consumption tax with flat rates. A postpaid consumption tax with progressive rates burdens investment income if the taxpayer's consumption is taxed at a rate higher than the rate that applied at the time the investment was made.[181] Consider a cash flow tax that applies a tax rate of 50% to the first $200 of taxable cash flow and 60% thereafter. If in year one a taxpayer invests $200, her deduction in year one will save her $100 in taxes. If she invests that $100 of tax savings and continues to invest the tax savings from each successive investment, she will have invested an additional $200.[182] If the total investment of $400 (the initial $200 investment plus the $200 of tax savings) yields 10%, she will have $440 at the end of year two. When she consumes that amount, she will pay a tax of $232 (50% of the first $200 and 60% of the remaining $220), meaning that she will have $208 after tax to consume. Her investment income has been burdened because with no tax she would have $220 (her initial investment of $200 plus the $20 earned thereon). Note that if the applicable tax rate had remained at 50% when she consumed her savings, she would have had $220 to

179. For example, if the taxpayer had been able to receive only a 5% return on his investment of the $200 of tax savings, he would have $430 to consume at the end of the year ($210 attributable to the tax savings and the 5% yield thereon, and $220 attributable to the $200 original investment and the 10% yield thereon). Consumption would generate a tax of $215 (50% of 230), leaving him with a net consumption of $215, a worse position than he would have been in the no tax world where he would have consumed $220. *See* Warren, *supra* note 177, at 3 (discussing this example); *see also* Cunningham, *supra* note 164, at 26-29 (discussing similar examples).

180. *See supra* note 176 for an explanation of inframarginal returns.

181. *See* McCaffery, *supra* note 12, at 854-55.

182. *See supra* text accompanying note 178. As discussed in note 178, the total amount of the tax savings that taxpayer will be able to be reinvest as a result of being able to deduct each successive amount is equal to the amount of the initial investment multiplied by $t/(1 - t)$, where t is the tax rate. We assume that the 50% rate would apply to the amount of tax savings generated on successive investments.

consume.[183] Her investment income is only burdened if a higher rate applies at the time of consumption.

Although the progressive cash flow tax may burden investment income, it does not satisfy our conditions for democracy for several reasons. First, a progressive consumption tax only burdens savings if the taxpayer is in a higher bracket when the savings are consumed compared to when the saving occurred. In other words, the taxpayer's savings are only burdened when her level of consumption is greater than it was during the period in which the savings occurred.[184] If the taxpayer never increases her level of consumption, then the return on investment will never be burdened. In addition, even when the savings are burdened, the timing is inappropriate. The savings are only burdened when consumption occurs. Until then, the taxpayer has an unfettered and continuous ability to influence politics by virtue of controlling where she places her investments. Lastly, depending on the design of the consumption tax, the act of contributing to political campaigns only will be taxed if donations are treated as consumption.

Professor Shaviro argues that a consumption tax burdens political power.[185] He asserts that political power is based on "what it can be used to buy." Because consumption is taxed when it occurs, he argues that the presence of the tax, as an unavoidable liability, reduces purchasing power and thereby reduces political power. He states:

> Why does wealth offer security, political power, and social standing? The answer must be because of its value—that is because of what it can be used to buy. . . . [A] postpaid consumption tax affects what the wealth one holds can be used to buy. It is no different in that regard than an arm's-length liability that one incurs to defray the cost of a prepaid tax. Even when wealthy people make bequests to their heirs from motives of benevolence, a postpaid consumption tax affects the benefits they are conveying—that is the amount that the heirs can buy. Murphy and Nagel fail to recognize that savings and wealth are indeed subsidiary to consumption in that they derive their value entirely form that potential use, whether its exercise is proximate or not. The ability to buy things is, after all, the difference between real money and play money from board games such as Monopoly and Life.[186]

This statement does not consider that political control arises from the placement of investments as well as from political contributions.[187] A taxpayer's decision about where to locate a factory

183. When taxpayer consumes $440 in year 2, she will pay a tax of $220 (50% of $440), which means that she will have $220 to consume.

184. McCaffery, *supra* note 12, at 855.

185. Shaviro, *supra* note 44, at 106; *see also* Bankman & Weisbach, *supra* note 4, at 1436-37, 1449 (making the same argument).

186. Shaviro, *supra* note 44, at 106.

187. *See supra* Section IV.B.1.b.

or in which bank to deposit a large sum has significant political impact.[188] Moreover, in the popular versions of a cash flow consumption tax, most business expenditures are immediately deductible.[189] Placements of advertisements and purchases of supplies are expenditures that are not taxed to the payer in a cash flow consumption tax, but they nevertheless exert as much political influence as direct campaign contributions.[190] The result is that a consumption tax fails to burden a significant portion of political power as compared to a progressive income tax, even if political contributions are treated as taxable consumption.

b. Income Tax

Initially, the income tax does not appear any better than the consumption tax. Like a consumption tax, an ideal income tax does not burden most of the return from investments if certain conditions are satisfied.[191] For an ideal income tax to exempt investment income, all losses must be fully deductible, the tax rate applicable to such losses must be the same rate applied to gains, and investors must take advantage of the full deductibility of losses by increasing their investment in risky assets.[192]

The following example illustrates how an ideal income tax fails to burden most investment income when these conditions are satisfied. Suppose that a taxpayer is considering an investment of $100 that has a 50% chance of either earning 40% or losing 20%. To keep this example simple, assume that this return consists entirely of risk return and that the riskless and inframarginal returns are zero.[193] The taxpayer's potential results in a tax-free world are depicted in Table 2.

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188. *See supra* Section IV.B.1.b.

189. *See, e.g.*, James M. Bickley, *Flat Tax: An Overview of the Hall-Rabushka Proposal*, 72 TAX NOTES 97, 99 (1996) (describing expenditures that would be deductible under the Hall-Rabushka flat tax proposal); Paul H. O'Neill & Robert A. Lutz, *Unlimited Savings Allowance (USA) Tax System*, 66 TAX NOTES 1482, 1492-93 (1995) (describing business expenditures that may be deducted under the USA Tax System). A significant difference between the USA Tax and Hall-Rabushka proposals is their treatment of wages. The USA Tax would not permit businesses to deduct wages, while the Hall-Rabushka proposal would.

190. *See supra* Section IV.B.1.b

191. The risk return from investments, which usually represents most of an investment return, is not burdened by an ideal income tax. *See supra* note 164.

192. *See e.g.*, Lawrence Zelenak, *The Sometimes-Taxation of the Returns to Risk Bearing Under a Progressive Income Tax*, 59 SMU L. REV. 879, 891 (2006).

193. For a discussion of the different components of investment income, see *supra* note 164.

TABLE 2

Tax Free		
	Lucky	Unlucky
Risky Investment	$100 + $40 = $140	$100 - $20 = $80
Percent Return	40%	(20%)

The taxpayer's expected return is 10% in a tax-free world.[194]

If we assume a 20% tax, and full deductibility of losses, taxpayer's results are depicted in Table 3.

TABLE 3

Taxable at 20%		
	Lucky	Unlucky
Risky Investment	$100 + 40 = $140	$100 - $20 = $80
Tax (Expense) Benefit	20% x $40 =($8)	20% x ($20) = $4
After-Tax Income	$132	$84
Percent Return	32%	(16%)

The 20% tax reduces the taxpayer's expected return to 8%.[195] Note that the ability to deduct the loss of $20 in the unlucky scenario generates a tax savings of $4.

The taxpayer can eliminate the tax burden in the lucky scenario by increasing his investment in the risky investment by a factor of 1/1-t, where t is the tax rate. Assume that the taxpayer borrows $25, paying $1 of interest (which represents an interest charge of 4%[196]) and increases his investment to $125.[197] The possible outcomes are depicted in Table 4.

194. Taxpayer has a gain of 40% in the lucky scenario and a loss of 20% in the unlucky scenario. The expected value of the return is .5(40% - 20%) = 10%.

195. Taxpayer has a gain of 32% in the lucky scenario and a loss of 16% in the unlucky scenario. The expected value of his return is .5(32% - 16%) = 8%.

196. 4% x 25 = 1.

197. 1/(1 - .2) = 25.

TABLE 4

Portfolio Adjustments Assuming Loss Deduction		
	Lucky	Unlucky
Risky Investment	$125 + $50 = $175.00	$125 - $25 = $100.00
Interest Expense	($1.00)	($1.00)
Tax (Expense) Benefit	20% x $49 = ($9.80)	20% x ($26) = $5.20
Loan Repayment	($25.00)	($25.00)
After-Tax Income	$139.20	$79.20
Percent Return	39.2%	(20.8%)

The taxpayer's total after-tax return of $139.20 if he is lucky and $79.20 if unlucky is almost identical to his position in the tax-free world—where he had $140 if lucky and $80 if unlucky. The difference in each scenario of $0.80 represents the after-tax interest cost of the loan.[198] His expected return in this scenario is 9.2%[199], which is also 0.8% less than his expected return in the no tax world. That $0.80 reduction in expected return represents the cost of the after-tax interest (0.8%) as a percentage of his net investment of $100.[200] The taxpayer's after-tax return increased with a larger investment because he was able to deduct his interest expense and loss in the unlucky scenario, thereby generating a tax savings of $5.20.

While these examples demonstrate that an ideal income tax exempts investment income, a major problem exists in the real world. There is no evidence that investors employ the portfolio adjustment technique described above. None of the portfolio managers for hedge funds and mutual funds to whom I have spoken take advantage of this opportunity by grossing up their investments. Moreover, as David Weisbach notes, standard public finance texts either ignore or give short shrift to this option.[201]

The conditions that must exist for the portfolio adjustments to work are restrictive. For an ideal tax to eliminate the burden on investment income, all losses must be fully deductible, the tax rate applicable to losses must be the same as the rate for gains, and

198. The interest expense of $1 generated a tax benefit of $0.20 (.2 x $1), which means that the after-tax cost of the interest charge is $0.80.

199. Taxpayer's gain in the lucky scenario is 39.2% and his loss is 20.8%. The expected value of his return is .5(39.2% - 20.8%) = 9.2%.

200. The interest expense of $1 generated a tax benefit of .2 (.2 x $1), which means that the after-tax cost of the interest charge is $0.80. This interest charge of $0.80 is .8% of the net investment of $100 (.8/100 = .008).

201. David A. Weisbach, *The (Non)Taxation of Risk*, 58 TAX L. REV. 1, 4-5 (2004).

investors must be able to make portfolio adjustments that reflect the fact that losses can be deducted fully (i.e., by increasing investment in a risky asset).[202] These conditions do not exist in our actual income tax system, which limits loss deductions in several ways. For example, interest expenses incurred on debt used for investments can be deducted only to the extent of investment income,[203] losses generally cannot be deducted to the extent financed by nonrecourse debt,[204] passive activity losses generally are deductible only to the extent of passive activity income or when the taxpayer disposes of her entire interest in the passive activity,[205] and capital losses of individuals are deductible only against capital gains and $3000 of ordinary income.[206] In addition, because we have a progressive tax, some taxpayers have losses deducted at rates that are lower than the rates applicable to their gains.[207]

Our system's limitation on loss deductions and its progressive rate structure discourage taxpayers from increasing their investment in the risky asset in an attempt to eliminate the tax on the risk return. Indeed, as shown below, increased investment in the risky asset may place the taxpayer in a *worse* position than he would have been had he not made the adjustments and paid the entire tax! To illustrate this, recall that in the above example, the portfolio adjustment eliminated most of the burden on the investment return because we assumed that the taxpayer could fully deduct his loss and interest expense if he were unlucky, thereby generating a tax benefit of $5.20. If he is not able to deduct the loss and interest expense when he is unlucky, he actually would be temporarily worse off than he was in the taxable world as a result of his portfolio adjustments, as depicted in Table 5.

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202. *See, e.g.*, Louis Kaplow, *Taxation and Risk Taking: A General Equilibrium Perspective*, 47 NAT'L TAX J. 789-90 (1994); Zelenak, *supra* note 192, at 891.

203. I.R.C. § 163(i) (2008).

204. I.R.C. § 465 (2000 & Supp. IV 2004).

205. I.R.C. § 469.

206. I.R.C. § 1211(b) (2000). Capital losses of corporations are only deductible against capital gains—corporations do not have the benefit of also deducting the losses against $3,000 of ordinary income. I.R.C. § 1211(a).

207. Zelenak, *supra* note 192, at 901. Professor Zelenak points out, however, that it is likely that the very rich do not deduct losses at lower rates than their gains are taxed, because our maximum tax rate of 35% applies to incomes over $349,700 for married individuals filing a joint return in 2007. It is likely that most wealthy taxpayers are deducting losses and reporting gains at the same rate. In addition, since capital losses primarily are deducted against capital gains, the same rate generally will apply to those losses and gains for most taxpayers.

TABLE 5

Portfolio Adjustments Assuming No Loss Deduction		
	Lucky	Unlucky
Risky Investment	$125 + $50 = $175.00	$125 - $25 = $100.00
Interest Expense	($1.00)	($1.00)
Tax (Expense) Benefit	20% x $49 = ($9.80)	$0
Loan Repayment	($25.00)	($25.00)
After-Tax Income	$139.20	$74.00
Percent Return	39.2%	(26%)

The taxpayer's inability to deduct his loss and interest expense will decrease his expected return to 6.6%,[208] a return that is worse than the 8% he had in the taxable world with no portfolio adjustments. This lower return will increase, however, when he eventually is able to deduct the expenses. If we assume a 10% discount rate,[209] he must deduct his loss and interest expense within seven years of incurring them to avoid a permanently lower return.[210]

A seven-year window may not seem like a serious impediment, but the period will be shorter if the interest expense on the loan is higher or the appropriate discount rate for calculating the present value of the tax benefits is greater. Moreover, the taxpayer may never be able to improve his position to that of the taxable world with no portfolio adjustment if he is in a lower tax bracket when he finally is able to recognize the deduction. For example, even if the taxpayer is able to deduct the suspended losses the following year, he will be worse off than he would have been without portfolio adjustments if his

208. If taxpayer cannot deduct the $25 loss and $1 interest expense, he finishes with $74 in the unlucky scenario. Thus, the outcomes are a net gain of $39.20 if lucky and a net loss of $26 if unlucky on a net investment of $100. This results in an expected return of .5(39.2% - 26%) = 6.6%.

209. This seems reasonable, given the taxpayer's willingness to invest in an asset having an expected return of 10%.

210. In order for the taxpayer to achieve the 8% expected return that he would have received in the tax world with no portfolio adjustments, the present value of the tax benefit arising from his eventual deduction of the suspended $25 loss and $1 interest expense must equal $2.80 or more. To see this, consider that a present value of tax benefits of $2.80 would increase the return in the unlucky scenario with portfolio adjustments from $74 with no tax benefit to $76.80. This would yield an expected return of .5(39.2% - 23.2%) = 8%. The present value of a $5.20 tax benefit (20% multiplied by the suspended loss of $25 and interest expense of $1) equals $2.80 only if the expenses generating that benefit are deducted no later than seven years after the expenses are incurred.

effective tax rate at the time of deduction is reduced from 20% to 10%.[211]

These uncertainties introduce additional risk that may deter taxpayers from engaging in the portfolio adjustments that theoretically enable them to eliminate tax on their risky income. Whatever the explanation, the wealthiest taxpayers are not eliminating tax on their investment income. Evidence suggests that our progressive tax system, as imperfect as it is,[212] imposes a heavier burden on high-income taxpayers, who earn the bulk of their income from investments, than on low-income taxpayers. Thomas Piketty and Emmanuek Saez, in reviewing income inequality in the United States in the twentieth century, remark on the steep decline in the concentration of capital income that occurred during that century:

> How can we explain the steep secular decline in capital income concentration [through 1987]? . . . The most natural and realistic candidate for an explanation seems to be the creation and the development of the progressive income tax (and of the progressive estate tax and corporate tax). The very large fortunes that generated the top 0.01 percent incomes observed at the beginning of the century were accumulated during the nineteenth century, at a time where progressive taxes hardly existed. . . . The fiscal situation faced by capitalists in the twentieth century . . . has been substantially different. Top tax rates were very high from the end of World War I to the early 1920's and then continuously from 1932 to the mid-1980's. . . . These very high marginal rates applied to only a very small fraction of taxpayers, but created a substantial burden on the very top income groups (such as the top 0.1 percent and 0.01 percent) composed primarily of capital income.[213]

The explanation by Picketty and Saez is consistent with other evidence. A recent analysis of the U.S. system found that, in 2007, the effective individual income tax rate on taxpayers in the top 0.1% of income was 19.3%, compared to an effective tax rate of negative 5.0% for taxpayers in the lowest quintile.[214] Because investment income in the form of capital gains accounted for 57% of the total adjusted gross income of taxpayers with incomes of $10 million or more in 2000, it is likely that investment income of the wealthy is being taxed.[215]

211. As discussed *supra* note 210, in order for the taxpayer to achieve the 8% expected return that he would have received in the taxable world without a portfolio adjustment, he would have to obtain a present value benefit from the deduction of the suspended loss and interest expense equal to $2.80. If taxpayer's effective tax rate is 10% when he deducts the $26 of suspended expenses, he will never reach the required $2.80 benefit, because the maximum tax benefit he could obtain would be $2.60 (.1 x $26).

212. Our current income tax could be improved significantly with regard to the taxation of investment income. For an excellent critique, see, e.g., McMahon, *supra* note 159, at 1017-21.

213. Thomas Piketty & Emmanuel Saez, *Income Inequality in the United States, 1913-1998*, 118 Q.J. ECON. 1, 21-23 (2003) (internal citations omitted).

214. Jeffrey Rohaly, *The Distribution of Federal Taxes*, 115 TAX NOTES 1293, 1293 (2007).

215. Burman & Kobes, *supra* note 171, at 783; *see also* Joel Slemrod, *Does the United States Tax Capital Income?*, *in* TAXING CAPITAL INCOME 3, 16 (Henry J. Aaron, Leonard E. Burman &

Consistent with this analysis, high-income taxpayers pay a disproportionate amount of tax in our current progressive system. The top 0.5% of taxpayers in the United States paid approximately 24% of all income taxes collected in 1995, and the majority of their income was investment income.[216] Thus, strong evidence suggests that an annual income tax that limits the deductibility of investment losses burdens high-income taxpayers even though they receive the bulk of their income from investments.[217]

D. Rate Structure

Both a proportional and a progressive income tax impose greater burdens on taxpayers with greater resources so long as the tax base reflects those resources. However, the relationship between political influence and wealth is likely a step function. Persons with little wealth have no power because all of their resources are devoted to basic needs. In contrast, persons with great resources have political power because they have significant amounts to invest and to

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C. Eugene Steuerle eds., 2007) (finding that, in the years 2002-2004, the effective U.S. tax rate on capital income ranged from 14% to 23%, depending on the measurement method that was used).

216. Daniel R. Feenberg & James M. Poterba, *Taxing the Rich: The Income and Tax Share of Very High-Income Households, 1960-1995*, 90 AM. ECON. REV. 264, 268 (2000).

217. For an insightful critique of our current tax system's taxation of investment income, see Deborah H. Schenk, *Saving the Income Tax With a Wealth Tax*, 53 TAX L. REV. 423, 429-33 (2000). Schenk argues that low-income taxpayers may bear a greater burden than wealthy taxpayers on investment income, because high-income taxpayers probably can minimize the tax on investment income more readily than low-income taxpayers through sophisticated tax planning. While it is true that high-income individuals do engage in more tax planning than low-income taxpayers, it does not follow that we should abandon imposing an income tax on investment income. As discussed above, high-income taxpayers are not eliminating the income tax on investment income. Moreover, it seems unlikely that the burden on low-income taxpayers is significant. Most investment income is reported by high-income individuals, not low-income individuals. In 2000, families with adjusted gross incomes ("AGI") of $75,000 to $100,000 had capital gains that comprised less than 5% of their total AGI. In contrast, investment income in the form of capital gains accounted for 57% of the total adjusted gross income of taxpayers with incomes of $10 million or more. Burman & Kobes, *supra* note 171, at 783. Moreover, there is evidence that even large corporations, the most sophisticated taxpayers, frequently are limited by restrictions on the use of losses and credits despite their extensive tax planning. *See* Roseanne Altshuler & Alan J. Auerbach, *The Significance of Tax Law Asymmetries: An Empirical Investigation*, 105 Q.J. ECON. 61, 69-72 (1990) (finding that, in 1982, approximately one half of corporations, weighted by asset size, were fully taxable and that an additional 29% paid taxes while they still had unused investment credits); Alan J. Auerbach, *Why Have Corporate Revenues Declined? Another Look* 18 (unpublished manuscript, presented at NYU School of Law Colloquium on Tax Policy and Public Finance, Spring 2007), http://www.law.nyu.edu/colloquia/taxpolicy/papers/07/AlanAuerbachSp07.pdf ("The recent upward spike in the average tax rate is largely attributable to the importance of tax losses, and casts some doubt on the importance of tax planning activities as a vehicle for reducing taxes.").

contribute to political campaigns.[218] This suggests that a tax on political power should apply to persons with great wealth, but not to persons with few resources. That is, the tax rate imposed on less advantaged individuals should not include an assessment on political power, but an increment should be added to the rate for wealthy individuals to burden political power. This increase is, of course, a progressive rate structure. The increase could be accomplished in two steps, or many steps could be used to provide a less abrupt transition.

Despite the imperfections of our current progressive tax system, statistics indicate that high-income taxpayers carry a heavier burden than low-income taxpayers. Table 6, which depicts data prepared by the Congressional Budget Office, indicates that the share of after-tax income of taxpayers in the highest quintile is lower than their share of pre-tax income.[219]

TABLE 6

Share of Income for 2002-03		
Quintile	Pre-Tax Income	Post-Tax Income
First	4.3%	5.2%
Second	9.3%	10.4%
Third	14.6%	15.7%
Fourth	21.0%	21.6%
Highest	51.6%	48.2%

In addition, a recent study measured the impact of taxes on the Gini coefficient, a measure of inequality, for the period 1979-2002.[220] In comparing pre-tax income to post-tax income, it found that federal income taxation decreased the Gini coefficient for all years. This means that the federal income tax has imposed heavier burdens on high-income individuals than on low-income individuals. These results are reproduced in Table 7.

218. *See supra* Section IV.B.1 (discussing the impact of income wealth on democracy).

219. CONGRESSIONAL BUDGET OFFICE, HISTORICAL EFFECTIVE FEDERAL TAX RATES 1979 TO 2003, at 5 (2005), http://www.cbo.gov/ftpdocs/70xx/doc7000/12-29-FedTaxRates.pdf.

220. MICHAEL STRUDLER, TOM PETSKA & RYAN PETSKA, FURTHER ANALYSIS OF THE DISTRIBUTION OF INCOME AND TAXES, 1979-2002, at 8-9 (2004), http://www.irs.gov/pub/irs-soi/04asastr.pdf.

TABLE 7

Year	Gini Before Tax	Gini After Tax	Difference	Percent Difference
1979	0.469	0.439	0.030	6.325
1980	0.471	0.441	0.031	6.477
1981	0.471	0.442	0.029	6.233
1982	0.474	0.447	0.027	5.731
1983	0.482	0.458	0.025	5.132
1984	0.490	0.466	0.024	4.933
1985	0.496	0.471	0.024	4.860
1986	0.520	0.496	0.024	4.573
1987	0.511	0.485	0.026	5.101
1988	0.530	0.505	0.026	4.817
1989	0.528	0.504	0.024	4.592
1990	0.527	0.503	0.024	4.498
1991	0.523	0.499	0.024	4.582
1992	0.532	0.507	0.025	4.709
1993	0.531	0.503	0.028	5.207
1994	0.532	0.503	0.028	5.292
1995	0.540	0.510	0.029	5.404
1996	0.551	0.521	0.030	5.496
1997	0.560	0.530	0.030	5.368
1998	0.570	0.541	0.029	5.136
1999	0.580	0.550	0.030	5.185
2000	0.588	0.558	0.031	5.222
2001	0.564	0.534	0.030	5.352
2002	0.555	0.525	0.030	5.339

E. Summary

Designing a tax to achieve equality of opportunity for self-realization and participation in the democratic process leads to a progressive income tax. Although an annual wealth tax targets wealth—the major source of political power—valuation difficulties make it impractical. A consumption tax also does not work well because it is ineffective in curbing disproportionate political power. Very wealthy individuals consume a small percentage of their

income,[221] and a consumption tax does not generally tax investment income.[222] Thus, wealthy investors enjoy the economic and political power attributable to the placement of their wealth and the return thereon without any tax burden. A postpaid consumption tax with a progressive rate burdens investment income, but only at the time that the yield is spent in the form of taxable consumption and only if the tax rate at the time of consumption exceeds the rate at the time of investment. Thus, under a progressive consumption tax, the taxpayer enjoys the economic and political power associated with her wealth unfettered by tax while the taxpayer's investment is accruing income. Moreover, if her tax rate at the time of consumption is not greater than the rate at the time of investment, the investment income escapes taxation. In contrast, experience shows that a progressive income tax does tax investment income in the United States. Taxpayers do not appear to use the portfolio adjustments that eliminate tax on the risk return in an ideal income tax. This failure may reflect the taxpayer's aversion to the risk of ending up in a worse economic situation with portfolio adjustments than she would in a fully taxable situation because of the application of loss limitations or changes in the applicable tax rates.

V. A RESPONSE TO OTHER ARGUMENTS FOR A CONSUMPTION TAX

Section IV argued that equal opportunity for self-realization and equal participation in the democratic process should motivate the design of a tax system. A progressive income tax that burdens investment income is the best design for achieving these goals. In addition, attaining these goals may have positive efficiency effects by increasing productivity. Other equity and efficiency concerns, however, may cause one to prefer a consumption tax. The remainder of this Article addresses those major concerns. This Part does not catalogue all of the remaining equity and efficiency concerns that pertain to the choice of an income tax over a consumption tax, but instead raises issues most pertinent to this Article.

A. Equity

One argument often advanced for the consumption tax is that it does not discriminate against future consumption because

221. *See supra* text accompanying notes 160-62 (noting that wealthy individuals save a higher percentage of their income than other individuals).

222. For a discussion of situations in which a consumption tax will burden investment income, see *supra* text accompanying notes 170-84.

investment income is not burdened.[223] In contrast, because an income tax burdens the return on investment, it discriminates against saving for future consumption. Many have challenged the legitimacy of this view as an important distributive justice issue. Alvin Warren, for example, argues that it is inappropriate to determine a tax policy's fairness based on the taxpayer's expectations about future consumption, rather than on what actually has occurred.[224] Alan Gunn asserts that discounting future consumption to present value is inappropriate because timing is part of consumption:

> Suppose a taxpayer who could expect to receive a secure income of $10,000 a year for the next ten years was offered, as an alternative, a present lump-sum payment of $100,000. Ignoring any possible effects of a progressive income tax, any rational person would accept the offer, since the opportunity for an investment return makes $100,000 now worth more than $10,000 a year for ten years to anyone. But it is surely not the case that any rational person who expected to consume $10,000 per year for the next ten years and who could give up that opportunity in exchange for $100,000 consumption this year on condition he consume nothing for nine years, would accept the offer.[225]

Advocates of a consumption tax also argue that protecting investment income from taxation properly compensates taxpayers for the pain of deferring consumption. However, Professor Warren has countered that normally we ignore psychic benefits and costs in our tax system. He quips, "One might as well argue for excluding wages as merely offsetting the pain of working."[226] Marvin Chirelstein similarly asserts that citizens may have difficulty embracing the notion that a consumption tax is unfair because it discriminates between current and future consumption:

> While there is force to these arguments most Americans would have difficulty recognizing the consumption tax as superior in fairness and equity to a *broad-based income tax*. The reason for this is that people do not regard saving as an act of self-denial where high-income taxpayers are concerned, or as mere postponed consumption. In our day at least, saving generally appears to take place only after all reasonable consumption preferences have been fully satisfied, and hence sometimes appears to be the ultimate luxury. It is hard to believe that a taxpayer who finds himself at the year's end with residual income which he elects to invest in the stock market should thereby effectively reduce his obligation to pay taxes.[227]

In resolving this debate, it is helpful to ascertain how much investment income actually represents remuneration for deferring

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223. Andrews, *supra* note 175, at 1116-17.

224. Warren, *supra* note 164, at 1098; *see also* Mark G. Kelman, *Time Preference and Tax Equity*, 35 STAN. L. REV. 649, 656 (1983) (noting that the discount rate is simply "an expression of ex ante time preference, which disappears ex post").

225. Alan Gunn, *The Case for an Income Tax*, 46 U. CHI. L. REV. 370, 375-76 (1979).

226. Warren, *supra* note 164, at 1107.

227. Marvin A. Chirelstein, *Back from the Dead: How President Reagan Saved the Income Tax*, 14 FLA. ST. U. L. REV. 207, 217-18 (1986) (emphasis added).

consumption. Some have suggested that interest represents a payment for the act of deferring consumption.[228] But this is too simplistic. Interest also represents a payment to give up control of the invested capital and to undertake a risk that repayment may not occur.[229] The portion of investment income that is not paid for risk—the riskless return—represents payment for deferring consumption.[230] Because the real riskless return is 0.6%,[231] only that amount need be excluded from taxation to avoid discriminating between current and future consumption.

It hardly seems worth moving to a consumption tax to avoid imposing a tax on a 0.6% return. But if we exempt all investment income from taxation, the government would be subsidizing investors' risk return. This subsidy creates a serious equity problem. Why should the government subsidize risky investments while simultaneously taxing labor? One could rephrase the issue and ask why the government should subsidize risky investments in capital and not subsidize risky investment in labor. Is there a reason that one should be favored over the other? It could be argued that investments in labor, not capital, should be subsidized because the pain from labor losses is greater for taxpayers than the pain from capital losses. Research suggests that a 1% increase in unemployment reduces welfare significantly more than a 1% increase in inflation.[232] It is possible that up to two thirds of the welfare decrease experienced by the unemployed is attributable to nonpecuniary losses such as lower self esteem, boredom, and less structure in their lives.[233] Most important from the perspective of this Article, exempting savings from taxation conflicts with the principles of equality of opportunity for self-realization and participation in democracy.

B. Efficiency Concerns

The fact that an income tax is better than a consumption tax at establishing the conditions necessary for equality of opportunity for self-realization and participation in the political process settles only part of the debate about which tax is better. Efficiency concerns play an important role as well.

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228. IRVING FISHER, THE THEORY OF INTEREST 61-98 (1930).

229. Bankman & Griffith, *supra* note 164, at 387; Warren, *supra* note 164, at 1097-99.

230. Bankman & Griffith, *supra* note 164, at 387.

231. STOCKS, BONDS, BILLS, AND INFLATION 2006 YEARBOOK, *supra* note 164, at 93.

232. FREY & STUTZER, *supra* note 82, at 99-100; Thomas D. Griffith, *Progressive Taxation and Happiness*, 45 B.C. L. REV. 1363, 1392 (2004).

233. FREY & STUTZER, *supra* note 82, at 99-100.

Economists often measure the efficiency of a tax in terms of its "excess burden." The excess burden represents the welfare loss created by a tax that exceeds the tax revenue generated by that tax. All taxes that are based on a taxpayer's activity create an excess burden.[234] Only a lump sum tax, which is not based on the taxpayer's behavior, avoids an excess burden. An income tax always has an excess burden because it creates a disparity between the income paid to the taxpayer and the after-tax income received by the taxpayer. This difference causes the taxpayer to change his behavior from what it would be in a tax-free world. For example, a tax on wages may influence a taxpayer to work more or less hours. Similarly, a tax on savings may cause a taxpayer to save more or less. This behavioral change creates a welfare loss to the taxpayer in addition to the taxes paid[235] because the tax distorts his behavior.

The income tax imposes an excess burden on a taxpayer's decision to consume or save by taxing the return on savings. In addition, an income tax imposes an excess burden on the taxpayer's decision between work and leisure. A consumption tax, in contrast, only distorts the work-leisure decision. It does not distort the save-consume decision because it generally does not burden savings.[236] Some economists argue that, although an income tax imposes burdens on both the work-leisure and consume-save decisions, it does not necessarily impose a greater excess burden than the consumption tax.[237] Instead, they suggest that the magnitude of the excess burdens will depend on the elasticities of savings and work in response to tax.[238]

Joseph Bankman and David Weisbach argue that an ideal consumption tax is always more efficient than an ideal income tax.[239]

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234. JANE G. GRAVELLE, THE ECONOMIC EFFECTS OF TAXING CAPITAL INCOME 30 (1994); John Creedy, *The Excess Burden of Taxation and Why It (Approximately) Quadruples When the Tax Rate Doubles* 17 (New Zealand Treasury, Working Paper 03/29, 2003), *available at* http://www.treasury.gov.nz/publications/research-policy/wp/2003/03-29/twp03-29.pdf. The excess burden is a function of the elasticity of the compensated demand curve for the item being taxed and the square of the tax exclusive tax rate. The elasticity of the demand curve is, in turn, a function of the willingness of the taxpayer to substitute another item for the item being taxed. The less willing a taxpayer is to substitute the item being taxed with another item, the less elastic the item is and, as a result, the smaller the excess burden.

235. *See* HARVEY S. ROSEN, PUBLIC FINANCE 319-20 (7th ed. 2005).

236. The context in which a consumption tax can tax savings is discussed *supra* text accompanying notes 163-85.

237. *See* CONGRESSIONAL BUDGET OFFICE, REVISITING THE INDIVIDUAL INCOME TAX 46 (1983) (same); GRAVELLE, *supra* note 234, at 31 (making this point in the context of comparing a consumption tax to an income tax); MUSGRAVE & MUSGRAVE, *supra* note 18, at 451 (same).

238. MUSGRAVE & MUSGRAVE, *supra* note 18, at 451.

239. Bankman & Weisbach, *supra* note 4, at 1424.

Their argument is based on deconstructing the income tax as a tax on wages and as an additional tax on future consumption. They observe that the tax on future consumption creates an excess burden by distorting a taxpayer's choice between present consumption and future consumption. They argue, however, that the tax on future consumption also imposes an additional excess burden on work and leisure because the taxpayer "knows that each hour of effort produces fewer goods at the future date."[240] In contrast, a tax applied only to consumption, while imposing a burden on the work-leisure decision, does not distort the taxpayer's allocation between present and future consumption. They argue that the sum of the excess burdens created by an income tax has to be greater than the excess burden created by the consumption tax. The logic is that if both taxes are collecting the same amount of revenue, both are imposing the same burden on the work-leisure decision. In addition, however, the income tax also is imposing an excess burden on the consumption-savings decision because it is distorting the taxpayer's choice between present and future consumption.

Professors Bankman and Weisbach's analysis is correct for an ideal consumption tax and income tax. Usually, one cannot count the number of distortions created by tax systems to determine which is most efficient.[241] The problem is that one distortion may offset the other,[242] or the magnitude of the excess burdens may differ.[243] It seems unlikely, however, that the distortion of the work-leisure decision that arises from taxing savings will offset the distortion of the work-leisure decision attributable to taxing wages. The impact of a tax on work may cause a taxpayer to work either more (the income effect) or less (the substitution effect). No apparent reason accounts for why the effect on the work-leisure decision of taxing wages should offset the effect on the work-leisure decision of taxing savings for the same taxpayer. Moreover, because Professors Bankman and Weisbach

240. *Id.*; *see also* Alan J. Auerbach, *The Future of Fundamental Tax Reform*, 87 AM. ECON. REV. 143, 145 (1997) (arguing that the real tax burden on wages is a function of the tax burden on savings as well as wages, where a taxpayer will be consuming in more than one period).

241. Joseph E. Stiglitz, *Pareto Efficient and Optimal Taxation and the New Welfare Economics*, *in* 2 HANDBOOK OF PUBLIC ECONOMICS 991, 1023 (Alan J. Auerbach & Martin Feldstein eds., 1987).

242. Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*, 29 J. LEGAL STUD. 821, 824 n.5 (2000).

243. The magnitude of the excess burdens will depend upon the tax elasticity of work for leisure. *See* CONGRESSIONAL BUDGET OFFICE, *supra* note 237, at 46 (same); GRAVELLE, *supra* note 234, at 31 (making this point in the context of comparing a consumption tax to an income tax); MUSGRAVE & MUSGRAVE, *supra* note 18, at 467 (same).

assume that the amount of revenue collected would be the same, the excess burden on the work-leisure decision should be the same under the income tax and the consumption tax. Thus, in theory, the excess burden of an income tax has to be greater than that of a consumption tax because the income tax also imposes an excess burden on the consumption-savings decision.

In the real world, however, the excess burden imposed by the income tax may not be significantly greater than the burden created by a consumption tax. The distortion of the work-leisure decision contributed by the income tax's levy on savings may not be large. Studies suggest that individuals irrationally tend to discount future events in comparison to current events.[244] For example, consumers may discount consumption deferred for one year by 30%, while deferral beyond one year may only generate an additional 5% discount.[245] This suggests that taxpayers do not save as much as they should because they heavily discount the benefits from savings.[246] If true, a taxpayer's decision to work may not be influenced by a tax on savings because the taxpayer discounts the benefit of saving at an irrationally high level.

There are additional reasons that the excess burden may not be much greater for an income tax than a consumption tax. The excess burden of the income tax may be lower than expected because taxpayers rationally may discount the effect on wages of a tax on savings because, at the time they earn wages, they may not know whether or how much they will save. In contrast, the excess burden of the consumption tax may be higher than expected because a tax that applies only to wages will have to be higher than the current income tax in order to make up for the revenue lost from not taxing savings.[247]

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244. David Laibson, Andrea Repetto & Jeremy Tobacman, *Estimating Discount Functions with Consumption Choices over the Lifecycle* 4 (NBER, Working Paper No. 13314, 2005), http://www.nber.org/papers/w13314; David Laibson, *Impatience and Savings*, 2005 NBER REP. 6, 6, http://www.nber.org/reporter/fall05/fall05.pdf.

245. Laibson, Repetto & Tobacman, *supra* note 244, at 4.

246. David Laibson, Andrea Repetto & Jeremy Tobacman, *Self Control and Saving for Retirement*, 1998 BROOKINGS PAPERS ON ECON. ACTIVITY 91, 95-96, have argued that the large discount applied to a benefit to be received next year causes taxpayers to postpone savings. *See also* Peter Diamond & Jerry Hausman, *Individual Retirement and Investment Behavior*, 87 J. PUB. ECON. 81 (1984) (explaining the same phenomenon).

247. *See* ANTHONY B. ATKINSON & JOSEPH E. STIGLITZ, LECTURES ON PUBLIC ECONOMICS 71, 564 (1980) (noting that a tax rate applied only to wages will have to be higher than a tax rate applied to all forms of income in order to collect same amount of revenue); David F. Bradford, *The Economics of Tax Policy Toward Savings*, *in* THE GOVERNMENT AND CAPITAL FORMATION 11, 15-19, 23-24 (George M. von Furstenberg ed., 1980) (same); Don Fullerton, *The Consumption Tax: An Idea Whose Time Has Come?*, 27 TAX NOTES 435, 435 (1985) (same); Edward J.

The higher tax on wages, coupled with the irrational tendency to discount heavily savings or the rational discount of savings because of uncertainty about the extent to which there will be any savings, may mean that taxpayers would respond more strongly to the consumption tax than they do to the income tax.

Empirical studies that have attempted to measure the efficiency effects of moving from a progressive income tax to a consumption tax have not considered the issues discussed above. Nevertheless, the studies show that while, in theory, the move to a consumption tax would result in major efficiency gains, such gains disappear in the real world if transition relief is provided and the tax is progressive.[248] Part of the difficulty is that the adoption of a consumption tax will impose a burden on existing capital depending on the form of tax. In a cash flow consumption tax, investment income that has been taxed under an income tax will be taxed again when consumed. Providing transition relief for these assets decreases the efficiency of the consumption tax because it shifts the burden from consumption using old capital (the holders of which may have a low propensity to save) to new capital (the holders of which may have a higher propensity to save).[249]

In addition, if the form of consumption tax is progressive, the efficiency gains of moving to a consumption tax may be reduced.[250] The formula for excess burden illustrates this point. The excess burden is a function of the square of the tax exclusive tax rate.[251] A progressive tax with an average rate equivalent to a proportional tax always will have a larger excess burden than the proportional tax

McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145, 1170 (1992) (same).

248. *See, e.g.*, Auerbach, *supra* note 240, at 145 (observing that adoption of the USA Tax System, described *supra* note 189, which would provide transition relief and maintain the same degree of progressivity as the existing income tax, would not increase, and may decrease, economic efficiency); Alan J. Auerbach, *The Choice Between Income and Consumption Taxes: A Primer* 23-24 (NBER, Working Paper No. 12307, 2006), *available at* http://www.nber.org/papers/w12307 ("Given the transition costs of moving from one tax system to another, it could easily be the case that a small efficiency gain in moving to a consumption tax could be outweighed by the transition costs of doing so.").

249. *See, e.g.*, Eric M. Engen & William G. Gale, *Consumption Taxes and Saving: The Role of Uncertainty in Tax Reform*, 87 AM. ECON. REV. 114, 114 (1997) (describing efficiency decreases likely to occur in transition from an income tax to a consumption tax).

250. *See, e.g.*, Alan J. Auerbach, Laurence J. Kotlikoff & Jonathan Skinner, *The Efficiency Gains From Dynamic Tax Reform*, 24 INT'L ECON. REV. 81, 97-98 (1983) (noting that a progressive consumption tax that is assessed by taxing wages reduces efficiency).

251. *See supra* note 234 (citing sources that describe the excess burden as a function of the elasticity of the demand curve and the square of the tax rate).

because the rates are being squared.[252] It seems likely that a consumption tax would be progressive, given the severely disproportionate rates of consumption among the poor and wealthy. As discussed earlier, a 2004 study found that families with income over $200,000 consume only 37% of their income, while families with income below $30,000 consume all of their income.[253]

Given the uncertain efficiency costs and benefits, equity concerns should determine the design of a tax system. If equality of opportunity to participate in democracy and equality of opportunity for self-realization are accepted as the appropriate equity goals of a tax system, a progressive income tax is the better choice.

VI. CONCLUSION

Although consensus exists regarding the need for equity, academics and policymakers have failed to agree about the best tax system because we have ignored the necessity of first identifying equity goals appropriate for a just government and then designing a tax system to help achieve those goals. This Article proposes that the principal equity goal underlying a just government is the creation of equal opportunities for all citizens to achieve self-realization—that is, to maximize their potential. It proposes, therefore, that a tax should be *designed* to achieve equal opportunity for self-realization as one of its principal goals. Viewing equal opportunity for self-realization as a design issue leads to the identification of another foundational principle: the promotion of democracy. Both political philosophy and empirical literature indicate that equal access to the electoral process and participation in the community has to exist for equal opportunity for self-realization to exist. Designing a tax system to help achieve these goals not only will increase equity, but it also may provide efficiency gains that analysts have ignored.

To illustrate the importance of designing a tax system based on these equity principles, this Article revisits the debate about the desirability of an income tax versus a consumption tax. It argues that a progressive income tax that limits loss deductions is better than an ideal consumption tax in establishing the conditions for equal opportunity for self-realization and democracy. A progressive income tax that limits loss deductions burdens investment income, which is a major source of political power. In contrast, a consumption tax cannot

252. *See* Auerbach, Kotliloff & Skinner, *supra* note 250, at 97 ("[F]or any single tax, the magnitude of the distortion rises roughly in proportion to the *square* of the marginal tax rate.").

253. Burman & Kravitz, *supra* note 162, at 875.

burden the disproportionate political power of the wealthy because it only burdens investment income in narrow situations, and wealthy individuals only consume a small percentage of their total income. Although taxpayers can use certain portfolio adjustments to eliminate the tax burden on investment income in an ideal income tax, they have not done so in our actual income tax. This behavior may result from taxpayer concern that, in our actual income tax, such portfolio adjustments might decrease after-tax returns if loss limitations are triggered or if tax rates change.

This Article also analyzes other aspects of the debate focusing on the efficiency and equity claims for the two forms of taxes. The efficiency claims for an ideal consumption tax versus our existing income tax are overstated when viewed in the context of real world systems that take into account taxpayer behavior and transition relief. Given the uncertainty that there will be any efficiency gains (much less large ones) from adopting a consumption tax in the real world, the equity goals discussed herein should govern the selection of a tax system. Such equity goals favor a progressive income tax that burdens investment income.

Arbitration and Article III

Peter B. Rutledge *61 Vand. L. Rev. 1189 (2008)*

This Article is part of a broader research agenda that studies the relationship between arbitration and constitutional law. Taking its cue from the recent Canadian Softwood Lumber *dispute over the constitutionality of NAFTA's dispute resolution boards, this Article asks a broader question: Why is arbitration compatible with Article III? Under the traditional account, when parties chose to arbitrate, they waive their right to an Article III forum, thereby eliminating any Article III issue. Accounts grounded in waiver, however, fail to grapple adequately with the significant structural concerns presented by arbitration. This Article defends the need for a more robust theory, one that accounts for these structural concerns and can address the novel constitutional challenges presented by a variety of arbitral schemes, ranging from domestic employment disputes to international commercial ones. Drawing on appellate review theory, the Article proposes a bipolar matrix for assessing the constitutionality of arbitration—an approach that comports with the core principles of the theory and also enhances its explanatory value. The Article concludes by applying this modified appellate review theory to a variety of contexts in arbitration law, including international commercial arbitration and NAFTA arbitration.*

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