High Tax Heresy

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ABSTRACT

An efficient and equitable income tax offers exclusions, deductions and credits that narrow the tax base and thereby require higher tax rates than would be necessary with a broad based income tax. Base narrowing features can make the tax system more efficient by focusing collection on revenue sources that are little affected by taxation, and they can promote equity by tailoring tax obligations to individual circumstances and supporting tax rate progressivity. Economic theory does not say that an efficient and equitable income tax system has a broad base and a low rate, and in fact the theory has never said that. Experience with efforts to reduce tax rates and broaden tax bases is that reforms can easily become focused on low statutory tax rates, to the detriment of efficiency and equity.

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1. **Tax Policy and Tax Politics.**

Taxation is an economic problem drenched in politics. That this is a dangerous mixture is a common theme among critics, who in every country and era lament the state of tax policy, declare the system broken, and attribute its shortcomings to politics. One is told that the distribution of tax burdens is wickedly unfair, that the tax system creates inefficient incentives, and that the ultimate cause of these problems is that certain groups, variously including the rich, the poor, multinational corporations, small businesses, nonprofits, consumer organizations, oil companies, labor unions, agricultural interests, urban dwellers, manufacturers, service providers, and every region of the country, hold excessive sway over the politicians who draft tax laws. These special interests seek and obtain tax preferences, thereby complicating the tax system, depressing collections, and requiring higher tax rates for everyone else. To judge from the critiques, every country’s system of tax laws is deeply flawed and its reforms misguided, constantly achieving new lows.

This dismaying description of the role of politics is all too familiar to citizens accustomed to tales of dysfunctional government. It is easy to believe that one’s own tax burdens, and the difficulty the government faces in raising sufficient tax revenue, are the result of others stacking and successfully gaming the system. If not for bad politics, it seems, countries could broaden their tax bases by removing exclusions, deductions and credits, and subjecting all forms of income (so defined) to full taxation, thereby restoring a semblance of tax equity while raising revenue that could be used to reduce tax rates or finance needed government expenditures. It is easy to conclude that such a reform would also improve economic efficiency.

The image of a needlessly complex tax system riddled with unjustified loopholes makes excellent material for politicians vowing to reform the system. The prospect of a broader tax base appeals to liberals, who suspect wealthy taxpayers of benefiting from existing tax preferences, and to conservatives, to whom selective taxation smacks of social engineering. Liberals envision the government programs that could be funded without higher tax rates, conservatives the lower tax rates a broader base would afford. Indeed, the desirability of a broader tax base may be the only important tax matter on which liberals and conservatives agree.
Given this bipartisan consensus, the fact that successive governments in the United States and around the world have nonetheless failed to adopt broad based income taxation confirms the views of those largely convinced of the wretched state of national politics.

An important part of the appeal of a broader tax base stems from the tax revenue it generates without raising rates. Another is the prospect of simplifying the tax system. Tax complexity seems to many reformers both a product of tax concessions and an enabler of their proliferation by obscuring the extent to which additional concessions erode the tax base. While in other legislative contexts competing interests may neutralize each other, the effect of competitive tax lobbying can be a proliferation of tax breaks that collectively makes the system cumbersome, confusing, and inefficient, rewarding well-advised or crafty taxpayers at the expense of the meekly compliant. It would be much better, so this reasoning continues, to force legislators to enact a simple and efficient tax system that includes a comprehensive tax base from which any deviations would be evident to all.

Would it in fact be better to have a more comprehensive tax base? There is good reason to think that an efficient and equitable tax system includes an array of exclusions, deductions, credits, and other tax preferences, even at the expense of high tax rates. Comprehensive income taxation is inefficient and inequitable because it improperly treats taxpayers in different situations as though they were alike. Properly crafted, significant deviations from comprehensive income taxation tailor tax obligations to individual circumstances and raise revenue from sources that are little affected by taxation. What this means in practice is that equitable and efficient tax systems offer significant breaks to selected activities, income sources, and individuals. In order to provide adequate government finance with a restricted tax base the accompanying tax rates may therefore need to be high.

It is hardly fashionable to recommend that the income tax have a narrow base and high rates. The rallying cry of tax reformers since the 1960s, whose ranks swelled with politicians in the 1980s, is that income taxes should have broad bases and low rates. Broaden the income tax base by reducing exclusions, deductions and credits, the advocates note, and governments can raise equal or greater tax revenue with lower tax rates. An income tax with a broad base and low rate thereby promotes economic efficiency, supports a just distribution of tax burdens based on true economic income, limits the influence of special interests over the political process, and
makes it possible to raise funds sufficient to finance the government. Put this way, the case is compelling. The only problem is that it is wrong.

The conceptual foundation of a broad-based, low-rate income tax system is ironically very narrow. Modern economic analysis points consistently in the opposite direction, concluding that taxing certain types of income heavily, others not at all, and permitting deductions and tax credits that vary across activities, is considerably more efficient than taxing all income in the same manner. From the standpoint of tax equity, arguments for broad-based low-rate taxation have a demonstrated political appeal, but on inspection rely on superficial real income comparisons that contradict otherwise widely accepted cannons of equity. And in practice it has proven difficult for governments of high-income countries to raise sufficient revenue with truly broad-based income tax systems, since the economic and distributional problems they create, and others they fail to address, are so severe that only with unsustainably low tax rates is the public willing to accept even loose variants of these systems. Broad-based income taxation is popular only insofar as it is not really used.

The efficiency case for broad-based taxation starts from the perfectly correct observations that taxes discourage economic activity and that the associated inefficiencies become increasingly severe as tax rates rise. Consequently, if faced with the choice between taxing the entire population at 20 percent, or taxing a randomly selected half of the population at 15 percent and the other half at a rate (somewhat higher than 25 percent) sufficient to yield the same total revenue, an efficiency-minded government should choose the same tax rate for all. It is a short step from this example to conclude that broad bases and low rates produce the most efficient outcomes.

Why would an efficient tax system feature differentiated tax burdens, including higher tax rates on some activities and income sources and lower tax rates on others? The reason stems from the fact that taxation inevitably creates inefficiencies, since any income tax reduces incentives to earn income. Taxpayers respond to these tax incentives to differing degrees, so the art of efficient tax design entails tailoring tax burdens to collect revenue from activities that are least responsive to taxation. For example, if capital gain realizations are highly sensitive to taxation and wage and salary income much less so, an efficient tax system imposes a lower tax rate on capital gains, notwithstanding the need to tax wages and salaries somewhat more heavily.
as a result. High tax rates are likewise inappropriate for other responsive activities, such as second earner parents who might choose to stay home, or international shipping that can simply sail away. Efficient systems typically mitigate double taxation; for example, favorable tax treatment of retirement saving not only encourages saving but also avoids imposing a second layer of tax on wage and salary income that is saved for retirement. Finally, an efficient tax system encourages expenditures on goods and services that benefit others, such as R&D spending that enhances the economy’s productivity, or charitable contributions that fund socially beneficial activities.

There is a deceptive logic that starts from the observation that lower tax rates encourage greater income production. Tax preferences, such as a charitable contribution deduction, reduce the tax base and require higher legislated tax rates to generate the same tax revenue. It would be much more efficient, so a seductive reasoning goes, to eliminate preferences such as the charitable deduction and use the resulting tax revenue to pay for lower legislated tax rates, because taxpayers will respond by earning more income. Alas, this conclusion does not follow. The ability to deduct charitable contributions from taxable income lowers the tax on any additional income earned by a taxpayer who plans to contribute some of the additional income to charity. Consequently, removing the charitable deduction to pay for reducing tax rates from 40 percent to 38 percent will not encourage income production by taxpayers who give ten percent of what they earn to charity, since the tax rate on additional income prior to the reform was just 36 percent (90 percent of 40), and rises to 38 percent afterward.

While it is an unusually generous soul who gives ten percent to charity, the lesson of the example is quite general, because any reform that broadens the tax base and lowers rates while not changing total tax collections necessarily gives some taxpayers greater incentives to earn income and others less. This is the product of the inexorable logic that with a fixed national income a revenue-neutral tax reform cannot change the average tax rate of taxpayers as a whole. It is simply not possible to reduce the tax burden on additional income earned by some taxpayers, leave other tax burdens on additional income unchanged, and nonetheless maintain the same average tax rate. One naturally associates reduced headline tax rates with better economic incentives, but tax preferences also affect incentives to earn income. Paying for lower tax rates with reduced tax preferences therefore has mixed results: it discourages income production by
taxpayers who previously benefitted disproportionately from tax preferences, and encourages income production by those who previously benefitted little. Any revenue-neutral reform does some of each.

The equity problems created by broad-based income taxation are apparent once one recognizes that a dollar of income can mean something very different to taxpayers in different situations. In the United States an annual income of $15,000 is sufficient to sustain a single individual, but a family of four struggles to survive at this income level. Similarly, taxpayers with extraordinary medical expenses, heavy state and local tax burdens, costly accidents, significant childcare expenses, and other economic burdens have lower effective purchasing power than others with identical money incomes but no such burdens. An equitable distribution of tax obligations should reflect differences in real purchasing power, which requires that the tax system offer exclusions, deductions and credits that tailor taxes to individual situations.

Tax rate progressivity has enormous implications for tax equity, and an important, albeit not widely appreciated, connection to the breadth of the tax base. A family earning $300,000 a year is perceived to be capable of paying a higher fraction of its income in taxes than is a family earning $30,000, which is why average tax rates generally rise with income, a feature known as progressivity. Citizens differ in their views of the appropriate extent of progressivity, though in practice every income tax has at least some progressive features. Broad-based income taxes make tax progressivity particularly costly by insisting that income sources and activities that are highly sensitive to taxation be taxed at the same rates as all others. This is clearly inefficient, quite apart from the question of the desirable magnitude of tax-based income redistribution. Any given degree of tax progressivity can be achieved more efficiently with an income tax featuring extensive exclusions, deductions and credits than it can with a broad-based income tax. Consequently, a narrow-based income tax can be seen as an efficient method of implementing whatever tax progressivity the political system chooses.

Realistically, narrow-based income taxes that reduce the efficiency cost of progressive taxation do more than generate economic savings: they also increase the feasibility of greater tax progressivity. Due to the concentration of business asset ownership, broad-based income taxes impose the top personal tax rate on much of the economy’s capital gains, small business income, and other tax-sensitive income associated with business activity. In order to maintain incentives
for business formation and expansion, governments imposing broad based income taxes limit top tax rates, and thereby limit the extent to which average tax burdens rise with income. If not restricted to a broad-based income tax, a government concerned about changes in the distribution of income could adopt a more progressive income tax with deductions and credits for business and other economic activity that might otherwise be unduly discouraged by high tax rates.

Existing tax structures in the United States and elsewhere exhibit the connection between tax base breadth and tax progressivity. When the U.S. Tax Reform Act of 1986 eliminated the preferential tax treatment of long-term capital gains (only 40 percent of which were taxable prior to the 1986 Act), the Act also reduced the top individual income tax rate from 50 percent to 28 percent. When the government’s revenue needs subsequently mandated higher individual tax rates, a capital gain tax preference reappeared in deference to the very high economic costs of taxing capital gains, as a result of which the 23.8 percent top U.S. capital gain tax rate currently lies well below the 43.4 percent top individual income tax rate. Liberal critics commonly complain that legislated tax avoidance opportunities such as preferential capital gains tax rates undermine the progressivity of the tax system, but in most cases these concerns are entirely misplaced, since it is the favorable tax treatment of selected income sources that makes it feasible to adopt progressive tax rates. The net effect of tax preferences for investment income and other tax-sensitive income items, together with the tax rate structure they allow, is surely a more progressive distribution of tax burdens than would be available and realistic with broad-based income taxation.

Instead of taxing income broadly defined, the U.S. tax system affords favorable treatment to certain types of receipts, permits taxpayers to claim deductions for a wide variety of expenses, and offers tax credits targeted at selected activities. Employer-provided fringe benefits are generally taxable, but there are important exceptions, among them exclusions for employer-provided health insurance and pension contributions. Capital gains are not taxed until realized, and on realization long-term capital gains are currently subject to a top tax rate (23.8 percent) that is only half of the top tax rate on other sources of income. Capital investments are depreciated more rapidly for tax purposes than they are for accounting purposes. The original U.S. income tax in 1913 permitted deductions for personal interest expenses, a practice that continued until the deduction was limited in 1986 to interest expense associated with home
mortgages and home equity loans. State and local property and income taxes – or in some circumstances state sales taxes – are permitted as personal deductions. Families with children face lower tax burdens than childless families with the same incomes. Tax credits are available for expenditures on education, electric cars, first time home purchases, and certain energy-efficiency improvements; and low-income earners are eligible for tax credits based on their wage incomes. The United States does not have a truly broad-based income tax, and never has.

The international experience is similar to that of the United States, in that no country has adopted a fully broad-based income tax. One important way in which the rest of the world differs from the United States is in its reliance on value-added taxes (VATs), from which virtually every country in the world other than the United States now raises a significant fraction of its tax revenue. A VAT in its pure form resembles a broad-based sales tax, though in practice countries do not use pure VATs, instead exempting certain goods and services from taxation. More importantly, VATs are not income taxes: they are consumption taxes, from which the normal return to saving is effectively exempt. The widespread use of VATs, and the unpopularity of broad-based income taxation, reflects dissatisfaction with the latter.

Exclusions, deductions and credits that reduce the comprehensiveness of income taxation are just some of the manifestations of selective taxation in practice. Arguably the most prominent feature of income taxation in high income countries is that tax rates are progressive, meaning that they increase with income. Progressive tax rates impose light tax burdens, measured by proportion of income, on those with lower incomes and therefore the least ability to pay, and heavier burdens on those with greater ability to pay. This is a form of selective taxation, in that not all taxpayers and income are taxed at the same rate, much like other more specific adjustments that are commonly thought to narrow the tax base. The arithmetic is such that tax bases and tax rates together determine tax liabilities, making it difficult in many cases even to classify whether a given tax provision represents an adjustment to tax rates or to the tax base. Income tax systems so commonly feature progressive tax rates that tax progressivity is noteworthy only in the rare instances when it is absent. That political systems over time and around the world demand tax rate progression makes other deviations from comprehensive income taxation, in the form of exclusions, deductions and credits, understandable as measures to adjust tax liabilities according to ability to pay.
Purists lament the common failure to tax income as broadly defined and the special-interest politics they feel is responsible. There is another possibility. It may be that there is no such thing as a pure income tax, and that repeated and misguided efforts to craft one come to naught because they produce unworkable, inefficient, and inequitable tax proposals from which the political system rightly recoils. One can entertain this possibility while acknowledging that current income taxes are imperfect, with features that too often reflect the influence of special interests and the politics of the moment. But the income tax systems that governments adopt typically make allowances for differences in individual situations, offer tax benefits designed to encourage desirable activities, make accommodations to the realities of tax enforcement, and seek to collect revenue where it is feasible and efficient to do so. Purists would replace these aspects of the income tax with systems that tax on the basis of measures of comprehensive income defined without regard to differences among taxpayers or differences between the activities that generate their incomes, thereby undermining the efficiency, equity, and viability of tax collection.

Perhaps this image of comprehensive income tax advocates is too severe. Some, such as Stanley Surrey, have been careful to cast their advocacy of comprehensive income taxation as a measurement issue, identifying deviations from comprehensive income taxation, skeptically labeling them “tax expenditures,” and demanding that they be subject to special scrutiny. Others agitate for reforms that they would almost surely oppose if enacted as a package. A good politician asks for too much, hoping to make a point and settle for less. The danger inherent in this strategy is that others may take you at your word, concluding that significant “tax expenditures” or other deviations from comprehensive income taxation are per se bad policy, and that their prevalence implies that the tax system is rotten, should be abandoned, and replaced by something simpler and more austere. Short of that, well-meaning reform efforts are apt to draw selectively on identified “tax expenditures,” proposing their removal in return for deficit closure, lower tax rates, or other possible attractions, failing to acknowledge or even realize the costs of repeal. Comprehensive tax advocacy is not idle chatter.

An unfortunate dynamic sets in when governments attempt to tax comprehensive income. Lower headline tax rates are always popular, and are the political reward for removing tax preferences, so the lower tax rates themselves rapidly become the policy objective, entirely
independently of any effects they may have on tax equity and economic efficiency. In order to reduce tax rates governments remove or limit the tax deductibility of business expenses, which is inefficient, and limit worthwhile personal deductions that benefit taxpayers with exceptional needs. The pursuit of lower tax rates almost inevitably leads to measures that boost tax collections temporarily, and to the unwitting use of overly optimistic revenue forecasts. As a result, significant tax rate reductions accompanied by base-broadening reforms, such as those introduced by the U.S. Tax Reform Act of 1986, produce sizeable budget deficits that have to be followed by tax rate increases, as was the U.S. experience in 1990 and 1993. This process offers not only short run debt accumulation and policy instability, but also the danger that unwise base-broadening measures will remain in place when it has run its course.

How can it be that broad-based income taxation is undesirable, given the iconic status of the U.S. Tax Reform Act of 1986, which broadened the tax base and dramatically lowered rates? In retrospect the attractive aspects of the 1986 reform consist largely of its removal of notorious tax shelters. The additional base broadening measures introduced by the 1986 Act were there to pay for tax rate reductions, which did not advance tax policy goals, though they did facilitate passage. It is important to distinguish the elimination of unwarranted tax shelters from general base broadening, a line that was blurred even in 1986. This legislation is fondly remembered for the bipartisan cooperation in its drafting, enabling the simultaneous removal of tax shelters and many other tax preferences in return for lower tax rates. Hazy memories associate the good feelings of the 1986 Act with base broadening and tax rate reduction, whereas in fact the positive substantive contribution of the Act was to eliminate undesirable tax shelters, with base broadening and rate reduction together constituting the price the country paid for passage.

What is the alternative to a broad-based income tax? Governments can, and do, tailor income taxes to encourage certain activities such as research, environmental protection, and education. The normal return to saving can be effectively exempted from taxation by permitting taxpayers to deduct amounts saved, thereby avoiding the double taxation of labor income and very high tax rates on future consumption that result from taxes compounding over the years. The tax system can offer beneficial treatment of individuals and families in challenging situations, such as those with significant child expenses, unreimbursed medical expenses, and unusually heavy state and local tax burdens. Income produced by activities that are unusually
sensitive to taxation, such as small business or foreign income, can be taxed at low rates. And the tax system can feature significantly higher rates on the wealthy than the less wealthy, with suitable adjustment for taxpayers with exceptionally few or exceptionally many preference items. All of these are characteristics of existing taxes, though not to the extent they would be if fewer people believed in broad-based income taxation.

Ultimately it is necessary and right that the political system determine government finance; but the fact remains that an efficient, equitable, and workable system necessarily taxes something other than comprehensive income. Viewed in this light, exclusions, deductions and credits are promising signs rather than indicators that something is amiss. Of course there are unwarranted tax preferences that should clearly be eliminated, and others that should never be enacted. In order to prune the tax code appropriately it is necessary to apply sound principles, since otherwise one risks removing valuable provisions. Smart tax reform is a different exercise than crudely reducing or removing all tax preferences, and one sure sign that reform has gone too far would be the absence of any tax preferences. Public health specialists worry that cardiologists may prescribe too many heart medications, or even the wrong medications, but there would clearly be even more to worry about if cardiologists never prescribed any medications at all.

To a perhaps surprising degree the propositions advanced in this paper reflect uncontroversial research findings. This is true notwithstanding repeated and vocal advocacy of base-broadening, rate-lowering, tax reform by many tax researchers. The paper draws freely from this body of research, interpreting it generously, identifying its implications for policy, and adding just enough original analysis to warrant independent consideration. Many of the examples are drawn from the United States, but the lessons for tax policy should apply with equal force to other advanced economies.

The paper offers an understanding of the unvarnished realities of tax policy. There are those who worry, in this context and others, that the truth is too complicated or dangerous a message to share with policy makers. Much better, so their thinking goes, to offer a simple, appealing, and hopefully not too inaccurate version of the truth, since the alternative is to expose policy makers to complications and subtleties that might empower them to make disastrous decisions. If one confesses, even insists, that taxation should be selective, taxing some activities,
income sources, and individuals more heavily than others, then what is to prevent legislators from dropping all restraints, enacting generous tax breaks for the powerful and well-connected, in the process undermining tax equity, efficiency, and perhaps even the legitimacy of the political process? Given the realities of special interest politics in democratic societies, is it not better to stretch the truth in the direction of supporting a system that, while inefficient and inequitable, at least seems to push against the worst political tendencies?

This is of course a very different argument than that usually advanced in favor of comprehensive taxation, but nonetheless cannot be lightly dismissed. The world of political realities knows no hard and fast rules, so it is conceivable that deceptive advocacy of bad policies might, in this twisted universe, produce the best feasible outcomes. But there are many reasons to think otherwise, notably including all the reasons why one prefers democratic government in the first place. Deliberations over how best to reflect shared values in tax legislation are unlikely to produce satisfactory outcomes if they start from false premises. Furthermore, the secret is at least partly out, as evidenced by the taxes we have. The U.S. Congress has discovered that the world does not end – in fact, the world works better – when it deviates from comprehensive income taxation. With a better informed and more systematic approach to what Congress already intuitions there is an opportunity to improve on the efficiency and equity of existing taxes. Tax policy truths are valuable not only as a matter of aesthetics but also because they are instrumental to better outcomes.

The unspoken presumption of most tax policy analysis is that society wants better and not worse taxation. Strange to say, this is not guaranteed. Some who oppose big government or tax-based redistribution prefer inefficient taxes, on the theory that costly taxation reduces the size of the public sector and the extent of tax progressivity. Others who favor big government or more extensive income redistribution might embrace any new taxes, and defend existing taxes, however poorly designed, if they appear to raise sufficient revenue, particularly from affluent taxpayers. These are dangerous gambits with uncertain payoffs, played against a background of highly indecisive evidence of the relationship between tax structure and government size. Enacting taxes that further political goals other than efficiency and equity guarantees that, barring remarkable luck, the outcome will not be as efficient and equitable as might otherwise have been the case. Bad tax policies are certainly costly, whereas the potential benefits of using
these costs to influence other government decisions are far more ephemeral, notwithstanding the convictions of advocates. This essay first addresses the conventional question of how best to finance a given set of public expenditures. It then moves to the more complicated question of how to reconcile good tax design with the realities of democratic governance.

Arguments advanced in support of comprehensive taxation invite skepticism. So these arguments go, comprehensive taxation is equitable because taxpayers with equal resources are taxed equally; it is efficient because it neither encourages nor discourages particular activities; and it controls the worst tendencies of the political system by reducing the potential to manipulate the tax code to favor special interests. It would be amazing for a single system simultaneously to achieve so many social goals. The history of comprehensive tax advocacy, discussed at greater length in the next section, is that an equity argument in favor of comprehensive income taxation subsequently expanded to encompass efficiency and political economy. The difficulty with all of these arguments is that they make the most sense when taxpayers are identical – which is a setting in which the equity and political issues disappear. Once one acknowledges that taxpayer circumstances differ, and that taxation creates inefficiencies under any circumstances, then the case favoring comprehensive income taxation starts to dissolve.

Utopian tax reform has a timeless quality. This is true of the comprehensive income taxes advocated by Robert Murray Haig and Henry Calvert Simons in the 1920s and 1930s; and it is also true of Henry George’s (1879) Single Tax (on the value of unimproved land) in the 1870s, Robert Hall and Alvin Rabushka’s 1980s Flat Tax (a 15 percent tax on wage and salary income only), the Fair Tax (a 23 percent broad-based sales tax), and others.¹ These reforms would introduce taxes with provisions that do not change subsequent to adoption, except possibly for upward or downward rate adjustment to pay for varying levels of government spending. Part of their popular appeal is the simplicity of their systems, and the apparent absence of opportunity for political manipulation.

Why would a good tax system have unchanging features? Over time economies globalized; production moved from agriculture to manufacturing to services; computers revolutionized production and markets; women entered the work force and children left it; incomes grew and become less equal; interest rates rose and fell; there were depressions and recessions, wars and other calamities. It strains credulity that only tax rates, and not anything else about the tax system, should change in response to these and hundreds of other developments. Yet if one acknowledges that more than just tax rates should adapt to changing economic and social conditions, the logical implication is that the tax system at any given time should be a function of prevailing economic and social conditions, and not the sterile and timeless ideals of utopian reformers.

Tax policy, however well-conceived, cannot simultaneously satisfy every social objective. Tradeoffs are inevitable, entailing sacrifices of each of equity, efficiency, and administrability in order not to sacrifice any of the others too greatly. In well-run democratic societies the legislatures choose tax policies, thereby implicitly or explicitly attaching weights to equity, efficiency, administrability, and possibly other considerations. This job may be performed well or poorly, but there is little question that the legislature must perform it, and that in so doing it is necessary to decide just how important different equity considerations are, and how much efficiency should be sacrificed in order to satisfy them. This is inevitably, and rightly, a political determination, one that is sensitive to current conditions as well as the need to make credible commitments to the future and adhere to credible commitments of the past. This process defies encapsulation in an unchanging tax formula, even while it rewards adherence to sound, and largely unchanging, principles.

Wise legislative principles, including tax principles, are sensitive to the realities of political processes. Politicians rightly feel that they must meet the needs of their constituents, so it is unrealistic to expect inaction in the face of significantly changed circumstances. Following the terrorist attack of September 11, 2001 the U.S. stock market fell dramatically and the U.S. Congress, concerned about economic repercussions of the attack and eager to encourage investment, introduced “bonus depreciation” that permitted firms to take an extra immediate deduction of 30 percent of new equipment expenditures. Rapid deduction of investment expenses stimulates investment, so even though bonus depreciation is inconsistent with
comprehensive income taxation and with the philosophy of U.S. business taxation following the 1986 tax reform, its introduction was a sensible reaction to the economic conditions that suddenly confronted the country. A government that had previously committed not to deviate from comprehensive income taxation would have faced the difficult choice of how best to respond to the need to stimulate the economy, and might have been driven to take other fiscal, monetary, or regulatory actions – or, more likely, to disregard its prior commitment. Inaction was not a realistic option.

A major terrorist attack on the United States is an unusual and particularly striking event, but other, less dramatic, developments may even more pressingly demand tax policy responses. The income distributions of high-income countries have significantly widened in recent decades as returns to highly skilled workers have risen while returns to less-skilled workers have stagnated or fallen. This trend is extremely costly from the standpoint of the welfares of low-income families. Furthermore, the resulting disparities in the lifestyles and economic prospects of the rich and the poor threaten social cohesion and possibly even the robustness of capitalism, as absence of opportunity for children in low-income families impairs the ability of the market system to find and successfully develop significant pools of talent.

Tax policy can be used to mitigate some of the direct effects of changes in income distribution by lightening the burden on low-income families and raising a higher fraction of tax revenue from the rich. Targeting tax benefits to the most needy requires a nuanced system that reflects that not all families have the same needs, nor are they affected by modern trends to the same degree; furthermore, significant tax progressivity is possible only with selective and efficient taxes that burden more heavily activities and individuals whose behavior is least affected by taxation. And direct redistribution through the tax system is only the beginning. Tax incentives to encourage and make feasible greater education and training, business development, and research that enhances worker productivity, to name just a few opportunities, offer the prospect of pushing back against recent trends. Almost any tax reforms that make the system more efficient have the potential to help address growing inequality by making it less costly and therefore more feasible to finance government expenditures on schools, infrastructure, health care provision, social welfare programs, and other efforts directed at improving the prospects of families most challenged by recent developments.
A policy that can effectively fund government operations and mitigate changes in income distribution has obvious appeal to liberals, but conservatives can also take heart from the greater efficiency offered by selective taxation and its transparency about the cost of the public sector. Government is expensive, hence it is tempting for those in government to obscure the costs by avoiding high tax rates, instead financing new government expenditures and even deficit closure with base broadeners and other gimmicks. Voters make no secret of their visceral dislike of high headline tax rates. If Congress made itself pay for additional expenditures with higher legislated tax rates, and rewarded itself for spending reductions with reduced tax rates, its appetite for some spending projects might diminish considerably. In a well-functioning democracy this dynamic makes Congress politically accountable for its spending and incentivizes sensible decision making.

These are vital issues. Governments that tax unfairly and inefficiently impose needless burdens on their own populations and impair their own abilities to obtain resources that might otherwise be deployed to socially productive ends. Taxes are central to everything that governments do. Legislatures devote enormous fractions of their time and effort to debating and crafting tax policies, in part fighting over who should pay, and in part wrestling with the knotty issues of how best to design a tax system in the modern world. Despite the abundance of controversial political elements there are better and worse tax systems, with known and knowable differences between them. Much of the tax policy challenge lies in forging consensus over the type of tax system that most fairly and efficiently advances national goals, while disregarding the siren calls of superficially appealing alternatives.

2. Comprehending Comprehensive Taxation

The earliest taxes consisted of whatever levies strongmen could most effectively impose. With the advent of democratic government taxation came to require consent – which, as many generations of frustrated leaders can attest, is far from automatic. By the time of the American Revolution western governments were financed largely by tariffs (taxes on imports), property taxes, and excise taxes (taxes on sales of specific goods, such as alcohol and tobacco), all of which are still used, but none of which currently constitutes a big portion of national government
revenues. Modern tax revenues come largely from income, payroll, and (in countries other than the United States) value added taxes.

Great Britain introduced the first modern income tax in 1799 to finance its war with Napoleonic France. Intended as a temporary gesture, the British income tax was suspended in 1802, reintroduced in 1803, abolished in 1816, and reinstated on a permanent basis in 1842. The United States introduced its first income tax in 1862 to finance the Civil War, repealed the tax in 1871, and reintroduced it in 1894. The following year the U.S. Supreme Court found the income tax unconstitutional, so the country adopted its income tax on a permanent basis only following ratification of an enabling constitutional amendment in 1913.

Early British and American income taxes served largely to supplement the main sources of government revenue, which were tariffs and excise taxes. The early income taxes seem quaint by contemporary standards, the 1913 U.S. income tax bruising U.S. taxpayers with a one percent tax and softening the blow with a hefty $3,000 personal exemption that guaranteed that very few Americans owed any tax. The original U.S. income tax featured surtaxes for the wealthy and very wealthy, the top tax rate of seven percent applying to the small number of taxpayers (it may have been only one) with taxable incomes exceeding $500,000. U.S. income tax rates rose dramatically during the Second World War, the top rate reaching 94 percent, and while rates subsequently fell, they did so gradually, and for most taxpayers never returned to their much lower prewar levels. The top U.S. personal income tax rate was 91 percent as late as 1964, at which point the Kennedy/Johnson tax cut reduced it to 70 percent, where it remained until 1981, when a tax cut enacted by the Reagan administration reduced it to 50 percent. The Tax Reform Act of 1986 lowered the top personal income tax rate to 28 percent, but by 2016 it had climbed back to 39.6 percent. Income-based medical insurance taxes add another 3.8 percent, bringing the total to 43.4 percent.

The long-run rise in tax rates over the first 100 years of the income tax broadly reflects the growing role of the federal government in U.S. economic life: U.S. federal government expenditures were 3.7 percent of national income in 1928, and 20.6 percent in 2013. Against this background, shorter term fluctuations in tax rates were compensated for by changes in taxes other than income taxes, changes in the base of taxable income under the income tax, and changes in government spending and borrowing.
As its name suggests, income taxation entails taxing income – a deceptively simple formulation, since on close examination the notion of “income” embodies many ambiguities. Section 61 of the U.S. Internal Revenue Code offers an only partly helpful self-referential definition of taxable income as “all income from whatever source derived,” the contribution of which is to clarify that “all” income is to be included. Taxable income is generally defined on a net basis, difference between gross revenue and deductible expenses. This notion is intuitive: a shop owner with annual sales of $100,000 and expenses of $60,000 has taxable income of $40,000, since the business produces $40,000 of purchasing power for the owner, notwithstanding the much greater $100,000 of sales. The significance of the net notion of taxable income is that in order to calculate income it is necessary to determine both includable revenue and deductible cost.

What constitutes taxable income in practice? On the inclusion side there are obvious components of taxable income, among them wages, salaries, and other compensations for working; various forms of small business income; dividends, capital gains, and interest, rent and royalty receipts. Taxable income includes employer-provided fringe benefits, such as use of a house or car, since otherwise an obvious tax dodge would be available if employees were paid largely in kind – though there are legislated exceptions in the United States that exclude from taxable income employer-provided health and life insurance (subject to limits), and defer taxation of pension contributions until pensions are received in retirement. Taxable income includes windfalls, gambling income, cancellation of indebtedness income, annuities, alimony receipts, and indeed “all” realized income other than that which is explicitly excluded.

From its inception the U.S. income tax permitted a deduction for interest expense, though in 1986 the interest expense deduction was limited to interest on mortgages and home equity loans. Individuals are permitted to deduct charitable contributions, state and local taxes, excessive medical expenses and casualty losses, and various educational and other expenses. Business expenses are properly deductible, though curiously since 1986 certain expenses associated with income-earning activities are deductible only to the extent that they exceed two percent of income. The availability of a significant standard deduction means that roughly 70 percent of taxpayers elect not to claim available itemized deductions, thereby making these options unimportant from the standpoint of their tax situations. More generally, the tendency of
the U.S. Congress and courts has been to treat deductions somewhat differently, and less
generously, than inclusions, notwithstanding the decidedly symmetric nature of these two
components of income. In an influential 1934 case (New Colonial Ice Co., Inc. v. Helvering)
the U.S. Supreme Court opined that “whether and to what extent deductions shall be allowed
depends upon legislative grace; and only as there is a clear provision therefor can any particular
deduction be allowed.” This dependence of deductions on legislative grace contrasts with the
inclusive nature of taxable income under Section 61, creating some situations in which taxpayers
are taxed on income without the ability to claim deductions for the costs of earning the income.

2.1. Comprehensive income taxation.

Comprehensive income taxation emerged as an ideal in the early days of income taxation
in part to distinguish the new tax concept of income taxation from more transactional taxes such
as tariffs, which applied only to imports, or excises, which were taxes on very specific items.
The comprehensive income tax concept is most often associated with Robert Murray Haig and
Henry Calvert Simons, who wrote in the 1920s and 1930s, though these two were preceded by
continental European writers, notably including Georg Schanz, and out-named by Edwin Robert
Anderson Seligman.2

Early writers, legislators and judges struggled with how to define income for tax
purposes, and in this endeavor were untroubled by optimal tax considerations such as designing
the income tax in a way that might, to the extent possible, avoid discouraging desirable income-
producing activity. In fairness, the modern optimal tax literature did not then exist. Slavish
devotion to the works of Haig and Simons therefore entails disregarding what has been learned
since the 1930s, and it is fair to ask whether Haig and Simons, who were both thoughtful and
learned scholars, would fail to update their own views in light of subsequent conceptual and
practical developments.

The comprehensive income tax idea is, as the name suggests, the notion that all income
should be subject to taxation. The art lies in the definition of “income.” Haig felt that an

2 Their most noteworthy contributions were: Robert Murray Haig, The concept of income – economic and legal
aspects, in Robert Murray Haig et al. eds., The Federal Income Tax (New York: Columbia University Press, 1921); Henry
Calvert Simons, Personal Income Taxation (Chicago: University of Chicago Press, 1938); Georg Schanz, Der
Einkommenbegriff und die Einkommensteuergesetze, FinanzArchiv, 1896, 13 (1), 1-87; Edwin Robert Allen
appropriate concept of taxable income was an individual’s command over economic resources, however the command was exercised. Thus, someone who earned a salary of $80,000 and spent $50,000, saving the remaining $30,000, would be taxed on the entire $80,000.

Simons similarly defined an individual’s taxable income as available resources, defining this notion as the sum of annual consumption plus change in net worth. In the case of an individual with a salary of $80,000 and expenditures of $50,000, this corresponds to the same taxable income as in the Haig definition: consumption plus the change in net worth is really consumption plus net saving. The Simons definition of income goes further, however: it explicitly includes in taxable income unrealized capital gains, windfalls and gift receipts. Of these, most modern income tax systems, including the U.S. system, tax windfalls while excluding unrealized capital gains and gift receipts.

Why tax consumption plus the change in net worth? Simons notes that this sum equals the annual change in a taxpayer’s ability to spend, and Simons was concerned that failure to tax on the basis of ability to spend could undermine the social contract that serves as the foundation of a capitalist economy. His proposition about the social contract is of course debatable, and very possibly influenced by U.S. conditions in the 1930s – and even in the context of the 1930s it is not clear to what extent social norms dictated taxation of gift receipts, unrealized sources of income, and all other used or unused opportunities to finance expenditures.

Simons and other early income tax advocates were considerably less concerned about the incentive effects of taxation than have been more modern writers. Virtually all of their arguments favoring comprehensive income taxation dwelt on equity issues, arguing in passing and with some justification that existing studies of the effects of income taxation on economic activity failed to demonstrate significant taxpayer responses. We have more studies now. By 2016 it is apparent that income taxation discourages income earning, and indeed every component of income earning, including labor supply, human capital accumulation, saving, investment, and the timing of economic activity. Consequently, it is necessary to incorporate anticipated taxpayer responses in designing income taxes.

2.2 The tax expenditure budget.
The tax expenditure budget was the brainchild of Stanley Surrey (1910-1984), longtime Harvard Law professor and from 1961-1969 a central figure in U.S. tax policy as Assistant Secretary of the Treasury for Tax Policy. Surrey fretted that carve-outs too greatly diminished the U.S. tax base, depressing collections, creating inefficient incentives, and breeding inequality. He noted that certain tax benefits share many attributes of spending programs. For example, one can conceive of the charitable contribution deduction as being akin to direct government sponsorship of nonprofit activity. Instead of permitting a taxpayer a deduction worth $1000 for a contribution to a local teaching hospital, the government might instead have denied the deduction and given the resources to the hospital directly. If the taxpayer, now bereft of the deduction, consequently reduced his contribution to the hospital by $1000, the outcome in terms of final resource allocation would be identical to the first case.

There is much that can be said about even this simple example, including that it is far from certain that the taxpayer would in fact reduce his charitable contributions by exactly $1000. But Surrey’s point that preferential tax treatment does much of the same thing as direct government expenditure is quite general, and examples abound. Thus, the Research and Experimentation Tax Credit, through which taxpayers can receive tax credits equal to 20 percent of qualifying research and development expenditures exceeding rather complicated thresholds, functions analogously to direct government sponsorship of research through the National Science Foundation; the Earned Income Tax Credit acts much like a welfare program in supplementing the wages of low-earning workers with children; the favorable tax treatment of low income housing has many of the same effects as spending on low income housing; and there are many other analogies of varying degrees.

Surrey found release in the formation of the Tax Expenditure Budget, a compilation of dollar “expenditures” corresponding to favorable tax treatment of various activities and income sources. Thus, in 2015 the U.S. tax expenditure for non-taxation of employer-provided health insurance was $207 billion; the tax expenditure for favorable tax treatment of capital gains was $158 billion; the tax expenditure for permitting deductions of state and local taxes was $83 billion; home mortgage interest came in at $74 billion; the exclusion of interest on state and local bonds was $35 billion; and there were many others, including $76 billion for deferral of U.S. taxation of foreign income.
What constitutes a tax expenditure? In Surrey’s formulation it is a deviation from standard income tax principles, roughly along the lines of Haig-Simons taxation, though notably excluding the taxation of gift receipts or unrealized capital gains. A charitable way of describing Surrey’s position is that he felt that tax expenditures would benefit from the same degree of scrutiny afforded ordinary spending programs, though a perhaps more realistic way of describing his position is that he would wish most tax expenditures to disappear.

There is much that can and has been said about the tax expenditure budget, much of it critical, but the practical reality is that the U.S. and many other governments around the world continue to compile these budgets. There is little apparent per se effect of a tax expenditure budget on tax expenditures, though the missionary zeal that motivates the compilation of tax expenditure budgets may also be responsible for episodic efforts to broaden tax bases by reducing tax expenditures. Certainly the aggregate magnitude of tax expenditures serve as talking points for low-rate, broad-based tax advocates on all sides of the political spectrum.


The high water mark of the comprehensive income taxation movement in the United States was passage of the Tax Reform Act of 1986. Nobody doubts that the 1986 Act was important; it made such sweeping changes to U.S. tax laws that the formal name of the body of U.S. tax laws became, and remains, the Internal Revenue Code of 1986.\(^3\) The crafting and passage of the Act is fondly remembered by almost every U.S. tax specialist, including some who are too young to have been engaged in, or even aware of, tax reform at the time, but whose current participation in the tax community so infuses them with the warm feeling of happier days of bipartisan national reform directed at the common good that memories blur and we were all present at the creation.

The 1986 Act is remembered for significantly reducing individual and corporate statutory tax rates, paying for the rate reductions by eliminating deductions, exemptions, and credits, thereby greatly broadening the tax base. The broad-base, low-rate reform mantra had irresistible appeal in 1986 just as it does today, and many take the 1986 experience to be a model, albeit perhaps unattainable, for current U.S. reform efforts.

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\(^3\) Its prior name was the Internal Revenue Code of 1954.
Daunting though it is to swim against this tide of happy opinion, it may be that the collective memory greatly misinterprets the Tax Reform Act of 1986. The Act’s successes do not stem from its broad bases and low rates, but instead from its elimination of loopholes that favored certain very specific activities, income sources, and industries. It is undoubtedly true that the 1986 Act broadened the tax base, but many of these base-broadening measures sacrificed efficiency and equity at the altar of lower statutory rates. Furthermore, the lower statutory personal income tax rates introduced by the 1986 Act solidified and if anything accentuated the distributional consequences of the huge tax reductions of 1981 (as subsequently modified in 1982 and 1984), which moved the U.S. tax burden significantly away from higher income taxpayers.

The Tax Reform Act of 1986 was designed to be revenue neutral, meaning that its overall effect was not to change total federal tax revenues, even while reducing individual income tax liabilities by $120 billion over five years and imposing a compensatory increase on corporations. The Act greatly lowered personal income tax rates, with the top personal rate declining from 50 percent to 28 percent, and rates on lower incomes declining as well. The Act simultaneously lowered the top corporate income tax rate from 46 percent to 34 percent, which together with the decline in personal income tax rates required vast base broadening in order to achieve overall revenue neutrality. Some of the base broadeners were desirable reforms, albeit decidedly unpopular among affected parties. What made passage of the Act politically feasible despite determined opposition by taxpayers who would be adversely affected was that the lure of lower tax rates together with the shared sense that comprehensive reform would be in the national interest ultimately generated sufficient momentum that wavering parties jumped on board to obtain the benefits of minor compromise rather than get run over and receive nothing.4

What drove this train were the lower tax rates promised by the Act. The cost of lower tax rates was that any and all sources of potential tax revenue became fair game if they could generate revenue that facilitated rate reduction. Another cost was that the only way to get tax rates sufficiently low to attract the necessary political support was by promising more than the

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Act could deliver. The U.S. government was running significant budget deficits in the mid-1980s, and the 1986 Act, which was presented as being revenue neutral, in fact lost money both in the short run and in the steady state. As a result ensuing tax legislation was necessary to close deficits, including two very large income tax increases, one in 1990 and a second in 1993.

Many of the base broadening reforms of 1986, notably including repeal of the favorable treatment of capital gains, repeal of the investment tax credit, and introduction of much less generous depreciation of capital expenditures, had the effect of increasing the taxation of capital income. It is ironic that 1986 was also the year in which Christophe Chamley published his very influential study calling attention to the inefficiency of taxing capital income.\(^5\) The Tax Reform Act of 1986 offered much more than capital tax increases: as noted earlier, the Act limited the ability of taxpayers to take deductions for expenses incurred in the course of income-earning activities; and the Act included many measures designed to obtain revenue from specific sources, including greater taxation of foreign income. While cast in comprehensive tax terms, the thinly veiled goal of these revenue enhancing provisions was to finance statutory tax rate reductions.

3. **Efficiency-Based Arguments for Comprehensive Income Taxation.**

Beyond the cosmetic appeal of affording lower statutory tax rates, broad tax bases are commonly thought to promote both economic efficiency and distributional equity. Further reflection should make one skeptical. It is almost impossible for a single system simultaneously to offer efficient incentives and optimal distributional outcomes, since differences between the two objectives imply that only by remarkably fortunate coincidence could they both be maximized by the same set of tax rules. This section considers the effect of comprehensive income taxation on efficiency, and section 4 addresses its impact on tax equity.

3.1. **Marginal tax rates.**

The efficiency justification for a broad tax base has two components, the first of which is that the accompanying lower tax rates reduce disincentives to earn income, and thereby mitigate the harmful economic effects of taxation. An income tax system with a 50 percent tax rate and a

relatively narrow base discourages the production of additional income by permitting taxpayers to keep only half of what they earn, a problem that might appear to be considerably less severe under an income tax system that raises the same tax revenue with a much broader base and an accompanying 25 percent tax rate.

As noted in the first section, this efficiency observation is clearly incomplete, in that it ignores any incentives created by the favorable tax treatment of certain activities and expenditures in the tax system with higher rates and a narrower base. The example of the charitable deduction – that it encourages the production of income, a portion of which will be contributed and therefore produce a tax deduction – is broadly characteristic of base narrowing income tax provisions. Deductions for state and local income taxes reduce the extent to which marginal income is subject to taxation; mortgage interest deductions reduce the cost of homeownership, making income production more valuable because some of it is used for home purchases; and exclusions for employer-provided health and retirement benefits increase the value of whatever portion they represent of marginal compensation. Favorable tax treatment of any item of income or expenditure effectively lowers tax rates on marginal income.

These examples illustrate a simple and much more general point, which is the impossibility of raising the same tax revenue with uniformly lower marginal tax rates applied to a given distribution of pretax income. Higher tax rates generate greater tax revenue, and lower tax rates generate less tax revenue. While some confusion is created by the fact that total tax obligations are functions of average rather than marginal rates, it remains the case that it is simply not possible to reduce marginal tax rates while leaving the average tax rate unchanged. Hence in order to satisfy revenue neutrality, base-broadening tax reform that lowers some marginal tax rates must raise others. Whether such a reform would increase or reduce the efficiency of the economy depends on whether the marginal rates that rise do more or less aggregate harm than the marginal rates that fall confer aggregate benefits. This, in turn, depends on the precise nature of the tax reform and the responsiveness of income earning to marginal tax rates at different points in the income distribution. In the case of the Tax Reform Act of 1986, the reform was intended to be revenue neutral and not to change the distribution of tax liabilities between different income groups. It is clear from these features that if there were only one kind of income – labor income, say – and the Act were perfectly designed not to change the
distribution of tax burdens, then the 1986 Act would have no effect whatsoever on incentives to earn income, since average tax liabilities at every point in the income distribution would be unchanged, and therefore marginal tax liabilities associated with transiting between different income levels would also be unchanged. In fact, there are multiple types of income that were affected quite differently by the Tax Reform Act of 1986, though since many of the revenue raisers were imposed on capital income, the production of which is notoriously sensitive to taxation, it may well be that the Act reduced incentives to earn income.

Average tax rates are determined by government revenue needs, which are in turn functions of government spending. If one takes government spending to impose tax collection requirements, then it is not possible to produce a tax reform that uniformly lowers marginal tax rates. The only potential escape from this harsh arithmetic lies in the “Laffer Curve” – the phenomenon that high tax rates may so discourage income production that in certain cases governments might actually be able to raise more revenue with lower tax rates than with higher tax rates. This possibility is quite real, but is generally thought not to have much practical application in places such as the United States, since governments of modern high income countries typically do not adopt tax provisions that are so wildly inefficient that greater revenue could be obtained with lower tax rates.

What if the government were to eliminate or reduce some deductions or exemptions, using the revenue thereby generated to lower all statutory marginal tax rates? As the charitable contribution example illustrates, tax deductions for activities that accompany greater income production effectively reduce marginal income tax rates, from which it follows that eliminating or shrinking these deductions increases marginal tax rates – but what about deductions or exemptions that are unrelated to income? The U.S. government might, for example, consider reducing the personal exemption from its current roughly $4,000 level to say $2,500, using the savings to reduce statutory marginal tax rates. Quite apart from how one evaluates its effect on income distribution, the contemplated reform significantly increases the marginal tax rates of low-income families whose tax obligations, and marginal tax rates, were zero prior to the reform, and become positive afterward because they find themselves in the first (positive) tax bracket. Furthermore, for taxpayers whose average tax rates change, the reform would affect marginal decisions that are functions of average tax rates, such as retirement decisions.
In evaluating the impact of deductions and exemptions on economic activity it is tempting to focus on high-income taxpayers who pay the bulk of the taxes and whose marginal decisions often consist of whether to take actions that would trigger taxation of additional dollars of income. If it were possible to leave their average rates unchanged while reducing marginal rates, such a reform would clearly increase the efficiency of the tax system. If everyone in the economy had an income of $100,000 or greater it would be possible to reduce marginal income tax rates by increasing the taxation of income up to $100,000 and reducing marginal tax rates above $100,000. But with a distribution of taxpayers at every conceivable income level, increasing the taxation of income up to $100,000 not only increases marginal tax rates on lower-income taxpayers but increases their average burdens as well. It is only by using head taxes or demogrants—lump-sum taxes or transfers that are arguably not income tax instruments at all—that governments can change average income tax rates without affecting marginal income tax rates, and greater use of head taxes to reduce marginal tax rates has seriously adverse distributional consequences for low-income taxpayers.

There is a separate question, to which the analysis will return, of the extent to which higher marginal tax rates at certain points in the income distribution might or might not advance distributional or efficiency goals. One of the serious concerns about high tax rates stems from a cost of tax-induced distortions that rises roughly with the square of the tax rate, so that a marginal tax rate of 40 percent does roughly four times the economic damage of a marginal tax rate of 20 percent. But any effort to reduce one taxpayer’s marginal tax rate entails higher marginal taxation of another. There are circumstances in which it is well worth reducing high marginal tax rates, and thereby avoiding some of their extremely distortionary effects, but the benefits must be weighed against the distributional and efficiency consequences of higher taxes imposed on other taxpayers, particularly those with low incomes. The fundamental point is that in the absence of head taxes or demogrants any apparent opportunity to broaden the tax base and thereby reduce marginal tax rates across the board in a revenue-neutral way is simply a mirage.

2.2. Distorted incentives.

The second component of the efficiency argument in favor of a broader tax base and lower tax rates is that a broader tax base affords equal tax treatment of different activities. This is thought to be desirable because the alternative is differing tax treatments, which encourage
activities that are taxed lightly at the expense of those that are taxed in full. Since a broad tax base subjects all sources of income to the same treatment, is it not more efficient?

In a word, no. Any kind of income taxation discourages income production, so efficient design of an income tax system entails finding the least distortionary way of raising revenue, acknowledging that some degree of inefficiency is inevitable. Since the publication of Frank Ramsey’s famous 1927 study it has been understood that properly differentiated commodity taxes raise revenue more efficiently than do single-rate broad-based sales taxes,⁶ and the same logic applies to income tax differentiation. The second-best nature of the taxing problem implies that it is efficient to tax income generated by relatively price-insensitive activities more heavily than income generated by price-sensitive activities. Furthermore, efficiency is enhanced by taxing heavily activities that generate negative externalities, such as harmful pollution, and taxing lightly or subsidizing activities that generate positive externalities, such as charitable contributions. And scholarly work of the last 30 years has forcefully argued that efficient tax systems have much lower, possibly zero, tax rates on capital income than they do on labor income, reflecting the compounding of capital taxes over time and the inability of taxpayers to deduct the opportunity cost of saving and investing.

This is not to say that any sort of tax differentiation is desirable, and the current U.S. income tax certainly contains some provisions that favor interests or activities with strong political advocates but little else exceptional to recommend them. In the textbook example of taxing labor income earned in two different occupations, both of which are equally agreeable to workers, both of which produce substitute outputs, and neither of which is associated with significant externalities, it would be inefficient to favor income from one over income from another. An example would be taxing income earned on two adjacent corn farms in Iowa: if the government were to tax wages paid by one of the farms more lightly than wages paid by the other, then the employer whose workers were more lightly taxed could offer lower pretax wages and nonetheless hire more workers, whereas the other employer would need to offer higher wages in order to hire fewer workers. The production process is distorted both by a relative shrinkage of output on the farm with more heavily taxed workers, and by tax-induced differences in the labor intensities of the two farms.

Clearly there is no point in arbitrarily distinguishing the tax treatment of equivalent forms of income, though what is perhaps most striking about the corn farm example is its fragility. If one farm offers the same cash wages as the other farm, together with more pleasant and convenient employment, then its workers effectively receive greater compensation, presumably because their greater productivity commands it, and they should efficiently (and equitably) be subject to higher taxes. If one farm produces corn and the other produces a unique type of vegetable that is consumed locally by consumers with inelastic demands, then there may be an efficiency rationale for taxing income earned on the two farms differently, based on elasticities of supply and demand in their respective final goods markets that affect the elasticity of demand for labor. If the farms are corporations whose profits are subject to the corporate income tax, and the corporations have characteristics (such as tax loss carryforwards) that distinguish their tax situations without impacting their employment conditions, then too there are circumstances in which differential taxation of labor income earned from these employers can be more efficient than uniform taxation. And if externalities are implicated – if, for example, runoff from one of the farms pollutes a nearby stream – then in the absence of other corrections it is more efficient to tax more heavily income earned on the polluting farm.

Activities that damage (or help) the natural environment, or promote economic activity through productivity spillovers, are textbook cases of externalities that cause inefficiencies the tax system can correct, but there is considerable scope for corrective tax treatment of many other daily activities. Gratuitous transfers offer an instructive illustration. Gifts are doubly blessed: they benefit recipients, and they also benefit transferors, who enjoy the good feeling that comes from assisting others and knowing that they benefit. An uncle who transfers $1,000 to his nephew presumably obtains at least $1,000 worth of satisfaction from doing so, or else the money would have found another use. The point, however, is that the $1,000 transfer also directly benefits the nephew, so adding the uncle’s satisfaction together with that of the nephew produces a minimum of $2,000 of value from the transfer, a very good deal for something that costs only $1,000.

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7 This requires that gratuitous transfers in fact be gratuitous, and not disguised payments. Disguised payments include gifts or promised bequests to descendants who in return are expected to visit, care for, entertain, flatter, and otherwise please transferors, in which case the transfers are effectively wages, and candidates for taxation rather than subsidies.
Indeed, in the absence of corrective policy gratuitous transfers are far too good a deal. Transfers have a strong externality component, in that transferors, however altruistic and generous, cannot fully incorporate the benefits of recipients in their own decision making. As a result there are far fewer transfers than the level that maximizes a simple sum of valuations.

What is the appropriate tax treatment of gratuitous transfers? Henry Simons favored taxing receipts, noting that they contribute to the welfare of beneficiaries in the same way as other forms of income. Despite taxing receipts, Simons would not permit transfers to be deducted by those who make them, arguing – again correctly – that transfers are akin to ordinary consumer purchases that are certainly nondeductible. The components of his argument are correct, but Simons’ conclusion, which is based entirely on equity considerations, is exactly the opposite of that implied by modern optimal tax theory.\(^8\) Modern theory dictates that transfers be subsidized by the tax system, since there are too few transfers in the absence of corrective policy; in concept, the subsidy could be paid either to those who make the transfers or those who receive them. This creates a potential inequity if two individuals with equal wages receive gifts of different value, since prior to the subsidy the one receiving the larger gift is better off but faces the same tax burden; and the subsidy only makes matters worse. Optimal tax theory has an answer of course, which is that income tax rates should be chosen cognizant of the likely pattern of gift payments and receipts across income classes, with tax rates inched upward for those income classes most apt to benefit from transfers and associated subsidies, and inched downward for others. This does not address equity issues between those who receive greater or fewer gifts than is typical of those in their income classes, but some degree of inequity is the price one pays for encouraging gifts and thereby improving social welfare.

The U.S. deduction for state and local income and property taxes has a similar rationale. There is considerable controversy over the desirability of permitting individual taxpayers to claim state and local tax deductions, despite their longstanding availability. A standard justification for state and local tax deductibility is that taxpayers do not have access to resources

that are taxed by state and local governments, so a fair accounting of disposable annual income would permit the deduction.\textsuperscript{9} On this view, the deduction should not be considered a tax preference. A more powerful argument relies on the externality produced by the federal income tax. If state and local governments spend resources on roads, port facilities, telecommunication links, or education designed to improve the incomes of residents, then the rest of the country captures a portion of the benefits in higher federal tax receipts. Since state and local governments presumably ignore this externality when making their tax and spending decisions, they will tax and spend too little unless encouraged by federal tax deductibility.\textsuperscript{10} Similar arguments have been applied to the taxation of foreign income.

From the standpoint of individual taxpayers the prevailing theory is that the most efficient income taxation is a function of individual characteristics, such as family size and composition, an individual’s height, background, birthplace, education, occupation, and any other characteristics that offer clues to the individual’s income earning potential and responsiveness to taxation.\textsuperscript{11} Such fine-grained differentiation affords the opportunity to tilt tax burdens among income sources and in the process impose lower marginal tax rates on highly responsive activities, while achieving desired tax burden distributions by making taxes partly functions of immutable characteristics that proxy for incomes. The Earned Income Tax Credit (EITC) offers an example. The EITC is a refundable tax credit available to low-income workers, with almost all of the benefits restricted to workers with children. An obvious cost of a means-tested tax credit like the EITC is that it discourages income earning by recipients who lose their benefits as their incomes rise. In directing almost all of the EITC benefits to workers with children, the EITC not only benefits those in society with the greatest needs, but also offers

\textsuperscript{9} For example, Borris I. Bittker, Income Tax Deductions, Credits, and Subsidies for Personal Expenditures, 71 MICH. L. REV. 1099 (1973). This argument was particularly potent in the era in which the top federal marginal income tax rate exceeded 90 percent, and some states imposed significant personal income tax rates in addition. Critics argue that that availability of the federal income tax deduction indirectly encourages state and local governments to impose taxes the burden of which is effectively shared by the U.S. Treasury, thereby providing an inefficient subsidy for state and local government expenditures. See, for example, Edward M. Gramlich, Deductibility of State and Local Taxes, 38 NAT’L TAX J. 447 (1985).


benefits to workers who are arguably less likely than others to reduce their income production in the face of higher marginal tax rates.

4. **Equity-Based Arguments for Comprehensive Income Taxation.**

   The equity case for broad-based taxation is commonly taken to be sufficiently self-evident as to require little justification, or indeed, thought. Probably the only other aspect of taxation that the public and a majority of analysts accept largely without question is the notion that an income tax should exhibit progressivity. That these two widely held beliefs are mutually contradictory appears not to have affected their popularity.

   If two workers each receive $60,000 in annual wages, then from an equity standpoint what would warrant asking them to pay different taxes? There are at least three powerful equity considerations that each point in the direction of treating these taxpayers differently.

   The first consideration is that real incomes can differ greatly even when nominal incomes are identical. This is familiar in the context of geography: the cost of living in San Francisco is considerably higher than in most of the rest of the United States. The U.S. federal income tax makes no adjustment for cost of living differences, a concession to practicalities that is broadly understood to be inefficient and unjust. Failure to adjust for cost of living differences means that someone with wages of $60,000 in San Francisco pays more in taxes, and is subject to a higher average tax rate, than someone with wages of $45,000 in rural Ohio, even though the real purchasing power of the Ohio wages may be greater. True, the average tax dollar paid by a San Franciscan commands fewer goods and services in San Franciscan than the average tax dollar paid by an Ohioan; but it is the progressive nature of the federal income tax means that makes taxpayers in high cost of living areas incur relatively heavier federal tax burdens than those living in parts of the country where prices are lower. The progressivity of the federal income tax is based on nominal, not real, dollars. As a result, those who live in more expensive parts of the country pay taxes at higher average rates than those who live in less expensive parts of the country.

   The problem of regional price differences under a uniform federal income tax is widely acknowledged, and conceivably could be addressed by using location-specific income deflators
in calculating tax liabilities. Governments have been loath to make such adjustments. The more important point, however, is that even doing so would only scratch the surface of price differences that are relevant to calculating taxpayer real incomes. The elderly spend their money very differently than do the young; women spend their money differently than men; the well-educated and less well-educated differ in their purchases; people of different ethnicities, religions, life philosophies, love of the outdoors, fascination with new cars, clothes, food, electronics – and every other of the countless ways in which people differ – have different spending patterns. As a result, the prices they face differ, and so, therefore, do their real incomes, even if their nominal incomes are the same. In the Haig-Simons world there is only a single good on which taxpayers spend their money, so what distinguishes individuals is not the composition of their consumption bundles – which are identical – but instead the sizes of their paychecks. In the actual world consumers spend their money on millions of different things, each with different prices.

Individual circumstances differ in many respects that are vitally relevant to income taxation. A family with five children and an income of $50,000 confronts a much more challenging economic situation than does a childless family with an income of $50,000, and as a result, there is a strong equity-based case to subject the larger family to lower taxes – despite the equality of pretax incomes. A taxpayer with an income of $60,000 who faces enormous medical bills due to expensive cancer treatments differs from a healthy taxpayer with an income of $60,000; and a taxpayer whose home was destroyed in a fire and whose insurance is insufficient to cover much of the cost of rebuilding is considerably poorer than another taxpayer with the same pretax income and a similar, but undamaged, home. These considerations motivate some of the current differential tax treatment of taxpayers with identical pretax incomes: personal exemptions for dependents, medical expense deductions, and casualty loss deductions. And these are merely examples; taxpayers earning the same wages differ in countless respects, and there is no presumption that they should be treated equally by the tax system. Yet that is what a comprehensive income tax system does.

Many taxpayer differences reflect personal choices, which some argue should make the tax system disregard them. Parents choose to have children; lifestyles and diet affect health outcomes; and homeowners can exert more or less effort to prevent fires. Offering tax relief
encourages these choices; and from an equity standpoint, one could argue for or against the equity of differentiating tax burdens based on events that are at least some of the time affected by taxpayers themselves. In practice, Congress has resolved this issue by demanding fewer tax payments from larger families, those with significant medical expenses, and those with unusual casualty losses.

What is the equitable tax treatment of two taxpayers with identical and unchanging wages if one spends much of his income on electronic gadgets that consistently decline in price while the other spends his money on goods and services that rise slightly in price? The worker who prefers electronics enjoys a consistent rise in real income, whereas the other worker’s real income declines. Does it follow that the tax burden of the electronics aficionado should rise relative to the tax burden of his unsophisticated counterpart? Some view consumption choices as inherently personal, and therefore not relevant to tax burdens, but this ignores the reality that nominal incomes are meaningful only relative to prices – that what matters for economic well-being are real incomes.

The Haig-Simons comprehensive income tax notion famously taxes all capital income, including unrealized capital gains. It is easy to understand why it does so. In a world without taxes a bond holder who receives $1,000 of interest income gets the same annual return as a stock investor whose shares rise $1,000 in value. Failure to treat these two returns equally means that the tax system implicitly favors one over the other, which, in the absence of a good reason to do so, might be both inefficient and inequitable: inefficient because the tax system more strongly encourages one form of investing; inequitable because both investors are equally better off at the end of the year.

As it happens, in an example like this capital market equilibrium makes it very unlikely that any inequity is apt to result from a favorable tax treatment. This is well understood in the context of the municipal bond market; but the point remains that there is an apparent inequity.

An important difficulty with the Haig-Simons concept is that it is not at all clear what constitutes an asset for this purpose. Advocates of comprehensive income taxation generally include corporate stock, consumer durables, real estate, and like investments; and surely one would want to include intangible investments such as investments in intellectual property. It has
long been noted that there is something odd about taxing someone on changes in the value of a primary residence that he or she continues to own and occupy, since the taxpayer’s situation does not change at all. This reflects that the change in the market cost of living in the house exactly equals the change in the house’s value, so the net change in real income – if the cost of living is properly calculated, and taxation were on a real basis, with individual-specific price indices – would be zero. A minor adjustment is required if the taxpayer’s stay in the home is not indefinite, but the point remains that apparent capital gains on the value of consumer investments are largely or entirely offset by reduced purchasing power due to the same price movement.

The case of owner-occupied housing is merely a prominent example of a much more general class of individual-specific assets, many of which are not traded as actively as is housing. Consider, for example, the value of the defined benefit retirement plan of someone whose employer will provide half of his final salary for as long as he lives. The market value of the future retirement benefits of a 55 year old worker who this year takes up smoking or develops a taste for heavy foods sharply declines, whereas if the same worker discovers the joy of vegetables and daily exercise it rises perhaps even more sharply. Should individual taxes be thereby adjusted (with presumably an offsetting change in the employer’s annual income)? Or consider the employer who provides good tickets to Detroit Tigers games to any executive working for the company for more than 10 years. The team suddenly acquires some star players on long-term contracts, making this fringe benefit considerably more valuable; does it follow that an executive who has invested eight years of his career in the company partly in anticipation of this benefit has significant Haig-Simons income this year? Can one think of homeowners as holding assets with negative values, such as expected liabilities from prospective future tort suits, and if so, does it follow that a homeowner has a loss for Haig-Simons income calculation purposes if a young child acquires an interest in marbles (that might someday be strewn across the front sidewalk to the detriment of pedestrians) or if a court decision stiffens homeowner expectations? And there are thousands of such assets, with market values that change daily.

It is tempting to respond to this indeterminacy by saying that only some assets fall within the ambit of income taxation, and others do not. On what basis are assets to be included and excluded? Selective inclusions of assets is highly problematic, as illustrated by the following example of selectively choosing assets so as to create any desired conceptual redistribution of
income. Everyone in the economy can be considered to have offsetting long and short positions in all assets: these long and short positions net to zero, and therefore do not affect behavior or financial life in any manner. Consider a single asset with a fluctuating price, such as a future contract on oil delivery. It is possible to assign everyone in the economy long and short positions in this future contract, with differing amounts: one consumer has 1,000 long and short contracts, another has one million long and short contracts, and so forth. This assignment produces an outcome that is exactly equivalent to what consumers have in the absence of such an assignment, so as an empirical matter it is impossible to distinguish having no interest in these contracts from having exactly offsetting long and short positions; for purpose of argument, suppose that everyone has the long and short positions. The long and short contracts make and lose money each year, but for each consumer the gains and losses offset exactly, leaving zero net income from the fictitious contracts. One can construct the contracts so that, viewed from one side of the market only, anyone – anyone – in the economy is the richest person in America this year (e.g., oil prices went up and we assign him 10 trillion long contracts), though of course the opposite would be true when viewed from the other side of the market. If for arbitrary reasons the tax system looked only at one asset (e.g., the long contracts) and not the other (the short contracts), then a Haig-Simons system could be manipulated to impose literally any assignment of tax burdens.

This is not to say that a clearly fictitious conceptual scheme somehow turns rich people into poor people, or vice versa. What it says is that failure to include all assets disconnects the calculation of taxable income from the distribution of changes in economic circumstances. But the inability to identify what should and should not count as an asset that is relevant to income taxation again undermines the notion that there exists a pure comprehensive income tax system. One of the benefits of the existing realization system is that asset returns are taxed only insofar as they deliver spendable income, so fictitious and speculative assets are excluded. But one of the major downsides of the realization system is that important assets – such as those connected to the purchasing power of income – are also excluded.

It is axiomatic that income should be taxed on a net basis. An individual who owns and runs a small produce stand that each year spends $50,000 buying vegetables from farmers that it ultimately sells to customers for $85,000 has taxable income of $35,000, not $85,000. The
question for the tax system is the extent to which other, less obviously business-related, expenses are properly deductible. Can the proprietor of the produce stand deduct the cost of cleaning tomato stains from his shirt, and if so, then what about the cost of frequent haircuts intended to present a clean-cut image that prevents customers from inquiring about the conditions under which the tomatoes were grown?

The standard answer that tax systems offer is that business expenses are deductible whereas personal expenses are not. There are well known difficulties in defining this boundary, including the appropriate tax treatment of commuting expenses, child care, work-related clothing, business meals, and other expenses that clearly can have important business or personal components, depending on the context. Vexing though these issues are, they pale in magnitude compared to much larger, yet apparently settled, issues related to the sources of labor and capital income. Workers are not permitted to deduct the cost of foregone leisure in calculating their wage and salary income, nor are small business owners permitted to deduct the value of their time and anguish when calculating business profits. And savers are not permitted to deduct the cost of delaying consumption in calculating their taxable income from saving.

The obvious practical reason for denying deductions for foregone leisure and consumption is that there would be precious little taxable income left if they were permitted. This does not, however, justify their exclusion on equity grounds. An individual who is just barely willing to do the additional work required to earn an additional $1,000, but decides nonetheless to do it, is in a very different position than someone else who finds $1,000 in an unmarked envelope on the beach; yet both are taxed equally by an income tax. In the first case the greater work generates very little additional net satisfaction after subtracting the value of time and effort, whereas in the second all of the $1,000 is surplus. Any system that taxed according to net contribution to economic value would subject the windfall to heavier taxation than the labor income, but that is not what an income tax does, since the practice is to ignore the cost of time and labor effort.

Comprehensive income tax systems adhere to the custom of not permitting deductions for effort entailed in generating labor income or the value of foregone consumption required to generate capital income, and in that sense fail to tax comprehensive income defined on a net basis. Proposals to exempt capital income from taxation would address one part of this
omission, effectively permitting deductions for foregone consumption but making no adjustment for foregone leisure. Given the revenue requirements of modern governments there is precious little practical import to noting the oddity that the opportunity cost of foregone leisure is not deductible from labor income, other than to suggest that windfalls be subject to particularly high tax rates. Presumably this would apply with equal force to windfall components of labor income, the wages and salary that a worker might receive for work that would have been happily, or at least not too grudgingly, done for much less, if only the windfall portion of labor income could be readily identified. But it cannot; and the arbitrary treatment of all labor income as though it were a windfall represents established custom rather than a feature that could possibly be justified as a component of a system that seeks to tax comprehensive net income.

It is possible for tax systems to attempt to address these opportunity costs, and indeed optimal income tax systems incorporate the cost of foregone leisure in determining tax rates applicable to different income levels. The models are stylized, and in particular assume that individuals are identical in every respect other than their market wages. As a result, two individuals with the same market income have the same (hidden) costs of foregone leisure, which can be implicitly recouped with lower tax rates on that income level. This adjustment can be applied to every income level, thereby – in the context of the model – correcting for opportunity costs. This is the kind of happy world that we could have if only everyone were identical. Regrettably, some workers with wages of $50,000 are single individuals, whereas others are married and have seven children, and one fears that their values of foregone leisure may differ. The optimal income tax models remind that the government’s choice of the tax rate structure can be, and should be, conditioned on differences in opportunity costs of generating income that differ systematically by income level, which is the only dimension of difference present in the models. In the absence of additional taxpayer information the government is unable to offer any further differentiation; though as the family size example illustrates, some adjustments may be quite feasible.

5. Conclusion
There is undeniable appeal in simple solutions to complicated problems. There were times, after all, when illness was remedied by bleeding; when witches were identified by their ability to float; when tulip bulbs were safe investments; and when droughts were ended by offerings to the gods.

Broad-based, low-rate income taxation has much of the same appeal, or perhaps more, since frustration with the need to pay taxes at all, and therefore with current taxes, combines with absence of experience to enhance the attractiveness of a pleasant-sounding alternative. Should the time come that governments attempt to enact comprehensive income taxes, proximity to the specifics will quicken taxpayer interest and enhance understanding of the costs. Until then there is the danger that beneficial reforms to existing income tax systems may advance with less urgency, in the belief that a much better world awaits; alternatively, inefficient and inequitable movements in the direction of comprehensive income taxation may appear attractive as overtures to the great performance to follow.

There is a prevailing narrative of government captured by special interests that conspire to advance their own interests by getting legislators to narrow the tax base. It is certainly possible to find examples of this phenomenon, which to many minds, particularly those with tax policy experience, offer compelling cases that governments need to respond by limiting departures from comprehensive taxation. This understandable reaction should be tempered by two important considerations. The first is that it disregards the reality that an income tax with a broad and comprehensive base is an inferior method of raising revenue. Governments enact the types of taxes they do not because they fail but instead because on close examination deviations from comprehensive income taxation produce outcomes that are more equitable and efficient than do the outcomes generated by comprehensive income tax alternatives – and where tax systems fall short in providing exclusions, deductions and credits, it is usually that they offer too few, rather than too many.

The second consideration is that the political process chooses tax rates together with tax bases. Adoption of a more comprehensive tax base is likely to be accompanied by tax rate changes, with consequences for overall tax progressivity that depend very much on the nature of the resulting tax rate changes. As noted, exclusions, deductions and credits facilitate tax rate progressivity. Furthermore, if special interests are as powerful as some fear, then blocking their
prospects of obtaining individual tax benefits in the form of base erosion is likely to drive them to seek favorable tax rates instead. In the current environment special interests can be deflected from the more formidable task of seeking rate changes with small tax benefits in the form of base erosion, but if denied this outlet en masse with a legislative commitment to comprehensive taxation, it remains to be seen what the outcome would be for tax rates.

The practical reality is that the U.S. government is unlikely to adopt low-rate, broad-based income taxation, and the implications of tax theory are that significant movements in the direction of low-rate, broad based income taxation are more apt to reduce the efficiency and equity of the U.S. tax system than they are to enhance them. Rather than a simple formula for better taxation, this leaves legislators with more general principles such as taxing inelastic sources of income and adjusting tax burdens for individual situations. In fact, existing taxes do some of this already, and the implication of modern tax theory may be simply to do more.