CAPITAL TAXATION IN AN AGE OF INEQUALITY

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I. <u>INTRODUCTION</u>.

    A. <u>The Project's Agenda</u>.

An old story recounts the two old ladies sitting down to dinner at Grossinger's, the long defunct Catskills resorts beloved of generations of New Yorkers. "Feh," says the first, "the food here is terrible." "Yes," replies the second, "and such small portions, too."

So it is with the standard view in the tax law academy of capital income taxation: it is a poor idea in theory – and completely infeasible in practice, too.[1] This consensus view holds that the principal difference between ideal income taxes and ideal consumption taxes is that only ideal income taxes burden normal riskless returns to capital – the dull, plodding returns that one might expect, for example, from an investment in government securities.[2] In turn, continues the analysis, public finance economics research, principally a landmark paper by Anthony Atkinson and Joseph Stiglitz,[3] as well as important contributions by Christophe Chamley[4] and Kenneth

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[1] Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 STAN. L. REV. 745 (2007), is an exception, in that it explores theoretical reasons derived from the new dynamic public finance literature for taxing capital income. See Section X.X., below. So too is David Gamage, *The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth*, 68 TAX L. REV. 355 (2015), which, among other points, argues that multiple tax instruments with different tax bases are less susceptible to the deadweight loss of tax avoidance strategies than is reliance on one tax instrument.

[2] Section I.B., below, discusses normal returns, including risk-adjusted normal returns, in more detail.

[3] A.B. Atkinson & J.E. Stiglitz, *The Design of Tax Structure: Direct Versus Indirect Taxation*, 6 J. PUB. ECON. 55 (1976).

[4] Christophe Chamley, *Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives*, 54 ECONOMETRICA 607 (1986).

Judd,[5] confirm in a rigorous manner the intuition dating back at least as far as John Stuart Mill, that taxing normal returns is undesirable because it is economically inefficient – the same revenues can be raised with less deadweight loss by forgoing the taxation of normal returns.[6]

What is more, continues the tax law academy consensus view, taxing capital income is an impossible undertaking in the real world, once *deus ex machina* solutions like universal mark-to-market taxation for all investment assets, whether publicly traded or not, are taken off the table. The unavoidable distortions introduced by the realization doctrine, the debt-equity distinction and legislative meddling with depreciation schedules and other investment incentives mean that the original sin of taxing capital income is greatly compounded in practice.

And of course each perspective reinforces the other: Why bother working to solve the tax engineering problems presented by capital income tax reform if the end product is undesirable for economic efficiency reasons? And why ruminate on the tax physics of ideal forms of taxation if a capital income tax is unimplementable in any event?

This paper takes issue with the consensus view, primarily by emphasizing the first-order importance of political economy issues in the design of tax instruments. In the decades since the landmark Atkinson-Stiglitz paper, economists have developed new theoretical models that find a role for capital taxation, but it is basically for political economy reasons that Anthony Atkinson and Joseph Stiglitz both reject the implications of their famous paper as a guide to actual tax policy. So, for that matter, do most practicing public finance economists, if a recent poll of them is to be believed.[7] Ironically, the last redoubt of the Atkinson – Stiglitz result as providing a realistic guide to actual tax policy is the legal academy, not economics departments.

As developed in a recent book by the economist Dani Rodrik, the science of economics is encapsulated in the development of new mathematical models of economic behavior, each in turn illuminating different aspects of the world not fully explored in earlier models. But the *art* of economics – and very much a part of the job of an economist who offers policy advice – is

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[5] Kenneth L. Judd, *Redistributive Taxation in a Simple Perfect Foresight Model*, 28 JOURNAL OF PUBLIC ECONOMICS 59 (1985). See Section IV.C., below.

[6] Consistent with other legal academic work in this area, this paper refers to the Atkinson – Stiglitz result as the "A-S Theorem." It is briefly summarized in Section X.X., below.

[7] See section X.X., below.

picking the right model for the task at hand.[8] The legal academy was quick to admire the elegance of the Atkinson–Stiglitz result, which unlike some other economic models could be explained through metaphorical arguments, but was a bit less deft at the art of deciding whether its assumptions mapped well onto actual political economy concerns.

When responding to the political economy exigencies we face, the model of choice should include a large role for capital taxation as a policy instrument. What is more, as this paper demonstrates, the most appropriate form of capital taxation in this context is an annual capital income tax levied at a flat rate – in contrast, for example, to relying primarily on an estate and gift tax, or a progressive income tax rate structure.

At least four important political economy concerns counsel reliance on capital taxation. First, the United States requires substantially higher levels of tax revenues than it currently raises, both to fund current government operations and to enable larger government investment and insurance programs that would augment the welfare of most Americans.[9] Capital income taxes today are a significant fraction of total tax revenues, and replacing them would not be easy. Moreover, those capital income taxes are baked into today's prices, so that radical changes will bring with them windfall gains and losses to affected taxpayers.

Second, many observers are greatly troubled by the increasing concentration of income and wealth (and therefore capital income) across the income distribution of individuals. In contrast to the first point, which emphasizes the need for revenues to bolster investment and insurance programs that principally benefit less affluent taxpayers, this second point focuses on the very top end of the income distribution, and accepts that there are independent social concerns raised by this increasing concentration. Capital taxation in some form responds directly to these concerns.

Third, the capital stock is not simply the result of lifetime consumption smoothing (that is, stored labor); instead, a significant fraction of the existing capital stock has been acquired through gratuitous transfers (i.e., gifts and bequests). In fact, about one-half of the existing

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[8] DANI RODRIK, ECONOMICS RULES: THE RIGHTS AND WRONGS OF THE DISMAL SCIENCE (2015).

[9] EDWARD D. KLEINBARD, WE ARE BETTER THAN THIS: HOW GOVERNMENT SHOULD SPEND OUR MONEY (2014).

capital stock in the United States is held by virtue of such gratuitous transfers, and much of that wealth is extremely concentrated in its ownership.[10] Economic models that assume that capital income is simply the byproduct of lifetime consumption smoothing thus are inapposite to the world we inhabit.

Finally, the United States, like all other developed countries, will likely continue to employ a corporate income tax, which is a species of capital income taxation, as a tax instrument, and that tax today is in crisis, principally because of its susceptibility to "stateless income" planning and inconsistent legislative goals.[11]

The project of which this paper is a part seeks to demonstrate that taxing capital income is responsive to these political economy exigencies, and that, somewhat more surprisingly, a flat rate capital income tax actually is progressive when measured against the relevant yardstick of time. Further, a flat rate tax on capital income has other properties (particularly neutrality with respect to risk) that makes such a rate structure desirable. By abandoning any insistence that an "ideal" income tax adopt a single progressive rate structure encompassing both labor and capital income – itself a reflection of a belief system more than an economic imperative – actual progress can be made in improving both the efficiency and the fairness of our federal tax policies.

The separation of a taxpayer's income into capital and labor components, and the application of separate rate schedules to each, are hallmarks of "dual income tax" instruments, of the sort explored in practice most comprehensively by several Nordic countries.[12] It is possible to design a comprehensive and reasonably accurate flat rate tax on capital income that is adminstrable, that builds on well-understood tax policies, that achieves integration between corporate and investor income, and that successfully distinguishes capital from labor income. I term this tax instrument the Dual Business Enterprise Income Tax, or Dual BEIT (where "BEIT" is pronounced "bite," as in tax bite). Its virtues also include minimizing the relevance of the

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[10] Section II.C., below.

[11] Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011).

[12] The first paper in this series, Edward Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 NW. J.L. & SOC. POL. 41 (2010), discusses some of the underlying policy objectives and experiences of Nordic countries in implementing dual income taxes.

realization doctrine, eliminating distinctions across different forms of capital investment, and offering business enterprises a consumption-tax environment in which to operate.

To make the project more tractable, the two themes just advanced – the why and the how of the Dual BEIT – are each the subject of a separate paper. They are meant to operate as twins, and together to demonstrate that the Dual BEIT satisfies theoretical concerns, as filtered through the political economy imperatives of the quotidian world, and also is straightforward to implement and administer.

This is the "why" paper. More specifically, this paper makes the following claims.

First, the Atkinson-Stiglitz result and the tax law papers that follow it are premised on the absence of pre-existing capital acquired through gratuitous transfers – that is, on the idea that all capital is labor income stored in one period and consumed by the same individual in another. But this assumption does not map at all onto contemporary society. Accordingly, as Atkinson and Stiglitz themselves have acknowledged in their own policy proposals, the Atkinson-Stiglitz result is not a reliable guide to designing capital tax instruments in practice.

Second, a flat-rate (proportional) capital income tax that is measured and collected annually has very attractive theoretical and political economy properties that can be harnessed in actual tax instrument design. As a proportional tax, it applies at the same marginal and effective rates to both income and losses, thereby preserving the symmetry on which rests the theoretical analysis of returns to risk. And as a political economy matter, a flat-rate capital income tax actually is a progressive tax in application: because only high-ability taxpayers or those who are the beneficiaries of gratuitous transfers can afford indefinite deferral of consumption, the increasing "tax wedge" on savings over time introduces a measure of top-bracket progressivity along the margin of time. In other words, what many economists view as the fatal flaw of capital income taxation (the increasing tax wedge over time) in fact is a feature, not a bug.

Third, annual capital income taxation has practical advantages over estate and gift taxation, or other taxes that effectively are paid in arrears (such as capital gains tax). The nominal tax rate required to have the same present value revenue impact can be lower, the opportunities for outright evasion are reduced (because capital flows leave a more visible

contrail than does capital stock), and the system is less vulnerable to "one-time" tax holidays of the sort witnessed in the international tax arena in 2004.[13]

Fourth, the tax law literature generally recognizes that a proportional consumption tax is a poor tax instrument for "redistributing" top-end income and wealth.[14] In response, the consensus recommendation is that the most efficient tax that also addresses top-end distributional concerns is a steeply progressive consumption tax. But a progressive consumption tax structure vitiates many of the efficiency claims made for ideal consumption taxes (which claims generally rely on proportional tax rate structures). A low flat capital income rate actually imposed annually may thus offer some efficiency gains when compared with an "ideal" progressive consumption tax straw man, while still being progressive in fact.

Fifth, the critical tax instrument design move that makes an income tax on capital feasible is to recognize that there is no reason, beyond pure coincidence, why an ideal income tax should burden labor income and capital income under the identical rate schedule. To the contrary, and as suggested above, a flat (proportional) tax on capital income will operate as progressive along the relevant margin of time, while an explicit progressive tax rate structure on labor income can both raise substantial revenues and do so in a way that satisfies political economy redistribution concerns.

Sixth, revenue considerations (including robustness to tax holidays along the lines of that adopted by the United States in favor of the offshore income of U.S.-based multinationals in 2004), tax avoidance concerns (through tax-induced incentives to recharacterize labor income as capital income), and international tax norms relating to the taxation of business enterprises, all counsel in favor of some form of annual corporate (more generally, business enterprise) income taxation. As a political economy matter, therefore, capital income taxation (of which the corporate income today tax is one instance) is largely inescapable in practice.

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[13] 26 U.S.C. § 965.

[14] As developed in EDWARD KLEINBARD, WE ARE BETTER THAN THIS: HOW GOVERNMENT SHOULD SPEND OUR MONEY (2014), this concern is overstated when applied to investment and insurance programs whose principal beneficiaries are not as affluent. When applied to most citizens, the spending side of the ledger is so progressive in its distributional impact that this fact dominates the design of the regressive tax system that raises the requisite revenue.

In short, and without regard to new developments in the theoretical literature, the dominant theoretical advice in the U.S. tax law academy not to tax capital income is inapposite, in first-order ways, when the exigencies of current social structures and political economy issues are squarely confronted. Once one focuses on the central importance of gifts and bequests in explaining the distribution of capital, and with it, capital income, as well as the social policy issues of wealth and income inequality, a tax on capital income becomes a much more rational policy instrument than much of the literature in the tax law academy of the last few decades would acknowledge. What is more, the progressive cash flow tax (a type of consumption tax with a progressive rate structure) has its own distortive effects on present versus future consumption patterns, thereby vitiating some of the efficiency claims advanced on its behalf.

The second of these twin papers makes the case that the Dual BEIT is an administrable and novel approach to taxing capital income that is both mindful of economic efficiency concerns and responsive to the political economy issues that confront the United States today. Some of the Dual BEIT's helpful properties in practice include the following:

- A consistent flat tax rate on capital income, combined with a progressive rate structure on labor income. This in turn means that the tax burdens imposed by the Dual BEIT in many instances are more neutral than those of a progressive consumption tax, because it applies symmetrically to gains and loses from risky investments. The flat rate tax on capital income can in turn accommodate ordinary lifetime consumption smoothing goals, through mechanisms such as Individual Retirement Accounts, but capped at a reasonable amount of deferred income. The resulting capital income tax accordingly becomes a tax instrument addressed to holders of substantial capital.

- A straightforward consumption-tax environment for business enterprises, thereby satisfying "competitiveness" agendas, which have a depressingly loud resonance within Congress. A consumption-tax environment means not only zero effective marginal tax rates on investment, but the elimination of all the complexity of "tax-free reorganizations" and the like. Normal returns are taxed at the level of investors, where those returns are easier to measure and are less mobile than at the firm level.

- Elimination of the debt-equity distinction, and a substantial attenuation of the relevance of the realization doctrine.

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- Effective integration of business enterprise and investor income inclusions, so that capital income is taxed once and only once, without any need for explicit coordination, "franked" dividends, or the like.

- Consistent and reliable measure of normal returns.

- A relatively featureless tax topography, with few conceptual cliffs or peaks, where the tax framework suddenly shifts from one mode to another.

- Immunity from legislative meddling with depreciation rates.

The Dual BEIT's dual income tax structure requires the development of a new tax tool, namely a "labor-capital income tax centrifuge," to tease apart labor and capital income when the two are hopelessly intermingled, as in the case of the owner-entrepreneur of a closely held business. One of the contributions of the companion paper is to specify a feasible and effective implementation of such a centrifuge.

The most intractable tax policy differences within Congress today relate to how to structure corporate income tax reform, including in particular the international income of U.S.-based multinational enterprises. As a political economy matter the Dual BEIT largely dissolves these differences – and does so in a way that declares most everyone a winner. U.S. businesses will now operate in a consumption tax environment, and less-leveraged firms will no longer be at a competitive disadvantage to aggressively leveraged ones in respect of their income tax burdens. The "missing" revenue is not missing at all, but is taxed at the level of investors, who in general are much less mobile than are firms.

The Dual BEIT represents a substantial evolution in thinking from the "Business Enterprise Income Tax" and "Cost of Capital Allowance" ideas that I first presented in 2007 and whose embryonic form dates back to 1989.[15] For readers familiar with those papers, the major developments include:

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[15] An early conceptual presentation of the BEIT was Edward D. Kleinbard, *Designing an Income Tax on Capital*, *in* TAXING CAPITAL INCOME (Henry J. Aaron, Leonard E. Burman & C. Eugene Steuerle eds., 2007). EDWARD D. KLEINBARD, REHABILITATING THE BUSINESS INCOME TAX (The Hamilton Project, The Brookings Institution, Discussion Paper 2007-09, 2007) presented a detailed explanation of the design and operation of the BEIT.

- The adoption of the dual income tax structure, in which capital income and labor income are taxed under two different rate schedules. As suggested above, this has important theoretical and practical implications.

- To implement the dual income tax structure, the development of a novel "labor-capital income centrifuge" to tease apart the two kinds of income when they are intermingled, as in the case of the owner-entrepreneur of a closely held firm.

- The explicit adoption of a consistent flat rate capital income tax rate on all forms of business capital income. This is consistent in practice with distributional concerns and preserve neutrality in the taxation of risky investments.

- A more complete articulation of a theory for taxing the international income of multinational enterprises, and its instantiation in the Dual BEIT.

- The abandonment of a second-level tax on extraordinary capital gains (itself the product of a misguided intuition as to the political climate at the time it was suggested).

B. <u>Terminology</u>.

1. *The Components of Capital Income*.

Throughout this paper, I use the term "capital income" to comprise all returns to capital, in the narrow, traditional sense of that term.[16] Capital income of course is not synonymous with "capital gain;" the latter is just one instance of capital income. Capital income includes, by way of example, interest and dividend income, property rental income, royalties, capital gains and the imputed rental income of owner-occupied housing. Capital income also includes most net business income. Firms bring both labor and capital to bear in generating net income; at least in the case of publicly held corporations, however, the labor component is fully compensated and

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Both presentations included for reasons of perceived political economy imperatives a feature (an extra tax on "excess returns") that was both complicated and logically unnecessary. This presentation does not repeat that tactical error.

The firm-level "Cost of Capital Allowance" was proposed in Edward Kleinbard, *Beyond Good and Evil Debt (And Debt Hedges): A Cost of Capital Allowance System*, 67 TAXES 943 (1989).

[16] Thus, as used in this paper the term "capital" does not include human capital.

deducted from the business tax base. As a result, the remaining business tax base contains only capital income. (The problem of the closely held business, where an owner-entrepreneur puts both her own capital and her labor to work, and where the net income of the firm cannot through simple inspection be divided into labor and capital income components, is addressed through the new "labor-capital income centrifuge" discusssed in the companion paper.)

Economists often equate capital (and therefore the measurement of returns to capital) with "real" assets employed in a business, by which they mean investments in tangible, greasy machinery, or buildings, or land, or even intangible assets like patents, trademarks, or goodwill, but *not* financial assets such as stocks and bonds. In a more quotidian sense, capital income is earned in respect of investments in both real assets and financial assets that, in the broadest sense, are indirect claims on those real assets.[17] Coordinating the taxation of returns to real and financial assets is one of the great challenges in designing an income tax on capital. Therefore, throughout this paper, "capital" comprises both real and financial assets.

The standard presentation in the legal tax literature basically divides the returns to capital into three categories.[18] First are "normal" returns, usually (incompletely) explained as the pure return to waiting, or time-value-of-money returns. These represent the core risk-free return from postponing consumption of one's wealth. These are the dull, plodding, interest-like returns that one might expect to earn, for example, by investing in a Treasury bond. To an economist, all capital earns at least this return.

Second are risky returns, the higher returns that one expects to obtain as compensation for accepting the risk of uncertain rewards. From an ex ante perspective, risky returns are measured by the risk premium associated with an investment, as reflected in its expected return

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[17] Mark P. Gergen, Taxing Capital (Feb. 2016) (unpublished draft paper).

[18] John R. Brooks II, *Taxation, Risk and Portfolio Choice: The Treatment of Returns to Risk Under a Normative Income Tax*, 66 TAX L. REV. 255, 261 n. 25 (2013); David A. Weisbach, The (Non)Taxation of Risk, 58 TAX L. REV. 1 (2004); Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, 103 TAX NOTES 91 (2004); Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006); Lawrence Zelenak, *The Sometimes-Taxation of the Returns to Risk-Bearing Under Progressive Income Tax*, 59 SMU L. REV. 879 (2006); Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX. L. REV. 17 (1996); Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319 (1993); Edward D. Kleinbard, *Designing an Income Tax on Capital*, *in* TAXING CAPITAL INCOME (Henry J. Aaron, Leonard E. Burman & C. Eugene Steuerle eds., 2007).

less the risk-free normal return. Actual ex post risky returns, of course, will vary considerably from this expected return, and often will be negative.

Finally, taxpayers also can earn "economic rents" or "inframarginal returns" – the supersized returns that come from a unique and exclusive market position or asset, such as a valuable patent or trade name.[19] Rental income from renting an undeveloped lot for use as a parking lot typically would represent a normal return on one's capital; economic rents, by contrast, are jumbo returns that are not attributable simply to taking on large quanta of risk.

The treatment of risk in this standard presentation often confuses ex ante and ex post perspectives. The pure time value of money is a risk-free "normal" return, but the normal return is a more elastic concept than this one instance, because it also encompasses any ex ante expected return on a marginal investment. In this second use, the normal return is sometimes labeled a risk-adjusted normal return. For example, an expected 7 percent return on a marginal $1,000 business investment (that is, one where the expected return just covers the firm's costs, including the cost of the firm's capital), and a riskless normal return of 2 percent from a $1,000 investment in a government bond have different ex ante expected payouts (to compensate for the assumption of risk), and in all likelihood different ex post actual returns, but equivalent ex ante values. Both earn ex ante normal returns, as adjusted to reflect any assumption of risk. That is, both are marginal returns to a $1000 marginal investment in their respective risk categories.

As a result, in a world of perfectly efficient markets, ex ante risky returns to marginal capital investments are simply normal returns by another name. The practical utility in characterizing returns to risk as a separate category is that, first, all tax systems burden ex-post results, not ex ante expectations, and, second, the category includes returns to pure bets (e.g., many derivative instruments), where capital is not explicitly invested in the instrument at the start.[20]

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[19] Robert H. Wessel, *A Note on Economic Rent*, 57 *American Economic Review* 1221, 1223 (1967) ("The traditional rent concept also allows to divide, conceptually at least, factor compensation into two parts, payments which induce factors to work and surplus which only confers a greater reward for work which would have been done anyway.").

[20] Where the other side of the bet is also held by a U.S. taxpayer, both taxpayers face the same tax rates, and net losses are fully refundable (all assumptions in the standard tax presentation), the aggregate tax collected on such bets should be zero.

All marginal investments should face the same tax rates; otherwise, investments will be misallocated. As Section III.C. describes in more detail, this means that extraordinary returns (or losses) from risky marginal investments should not bear a different tax burden than that imposed on risk-free normal returns. A progressive income tax, and an income tax that does not treat losses symmetrically with positive returns, are both problematic from this perspective. Nonetheless, both U.S. tax law and U.S. tax law academic work has struggled with the relationship between ex post outcomes and the ex ante risk premium associated with a risk-adjusted normal return.

For a business enterprise, the risk-free return is largely meaningless, just as its own cost of capital will never equal the government's risk-free rate. A firm operates in a world of marginal investments with risk-adjusted normal returns whose ex ante expected returns substantially exceed the risk-free rate. For a firm to invest in risk free assets would be to engage in negative arbitrage.[21] And from the firm's perspective, its cost of capital (which is to say, the minimum return demanded by investors in the firm) is an existential imperative. This distinction between risk-free and normal returns becomes important when implementing the dual BEIT.[22]

2. *Ideal Tax Norms*.

This article employs the term "flat-rate capital income tax" to mean a tax on capital income measured and imposed *annually* at a single tax rate.[23] The U.S. federal corporate income

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[21] An exotic exception would be a securities dealer borrowing on a short-term basis to hold government bonds, and using secured "repo" financing, which has a special creditor-friendly status under bankruptcy law, to do so.

[22] In the language of the next subsection, the issue is relevant to the implementation of any profits-only tax through a mechanism that replaces the scaling up framework of much of the literature, in which government can be viewed as purchasing a share of each asset outright, with a direct government subsidy for the marginal cost of capital expended to acquire the asset, as in an allowance for corporate capital framework (including the capital account allowance type mechanism employed by the Dual BEIT), or for that matter, an allowance for corporate equity, which provides a firm with full interest deductions plus an additional allowance in respect of its equity capital.

[23] In practice there inevitably are exceptions for small businesses and investors of modest means, as well as exceptions for some retirement savings.

tax operates essentially as a flat-rate capital income tax.[24] By contrast, current law's taxes on capital gains and dividends are not within the meaning of this term, because they are not imposed annually as the relevant income accrues, but only on certain ex post realization events. When compared with a tax at the same rate imposed and collected annually, this deferral in the imposition of tax operates to exempt the compounding of returns from the tax; phrased alternatively, the effective tax rates fall over the relevant margin of time.[25]

Economists and tax law academics often confuse one another by applying different meanings to the same word; the problem is compounded when moving between American and British usages. In general, I follow the practice of using the phrase "capital income" to include all returns to capital, including risk-free returns, ex-post actual returns to risk (in contrast to ex-ante marginal expected returns to risk, which constitute risk-adjusted normal returns), net business income after labor inputs are accounted for, and rents. [26] I follow economists in using the word "profits" to mean returns over and above risk-adjusted ex ante normal returns.[27] This means that in ideal implementations the term encompasses only economic rents (again, when measured from an ex ante perspective).

In the U.S. tax law academy, at least, any tax that by design does not burden normal returns is swept up in the term "consumption tax." This would include a value added tax, a wage tax, or a cash-flow tax. Most U.S. tax work in recent decades takes the cash-flow tax, and in particular a progressive cash-flow tax, as its preferred instantiation of a consumption tax. In an effort at cross-Atlantic comity, from this point forward this paper sometimes employs the term "profits-only" tax to refer to all such taxes. Rigor would require me to constrain references to "consumption tax" only to taxes whose nominal incidence falls on consumption itself (retail

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[24] The apparent progressive rate structure of I.R.C. section 11(b)(1) is clawed back by the flush language at the end of that paragraph.

[25] STAFF OF THE J. COMM. ON TAXATION, PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART II, JCX-63-07, at 6-7 (Sept. 4, 2007); Section IV.A., below.

[26] *Cf.* ANTHONY B. ATKINSON, INEQUALITY: WHAT CAN BE DONE? 309 (2015) ("Capital income is income generated by the ownership of an asset, and includes interest income, dividends on shares, rent, and capital gains/losses; it may include part of the income accruing to a person who owns a business.").

[27] *E.g.*, Jennifer Gravelle, Corporate Tax Incidence with Excess Profits (unpublished draft paper).

sales tax, value added tax), but in discussing the existing U.S. tax law literature it is difficult not to follow its practice of applying the term to all profits-only taxes. Finally, the paper uses the term "mark-to-market" rather than "accruals" accounting, to avoid confusion with cash vs. accrual methods of income tax accounting.

A "cash-flow tax" is a profits-only tax, because a well-designed one does not burden normal returns. An ideal firm-level cash-flow tax looks very much like an income tax, except that firms are permitted an immediate deduction for any business investments that they make, and must include in income all returns in respect of that investment, including the return of the original amount invested. Under the well-known "Cary Brown Theorem," this seemingly innocuous step is understood to exempt from tax the normal returns on a taxpayer's investment.[28]

By contrast, in an ideal income tax all investments are capitalized, and those capitalized amounts are recovered only through depreciation (which is meant to accord with the economic loss incurred in respect of wear and tear on a real asset) or on sale of the asset. One of the greatest difficulties in applying the U.S. federal income tax to business income is determining which expenses relate to the current period, and should be deductible, and which expenses give rise to a tangible or intangible asset, such as goodwill, and should be capitalized.

In most of the tax law literature, an ideal income tax is understood to comprise a comprehensive Haig-Simons type income tax, with one tax rate schedule for both labor and capital income. Both an ideal income tax and an ideal cash-flow tax tax allow for an immediate cash refund of the tax benefit of any net losses or deductions in excess of receipts.[29]

A cash-flow tax is simply one mechanism to implement a profits-only tax while still preserving income tax-like optics (in particular, annual tax returns that look to receipts and expenses to determine a tax base). Another approach to designing a profits-only tax base for

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[28] A cash-flow tax is described in the literature as an "R" based cash-flow tax if it ignores financial flows entirely (such as borrowing money, paying interest thereon and ultimately repaying the loan), and an "R+F" base if financial flows are included in income when received (e.g., when borrowing money) and deducted when repaid. J.E. MEADE, THE STRUCTURE AND REFORM OF DIRECT TAXATION (2011 ed. 2011).

[29] John Brooks specifies in more detail the key terms of the idealized income tax that most authors appear to assume. John R. Brooks II, *Taxation, Risk and Portfolio Choice: The Treatment of Returns to Risk Under a Normative Income Tax*, 66 TAX L. REV. 255, 263 (2013).

firms is to introduce a new tax deduction that is designed explicitly to exempt a normal return from tax. Under the standard interpretation of the burdens of capital taxes (as described in Part III), a deduction that offsets a firm's normal returns from invested capital leaves only profits (rents) in the tax base, because under the standard interpretation, pure ex-post returns to risk, in the form of capital-free bets, are not taxed by either an income or a profits-only tax.

These "cash-flow equivalent taxes" rely on a "capital account allowance," "allowance for corporate equity" ("ACE"), or the like.[30] In the case of an allowance for corporate equity, for example, the combination of a firm's deduction of its actual interest expense, plus a notional deduction for a deemed normal return on the firm's equity capital, is designed to shelter a firm's normal returns from tax. Several European countries have adopted ACE regimes as their corporate tax model.[31] A capital account allowance dispenses with a deduction for interest expense, and instead provides a single tax deduction for all of a firm's invested capital, whether financed through debt or equity.

As described in detail in the companion paper to this one, the Dual BEIT employs a capital account allowance to create a profits-only tax base for a firm's business income.[32] But

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[30] "Capital Account Allowance" is the terminology used in ROBIN BOADWAY & JEAN-FRANCOIS TREMBLAY, CORPORATE TAX REFORM: ISSUES AND PROSPECTS FOR CANADA (Mowat Centre for Policy Innovation, School of Public Policy and Governance, University of Toronto, Mowat Research No. 88, 2012). Other authors use synonymous terms, like "allowance for corporate capital." For reasons of personal history and idiosyncratic preference, I use "Cost of Capital Allowance" (COCA).

[31] Croatia was the first to implement a full ACE regime from 1994 to 2000 with a notional deduction for a deemed normal return on the firm's equity capital. Austria had a partial ACE regime from 2000 to 2004, taxing at a reduced rate notional return on new equity capital. Italy also implemented a regime similar to Austria's, in which notional return on new equity capital was taxed at a lower rate whereas profits were taxed at a higher rate. Since 2006, Belgium has used a full ACE regime with a deductible notional rate of return on equity. Since 1996, Brazil has used a partial ACE regime where notional interest is deductible when paid out to shareholders. For an overview of ACE regimes, see Alexander Klemm, *Allowances for Corporate Equity in Practice* (Int'l Monetary Fund, Working Paper No. WP/06/259, November 2006).

[32] A capital account allowance has the advantage over an allowance for corporate equity in not encouraging the issuance of equity-flavored debt instruments. And cash-flow equivalent taxes in general have the advantage over cash flow taxes of easier transitions from current law (because existing investment in assets – i.e., tax basis – at the time of transition does not become useless in the new regime), and because they are less susceptible to windfall gains and losses through the timing of investments as tax rates change. Christian Keuschnigg & Martin D. Dietz, *A Growth Oriented Dual Income Tax*, 14 INT'L TAX & PUB. FIN. 191, 197 (2007); David Bradford, *Transition to and Tax-Rate Flexibility in a Cash-Flow-Type Tax*, *in* TAX POLICY AND THE ECONOMY (1998).

unlike a standalone profits-only tax, however implemented, the Dual BEIT uniquely is designed as a true income tax. The missing piece that must be added to economic profits (rents) to turn a profits-only tax into an income tax – basically, normal returns – is accomplished by requiring *investors* in business enterprises to include deemed normal returns in income every year. This is the unique feature of the Dual BEIT: a profits-only tax at the firm level combined with a correlative tax only on normal returns at the investor level equals an income tax on capital income. For reasons of history[33] and idiosyncratic preference, I use the term "Cost of Capital Allowance" (COCA) to describe the Dual BEIT's firm-level capital account allowance. Importantly (and again uniquely) the same COCA rate is applied at the investor level to measure investors' deemed normal returns on their investments in business capital.

    C. <u>Outline of Remainder of Paper</u>.

    Part II makes the case that political economy concerns counsel strongly in favor of retaining a capital income tax, but it would behoove us to do a much better job of it. In particular, capital income taxes respond to both revenue constraints and concerns relating to growing top-end wealth and income inequality. Admittedly, our current approaches to the taxation of returns to capital are fragmentary and highly distortionary, and doing better can seem overwhelmingly difficult. The companion paper to this one demonstrates that it is possible to do better through a handful of policy moves that build incrementally on current tax law concepts.

    Part III turns to the fraught question of why capital should be taxed at all, which is a logical prior to developing a practical mechanism for doing so. It demonstrates that political economy considerations, in particular the pervasive role of gratuitous transfers (gifts and bequests) in the distribution of wealth, vitiate the usual admonition that normal returns on capital should not be taxed. In a world imbued with inheritances and gifts, the important theoretical work of Atkinson and Stiglitz no longer serves to scold academics who venture to suggest that capital income is not such a bad idea after all – as Messrs. Atkinson and Stiglitz themselves both agree.

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[33] I first deployed the term in 1989, in Edward Kleinbard, *Beyond Good and Evil Debt (And Debt Hedges): A Cost of Capital Allowance System*, 67 TAXES 943 (1989).

Part IV then makes the case that capital income taxes should retain their role as the most important form of capital taxation, but that a flat-rate capital income tax, combined with a progressive tax rate on other income, has practical and efficiency gains over the usual ideal of a single progressive income tax. Theory suggests that economic rents can bear higher tax rates than normal returns, but in practice it is much more difficult than is commonly appreciated to distinguish among normal returns, returns to risk and rents. A firm's rents, for example, are normal returns in the hands of a recent purchaser of the firm's equity.

A progressive consumption tax, by contrast, is poorly targeted at the political economy issues motivating this paper, and abandons proponents' own claims of efficiency gains by virtue of its asymmetrical treatment of returns to risk. The flat-rate capital income tax is the better tax instrument for real-world tax policy.

D. High Level Summary of Dual BEIT Proposal.

Although the detailed design of the Dual BEIT is the subject of the companion paper, it is helpful to summarize the instrument's operation in a few paragraphs, so that readers of this paper can bear in mind what the ultimate policy proposal looks like.

The Dual BEIT looks superficially much like the current income tax. The Dual BEIT taxes all business operations identically (by taxing all enterprises, regardless of legal form, as taxpaying entities, and subject to the same rules). At its simplest, the Dual BEIT imposes a firm-level flat-rate profits only tax, implemented through its Cost of Capital Allowance, which is a deduction equal to a statutorily-set rate (as an arbitrary example, 1-year Treasury Bills plus 300 basis points[34]) applied to all of a firm's business capital, whether actually financed by debt or equity. (In other words, at the firm level the COCA deduction is a capital account allowance mechanism.) The COCA deduction replaces a deduction for interest expense, and, because it applies to the entirety of a firm's business capital, renders moot for tax purposes the firm's capital structure.

The Dual BEIT taxes investors in business enterprises each year at a flat rate on a deemed normal return on their business investments, again regardless of how those investments are

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[34] The reasons why the COCA rate should be a risk-adjusted normal return, rather than a risk-free normal return, are discussed in the companion paper.

denominated. The deemed normal return is the same COCA rate, but now applied as an income-measuring device in respect of an investor's investments in firms. Cash returns on investments are ignored, except insofar as they are treated as reductions in invested capital. At the investor level, then, the COCA mechanism functions much like original issue discount: investors include in income the statutory COCA rate, and if that amount is not paid in cash, investors add the income to their investment (tax basis). All cash flows received in respect of an investment simply reduce the investor's unrecovered investment for purposes of applying the COCA rate in subsequent periods.

The combination of the firm-level profits-only tax base, and the investor-level tax on normal returns is a single tax on capital income (again, relying on the standard view summarized in Part III that returns to risk-taking are not burdened by income or profits-only taxes). The Dual BEIT thus taxes all capital income once, and only once, without cumbersome (and frequently abused) integration schemes or the like. Economic profits are taxed to the enterprise, and normal returns to investors.

The "dual" part of the Dual BEIT contemplates that capital income will be taxed at a flat rate, so that business enterprises and investors alike will pay tax at the same rate on their respective tax bases – again by way of arbitrary example, 25 percent. It falls to this paper to make the case that a flat-rate tax on capital income is appropriate as a matter of political economy and tax theory. But a dual income tax structure means that labor (and miscellaneous) income will be taxed on a different tax rate schedule – say, progressive rates ranging up to 40 or 45 percent. A dual income tax therefore requires the introduction of a novel labor-capital income centrifuge, to tease apart labor and capital income when those two factors are hopelessly intermingled, as in the case of the closely-held firm whose owners also are the entrepreneurs managing the enterprise. The companion paper takes up the challenge of describing the design of such a labor-capital income centrifuge.

In turn, disguised labor income retained by the firm becomes capital (in the form of retained earnings), and that capital again is taxed neutrally, whether inside or outside the firm.

The Dual BEIT is an administratively feasible tax, even for a large modern economy like the United States. Its components are analogous to features of the current income tax (interest expense deduction, inclusion of original issue discount income), save for the new labor-capital

income centrifuge – even though the combined effect of these component parts is a single tax on capital income, measured with greater accuracy than under current law.

The Dual BEIT thus replaces the disarray of current law's taxation of capital income with a coherent regime, in which all capital income, regardless of legal label, is taxed at a consistent rate. That moderate rate mitigates the distorting effects of high marginal rates on some capital income, and collects substantial revenues (especially when compared with the current partiality to bonus depreciation and the like). Moreover, the Dual BEIT eliminates enormous layers of firm-level tax rule complexity, such as the multiplicity of rules for different forms of business organization, the consolidated return rules, and the "tax-free reorganization" (merger) rules.

The Dual BEIT eliminates the debt-equity distinction, neutralizes the importance of different depreciation or capitalization regimes, automatically coordinates firm-level and investor level incomes, and mitigates (but does not wholly eliminate) the consequences of the realization doctrine. The tax liabilities of investors are driven by the capital they invest, not the label of the instruments they hold. What is more, the Dual BEIT moves a large fraction of capital income to the level of investors, rather than firms, a development that has important helpful ramifications in light of the relative international capital mobility of firms, compared to people.

Finally, the Dual BEIT, although an income tax, offers corporate managers a profits-only tax environment in which to conduct business. This should resonate with managers who today express concern about international "competitiveness," and further means that those managers will be able to pursue acquisitions and divestitures without regard to any significant tax consequences.

For all these reasons, the Dual BEIT is the right direction in which capital income taxation should head.[35]

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[35] Christian Keuschnigg & Martin D. Dietz, *A Growth Oriented Dual Income Tax*, 14 INT'L TAX & PUB. FIN. 191 (2007) proposed a roughly analogous dual income tax, also emphasizing the efficiency gains relative to current law. As in the Dual BEIT proposal, Keuschnigg and Dietz contemplate a firm level profits-only tax, in their case implemented through an allowance for corporate equity, rather than a uniform allowance for corporate capital; the difference is simply that the former contemplates keeping interest deductions, while the latter replaces interest deduction with the uniform capital allowance. Unlike the Dual BEIT, however, the Keuschnigg and Dietz proposal retains the realization principle for income inclusions at the investor level, and in turn relies on retrospective interest charges (analogous to the U.S. rules for gains from passive foreign investment companies) to remove the benefit of deferral. The

II. POLITICAL ECONOMY CHALLENGES TO CAPITAL TAX INSTRUMENT DESIGN.

A. We Need the Eggs.

Like the fellow who delayed seeking medical attention for his wife who thought she was a chicken, because they needed the eggs, most developed economies need the eggs, today: deficit financing is an important political economy constraint on government policy. A new profits-tax only environment with equivalent present value revenues to those raised by capital income taxation today would be heavily back-loaded as a cash flow matter. This in turn would have important practical repercussions for the role of government today, in light of vigorous political debates around current year deficits. There are also of course the exhaustively studied transition problems of substituting profits-only taxes and consumption taxes for capital income taxes.

The nonpartisan Congressional Budget Office projected in August 2015 that, based on current tax laws, federal government deficits will total about $7 trillion over the 2016-2025 period, and that U.S. Treasury debt held by the public will grow from 73 percent of GDP (in 2018) to about 77 percent of GDP in 2025. Most public finance economists and policy analysts are troubled by that trend.[36] Discussions of replacing current capital income taxation with profits-

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Keuschnigg and Dietz proposal also does not cap investor level tax at normal returns, thus setting up possible double tax scenarios. Finally, the sum of firm-level and investor-level taxes on capital income in the Keuschnigg and Dietz proposal is intended to be the same as the top rate as labor income, thereby avoiding the necessity to design a labor-capital income centrifuge, but arguably taxing capital income at too high a rate to achieve all the efficiency goals it sets for itself.

In 2005, President Bush's Advisory Panel on Federal Tax Reform proposed a "Growth and Investment Tax Plan," which again in broad terms had some features in common with the Dual BEIT. The Growth and Investment Tax Plan contemplated a 30 percent cash flow tax on businesses, a modestly progressive labor tax on individuals with a top rate of 30 percent, and a flat 15 percent tax on dividends, interest and capital gains. Again, the two parts of the proposal were not specifically designed to impose a single uniform tax on capital income (by taxing only normal returns to investors), and individuals apparently would have had reason to stuff capital into business entities, to benefit from the profits-only tax environment and deferral of the individual level of tax.

[36] CONGRESSIONAL BUDGET OFFICE, AN UPDATE TO THE BUDGET AND ECONOMIC OUTLOOK, 2015 – 2025, at 2 (Aug. 2015). Longer term forecasts are even more depressing. Alan J. Auerbach and Willaim

only taxes therefore must begin from the proposition that our existing revenue base is inadequate to fund the government we have today.

In *We Are Better Than This: How Government Should Spend Our Money*,[37] I focus primarily on the economic health of lower and middle income Americans, rather than the runaway success of the most financially well-off.[38] My point there was that well-targeted government investment and insurance programs, whether in education, infrastructure, healthcare, or a dozen other areas, are complementary to the private sector, absolutely necessary if we are to honor fundamental principles like equality of opportunity (for example, through equal investment in the human capital of equally-talented children), and highly progressive in their distributional impact. But these sorts of programs require additional government revenues over our existing base (I estimate on the order of 2 percent of GDP), which in turn puts tremendous pressure on sources to fund these incremental revenues, beyond the revenues needed to support the modest levels of government investment and insurance we have in place today.

We Are Better Than This demonstrates that we can raise sufficient revenues to accommodate these objectives within the confines of existing tax instruments, and without resorting to extraordinary increases in top marginal individual income tax rates. One can of course hypothesize one's way to a solution, for example through national sales taxes, or much higher marginal tax rates on labor incomes, but the path of least resistance is to follow the maxim that an old tax is a good tax, and therefore to continue to rely on capital income taxation to generate an important stream of government revenues, which in turn can fund highly redistributive government investment and insurance programs.

Capital income taxation in the United States today is poorly implemented, but even so it raises substantial revenues. Capital income now accounts for about 40 percent of gross domestic

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C. Gale, *Once More Unto the Breach: The Deteriorating Fiscal Outlook*, 150 TAX NOTES 1293 (MAR. 14, 2016).

[37] EDWARD KLEINBARD, WE ARE BETTER THAN THIS: HOW GOVERNMENT SHOULD SPEND OUR MONEY (2014)

[38] This indeed is the principal criticism of the book in an otherwise positive review by Daniel Shaviro, *Review: We Are Better Than This: How Government Should Spend Our Money*, 68 NAT'L TAX J. 681 (2015).

income in the United States: pragmatic political constraints on tax rates suggest that it would be extraordinarily difficult to envision tax rates sufficiently high on a narrower base to hold tax revenues constant on a present value basis.[39] (This allocation is more heavily weighted towards capital income than was true a few decades ago, when the split might better have been summarized as 65 - 35.[40]) This means that we intuitively can expect the taxation of capital income to be highly relevant as a matter of government revenues.

The Congressional Budget Office projects that for fiscal year 2016 the federal corporate income tax (which is a tax on capital income, since in the case of public companies at least labor inputs will be fully compensated) will by itself raise some $445 billion in revenues – about 12.6 percent of all federal tax revenues projected to be collected. [41] (Over the 10-year period 2016 – 2025, the figure is $4.4 trillion.) And these revenue projections reflect the aggressive stateless income tax planning of U.S.-based multinational firms, through which at least $2 trillion of low-taxed foreign income, untaxed by the United States, sits in offshore affiliates.

It is true, of course, that the corporate income tax base includes not simply returns to marginal investments, but also ex post returns to risky ones, as well as rents, and that rents at least would also be taxed by a well-designed consumption tax.[42] As a result, this observation should not be misconstrued as suggesting that the revenues today collected through the corporate

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[39] CONGRESSIONAL BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2012 TO 2022 (Jan. 2012), at 42 figs. 2-8 (labor income share of gross domestic income estimated to be roughly 60 percent in 2012 and 2017).

[40] CONGRESSIONAL BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2012 TO 2022 (Jan. 2012), at 41 n. 27. The CBO allocates 65 percent of proprietorship and partnership income to labor, and 35 percent to returns to capital, based on this older benchmark.

[41] CONGRESSIONAL BUDGET OFFICE, AN UPDATE TO THE BUDGET AND ECONOMIC OUTLOOK, 2015 – 2025 (Aug. 2015).

In theory some portion of the corporate income tax could be a tax on labor income not extracted by the owners of closely held "C" corporations in the form of arm's length compensation rates (what this paper calls "labor stuffing"), but that behavior would be irrational in the current tax environment. Moreover, the great bulk of the corporate income tax is paid by large public corporations, where the occasion for labor stuffing is more attenuated.

[42] Joel Slemrod, *Does the United States Tax Capital Income?*, *in* TAXING CAPITAL INCOME (Aaron, Burman and Steuerle, eds., 2007).

tax would entirely disappear in a consumption tax. Nonetheless, it is a helpful place to start in appreciating the extent to which capital income in fact is taxed in the United States today.

The Internal Revenue Service publishes aggregate data from tax returns. For 2013 – the most recent year available – the IRS preliminary data show total adjusted gross incomes (net of losses) reported on personal income tax returns of $9.1 trillion, of which wages and salaries comprised $6.6 trillion. So without more one can see that incomes other than explicit labor incomes amounted to $2.5 trillion in that year. Drilling down, individuals reported $79 billion in taxable interest income, $191 billion in dividend income, $436 billion in net capital gains (that is, gain taxed at long-term capital gains rates), $51 billion in rents and royalties (net of losses), and about $770 billion in net business income (including sole proprietorships, partnerships and S corporations). Again, the point is simply to remind readers of the enormous amounts of capital income actually subject to tax today, and to suggest that it might behoove us to do a better job of taxing these enormous sums in a consistent manner.

One European cross-national study concluded that in 2004, when corporate income taxes amounted to 8.7 of all tax revenues in the United States (federal, state and local), personal capital income taxes amounted to another 7.5 percent, for a total of 16.2 percent of all tax revenues collected in the United States.[43] And a paper by Joel Slemrod summarizing his work with several colleagues concluded that, in pure revenue terms, federal revenues collected in 2004 in respect of marginal returns to capital — which his team measured by calculating the excess of the revenues collected by the *actual* income tax then in effect (including the expiration of the 2003 bonus depreciation rules) on marginal investments (that is, excluding rents) over the revenues that would have been collected by an *ideal* profits-only tax – amounted to about $89 billion for that one year.[44] (Slemrod estimated the effective marginal tax rate on capital income to be in the

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[43] Peter B. Sørensen, *Can Capital Income Taxes Survive? And Should They?*, 53 CESIFO ECON. STUD. 172, 192-96 (2007).

[44] Joel Slemrod, *Does the United States Tax Capital Income?*, *in* TAXING CAPITAL INCOME (Aaron, Burman and Steuerle, eds., 2007).

The Slemrod analysis is particularly interesting in its demonstration that the U.S. tax burden on capital income has fluctuated very substantially over the last couple of decades. *Id.* at n. 14 (reporting a swing in incremental income tax collections over ideal consumption tax collections from negative $15.2 billion for 1983 to positive $108 billion in 1995).

neighborhood of 14 to 23 percent.) I would submit that the difference in taxes that might be collected from an actual income tax when compared to an *actual* profits-only tax (were such a comparison feasible) might be greater than that sum.

The Congressional Budget Office and the U.S. Treasury Department have each conducted studies of effective marginal tax rates on capital income under the Internal Revenue Code as then in effect. In 2007, for example, the Treasury Department found that the effective marginal tax rate on new business investment (including any relevant taxes on distributions to ultimate owners) averaged 29.4 percent for corporations and 20 percent for noncorporate firms.[45] The Congressional Budget Office has published several studies along similar lines; in the most recent one, the CBO found that the effective federal marginal tax rate on corporate investments (again including taxes on distributions to investors) averaged 31 percent, and for pass-through entities, 27 percent.[46]

In short, despite all the preferences and incentives of current law, the United States today imposes significant levels of tax on capital income, whether understood in the broad sense to include returns to risk and economic rents, or in a narrower sense of including only marginal returns (although admittedly some of the data summarized above do not distinguish between the two). To replace revenues forgone under a progressive consumption tax or the like would require much higher nominal top tax rates than might seem feasible in the current political environment.[47]

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[45] U.S. TREASURY DEPARTMENT, BUSINESS TAXATION AND COMPETITIVENESS (Jul. 2007), *reprinted in* 116 TAX NOTES 399, 411 tbl. 4.1 (Jul. 30, 2007).

[46] CONGRESSIONAL BUDGET OFFICE, TAXING CAPITAL INCOME: EFFECTIVE MARGINAL TAX RATES UNDER 2014 LAW AND SELECTED POLICY OPTIONS (Dec. 2014), at 10 tbl. 2.

[47] *See, e.g.*, the comprehensive and accessible summary of the case for profits taxes by ROBERT CARROLL & ALAN D. VIARD, PROGRESSIVE CONSUMPTION TAXATION: THE X TAX REVISITED 41 (2012) ("Because consumption is smaller than income, particularly at the top of the income distribution, consumption taxes tend to require higher statutory tax rates than income taxes, holding fixed other factors."). Carroll and Viard decline to specify an actual rate structure for the profits tax they have in mind.

CONGRESSIONAL BUDGET OFFICE, TAXING CAPITAL INCOME: EFFECTIVE MARGINAL TAX RATES UNDER 2014 AND SELECTED POLICY OPTIONS (2014), sets out several policy alternatives to current law, including expensing of all capital investment. The study presents the impact of these alternatives on effective marginal tax rates, but unfortunately does not quantify the revenues that would be forgone.

Moreover, through the phenomenon of tax capitalization (implicit taxation), capital income taxation is baked into the price levels of financial investments today.[48] As a result, after-tax returns should be in equilibrium across all capital investments with comparable risk profiles, and the consequences of capital income taxation (including its uneven application today) should be evidenced in the social misallocation of investments, not in their after-tax returns. This means that a comprehensive move away from capital income taxation will create windfall winners and losers. This transition issue is well-known in the consumption tax literature, but its practical impact on market prices if anything is underappreciated in evaluating the benefits of a major change in tax systems.

In contrast to capital income taxes, the federal gift and estate taxes are inconsequential as a matter of tax revenue.[49] The estate tax raised only $16.4 billion in 2014, from about 12,000 estate tax returns filed in that year. The gift tax added another $1.7 billion in revenue, from fewer than 3,000 returns. Estate and gift taxes have been whittled into insignificance through both tax planning and the very large exclusions provided by Congress. In 2015, for example, an estate tax return was required to be filed only for gross estates exceeding $5.4 million, up from $1.5 million in 2005. By virtue of the spousal exemption and "portability," a married couple effectively can today leave almost $11 million to heirs tax-free. To be sure, the estate and gift taxes have deadweight losses not captured by these figures, such as in respect of the complex planning devices adopted by many wealthy taxpayers to avoid their reach, but they remain a trivial revenue source to government.

See also Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, 91 TAX NOTES 101 (Apr. 5, 2004). Shaviro concedes the necessity of higher nominal rates under a progressive consumption tax than a progressive income tax, but argues that these higher rates are a fiscal illusion, because a capital income tax is a double tax on labor income, at least in a world abstracted from inheritances. Of course, inheritances are a central feature of capital endowments, and in any event the art of political economy legerdemain is to apply fiscal illusion in socially useful ways.

[48] *Cf.* Edward Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 106 – 09, 124 – 130 (describing operation of tax capitalization in capital asset prices).

[49] The underlying data are available at https://www.irs.gov/uac/SOI-Tax-Stats-Estate,-Gift-and-Trust-Statistics.

B. Top-End Inequality and Tax Instrument Design.

The work of Thomas Piketty, Emmanuel Saez, many other academic researchers, and important nonpartisan organizations with unique access to granular-level data (particularly, the Congressional Budget Office) all point in the direction that inequality in market incomes and wealth have increased dramatically at the top end in recent decades, particularly in the United States. *In We Are Better Than This*, I survey the research on these trends.[50] Thomas Piketty's book *Capital in the 21st Century* is controversial in many respects, but there can be little doubt that one of its central theses – the increasing concentration of capital income and capital ownership among the very wealthiest citizens – is robust.[51] These arguments are sufficiently well-known, and have achieved sufficient (if not unanimous) acceptance, as not to require great elaboration here. Nonetheless, a very quick review of some of the research is helpful here.

CBO data show that the growth in real market incomes of the top 1 percent has vastly exceeded that of other income groups.[52]

[50] EDWARD KLEINBARD, WE ARE BETTER THAN THIS: HOW GOVERNMENT SHOULD SPEND OUR MONEY (2014).

[51] Hubbard argues that the data in fact are more ambiguous in showing a trend of increasing capital income relative to national incomes, but many recent studies suffer from the problem that the terminal date for their data falls in a period still affected by the large capital losses incurred in 2008 - 2010, and since largely recovered. Estate tax data are similarly fraught, because the estate tax is famously susceptible to tax avoidance planning. Glenn Hubbard, *Taking Capital's Gains: Capital's Ideas and Tax Policy in the Twenty-First Century*, 68 NAT'L TAX J. 409, 410. In any event, the question whether capital income represents an increasing share of national income is different from the question here, which is whether there is evidence of increasing concentration of wealth at the top end.

Admittedly, there are interesting distinctions that can be drawn between wealth and capital (meaning, in the latter case, wealth invested in productive enterprises). J. Bradford DeLong, *Mr. Piketty and the 'Neoclassics': A Suggested Interpretation*, 68 NAT'L. TAX J. 393 (2015); Joseph E. Stiglitz, *The Origins of Inequality, and Policies to Contain It*, 68 NAT'L TAX J. 425, 431 (2015). Wealth invested in "sterile" assets like art or wine, or even owner-occupied housing, in this sense is not part of productive capital.

[52] These figures come from CONGRESSIONAL BUDGET OFFICE, THE DISTRIBUTION OF HOUSEHOLD INCOME AND FEDERAL TAXES, 2011 (Nov. 2014).

Figure 8.

Cumulative Growth in Average Inflation-Adjusted Market Income, by Market Income Group, 1979 to 2011
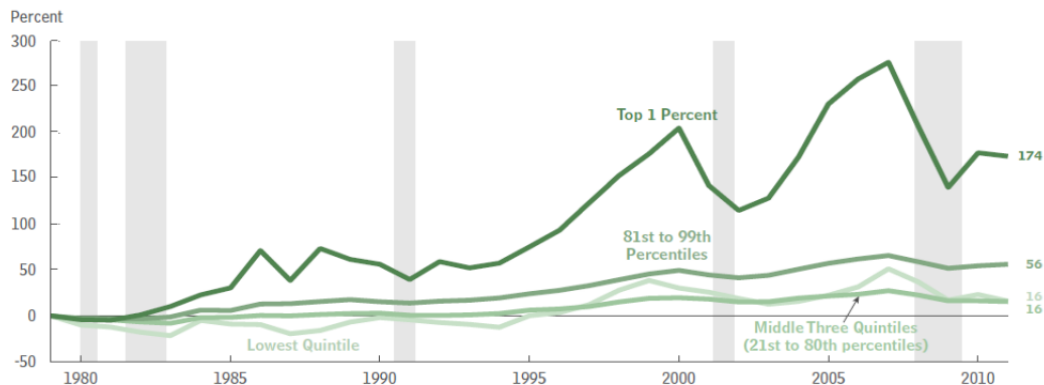
Source: Congressional Budget Office.

Notes: Market income consists of labor income, business income, capital gains (profits realized from the sale of assets), capital income excluding capital gains, income received in retirement for past services, and other sources of income. Government transfers are cash payments and in-kind benefits from social insurance and other government assistance programs. Those transfers include payments and benefits from federal, state, and local governments.

Income is converted to 2011 dollars using the personal consumption expenditures price index.

Income groups are created by ranking households by market income, adjusted for household size. Quintiles (fifths) contain equal numbers of people; percentiles (hundredths) contain equal numbers of people as well.

For more detailed definitions of income, see the appendix.

The year 2011 was still influenced by the fallout from the financial crisis of 2008-2010; for that reason, I believe that a pre-crisis year like 2006 or 2007 gives a better picture of what the data will show as the CBO updates its work in the future.

To the same effect, the Gini index for the distribution of U.S. household incomes has increased substantially from 1979 to 2011, whether measured by market incomes (from 0.48 in 1979 to 0.59 in 2011) or after-tax and transfers (from 0.36 to 0.44).[53] The Gini index is an imperfect measure of inequality, but it does give a sense that the trend is to significantly greater inequality in distributions of market incomes and after-tax and transfer incomes.

The CBO data also demonstrate that capital income is very top weighted in its income distribution, and that it constitutes a large fraction of top incomes. Thus, in 2011 the second, third and fourth quintiles of households (ranked by market incomes) all earned 8 percent or less of their total market income from businesses they owned or capital income and capital gains. By contrast, the top 1 percent of households – whose median income was 16 times that of the

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[53] CONGRESSIONAL BUDGET OFFICE, THE DISTRIBUTION OF HOUSEHOLD INCOME AND FEDERAL TAXES, *2011* (Nov. 2014). See figure 14 and Excel data workbook with detailed numbers.

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median household in the fourth quintile – earned 22 percent of their income from business, and 36 percent from portfolio capital income. (In 2007 the capital income numbers were even higher, because of very high capital gain realizations.) More remarkably, the share of market income represented by labor income in 2011 was about the same for households in the fourth quintile of market incomes and for taxpayers in the $91^{st} – 95^{th}$ percentiles. It is only above that level that one observes a significant drop in labor income as a share of that group's total market income, and a concomitant rise in capital income and business income.[54]

Figure 9.

Components of Inflation-Adjusted Market Income for the Top 1 Percent of Households, 1979 to 2011

Thousands of 2011 Dollars
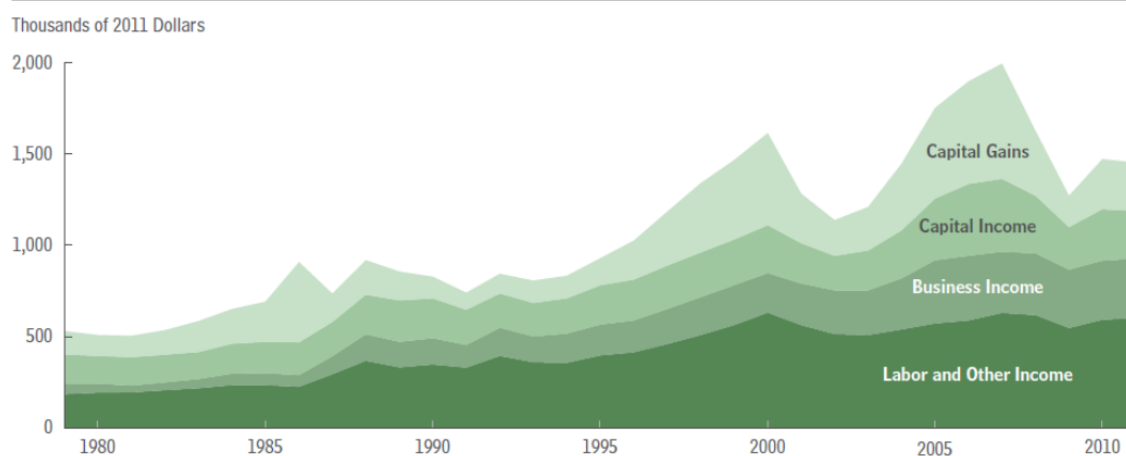
Source: Congressional Budget Office.

Notes: Other income includes income received in retirement for past services and other sources of income.

Income is converted to 2011 dollars using the personal consumption expenditures price index.

Income groups are created by ranking households by market income, adjusted for household size.

For more detailed definitions of income, see the appendix.

Patrick Driessen, a public finance economist and former senior revenue estimator for the Congress's Joint Committee on Taxation, has written persuasively that these data if anything

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[54] CONGRESSIONAL BUDGET OFFICE, EXCEL WORKBOOK OF SUPPLEMENTAL DATA FOR THE DISTRIBUTION OF HOUSEHOLD INCOME AND FEDERAL TAXES, 2011 (Nov. 2014).

greatly understate the relative gains of the top 1 percent with respect to capital income shares, because the CBO data ignore undistributed corporate earnings and unrealized capital gains.[55]

Again, it must be acknowledged that some indeterminate fraction of capital income, as defined by the Congressional Budget Office, would be taxed under a profits-only tax, as comprising rents and ex-post returns to risk.[56] A better way of getting a handle on the distribution of normal returns to capital across households is to examine directly the distribution of wealth, since investable wealth by definition attracts normal returns. Here the data become somewhat less reliable, because government agencies do not directly collect data on the wealth of all households, but one recent effort by Emmanuel Saez and Gabriel Zucman, relying on capitalized values of observable or imputable income flows, concludes that wealth in the United States is highly concentrated at the top-end, and has become more so over recent decades:[57]

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[55] Patrick Driessen, *Corporate Tax Fate May Hinge on Modeling Omission*, 145 TAX NOTES 1071 (Dec. 1, 2014); Patrick Driessen, *The Brookings Top Tax Rate Ruckus and Other Odd Inequality Doings*, 149 TAX NOTES 1071 (Nov. 23, 2015).

[56] The consensus theory of capital income taxation laid out in Part III argues that risky returns are not taxed under an ideal tax, but some recent scholarship has challenged the viability of that analysis, and, more important, the current tax system is far from ideal, in that it does not provide for the refundability of tax benefits from losses, or even their accretion at a rate of return. It therefore is fair to suggest that risky returns today are taxed at least to some extent under our income tax, and are likely to be taxed tomorrow under a progressive profits-only tax. See, e.g., Theodore Sims, *Capital Income, Risky Investments, and Income and Cash Flow Taxation*, 67 TAX L. REV. 3 (2014); John R. Brooks II, *Taxation, Risk and Portfolio Choice: The Treatment of Returns to Risk Under a Normative Income Tax*, 66 TAX L. REV. 255 (2013).

[57] Emmanuel Saez and Gabriel Zucman, *Wealth Inequality in the United States since 1913: Evidence from Capitalized Income Tax Data*, Q.J. ECON. (forthcoming).
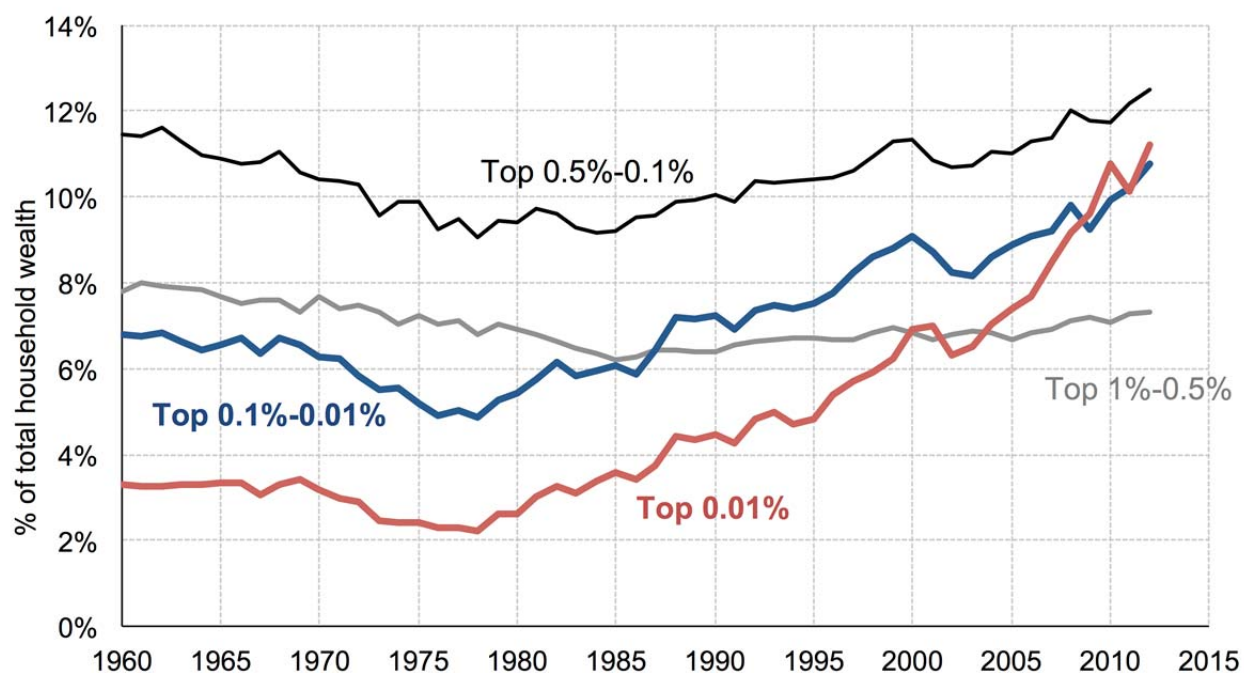
(source: Saez and Zucman)

Saez and Zucman further conclude that in 2012 the top 1 percent of families earned about 42 percent of all taxable capital income in the United States, and that the wedge between these families' share of all national income and their share of all labor income has grown (which is to say, their share of capital income has grown more rapidly than their share of labor income). The methodology employed by Saez and Zucman is controversial, but again the point here is simply to suggest that it reasonable to conclude that wealth, returns to capital (in the broad sense), and normal returns to capital all are extremely concentrated at the very top end of distributions.

The Federal Reserve's Survey of Consumer Finances estimates somewhat less extreme wealth distributions, but is not different by an order of magnitude from the results obtained by Saez and Zucman.[58] To the same effect, in a 2015 study, Piketty and Gabriel Zucman conclude that wealth in the United States in 2010 (indeed, in the entire period 1970 – 2010) was more

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[58] Jesse Bricker, Arthur B. Kennickell, Kevin B. Moore & John Sabelhaus, *Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances*, FED. RES. BULL., June 2012.

concentrated in the United States than in Europe, whether measured at the P99 level (i.e. the top 1 percent) or the P90 level (the top 10 percent).[59] This study concluded that in 2010, the top 10 percent in the United States held about 75 percent of the country's wealth, while the top 1 percent held about 40 percent.

C. Capital Is Not Simply Lifetime Consumption Smoothing.

Imagine a world in which all agents have finite lives, begin with zero capital, leave nothing by way of gifts or bequests, and earn normal returns on all capital created during their lives. In this world, all capital accumulated during a lifetime simply represents an agent's stored-up labor. The capital an agent possesses at any moment in time is the device by which the agent defers consumption of her wage income from the current period to a future period. If pretax interest rates are interpreted as the price an agent demands (the return she must receive) to make her indifferent between current and future consumption, then as an intuitive matter we can see the justification for not taxing capital income.[60] A flat-rate consumption (profits-only) tax imposes tax at a uniform rate on all consumption, but since the only source of money to consume is wage income, a flat-rate consumption tax alone is the equivalent of a uniform tax on lifetime income.[61] It would follow that capital income taxation (which here means taxation only of normal returns) is undesirable.

As discussed in Part III, the best-known theoretical work pointing towards the non-taxation of normal returns to capital relies on the model just laid out (along with other important assumptions). The problem is not with the logic but with the setup; gifts and bequests of capital are prevalent and important in the real world, and fundamentally change the analysis.[62] The ne'er-do-well heir in fact can consume for a lifetime without earning any income at all, and her

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[59] Thomas Piketty & Gabriel Zucman, *Wealth and Inheritance in the Long Run*, *in* HANDBOOK OF INCOME DISTRIBUTION 1536 fig. 15.16 (2015).

[60] Sections III.B. and C. develop this point in more detail.

[61] JOSEPH E. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 579 (3d. ed. 2000).

[62] Thomas Piketty & Emmanuel Saez, *A Theory of Optimal Capital Income Taxation* (Nat'l Bureau of Econ. Research, Working Paper No. 17989, 2012).

thrifty sibling can earn large amounts of income while consuming only a small fraction, leaving the remainder to heirs. Accordingly, this Section II.C. examines the data capturing the flows of capital obtained through inheritance or gift, rather than through an individual's own past labor, because this turns out to be the central political economy factual issue relating to the normative desirability of taxing capital in some fashion.

Thomas Piketty considers the issue in detail in *Capital in the 21st Century*.[63] He has good quality data to work with in France in particular, and finds that inherited wealth accounted for about two-thirds of all wealth held by the living in France in 2010.[64] Piketty and other researchers have much poorer quality data for the United States.[65] Piketty and Zucman describe some of the U.S. data limitations bedeviling researchers: only a few thousand estate tax returns are filed annually (12,000 in 2014), even those are obscured by elaborate tax planning, lifetime gifts are often unreported, and self-reported estimates of wealth in response to government surveys are systematically downwards-biased.[66]

In *Capital in the 21st Century*, Piketty estimates that inherited wealth in the United States as a share of total wealth held by the living in 2010 was somewhat lower than in France, but that the general pattern over time was similar.[67] And a very recent working paper by Alvaredo, Gabinti and Piketty develops a benchmark estimate for the United States in 2010 that gifts and

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[63] THOMAS PIKETTY, *Merit and Inheritance in the Long Run, in* CAPITAL IN THE 21ST CENTURY (2013).

[64] THOMAS PIKETTY, *Merit and Inheritance in the Long Run, in* CAPITAL IN THE 21ST CENTURY 402 (2013).

[65] For example, Thomas Piketty & Gabriel Zucman, *Wealth and Inheritance in the Long Run*, *in* HANDBOOK OF INCOME DISTRIBUTION (2015) essentially declines to provide an estimate for the United States, because of the poor quality of the data.

[66] Thomas Piketty & Gabriel Zucman, *Wealth and Inheritance in the Long Run*, *in* HANDBOOK OF INCOME DISTRIBUTION 1303, 1536 fig. 15.16 (2015).

[67] THOMAS PIKETTY, *Merit and Inheritance in the Long Run, in* CAPITAL IN THE 21ST CENTURY 427-28 (2013).

bequests accounted for about 55 percent of total wealth held by the living. [68] This figure is slightly higher than their estimate for Europe as a whole.[69]

In a 2013 study, Steven Kaplan and Joshua Rauh explored the sources of wealth among the "Forbes 400" list of the wealthiest individuals in the United States in each decade from 1982 – 2011.[70] Using public information to obtain biographical data, they coded the Forbes 400 individuals as having grown up in households that were wealthy, had some wealth, or had little to no wealth. For example, Bill Gates, whose father was a founding partner at a large and successful law firm, was coded as having grown up in a household with some wealth.[71]

Kaplan and Rauh essentially found that the percentage of Forbes 400 members who had grown up with little or no wealth remained relatively constant over time, at about 20 percent, but that there was a pronounced shift within the other two categories, with Forbes 400 members whose wealth was inherited (i.e., grew up in a "wealthy" household) falling from 60 percent of the Forbes 400 in 1982 to 32 percent in 2011. The two categories together aggregated to roughly 80 percent of the names on the Forbes 400 list each year. Kaplan and Rauh also found that 69 percent of the members of this list in 2011 had started their own businesses, as opposed to about 40 percent in 1982. The others presumably inherited their businesses, which they in turn in many cases expanded.

The Kaplan and Rauh paper has been cited in some popular media as proving that wealth inequality in the United States has diminished over time, or that the United States is part of the

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[68] Facundo Alvaredo, Bertrand Garbinti & Thomas Piketty, *On The Share Of Inheritance In Aggregate Wealth Europe And The United States, 1900-2010* (Oct. 29, 2015), available at http://piketty.pse.ens.fr/files/AlvaredoGarbintiPiketty2015.pdf.

[69] Facundo Alvaredo, Bertrand Garbinti & Thomas Piketty, *On The Share Of Inheritance In Aggregate Wealth Europe And The United States, 1900-2010* 24 fig. 1 (Oct. 29, 2015), available at http://piketty.pse.ens.fr/files/AlvaredoGarbintiPiketty2015.pdf.

[70] Steven N. Kaplan & Joshua D. Rauh, *Family, Education, and Sources of Wealth among the Richest Americans, 1982–2012*, 103 AM. ECON. REV. 158 (2013).

[71] Steven N. Kaplan & Joshua D. Rauh, *Family, Education, and Sources of Wealth among the Richest Americans, 1982–2012*, 103 AM. ECON. REV. 159 (2013).

"world-wide rise of the self-made among the world's super rich."[72] But it takes a narrow construction of "self-made" to conclude that individuals born into significant wealth owe their success solely to their personal moxie. As Kaplan and Rauh note, "Entering the elite group of the wealthiest individuals no longer requires having grown up rich, but having some wealth confers advantages, particularly in access to education. The wealthiest individuals increasingly comprise individuals who accessed this education while young and then implemented their skills in the most scalable industries, where increasing technology and returns to skill allow for the greatest generation of wealth."[73] Kaplan and Rauh conclude that such individuals have "scrapped their way on to the list through their own efforts," but having a father who is a senior partner at a profitable and prestigious law firm, with a net worth presumably in the millions of dollars, still means that one starts life with much greater investments in one's human capital, and a much more secure safety net of family affluence to encourage risk-taking, than are available to a typical child born to parents of modest means.[74]

Kaplan and Rauh do not explain their categories of "wealthy" and "some household wealth" at all, and they further offer no explanation why a snapshot of 400 names is fairly representative of top-end wealth trends, when "top-end" wealth is understood to refer to more than 400 names out of 330 million. Even in 2010 households with net worth exceeding $1 million constituted only about 6.5 percent of households; by this measure, most names in Kaplan and Rauh's "somewhat wealthy" category in fact were rich by national standards. [75]

More generally, the study of the role of gifts and bequests in top-end wealth requires a shift in focus from individuals to families, because by definition the importance of gifts and bequests can only be seen through the lens of multigenerational wealth accumulations. In

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[72] Paul Roderick Gregory, *Taking On Robert Reich And The Myth Of The "Non-Working Rich"*, FORBES, Apr. 16, 2015, http://www.forbes.com/sites/realspin/2015/04/16/taking-on-robert-reich-and-the-myth-of-the-non-working-rich/#2715e4857a0b65d3e3ed2359.

[73] Steven N. Kaplan & Joshua D. Rauh, *Family, Education, and Sources of Wealth among the Richest Americans, 1982–2012*, 103 AM. ECON. REV. 158, 161 (2013).

[74] Ironically, this fact pattern describes not only Bill Gates but also Evan Spiegel, founder of Snapchat.

[75] Edward N. Wolff, *Recent Trends in Household Wealth in the United States: Rising Debt and the Middle-Class Squeeze: An Update to 2007* (Levy Economics Institute of Bard College, Working Paper No. 589, Mar. 2010); Edward N. Wolff, *The Asset Price Meltdown and the Wealth of the Middle Class* (Nat'l Bureau of Economic Research, NBER Working Paper No. 18559, Nov. 2012).

addition to publishing its annual Forbes 400 list, the same journal has recently begun to profile American dynastic wealth in a Forbes 200 list of America's richest families. The Forbes 200 list by itself includes only multigenerational wealth, and thereby excludes individuals like Bill Gates or Warren Buffett.

By comparing the Forbes 400 list of individual wealth with the same journal's Forbes 200 list of family wealth, a very different picture of wealth accumulation in America eemerges than is visible in the Forbes 400 list by itself. Interleaving the two lists together for 2015, five of the top 12 spots are held by intergenerational families:

1. Walton family $149 billion
2. Koch family $86 billion
3. Mars family $80 billion
4. Bill Gates $76 billion
5. Warren Buffett $62 billion
6. Larry Ellison $48 billion
7. Jeff Bezos $47 billion
8. Cargill-MacMillan family $45 billion
9. Mark Zuckerberg $40 billion
10. Michael Bloomberg $39 billion
11. Cox family $35 billion
12. Larry Page $33 billion

The Cargill-MacMillan family is instructive here. As individuals, its highest ranking member is number 90 in the Forbes 400 list, yet the family's wealth is the eighth largest concentration of personal wealth in the country, exceeding that of Mark Zuckerberg and other well-known "self-made" individuals. Seven of the 25 wealthiest families in America today have been among the most affluent for over 100 years, including the DuPonts, Rockefellers, Buschs, Pulitzers and Mellons.[76] Wealth in the United States today is not a simple story of self-made 'scrappers.'

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[76] Katia Savchuk, *America's Oldest Billion-Dollar Family Fortunes*, FORBES, July 1, 2015, http://www.forbes.com/sites/katiasavchuk/2015/07/01/americas-oldest-billion-dollar-family-fortunes/#64cb147e7d07c4c31ec7d077.

D. Implications.

Piketty, Stiglitz,[77] Thomas Frank[78] and many others have made the case that top-end increases in income and wealth inequality have important social costs, including the apparent rise in rents as a fraction of capital income.[79] Again, this literature is very well known, and little purpose is served in revisiting it here. There are competing points of view on this cluster of claims, but the concern is widely shared, and capital taxation in some form is directly responsive to this perceived problem.[80]

Most readers do not need to be reminded, but gifts and bequests are more than just another source of income and wealth inequality. Put simply, gifts and bequests provide the recipient with a profound economic head start – hence the joke about the heir who declared he hit a home run when he was born on third base. In a country where investment in human capital is extremely important, but is not a public good, money in the heir's bank account translates into greater human capital investment, simply because he can afford those private costs, including the opportunity cost of not contributing to a family's income while he attends university. So, too, financial anxiety is itself a debilitating quasi-disease that unproductively absorbs a significant fraction of the sufferer's cognitive bandwidth at any time.[81]

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[77] JOSEPH E. STIGLITZ, THE PRICE OF INEQUALITY: HOW TODAY'S DIVIDED SOCIETY ENDANGERS OUR FUTURE (2012).

[78] THOMAS FRANK, PITY THE BILLIONAIRE: HARD-TIMES SWINDLE AND THE UNLIKELY COMEBACK OF THE RIGHT (2012).

[79] J. Bradford DeLong, *Mr. Piketty and the 'Neoclassics': A Suggested Interpretation*, 68 NAT'L. TAX J. 393 (2015); Joseph E. Stiglitz, *The Origins of Inequality, and Policies to Contain It*, 68 NAT'L TAX J. 425, 431 (2015); Jason Furman & Peter Orszag, A Firm-Level Perspective on the Role of Rents in the Rise in Inequality, Presentation at "A Just Society" Centennial Event in Honor of Joseph Stiglitz at Columbia University (Oct. 16, 2015), *available at* https://www.whitehouse.gov/sites/default/files/page/files/20151016_firm_level_perspective_on_role_of_rents_in_inequality.pdf (discussed in Part IV, below).

[80] For example, Daniel Shaviro, in his review of We Are Better Than This for the National Tax Journal, argues that the book understates the first order importance of the social costs of top-end income and wealth inequality. Daniel Shaviro, *Review: We Are Better Than This: How Government Should Spend Our Money*, 68 NAT'L TAX J. 681 (2015).

[81] EDWARD KLEINBARD, WE ARE BETTER THAN THIS: HOW GOVERNMENT SHOULD SPEND OUR MONEY 21-23 (2014).

Increasing wealth inequality is in part simply the application of compounding returns to preexisting capital. This is true regardless of the validity of Thomas Piketty's controversial claim that normal returns on capital ordinarily outstrip economic growth.   If one compares two otherwise identical individuals (including in their appetite for work) who differ only in their starting wealth, the individual who starts with more wealth than the other will end up with disproportionately more, simply by virtue of the compounding of her starting wealth.

We Are Better Than This develops these points in more detail. The point here is simply that a desire for a fiscal system consonant with core American values like equality of opportunity must confront a world in which inherited private wealth explains half or more of the country's entire stock of capital, and in which that capital can be put to work to generate higher levels of labor income (through investment in human capital), capital income, and welfare than can be achieved by an otherwise-identical agent who starts without that advantage.

III. THE (NON)LESSONS OF OPTIMAL TAX THEORY.

Writing two long papers on the institutional engineering required to implement a successful income tax on capital presupposes a commitment either to the wisdom or the necessity of capital income taxation. This Part III attempts to make that case.

As described in Section I.B., the standard presentation in the legal tax literature basically divides the returns to capital into normal returns, ex post returns to risk taking, and rents. Part V returns to this taxonomy, and argues that in practical application these neat categories largely dissolve into one another, so that it is not useful to pursue differential tax rates on different components of capital income. But for the moment, the paper follows precedent by accepting this taxonomy as meaningful, and proceeds to review the consensus understanding.

A. Ideal Income and Consumption Taxes.

There is a vast literature exploring the taxation of capital income under idealized tax systems, both from a tax law and a public finance economics perspective.[82] Painting with a broad

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[82] *See, e.g.*, David Hasen, *Income Taxation and Risk-Taking,* (unpublished manuscript), at n.1; Theodore Sims, *Capital Income, Risky Investments, and Income and Cash Flow Taxation*, 67 TAX L. REV. 3 nn.2-

brush, much of the literature begins with the standard decomposition of capital income into normal returns, risky returns, and rents, and then proceeds to consider how each of these types of returns is taxed under an ideal income tax, or, alternatively an ideal profits tax implemented as a cash-flow tax.[83]

The standard theoretical argument for why ideal cash-flow taxes dominate ideal income taxes proceeds in two steps. First, the literature demonstrates that the difference between an ideal income tax and an ideal cash flow tax is that the former burdens normal returns while the latter does not. This section III.A. summarizes this part of the analysis. Then, the argument continues, important work in optimal tax theory demonstrates that taxing those returns to waiting is fundamentally inefficient: the same revenue can be raised with less deadweight loss by exempting the normal return from tax. Section III.B., below, summarizes the theoretical reasoning behind this second step.

The standard analyses of the tax burdens imposed on stylized income and cash-flow taxes hinge on a common strategy of "scaling up" (or alternatively "grossing up") an investment to obviate the tax burden on certain returns, in whole or in part.[84] The application of this principle in the cash-flow tax context is usually traced to Cary Brown, who demonstrated that expensing an investment that yielded normal returns was the same as exempting the investment's yield.[85] This of course exactly describes how a cash-flow tax operates: by expensing all investments, therefore, it is said that a cash-flow tax exempts from tax the normal return on those investments.

5 (2014); and John R. Brooks II, *Taxation, Risk and Portfolio Choice: The Treatment of Returns to Risk Under a Normative Income Tax*, 66 TAX L. REV. 255 n.2-6 (2013), for references to much of the tax law literature.

[83] This convention is not unique to the tax law literature. See [Mirrlees Review; Sorensen] for examples in the public finance tradition.

[84] Alvin C. Warren, Jr., *How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax?*, 52 TAX L. REV. 1 (1996), explores the two different applications of the scaling up principle, to show how a cash flow tax exempts normal returns, and to explain how ex post returns to risk are not taxed under an ideal income or profits-only tax.

[85] E. Cary Brown, *Business-Income Taxation and Investment Incentives*, *in* INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300, 309-10 (1948); What is today called the Cary Brown Theorem was introduced to tax law specialists by William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

Cary Brown's insight was sufficiently straightforward that it is taught in most introductory income tax courses. An investor permitted to expense an investment – that is, an investor operating in a cash flow tax environment – receives an immediate cash refund of the tax benefit of that deduction, which can be used to buy more of the same investment (the simplest assumption being that, since the investment yields only normal returns, there should be infinitely elastic supply[86]), which in turn generates a second deduction, and so on, until the investor has a total investment, not of her original pretax investment of I, but rather of I/(1 – T), where T is the tax rate. The cash flow tax applied to this scaled-up investment yields a return r equal to the investor's pretax rate of return: that is, $r(1 – T) \times I/(1 – T) = r\,I$.

In short, the tax deduction afforded by the immediate write-off of investments under a cash flow tax means that the *government* theoretically funds the scaling up of the investor's investment without cost to the investor, thereby immunizing the investor from any tax burden on normal returns.[87]

By definition, an ideal income tax does not permit an investor to deduct the amount of an investment when made, but instead requires that the investment be capitalized; as a result, the tax system does not provide any mechanism by which the taxpayer can costlessly scale up her investment in the face of the imposition of an income tax. It follows that the income tax burdens normal returns, while a cash flow (or other profits tax) does not.[88] In fact, the consensus view is that this is the only important difference between a well-designed income tax and a cash-flow or

[86] For the sake of brevity I skip over here Louis Kaplow's general equilibrium solution. Louis Kaplow, *Taxation and Risk: A General Equilibrium Perspective*, 47 NAT'L. TAX J. 789 (1994).

[87] Another formulation of the same point is that the government has purchased an undivided partial interest in the investment, so that the investor's after-tax investment (immediately following her original investment) is simply smaller than her pretax investment, and she therefore can acquire more of the asset than she could in a tax-free environment, using the government's money to do so. Finally, the government can be described as making an interest-free loan to the investor, repayable when the investment is sold. All are simply different phrasings of the same phenomenon.

[88] Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006); Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, 103 TAX NOTES 91 (2004); Joseph Bankman & David A. Weisbach, *Consumption Taxation is Still Superior to Income Taxation*, 60 STAN. L. REV. 789 (2007-08); Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter?*, 47 TAX L. REV. 377 (1991-92).

other profits-only tax: by design, the former taxes normal returns, whereas the latter exempts them from the tax base. The measure of success of a capital income tax under this view is its ability to measure and tax normal returns consistently.[89]

A corollary to the Cary Brown theorem is that rents are taxed under both a cash flow tax (or other profits tax) and an income tax. In the income tax case rents are taxed as income, and in a profits-only tax, whether implemented as a cash flow tax or otherwise, those returns either are taxed directly or fund consumption (which is all that money is supposed to be good for), which in turn is taxed. The critical assumption here is that an investor has already exploited all the rents available to him, and that under a cash flow tax the investor therefore can expect to earn only normal returns on his government-funded additional investment. Because rents cannot be scaled up (there being no additional rent-bearing investments to make), rents are taxed under both the ideal income tax and the ideal cash flow tax. Taxing rents is viewed as unproblematic, because, even after a substantial tax burden, rents are more desirable than the next best alternative (investing in generally-available marginal returns).[90]

B. <u>The Theory of Why Ideal Consumption Taxes Dominate Income Taxes</u>.

Section III.A. has reminded readers that, under the consensus tax law academy analysis, the difference between an ideal income tax and an ideal consumption (profits-only) tax is that only the former burdens normal returns. But none of this answers the question, is burdening normal returns to capital a good idea or a bad one?

In the U.S. law school academy, the analysis of the wisdom of capital income taxation has been dominated for many years by the pathbreaking work of Joseph Bankman and David

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[89]Jack M. Mintz & Jesús Seade, *Cash Flow or Income? The Choice of Base for Company Taxation*, 6 THE WORLD BANK RES. OBSERVER 2, 182-83 (July 1991) (describing why it is more difficult to accurately measure the tax base under an income tax as compared to a cash flow tax); Peter Wilson, *An Analysis of a Cash Flow Tax for Small Business* 5-7 (New Zealand Treasury, Working Paper 02/27, Dec. 2002) (arguing that valuation, realization, and attribution problems present in an income tax structure are greatly reduced in a cash flow tax regime).

[90] Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter*?, 47 TAX L. REV. 377, 406 (1992) (arguing that taxation of economic rents is "much less troublesome" than taxation of normal returns).

Weisbach,[91] who introduced to tax law academics the Atkinson-Stiglitz Theorem (A-S Theorem).[92] The A-S Theorem has been described as "arguably the most policy-relevant result to come out of the optimal income tax literature;"[93] this paper argues that in retrospect this is damning it with faint praise.

In a nutshell, the A-S Theorem holds that, if an optimal progressive wage tax is an available tax instrument for government to deploy, and if certain conditions are satisfied (which conditions either do or do not approximate reality, depending on which strand of the post-A-S Theorem literature one prefers[94]), then there is no reason to employ differential commodity taxation on top of that progressive wage tax, whether for revenue or "redistributive" purposes.

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[91] *See, e.g.*, Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006). This paper spawned a mini-industry of point and counterpoint with Daniel Shaviro and Chris William Sanchiricco. *See* Joseph Bankman & David A. Weisbach, *Consumption Taxation is Still Superior to Income Taxation*, 60 STAN. L. REV. 789 (2007-08); Joseph Bankman & David A. Weisbach, *A Critical Look at a Critical Look*, 64 TAX L. REV. 539 (2010-11); Chris William Sanchirico, *A Critical Look at the Economic Argument for Taxing Only Labor Income*, 63 TAX L. REV. 867 (2009-10); Chris William Sanchirico, *A Counter-Reply to Bankman and Weisbach*, 64 TAX L. REV. 551 (2010-11); and Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 STAN. L. REV. 745 (2007-08).

Other important contributions include Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807 (2005); Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, 103 TAX NOTES 91 (2004).

[92] Anthony B. Atkinson & Joseph E. Stiglitz, *The Design of Tax Structure: Direct Versus Indirect Taxation*, J. PUB. ECON. 6, 55–75 (1976). U.S. law school academics have not emphasized the alternative argument for zero taxation of capital income that follows from Christophe Chamley, *Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives*, 54 ECONOMETRICA 607 (1986); and Kenneth L. Judd, *Redistributive Taxation in a Simple Perfect Foresight Model*, 28 J. PUB. ECON. 59 (1985), probably because the key assumption in those models of infinitely-lived agents with perfect foresight and supreme rationality does not map well onto the experience or training of lawyers. The A-S Theorem, by contrast, has the quality of a simple and elegant syllogism (which lawyers can enjoy) that does not on its face make heroic assumptions about human nature (although in fact the assumptions that are made arguably are stronger than sometimes appreciated).

[93] Robin Boadway & Pierre Pestieau, *Indirect Taxation and Redistribution: The Scope of the Atkinson-Stiglitz Theorem*, *in* ECONOMICS FOR AN IMPERFECT WORLD: ESSAYS IN HONOR OF JOSEPH STIGLITZ, MIT PRESS (R. Arnott, B. Greenwald, R. Kanbur, B. Nalebuff eds., 2003); Elmuth Cremer, Pierre Pestieau & Jean-Charles Rochet, *Direct Versus Indirect Taxation: The Design Of The Tax Structure Revisited*, 42 INT'L ECON. REV. 781 (2001).

[94] *See* [NOTE XXX] and accompanying text.

The conditions underlying the A-S Theorem include the absence of inheritances (so that wage rates and hours worked alone determine income), that individuals differ only in their wage rates (earnings ability), and that individuals with the same wage incomes have the same consumption preferences (including the preference to defer current consumption for future consumption), even if one (for example) must work twice as many hours as the other to earn that income, and therefore has fewer hours available for leisure.[95] (This last assumption is termed the "weak separability of leisure," even though it arguably is a pretty strong assumption.)

The extension of the A-S Theorem to the taxation of capital income works by considering future consumption goods (tomorrow's apples) as just more consumption goods arrayed on the buffet table of a consumer's life, along with present day consumption goods (today's apples).[96] To buy tomorrow's apples, an individual with a fixed budget constraint must forgo today's apples (or tomatoes, or whatever) and invest the savings at normal rates of return. When an individual does so, her budget in the future reflects the interest return on her savings as well as today's forgone consumption. An individual's "purchase" of tomorrow's apples by forgoing current consumption signals that the slightly larger quantity of apples she can buy tomorrow with the interest on her forgone consumption compensates her today for deferring the pleasure of biting into a juicy Red Delicious right now.

A tax on an individual's returns on her savings serves to increase the after-tax price of tomorrow's apples relative to today's, when compared to the relative prices of the two goods in a world without taxes. This distortion in *relative* prices through the introduction of a tax on returns to savings therefore operates as a differential commodity tax. By contrast, a simple wage tax (or, for that matter, a cash-flow tax) reduces an individual's budget constraint, but does not distort the relative prices of the consumption goods arrayed before her.[97]

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[95] Joseph Stiglitz has written a plain English summary of these conditions in his textbook. Joseph E. Stiglitz & Jay K. Rosengard, Economics of the Public Sector 640 (4th ed. 2015). A more formal presentation is Louis Kaplow, *On the Undesirability of Commodity Taxation Even When Income Taxation is Not Optimal*, 90 J. PUB. ECON. 1235, 1239 (2006).

[96] *Id.*

[97] *Id.* at 1237.

From this follows the fundamental conclusion that consumption taxes dominate income taxes. Since the source of all consumption inside the model ultimately relates back to the agent's wages (because there is no wealth inside the model at Time 0), the income tax imposes two forms of deadweight loss on the agent – the unavoidable distortion of her labor-leisure tradeoffs (because leisure is not taxed in the model, any more than it is in the real world), and a second distortion in the relative prices of current and future consumption goods. The wage tax, by contrast, preserves the pretax relative prices of current and future consumption goods, without imposing any additional burden on the labor-leisure tradeoff.[98]

Within the tax law literature, Chris William Sanchirico has vigorously contested the invocation of the A-S Theorem to conclude that an ideal consumption tax invariably dominates an ideal income tax. Sanchirico essentially has argued that the A-S Theorem's assumptions map poorly onto reality. His challenges did not go unanswered, and the result has been a volume's worth of attacks, defenses, rebuttals and surrebuttals between Sanchiricco and the original authors.[99]

Notwithstanding this heroic debate, in American law schools at least, the A-S Theorem retains its position as the paramount guide for actual policy in the (non)taxation of capital income.[100] The usual recommendation that follows is the adoption of a "progressive

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[98] That is, it is a categorical error to argue that two smaller taxes might be less distortive than one larger one that raises the same revenue when in fact the incidence of both smaller taxes ultimately falls on same thing – labor inputs. David Gamage, *The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth*, 68 TAX LAW REV. 355 (2015), is best seen here as a commentary on the deadweight losses associated with real-world taxes, not ideal ones.

[99] Compare Chris William Sanchirico, *A Critical Look at the Economic Argument for Taxing Only Labor Income*, 63 TAX L. REV. 867 (2010); Joseph Bankman & David A. Weisbach, *A Critical Look at a Critical Look*, 64 TAX L. REV. 539 (2010-11); and Chris William Sanchirico, *A Counter-Reply to Bankman and Weisbach*, 64 TAX L. REV. 551 (2010-11).

David Gamage, *How Should Governments Promote Distributive Justice? A Framework for Analyzing the Optimal Choice of Tax Instruments*, 68 TAX L. REV. 1 (2014), summarizes this academic donnybrook.

[100] Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 STAN. L. REV. 745 (2007-08); and Theodore Sims, *Capital Income, Risky Investments, and Income and Cash Flow Taxation*, 67 TAX L. REV. 3 nn.2-5 (2014).

One perfectly fair reason to deprecate capital income taxation that falls squarely within the domain of legal academics is that as a matter of institutional design we have failed so miserably at the task for so many decades. The Dual BEIT is responsive to these institutional failures, and I therefore ask readers

consumption tax" of the cash-flow type, which, following the terminology employed in this paper, would be a progressive profits tax. A central tenet of this paper is that many authors who state their preference for an ideal cash-flow tax over an ideal income tax, and who then go on to express a concern with "redistribution" as a goal of the tax system, elide too quickly over the fact that their preferred solution for redistributive reasons – a cash-flow tax with a progressive rate structure – in fact undercuts much of their own theoretical argument in favor of consumption taxes. A progressive consumption tax imposes anomalous tax burdens on normal returns, and produces predictably inefficient results when applied to risky returns.[101] By contrast, a flat rate capital income tax has desirable political economy implications when applied to normal returns, and is neutral when applied to risky ones.[102]

Within the economics discipline, some recent public finance literature has explored new economic models whose results imply that the A-S Theorem might not necessarily yield robust results to guide policy. As nicely laid out in Mankiw, Weinzierl and Yagan (2009), "the central tax problem" in optimal tax theory is that, in the face of significant wage taxation, a high wage-rate individual might choose to work less (to "mimic a low wage-rate person," in the unfortunate framing of the literature), and that government is unable directly to observe ability or work effort. Government therefore cannot impose taxes on high ability individuals directly measured by those abilities rather than incomes, in order to fund "redistribution" to lower ability individuals. Instead, government, constrained by its information vacuum, must "provide sufficient incentive for high-ability taxpayers to keep producing at the high levels that correspond to their ability," which translates into lower tax rates on high-ability individuals than would be the case if their ability were fully transparent to government.

inclined to be skeptical about the institutional ability of government actual to tax capital income to hold this objection in abeyance until they have the opportunity to read the companion paper.

[101] Edward McCaffery and Lawrence Zelenak, among others, have considered to some extent the whether progressive tax rate structures affect the conclusions reached under proportional cash-flow and income taxes, respectively. Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807 (2005); Lawrence Zelenak, *The Sometimes-Taxation of the Returns to Risk-Bearing Under a Progressive Income Tax*, 59 SMU L. REV. 879 (2006). Zelenak describes how a progressive income tax, which already burdens normal returns, can burden risky returns as well, but his argument applies with equal vigor to a progressive profits tax. Sections IV.B. and D. return to these points.

[102]*See* Robin Boadway & Neil Bruce, *A General Proposition On The Design Of A Neutral Business Tax*, 24 J. PUB. ECON. 231 (1984).

This formulation of the central problem of optimal tax theory ties into the A-S Theorem because, as Mankiw and colleagues explain, the Theorem rests on the assumption that "there is no information about unobserved ability in an individual's consumption choice that is not also revealed by the individual's income." (This is what the weak separability of leisure assumption means – low-ability/long-hour workers have the same consumption preferences as high-ability individuals who "mimic" them by working fewer hours.) But what if the act of savings itself is a marker of a high-ability person? Then the A-S Theorem no longer holds, and taxing those savings is a way of increasing the tax burden on high-ability taxpayers, just as optimal tax theory might suggest.

This is one of several points made by Banks and Diamond (2010) in their comprehensive review of the literature for the Mirrlees Review. [103] Banks and Diamond conclude that there in fact is room for capital income taxation in optimal tax theory, and summarize their findings in part as follows:

> Support by economists and tax lawyers for exempting capital income from direct taxation has been influenced by the well-known Atkinson–Stiglitz and Chamley–Judd analyses. However, we conclude that the policy relevance of the sharp finding of the optimality of no taxation of capital income is thoroughly undercut by the implications of large uncertainty about future earnings [i.e., that the A-S Theorem's assumption of fixed wages is not empirically accurate over time] and the growing disparity in earnings as a cohort ages. Adding such uncertainty and disparity to the frameworks employed by Atkinson–Stiglitz or Chamley–Judd results in the conclusion that taxation of capital income or of wealth is indeed part of optimal taxation. . . . In addition, in light of the widely varying individual saving rates in the economy, there is a natural presumption that during working years there is a positive correlation between the tendency to save and earnings potential (although the empirical underpinning is not so clear). This is another reason for taxing capital income as a means of more efficiently taxing those with higher earnings potentials. A further case comes from the difficulties in distinguishing between labour and capital incomes, which gives an advantage to reducing the difference in taxes between them. [104]

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[103] James Banks & Peter Diamond, *The Base for Taxation*, *in* DIMENSIONS OF TAX DESIGN: THE MIRRLEES REVIEW, ch.6 (2010). The Mirrlees Review was a comprehensive rethink by some of the world's leading public finance economists, and chaired by Sir James Mirrlees, of the lessons for actual tax policies to be drawn from the current state of the art in public finance economic analyses.

[104] *Id.* at 634.

The summary volume published by the Mirrlees Review, *Tax By Design*, summarizes these arguments and acknowledges their theoretical strength, but for reasons that are not fully articulated, in the end concludes that they are not sufficiently robust to change the standard recommendation that capital income not be subject to taxation.[105]

Peter Diamond and Emmanuel Saez also conclude that capital income taxation is consistent with best practice policy recommendations.[106] They find that the results obtained by Atkinson-Stiglitz (and Chamley-Judd) are "not robust enough to be policy relevant."[107] Like Banks and Diamond, Diamond and Saez emphasize the difficulty of distinguishing between labor and capital income in many instances, and the heterogeneity of savings preferences, which in turn signals something useful about abilities (wage rates). They also develop the claim that when individuals are borrowing-constrained in the capital markets, a tax on capital income (which falls on those individuals who are not borrowing-constrained) and a wage tax reduction on those who are so constrained leads to greater efficiency in outcomes. Finally, Diamond and Saez consider the role of savings (and taxing savings) in a world imbued with uncertain future earnings, including the "new dynamic public finance" literature;[108] the conclusion is that high-ability individuals might choose to over-save as insurance against future earnings drops, and in these circumstances taxing savings can encourage such individuals to keep their noses to the collective grindstones.[109]

In a similar vein, Peter Birch Sorensen has observed that in many cases the consumption of leisure increases with age. This means that leisure in fact is complementary to capital income,

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[105] A shorter presentation of the arguments is in James Mirrlees et al., *Tax By Design: The Mirrlees Review*, at 307-317 (concluding that the efficiency arguments for taxing returns to household savings ultimately are not convincing).

[106] Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, 25 J. ECON. PERSP. 165 (2011).

[107] *Id.* at 167.

[108] *See* Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 STAN. L. REV. 745 (2007-08).

[109] Because this last set of arguments is counterintuitive and seemingly inconsistent with U.S. social norms about personal liberties, I do not emphasize them.

and taxing capital income therefore is justified even under a straightforward reading of the A-S Theorem.[110]

This article does not wade further into these debates, because events have outpaced theory. Increasing concern over the political economy crisis of rising income and wealth inequality has led many sober-minded economists – including, as it happens, Messrs. Atkinson and Stiglitz – to urge that capital in fact be taxed, either directly or through capital income taxation.

C. Life Imitates Art: The Political Economy of Taxing Capital Income.

In the movie *Annie Hall*, Woody Allen is able to set the record straight on the meaning of Marshall McLuhan's work by suddenly producing McLuhan from behind a screen to deliver a lecture to an incredulous pundit standing in a movie line behind Allen. In the same vein, I am able in this Section III.C. to let Anthony Atkinson and Joseph Stiglitz speak for themselves on the policy relevance of the A-S Theorem in light of the critical social importance of top-end income and wealth inequality.

The policy recommendations drawn from the A-S Theorem do not dominate tax policy as it is lived, in that capital income in general is taxed in almost all developed economies.[111] They further have surprisingly little sway over the policy recommendations of working public finance specialists, if a recent survey of members of the National Tax Association is to be believed.[112] One possible explanation for this lack of influence on policy recommendations is that the "A-S proposition assumes that one starts with such a tax. It is far from being granted that existing

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[110] Peter Birch Sorensen, *The Theory of Optimal Taxation: New Developments and Policy Relevance*, 148 NATIONALØKONOMISK TIDSSKRIFT 212 (2010).

[111] N. Gregory Mankiw, Matthew Weinzierl & Danny Yagan, *Optimal Taxation in Theory and Practice*, 23 J. ECON. PERSP. 147-74 (2009), at 167 -169 (contrasting theory of zero tax on capital income with practice of taxation that is "far from zero.")

[112] Eight percent of those surveyed thought that capital income should not be taxed at all; 62 percent thought that realized, inflation-adjusted capital gains should be taxed as ordinary income, http://ns.umich.edu/new/releases/21386-what-do-tax-policy-exp.

income tax systems correspond to such a scheme, and without optimal income taxation there is no AS proposition."[113]

The political economy case for taxing capital income does not rely simply on claims that we need the money, or that wealth and income inequality are increasing through the increasing payoffs captured by self-made individuals. Instead, it draws its strength from the insight is that there is something special going on in the real world that is wholly ignored by the A-S Theorem (as Messrs. Atkinson and Stiglitz readily acknowledge), and that is the pervasive presence of gifts and bequests as drivers of the distribution of capital (and therefore of capital income). Indeed, as described in Part II, roughly half of the capital held by individuals in the United States is attributable to gifts and bequests, not those individuals' labor. And that starting stock of capital permits heirs a head start in human capital investment, in emotional security, and in myriad other real payoffs.

The A-S Theorem holds, within its assumptions, that taxing capital income distorts an agent's intertemporal consumption decisions with respect to his labor income, which introduces deadweight loss that can be avoided by relying solely on a progressive wage tax as a tax instrument. But once gifts and bequests are considered, capital in the real world cannot be explained as the taxpayer's own stored labor. The fundamental premise of the A-S Theorem no longer holds, and as a result the A-S Theorem's conclusions cannot simply be mapped onto tax instrument design.

Instead, from the perspective of the recipient, gifts and bequests are pure windfalls, and the recipient's claim to that capital therefore is highly contingent as a matter of economic efficiency, in the same way that is a claim to rents. In each case the recipient is unambiguously better off with the tax-reduced windfall, and as a result her behavior is not affected by any taxation. And of course, as a matter of moral philosophy the recipient's claim to windfall gifts and bequests also rests on unstable ground.

It might be argued that, because capital transferred by gift or bequest can be traced back to someone's labor at some past date, the labor income distortion thesis remains valid, but simply

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[113] Robin Boadway & Pierre Pestieau, *Indirect Taxation and Redistribution: The Scope of the Atkinson-Stiglitz Theorem*, *in* ECONOMICS FOR AN IMPERFECT WORLD: ESSAYS IN HONOR OF JOSEPH STIGLITZ, MIT PRESS (R. Arnott, B. Greenwald, R. Kanbur, B. Nalebuff eds., 2003), at 16-17.

pushed back in time. Under this reading, the efficiency case for not taxing income on capital received as a gift or bequest mutates into the more attenuated argument that the original generator of excess labor stored as capital would have behaved differently had he known that one day it would be subject to tax. But given that large accumulations of capital can affect top-end distributions of capital and capital income for generations, this argument seems strained in practice, whatever its power in models of agents with perfect foresight. [114]

What is more, from the perspective of donors there are non-market payoffs to savings, which payoffs themselves operate as forms of current consumption; exempting these forms of consumption from tax actually would be inconsistent with the A-S Theorem, thereby further muddying any claim that taxing the returns to capital transferred through gifts and bequests unequivocally introduces deadweight loss. The best evidence here lies in the fact that bequests dominate inter-vivos gifts, for reasons difficult to explain as the accidental outcomes of lives, interrupted.[115] The most plausible inference is that savers derive independent utility from possessing savings, and that utility is a form of consumption. One such example is the direct power that a saver can exert over family members angling for bequests (what Barbara Fried described as the "exchange motive"[116]). The point survives the usual retort that any power or prestige that come with savings rest simply on the ability to consume in the future, because however that utility is described, it exists in the present, not the future.[117]

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[114] [Info on Waltons and other beneficiaries in top 400 because of gifts and bequests; British fellow's paper on UK inheritances – ask Shaviro to remind the name.]

[115] Barbara H. Fried, *Who Gets Utility from Bequests? The Distributive and Welfare Implications for a Consumption Tax*, 51 STAN. L. REV. 641 (1999).

[116] Barbara H. Fried, *Compared to What? Taxing Brute Luck and Other Second-Best Problems*, 53 TAX L. REV. 377, 389 n.53 (1999-2000).

[117] For an example of the standard view, *See e.g*., David A. Weisbach, *The Case For a Consumption Tax*, 110 Tax Notes 1357 (Mar. 20, 2006) ("Perhaps savings bring benefits beyond consumption -- say, power and prestige. Robert Frank famously argued the opposite -- prestige and status come from too much consumption -- but maybe he had it backwards. Power and prestige from savings come from the ability to direct the money, from the possibility of future consumption. They come from the fact that bank accounts are not Monopoly money. Taxing that future consumption reduces the power and prestige from savings").

This idea that gifts and bequests fundamentally change the case for capital income tax has been made in the economic literature. Thus, for example, Cremer, Pestieau and Rochet, in a paper arguing the limitations of the A-S Theorem, wrote:

> The practical implications of Atkinson and Stiglitz's result certainly hinge on the empirical validity of their separability assumption, which has been questioned . . . . However, the spirit of their result goes through even under nonseparability as long as labor supply has no "significant" effect on individuals' marginal rates of substitution (between goods). . . .

> The most fundamental shortcoming of Atkinson and Stiglitz's analysis appears, however, to be of a completely different nature. They assume (like most of the literature on nonlinear income taxation) that individuals differ in one single characteristic, namely wage (earning ability). There are no taste differences nor any other sources of heterogeneity (like wealth differentials). This assumption appears to be motivated by technical considerations rather than by economic or empirical arguments. There is certainly no reason to believe that individuals are alike in all respects but their earning ability; however, so far, this assumption has been the price to pay for solving the optimal taxation problem. Multidimensional heterogeneity (adverse selection) would have made the problem quite untractable. As a matter of fact, [it is straightforward] to show that Atkinson and Stiglitz's result does not in general hold in such a setting.[118]

The particular forms of heterogeneity that Cremer, Pestieau and Rochet explored in their model were differences in starting period wealth (which, to remind readers, Atkinson and Stiglitz assumed did not exist). Since this "heterogeneity" is in fact one of the central fiscal policy and social problems of the moment, it bears directly on the political economy of capital income taxation.

More recently, Thomas Piketty and Emmanuel Saez come to similar conclusions, albeit framed primarily in terms of the desirability of directly taxing bequests, or capital income as a surrogate.[119] The authors' basic point is that in a world imbued with both imperfect capital markets and bequests, made in differing amounts, an individual's stock of capital depends in part

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[118] Elmuth Cremer, Pierre Pestieau & Jean-Charles Rochet, *Direct Versus Indirect Taxation: The Design Of The Tax Structure Revisited*, 42 INT'L ECON. REV. 781, 783 (2001).

[119] T. Piketty & E. Saez, *A theory of optimal inheritance taxation*, 81 ECONOMETRICA 1851-86 (2013). A working paper version of this research was titled *A Theory of Optimal Capital Taxation* (NBER Working Paper 17989, Apr. 2012). The model in the two papers is similar, but the published paper is framed primarily in terms of the desirability of taxing bequests, except in the last paragraph, which considers the tradeoffs between bequest taxation and lifetime capital income taxation.

on the heterogeneous abilities of an individual's predecessors and those predecessors' heterogeneous tastes for bequests. As a result, a realistic model of lifetime income must consider two factors, not one — one's own labor productivity/effort, and one's inherited capital. But because of the heterogeneity of prior generations' abilities and tastes for bequests, the two factors are weighted differently in different people today — someone in the 95th percentile of inheritance receivers is not necessarily in the 95th percentile in labor income earnings ability: "With inheritances, labor income is no longer the unique determinant of life-time resources. [And in contrast to A+S], two-dimensional inequality [different distributions of inheritances and ability across a population] requires two-dimensional tax policy tools."[120]

Because inherited (starting point) capital is highly concentrated relative to earnings abilities, differential taxation of capital (measured either as stock or flows) and labor income becomes useful. Piketty and Saez therefore develop a model that reflects variation in inheritances, in turn not linked to earnings ability. The model treats bequests and capital income as economic equivalents of each other, because in the model each generation has a specified term and does not overlap with other generations, and returns on capital are normal returns.[121]

The model does not assume anything to the effect that the rich get a better education and therefore in fact operate at a higher functional level of ability than do those deprived of those educational opportunities. Instead, it assumes that the total lifetime returns to inherited capital are simply financial returns on that capital. In practice, of course, the connection between inherited capital and higher wage rates (through greater investment in human capital) would only increase the robustness of the conclusions reached by Piketty and Saez.

The Piketty and Saez model yields an important result, which is that across many plausible assumptions, social welfare is maximized with a significantly positive tax on bequests,

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[120] The quotation is from the working paper. The published paper makes the same point, with less rhetorical flourish: "In our model with bequests, inequality is bi-dimensional and earnings are no longer the unique determinant of lifetime resources. As a result, the famous Atkinson and Stiglitz (1976) zero tax result breaks down." *Id.* at 1853.

[121] *Id.* at 1886 ("In our one-period life model, a capitalized inheritance tax . . . is actually equivalent to a pure capital income tax . . . , so that our results can also be interpreted as a theory of capital income taxation. In practice, capital income and wealth taxation is much more significant than bequest taxation.")

or, alternatively, on annual capital income.[122] Because the government revenue requirement is fixed, taxing bequests reduces the need for revenues from a labor income tax, and thereby improves the welfare of those receiving no or small bequests. Taxing bequests at 100 percent and redistributing the revenues is undesirable, because even those who inherit nothing can believe they will pass on substantial assets to their heirs, but overall social welfare is enhanced by a significant capita income or bequest tax, to reduce labor income tax burdens.

Piketty and Saez conclude that, for a given total government tax take, the mix of the bequest tax rate and the labor income tax rate will vary, depending on three factors: the "bequest flow" (i.e., the percentage of annual national income that is inherited by the next generation), the rate of growth in national incomes (g), and the prevailing returns to capital (r). "There is no general reason why . . . inheritance would be taxed more or less than labor income. Any situation can be optimal, depending on parameters [described above]." High national income growth rates imply lower bequest flows [bequests as percentage of national income], just because the denominator is outstripping the numerator. And high r relative to g (a "rentier society") implies that bequest flow rates are increasing. In the former fact pattern, the case for taxing bequests (or annual capital income) is weaker. In the latter, it is stronger. These last conclusions will be familiar to readers of Thomas Piketty's book *Capital in the 21st Century*.

Finally, Messrs. Atkinson and Stiglitz have both recently argued for capital taxes as a necessary response to the crisis of escalating top-end income and wealth in inequality. In his 2015 book, *Inequality: What Can Be Done?*, made three tax proposals that are relevant here.[123] First, Atkinson proposed a steeply graduated rate structure for personal income tax, with a top marginal rate of 65 percent.[124]

Second, Atkinson recommended imposing gift and estate taxes in the form of a capital receipts tax. Citing Piketty's research regarding the dramatic increase in inherited wealth as a proportion of national income, Atkinson argued for a lifetime capital receipts tax:[125]

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[122] *Id.*

[123] Anthony B. Atkinson, *Inequality: What Can Be Done?*, HARV. U. PRESS, ch.7, 2015, at 195.

[124] *Id.* at 187-88.

[125] *Id.* at 194.

The idea of such a tax is not revolutionary; it was proposed more than 100 years ago by John Stuart Mill: there should be "a heavy graduated succession duty on all inheritances exceeding [a] minimum amount, which is sufficient to aid but not supersede personal exertion." Under such a tax, every legacy or gift received by a person would be recorded from the date of initiation of the tax, and the tax payable determined by the sum received to date. The tax would include all gifts inter vivos above an additional modest annual exemption. Transfers between spouses or persons in civil partnerships would not be taxed.[126]

Similar to his labor income taxation proposal, Atkinson recommends a graduated rate structure on bequests with a top marginal rate possibly exceeding 65 percent.[127] According to Atkinson, a progressive rate structure for bequests would incentivize people to spread their wealth so as to avoid tax, thus theoretically accomplishing redistribution goals.[128]

Atkinson also championed an annual wealth tax, although he is less specific here as to the details of his proposal.[129] He writes:

> Among the reasons for considering an annual wealth tax more favourably in the UK today than forty years ago are the much higher level of income inequality and the rise in the ratio of personal wealth to Gross Domestic Product. There have been many changes to this ratio over the postwar period. In the immediate postwar decades the ratio fell, but from the early 1980s it began to rise again, and personal wealth in the 2000s was some five times the Gross Domestic Product.[130]

Not to be outdone, in his 2012 book on inequality, Joseph Stiglitz argued for higher taxes on capital gains, a more robust corporate income tax, and a more robust estate tax.[131] He pointed out that the bottom 90 percent of the population earns less than 10 percent of all capital gains, with fewer than 7 percent of households that earn less than $100,000 annually receiving any

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[126] *Id.*

[127] *Id.* at 195.

[128] *Id.* at 196.

[129] *Id.* at 199.

[130] *Id.* at 200.

[131] Joseph E. Stiglitz, THE PRICE OF INEQUALITY: HOW TODAY'S DIVIDED SOCIETY ENDANGERS OUR FUTURE (W. W. Norton & Co. 2012).

capital gains income at all. Meanwhile, the top 400 households receive 73 percent of their income from either capital gains or interest and dividends.[132] Stiglitz argued that the effect is that the wealthiest Americans face a lower effective tax rate rate than do most taxpayers, who rely primarily on labor income, further increasing the rate of wealth accumulation at the very top of the distribution.

Putting matters succinctly, Stiglitz wrote: "Some earlier, idealized models suggested that it was optimal not to tax interest income (income from capital), but subsequent research showed that this result was not robust: capital taxation is desirable." [133]

And Stiglitz has written in a very recent article:

The standard argument against differential taxation is based on Atkinson and Stiglitz (1976), in which we showed that if there is an optimal income tax, then no differential taxation on commodities is desirable. An implication is that, treating consumption at different dates as different commodities, one should not impose an interest income tax, which changes the relative price of consumption at different dates. That model entailed special technical assumptions (e.g., about the separability between consumption of all goods and leisure) that limit its applicability. Beyond that, several factors are omitted from this model.

First, there are no inheritances. If there were, and they were observable, then they would normally be taxed. How they should be taxed within the standard social welfare framework is a more complicated matter.

Second, there are no rents. As explained above, much of the seeming return to capital is actually rents, and the Henry George principle says that such rents should be taxed at 100 percent.

Third, in the Atkinson-Stiglitz framework, individuals differ in only one respect — their output per hour. But skill mixes are far more heterogeneous, and tax policy (encouraging, say, some kinds of investments and discouraging others) can affect the before-tax distribution of income just as it can affect the after-tax distribution of income.[134]

Stiglitz does retain a preference for the exemption of normal returns from life cycle savings. His specific policy recommendations are a bit vague, but in the end he concludes that

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[132]*Id.* at 90.

[133] *Id.*, ch.4, n.68.

[134] Joseph E. Stiglitz, *The Origins of Inequality, and Policies to Contain It*, 68 NAT'L TAX J. 425, 443 (2015).

There is a practical challenge in parsing out the components [of capital income], but, at the very least, this parsing of the nature of the returns to capital should make it clear that the returns to capital should be taxed, and possibly at rates even higher than those imposed on conventionally measured labor income. If one cannot parse out the different components [and exempt the pure rate of interest], then the tax rate imposed should reflect the relative importance of the different components even if one were not concerned with redistribution.[135]

In sum, the A-S Theorem is a vitally important economic model, but like all such models it must be interpreted judiciously before drawing policy lessons from it.[136] In particular, the model's assumption of a world in which all capital constitutes an agent's stored labor is fundamentally inapposite to the world we inhabit, where gratuitous transfers of capital play a large role in its distribution, and therefore in the distribution of capital income. Taxing returns on capital received as a gift or bequest is not a distortionary and unnecessary tax on the labor income of the recipient, and the impact of such taxation on the donor's behavior is at best ambiguous – particularly given that the original accumulator of capital might have lived several generations ago. Theory does not stand implacably opposed to capital income taxation in practice.

IV. THE DISCREET CHARMS OF A FLAT-RATE TAX ON CAPITAL INCOME.

A. Political Economy Lessons.

This Part IV begins from the assumption that, whatever one thinks of the evolving theoretical arguments for taxing capital income summarized in Part III, the political economy case laid out in Section III.C. overwhelmingly favors some sort of sensible capital taxation. The logic behind ideal profits taxes of all kinds, including cash flow taxes, requires a flat tax rate, but this is inconsistent with the exigencies of addressing top-end economic inequality (which requires a progressive rate structure). In turn, adopting a progressive consumption tax rate structure leads to anomalous tax burdens on both normal returns and risky returns, in ways that

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[135] *Id.* at 442.

[136] Cf. Dani Rodrick, *Economics Rules: The Rights and Wrongs of the Dismal Science* (W.W. Norton 2015).

undercut the efficiency claims for profits-only taxation. Moreover, political economy realities make it improbable that a progressive consumption tax designed to address this first issue will raise sufficient revenues to fund a government whose size and scope is adequate to address the investment and insurance needs of the rest of our citizens. A flat rate capital income tax, divorced from a progressive rate labor income tax – which is to say, a dual income tax structure – cuts this Gordian knot, and does so in ways that can actually impose more neutral burdens on returns to risk than does a progressive consumption tax.

The remainder of this Part IV first explores the relative practical advantages of wealth and capital income taxes, and concludes that capital income is a better base for accomplishing most of the political economy agenda that motivates this paper. It then argues the case that a flat rate capital income tax has both practical and theoretical advantages over a progressive consumption tax – including the fact that it is a progressive tax in application along the relevant margin of time. Finally, it considers the theoretical decomposition of capital income into normal returns, risky returns and rents, and asks how realistic those categories are when applied in the field. The Dual BEIT proposal allocates the taxation of these components among business enterprises and investors in a novel way, but for simplicity this Part IV ignores the design of the Dual BEIT to concentrate instead on tax instrument design lessons that might be drawn from the analysis to this point.

B. <u>Nibbled to Death by Ducks</u>.

Capital, capital income and consumption all are tightly tied up in each other, because capital yields capital income and funds consumption. In ideal circumstances, wealth and capital income taxes can be directly substituted for one another, because the value of a capital investment is nothing other than the present value of its future income.[137] But just as a homeowner embarked on a renovation project discovers that the constant flow of small bills soon overwhelms any projected lump sum cost, the political economy considerations that motivate this paper favor relying principally on an annual tax on flows (a capital income tax), rather an irregular tax on stock (i.e., gift or bequest taxation).

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[137] Thomas Piketty & Emmanuel Saez, *A Theory of Optimal Inheritance Taxation* at 1880; Joseph Bankman, Commentary, *What Can We Say About a Wealth Tax?*, 53 TAX L. REV. 477 (2000).

A profits-only (consumption) tax also burdens capital, in some ultimate sense, because capital when finally spent on consumption is subject to such a tax.[138] But the political economy concerns that motivate this paper are not addressed by flat-rate consumption taxes, and as described below in the context of gift and estate taxes, the excise tax like nature of consumption taxes means that the effective rate of tax on the income used to fund consumption declines as consumption is deferred. Moreover, as section IV.C. below argues, progressive consumption taxes actually produce anomalous results that undercut the efficiency claims advanced for profits-only taxation.

To be clear, one tax instrument need not be chosen to the exclusion of others: there are good reasons to rely on several tax instruments here, as elsewhere.[139] For example, if extraordinarily large concentrations of wealth are viewed as having important negative externalities, a functioning gift and estate tax will constitute one element of a policy response. But one does need to decide which instrument will do the bulk of the heavy lifting, and in this Part IV I argue that a capital income tax has desirable properties that are not always fully appreciated.

Further, these instruments can be combined, or exceptions crafted, better to balance competing efficiency and political economy concerns. For example, several of the economists quoted at the end of Part III are troubled by the distortive effects of capital income taxation on lifetime income smoothing. But this efficiency issue can be accommodated within the general fabric of a capital income tax by IRA type mechanisms of the sort familiar to readers, provided that the aggregate deferral in such accounts is capped, to distinguish between reasonable income smoothing and dynastic wealth deferral. I return to this later in this section.

I do not consider in this paper or its companion a tax on wealth as such, on the theory that in the United States federal direct wealth taxes can be ruled out simply by virtue of the Constitutional proscription against "direct" taxation, except by apportionment among the states

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[138] McCaffery & Hines, Last Best Hope for Progressivity in Tax.

[139] David Gamage, *The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth*, 68 TAX LAW REV. 355 (2015).

in proportion to their populations.[140] Whatever optimism one might have had in years past that the Supreme Court could be expected to adopt a narrow reading of the direct tax clause has largely been overwhelmed by the vituperative debate surrounding the constitutionality of the Affordable Care Act.[141] This author, at least, has little enthusiasm for developing a new tax instrument than on its face would precipitate a similar tsunami of constitutional criticism. As a practical matter, therefore, the important tax instruments directly related to capital are a gift/estate tax and a capital income tax.[142]

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[140] The Constitutional mandate would mean that, if States A and B had equal populations, but unequal wealth, the poorer of the two states would be required to impose a higher tax rate on its residents to collect as much per capita as did the wealthier state.

Deborah H. Schenk, *Saving the Income Tax With a Wealth Tax*, 53 TAX L. REV. 423, 441 n.95 (2000), acknowledges the Constitutional risk, and speculates that an income tax on notional risk free returns might, or might not, survive a similar challenge. This points in the direction of the Dual BEIT, but the Dual BEIT makes one critical move that I believe resolves any Constitutional ambiguity, which is that it permits a loss deduction if the deemed returns are never actually realized. In addition, the Dual BEIT applies to business investments only, and in that context is part of a larger fabric to ensure that business income is taxed once, and only once.

As briefly summarized in Part I and developed in the companion paper to this, by relying on a deemed return to capital for one part of its income tax, the Dual BEIT materially vitiates the importance of the realization doctrine. I therefore submit that the Dual BEIT in fact responds to Schenk's challenge that "The realization requirement essentially makes the tax on capital income avoidable and so far no one has offered an effective stratagem to limit this." *Id.* at 424.

[141] Nat'l Federation of Indep. Bus. v. Sebelius, 132 S. Ct. 2566 (2012) (upholding constitutionality of the Affordable Care Act as a tax, in a strongly divided 5-4 opinion); Jasper L. Cummings, Jr., THE SUPREME COURT, FEDERAL TAXATION, AND THE CONSTITUTION (2013), at 230 ("The most important aspect of [the majority opinion in *Sebelius*] is the 'dog that didn't bark' (or perhaps barked softly): the Chief Justice did not go out of his way to extol the federal taxing power, in contrast to statements made by even conservative Justices of the past in describing the federal taxing power."). Remember as well that Chief Justice Roberts, in the majority opinion in *Sebelius*, was careful to cite Pollock v Farmers' Loan & Trust Co., 157 U.S. 429 (1895), confirmed and expanded, 158 U.S. 601 (1895), and implied that it remained good law ("In 1895, we expanded our interpretation to include taxes on personal property and income from personal property, in the course of striking down aspects of the federal income tax. *Pollock v. Farmers' Loan & Trust Co).* That result was overturned by the *Sixteenth Amendment*, although we continued to consider taxes on personal property to be direct taxes. *See* Eisner v. Macomber*,* 252 U.S. 189 (1920).*"* [citations omitted]. 132 S. Ct. 2566, 2598

[142] Taxes on gratuitous transfers by gift or bequest plainly pass Constitutional muster. Bromley v. McCaughn, 280 U.S. 124 (1929) (gift tax is an excise on a use of property, and hence an indirect tax); Fernandez v. Wiener, 327 U.S. 340 (1946) (similar argument for estate tax).

A capital income tax has several important practical advantages over gift and estate taxation as the principal means of addressing the political economy concerns motivating this paper. First, taxes on gratuitous transfers today are so narrow in application that only a few thousand families incur any tax liability. A broad-based gratuitous transfer tax essentially would operate as a new, and no doubt deeply unpopular, tax. There are good reasons to improve the gift and estate tax, which is well-targeted at the greatest concentrations of wealth, and to hope that it can raise significantly more revenue than it does today, but it seems unrealistic to imagine that it would largely replace the much larger sums raised even today by capital income taxation.

By contrast, taxes on capital income have the merit of being long-established, which fact has the twin political economy virtues of implying broad (if grudging) acceptance, and being reflected in asset prices. (This is the basis for the ancient political economy maxim that an old tax is a good tax.) Moreover, and as described in Part II, the corporate income tax is a tax on capital income; in light of both the substantial revenues it raises and its consistency with international tax policy design norms, the corporate income tax is likely to remain an important tax instrument in the United States.

Second, flows leave behind them a more visible trail than does stock. Virtually all portfolio capital income earned by individuals passes through one financial institution or another, which reports those amounts to investors and the Internal Revenue Service. By contrast, there is no systematic information reporting system in the United States for capital (in the narrow, productive investment, sense) or wealth more generally, and it is not easy to see how one would be created out of whole cloth. Small business net income is a principal exception, in that tax compliance rates are notoriously low in this area. But the same is true of any gift/estate tax on such activities, and one further must battle both creative efforts to pass small business wealth to the next generation free of gift/estate tax,[143] and the overwhelming Congressional impulse, as seen in family farm exceptions today, to excuse small business from any intergenerational transfer tax inconvenience.

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[143] *See, e.g.*, Paul Sullivan, *Small, Private Insurers Face Increasing Scrutiny on Avoided Taxes*, N.Y. TIMES, Jan. 15, 2016 (detailing purported "captive insurance companies" established by small businesses to move wealth between generations).

Third, a gift/estate tax, like taxes on capital gains, dividends, or the distribution of the retained earnings of foreign subsidiaries of U.S. corporations (so-called permanently reinvested earnings), operates essentially as an excise tax: the imposition of the tax is delayed until the event triggering it occurs. One consequence is that, as the untaxed reservoir of income or capital fills up behind the dam of the triggering event, the tax becomes more and more vulnerable to a one-time, never to be repeated, tax holiday, of the sort actually adopted by the United States in 2004 in respect of the permanently reinvested earnings of U.S. multinational companies.[144] In that instance, income that ordinarily would have been taxed by the United States at the 35 percent corporate income tax rate (subject to a foreign tax credit) was eligible for one year to be taxed at a 5.25 percent rate (subject to a prorated credit). The purported reasons for doing so – to encourage investment and employment in the United States in the face of a mild recession – were not realized, but about $310 billion in incremental dividends from foreign subsidiaries to U.S. parent companies were paid in the holiday year.[145]

A progressive consumption tax has the same risk: the commitment to tax the reservoir of capital income when finally consumed will on occasion be breached by the exigencies of the moment, such as a major recession. In such circumstances, the cry to offer a one-time tax holiday on consumption, to stimulate the economy, will be difficult to resist. Can anyone imagine that, if this country relied on a progressive cash-flow tax model, in which individuals held all their savings in tax-deferred accounts, Congress in the midst of the 2008-10 financial crisis would have been able to resist the temptation to offer a one-time, never to be repeated, tax holiday on that pool of savings, to jump start consumption?

Finally, like the nibbling of ducks, an annual tax on capital income can raise the same present value of tax revenues in respect of the returns on capital over time as does a gift/estate tax, capital gains tax, or other quasi-excise taxes imposed on future transfers, while employing a lower nominal tax rate. The reason is simply that the tax deferral implicit in any excise tax, when compared with an annual income tax, operates to exempt from tax, not the base returns on capital

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[144] 26 U.S.C. § 965.

[145] Edward Kleinbard & Patrick Driessen, *A Revenue Estimate Case Study: The Repatriation Holiday Revisited*, 120 Tax Notes 1191 (Sept. 22, 2008).

(those indeed are taxed when the tax is triggered), but the internal compounding of those base returns over the term of the deferral.[146]

By way of an example, imagine that a taxpayer today creates an investment account comprising $1,000 earning 5 percent per annum (compounded annually), the earnings in which account (but not the original investment) will be subject only to a 40 percent transfer tax in 30 years. (One can imagine this setting as analogous to the operation of a capital gains tax, or a consumption tax.) The account will grow to $4322 at the end of year 30; $3322 represents the return over that time. A 40 percent tax on that return is $1329, which would leave the taxpayer with $1993 in after-tax return ($2993 in total, including principal). This amount, in 30 years, is equivalent to a 3.72 percent return on $1,000 over the 30 years, which is another way of saying that an annual income tax of 1.28 percentage points – or about 26 percent of the 5 percent pretax yield on the instrument – would equate with the 40 percent transfer tax on the income earned by the account 30 years out. The greater the the deferral period or the higher the pretax yield of the investment, the lower the equivalent annual income tax rate can be.

In this example, I excluded from tax the original $1,000 in capital. If the original investment also were subject to the 40 percent transfer tax, as would be true in a normal gift/estate tax, then the taxpayer would be left with $2593 after the transfer tax, and the equivalent income tax rate on the return on the investment (but not on the capital itself) would need to be about 36 percent. A politically salient way of describing this outcome is that, for a 10 percent (not percentage point) lower nominal tax rate, I have solved the problem of the apparent double taxation implicit in all gift and estate taxation, once as capital income is earned, and again when it is transferred. Annual income taxation eliminates the tax exemption of the internal compounding.

A more general description is that deferral – that is, an excise tax structure payable in arrears, by whatever name – provides a taxpayer a pretax return on her after-excise tax cash flows.[147] This is easily seen by imagining that a taxpayer divides up each flow as received into an

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[146] Edward Kleinbard, *Corporate Capital and Labor Stuffing in the New Tax Rate Environment* (Working Paper), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2239360.

[147] Staff of the Joint Committee on Taxation, titled *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II*, JCX-63-07, Sept. 4, 2007, at 6-7. As that pamphlet explains, the case considered here, the time value of deferring compensation income, and many

amount sufficient to pay the excise tax due in the future, and a remainder. Both will grow at the pretax rate of return. For example, as noted, the $1993 after-tax return at the end of year 30 in the first case represents an internal yield of 3.72 percent. This figure can be decomposed into a 5 percent (i.e. pretax) rate of return on the taxpayer's base after-excise tax income of 3 percent (40 percent of 5 percent) payable annually.[148] In the second case, $2593 represents an effective 5 percent return compounded for 30 years on the after-excise tax remainder of $600.

C. Progressive Consumption Tax or Flat Rate Capital Income Tax?

Assuming long enough deferral periods or high enough returns, an annual capital income tax can raise the same present value in revenues as a gift/estate tax with a higher nominal rate, while avoiding the rhetorical argument that an individual's capital has been taxed twice. Exactly the same argument applies with a profits only (consumption) tax at the individual level. By design, the consumption tax operates like other excise taxes, by offering taxpayers the deferral of tax on returns to savings. In the phrasing of the preceding section, a flat-rate cash-flow or other profits-only tax offers an individual a pretax return on the individual's initial year after-tax income, and the same analysis then follows. Phrased alternatively, while a consumption tax can be described as applying the same tax rate on consumption whenever it occurs, such a tax can also be understood as imposing a diminishing annual effective tax rate on savings over time.

Proponents of consumption taxes recognize that a flat rate consumption tax raises less revenue than does a capital income tax with the same nominal rate, and therefore if implemented as a flat rate tax would require a higher nominal rate than a flat rate capital income tax. Proponents of profits-only taxation further appreciate the distributional implications of such a consumption tax regime, under which the majority of taxpayers, who of necessity spend what they earn, would face those higher nominal rates each year.[149]

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other time value of money inquiries can all be understood by applying this same methodology of visualizing a prefunding of the flat-rate toll charge, whether denominated a dividend tax, a capital gains tax, or an income tax payable only at some future date.

[148] That is, a 30-year annuity of $30/year, compounded at 5 percent, equals $1993.

[149] *See, e.g.*, Daniel N. Shaviro, *Replacing The Income Tax With a Progressive Consumption Tax*, 103 Tax Notes 91, 92 (Apr. 5, 2004).

The proposal to address these issues typically is couched as a progressive tax rate cash flow (profits-only) tax. A progressive cash-flow tax not only addresses revenue and distributional concerns, but in the view of some has positive moral elements as well, by simultaneously rewarding income smoothing and punishing excessive sumptuary spending in any year.[150] As noted earlier, however, a capital income tax can accommodate an allowance for reasonable amounts of lifetime consumption smoothing in the form of a capped IRA – that is, a limited profits-only tax nested inside the capital income tax. In practice, then, accommodating university professors saving a bit in a rainy day fund is not the basis for preferring one approach to another.

But a progressive consumption tax vitiates the economic efficiency claims for profits-only taxes going back to the A-S Theorem, and in fact can lead to anomalous burdens on normal returns, rather than the imposition of tax at zero rates. By imposing increasing tax rates on increased consumption within a period, a progressive cash-flow tax either burdens or subsidizes normal returns, depending on the pattern of annual earnings and consumption.

For example, imagine a low wage earner under a cash-flow tax that employs a progressive rate structure. The individual scrimps and saves for years to enjoy an orgiastic experience in Las Vegas to celebrate his 60th birthday. This individual obtains a low tax rate benefit in respect of his annual deductions for savings, but suffers a high tax rate on his big-ticket spending spree. This fact pattern violates the Cary Brown theorem's scaling up mechanism (which relies on a constant tax rate to show that deducting investment is identical to exempting the normal return from tax[151]) in a direction that in retrospect imposes a significant tax burden on the now sadder but wiser individual's normal returns.

From the other direction, imagine a high wage earner who saves a little bit every year and who then constrains her consumption patterns in her dotage. She actually finds her normal returns subsidized, by virtue of a high tax benefit from her peak year savings and modest

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[150] Edward McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807 (2005).

[151] Staff of the Joint Committee on Taxation, "Present Law And Analysis Relating To Tax Treatment Of Partnership Carried Interests And Related Issues, Part II," JCX-63-07, Sep. 4, 2007, p. 7.

consumption in her later years.[152] That is, her first dollar of savings is a deduction against her highest dollar of income in her peak years, but her consumption in later years is taxed at lower rates, because her wage income has disappeared. Again, a progressive cash-flow or other profits tax leads to an anomalous outcome when applied to normal returns earned in a realistic scenario.

The other efficiency claim for cash-flow taxes – that they do not burden ex-post risky returns, because taxpayers can scale up their investment to return themselves to the same after-tax position they were in before tax – depends critically on that cash flow tax (or other profits-only tax) employing a flat tax rate. The taxation of returns to risk, is an exercise in correlating ex post actual returns to ex ante risk adjusted normal ones. The most important institutional design criterion for the taxation of risky returns is symmetry: that is, the government as silent partner should absorb losses on a current basis, just as it takes its share of winnings, and further should absorb the same share of each. This approach avoids introducing any tax distortion between ex ante expectations and after-tax ex post outcomes: the deal that offers the marginal ex ante return to risk will also be the marginal investment after taxes are considered.

This point can be made more salient by returning to a point made in Part I, which is that what the tax law literature calls risky returns, what that literature actually is describing are risk-adjusted normal returns. The $1,000 investment in Treasury securities yielding 2 percent and the $1,000 marginal investment in an operating business yielding 8 percent have identical values

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[152] Edward McCaffery acknowledges that the combination of a postpaid consumption tax and progressive rates of tax on the amount consumed in a year can be viewed as taxing normal returns in a year of outsized consumption, when compared with the results reached under a "steady state" consumption model, in which savings are used to smooth lifetime consumption, rather than to finance a single year of consumption run riot. Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. LAW REV. 807–938 (2005).

McCaffery however seems to see these results as a feature rather than as a bug, because he relies less than do other authors on a rigorous application of the theoretical reasons to prefer a consumption tax as do other authors, and therefore is more tolerant of its failures in periods of high consumption. Instead, underlying his work is a strong normative bias against binging. Economic theory, however, usually is understood to privilege agents' preferences, not to embed a particular normative view as to appropriate and inappropriate spending patterns

McCaffery's normative stance arguably conflates two different issues. If one sees progressive tax structures as socially useful, the high-income taxpayer who consumes heavily today should bear more tax than one who consumes more modestly today, but that does not mean that future consumption should be tax-subsidized relative to current taxation, which is what the progressive structure does in some fact patterns.

because each bears the marginal rate of return for an investment in that risk category. If a progressive rate structure is imposed directly (in the form of a progressive capital income tax) or indirectly (through a progressive profits-only tax imposed on the consumption of those returns), the investment with the higher risk-adjusted normal return will be systematically disfavored relative to the lower-risk investment.

In the case of an income tax, the expected after-tax return of a higher risk-adjusted normal return will be affected directly by the progressive rate structure. And in both an income tax and a cash flow tax, losses or deductions will not necessarily be tax-effected at the same rates that apply to gains. For example, "grossing up" within a cash-flow tax is not fully effective as a strategy here, because that mechanism requires that the value of the deduction generated by expensing the deduction equal the present value of the future income from the investment. But the value of the expense deduction will be driven by unrelated income earned within the year (which determines the tax rate benefit of the deduction).

Similarly, differences in patterns of losses (or expenses) and gains over time can effect the tax burden imposed. A progressive rate cash-flow tax disproportionately taxes highly successful winners, given that an investment's upside is unlimited, while its downside is capped at the amount invested.[153] The ex ante positive expected return to risk means that the after-tax value of losses will systematically fall short of compensating firms for the higher tax burdens imposed on gains.

Both a flat rate profits-only tax and a flat-rate income tax on capital have the desirable property of preserving symmetry in tax burdens on ex ante risk-adjusted normal returns, provided that each contemplates the immediate refundability of losses, which admittedly is not the norm in current practice.[154] If, by contrast, gains are taxed more heavily than losses, or if ex

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[153] Lawrence Zelenak develops this argument in the context of progressive income taxation, but his reasoning applies with equal force to a progressive consumption tax. Lawrence Zelenak, *The Sometimes-Taxation of the Returns to Risk-Bearing Under a Progressive Income Tax*, 59 SMU L. REV. 879 (2006).

[154] A second best resolution is to permit net operating loss carryovers that, if unused, increase in value each year by a specified interest charge, to reflect the fact that the government effectively has borrowed from the taxpayer when the government does not absorb its share of losses on a current basis.

It has been suggested that this second best solution requires ultimate refundability of unused losses on the winding up of a failed company, but again this is wholly implausible in practice. I further would argue that that it is not strictly necessary, at least when viewed from the firm's perspective, because from that

post positive returns to risk are taxed at progressive rates, then we can expect the private sector to respond to the skewed after-tax returns available to it by systematically underinvesting in risk. Government can skew returns in this inefficient manner by failing to cover losses (whether through immediate refunds or accreting net operating loss carryovers), and also by adopting a progressive rate structure.

There are no easy solutions inside a profits-only tax to the tension between the efficiency case for a flat rate structure and the political economy imperative of graduated rates to address the inequality issues described earlier. A flat rate cash flow tax is neutral with respect to the taxation of normal returns and returns to risk, but then limits tax progressivity tools to exclusions and demogrants. A wage tax again is neutral, but does not reach rents, and is extraordinarily vulnerable to the recharacterization of labor income as capital income. The point here is simply that the practical alternatives to capital income taxation that include some measure of progressivity are not easily designed to exempt normal returns, and only normal returns, from the tax base

In sum, we are faced with a dilemma. A flat rate profits-only tax preserves tax neutrality as between gains and losses, and therefore efficiency, but is a poor instrument with which to address top-end economic efficiency. A progressive cash-flow or other profits-only tax responds to the latter concern, at the cost of the former.

By contrast, a *flat-rate* capital income tax preserves symmetry in the taxation of risky returns, by virtue of its single tax rate. A flat-rate capital income tax with a capped IRA mechanism nested inside it also responds to the political economy concerns that motivate this paper, because capital ownership is highly concentrated at the top end of the distribution (much more so than is income), and because normal returns on moderate lifetime consumption smoothing would be taxed at zero rates.

Surprisingly, a flat rate capital income tax – even one imposed at moderate nominal rates – in fact is highly progressive in its distributional implications, because its effective tax rate rises

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point of view winding up is a post mortem experience. The firm's existential imperative is to remain a functioning enterprise, and it therefore makes investments on the basis that it will endure forever. When that premise fails, its past risk calculus becomes essentially irrelevant.

the longer the capital is invested. In other words, a flat-rate capital income tax is progressive in its distributional implications along the relevant margin of time.

Many describe this as a fatal defect in capital income taxation.[155] This paper by contrast sees the increasing tax wedge (that is, an increasing effective tax rate) as a feature, not a bug.[156]

For example, imagine that an investment yields 5 percent per annum pretax, and is subject to tax at a 40 percent tax rate, so that it yields 3 percent after tax.[157] In the first year, the effective tax rate is 40 percent. After 5 years, the effective tax rate over the life of the investment rises to 48 percent. And after 30 years, the tax wedge rises to 61 percent. After 100 years, the nominal 40 percent tax wedge reaches 87 percent of the aggregate pretax return. If one thinks in more geological time frames, the effective tax rate rises asymptotically towards 100 percent. The reason is simply the difference over time in compounding at different rates – 5 percent in the pretax case, and 3 percent in the after-tax case; the former exponentially outstrips the latter over time.

This ever-increasing effective tax rate on deferred consumption is the intuitive popular explanation for the results reached about 30 years ago in important articles by Christophe Chamley and Kenneth Judd.[158] In a world with infinitely lived agents (which implies, among

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[155] Ludwig Straub & Ivan Werning, *Positive Long-Run Capital Taxation: Chamley-Judd Revisited* (NBER Working Paper 20441, Aug. 2014) ("Judd (1999) also offers an intuitive interpretation for the Chamley-Judd result pointing out that a tax on capital is equivalent to an increasing tax on consumption. This casts indefinite taxation of capital as a villain, since increasing and unbounded taxes on consumption do not seem intuitively reasonable and seemingly contradict standard commodity tax principles . . . ."); Robert E. Lucas, Jr., *Supply Side Economics: An Analytical Review*, 42 O. ECON. PAPERS 293, 300 (1990) ("Ramsey's analysis is that goods that appear symmetrically in consumer preferences should be taxed at the same rate – taxes should be spread evenly over similar goods. In this application, this principle means that taxes should be spread evenly over consumption at different dates. Since capital taxation applied to new investment involves taxing later consumption at heavier rates than early consumption, this second principle implies that capital is a bad thing to tax.").

[156] Jonathan Gruber, Public Finance and Public Policy 641 (4th ed. 2013), defines a "tax wedge" as "any difference between pre- and post-tax returns to an activity caused by taxes." See also Congressional Budget Office, *Computing Effective Tax Rates on Capital Income*, Dec. 2006, at 1.

[157] The example assumes annual compounding.

[158] "The Chamley-Judd zero capital income tax result - developed in Chamley (1986) and Judd (1985) - states that in a dynamic Ramsey model featuring agents with infinite lives, an asymptotically zero tax on capital income is optimal. The result is based upon the intuition that the growth of the tax wedge between current and future consumption is related to the growth of the time horizon. So as to avoid unlimited

other consequences, no inheritances), their papers argue that the steady state long-run tax on normal returns should be zero, although the starting tax rate need not be.[159] Indeed, the Chamley result in particular argues for very high initial capital taxation; the zero tax result applies only in the long term balanced growth path.[160]

Unsurprisingly, the first half of this thought is often neglected in popular articles calling for lower capital income taxes.[161] As Peter Diamond and Emmanuel Saez explained:

> Another straightforward conclusion coming out of the Chamley–Judd model is that it is better to tax existing wealth rather than future capital income because a tax on current wealth is lump-sum, while a tax on future capital income distorts intertemporal choices. While the asymptotic zero capital income tax result has drawn great attention, the initial result is largely ignored for policy purposes. . . . However, taxing initial wealth as much as the available tax tools allow (whether as a wealth tax or a capital income tax) strains the relevance of the assumption that the government is committed to a policy that this taxation of wealth will not be repeated [because it is committed to reducing capital income taxes to zero in the long run]. Without a credible commitment (which may not be possible), confiscatory wealth taxation would adversely affect saving behavior and have serious efficiency costs because of concerns that such taxation will return. In short, we do

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growth in tax compounding as the horizon extends, the optimal average capital tax rate approximates zero." Wikepedia entry, Optimal capital income taxation.

The papers in question are C. Chamley, *Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives*, 54 ECONOMETRICA 607 (1986); Kenneth L. Judd, *Redistributive Taxation in a Simple Perfect Foresight Model*, 28 J. PUB. ECON. 59 (1985).

[159] Kenneth L. Judd, *Optimal Taxation and Spending in General Competitive Growth Models*, 71 J. PUB. ECON. 1, 1 (1999).

[160] Robert E. Lucas, Jr., *Supply Side Economics: An Analytical Review*, 42 O. ECON. PAPERS 293, 300, 312 (1990).

[161] *See, e.g.*, Garrett Jones, *Living With Inequality: Has Thomas Piketty Found 'the Central Contradiction of Capitalism'?*, Reason, Apr. 26, 2014, *available at* https://reason.com/archives/2014/04/26/living-with-inequality:

> "The Boston University economist Christophe Chamley and the Stanford economist Kenneth Judd came up independently with what we might call the Chamley-Judd Redistribution Impossibility Theorem: Any tax on capital is a bad idea in the long run, and that the overwhelming effect of a capital tax is to lower wages. A capital tax is such a bad idea that even if workers and capitalists really were two entirely separate groups of people—if workers could only eat their wages and capitalists just lived off of their interest like a bunch of trust-funders—it would still be impossible to permanently tax capitalists, hand the tax revenues to workers, and make the workers better off."

not believe that the modeling assumptions behind the Chamley and Judd results are strong enough to support drawing policy lessons about the appropriate taxation of capital.[162]

Again, the most straightforward objection to the Chamley – Judd model is not to its internal logic but rather to the premise (although papers have in fact criticized the internal logic of those articles[163]). We do not live the lives of gods, blessed with perfect foresight and infinite life. Once attention shifts to the world we inhabit, of imperfect clairvoyance and all too short lifespans, we must address the welfare of the living as well as the infinite future, and consider the political economy implications of a world where a large fraction of the total stock of capital is the result of gifts and bequests.[164] The ability to invest in one's own human capital at no cost beyond forgone returns on the capital dropped in one's lap by itself puts the lie to important political nostrums like equality of opportunity. And to be told that in the long run we all will be better off if wealth were allowed to compound indefinitely ignores the fact that the we who hear the message will not in fact be here to see the result of the natural experiment. It also leaves unanswered how exactly that future world might look, in light of important and distressing recent investigative work showing profound and not necessarily constructive imprints of the application of wealth to current political processes.[165]

Enormous concentrations of wealth are susceptible to compounding for many decades (or, as the Forbes 200 family compilation demonstrates, for centuries) without being drawn down for current consumption. Under these facts, effective tax rates that rise along the margin of time

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[162] Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, 25 J. ECON. PERSP. 165, 179 (2011).

[163] Ludwig Straub & Ivan Werning, *Positive Long-Run Capital Taxation: Chamley-Judd Revisited* (NBER Working Paper 20441, Aug. 2014); S. Rao Aiyagari, *Optimal Capital Income Taxation with Incomplete Markets, Borrowing Constraints, and Constant Discounting*, 103 J. POL. ECON. 1158 (1995); Juan Carlos Conesa, Sagiri Kitao & Dirk Kreuger, *Taxing Capital? Not a Bad Idea After All*, 99 AM. ECON. REV. 25, 26 (2009) ("We find that the optimal capital income tax is significantly positive at 36 percent").

[164] Thomas Piketty & Emmanuel Saez, *A Theory of Optimal Capital Income Taxation* (Nat'l Bureau of Econ. Research, Working Paper No. 17989, 2012), develop a formal framework for analyzing optimal tax policies in light of this critical fact.

[165] Cite 12/29 NYT story on rich buying tax policy, and earlier NYT story on how a few hundred families supply bulk of money to 2016 campaigns to date.

mean that a low flat rate capital income tax nonetheless operates as a progressive one in application, provided the tax is well designed (so that it in fact reaches annual accretions of normal returns).[166] Owners of dynastic levels of wealth thereby contribute to general government resources at higher effective rates than do owners of modest levels of capital, and in doing so reduce the need for taxing less affluent taxpayers' labor incomes, which is efficiency-enhancing.[167] At the same time, the incremental tax revenues derived from a capital income tax that is progressive over the relevant margin of time can help to fund a level of government able to make public investments in education, in science and in infrastructure, to the betterment of the great preponderance of citizens.[168] Finally, perceived fairness is satisfied by the idea that tax policy results in those able to devote their private wealth to investment in their own human capital helping their fellow citizens who must rely on public investment to realize the potential of their human capital.

Once the increasing tax wedge over time is understood as a political economy virtue, then, if a labor-capital income centrifuge is available, the tax rate on capital income can be divorced from consideration of labor income rates. The assumption made in most of the ideal income tax literature that a single rate structure applies to all forms of income is neither necessary nor desirable – a flat rate tax on capital income is itself a progressive rate structure.

In sum, a flat-rate capital income tax actually is progressive in its application when measured along the relevant margin of time. By design it burdens returns to savings – deferred consumption – at increasing effective tax rates the longer the deferral period. Particularly if one assumes that ordinary course retirement savings would continue to be exempt from taxation (as indeed the Dual BEIT contemplates), capital income taxation in practice becomes the concern

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[166] A retrospective capital income tax has similar properties, provided that the tax bill reflects a compounding "interest" charge over time. The United States has some experience with such a tax under the Passive Foreign Investment Company (PFIC) rules. That experience suggests that as a political economy matter very high nominal tax bills relative to realized gains are nearly impossible to explain as a fair tradeoff for having deferred that bill for an extended period.

[167] T. Piketty & E. Saez, *A Theory of Optimal Capital Taxation* (NBER Working Paper 17989, Apr. 2012, at 2-4).

[168] This is a principal theme of Edward Kleinbard, *We Are Better Than This: How Government Should Spend Our Money*, O.U. PRESS (2014).

only of the affluent. And in turn, the ability to defer consumption for extraordinarily long periods of time is an attribute of the most affluent. A flat-rate capital income tax burdens an attribute of consumption that ordinarily is an indicia of great affluence, but introduces no other consumption distortions through bunching or stretching out consumption decisions.

D. Teasing Apart Rents and Risky Returns.

Economists generally agree that economic rents can bear much higher tax burdens than can risk-adjusted normal returns, because even after tax, economic rents offer higher returns than the next best alternative. A progressive cash-flow tax at a business enterprise level arguably does just this. On the other hand, tax neutrality in returns to risk contemplate flat tax rates. In this Section IV.D., I argue that, whatever the theoretical reasons to tax rents at higher rates, in practice it is not feasible to tease apart the components of capital income along the line that the theoretical literature lays out.

Much of the applied public finance literature (and in particular the tax law literature) assumes that economic rents are as scarce as hen's teeth, but in practice the economy seems to be a toothy fowl.[169] In an important recent paper, Jason Furman and Peter Orszag outline the indirect evidence for the pervasive role of rents in the American economy.[170] They show that the distribution of annual returns on equity across the firms comprising the S&P 500 in 2014 was heavily skewed to the high end of the distribution (significantly more so than in 1996). Similarly, data on the return on invested capital across publicly traded nonfinancial firms demonstrate that the 90th percentile of this distribution has grown substantially over the last 25 years, so that the ratio of returns on invested capital for firms in the 90th percentile to those in the 50th percentile

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[169] In addition to the paper described below, *See* Joseph E. Stiglitz, *The Price of Inequality: How Today's Divided Society Endangers Our Future*, W. W. Norton & Co. (2012); Joseph E. Stiglitz, *The Origins of Inequality, and Policies to Contain It*, 68 NAT'L TAX J. 425, 443 (2015).

[170] Jason Furman and Peter Orszag, *A Firm-Level Perspective on the Role of Rents in the Rise in Inequality*, Oct. 16, 2015, *available at* https://www.whitehouse.gov/sites/default/files/page/files/20151016_firm_level_perspective_on_role_of_rents_in_inequality.pdf. [*See also* Robin Boadway, *Tax Policy for a Rent-Rich Economy, Canadian Public Policy* 253 (Dec. 2015). *But see* Jennifer Gravelle, *Corporate Tax Incidence With Excess Profits* (Draft Paper) (arguing that rents are not as large a feature in the economy as is suggested by Furman and Orszag).

has increased over that period from approximately 3:1 to 10:1. What is more, there is evidence of persistence in such returns over time, so that, among firms with a return on invested capital above 25 percent in 2003, 85 percent remained in that category in 2013.

It is not surprising to a business person that rents are real and pervasive, at least if the term is interpreted broadly enough to include quasi-rents that may dissipate over time. After all, from their own vantage points businesses do not exist to make fair bets on returns to risk, but rather to engage in entrepreneurial ventures into the unknown or (more relevantly here) to exploit organizational or informational advantages that yield inframarginal returns. Walmart brings quasi-rents to bear when it expands into an underserved local market, in the form of a lower cost of capital, global supply chain, and advanced logistics and inventory systems that small local competitors (and most national retailers) cannot match. So, too, a successful local restaurateur who has built up local goodwill and professional relationships through years of operating a French bistro has a far greater likelihood of success when opening a Spanish tapas restaurant a few blocks away than would another entrepreneur with equal capital to invest in the venture.

Ex-post successful returns to risk beget rents, or more accurately quasi-rents (rents that dissipate over time), in ways that are not susceptible of neat division. In practice, therefore, it is very difficult to tell when returns to risk leave off, and rents begin.

For example, assume that Microsoft's original development of its Office Suite was an exercise in risk. Once that original highly risky investment in a complex new suite of computer applications proved to be hugely successful, the Portugese language implementation of Office presumably was a straightforward extension of Microsoft's existing cluster of Office-related intangible assets (including global market share), on which Microsoft presumably captured rent-type returns. The Starbucks story is another example. An individual gets an idea for a new way of serving coffee, and Starbucks is born. The expansion of "the Starbucks experience" (as the firm describes it) to the United Kingdom in turn yielded outsized profits, because the original returns to uncertainty generated a cluster of intangible assets that could be extended to new horizons far beyond what the founder would ever have confessed to having in the back of his mind when he started.[171]

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[171] Edward D. Kleinbard, *Through a Latte, Darkly: Starbucks' Stateless Income Planning*, 139 Tax Notes 1515 (Jun. 24, 2013).

Finally, rents logically evolve towards normal returns in the secondary markets. Again continuing with Microsoft by way of an example, once Office's global dominance was ensured, a subsequent purchaser of Microsoft stock would expect, and pay for, the relatively predictable stream of revenue attributable to that product. Earlier investors would see their returns to risk eventually spawn rents from the extension of the original investment, and later investors would pay for a lower risk stream of future revenues protected to a large extent by Office's market dominance. Microsoft itself thus can continue to show rent-like returns to invested capital while new investors in Microsoft stock enjoy utility-like relatively safe returns.

These observations become highly relevant when fashioning an income tax on capital, because they mean that it is very difficult in practice to distinguish among the usual categories of returns to risk, rents and normal returns.[172] Risk begets rents, as firms extend successful returns to risk in straightforward ways, and a mature firm can be said to earn either rents or normal returns on equity, depending on whether the perspective is that of the firm or its owners (as they turn over). The theoretical case for taxing rents remains, but in practical application it is far more difficult to identify rents than is sometimes appreciated. A flat-rate tax on capital income is simple, and progressive as applied to normal returns, and neutral as applied to the ex post returns from ex ante risk adjusted normal returns. Perhaps this is as much as one can ask from a practical tax instrument.

E. <u>Entrepreneurial Uncertainty</u>.

Finally, the concept of risk itself is as slippery as is the category of rents. As John Brooks has shown, much of the tax law literature in this field, perhaps overreading the seminal paper by Domar and Musgrave,[173] equates "risk" with simple variance of returns; modern finance theory, by contrast, when measuring risk weights the risk of loss more heavily than the risk (i.e.,

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[172] As noted earlier, risk in the way used in much of the literature ought to be subsumed within a larger category of risk-adjusted normal returns.

[173] Cf. Theodore Sims, *Capital Income, Risky Investments, and Income and Cash Flow Taxation*, 67 TAX L. REV. 3, 21-22 (2014).

prospect) of gain.[174] The consequence of this understanding of risk as inherently asymmetrical is that the standard scaling up story may rest on a false model of human behavior. When loss aversion is properly considered, it is rational to expect risk takers not to scale up perfectly; as a result, risk taking is not untaxed after all.

Further, much of the tax law literature conceives of risk either through the metaphor of coin tosses or through similar exercises where all possible outcomes are known with absolute certainty, [175] and further assumes that markets are complete, so that that every form of risk is owned and priced in efficient markets.[176] These assumptions mean that markets price all risks, and that market participants agree that those prices are accurate.

To a businessperson, this construction of risk as a good accurately priced in complete markets seems woefully unsophisticated. To paraphrase Frank Knight, a business person might argue instead that what the standard presentation labels returns to risk in many cases are returns to uncertainty.[177]

Knight's prose is dense, sometimes internally inconsistent and often vague, even as he lectures the reader about the necessity for precision. The result is an entire corner of literature devoted to explaining what he really meant, at least to each writer. In my reading, however, Knight tried to establish a class of returns to capital exposed to uncertainty, which he labeled "profits," that he distinguished from returns to risk and economic rents.[178] He then related profits

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[174] John R. Brooks II, *Taxation, Risk and Portfolio Choice: The Treatment of Returns to Risk Under a Normative Income Tax*, 66 TAX L. REV. 255, 258 (2013).

[175] Weisbach, Cunningham, Warren.

[176] David Hasen, *Income Taxation and Risk-Taking*, (unpublished manuscript at 34-35).

[177] Frank Knight, *Risk, Uncertainty and Profit*, 31 ECON. INQUIRY 456 (Jul. 1993). CITE also Sarah Lawsky, *Unknown Probabilities and the Tax Law*, STAN. L. REV; Lawsky, *Probably?: Understanding Tax Law's Uncertainty*, 157 U. PENN. L. REV. 1017 (2009) (examining uncertainty and risk in the context of the decision to comply with tax law).

[178] More specifically, Knight outlines three types of probability situations. The first is "a priori probability." A priori probability entails exact determination of the proportion of distribution among the different possible outcomes. The classic example is a calculation of the probability that a die will come out a certain way. If the die is perfect, a "mathematician can easily calculate the probability that any

to the role of the entrepreneur, as the party willing to bear uncertainty in return for these profits.[179]

A more colloquial interpretation of Knight takes inspiration from Donald Rumsfeld to argue that the world is full of known knowns, known unknowns, and unknown unknowns. The first are risk-free returns, the second risk-adjusted normal returns, and the third are returns to uncertainty, which is the province of the entrepreneur. Glimmers of this taxonomy can be gleaned from Knight; his idea again is that someone absorbs the unknown unknowns.

The key idea, imperfectly articulated by Knight, is that business involves accepting an unavoidable residuum of risk whose magnitude (or alternatively whose returns thereon) are not susceptible of pricing through the workings of a market's price mechanism. That unavoidable residuum exists because some risks are uninsurable, or unhedgeable, or because the risk itself is

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proposed distribution of results will come out of any given number of throws." RUP at 215. Much of the tax law literature on risk focuses on a priori probability.

The second of Knight's three categories is "statistical probability." Statistical probability is more common in business, and is the empirical method of applying statistics to many uncorrelated instances, as for example in casualty insurance. Statistical probability will always involve tracking and other errors, but is nonetheless very important in business. RUP at 216.

The third probability situation is "estimates." RUP at 225. Rather than reasoning or inferences from past occurrences, "estimates" are based upon opinion, intuition, and judgment and are the most common probability situations in business. In any given decision based on "estimates," there are in fact two estimates occurring – an estimate of the outcome and an estimate that the estimate of the outcome is correct. As Knight states:

> The business man himself not merely forms the best estimate he can of the outcome of his actions, but he is likely also to estimate the probability that his estimate is correct. The "degree" of certainty or of confidence felt in the conclusion after it is reached cannot be ignored for it is of the greatest practical significance. The action which follows upon an opinion depends as much upon the amount of confidence in that opinion as it does upon the favorableness of the opinion itself.

RUP at 226-27. Estimates are used when evaluating circumstances "so entirely unique that there are no others or not a sufficient number to make it possible to tabulate enough like it to form a basis for any inference of value about any real probability in the case we are interested in." RUP at 226. Thus, a priori or statistical probability often cannot be applied to such circumstances. RUP at 231.

Knight classifies the first two probability situations, a priori and statistical, as "risk," whereas estimates are classified as "uncertainty." RUP at 233. "Life is mostly made up of uncertainties." RUP at 235.

[179] RUP at 269-270, 290-94.

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unknowable, or because the dispersion of returns on that risk are so difficult to measure that reasonable people throw up their hands and say, 'I can't price that.' Knight usefully labels this unavoidable residuum of risk as "uncertainty." [180]

In turn, the entrepreneur is the person who is willing to absorb the unavoidable residuum — the uncertainty — in return for the possibility of profits. The entrepreneur has unique foresight and managerial skill, along with confidence in her judgment and the "disposition to 'back it up in action.'"[181]

Why would any entrepreneur take on unavoidable and unpriceable risk for completely uncertain returns? The answer is that the entrepreneur takes on uncertainty because the entrepreneur is irrationally optimistic. That is plainly true from observation, and (together with uncertainty) offers a useful model of what makes the entrepreneur special: the entrepreneur, unlike the risk-averse general population, or the risk neutral homus economicus, accepts uncertainty because the entrepreneur alone is irrationally optimistic.

What follows for capital income taxation from the story of the entrepreneur as incorrigibly optimistic? The standard story about tax and risk, as summarized above, is that even in an income tax, pure risk is not taxed. The government becomes a silent partner, taking a fixed share of the profits, but also absorbing a fixed share of the losses; risk is therefore reduced by the symmetrical tax (because both upside and downside are scaled back for the same investment). To restore the original risk profile, one need only scale up one's bet.

If, however, the basic story of entrepreneurship is that of irrational optimism, then it follows that from the perspective of the entrepreneur, the interposition of a silent partner is fundamentally unfair, because the entrepreneur (irrationally) values the silent partner's absorption of a percentage of possible losses much less than the entrepreneur values the silent partner's slicing off of a share of profits. The optimism leads to an asymmetrical view of risk, and therefore of the cost to the entrepreneur of the silent partner (the tax system). Instead of loss aversion leading to less scaling up, this mode of thought emphasizes that the entrepreneur

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[180] Knight does not do himself much of a favor when he describes this residual risk as what today would be called "tracking error" — positive or negative returns associated with imperfect hedges or insurance. That is a trivialization of his own insight.

[181] RUP at 269-270.

responds like Achilles sulking in his tent, refusing to take on uncertainty when a silent partner comes along for a share of the upside.

In other words, in a Knightian world, uncertainty, unlike coin tossing, either is not scalable by the entrepreneur (because the entrepreneur's particular insight cannot simply be replicated), or alternatively loses its appeal once the freeriding government comes in for its share. Without scaling, the nontaxation of returns to uncertainty is not achieved.

Ronald Coase in his *Theory of the Firm* takes jabs at Knight, but there is something incomplete in Coase's story. His story is largely about the managerial aspects of the firm — the idea that the firm exists because the price discovery mechanism itself has agency costs, and the firm occupies the conceptual space where management is more efficient than contracts, after the costs of contracting are considered. That insight is powerful and plainly true, but what Knight said (or should have said) is that this is incomplete. The firm also occupies another conceptual space that is orthogonal to Coase's point, which is the firm is the name we give for the entrepreneur as actualized in practice — the person or institution willing to absorb uncertainty in risk or returns, because of a fundamental bias towards irrational optimism.

One story does not crowd out the other: some firms are primarily about the managerial case for the firm, and others about the entrepreneurial case. For example, it is possible today to have a firm that is nothing but contracts — an entrepreneur can have an idea for a new gadget, hire a design firm to design it, hire Foxcomm to build it, and hire Amazon to sell it. In this firm, the entrepreneurial element dominates any modest managerial added value.

Perhaps intuitions along these lines explain the broadly shared view among policy makers that entrepreneurship is special (in a good way), and has positive externalities. The common view of the positive externalities of entrepreneurship and the heroic nature of the entrepreneur standing firm in the face of the void of unknowns, leads to the universal instinct among policymakers (but not economists) that positive entrepreneurial returns should be taxed more lightly than returns from nonentrepreneurial endeavors, to create a "neutral" investment horizon for this special class of cockeyed people. This usually is phrased as a plea for the tax system in some way to "reward" entrepreneurial returns relative to other returns.[182] The cult of "small

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[182] Giles Wilkes, *The Misplaced Hero Worship of Start-Up Founders*, FIN. TIMES, Jun. 3, 2015.

business" among many policymakers might in fact be a misphrasing of what the proponents really admire, which is entrepreneurship.

If one accepts the policy bias in favor of entrepreneurship, there is a fundamental tension in practice between getting correct the taxation of rents, on the one hand, and entrepreneurial returns, on the other. One points in the direction of high tax rates, the other in the direction of concessionary low rates. But because returns to uncertainty in turn can beget rents, distinguishing between the two seems impossible in any reasonably implementable capital income tax. And again, a firm's rents can simultaneously be an equity investor's normal returns.

Against these unresolvable problems, a flat-rate capital income tax makes a virtue of necessity, by taxing all returns on capital at one rate. The result might be systematic undertaxation of some rents, assuming they could be identified with confidence, but in exchange the capital income tax system does not distort risktaking and is much simpler. At the same time, a flat-rate capital income tax is progressive in application when measured along the relevant margin of time. A progressive rate profits-only tax actually abandons neutrality in the taxation of returns to risk, and burdens or subsidizes normal returns, in each case in unpredictable ways. In practice, the flat-rate capital income tax is the superior instrument, once all revenue, efficiency and distributional concerns are properly weighed.

V. <u>CONCLUSION.</u>

This article has argued that it is better to do a good job of measuring and taxing all capital income at one rate than to chase the will o' the wisp of differential tax burdens on economic rents and other forms of capital income. Building on this, and on the key insight that a flat-rate capital income tax in fact is progressive when applied to normal returns over the relevant margin of time, the companion paper to this one demonstrates that it is possible to design a flat-rate tax on capital income that is administrable, reasonably accurate and built on familiar principles. This is the Dual Business Enterprise Income Tax – the Dual BEIT.

The Dual BEIT gives policymakers the flexibility to tax rents and normal returns on completely different schedules; nonetheless, for reasons developed above, there are good reasons not to do so. Instead, all returns to capital would be taxed at one low flat rate, while labor income

would be taxed at increasing marginal rates to a top rate considerably higher than the capital income tax.

We start from a place where capital income often is untaxed, or taxed at wildly different effective rates. To move to a world where all capital income is taxed consistently would be an enormous accomplishment; if doing so required undertaxing economic rents somewhat, I would argue that the result still would be good enough for government work.