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## Accretion-Based Progressive Wealth Taxation

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## ACCRETION-BASED PROGRESSIVE WEALTH TAXATION

by

David Hasen\*

### ABSTRACT

*A large literature has compared the efficiency properties of income and consumption tax bases. Its general conclusion is that a consumption base dominates an income base, except to the extent that practical compliance and administrative problems create opportunities for avoidance and evasion under a consumption tax that are absent under an income tax. An apparent corollary is that the same superiority holds in the comparison of an ideal accretion wealth tax and an ideal consumption tax, because an accretion wealth tax seems not to differ in relevant ways from an ideal income tax.*

*This article argues that these conclusions are significantly qualified. A progressive accretion wealth tax can curb negative externalities that remain in place under a consumption or an income tax, and it can do so more effectively than an excise wealth tax; the article accordingly argues for an accretion tax as a supplement to existing federal taxes (or to a consumption tax, if enacted). The article also argues that any practicable consumption tax creates timing distortions absent under an accretion-type tax, whether on income or on wealth, because of the need for progressivity in rates. Policymakers need to consider all of these issues when weighing the relative merits of income, consumption, and wealth taxes.*

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## INTRODUCTION

A large literature has examined the relative merits of income and consumption taxation.<sup>1</sup> A smaller but still extensive literature has focused on the question of whether a wealth tax, in either accretion or excise form, would be a suitable addition to or substitute for a consumption or an income tax.<sup>2</sup> An excise tax applies to a transaction or event, while an accretion tax applies periodically and without regard to whether any transaction or event has taken place.<sup>3</sup> The general conclusion of these literatures is that a consumption tax is superior to both income and accretion-type wealth taxation, largely because of the adverse incentive effects that arise under the latter bases. This article argues that a federal accretion-type, progressive wealth tax would appropriately supplement either an income tax or a consumption tax and would do so more effectively than our existing excise wealth tax regime, the federal estate and gift tax.<sup>4</sup> It further argues that such a supplement need not be

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1. Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, TAX NOTES 91, 92 (Apr. 5, 2004) (“The literature on income versus consumption taxation could fill many rows of library shelves . . .”).

2. See generally *Symposium on Wealth Taxes*, 53 TAX L. REV. 257 (2000).

3. Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817, 1819 (1990).

4. Technically, the estate tax and the gift tax are two separate taxes. See I.R.C. §§ 2001(a) (imposing a tax on the taxable estate on decedents who are citizens or residents of the U.S.), 2501(a) (imposing a tax on the transfer of property by gift by

equivalent to a tax on income, contrary to arguments commonly offered about the relationship between ideal forms of income and wealth taxation.<sup>5</sup>

An income tax generally reaches a proper fraction of the taxpayer's income during the taxable period, leaving some positive balance to the taxpayer. Notably, although it is possible to frame a wealth tax as a tax on a broader base at a lower rate such that on average the two regimes burden income to the same extent, one need not do so. A wealth tax also can be designed to exceed the expected returns to wealth, so that in the ordinary course the tax tends to reduce holdings to some chosen level. Expressed in income tax terms, such a tax would exceed 100% for some holders, arguably no longer qualifying as a tax on "income." This feature of a wealth tax nevertheless may be appropriate where the tax mitigates the adverse effects of wealth concentration—essentially, negative externalities deriving from wealth concentration. In that case, the tax does not merely (or even primarily) generate revenue for the government; it also induces efficiency-enhancing behavioral and allocative adjustments. The proper price for these adjustments exceeds the expected return to wealth for individuals in upper-wealth brackets.

The article makes a number of subsidiary points along the way. Perhaps the most important concerns arguments over the differences between—and relative merits of—income and consumption taxation. The discussion does not purport to settle the question of which base is superior or even which is superior under limited assumptions about how best to address practical problems of implementation; rather it shows that much of what passes under the heading of "income versus consumption taxation" is really a debate about two more general concepts: excise taxation and accretion taxation, or whether to tax resources once or on an ongoing basis.

To be more specific, I argue that the main incentive differences between pure forms of income and consumption taxation are traceable to the consistency with which the underlying principle is applied—taxation on an event or periodically—not to whether the base is income or consumption.<sup>6</sup> An

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an individual resident or nonresident). Nevertheless, the two taxes are designed to, and do, operate in tandem to apply once to certain gratuitous transfers, whether made during life or at death. See I.R.C. §§ 2001(b)(1)(B) (including "amount of adjusted taxable gifts" in the base), 2010 (providing a unified credit against estate and gift tax due measured by the sum of lifetime gifts and bequests). See generally BORIS BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS* ¶ 120.2. Accordingly, I refer to them throughout as a single "tax."

5. Michael S. Knoll, *Commentary of Fruit and Trees: The Relationship Between Income and Wealth Taxes*, 53 TAX L. REV. 587, 587–88 (2000).

6. See Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 STAN. L. REV. 745, 747–49 (2007), for a discussion of the related point that

accretion tax, to be consistent, would need to reach not only physical capital but also as yet unrealized human capital. Such a tax, though impracticable, would remove incentive effects. An excise tax, by contrast, does reach human capital as long as the capital is eventually realized and consumed in a market transaction. One may formulate the point as follows: a consistently applied income tax—that is, a tax applied to changes in the value of both physical and human capital—reduces to a tax on wage rate, which has long functioned as an ideal for the purpose of evaluating actual tax systems.<sup>7</sup> But an inconsistently applied accretion tax will induce more distortion than an inconsistently applied excise tax, because an excise tax leaves more out of the base.

Apart from incentive effects, an excise tax may actually be inferior to an accretion tax if the objective is to siphon off privately held resources for tax as and when they are created. Further, in the case of taxes designed to curb unwanted behavior, an accretion tax such as a progressive wealth tax may dominate an excise tax in incentive terms. And, finally, where progressive tax rates are in effect—as commentators across the political spectrum commonly assume they must be, regardless of the base<sup>8</sup>—practicable excise-type taxes create timing distortions that offset some of the efficiency benefits they provide under the standard analysis that assumes flat rates. These timing distortions are absent under an accretion base.

The discussion is organized as follows. Part I outlines the structure of an accretion-based wealth tax, contrasting it with excise taxation. Part II reviews arguments traditionally offered in favor of and in opposition to wealth taxation. Part III argues in favor of an accretion wealth tax in part on the novel basis that wealth concentration creates negative externalities that derive solely from the potential power that concentrated wealth gives to its owners, apart from whether the wealth is spent. It is well understood that taxes can effectively reduce or eliminate externalities;<sup>9</sup> a properly structured accretion

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consumption taxation and income taxation differ largely in whether they consider the appropriate accounting period to be one year or a lifetime.

7. See Daniel N. Shaviro, *Commentary: Inequality, Wealth, and Endowment*, 53 TAX L. REV. 397, 407 (2000) (arguing that “endowment or ability is the best available measure of inequality” relevant to assigning differential tax burdens). See generally HARVEY S. ROSEN & TED GAYER, *PUBLIC FINANCE* 327–29 (10th ed. 2013) (explaining the standard result that a lump-sum tax is maximally efficient).

8. See discussion *infra* note 64.

9. See, e.g., David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 TAX L. REV. 19, 72 (2011) (“When market decisions produce externalities—costs or benefits to parties other than those making the market decisions—social welfare generally can be enhanced by

wealth tax can fulfill this role with respect to externalities that are due to wealth concentration. Part III also addresses potential constitutional objections to the tax, drawing on recent work by John Plecnik to show that the tax can satisfy the Constitution's apportionment requirement for direct taxes without compromising its capacity to curb wealth concentration.<sup>10</sup>

## I. WEALTH TAXATION

### A. *Wealth Taxes Generally*

In concept, a wealth tax is simple: it (tautologically) assigns tax liability based on the taxpayer's wealth. The tax may be a one-time (excise-type) levy or periodic (accretion-type); it may be flat or have varying rates. In general, however, the tax simply withdraws for government use a portion of the taxpayer's resources based on the taxpayer's total resources.

In practice, of course, a wealth tax may be complicated, primarily because of problems of base definition and valuation.<sup>11</sup> As examples of the former, questions that may arise include whether "wealth" encompasses the value of human capital, of various intangible attributes such as favorable relationships, or even of psychic characteristics, such as a propensity to enjoy various costless enjoyments, like beautiful sunsets or hiking. Other base definition questions include whether to tax on a gross basis (so that liabilities do not offset assets for purposes of calculating the wealth base) or only on a net basis, and whether certain assets, such as consumer durables or principal residences, are excluded from the base on policy or administrative grounds.

More practically, an administrable wealth tax also must be able to assign values to taxable assets in a way that makes compliance and administration relatively easy. In principle, it is possible to assign a value to almost any asset, as the long history of the federal estate and gift tax demonstrates: all of the assets of the estate of a decedent subject to the estate tax must be valued.<sup>12</sup> Nevertheless, while valuation is straightforward in the case of publicly-traded property and other financial assets for which ready market quotations are available, valuation often is quite difficult in the case of unique or uncommon property, such as land holdings, collectibles, closely-

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imposing taxes equal to negative externalities or subsidies equal to positive externalities."); *see also id.* at 72 n.240 (citing authorities for the proposition).

10. John T. Plecnik, *The New Flat Tax: A Modest Proposal for a Constitutionally Apportioned Wealth Tax*, 41 HASTINGS CONST. L.Q. 483 (2014); *see infra* Part III.A.3.

11. Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 TAX L. REV. 423, 445 (2000).

12. I.R.C. § 2001.

held businesses, and patents, licenses, and other intangible rights.<sup>13</sup> In the estate and gift tax context, costly valuation may be partly justified by the fact that the tax generally is applied just once per lifetime (either on gift or during estate administration), and typically at a rate that generates revenue greatly exceeding the cost of valuation. By contrast, in the case of an accretion-style wealth tax, the same valuation issues may arise as often as every period for which the tax is due.<sup>14</sup>

Nevertheless, for reasons developed below, the benefits associated specifically with an accretion-type wealth tax make the tradeoff worthwhile. One way to frame this point is to consider the extent to which the estate and gift tax's objectives overlap with those of the proposed accretion wealth tax but also fail to meet them because the tax applies on an excise rather than on an accretion basis. If an accretion tax has better distributional and incentive properties than does an excise tax such as the estate and gift tax, the added administrative and compliance costs may be worth it.

### B. Excise Versus Accretion Taxation

An excise tax applies to or is triggered by a transfer or other event. Depending on the nature of the tax, it may effectively apply only once with respect to any given type of property or to any owner of property. For example, a consumer good generally will be subject to a retail sales tax only once, unless it is resold prior to complete use. Common excise taxes include consumption taxes; various types of taxes on particular uses, such as tolls or gasoline taxes (effectively a tax on road use); and real property transfer taxes.<sup>15</sup> The current estate and gift tax is an excise regime, applying only to certain gratuitous transfers of property.<sup>16</sup>

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13. See David J. Shakow, *A Wealth Tax: Taxing the Estates of the Living*, 57 B.C. L. REV. 947 (2016), for a discussion of the practical problems of valuing assets under a wealth tax.

14. A number of commentators have suggested ways to tackle valuation problems under the income tax or a wealth tax. See, e.g., Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167 (1991) (proposing imputation of income based solely on the risk-free rate, selling price, and length of holding period); Mark Gergen, *How to Tax Capital*, TAX L. REV. (forthcoming 2017), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2749422](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2749422) (proposing a similar regime for a wealth tax on non-publicly-traded property).

15. See ROSEN & GAYER, *supra* note 7, at 476 (listing some examples of excise taxes).

16. I.R.C. §§ 2001 (estate tax), 2501 (gift tax). As explained below, either tax generally applies only to the extent that total transfers during the donor's lifetime exceed the amount against which the unified credit for tax may be applied.

A more complicated excise tax would be a cash-flow “income” tax, such as the tax William Andrews proposed more than 40 years ago in a comparison of income and consumption taxation.<sup>17</sup> Such a tax nominally would apply to realized income—just as the current income tax does—but also would offer a full deduction for amounts invested. The main consequence of the deduction is that the only event that is taxed with respect to any asset is its expenditure for private preclusive use; there is no “penalty” for earning returns to capital.<sup>18</sup> In other words, the tax reduces to a consumption tax. However, unlike a point-of-sale or other transfer-type excise tax, a cash-flow consumption tax can have different marginal brackets.<sup>19</sup> The significance of this feature is that it appears to overcome the principal objection to consumption taxes that income tax proponents have identified, which is the regressivity of the tax.

In contrast to excise taxes, accretion taxes apply to the “same” item over time. The most salient operative example of accretion taxation is real property taxes, which generally apply annually on the basis of estimated (or statutorily determined) appraised values.<sup>20</sup> A pure income tax also would be an accretion tax. It would apply to the net change in value of the taxpayer’s market power during the period, offering a deduction for net declines in value and taxing net gains, without regard to whether the taxpayer disposed of assets subject to the tax.<sup>21</sup> The actual income tax is a qualified accretion tax, because, in the case of fluctuating or risky returns, it generally applies only when gain or loss is “realized”—typically through a sale or other disposition.<sup>22</sup> In this regard, the tax operates similarly to an excise tax, but with liability measured by income.<sup>23</sup> Nevertheless, the realization rule is widely considered to be a

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17. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

18. David Shakow & Reed Shuldiner, *A Comprehensive Wealth Tax*, 53 TAX L. REV. 499, 558 (2000).

19. See Andrews, *supra* note 17, at 1174–75.

20. Typical real property taxes are at rates less than the average annual appreciation of the property subject to tax. Often, real estate taxes are substantially less than average annual appreciation because assessed values are well below fair market values. See, e.g., CAL. REV. & TAX CODE § 51(a) (effective January 1, 2001) (setting the “base year value” for real property that has not changed hands equal to a compounded value of the purchase price).

21. See generally Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081 (1980), for a general discussion of the features of a pure income tax and of the realization-type tax that has been in effect at all times since adoption of the modern income tax.

22. I.R.C. § 1001(a).

23. See Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 1 (1993)



concession to practicalities,<sup>24</sup> and, in the context of a debate over the merits of pure forms of taxation, it can be disregarded. In that case, the income tax becomes a pure accretion tax: fluctuating returns would be taxed on the same periodic basis as are fixed ones, without a requirement of disposition for tax to apply.<sup>25</sup>

An ideal accretion wealth tax is widely thought to differ from an ideal income tax only in that it applies to average rather than actual returns, because in other respects the taxes differ only in nominal rates.<sup>26</sup> In particular, assuming in the simple case that returns to capital are uniform, a periodic wealth tax at a given rate is identical to an income tax at an appropriately higher rate. For example, if the risk-free rate of return is 10%, a capital income tax at 40% is the same as an accretion wealth tax at 3.64%.<sup>27</sup> A taxpayer with wealth of \$100 at the beginning of the period would have \$10 of pre-tax income. Under the income tax, he would owe \$4 on \$10 of income, leaving \$106 total; under the wealth tax, he would owe 3.64% of \$110, which also is \$4.<sup>28</sup>

If, however, one introduces elements of real-world complexity into the return to capital, the accretion wealth tax looks similar to, but not the same as, an accretion income tax. One such element is fluctuating returns: in any period, taxpayers may receive returns on capital that differ from the risk-free rate. If excess amounts received are not reinvested (and thereby do not become part of the wealth tax base), they may escape a wealth tax even though the income tax would capture them. Conversely, if the taxpayer's return is less than the risk-free rate, the tax on capital exceeds a comparable income tax; in the more extreme case where actual returns are sufficiently below the riskless rate, the income tax equivalent to the wealth tax would exceed 100% in a given

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(arguing that one can characterize the actual "income" tax as a tax on transactions where tax liability is measured by economic income or loss).

24. *Cottage Sav. Ass'n v. Comm'r*, 499 U.S. 554 (1991).

25. See Shaviro, *supra* note 23, at 7 ("When theoreticians have considered what the term 'income,' in its broadest sense, means, they have recognized that accretion, not transfer, is at its core.").

26. See, e.g., Barbara H. Fried, *Commentary: Compared to What? Taxing Brute Luck and Other Second-Best Problems*, 53 TAX L. REV. 377, 378 (2000) ("A wealth tax is simply a different means of administering an income tax on capital.").

27. See generally Shakow & Shuldiner, *supra* note 18, for a detailed discussion of the features of accretion wealth taxation.

28. Similarly, after the second year, the taxpayer would have \$116.6 before tax. Under the income tax, the \$10.6 of income is taxed at 40%, leaving \$112.36; under the wealth tax, the entire \$116.6 is taxed at 3.64%, also leaving \$112.36.

period.<sup>29</sup> Again, however, the adjustment to wealth for subsequent years would mostly, but not fully, eliminate the discrepancy from the prior period.

Another element of real-world complexity is the availability of infra-marginal returns, or returns to special but limited investment opportunities.<sup>30</sup> For example, an investor may have an opportunity to invest in a special project such as a new technology at a return that exceeds the risk-free rate (or at an expected return that exceeds the risk-adjusted rate). An income tax and a cash-flow consumption tax both reach the return to such an investment, but an accretion wealth tax will not if the income is spent during the period in which it is earned. If it is not spent, taxable wealth increases in the next period so that the return becomes part of the base, thereby approximating, but not equaling, the effect of an income or consumption tax.<sup>31</sup>

In summary, an accretion income tax reaches actual returns to capital, whether realized or not, while an accretion wealth tax typically reaches the average returns to capital. Both taxes periodically withdraw the returns from the private sector. An accretion wealth tax, however, can be set (for certain marginal brackets) at a level in excess of the expected returns to capital, in which case the tax has an absolute leveling function for taxpayers in the bracket. Arguably such a tax is not equivalent to an income tax because the equivalent income tax would exceed 100%, meaning that more than just “income” is taxed. The advantages of such a tax are explained in Part III.A.

An excise tax effectively misses the ordinary returns to capital, because the tax is not applied on an ongoing basis to them but only when the excise event occurs. Consequently, setting aside efficiency effects, an excise tax generally would need to apply at a higher rate than would an accretion tax in order to meet the same revenue target. Thus, the efficiency question is whether distortions are lower under the broader base but nominally lower rate for an accretion tax, or under the narrower base and nominally higher rate for an excise tax. These points are developed in Parts II and III.

## II. ARGUMENTS FOR AND AGAINST WEALTH TAXATION

Arguments for wealth taxation tend to be grounded in distributional concerns and, to some extent, in concerns about the capacity of wealth to be a

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29. For example, if the taxpayer earns just 3%, instead of 10%, then a wealth tax of 3.64% is equivalent to an “income” tax of approximately 125%.

30. David A. Weisbach, *The (Non)Taxation of Risk*, 58 TAX L. REV. 1, 19 (2004).

31. The longer that the extra return is held (rather than spent), the more closely the accretion wealth tax approximates an accretion income tax with respect to the income.

corrupting political influence.<sup>32</sup> Arguments against tend to be grounded in concerns about efficiency costs, double taxation, and fairness.<sup>33</sup> This part canvasses both sets of arguments, though it does not address them in detail because the argument offered in Part III in favor of an accretion wealth tax rests on somewhat different grounds.

#### A. Arguments for

The main attraction of a wealth tax is that it seems to target inequality particularly effectively. If inequality of resources is an evil to be avoided, then taxing according to resource ownership is an effective way to counteract the evil. Reuven Avi-Yonah has noted, for example, that a justification offered for the corporate tax at the time it was adopted was that it would curb concentrations of wealth in the hands of corporations and thereby blunt their capacity to influence political outcomes favorable to them but harmful to public welfare; this argument was merely an extension of the idea, already circulating, that extreme wealth concentration breeds political corruption and undue market power.<sup>34</sup> Similarly, in the course of opposing wealth taxation, Eric Rakowski notes what he regards as the apparent attractiveness of wealth as a base: disparities in wealth reflect disparities in well-being.<sup>35</sup> In considering both how best to share the burden of public goods and how to maximize equality of opportunity, drawing from the most well-off appears to be the most appropriate policy, because it reduces the well-being of those who are already most well-off, thereby promoting equality, and because it properly charges for the benefits the wealthy enjoy from the government.<sup>36</sup> Indeed, the

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32. For an example, see Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1239–41 (2004).

33. See, e.g., Eric Rakowski, *Can Wealth Taxes Be Justified?*, 53 TAX L. REV. 263 (2000); Shaviro, *supra* note 1.

34. Concern for the need to curb wealth concentration was a major motivating factor in adoption of the federal estate tax, in 1916. Christine M. Mumford, *Up and Down and Back Again: Troubled Childhood Notwithstanding, Washington's Stand Alone Estate Tax Deserves to Be Defended*, 29 SEATTLE U. L. REV. 687, 690 (2006).

35. Rakowski goes on to oppose wealth as a base on the basis, among others, that the appropriate metric for redistributing resources is luck. Those who enjoy benefits purely by accident of birth or other circumstances can legitimately be compelled to transfer some of the benefits to those who, also because of accident or circumstance, are unusually poorly off. See Rakowski, *supra* note 33, at 352–53.

36. *Id.* at 264–65.

benefit theory seems to have underlain Congress's decision to adopt the original version of the estate and gift tax, in 1916.<sup>37</sup>

A utilitarian theory of resource allocation also seems to support wealth as a base, given the commonly held assumption of the declining marginal utility of wealth. Under this assumption, the “next” dollar of wealth has less utility than the previous dollar to its owner: the loss of a dollar to someone who has \$1 million is lower in utility terms than is the same loss to someone who has just \$1,000.<sup>38</sup> Given that others less well-off benefit more from receiving a dollar than the wealthier person suffers from the loss, total social utility increases as wealth becomes more evenly distributed, with an optimum distribution reached when all resources are distributed equally.<sup>39</sup>

In addition to these theoretical considerations, arguments for wealth taxation sometimes are more historically grounded, such as in the claim that the current pattern of wealth ownership reflects injustices that society ought to rectify.<sup>40</sup> Under this view, an effective wealth tax would be a temporary measure designed to establish justice in holdings; once the proper pattern was approximately realized, the tax would be repealed. As an example, John Rawls took the view that consumption taxation would be appropriate if operating from a clean slate, but given historical injustices, the optimal base might look different for a time and include, perhaps, a tax on income or wealth.<sup>41</sup>

More recently, some have argued in favor of wealth taxation on practical grounds—in particular on the basis that a wealth tax would more effectively raise funds than would an income tax, because the wealth tax is less subject to manipulation. For example, David Shakow argues that the complexity of the income tax more than outweighs the valuation and liquidity problems associated with wealth taxation—the tradeoff between the two is worth it. Further, because in his model the wealth tax can be flat, incentives for tax-shifting across periods or persons will be relatively modest, thereby reducing opportunities for tax avoidance.<sup>42</sup> Mark Gergen argues that a tax on

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37. See Shakow, *supra* note 13, at 948 (arguing that in adopting the estate tax, “Congress, as expressed in the Committee report, was concerned with the equity of the tax system, and was looking for a way to impose the tax burden on ‘those deriving the most benefit and protection from the Government.’”).

38. Rakowski, *supra* note 33, at 315.

39. See, e.g., Sarah B. Lawsky, *On the Edge: Declining Marginal Utility and Tax Policy*, 95 MINN. L. REV. 904, 904–05 (2011) (discussing the commonly held assumption of declining marginal utility and its implications for theories of optimal wealth distribution).

40. Rakowski, *supra* note 33, at 278.

41. JOHN RAWLS, *A THEORY OF JUSTICE* 245–47 (1999) (arguing for a consumption base if the society's pretax distribution is just).

42. Shakow, *supra* note 13, at 950–51.

publicly-traded securities, together with a complementary tax on other holdings, provides a more administrable and politically feasible way of raising revenue than does the income tax as applied to capital.<sup>43</sup>

Finally, in his influential *Capital in the Twenty-First Century*, Thomas Piketty has argued that wealth concentration is endemic to unregulated capitalism and brings a train of social ills, including corruption and impoverishment of less-wealthy segments of the population.<sup>44</sup> Other studies corroborate these claims, adding as well political and economic instability and persistent economic stagnation as consequences of income inequality.<sup>45</sup> For this reason (and others), Piketty supports a progressive global tax on capital.<sup>46</sup> Like the tax described below, Piketty's tax would function as a periodic accretion tax.<sup>47</sup>

## B. Arguments Against

### 1. In General

As in the case of arguments in favor, arguments opposed to wealth taxation may be categorized as rights-based or utilitarian. In the former category, the principal objection has been that taxing on the basis of wealth penalizes choices about the use of wealth that are morally neutral. The quantity of wealth one has may be due to decisions to save rather than spend, or to the application of effort rather than giving in to sloth; as a matter of justice, neither should be penalized or promoted.<sup>48</sup> Utilitarian arguments generally have focused on the adverse incentive effects of wealth taxation. A tax on wealth tends to discourage wealth accumulation both in the form of labor-leisure distortions and saving-spending distortions, just as an income tax does.

As an example of rights-based arguments, consider two individuals, *A* and *B*, identical in earning power, each of whom accumulates \$*X* in wealth through his or her own efforts. *A* spends most of her wealth, while *B* saves his. It is unfair, so the argument goes, to tax *B* more heavily on the basis of his morally neutral (or perhaps even morally commendable) choice to save rather than spend: the difference in wealth each experiences is due to matters of taste

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43. Gergen, *supra* note 14, at 11–12.

44. THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* 571 (Goldhammer trans. 2014).

45. ERA DABLA-NORRIS ET AL., IMF STAFF DISCUSSION NOTE: CAUSES AND CONSEQUENCES OF INCOME INEQUALITY: A GLOBAL PERSPECTIVE 5 (2015), <https://www.imf.org/external/pubs/ft/sdn/2015/sdn1513.pdf>.

46. PIKETTY, *supra* note 44, at 515–39.

47. *Id.*

48. See generally Rakowski, *supra* note 33.

rather than to any morally relevant characteristic of *A* or *B*. Indeed, the same argument has been made in favor of consumption taxation over income taxation (most notably by John Stuart Mill<sup>49</sup>), an unsurprising fact given the close similarity between income and wealth as bases: taxation of the returns to capital, at least where the funds to purchase the capital already have been taxed, is an unfair (and inefficient) double tax; it is a penalty for abstaining from the use of the saved amount.<sup>50</sup>

Fairness objections also have been raised to the idea of using a wealth tax for more targeted purposes, such as to correct historical injustice or to curb undue political influence. With regard to the former, current wealth ownership may be a poor proxy for whatever gave rise to an unjust distribution of wealth. There may be relatively wealthy people who “came by it honestly” and relatively poor ones who gained amounts unjustly that they then spent.<sup>51</sup> Consequently, indiscriminately taxing wealth to reach a more historically accurate distribution of resources may even be counterproductive. With regard to political influence, the response is similar: the appropriate mechanism is direct regulation of political activities, not regulation of something else that, again, may be a poor proxy for the evil sought to be remedied but is not an evil in itself.<sup>52</sup> In short, in both cases the argument is that taxation of wealth is based on a proxy theory that is itself unsupported and indeed unnecessary given more direct ways of addressing the inequity. In the absence of a showing that it is not possible to control directly the very thing the tax attempts to control indirectly, the tax is not justifiable.

In this connection, the further point has been raised that even if one grants that wealth is inequitably distributed or that wealth can be used to exercise undue political influence, it is not clear that one needs to tax wealth directly in order to rectify these problems.<sup>53</sup> The point is significant in light of the argument, explained in the next section, that efficiency considerations seem to point decisively in favor of consumption taxation over income taxation in the case of ideal forms of the two bases. In light of the fact that income and wealth taxation may be close substitutes for each other, the same superiority may be thought to extend to the comparison of consumption taxation and accretion-based wealth taxation.

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49. JOHN STUART MILL, *PRINCIPLES OF POLITICAL ECONOMY*, at bk. V, ch. 2, § 4 (1848).

50. The claim is developed below that the “double tax” argument is circular in both the income and the wealth taxation cases. *See infra* Part III.

51. Rakowski, *supra* note 33, at 359–60.

52. *Id.* at 292–94.

53. *See* Shaviro, *supra* note 1, at 103.

## 2. *The Double Distortion Argument*

A very large literature has evaluated the relative merits of consumption taxation and income taxation.<sup>54</sup> Because of the close similarities between income taxation and accretion-type wealth taxation, its conclusions tend to apply to accretion-type wealth taxes as well.

The general drift of the literature in recent years has been in favor of a consumption base,<sup>55</sup> principally because a consumption tax is less distortionary than an income tax—at least in the comparison of pure versions of either base.<sup>56</sup> A secondary reason is that a consumption tax is easier to administer than an income tax.<sup>57</sup> Of importance for present purposes is the first claim. In recent iterations, it has rested on the “double distortion argument,” which originated approximately 40 years ago in the economics literature.<sup>58</sup> The double distortion argument relies on the notion that two distortions of the same decision are always worse than one: an income tax, but not a consumption tax, distorts the decision to save or spend twice.

Specifically, both consumption taxation and income taxation affect the choice of whether to work or to consume leisure (the “labor-leisure distortion”), because leisure is untaxed under either base and work is taxed under both. Therefore both taxes will cause taxpayers to work less and consume more leisure than they would in the absence of the tax. Income taxation, however, also affects the decision whether to save or to consume currently because no further tax is due on consumption, while income earned on amounts saved is subject to tax.

One might respond that, because an income tax applies to both wages and savings, the nominal tax rate for any given revenue target can be lower than it is under a consumption tax. In essence, a consumption tax has “one shot” to claim private resources for government use, whereas an income has two shots: it taxes both wage income and the earnings on wages that are later invested. From this perspective, it seems that the question of which base is superior on efficiency grounds depends on relative distortions: for any given revenue target, is the larger distortion to labor-leisure under a consumption base (because of the higher consumption tax rate) more than offset by the fact

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54. *Id.* at 92.

55. Shaviro, *supra* note 6, at 745–47.

56. This is a central argument of Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006).

57. Shaviro, *supra* note 1, at 92.

58. A.B. Atkinson & J.E. Stiglitz, *The Design of Tax Structure: Direct Versus Indirect Taxation*, 6 J. PUB. ECON. 55 (1976). See Bankman & Weisbach, *supra* note 56, at 1422–30, for a discussion of the history of the double distortion argument.

that consumption places no distortion on the choice to save or spend, whereas the income tax does distort that decision? In other words, are the two distortions under an income tax greater than, equal to, or less than the one distortion under a consumption base? This appears to be an empirical question.

The double distortion argument claims that this analysis is faulty, because the tax on saving under the income tax also affects the decision whether to work or not: an individual will adjust work effort both because of the tax on work but not leisure and because of the prospect of the tax on amounts earned that are later invested but not on amounts earned and immediately consumed.<sup>59</sup> This means that the income tax distorts the decision to save or spend twice: in deciding how much to save, but also, though not as obviously, in deciding how much to work for the purpose of later saving. The sum of these distortions on the labor-leisure choice is the same as the distortion that a consumption tax places on that decision. It therefore seems that for any given tax rate, income taxation both affects the labor-leisure decision to the same extent as consumption taxation does and further distorts the subsequent allocation of resources between present and future consumption. Therefore, in their pure forms, an income tax is unambiguously worse than a consumption tax on efficiency grounds.<sup>60</sup>

For present purposes, the significance of the double distortion argument is that it also seems to extend to the question of whether an accretion wealth tax is inferior in efficiency terms to an excise wealth tax. Recall that an accretion wealth tax is identical to an income tax on capital under stylized assumptions and can be close to one under more realistic ones.<sup>61</sup> Consequently, it seems that an accretion wealth tax is also inferior to a consumption tax (or more generally to excise taxes) in efficiency terms, again assuming the idealized case just discussed: zero compliance costs and no opportunities for avoidance or evasion. As a number of commentators have argued, however, none of these assumptions holds: compliance costs are positive, and different bases offer different avoidance opportunities in the real world.<sup>62</sup>

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59. Bankman & Weisbach, *supra* note 56.

60. *Id.*

61. *See supra* Part I.

62. Practical considerations such as differing means by which to avoid or evade different types of taxes suggest that a mix of taxes rather than a single tax base is optimal. *See* David Gamage, *The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth*, 68 TAX L. REV. 355, 358 (2015) (arguing that “overall distortionary costs can be reduced by utilizing some approach for taxing *all of* labor income, consumption, capital income, and wealth.”). As an example, one can evade a consumption tax such as a value-added tax (VAT) by purchasing goods through untaxed intermediaries, whereas the cash earned to purchase the good may unavoidably be part of an income base. *Id.* at 407. Conversely, taxpayers adept at



Even assuming away these practical difficulties, a workable consumption tax comes with significant problems. A further distortion, beyond the labor-leisure distortion, concerns patterns of consumption if the tax is progressive, assuming the tax has workable periodic assessments, such as annually.<sup>63</sup> Progressivity in consumption taxation is widely viewed as desirable because of the assumed correlation between levels of consumption and welfare, but it may induce taxpayers to shift the timing of consumption or, if possible, the identity of the consumer. An accretion wealth tax is actually superior to a consumption tax in this regard, in that (apart from planning opportunities that in principle could be shut down) it is not really possible to adjust the timing of the taxable event. Thus, a wealth tax may create an incentive, absent under a consumption tax, to choose leisure over work, but there is no incentive, once the wealth is created, to adjust the timing of wealth realization because the tax does not require realization (the analog of consumption) in order to apply. In this respect, both pure income and pure wealth taxes are superior in efficiency terms to standard consumption taxes or to other excise taxes that apply to events whose timing is in the taxpayer's control. This point is developed in the next part.

### III. WEALTH TAXATION: NEGATIVE EXTERNALITIES AND TIMING PROBLEMS

The preceding part canvassed familiar arguments in favor of and opposed to wealth taxation; it also reviewed the argument for the superiority on efficiency grounds of consumption taxes to ideal income and, by extension, to ideal wealth taxes. In this part, I make two distinct arguments in favor of an accretion wealth tax. The first concerns the power of a wealth tax to control negative externalities; in this regard, the tax is similar, but superior, to an ideal income tax. As contrasted with earlier arguments along these lines, however, the argument here focuses as well on the benefits to wealthy persons of the mere potential purchasing power of wealth, as contrasted with its actual purchasing power. The fact that wealth produces benefits even if it remains unspent strengthens the case for an accretion wealth tax over other types of wealth tax, including the federal estate and gift tax.

The second argument concerns the efficiency advantages of accrual-over excise-type taxation where, as here, the tax is designed to be progressive

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converting labor income to capital income can avoid a labor income tax but will not avoid a VAT if the income is spent on goods or services subject to the VAT. *Id.* at 404-05.

63. See generally Shaviro, *supra* note 6, for a discussion of inaccuracies that can result from a progressive rate structure annually applied to a consumption base.

and where it is assumed that income or consumption taxes will be progressive as well. Progressivity in taxation enjoys support across a relatively wide swath of the political spectrum, be it of income or consumption,<sup>64</sup> because it is generally recognized that a flat tax either would raise insufficient revenue or impose too great a burden on taxpayers with relatively few resources. If, however, one assumes progressivity, the incentive arises for taxpayers to shift the taxable base from high-tax to low-tax periods, thereby reducing revenues and, ultimately, shifting the incidence of the tax to less well-off persons not intended to bear additional tax. Excise taxes are more susceptible to this kind of timing distortion than are accretion taxes. Accordingly, in the context of progressive rates, the efficiency case for excise regimes such as a consumption tax is weakened.

#### A. Negative Externalities

##### 1. Progressive Accretion Wealth Taxation

An externality is a non-alignment of costs imposed and benefits enjoyed.<sup>65</sup> It arises from the transfer of either a benefit to someone who does not bear the cost of supplying the benefit (a so-called “positive externality”), or a cost to someone who does not enjoy the benefit that incurring the cost provides (a “negative externality”).<sup>66</sup> Both types of externality are inefficient, in that they result in incorrect levels of supply and demand. In the case of a negative externality, oversupply of the activity creating the externality results

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64. Progressivity in income taxation is routinely supported by political liberals. See, e.g., James R. Repetti, *Introduction to the State of Federal Income Taxation: Rates, Progressivity, and Budget Processes*, 45 B.C. L. REV. 989 (2004). Progressivity in a consumption base, however, has been a common feature of proposals from more conservative scholars, including the late David Bradford (author of the X Tax), Robert Carroll and Alan Viard of the American Enterprise Institute (proposing a reconsideration of the X Tax), and Robert Hall and Alvin Rabushka (authors of the Flat Tax). The Flat Tax exhibits average progressivity because of its exemption bracket. For a brief discussion of these taxes and their proponents, see Len Burman, *A Progressive Consumption Tax?*, FORBES (June 4, 2012, 5:33 PM), <http://www.forbes.com/sites/leonardburman/2012/06/04/a-progressive-consumption-tax/#7cf0ea1c316d>; Howard Gleckman, *A New Look at an Old Consumption Tax*, TAX POL'Y CTR. (June 21, 2012), <http://www.taxpolicycenter.org/taxvox/new-look-old-consumption-tax>. In other words, progressivity appears to be a shared value across the political spectrum, with disagreements centering on the base.

65. For an overview, see Bryan Caplan, *Externalities*, in THE CONCISE ENCYCLOPEDIA OF ECONOMICS (David R. Henderson ed., 2d ed. 2007), <http://www.econlib.org/library/Enc/Externalities.html> (last visited Feb. 28, 2017).

66. *Id.*

because the producer's costs are artificially low. In the case of a positive externality, undersupply results for the analogous reason. Familiar examples of negative externalities are pollution when the cost of remediation is spread beyond the polluter, failing to keep one's yard up to community standards, and overuse of the judicial system because the cost is spread beyond litigants to taxpayers generally. Examples of positive externalities include showing movies at open-air theaters, the operation of lighthouses,<sup>67</sup> and costless sharing of intellectual property.

It is widely recognized that taxes can be effective correctives to negative externalities.<sup>68</sup> The general idea is that a tax on the actor equal to the marginal social damage from the activity properly "internalizes" costs, so that the correct level of supply results.<sup>69</sup> For example, if *Factory Owner* causes \$Y of environmental damage with every unit of production, a per-unit tax in that amount on *Factory Owner* will result in the proper level of supply, because *Factory Owner's* marginal private costs of production will equal the marginal public cost of production.

The contention here is that wealth concentration creates a number of negative externalities.<sup>70</sup> One is the power that relatively greater wealth confers to influence decision makers and others inappropriately; the inappropriate influence imposes costs on others (those improperly denied fair decisions or otherwise improperly regarded). This problem is not the same as that traditionally identified by many wealth tax proponents, who typically focus on

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67. See Yoram Margoliath, *Tax Policy Analysis of Climate Change*, 64 TAX L. REV. 63, 63–64 (2010).

68. *Id.* Such taxes commonly are referred to as "Pigovian [or "Pigouvian"] taxes." Arthur Cecil Pigou, in *ENCYCLOPEDIA OF ECONOMICS*, *supra* note 65, <http://www.econlib.org/library/Enc/bios/Pigou.html> (last visited Feb. 28, 2017).

69. See Margoliath, *supra* note 67. The problem can be somewhat harder to solve for positive externalities, where the solution is to subsidize producers. If one wants the beneficiaries of the externality to pay for the benefits they enjoy, the subsidy should be financed with a tax on the beneficiaries, but the latter may be a diffuse group that is particularly hard to tax.

70. William Dugger made a similar proposal in 1990, though he did not ground the tax in the externality of undue influence. William M. Dugger, *The Wealth Tax: A Policy Proposal*, 24 J. ECON. ISSUES 133 (1990). Instead, his view was that a steep wealth tax was necessary to rectify wealth concentration, which he viewed as an evil on grounds of distributive fairness and growth effects (principally chronic under-demand). *Id.* at 139–40 (noting, among other effects, the crowding out of public investment in infrastructure and other public goods by reason of required interest payments on national debt). Dugger suggested a rate for the wealth tax of 20%, which is greatly in excess of rates of return to capital. *Id.* at 142.

the quantity of wealth rather than its relative size,<sup>71</sup> and who look solely to its buying power rather than also to its potential buying power. Consequently, the claim that wealth is reducible to consumption and therefore that one may control wealth by taxing consumption does not directly apply to the argument offered here.<sup>72</sup> Rather, comparatively wealthy individuals wield the power by reason of their potential to confer benefits on third parties, even if they do not actually confer the benefits in every or even most cases.

A second externality, less direct, is that income inequality can have dramatic, systemic consequences if it becomes extreme.<sup>73</sup> Thomas Piketty conjectures that a significant contributing factor to the 2007–08 financial crisis was the lack of purchasing power for individuals in the bottom quintiles of the wealth distribution.<sup>74</sup> Wealth concentration alone does not imply that others lack purchasing power as it is theoretically possible that wealth concentration is mostly due to the efforts that individuals at the top of the wealth distribution make to enhance their wealth—that is, wealth concentration may simply reflect fair payment for the goods and services that high-end individuals provide.<sup>75</sup> In that case, inequality may be compatible with adequate purchasing power of those in lower quintiles. The evidence, however, tends to suggest the opposite. Rising income inequality is associated with declining total growth relative to growth where inequality is less extreme.<sup>76</sup> In addition, Piketty argues that the general trend in industrialized economies has been for the return to capital to exceed the overall growth rate, suggesting that inequality is mostly traceable to capital ownership, not to value added through personal services.<sup>77</sup>

Richard McAdams, reviewing empirical studies, finds evidence that directly supports the first hypothesis and indirectly supports the second.<sup>78</sup> First, he notes that one 2005 study examining the connection between

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71. See, e.g., Edward J. McCaffery, *Taxing Wealth Seriously* 9–11 (Univ. S. Cal. Legal Studies Research Papers Series No. 16-10, 2016), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2738848](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2738848).

72. This argument is taken up in the next Section.

73. The argument draws from the recent work of Thomas Piketty. See *supra* note 44, at 297–98.

74. *Id.* at 297.

75. N. Gregory Mankiw, *Yes,  $r > g$ . So What?*, 105 AM. ECON. REV., no. 5, 2015, at 43.

76. DABLA-NORRIS ET AL., *supra* note 45.

77. PIKETTY, *supra* note 44, at 244. (“The distribution of capital ownership (and of income from capital) is always more concentrated than the distribution of income from labor.”).

78. Richard H. McAdams, *Economic Costs of Inequality*, 2010 U. CHI. LEGAL FORUM 23 (2010).

inequality and political corruption identified a significant, positive correlation.<sup>79</sup> McAdams notes that the 2005 study is to some extent corroborated by another study, which found that inequality was inversely correlated with effective “rule of law” institutions.<sup>80</sup> McAdams also identifies another study, from 2008, that seems to find the opposite correlation, but he observes that the 2008 study is limited to the United States and covers only events at the federal level.<sup>81</sup>

With regard to the second hypothesis, concerning the systemic consequences of extreme inequality, McAdams notes that studies indicate that inequality not only is associated with crime but causes it.<sup>82</sup> The analyses focus on the effect on poorer persons of having insufficient resources rather than on the effect on wealthy people of having too much, but to the extent inequality is persistent, an effective mechanism for alleviating poverty would be taxing the wealthy more heavily to make the poor somewhat wealthier.

Finally, a raft of other studies examining the different but related question of the relationship between inequality and happiness have found a strong negative correlation between the two.<sup>83</sup> The basic thrust of these studies is that, other things equal, greater equality than is observed in most industrialized nations is associated with greater levels of happiness.<sup>84</sup>

Taken as a whole, the evidence strongly suggests that substantial benefits would result from reducing inequality in the United States. A tax imposed, for higher wealth brackets, at a rate in excess of the expected return to capital would be an effective means of doing so. Because the tax is progressive and exceeds 100% of the expected return on ownership that

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79. *Id.* at 39–40 (summarizing a study by You and Khagram, which found that a one standard deviation in reduction in inequality correlated with an approximately two-thirds standard deviation reduction in corruption).

80. *Id.* at 40 (discussing 2003 study by Glaeser et al.).

81. *Id.* at 40–41 (discussing 2008 study by Alt and Lassen).

82. *Id.* at 32–37; *see also id.* at 37 (“In sum, though the empirical connection between inequality and crime is not fully resolved and requires more study, there is significant evidence that it is real and substantial. An economic cost of inequality is greater street crime.”).

83. *See* Tomi Ovaska and Ryo Takashima, *Does a Rising Tide Lift All the Boats? Explaining the National Inequality of Happiness*, 44 J. ECON. ISSUES 205, 209 (2010) (“[C]urrent research findings, such as Easterlin (1995), Clark and Oswald (1996), Veenhoven (1996), D’Ambrosio and Frick (2004) and Gilbert (2006) show that one’s relative standing on the income ladder matters to individuals.”).

84. *See* J.C. Ott, *Government and Happiness in 130 Nations: Good Governance Fosters Higher Level and More Equality of Happiness*, 102 SOC. INDICATORS RES. 3 (2010), which finds a strong correlation between economic equality and overall happiness, with Scandinavian countries (such as Denmark) and the Netherlands scoring particularly highly on both measures.

creates an externality, over time the tax will tend to eliminate extreme concentrations of wealth through absolute reductions in holdings. For individuals in lower brackets, the tax rate would not be in excess of the expected rate of return to capital and for that reason would neither reduce the absolute size of holdings nor eliminate the incentive to accumulate wealth for those of comparatively modest means. In this regard, the tax becomes self-regulating: it can be designed to eliminate or at least to reduce the externality to the extent it is present but not otherwise to reduce wealth in absolute terms.

One might legitimately raise the same objection to the proposal here that others have raised to wealth taxation generally, discussed in Part II: why attack a problem indirectly, through a tax on it, rather than directly, by regulating the harm itself? If the problem that wealth concentration creates is the exercise of undue influence, why not curb the exercise rather than the wealth?<sup>85</sup> One reason, which others also have identified,<sup>86</sup> is that in practice a number of instruments are likely necessary to address the problem, because a perfectly targeted solution, just like a perfect tax, is unavailable. For example, legal provisions designed to mitigate or eliminate undue influence through direct measures are common,<sup>87</sup> yet we still observe undue influence, which suggests that more of the same may offer declining marginal benefits as well as declining benefits relative to those of other instruments. Rather than adopt more such provisions, a better response may be to add taxation to the mix. The question, in short, is not whether a direct solution is preferable but instead whether, given that all solutions including direct ones are imperfect, an accretion wealth tax should be in the mix of solutions.

A second reason for the tax is that for some of the identified externalities a wealth tax is highly targeted. For example, chronic under-demand may be due to the lack of resources for innovative products among large segments of the population.<sup>88</sup> Directly increasing their wealth provides purchasing power for innovative products, thereby promoting innovation and

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85. Rakowski, *supra* note 33, at 292–94.

86. *See, e.g.*, Fried, *supra* note 26, at 378; Shaviro, *supra* note 7, at 420–21.

87. Examples include open records laws and separation-of-power provisions.

88. PIKETTY, *supra* note 44, at 297 (“[O]ne consequence of increasing inequality was virtual stagnation of the purchasing power of the lower and middle classes in the United States, which inevitably made it more likely that modest households would take on debt . . .”). *See also* Josef Zweimüller, *Schumpeterian Entrepreneurs Meet Engel's Law: The Impact of Inequality on Innovation-Driven Growth*, 5 J. ECON. GROWTH 185 (2000) (developing a model under which dramatic inequality drives down demand for innovations because of the reduction in lower-wealth persons' resources to purchase innovative products).

economic growth. Similarly, if wealth concentration causes lower levels of happiness and if it is due in part to an unjust allocation of resources (for example, because of elite capture of decision makers), reducing levels of wealth concentration can directly and appropriately increase happiness.

## 2. *Excise Taxes and Wealth Concentration*

Another, more powerful argument against an accretion-type wealth tax is based on the idea that directly taxing wealth is not necessary, because an appropriately strengthened estate and gift tax or a tax on consumption will have the same effects on wealth accumulation as will taxation of wealth on an accretion basis.<sup>89</sup> In light of the perceived superiority on efficiency grounds of consumption taxation to an accretion-type tax (because of the double distortion argument), the case for an accretion wealth tax would seem to be fairly weak. Adoption of an accretion tax simply magnifies the distortions already operative under the income tax and does so unnecessarily in light of the capacity of a progressive consumption or other excise tax to achieve the same goals.

At least two features of concentrated wealth ownership, however, make it irreducible to consumption and therefore make taxation of consumption an inadequate proxy for taxing concentrated wealth directly. Further, for reasons explained below, the deficiencies of a consumption tax in this respect do not derive specifically from the fact that consumption is the base but rather from the fact that a consumption tax is an excise tax. Therefore the argument extends as well to the comparison of an accretion wealth tax to the existing federal estate and gift tax.

The first feature of concentrated wealth ownership relevant to the claim is the enjoyment one gets from mere ownership as contrasted with the enjoyment due to spending the wealth.<sup>90</sup> If one thinks that the true object of the tax base is something like welfare or well-being, it seems one would want to tax this enjoyment, which would entail taxing wealth on an ongoing basis. The second feature is the fact that the power to influence decision makers can be exercised without actually spending the wealth, as discussed in the last section. The power gives an advantage to the mere possession of wealth, which, because it remains unspent, also will not be accurately picked up by a consumption or other excise tax.

The points are worth stressing, because they run counter to prominent claims in the literature about the adequacy of consumption as a base for these

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89. See, e.g., Shaviro, *supra* note 1.

90. See, e.g., LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP* 114 (2002) (“Commentators [describing the benefits of wealth ownership] typically mention such factors as security, political power, and social standing.”).

purposes. For example, in opposing the argument that security, political power, and social standing are not reducible to purchasing power, Dan Shaviro writes:

Why does wealth offer [these benefits]? The answer must be because of its value—that is, because of what it can be used to buy. . . . [A] postpaid consumption tax affects what the wealth one holds can be used to buy. It is no different in that regard than an arm’s-length liability that one incurs to defray the cost of a prepaid tax. Even when wealthy people make bequests to their heirs from motives of benevolence, a postpaid consumption tax affects the benefits they are conveying—that is, the amount that the heirs can buy.<sup>91</sup>

Shaviro concludes that because all the benefits of wealth ultimately are realized in its consumption, a tax on wealth is not necessary to control the externalities that wealth provides—a consumption tax will pick them up.<sup>92</sup>

The difficulty with the argument is that it appears to beg the question. It may be true that wealth can offer security, political power and the like because it can be used to buy things that people want, but it does not follow that wealth is reducible to the power to buy things people want. One could equally say that wealth has value because it can influence people through the prospect it offers to them of acquiring these things, even though the prospect may never materialize. If *A* is wealthy and *B* is not, *A* may be able to induce *B* to take a certain course of action on the basis that *A* may (not will) confer a benefit on *B* for so doing. The value of *A*’s wealth is no less attributable to its mere prospect of providing *B* with purchasing power than to its actual power to purchase things. Each attribute of wealth has value. One could state the point as follows: it is possible to conceive of a world in which concentrated wealth conferred no ability to affect decision makers inappropriately. In that world, a given relative quantity of wealth would have less value than it does in the actual world. The difference between the two worlds reflects the added benefit that concentrated wealth provides in the actual world. Critically, this element of value represents a pure transfer from those who lack the power—it is an economic rent, not a true economic return.

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91. Shaviro, *supra* note 1, at 106.

92. *Id.* (“[S]avings and wealth are indeed subsidiary to consumption in that they derive their value entirely from that potential use, whether its exercise is proximate or not.”). See also Joseph Bankman & Daniel Shaviro, *Piketty in America: A Tale of Two Literatures*, 68 TAX L. REV. 453, 465 (2015) (“[W]ealth only derives value from the fact that it can be spent.”).



One might counter that even if benefits do result from the mere power to spend concentrated wealth, these benefits will ultimately be realized in the form of additional explicit consumption, so that a tax on consumption reaches both actual spending and the power to spend that concentrated wealth provides. But if ownership of concentrated wealth confers substantial enough benefits, it is optimal never to reduce some of it to consumption—and this, in fact, is what we observe. In the United States, large concentrations of wealth tend not to dissipate but to grow.<sup>93</sup> If wealth concentrations are systematically increasing, then a tax on consumption systematically fails to burden some wealth. Indeed, as stated above, it was largely the perceived problems of dynastic wealth—of wealth accumulated and passed on to later generations—that motivated adoption of the federal estate and gift tax, in 1916.<sup>94</sup> It is well understood that the estate and gift tax have been only modestly successful, in part because of their dilution in recent years<sup>95</sup> and in part because of the availability of effective tax planning techniques that reduce the effective tax rate materially.<sup>96</sup> But even a strengthened estate and gift tax will not reach the benefits of wealth ownership as effectively as an accretion tax does.

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93. Emily Beller & Michael Hout, *Intergenerational Social Mobility: The United States in Comparative Perspective*, 16 *FUTURE CHILD*. 19, 26–27 (2006) (noting low rates of wealth mobility in the U.S. and especially low rates of wealth mobility in the wealthiest quintile); Nancy A. Jianakoplos & Paul L. Menchik, *Wealth Mobility*, 79 *REV. ECON. & STAT.* 18 (1997) (same). See also Elise Gould, *U.S. Mobility Lags Behind Peer Countries in Mobility*, *ECON. POL’Y INST.* (Oct. 10, 2012), <http://www.epi.org/publication/usa-lags-peer-countries-mobility/> (noting low rate of income mobility in the U.S. as compared to rates in peer countries). Apart from the period from 1910 to 1950, inequality in the U.S. generally has increased dramatically over time. PIKETTY, *supra* note 44, at 347–49. Increasing wealth accumulations among high-wealth individuals follows from the trends of low mobility among high-wealth populations and increasing inequality.

94. James R. Repetti, *Should We Tax the Gratuitous Transfer of Wealth? An Introduction*, 57 *B.C. L. REV.* 815, 816 (2016) (“The second principal reason for the adoption of the estate tax was to curb dynastic wealth.”).

95. As examples of dilution, prior to 2001, the amount of wealth for which the lifetime unified credit was available was \$675,000, and the top marginal estate tax rate was 55%. I.R.C. §§ 2010, 2001(c) (as in effect immediately prior to Pub. L. No. 107-16 (2001)). The current lifetime exclusion stands at more than \$5 million and is indexed annually for inflation. I.R.C. § 2010(c)(3)(A), (B). The current top marginal rate is 40%. I.R.C. § 2001(c).

96. Among the techniques are “estate freezes” using irrevocable trusts, see BITTKER & LOKKEN, *supra* note 4, ¶ 136.1, planned annual giving up to the annual gift exclusion amount, see I.R.C. § 2503(b), and the use of valuation discounts to reduce the size of the taxable estate. See BITTKER & LOKKEN, *supra* note 4, ¶ 135.3.

Lastly, even if one grants that all wealth is ultimately consumed and therefore burdened by a consumption tax, one is likely to end up under-taxing wealth if tax rates on consumption are progressive. To begin with, observe that a progressive tax on wealth, because it is progressive, is not genuinely designed to reach wealth but rather uses wealth as a proxy. If wealth itself were the target, then the tax would apply to all wealth at the same rate; concomitantly, the consumption tax would apply to all consumption at the same rate if it is to be understood as a perfect proxy for a wealth tax. But, as argued above, a progressive wealth tax is more properly viewed as a proxy for a tax on the power to use concentrated wealth in socially harmful ways. It is progressive with respect to wealth because the power does not attach to wealth itself but to sufficiently concentrated wealth.

Indeed, it is a feature of any progressive tax—or indeed of any tax that is not uniform with respect to its base—that the “thing” targeted by the tax is not directly the object of the tax. If, for example, “consumption” were the very thing we wanted to tax, then the tax would be uniform with respect to consumption. The same is true of income. But none of income, consumption, or wealth is the very thing we want to tax. Rather, the target is something for which each base functions as an approximation. As evidence for this proposition, consider that even flat taxes generally have exemption amounts to reflect that persons of very little means should not be subject to tax. In fact, as others have noted, the thing we would like to tax in an ultimate sense, at least if the question is how to share the cost of government, is probably something like inequality or relative well-being understood more generally and more comprehensively.<sup>97</sup> Large literatures in both the rights-based and consequentialist traditions focus on this type of measure rather than on income, consumption, or wealth, each of which is in a sense a highly imperfect approximation of well-being.<sup>98</sup>

What follows is that if wealth should be progressively taxed, a consumption tax considered a substitute for such a wealth tax ought to be progressive, and in the same way that the wealth tax would be. It must tax consumption at high rates to the extent the consumption is attributable to the exercise of influence due to concentrated wealth ownership. Again, this follows because the object is to target higher wealth and the consumption tax

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97. Daniel N. Shaviro, *supra* note 7, at 398–99.

98. See Rakowski, *supra* note 33, for a discussion of some of the rights-based literature. See MURPHY & NAGEL, *supra* note 90, for a broader analysis of theories of taxation. See LOUIS KAPLOW & STEVEN SHAVELL, *FAIRNESS VERSUS WELFARE* (2002) for an extended argument in favor of welfare over fairness considerations in evaluating social policy.

is supposed to mirror a tax directly on the non-spending use of the wealth.<sup>99</sup> By hypothesis, non-spending use of wealth is available only to high-wealth taxpayers. The difficulty is that there is no necessary connection between the period in which one uses wealth to influence other actors and the level of consumption in the (typically later) period in which the goods acquired through that use are consumed. *Smith* may deploy her concentrated wealth to great influence in Year 1 in order to obtain goods that are consumed only twenty years later—or perhaps by a subsequent generation if the wealth is passed on. *Smith's* total consumption in Year 21 or the total consumption by an heir in the relevant period may be relatively modest.

In concluding this discussion, it may be helpful to compare the proposal to the existing estate and gift taxes. As noted above, one of Congress's principal purposes in enacting the estate tax was to curb dynastic wealth. That objective is consistent with the idea of internalizing a negative externality. The problems with dynastic wealth that concerned Congress included, in particular, the undue influence that wealthy families can exert over political and economic decision making.<sup>100</sup> This is a feature of wealth concentration, not wealth itself. Congress chose, however, to manage the problem with an excise-type regime, in part because of the difficulties of valuation and, later, because of concerns about liquidity<sup>101</sup> as well as, presumably, over concerns about apportionment.<sup>102</sup> But to the extent that the mere ownership, rather than the actual spending, of wealth creates the externality, the estate tax is ill suited to control it. If the power to influence outcomes derives from mere ownership without disposition, the amount of power is a function of the length of time held, and wealth that is set aside to satisfy the looming tax liability may still perform double duty by affecting decisions without being spent (or it may have the effect of creating wealth for favored others, such as offspring, without having that wealth be taxed). An accretion-style wealth tax that steadily erodes wealth concentrations directly reduces the amount of time during which the externality operates.

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99. This is Shaviro's argument in *Replacing the Income Tax with a Progressive Consumption Tax*, *supra* note 1.

100. Repetti, *supra* note 94, at 816.

101. Section 6166(a) of the Code permits deferral of estate tax liability for up to 14 years where the principal assets of the estate consist of a sufficiently large interest in one or more closely held businesses. The purpose of the provision, adopted in 1976 (Tax Reform Act of 1976, Pub. L. No. 94-455, § 2004(a), 90 Stat. 1520, 1862 (1976)), was "to alleviate liquidity problems and prevent the involuntary dissolution of small businesses." Henry C. Darmstadter III & G. Patrick Jennings, *Can A Judicial Forum Be Obtained for Estate Tax Deferral Disputes?*, 82 J. TAX'N. 74, 74 (1995).

102. See *infra* Part III.A.3 for a discussion of the constitutional apportionment requirement.

### 3. Constitutional Objections

The proposal to tax wealth on an accretion basis assumes Congress has the power to enact the tax. The U.S. Constitution generally requires “direct” taxes to be apportioned among the states in accordance with their populations.<sup>103</sup> The apportionment requirement means that federal revenue derived from a direct tax in a given state must be in the same proportion to total federal revenue from the tax that the state’s population bears to the population of the United States as a whole.<sup>104</sup> Thus, if a wealth tax is direct, then tax revenues from states of equal populations must be equal, even if the wealth in the two states is unequal.<sup>105</sup> This requirement would substantially subvert the capacity of the tax to serve its purpose of curbing wealth concentration.

Although there is some uncertainty about the contours of the term “direct,” it seems relatively clear that it includes an accretion wealth tax. It appears that at the time of the founding, “direct” generally was thought to describe almost all taxes, with “indirect” confined mostly to “imposts.”<sup>106</sup> Over time, however, this narrow interpretation of “indirect” became eroded, so that by the Civil War, “indirect” had expanded to include all excise taxes, as was affirmed in *Pollock v. Farmers’ Loan and Trust Co.*<sup>107</sup> In *Pollock*, the Supreme Court invalidated the portion of the 1894 income tax that applied to income from capital, on the basis that a tax on such income was a tax on the underlying property and therefore subject to apportionment as direct.<sup>108</sup> Other features of the tax, however, such as the imposition on wages and other amounts severed from capital, were held indirect and so not subject to apportionment.<sup>109</sup> What has emerged out of *Pollock* and subsequent cases is that “indirect” does not extend to property taxes,<sup>110</sup> a conclusion recently confirmed by the Supreme Court’s decision upholding the Affordable Care Act’s mandatory insurance coverage provision.<sup>111</sup> Consequently, there seems

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103. U.S. CONST. art. I, § 2, cl. 3. The apportionment requirement does not apply to “indirect,” or excise-type taxes. Indirect taxes instead are subject to a uniformity requirement under which they must apply at the same rate in the states. *Id.* at art. I, § 8, cl. 1.

104. Plecnik, *supra* note 10, at 510–11.

105. *Id.*

106. Calvin H. Johnson, *Apportionment of Direct Taxes: The Foul-Up in the Core of the Constitution*, 7 WM. & MARY BILL RTS. J. 1, 47 (1998).

107. 157 U.S. 429 (1895).

108. *Id.* at 573–74.

109. *Id.* at 579.

110. *Id.* at 583.

111. *Nat’l Fed’n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2598 (2012).

to be little question that an accretion wealth tax would constitute a direct tax. (An excise wealth tax such as the federal estate and gift tax, because it is triggered on a transaction, is an indirect tax not subject to the apportionment requirement.<sup>112</sup>)

As indicated above, apportionment threatens to undermine the effectiveness of a wealth tax, because the tax is designed to burden the taxpayer based on wealth, but wealth is not a function of state population. John Plecnik explains the difficulty:

To illustrate, if 10% of the nation lives in Ohio, and 10% lives in New York, the Apportionment Clause requires Ohioans and New Yorkers to collectively pay the same amount (i.e., 10%) of any direct tax—even if Ohioans possess half the wealth of New Yorkers.<sup>113</sup>

Plecnik himself offers a solution to the problem. He notes that there are in principle at least two ways to satisfy the apportionment requirement. The intuitive way is to collect taxes in proportion to state populations, giving rise to the problem he describes.

The other way is to apportion federal *revenues* from the tax in a way that matches state populations.<sup>114</sup> Plecnik's proposal accomplishes this objective through a revenue-sharing program. In his model, the federal government collects a flat wealth tax uniformly, without regard to apportionment, but returns excess collections to the governments of the states from whose populations the excess is collected.<sup>115</sup> The repayments are set so that total federal revenue from each state satisfies the apportionment requirement. States receiving remittances in turn can use the revenue as they wish. If, for example, the revenue from a state's residents is above the average revenue per person, the federal government will remit to the state the difference between the actual and average revenue per person in the state, multiplied by the state's population.<sup>116</sup>

Importantly, there is nothing in Plecnik's proposal that defeats the same approach when applied to a graduated wealth tax. Graduation will simply affect the amounts returned to various states, with relatively wealthier states (for a given population) receiving a greater return of federal collections than do poorer states; it does not preclude imposition of a nominally uniform

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112. *See supra* note 103.

113. Plecnik, *supra* note 10, at 510.

114. *Id.* at 511–15.

115. *Id.*

116. *Id.*

national tax under which the marginal rate depends solely on wealth. Similarly, the fact that the federal government is not able to keep all the revenue from the tax is immaterial. The purpose of the tax is to reduce inequality, not necessarily to meet a federal (or state, for that matter) budget target; the latter objective can be accomplished either through an income tax, which, by reason of the Sixteenth Amendment, need not be apportioned even if it is “direct,” or through a consumption or other tax that is not subject to apportionment. As long as taxpayers’ liabilities under the wealth tax are an appropriately increasing function of their wealth, the objective of the wealth tax is satisfied.

### *B. Accrual Versus Excise Taxation*

The preceding subpart argued for a progressive accretion-type wealth tax on the basis that the tax would reduce negative externalities associated with the undue concentration of wealth. This subpart picks up on the theme of accretion versus excise taxation in order to demonstrate how the advantages of a wealth or an income base for some purposes, and of a consumption base for others, relate to the more basic distinction between accretion and excise taxation. Section 1 focuses on the distortionary effect of taxes when rates are progressive. Section 2 focuses on the related but distinct question of neutrality, a topic often conflated with incentive effects. Section 3 addresses the problem of consistency in taxation of realized and human capital. It shows that the chief virtue in incentive terms of excise taxes is that they more consistently reach human capital than do accretion regimes. It is this feature of a consumption tax, and not the fact that it is on consumption rather than on either income or wealth, that makes it superior in incentive terms to the latter bases. Finally, Section 4 examines the tradeoff between accuracy, which may be better served by accretion bases, and efficiency, which may be better served by excise bases.

#### *1. Distortions*

Part II explained the double distortion argument in favor of consumption as a base over either income or wealth (in either case on an accrual basis). In the stylized world of pure bases and flat rates where evasion and avoidance opportunities do not exist, the argument in favor of consumption holds, but it is also important to recognize its limitations. The limitation on which I focus here is the assumption that the tax is flat, an assumption that is widely recognized to be unrealistic for any workable tax adequate to meet revenue needs.<sup>117</sup>

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117. See *supra* text accompanying note 64.

Specifically, and as previously noted, it is generally understood that large-scale taxation under any base needs to be progressive, because a flat-rate tax either will raise insufficient revenue or be too onerous on taxpayers of lesser means. Under a progressive rate schedule, of course, the rate of tax increases with the amount of the thing held by the taxpayer that is subject to tax. In the case of income, marginal tax rates increase as income increases;<sup>118</sup> in the case of consumption, marginal tax rates increase as consumption increases. The significance of progressivity for efficiency analysis is that progressivity creates an incentive to smooth whatever is taxed under the base, if the taxpayer has control over the period in which the trigger for the tax operates.<sup>119</sup> As a simple example, suppose marginal rates under a consumption tax are 10% for the first \$10,000 spent in the taxable period and then jump to 25% for all amounts spent in excess of \$10,000. A taxpayer who spends \$20,000 in Year 1 and \$0 in Year 2 has a total tax liability of \$3,500; if, instead, the spending is spread evenly across the two years, total tax liability is just \$2,000.

In the debate over the relative merits of a progressive, realization-based income tax such as our own and a progressive consumption tax, it therefore becomes important whether progressivity in income taxation or in consumption taxation induces greater substitution effects. The analysis turns on the relative elasticities of the timing of income realization and of consumption.<sup>120</sup> Setting aside double distortion questions, if the time of income realization is more sensitive than that of consumption to higher marginal tax rates, then the timing distortion and consequently the efficiency losses from taxing income will exceed those from taxing consumption. If the timing of consumption is more sensitive, greater efficiency losses run the other

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118. As an example, in 2016, under the U.S. income tax, marginal rates on taxable income start at 10% and rise to 39.6% on taxable income in excess of \$415,050 (\$466,950 in the case of married taxpayers filing jointly). Rev. Proc. 2015-53, 2015-44 I.R.B. 615.

119. In theory, a lifetime income averaging regime or, equivalently, a taxable period of one lifetime (with periodic payments and adjustments thereto over the taxpayer's lifetime) would remove the distortion, but the feasibility of such a program has been called into question. See Shaviro, *supra* note 6, at 770-74.

120. "Elasticity" refers to the change in quantity demanded of a good in response to a change in price—either of the good in question ("own elasticity") or of another good ("cross-elasticity"). David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1654 (1999). The goods in question under the analysis here are consumption and income realization in the tax period that is subject to a higher marginal rate. The change in price is the additional tax liability due to being in a higher marginal bracket than would apply if the goods were consumed or the income realized in another available period.

way. In evaluating the overall distortions from either base, this timing distortion needs to be added to the mix, together with the “double distortion” under the income tax as applied to the saving-spending decision.

In point of fact, it seems likely that the timing of consumption is more elastic to marginal tax increases than is the timing of income realization. Especially in the case of consumption by high-resource individuals, which by definition is not for necessities, the cost to the taxpayer of shifting consumption from one taxable period to another may not be very great.<sup>121</sup> In many cases, it will be simply a question of the willingness to defer the enjoyment that comes from non-essential consumption. By contrast, income realization seems comparatively fixed. While taxpayers have substantial control over the timing of dispositions and therefore of capital gains and losses for investment property, many common forms of income cannot easily be timed, including most personal services income,<sup>122</sup> interest and dividend income, rents, and royalties. At least one study supports the further conclusion that capital income from business transactions (as opposed to income from the

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121. A cash-flow consumption tax sometimes is said to be equivalent to a wage tax under limiting conditions, in which case the elasticity question would have to do with the timing of earned income rather than of consumption. *See, e.g.*, J.A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175 (1971). However, a wage tax is a poor substitute for a cash-flow consumption tax under real-world conditions where, among other things, policymakers seek to tax infra-marginal returns and returns (positive or negative) that differ from the risk-free rate. *See* Edward J. McCaffery & James R. Hines, Jr., *The Last Best Hope for Progressivity in Tax*, 83 S. CAL. L. REV. 1031 (2010) (generally arguing for a progressive cash-flow consumption tax in order to capture, among others, infra-marginal returns). Therefore, the question posed in the text concerns the incentive to shift the timing of spending rather than of earning personal services income.

122. So-called “nonqualified deferred compensation arrangements” might be considered an exception to the statement in the text. Under deferred compensation arrangements generally, the taxpayer may defer personal income for years or decades. In the case of qualified deferred compensation arrangements, such as “401(k)” and “403(b)” plans (among others), true deferral occurs, but the amounts subject to deferral are relatively limited. *See* I.R.C. § 415(c)(1)(A), (d)(1)(C) (setting an overall per-taxpayer limit in 2016, with inflation adjustments, of \$53,000 in annual contributions to defined contribution retirement plans). In the case of nonqualified deferred compensation, which is not subject to the contribution limits for qualified plans, deferral to the taxpayer is available, but at the cost of denying the deduction to the service recipient of amounts deferred. *See* Rev. Rul. 60–31, 1960–1 C.B. 174. Consequently, for such plans, the revenue effects are limited to the difference in tax rates between the service provider and the service recipient.



disposition of assets held for investment) is relatively insensitive to changes in tax rates.<sup>123</sup>

In any case, for present purposes, the comparison is starker because the proposal under consideration is for accretion-based wealth taxation—the rough analog to an accretion-based income tax, not the realization-based income tax currently in effect. In an accretion-tax world, the delta between economic and taxable income or wealth tends toward zero: only in the case of assets too speculative or costly to value does it make sense to permit deferral of taxation.<sup>124</sup> In contrast, a realization-based income tax typically defers taxation of gains and losses until disposition or some other realization event, thereby moving towards excise taxation for market-based returns to capital.

To be sure, the need for reasonably accurate valuations under an accretion tax raises its own concerns, and the fact that concessions to valuation may require putting some wealth on a realization tax basis is likely to create distortions of its own.<sup>125</sup> Setting these issues aside, however, there may be substantial efficiency benefits from removing the timing option to taxpayers, if the tax is steeply progressive. To give a sense of the magnitude of the benefit, evidence suggests that the revenue-maximizing rate of tax on capital income under the current system (which, admittedly, includes not only a general realization rule but also the rule that sets basis equal to fair market value for

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123. The study finds high responsiveness to tax for capital gains realizations of personal assets but much lower responsiveness for business asset realizations, suggesting that a large quantity even of capital gain income is relatively inelastic to tax timing. JOINT COMM. ON TAX'N, 112TH CONG., JCX-56-12, NEW EVIDENCE ON THE TAX ELASTICITY OF CAPITAL GAINS: A JOINT WORKING PAPER OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION AND THE CONGRESSIONAL BUDGET OFFICE (2012).

124. Technically, deferral arises even under an accretion tax if the taxable period is greater than infinitesimal. See generally Strnad, *supra* note 3, at 1832–46 (discussing optimal accretion periods). I assume for the sake of discussion that a realistic accretion tax would not be computed (or assessed) more frequently than annually.

125. See, for example, David A. Weisbach, *A Partial Mark-to-Market Tax System*, 53 TAX L. REV. 95 (1999), for a thoughtful discussion of the tradeoffs that adoption of a workable mark-to-market system may entail. See also Shakow, *supra* note 13, at 952–58, for an argument that valuation concerns under an accretion-type wealth tax may not be as great as commonly assumed. These issues are discussed more fully in Part III.

property held at death<sup>126</sup>) is around ten percent.<sup>127</sup> In other words, when rates go higher, taxpayers defer realizations. This result suggests that substantial tax-motivated consumption shifting would occur under a progressive consumption tax if rates between periods differ greatly as a result of progressivity.

## 2. Neutrality

I earlier suggested that accuracy in taxation may be better served through accretion than excise taxation, assuming behavioral effects of the tax were not operative.<sup>128</sup> This section sets forth the argument. It is a significant point in light of the widespread belief that income or accretion-based wealth taxation “double-taxes” investment income and for that reason distorts investment choices as compared to a consumption tax, which, it is said, does not.<sup>129</sup>

The argument that an income tax double-taxes saving typically takes something like the following form.<sup>130</sup> Consider A, who earns taxable wages in period 1 of \$100. A has the choice either to spend the \$100 currently or to save for one year, at which point she will consume what she has. Assume the risk-free rate of return is ten percent. In the absence of taxes, the \$100, if saved, will grow to \$110. This amount is said to be “equivalent” to the \$100 A has today: A can choose one or the other, and, if A is the marginal investor, she is indifferent between the two. Now consider the effect of taxes. Under a consumption tax, the same relationship between present and future value holds as in the absence of the tax. Suppose that a 30% flat consumption tax is in effect. If A consumes today, she purchases \$70 of consumption. If, instead, she invests the \$100 of earnings for one year and then consumes, the \$100 is not currently taxed, it grows to \$110 in period 2, and A pays \$33 of tax at the end

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126. I.R.C. § 1014(a).

127. Paul Evans, *The Relationship Between Realized Capital Gains and Their Marginal Rate of Taxation, 1976–2004*, CAPITAL GAINS SERIES, Oct. 9, 2009, at 17–18, <http://iret.org/pub/CapitalGains-2.pdf>.

128. See *supra* Introduction.

129. As previously indicated, the argument dates at least to John Stuart Mill. It also finds widespread support today. See, e.g., Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 810–13 (2005) (noting that the double tax argument dates to Mill and agreeing that an income tax “double-taxes” saving).

130. See Gregory Arnold, *Is the Double Taxation of Savings Unfair?*, 20 NEW MEX. L. REV. 609 (1990), for a review of the argument. The argument extends as well to accretion wealth taxes, because of the similarity of the two bases, as previously discussed. For simplicity, the discussion compares income and consumption taxation, but it generally applies to accretion wealth taxes with equal force.

of the period, leaving her with \$77 to spend. Since \$77 at the end of period 2 is equivalent to \$70 at the end of period 1, the tax is neutral with respect to saving, in that it creates no incentive to spend currently as compared to the incentive in a no-tax world.

Under an income tax, by contrast, the equivalence no longer holds. The tax leaves A with \$70 of after-tax income at the end of period 1. If she consumes \$70 of goods and services at that point, no further tax is due, just as under a consumption tax. But if, instead, A invests the \$70, it earns \$7 of interest that is subject to \$2.10 of tax, leaving A with \$74.90 after one year, which has a present value in period 1 of just \$67.90, not \$70. Thus, A is worse off if she saves than if she consumes currently: she has \$70 if she consumes now, but the equivalent of just \$67.90 now if she saves. Thus, only inframarginal savers will save under an income tax.

The argument has a surface plausibility that, I believe, masks confusion. To say that an income tax treats present and future consumption differently because it “double taxes” saving seems to beg the question. One could (and should) equally say that the equivalence between present and future consumption derives from the fact that in exchange for deferring consumption, the taxpayer receives income. That is, future consumption is greater in absolute terms than present consumption (ten percent per year greater under the facts of the example), because saving produces an additional return. While taxation of the return may or may not violate neutrality, the reason is not that the tax double taxes income but that the additional earnings on saving are more income and therefore attract tax under an income tax.

A related claim of double taxation seems to rest on the different idea that, in pre-tax terms, the present and future consumption values are “equivalent.” One hundred dollars today is equivalent to \$110 in one year. The claim of equivalence derives, in turn, from the assumption of a precisely offsetting cost to putting off consumption until the future. That cost generally is understood to be the pain of deferral.<sup>131</sup> In particular, the marginal saver is prepared to forgo current consumption at the price of ten percent per year, which pain offsets the income earned on the saved amount. Note, however, that the pain of deferral is not particularly something to be accounted for under an income tax or, for that matter, under a consumption tax. Consider the pain of work (for those who do not enjoy working). No tax offset to realized personal services income is available for the pain of work under either an income or a consumption tax, nor does any claim of double taxation of work

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131. See Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961, 968 (1992) (describing the equivalence argument as “[s]aver’s additional utility [from consuming more in the next year] is offset by an equal psychic cost incurred by having to wait for the future consumption”).

arise because the offset is not available. Analogously, the claim of double taxation of returns to saving seems inapt, inasmuch as income is received in exchange for the non-deductible pain of deferral.

A third, somewhat different argument is that although an income tax does not “double tax” saving, it is not neutral with respect to saving, whereas a consumption tax is.<sup>132</sup> This claim, however, seems to be either trivial or not true. Certainly, an income tax burdens saving more than a consumption tax does, simply because saving generates income and that is what an income tax reaches. Therefore, if one considers that the equivalence between present and future consumption rests on the income that future, but not present, consumption generates, the tax is non-neutral with respect to saving. This claim, however, is merely a definitional truth. Any tax is non-neutral with respect to what it taxes.

A stronger claim would be that a consumption tax—but not an income tax—is neutral with respect to saving in that it preserves the relationship that holds between present and future consumption in the absence of taxes.<sup>133</sup> In other words, if we consider the relationship that obtains between saving and spending in the non-tax world to be “neutral” and then examine the effect of taxes, it seems that a consumption tax takes the same proportional bite out of each but an income tax does not—it takes a greater bite out of saving.

Daniel Shaviro aptly formulates the point as follows:

From a welfare economics perspective, the core distributional argument for a consumption tax is that lifetime earnings determine one’s budget line. Savings decisions merely reflect commodity choice within this budget line as between present and future consumption. Thus, individuals who save more and thus derive greater returns to saving (which an income tax reaches and a consumption tax does not) are not relevantly better off and should not pay more tax on a lifetime basis.<sup>134</sup>

Stated otherwise, a tax scheme neutral with respect to two commodities—one that does not favor one commodity over another—does not differentially tax them. Because one can view present and future consumption (that is, savings-financed consumption) simply as different commodities, akin, for example, to

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132. See, e.g., Joseph Bankman & David Weisbach, *Reply—Consumption Taxation Is Still Superior to Income Taxation*, 60 STAN. L. REV. 789, 794 (2007).

133. See, e.g., Shaviro, *supra* note 6, at 759–60.

134. *Id.* at 781.

apples and oranges, it follows that a neutral tax scheme would treat them the same.<sup>135</sup>

This set of claims is meaningful, but it does not appear to be true. As an initial matter, note that the assumption that the observed pretax return to saving is what would obtain in the absence of taxes is not correct, for at least two reasons. First, taxes pay for many goods that make saving at a given rate of return possible, so that without taxes it is not clear what the return would be. Secondly, even if one assumes instead that revenues were exogenously supplied (rather than funded through taxes), the additional resources that individuals would have by reason of not having to pay tax would affect the rate of return to saving, simply because real taxes have an income effect. The income effect is the change in behavior that is due to the fact that the tax burden makes the taxpayer poorer.<sup>136</sup> Any material tax will reduce amounts available for savings for some people, which may have the effect of raising the return to saving.

Finally, and more important than either of these observations, the idea that failure to tax saving means that saving is treated neutrally is not correct under a reasonably accurate understanding of neutrality. Virtually any activity, including saving, places a burden on resources that is paid for with taxes. For example, an effectively functioning large economy may require a large defense sector. Indeed, it seems undeniable that saving (as well as many other activities, of course) benefits from the defense sector, which means that some of the cost of defense is allocable to saving—saving imposes a defense cost. If by “neutral” is meant properly internalized costs, then the cost of defense—as well as of other public goods—allocable to saving ought to be taxed to saving; otherwise, an externality results.

More generally, a neutral tax would be one that burdens each activity in exact proportion to the public costs (those paid for with taxes) associated with supplying the activity, since efficiency requires that all costs of an activity be borne by the activity.<sup>137</sup> In some cases, it is relatively easy to connect the activity with the cost, such as for market or quasi-market goods like roads that governments often supply. For goods of this type, the tax—for example, in the case of a road, a toll or an excise tax on gasoline—looks a lot like a user fee.

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135. See generally Bankman & Weisbach, *supra* note 56, for a detailed interpretation of present and future consumption in terms of differential commodity taxation.

136. Jodie T. Allen, *Negative Income Tax*, in *ENCYCLOPEDIA OF ECONOMICS*, *supra* note 65, <http://www.econlib.org/library/Enc1/NegativeIncomeTax.html> (last visited Feb. 28, 2017).

137. See, e.g., Anil K. Gupta & Aseem Prakash, *On Internalization of Externalities 2* (Indian Inst. of Mgmt., Working Paper No. 1126, 1993) (“[T]o have a socially efficient allocation of resources, externalities need to be internalized.”).

In other cases, the connection between the activity and what it finances is more attenuated, for example, a country uses tax revenue to supply national defense. National defense is in some degree necessary for saving, but it is not clear precisely to what extent. Nevertheless, a tax to pay for national defense that was “neutral” with respect to saving would require some way of associating saving with the benefits it derives from national defense, and therefore of burdening saving appropriately. The point is that if there is some support to saving from national defense, the failure to burden saving to pay for defense means the tax is not neutral with respect to it: the tax favors saving.

As an example, consider two individuals, one of whom realizes \$100 of income in Year 1 and saves it, and the other of whom does not work. The \$100 saved earns \$5 of interest by the time it is spent, in Year 2. The non-saver is paid \$105 in Year 2 for work performed in that year and also spends it. Both face a tax on the \$105 in Year 2 only, but the saver has derived benefits from public goods paid for with taxes that the non-saver has not.

What follows is that any tax other than one that could somehow burden each activity appropriately will fail to be neutral (activities available at no cost to the fisc excepted), whether taxed or not. The taxed activity typically will be overburdened, and untaxed activities under-burdened. The argument does not imply that taxes should be more neutral in this sense (since overall efficiency depends primarily on behavioral effects) but that the claim of neutrality for a consumption tax with respect to saving is simply incorrect. The more general point is that efficiency in taxation does not rest on the neutrality analysis just described. The superiority in efficiency terms of a consumption tax over an income tax, if indeed it is superior in the case of any workable tax, derives from its better effect on incentives.

### *3. Income Taxation and the Problem of Inconsistency*

A final argument about double taxation focuses on a different comparison—that between earning and saving on one hand, and simply earning later on the other. Total economic income in the two cases can be the same, but the present value of the total tax paid under an income tax (but not a consumption tax) will differ, with a greater burden in the case of the person who explicitly saves. In this comparison, actual income is higher but explicit saving is disadvantaged relative to implicit saving. The significance of this example is that it demonstrates that the reason why consumption taxation dominates income taxation in incentive terms is that, more generally, excise taxation dominates accretion taxation.

Returning to the earlier example, under an income tax, the saver earns \$100 in period 1 and pays \$30 of tax, saves the \$70 balance, earns \$7 on the savings in period 2, and pays \$2.10 in tax, leaving \$74.90 at the end of period

2. Total income earned is \$107, and total taxes paid are 30% of that amount, or \$32.10.<sup>138</sup> But if the saver simply deferred all work until period 2 and then earned \$110 of wages (which would require the same output as would be required to earn \$100 in period 1), the saver would pay \$33 in tax, leaving \$77, which is the same as what the saver has under a consumption tax where the saver earns in period 1 and defers consumption to period 2.

The difference in outcomes is attributable to the inconsistent application of accrual principles under even an accrual income tax. Even though it is an accrual tax, it still fails to reach the unrealized increase in value of human capital of the saver—accrual does not go that far. Rather (and as contrasted with the actual income tax), it reaches unrealized returns on physical capital only.<sup>139</sup> A consistently applied income tax, however, would have to reach even the implicit income earned by human capital.

Specifically, if unrealized human capital were taxed, then individuals would acquire a basis in their human capital, with additional appreciation taxed on accrual. Under such a system, the individual in the example would already have paid tax on the value of all her human capital as of the beginning of period 1 (or would have accrued it as a liability to be paid at some future time). If we assume for simplicity that \$100 is the full value of her capital before tax, then her “after-tax” human capital is worth \$70, and the present value of the tax she previously paid (owes) is \$30. During period 1, her human capital appreciates by \$7, and she pays \$2.10 of tax. The \$30 of capital set aside for the government also appreciates by ten percent, or \$3, so that \$33 also is due on realization (assuming not previously paid). She is left with \$74.90 of after-tax value in period 2.<sup>140</sup> She is therefore taxed the same whether she realizes her human capital in period 1 or not.

The problem of inconsistency does not arise on these facts under an excise tax. As long as the tax will apply at some point, the burden will be the same regardless of when the income is realized because an excise operates as a toll charge with equal force whether the thing tolled appreciated in the form of human capital or instead of physical capital. Consider that, under stylized conditions, the following are the same: a wage tax, a tax on consumption, and

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138. That is, Saver earns \$100 in wages, pays \$30 in tax and earns another \$7 on the \$70 after-tax wage income. Of the \$7, \$2.10 is paid in tax.

139. The actual income tax applies accrual-type principles in a few areas, such as for inventories, I.R.C. § 471, dealers in marketable securities, I.R.C. § 475, certain forward and futures and foreign currency contracts, I.R.C. § 1256, and original issue discount, I.R.C. §§ 1272–75.

140. The tax on previously accrued but unrealized human capital need not have been paid in a prior period; it may be paid in a later period. For example, the saver could be treated as having a \$30 liability as of Year 1, payable on realization of the \$100 in services income.

an estate and gift tax.<sup>141</sup> Under the first, tax arises as amounts are earned, with no further tax due. Under the second, tax follows cash flows, but for the reasons explained earlier, the amounts due are equivalent assuming all parties invest at the risk-free rate. The third case is simply an extension of the second—tax is deferred until the very end of the taxpayer's life, but it has the same present value and, because it looms as a claim on the assets the taxpayer holds, it has the same incentive effects as the wage and cash-flow taxes.<sup>142</sup> Critically, it does not matter for any of these whether the increase in wealth that gives rise to the tax occurs in already-existing physical capital or in the appreciation of human capital. As long as the appreciation results in a tangible and taxable benefit, the tax burden is the same.

The analysis does not support the idea, of course, that an excise tax comes with no distortions at all. A consistently applied excise tax regime would need to apply to consumption that does not manifest in some kind of market transaction or other taxable external effect in order to make the choice between additional labor and additional leisure completely tax neutral. It would need to reach, for example, intangible psychic benefits as well as self-provided goods and services such as produce from one's own garden or painting one's own house. Because these goods remain untaxed, the tax incentive to choose leisure over labor remains to some extent. Nevertheless, the failings of excise regimes in this regard are generally less than those of accretion regimes: an accretion regime that fails to tax human capital as it fluctuates in value is inconsistent, whereas an excise regime effectively treats human capital the same as physical capital as long as the product of capital is manifested in a taxable transaction.

#### 4. Accuracy

Considerations similar to those that apply under the neutrality analysis indicate why—incentive effects aside—an accretion-type tax may be more accurate than an excise-type tax. The key, again, is to separate efficiency

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141. Differences in total tax receipts can arise because of infra-marginal returns; differences among taxpayers can also arise because of the difference between *ex ante* and *ex post* assessments. Failure to reach infra-marginal returns results in under-taxation of the base; use of *ex ante* rather than *ex post* leaves total tax collections the same but shifts tax liability depending on who come out as winners and who as losers. See McCaffery, *supra* note 129, at 825–29, for a discussion of the relative merits of different excise bases along these margins.

142. As stated, these identities hold under stylized conditions. Factors that cause the identity not to hold include the availability of infra-marginal returns, non-flat rates, and risky returns. See *id.* at 812–14 (explaining why a graduated cash-flow tax is superior to a wage tax in equity terms).



considerations, resting on an analysis of incentive effects, from considerations relating to the problem of withdrawing the appropriate quantity of resources from the private sector to fund government activity. Efficiency considerations ultimately derive from the effects that ownership has on behavior.<sup>143</sup> Behavioral distortions arise because taxed resources are owned by persons subject to the tax; therefore, taxpayers adjust their behavior to maximize their own after-tax resources. Behavioral distortions tend to be minimized through the use of excise-type taxes, for the kinds of reasons put forward in the double distortion argument discussed above. However, although it is appropriate to take these considerations into account in designing a tax that minimizes distortions, the resulting tax rules are not accurate in the sense of reliably drawing the correct proportion of available societal resources from the private sector necessary to finance government activity.

Consider the stylized case in which a flat consumption tax serves as the sole means to raise government revenues, and there is no externality problem. (If a graduated tax is necessary, behavioral distortions become worse for the reasons previously discussed.) Assume no other taxes are in effect and that administrative and compliance costs are zero. Under the double distortion argument, this tax dominates a flat-rate income tax in efficiency terms,<sup>144</sup> and therefore it dominates a flat-rate accretion wealth tax as well. Nevertheless, it is less accurate than a flat-rate accretion wealth tax in the following sense: the government finances its budget with real resources. Resources consist of property, or more generally real wealth. The government wishes to finance its activities by taking an appropriate proportion of real resources in the private sector for its own use. A consumption tax, even disregarding behavioral effects (which may include a bias towards saving rather than spending, for the reasons discussed in the preceding section), does not withdraw resources from the private sector as a proportion of total real resources, because it applies on the basis of the taxpayer's decision to consume. By contrast, accretion taxes may take as the measure of the base the very thing the government wants to withdraw from private holdings to finance its activities. Because this quantity necessarily varies in unpredictable ways over time, regularly withdrawing on an accretion basis will more closely approximate the extent to which taxes should burden real resources than will withdrawing on an excise basis. In short, because excise burdens can be in control of taxpayers, amounts subject to tax have an attenuated relationship to resources that are in principle available for tax.

One might counter that a one-time excise wealth tax also could finance government activities accurately. In particular, if the government took, in a

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143. See generally ROSEN & GAYER, *supra* note 7, at 324–46.

144. See *supra* Part II.

single excise payment, a ratable portion of all private wealth sufficient to finance its revenue needs, then the effect would be the same as that of a fixed-rate accretion wealth tax imposed at the same rate, because the government's resources would simply be a ratable share of all real resources. In this model, the government effectively becomes a private investor in every enterprise, obtaining returns in exact proportion to real wealth. The difficulty is that the government cannot practicably become a co-owner in every venture. Many activities are not publicly traded, and the government certainly cannot operate as an active owner in all investments. Failing comprehensive co-ownership, an accretion tax that attaches to the returns from all capital closely mirrors true ownership, while an excise tax that merely produces the same revenue will under-tax certain assets and overtax others.

In short, if taxes had no effect on behavior, an accretion-style wealth tax would be more accurate than a consumption or other excise tax. The conclusion is important for two reasons. First, greater conceptual clarity is always desirable in formulating policy. Current debates conflate problems that are due to behavioral effects with those traceable to other features of the tax system—as the neutrality discussion above demonstrates. More generally, it is helpful to have an understanding of each of the sources of non-neutrality or inaccuracy that may result from implementing a particular type of tax.

The second reason is that the inaccuracy associated with excise taxes may have relevance for an efficiency analysis of the social cost of taxation. If in a given period the government over or under-taxes relative to its budget requirement, unnecessary interest income and expense arise. The government either borrows needlessly or lends needlessly. Excess borrowing or lending supplants other activities that would take place if the government's revenues more accurately reflected its budget requirement. Against the losses due to this inaccuracy is the benefit derived from not doubly distorting the decision to save or to spend. In a flat-tax world, the double distortion from accretion taxes almost certainly dominates the distortions due to inaccurate measures of societal resources available to fund the government under an excise tax, but in a world of progressive excise taxes, including consumption taxes, the answer is less clear.

#### IV. CONCLUSION

The question of what constitutes the optimal mix of tax instruments has lately become prominent in tax policy circles.<sup>145</sup> Most of the analyses focus

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145. See generally Gamage, *supra* note 62, for an example of an approach to taxation oriented specifically to answering the question of optimal tax instruments in light of real-world practicalities of tax administration.

on the canonical problem of raising revenue as efficiently as possible in order to finance public goods and, assuming it is politically desirable, redistribution.<sup>146</sup> The present discussion suggests that an accretion wealth tax ought to be part of the mix, but for another reason—not primarily because it is efficient for these purposes, but because it can efficiently reduce negative externalities associated with wealth concentration.

In explicating the reasons for why such a tax is a good idea, two further points emerge. First, standard explanations for the superiority of a consumption base over an income or a wealth base are more qualified than have been acknowledged, due both to timing distortions from progressivity and to the tradeoff between efficiency and accuracy. Second, the efficiency advantages of a consumption base over an income or accretion wealth base mostly derive from the consistency with which it is possible to apply the underlying taxation principle. To be consistent, an accretion tax must reach wealth while it is in unrealized form—essentially, as human potential. Such a tax is impracticable. By contrast, an excise tax will consistently reach both realized and unrealized wealth as long as the wealth created is taxed in a market transaction.

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146. See Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. & STAT. 387 (1954), for a canonical framing of the problem of efficient taxation. See ROSEN & GAYER, *supra* note 7, at 58–61, for a textbook application of Samuelson's theory. See generally Gamage, *supra* note 62, for a recent discussion of the general problem of determining the optimal mix of tax instruments given real-world opportunities for avoidance and evasion that come with each base.