Book Review

Why Tax the Rich?
Efficiency, Equity, and Progressive Taxation

Reuven S. Avi-Yonah†

Does Atlas Shrug? The Economic Consequences of Taxing the Rich. Edited by Joel B. Slemrod.* *Cambridge: Harvard University Press*, 2000. Pp. 524. $57.95.

In Greek mythology, Atlas was a giant who carried the world on his shoulders. In Ayn Rand's 1957 novel *Atlas Shrugged*, Atlas represents the "prime movers"—the talented few who bear the weight of the world's economy.[1] In the novel, the prime movers go on strike against the oppressive burden of excessive regulation and taxation, leaving the world in disarray and demonstrating how indispensable they are to the rest of us (the "second handers").

Rand wrote in a world in which the top marginal federal income tax rate in the United States was 91% (beginning at taxable income of $400,000).[2] This is an unimaginably high rate by today's standards, when the dominant view in Washington is that a marginal rate of 39.6% (the top

† Irwin I. Cohn Professor of Law, University of Michigan. I would like to thank Yossi Edrey, Allen Graubard, David Hasen, Judy Herman, Don Herzog, Jim Hines, Bob Kuttner, Doron Lamm, Jeff Lehman, Kyle Logue, Dan Shaviro, Joel Slemrod, Dennis Ventry, and Larry Zelenak for their extremely helpful suggestions. All errors are mine.

* Paul W. McCracken Collegiate Professor of Business Economics and Public Policy, University of Michigan.

1. AYN RAND, ATLAS SHRUGGED (1957).
2. Joel B. Slemrod, *The Economics of Taxing the Rich*, *in* DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 3, 3 (Joel B. Slemrod ed., 2000) [hereinafter DOES ATLAS SHRUG?].

rate from 1993 to 2001) is too high.[3] The key turning point in the process of abandoning high marginal tax rates occurred in the presidency of Ronald Reagan. When Reagan became President in 1981, the top marginal federal income tax rate was 70%; when he left office in 1989, the top rate was 28%.[4]

The reduction of marginal tax rates in the Reagan years was driven by a new policy consensus that still persists today. That consensus is that high marginal tax rates on the rich come with an unaffordably high price for the U.S. economy in the form of reduced incentives for the rich to work and to save, and increased incentives to engage in socially wasteful tax planning. And yet 1957, when Rand wrote *Atlas Shrugged* and the top income tax rate was 91%, falls in the middle of the period from 1951 through 1963. Those were the golden years of the U.S. economy, in which the average annual rate of productivity growth was 3.1% (compared with about 1.5% after 1981).[5] Of course, the growth might have been even faster had the marginal tax rates been lower, but the coincidence of high rates and high productivity raises challenging questions for those who believe that high marginal tax rates carry an unacceptable cost.[6]

Thus, the question of whether high marginal tax rates come with an unaffordably high cost to the U.S. economy remains unsettled. *Does Atlas Shrug?*, a recent collection of papers written mostly by public finance economists and superbly edited by Joel Slemrod, represents the most recent

3. I.R.C. § 1 (1994), *amended by* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38. The Act reduces the top marginal rate from 39.6% to 35%, phased in gradually over the period 2001 to 2006. For the arguments leading to the enactment of the 2001 Act, see, for example, the testimony of R. Glenn Hubbard, Chairman of the Council of Economic Advisers, before the Joint Economic Committee of Congress:

> [T]he key to the President's plan is its focus on reducing marginal tax rates. . . . There is now a large body of evidence that improving marginal incentives . . . is the key to ensuring these investments in our economic future.
>
> . . . High marginal tax rates are especially damaging.
>
> . . . .
>
> The incentives provided by lower marginal tax rates are especially important for the top marginal tax rate.
>
> Cutting the top marginal tax rate leads to the greatest response in taxable income.

Hubbard Testimony at JEC Hearing on Economy, TAX NOTES TODAY, May 24, 2001, ¶¶ 43-52, 2001 TNT 101-66 (LEXIS) [hereinafter *Hubbard Testimony*].

4. MICHAEL GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX 133 (1997); W. Elliot Brownlee, *Historical Perspectives on U.S. Tax Policy Toward the Rich*, *in* DOES ATLAS SHRUG?, *supra* note 2, at 29, 61 tbl.2.6.

5. Slemrod, *supra* note 2, at 3.

6. Similarly, productivity soared again in the "new economy" period of the late 1990s, despite the Clinton tax increases of 1993 (which increased the top marginal tax rate from 31% to 39.6%). Productivity from 1995 to 2000 grew at close to 3% each year. ALAN S. BLINDER & JANET L. YELLEN, THE FABULOUS DECADE: MACROECONOMIC LESSONS FROM THE 1990S, at 62 (2001).

attempt to answer this question. Unfortunately, no clear-cut answer is forthcoming in the book, and the debate is sure to rage on.[7]

This Review is divided into three Parts. In Part I, I summarize the main findings of *Does Atlas Shrug*?, emphasizing their contribution to the debate on taxing the rich. In Parts II and III, I discuss a question that is only briefly touched on in the book: *Why* should the rich be taxed? Part II surveys the existing—and to me incomplete—legal literature on this issue, while Part III begins to outline some tentative alternative answers. In my view, the debate about the economic consequences of taxing the rich has obscured this fundamental normative question, and answering it is essential to assessing the merits and relevance of the findings contained in Slemrod's book.

I. THE ECONOMIC COST OF TAXING THE RICH: DOES ATLAS REALLY SHRUG?

Slemrod's book is divided into three parts. Part I provides history and background. Part II is the heart of the book and contains nine new empirical studies on the behavioral responses of the rich to taxation. Part III is called "alternative perspectives" and discusses taxation of the rich on the basis of assumptions that deviate from the standard ones underlying the economic models of Part II.

Part I begins with an excellent historical survey by W. Elliot Brownlee of the rates facing the rich from the beginning of the U.S. income tax in 1913 to the present. In terms of the top marginal rate, the income tax began modestly at 7%, but climbed precipitously to 77% during World War I. Post-war reductions brought the rate down to 25% (in 1925), but during the Hoover Administration it went back up to 63% (in 1932). The rise in rates continued through the New Deal and culminated during World War II, when the top marginal rate reached 94% (in 1944-1945). The top rate remained at 91% until 1964, when it was reduced to 77%, and then to 70% in 1974. The Reagan tax cuts sharply reduced the top rate to 28% by 1986. The rate then grew to 31% in the "read my lips" tax hike of 1990, and to 39.6% in the Clinton tax increase of 1993, before being reduced again to 35% (phased in to become fully effective in 2006) in the Bush tax cut of 2001.[8]

7. *Compare* GEORGE GILDER, WEALTH AND POVERTY 188, 245 (1981) (arguing that "[a] successful economy depends on the proliferation of the rich," and that "to help the poor and middle classes, one must cut the tax rates of the rich"), *with* Robert Lenzner & Stephen S. Johnson, *Seeing Things as They Really Are*, FORBES, Mar. 10, 1997, at 122, 124 (discussing Peter Drucker's view that "[i]f all the super rich disappeared, the world economy would not even notice. The super rich are irrelevant to the economy").

8. Brownlee, *supra* note 4, at 41-63.

Statutory marginal tax rates are important for their symbolic significance and incentive effects, but from an economic perspective, it is just as important to determine the effective tax rate facing the rich. The effective rate is the rate the rich pay after taking into account lower rates for lower brackets of income and the available deductions, credits, and other methods of narrowing the tax base (i.e., reducing the taxable income on which the marginal rate is imposed). Brownlee helpfully provides estimates of the historical effective rates for the richest one percent of households as well. He indicates that effective rates during the high marginal rate years of World War I reached 15.8%, and that during the high marginal rate years of World War II they reached an astonishing 58.6% in 1944.[9] After the war, while the top marginal rate remained extremely high at 91%, the effective rate for the rich declined to 32.2% in 1952, then 24.6% in 1963, rising to 28.9% when Ronald Reagan took office and declining to 22.1% following the 1986 tax reductions.[10] More recent estimates for the Clinton years are not yet available. The conclusion drawn by Brownlee is that the rich *can* be taxed at very high effective rates during times of national emergency, but that at other times their political clout ensures that effective rates are much lower than marginal rates. It turns out that when Ayn Rand was writing *Atlas Shrugged*, the actual burden borne by the "prime movers" was not so high after all; by the late 1940s the rich had "largely succeeded in removing the redistributional fangs from the movement for progressive taxation."[11]

Another introductory chapter by Edward N. Wolff attempts to identify "the rich" by looking at demographic data from 1983 to 1992. He focuses on the top one percent of U.S. households (by wealth) and shows that in 1992 they owned 35.9% of total wealth (up from 32.6% in 1983) and earned 15.7% of total income (up from 12.8% in 1983)—a remarkable rise, which continued through the 1990s.[12] Wolff also shows how the demographics of the richest one percent changed from 1983 to 1992. The rich became younger and earned more labor income and less income from property.[13] The rich were also more likely to be self-employed and less likely to be salaried managers or professionals.[14]

The final introductory chapter by Douglas A. Shackelford analyzes the current tax environment facing the rich, which includes both income and transfer taxes (the estate and gift tax). Shackelford shows that under the

9. *Id.* at 45 tbl.2.3, 60 tbl.2.5.

10. *Id.* at 61 tbl.2.6.

11. Slemrod, *supra* note 2, at 20.

12. Edward N. Wolff, *Who Are the Rich? A Demographic Profile of High-Income and High-Wealth Americans*, *in* DOES ATLAS SHRUG?, *supra* note 2, at 74, 78 tbl.3.2.

13. Fifteen percent of heads of the richest one percent of households in 1992 were under forty-five, compared to only 10% in 1983; 69% earned labor income in 1992, compared to 51% in 1983; and 27% earned income from property, compared to 46% in 1983. *Id.* at 79, 80-82 tbl.3.3.

14. *Id.* at 92-93.

most tax-disadvantaged form of earning income (in which the income is taxed as ordinary income when earned and interest on the after-tax income is taxed again, and what remains is subject to the estate tax), the marginal tax rate facing the rich can be as high as 91%. He also shows, however, that various forms of legal tax avoidance (e.g., transforming ordinary income into capital gains, postponing realization of capital gains, making tax-free gifts, and transferring future interests to heirs) can reduce the effective tax rate to close to zero.[15]

The core of the book is the nine empirical studies of Part II. In general, they provide a mixed answer to the question of what the economic costs are of taxing the rich. While there is some evidence of behavioral responses, it is quite limited and seems to depend crucially on the authors' chosen methodology. Importantly, most of the findings of behavioral response relate to the use of various tax avoidance techniques—and even there the evidence is mixed, with some obvious techniques being used less than they should be in a world in which tax minimization is very important to the rich. Real behaviors, such as labor and saving, seem much less affected by taxation. This distinction is important because while both tax avoidance techniques and real behavioral changes cause deadweight losses, the former can be partially prevented by changing the law, while the latter are less amenable to legal change since one cannot force the rich to work or save more.

The papers in Part II can be divided into three broad groups. The first group contains studies that address the limitations of the previous literature on the economic consequences of taxing the rich. Thus, the chapter by Austan Goolsbee responds to the "new tax responsiveness" (NTR) literature pioneered by Lawrence Lindsey (President George W. Bush's chief economic adviser) and Martin Feldstein. The traditional economics literature found little evidence that high tax rates discourage labor supply by the rich. The NTR literature focused instead on the elasticity of taxable income and, by using "natural experiments" (tax rate increases and decreases), found very high responsiveness (elasticities exceeding one).[16] Goolsbee argues, however, that this literature is fatally flawed because it assumes that the rich are similar to other income groups except for their higher tax rates. In fact, the rich are different in at least three ways. First, their incomes have recently been trending upward at a rate that is faster than others' incomes, which, in a time of tax cuts for the rich, can appear as

15. Douglas A. Shackelford, *The Tax Environment Facing the Wealthy*, *in* DOES ATLAS SHRUG?, *supra* note 2, at 114, 121, 130-32.

16. This means that for every one percent increase in the tax rate, taxable income decreases by over one percent. *See, e.g.*, Martin Feldstein, *The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act*, 103 J. POL. ECON. 551 (1995); Lawrence Lindsey, *Individual Taxpayer Response to Tax Cuts 1982-1984*, 33 J. PUB. ECON. 173 (1987).

tax responsiveness.[17] Second, the rich are more sensitive to demand conditions than others, and therefore their incomes tend to surge in good times that also happen to coincide with tax cuts.[18] Finally, the compensation of the rich can easily be moved to a different taxable year, and consequently observed changes in taxable income may reflect timing rather than long-lasting behavioral responses to tax changes.[19] Goolsbee estimates that the combination of these factors cuts the NTR elasticities by over seventy-five percent.[20] Similarly, the chapter by Gordon and Slemrod suggests that natural experiments around the 1986 Act can be misleading because they reflect shifting of income from corporations (whose rates went up) to individuals (whose rates went down).[21]

The second group is made up of studies that support the view that behavioral responses by the rich to taxation are quite limited. A study by Moffitt and Wilhelm investigates the labor supply decisions of the rich based on responses to the 1986 Tax Reform Act and finds essentially no responsiveness of the hours of work of high-income men to tax reductions.[22] This finding is consistent with previous studies that reached the same conclusion. It also makes intuitive sense because high-income men tend to work very long hours in any case and are unlikely to be able to increase them easily. But the studies also suggest that high-income men are unlikely to decrease hours worked as tax rates go up—either because they find the work inherently satisfying (there is no "substitution effect") or because they focus more on maximizing their after-tax income (there is an offsetting "income effect").[23]

Other studies in this group suggest that even financial behaviors, which are less "real," and therefore more likely to be tax-motivated than labor or saving decisions, do not respond much to taxation. For example, Andrew A. Samwick finds that portfolio choice (e.g., investing in tax-exempt securities) is not significantly responsive to changes in the tax rate. Predicted effects from tax changes constitute only about ten percent of observed changes, and the portfolio responses of the wealthy do not seem more tax-related than the responses of people in other net worth

17. Austan Goolsbee, *It's Not About the Money: Why Natural Experiments Don't Work on the Rich*, *in* DOES ATLAS SHRUG?, *supra* note 2, at 141, 148-51.

18. *Id.* at 151-52.

19. *Id.* at 152-55.

20. *Id.* at 156. This means that every one percent increase in the tax rate decreases taxable income by less than 0.25%.

21. *See* Roger H. Gordon & Joel B. Slemrod, *Are "Real" Responses to Taxes Simply Income Shifting Between Corporate and Personal Tax Bases?*, *in* DOES ATLAS SHRUG?, *supra* note 2, at 240.

22. *See* Robert A. Moffitt & Mark O. Wilhelm, *Taxation and the Labor Supply Decisions of the Affluent*, *in* DOES ATLAS SHRUG?, *supra* note 2, at 193.

23. In the latter case there would still be a deadweight loss because they would have preferred to work less.

categories.[24] Likewise, Auerbach, Burman, and Siegel conclude in their chapter on capital gains taxation that high-income people do not generally shelter most or all of their capital gains with judicious realization of capital losses.[25] James Poterba analyzes the effect of estate and gift taxes on inter vivos giving and finds that the actual levels of giving are much lower than one would expect if households were taking full advantage of this estate tax avoidance technique.[26]

The third and final group is made up of studies that do find some behavioral responses to taxation. For example, Auten, Clotfelter, and Schmalbeck find that the current tax system does stimulate some charitable giving by the wealthy, compared with a system in which contributions are not deductible, but that the sensitivity of giving to tax changes is smaller than suggested by previous researchers.[27] They also find that current law does encourage the wealthy to engage in elaborate estate tax arrangements associated with their charitable donations.[28] Alm and Wallace examine a wide range of taxpayer reporting decisions[29] by the rich in the wake of tax law changes and suggest that they show increased responsiveness due to their larger control over the form of their compensation.[30] Finally, Carroll, Holtz-Eakin, Rider, and Rosen investigate the behavior of entrepreneurs in response to tax rate increases and conclude that individual income taxes do have a large negative effect (a five percent increase in marginal tax rates decreases mean capital expenditures by approximately ten percent).[31]

Slemrod summarizes these findings by stating:

> Taken as a whole . . . the evidence of part II is more mixed on the question of how, and how much, today's Atlases shrug. . . . All in all, these studies do not suggest anything like the complete withdrawal of productive energies that Ayn Rand warned of. Nevertheless, the tax system clearly induces people to rearrange

24. Andrew A. Samwick, *Portfolio Responses to Taxation: Evidence from the End of the Rainbow*, *in* DOES ATLAS SHRUG?, *supra* note 2, at 289, 318.

25. Alan J. Auerbach et al., *Capital Gains Taxation and Tax Avoidance: New Evidence from Panel Data*, *in* DOES ATLAS SHRUG?, *supra* note 2, at 355, 380.

26. *See* James M. Poterba, *The Estate Tax and After-Tax Investment Returns*, *in* DOES ATLAS SHRUG?, *supra* note 2, at 329.

27. Gerald E. Auten et al., *Taxes and Philanthropy Among the Wealthy*, *in* DOES ATLAS SHRUG?, *supra* note 2, at 392, 414-18.

28. *Id.* at 418.

29. Such decisions include reporting wage income or capital gains, as opposed to unrealized appreciation. James Alm & Sally Wallace, *Are the Rich Different?*, *in* DOES ATLAS SHRUG?, *supra* note 2, at 165, 184.

30. *Id.*

31. Robert Carroll et al., *Entrepreneurs, Income Taxes, and Investment*, *in* DOES ATLAS SHRUG?, *supra* note 2, at 427. This is the only study in the book that finds a behavioral response to taxation that implicates real behaviors (as opposed to tax avoidance schemes). Not surprisingly, it is also the only study from the book that was cited by Hubbard in his testimony before Congress. *See Hubbard Testimony*, *supra* note 3, ¶ 47. Hubbard also cited the NTR literature without mentioning the limitations identified by Goolsbee. *Id.* ¶ 52 (citing Feldstein).

> their affairs and change their behavior, and these changes are evidence of an unseen but real cost of levying taxes.[32]

I agree with this assessment. I would also add that most of the evidence for behavioral responses in the book relates to tax avoidance strategies (e.g., charitable giving techniques, shifting income from corporations to individuals, and the timing of receipts), rather than to real activities (labor and saving decisions). This difference is important because tax avoidance techniques can in theory be addressed by making the tax base more comprehensive and enforcement more effective—as it presumably was when the rich paid a 58.6% effective rate during World War II.[33]

The question of whether the rich can effectively be taxed is related to another aspect of taxation that is almost not addressed in the book—the possibility of illegal tax evasion. In other countries, there is evidence that the "underground economy" that is not reported to the tax authorities is as much as fifty percent of GDP. The size of the "tax gap" in the United States is presumably much smaller (we have the best collection system in the world, although it depends heavily on withholding and information reporting), and much of it is not applicable to the rich (e.g., tipping income). But there is one avenue of evading taxes that is particularly open to the rich—shifting the income to tax havens overseas and not reporting it to the IRS. This form of tax evasion is more available to the rich because income from capital is easier to shift than labor income, and the rich earn more income from capital. There are no solid recent estimates of how much tax evasion of this sort is engaged in by U.S. residents. But in other developed countries, such as Germany, tax evasion by capital owners is estimated to be rampant (about fifty percent of interest income by German residents is estimated not to be reported).[34] Slemrod is not to be blamed for not focusing on this issue because no recent data exist, but it is high time for Congress to study the question of illegal tax evasion by Americans. Such a study could provide a much-needed stimulus for current efforts by the Organization for Economic Cooperation and Development (OECD) to bear down on the tax havens (in the face of considerable opposition from the Bush Administration).

The main drawback of the volume from a lawyer's perspective is that it concentrates almost entirely on the economic issue of the behavioral effects

32. Slemrod, *supra* note 2, at 24.

33. *See supra* note 9 and accompanying text. Slemrod has suggested doing just that. *See* JOEL SLEMROD & WOJCIECH KOPCZUK, THE OPTIMAL ELASTICITY OF TAXABLE INCOME (Nat'l Bureau of Econ. Research, Working Paper No. 7922, 2000); Joel Slemrod, *Fixing the Leak in Okun's Bucket: Optimal Tax Progressivity when Avoidance Can Be Controlled*, 55 J. PUB. ECON. 41 (1994).

34. On this issue, see generally Reuven S. Avi-Yonah, *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1583 (2000).

of taxation on the rich and omits almost entirely any discussion of why the rich should be taxed. This is understandable because, as Slemrod writes, "[h]ow much and how to tax high-income individuals are questions at the core of many recent proposals for incremental as well as fundamental tax reform. The right answers depend in part on value judgments to which economic analysis has little to contribute."[35] The rest of this Review concentrates on those noneconomic questions. It should be noted, however, that the answers to these questions as well depend in part on useful input from economists, and this input will be reflected in the remaining sections.

II. WHY TAX THE RICH: CURRENT ANSWERS

In 1952, when tax rates were, as noted above, steeply progressive, Walter Blum and Harry Kalven published a classic article entitled *The Uneasy Case for Progressive Taxation*.[36] Blum and Kalven used most of the article to demolish systematically all previous arguments for progressivity made in the name of "ability to pay" and "equal sacrifice."[37] In the end, they concluded that any remaining case for progressivity must be made in the name of redistribution, or an inherent objection to social inequality, but without explaining what makes inequality objectionable. This is the same type of "aesthetic" argument that motivated Henry Simons's oft-quoted conclusion in *Personal Income Taxation* (published in 1938 at the height of New Deal progressivism) that sharply graduated rates are defensible only because there is something inherently "unlovely" about inequality.[38]

Blum and Kalven's skepticism about graduated rates remained the standard view among legal theorists until 1987. In that year, just after the progressive rate structure had been demolished in the 1986 Act, Joseph Bankman and Thomas Griffith published an article that has shaped the progressivity debate among legal scholars ever since.[39] Bankman and Griffith's main contribution was to introduce into the legal literature optimal tax theory, developed by economist James Mirrlees in his Nobel Prize-winning work in the early seventies.[40]

35. Slemrod, *supra* note 2, at 19-20.

36. Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952).

37. *Id.* at 445-86. The basic problem with previous arguments in favor of progressivity was that they depended on interpersonal comparisons of utility or well-being, which, as Blum and Kalven pointed out, are not feasible. *Id*. at 476. This problem is addressed in the more recent optimal tax literature by introducing the social welfare function, discussed below.

38. HENRY C. SIMONS, PERSONAL INCOME TAXATION 19 (1938).

39. Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 (1987).

40. James Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175 (1971).

Optimal tax theory seeks to answer the following question: Given that income taxes generate a disincentive effect on work, what is the ideal tax and transfer system if the ultimate goal is to maximize the sum of the utilities of individuals with identical preferences? To answer this question, optimal tax theory makes a series of assumptions regarding the distribution of income-earning ability in society, the rate at which the marginal utility of income declines, and how much less the imposition of an income tax causes individuals to work. Having made these assumptions, optimal tax theorists then derive the desirable combination of taxes and transfers from a specified social welfare function. This function can be either strictly utilitarian (i.e., maximizing the sum of individuals' utilities without assigning weights) or more weighted toward the welfare of the poor. At the extreme is the Rawlsian maximin function, in which the goal is to maximize the welfare of the least-well-off member of society.

The problem for advocates of progressive taxation is that most tax structures derived from optimal tax theory are not marginal-rate progressive. For example, Bankman and Griffith's article, even though it is cast as a defense of progressive income taxation against Blum and Kalven, actually proposes a regressive marginal rate structure. The progressivity in their proposal comes entirely from its combination with a demogrant (a universal payment to all residents) which makes the average tax rate progressive. But as Larry Zelenak and Kemper Moreland point out, average rates are less important than marginal rates when it comes to taxing the rich. If the tax system consisted of a $10,000 demogrant and a 30% flat tax, the average rate would be progressive, but Bill Gates would pay taxes at just under 30%, and we could not increase his rate without increasing everyone else's. Fundamentally, "graduated rates permit much greater flexibility in average rate distributions than does a flat tax with a demogrant or an exemption."[41] In addition, as Zelenak and Moreland also point out, demogrants are unlikely in the United States on political grounds, and, without demogrants, the progressivity of Bankman and Griffith's proposal disappears.[42]

Other optimal tax writers have likewise proposed regressive tax rate structures.[43] Mirrlees's original work in 1971 concluded that the optimal tax

41. Lawrence Zelenak & Kemper Moreland, *Can the Graduated Income Tax Survive Optimal Tax Analysis?*, 53 TAX L. REV. 51, 59 (1999).

42. *Id.* at 60-62.

43. Most strikingly, Seade and Sadka have shown that under certain assumptions, optimal tax analysis concludes that the marginal tax rate at the highest level of income should be precisely zero. The reason for this surprising finding is that raising the marginal tax rate at the very top of the income distribution above zero distorts the labor supply decision of the highest earner but raises no revenue. Slemrod, *supra* note 2, at 11 (citing Efraim Sadka, *On Income Distribution, Incentive Effects, and Optimal Income Taxation*, 43 REV. ECON. STUD. 261 (1976); and Jesus Seade, *On the Shape of Optimal Tax Schedules*, 7 J. PUB. ECON. 203 (1974)). As Slemrod points out, this conclusion is not very interesting because it applies only precisely at the top of the

structure is approximately linear (with an exemption) and has tax rates between 20% and 30%.[44] Slemrod, Yitzhaki, Mayshar, and Lundholm investigated a two-bracket system and concluded that for most assumptions, the optimal tax structure features a top marginal rate that is lower than the first marginal rate, although the combination with a demogrant assures average rate progressivity.[45]

The reason why optimal tax theory generally rejects progressive marginal rates is as follows. While the assumed declining marginal utility of income supports redistribution, any countervailing efficiency losses apply only at the margin (the point at which the taxpayer chooses between work and leisure). Since high tax rates on inframarginal income do not impact work decisions, they raise revenue for redistribution without any efficiency cost. Thus, there should be high tax rates at a range in which there are many taxpayers for which the range is submarginal, relative to the number of taxpayers at the margin within that range (i.e., the middle class). But the tax rate should be low in the income range where there are mostly marginal taxpayers—i.e., the higher income ranges.[46] Therefore, as Matti Tuomala has noted, "[o]ne of the main conclusions to be drawn from the Mirrleesian optimal non-linear income tax model is that it is difficult (if at all possible) to find a convincing argument for a progressive marginal tax rate structure throughout."[47]

Larry Zelenak and Kemper Moreland have recently mounted a vigorous defense of progressive marginal rates against the optimal tax critique. They point out that the above conclusions rest crucially on several untested assumptions, and if these assumptions are relaxed, progressive marginal rates can be accommodated within optimal tax theory. Specifically, they point out that optimal tax theory can be consistent with progressive marginal rates if (1) demogrants are ruled out on political grounds; (2) concern with relative position (envy) figures into the social welfare function; (3) taxation serves as a form of insurance against wage uncertainty; (4) high income taxpayers are less responsive to the work disincentive effect of taxation; (5) the distribution of ability in the population is more unequal than is usually assumed; or (6) the labor market consists in large part of winner-take-all competitions.[48]

income distribution, not near the top. *Id.* at 12. Numerical calculations by Mirrlees suggest that zero is a bad approximation to the optimal marginal tax rate even within most of the top percentiles. Mirrlees, *supra* note 40, at 195.

44. Slemrod, *supra* note 2, at 10.

45. *Id.* at 12 (citing Joel Slemrod et al., *The Optimal Two-Bracket Linear Income Tax*, 53 J. PUB. ECON. 269 (1994)).

46. Zelenak & Moreland, *supra* note 41, at 54-55.

47. MATTI TUOMALA, OPTIMAL INCOME TAX AND REDISTRIBUTION 14 (1990).

48. Zelenak & Moreland, *supra* note 41, at 56-57; *see also* Martin J. McMahon, Jr. & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1 (1998) (defending progressive taxation in a winner-take-all society).

Most of these modifications to the standard assumptions seem plausible.[49] However, as Zelenak and Moreland point out, their argument merely means that taxing the rich at higher rates is possible under an optimal tax analysis, not that it is indicated:

> Regardless of the results of any simulation, optimal tax analysis can never prove that the income tax should have progressive marginal rates. Even if a simulation indicated gradual rates were optimal, and even if the simulation's factual assumptions were unassailable, an opponent of progression could still dismiss the results by rejecting the philosophical basis of the simulation. If the premises of the simulation are utilitarian or Rawlsian, no amount of sophisticated mathematics will convince someone who objects to those premises.[50]

Fundamentally, the problem with optimal tax theory is that, like any welfarist theory, it focuses completely on the well-being of individuals.[51] But a society is more than the sum of the individuals who compose it at any given moment in time. A society is a community with a shared culture and shared interests that transcend the interests of its individual members and extend back to its historical roots and forward into its future. Thus, it is necessary to look for affirmative reasons for taxing the rich that are rooted in a broader social and historical understanding of the vital function of taxation in maintaining such a community over time. The remaining Parts of this Review represent an initial attempt in that direction.

49. Some of them are supported by evidence in Slemrod's book. See the findings on labor-leisure substitution in Moffitt & Wilhelm, *supra* note 22, at 221, and the relative position argument in Robert H. Frank, *Progressive Taxation and the Incentive Problem*, *in* DOES ATLAS SHRUG?, *supra* note 2, at 490, 498-503.

50. Zelenak & Moreland, *supra* note 41, at 90. The same criticisms apply to simulations that recommend a regressive structure.

51. This individualistic framework is shared by utilitarians and liberals, which makes it difficult for liberals to criticize optimal tax theory consistently. *See, e.g.*, Edward J. McCaffery, *The Political Liberal Case Against the Estate Tax*, 23 PHIL. & PUB. AFF. 281 (1994); Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283 (1994); Eric Rakowski, *Transferring Wealth Liberally*, 51 TAX L. REV. 419 (1996). *But see* Anne L. Alstott, *The Uneasy Liberal Case Against Income and Wealth Transfer Taxation: A Response to Professor McCaffery*, 51 TAX L. REV. 363 (1996) (arguing that a liberal philosophy cannot be used to advocate repeal of the income and estate taxes); Liam B. Murphy, *Liberty, Equality, Well-Being: Rakowski on Wealth Transfer Taxation*, 51 TAX L. REV. 473 (1996) (arguing that Rakowski's definition of liberalism, used to criticize wealth taxes, is too narrow). A better foundation for critique is a communitarian viewpoint that relates back to the republican tradition and finds its modern expression in the work of philosophers such as MacIntyre, Taylor, Walzer, and Sandel. *See, e.g.*, MICHAEL J. SANDEL, LIBERALISM AND THE LIMITS OF JUSTICE (2d ed. 1998).

III. WHY TAX THE RICH? ALTERNATIVE SUGGESTIONS

This Part begins to develop an alternative rationale for taxing the rich that is based on a community-oriented rather than an individual-oriented view of society. In general, one can advance three broad reasons for taxing the rich: that they control a disproportionately large share of the country's wealth, that their wealth is not just the result of their own choices but also stems from a combination of benefits conferred by society and brute luck, and that their wealth gives the rich a social, economic, and political power base that is inimical to the proper functioning of a democratic polity.

A. *"That's Where the Money Is"*[52]

If one accepts the need for redistribution on other grounds, the most obvious response to the question of why the rich should be taxed is found in Willie Sutton's immortal response to the question why he robbed banks. In 1994, the top one percent of taxpayers by gross income received 13.8% of total income and remitted 28.7% of total federal personal income tax. Increasing these payments by 25% would generate $38.2 billion in additional tax revenue and would finance a 10% across-the-board tax cut for the other ninety-nine percent of U.S. taxpayers.[53]

Even more significant is the wealth of the rich. In 1983 the top one percent of wealth-holders owned 32.6% of total net wealth and 42.9% of financial wealth (wealth excluding houses and autos).[54] In 1992, these figures had increased to 35.9% of total net wealth and 45.6% of financial wealth.[55] The distribution of net savings is similarly skewed. The top one percent of 1986 wealth-holders accounted for 53.7% of net real saving.[56]

Of course, the fact that the rich (defined as the top one percent by wealth or income) hold disproportionately large percentages of the country's wealth does not by itself constitute an argument for taxing them more. While these facts demonstrate the potential for large redistributive gains by increasing taxes at the very top of the income distribution, they also illustrate the importance of the rich to the economy and thus the potential cost of taxing them.[57] Thus, any argument for taxing the rich must depend on more than mere income or wealth distribution numbers.

52. John C. Coffee, Jr., *The SEC and the Institutional Investor*, 15 CARDOZO L. REV. 837, 862 (1994) (paraphrasing Willie Sutton).
53. Tax Found., *Latest Data Shows Trend Reversal: Top 1 Percent Not Paying Larger Share of Federal Income Taxes*, 40 TAX FEATURES 1 (1996).
54. *See* Wolff, *supra* note 12, at 78.
55. *Id.*
56. Slemrod, *supra* note 2, at 6.
57. *See id.*

B. *"I Took All of It from Them"*[58]

Another argument for taxing the rich can be summarized in department store mogul Edward Filene's explanation of why he approved of the income tax: "Why shouldn't the American people take half my money from me? I took all of it from them."[59]

Michael Graetz has justified taxing the rich by arguing that all income-generating activities depend on a combination of individuals' own contributions and a variety of services provided by the government. Those services include the rule of law and the protection of private property, as well as more tangible services such as infrastructure and education.[60] Recent comparative research of economic growth has likewise highlighted the importance of legal protections afforded by the government.[61] From this perspective, all income-generating activities can be conceived as a partnership between individuals and the government, and taxation can be justified as the government receiving its share of partnership income. This argument thus serves as a rebuttal of the Lockean/Nozickian view that individuals have an inherent right to their property, which is impeded by redistributive taxation.[62] Presumably, the government has the right to use its partnership distributions as it sees fit, including by giving them to other individuals.

There are, however, some problems with this conception. First, since it is as focused on individual taxpayers as optimal tax theory, individual taxpayers can object that the partnership does not apply to them.[63] Second, even if one accepts the partnership model, it is still unclear that it justifies progressive taxation of the rich rather than mere proportionate taxation. Is

58. Jeffery L. Yablon & Shaw Pittman, *As Certain as Death—Quotations About Taxes*, 86 TAX NOTES 231, 267 (2000) (quoting Edward A. Filene).

59. *Id.*

60. Michael J. Graetz, *To Praise the Estate Tax, Not To Bury It*, 93 YALE L.J. 259, 275-76 (1983) (arguing that market rewards also depend on factors beyond the control of individuals such as demand, social resources, and general societal conditions); *see also* Yosef Edrey, *Hukah Deklarativit U-benuyah: Hazekhut lekinyan tahat ha-mishpat ha-hukati ha-yisraeli u-mekoma besulam hazekhuyot hahukatiyot* [*A Declarative and a Constructed Constitution: The Right for Property Under the Israeli Constitutional Law and Its Location on the Constitutional Rights Scale*], 28 MISHPATIM 461 (1997) (providing an elaborate and expanded argument for society's role in producing income).

61. Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998) (finding that the rule of law is a crucial component in concentration of corporate ownership and further arguing that concentration of corporate ownership explains growth differentials).

62. *See* JOHN LOCKE, TWO TREATISES OF GOVERNMENT 360-62 (Peter Laslett ed., Cambridge Univ. Press 1988) (1690). But Locke also seems to concede that a parliamentary majority may tax as much as it wants. *Id.* at 362.

63. From a communitarian perspective, however, this objection is irrelevant: The rich can be deemed to have entered into a social contract that gives society the right to tax them. *See* JOHN RAWLS, A THEORY OF JUSTICE 11-13 (1971); SANDEL, *supra* note 51, at 123-24.

there any reason to assume that the government contributes more to the success of the rich, and, therefore, its partnership share should be larger?

Theodore Roosevelt certainly believed there was. "The man of great wealth," he stated in 1906 while arguing for progressive taxation, "owes a peculiar obligation to the State, because he derives special advantages from the mere existence of government."[64] But this is hard to prove, and many government services (such as national defense) benefit the poor as well as the rich. In general, the partnership theory is based on the view that taxation is justified as a payment for benefits received rather than on ability-to-pay grounds. But benefits-based taxation is typically not progressive, just proportionate.[65]

Another way of conceptualizing the benefit derived by the rich from society is that the rich were lucky. In fact, there is some evidence that economic success depends more on luck than on skills, although "[t]hose who are lucky tend, of course, to impute their success to skill."[66] It is unclear whether luck plays a larger part in the success of the rich than in that of everyone else, although introducing luck (in the form of wage uncertainty) is one way of permitting progressivity to occur within the optimal tax framework. Thus, it is not clear that the partnership model supports progressivity specifically, as opposed to supporting the income tax or the estate tax in general.

C. *"Money Is the Measuring Rod of Power"*[67]

Howard Hughes's remark is echoed by the words of other very rich people[68] and serves to explain a puzzling phenomenon: Why do the rich strive to increase their wealth when any conceivable use of that additional wealth for consumption purposes is already provided for by their existing resources? For example, if one estimates Mr. Gates's wealth at a conservative fifty billion dollars, he would have to spend over twelve million dollars per day to consume the interest earned on his existing wealth.

64. 41 CONG. REC. 27 (1906) (remarks of Theodore Roosevelt), *quoted in* Dennis J. Ventry, Jr., *Equity vs. Efficiency and the U.S. Tax System in Historical Perspective*, *in* TAX JUSTICE (Dennis J. Ventry, Jr. & Joseph J. Thorndike eds., forthcoming 2002) (manuscript at 1, on file with author).

65. FREDERICK A. HAYEK, THE CONSTITUTION OF LIBERTY 316 (1960). For a critique, see Barbara H. Fried, *Why Proportionate Taxation?*, *in* TAX JUSTICE, *supra* note 64 (manuscript at 4, on file with author).

66. CHRISTOPHER JENCKS ET AL., INEQUALITY: A REASSESSMENT OF THE EFFECT OF FAMILY AND SCHOOLING IN AMERICA 227 (1972).

67. Christopher D. Carroll, *Why Do the Rich Save So Much?*, *in* DOES ATLAS SHRUG?, *supra* note 2, at 478 (quoting Howard Hughes).

68. *Id.* at 478-79 (collecting quotations).

Christopher Carroll has assembled considerable evidence that the rich derive utility from the mere possession of wealth over and above its consumption value. He begins by noting that the standard life-cycle model of household consumption and saving decisions, which assumes that people save to finance their own future consumption, cannot explain the behavior of the rich.[69] Moreover, a "dynastic" model, under which the rich save mainly for the benefit of their heirs, cannot explain why childless, elderly rich people save as much of their wealth as their counterparts with children.[70] Carroll then argues that the best explanation for observed behaviors of the rich is a model in which they derive utility from the pursuit of wealth for its own sake, or from the added power that comes from the accumulation of wealth. This is well documented in discussions of the "Gilded Age" of 1870-1910: "'[T]he ultimate gift of colossal wealth, at least for the founders of the richest families [of the Gilded Age], was power.'"[71] The Gilded Age financier James Stillman similarly remarked that "['t]wasn't the money we were after, 'twas the power. We were all playing for power. It was a great game."[72] And Cornelius Vanderbilt explained that he did not want to give away the wealth he did not need for consumption because "[i]f you give away the surplus, you give away the control."[73]

Wealth confers power beyond its consumption value.[74] This power is economic, social, and political. The economic power of the rich derives primarily from their ability to use their wealth to invest in enterprises that employ thousands of people and can dominate large sectors of the economy. The social element derives from the knowledge other people have of the potential ability of the rich to use their wealth to acquire goods and to contribute to charities, which leads them to court such acquisitions and contributions even without such consumption taking place. Finally, the political power of the rich stems not just from their actual donations or their ability to finance runs for political office, but, more importantly, from politicians knowing that they have the excess funds to donate. Note that none of these three forms of power depends on actual (as opposed to

69. *Id*. at 466-70.

70. *Id*. at 470-73.

71. *Id.* at 478 (quoting Frederic Cople Jaher, *The Gilded Elite: American Multimillionaires, 1865 to Present*, *in* WEALTH AND THE WEALTHY IN THE MODERN WORLD 189, 215 (W.D. Rubinstein ed., 1980)).

72. *Id.* at 478 (quoting James Stillman).

73. *Id.* at 479 (quoting Cornelius Vanderbilt).

74. Alstott, *supra* note 51, at 371-72. On the definition of power in political science and sociology, see, for example, KENNETH E. BOULDING, THREE FACES OF POWER 10, 15 (1989), which defines power as "the ability to get what one wants" and distinguishing threat, economic, and integrative power—the stick, the carrot, and the hug; VALERI G. LEDYAEV, POWER: A CONCEPTUAL ANALYSIS (1997); POWER (Steven Lukes ed., 1986); POWER: CRITICAL CONCEPTS (John Scott ed., 1994); and POWER IN MODERN SOCIETIES (Marvin E. Olsen & Martin N. Marger eds., 1993).

potential) consumption by the rich. As the eminent public finance economist Richard Musgrave has stated, a consumption tax is deficient because it "assumes that consumption, current or future, is the only benefit that income provides. This overlooks the benefits derived from the accumulation and holding of wealth, whether in terms of security, power, or social standing."[75]

If this analysis is true, what does it imply for taxing the rich? From an optimal tax perspective, arguing that the rich derive added utility from their wealth that is not available to people for whom (because of their lesser means) money only has consumption value is an argument *against* taxing the rich. That is because any redistribution in the optimal tax model derives from its assumption of the declining marginal utility of money, and the "riches mean power" model militates against this assumption.[76]

But there is another, broader way of formulating the question. The modern democratic state is built on the assumptions that all power should ultimately reside in the people and their representatives, and that undue concentrations of private power that is unaccountable to the people should be discouraged.[77] The origins of this conception go all the way back to the feudal monarchy of the high Middle Ages, which was founded on the "feudal pyramid" with the monarch at its top. In a feudal monarchy, "the vassal of my vassal is not my vassal": Power was explicitly distributed throughout the pyramid.[78] But from the twelfth century onward, European monarchs waged a long struggle to concentrate power in themselves and eliminate competing centers of power.[79] As Tocqueville noted, the French

75. Richard A. Musgrave, *Clarifying Tax Reform*, 70 TAX NOTES 731, 733-34 (1996); *see also* INST. FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION 351 (1978) ("The holding of wealth itself . . . can confer on the owner benefits of security, independence, influence and power, quite apart from any expenditure which the income from it may finance."); William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947, 956 (1975) ("It may well be unacceptable to rely solely on consumption as a personal tax base because for some people wealth has a welfare value above and beyond the deferred consumption it may operate to support . . . ."). Indeed, the notion that the difference between the rich and everyone else is merely that the rich have chosen to defer their consumption and should not be penalized for doing so, which underlies many modern defenses of consumption taxes, seems preposterous when applied to the super-rich. *See* SIMONS, *supra* note 38, at 97 ("In a world where capital accumulation proceeds as it does now, there is something sadly inadequate about the idea of saving as postponed consumption.").

76. The declining marginal utility assumption is supported by empirical evidence regarding insurance: The richer people are, the less likely they are to insure their lives (and income), suggesting that their income has a declining marginal utility. *See* Milton Friedman & L.J. Savage, *The Utility Analysis of Choices Involving Risk*, 56 J. POL. ECON. 279 (1948). But this decline is not applicable to the distinction between the merely rich (top five percent) and the super-rich (top one percent), which is crucial for a power-based analysis because only the super-rich do not consume most of their wealth.

77. Ventry, *supra* note 64 (manuscript at 48).

78. *See* F.L. GANSHOF, FEUDALISM 88 (1952).

79. *See* THE FORMATION OF NATIONAL STATES IN WESTERN EUROPE (Charles Tilly ed., 1975); POWER ELITES AND STATE BUILDING (Wolfgang Reinhard ed., 1996).

Revolution, with its explicit confiscation of lands belonging to the nobility, was merely the culmination of this long trend, and in its aim was no different from Louis XIV's practice of forcing all noblemen to spend most of the year at Versailles, away from their sources of landed power in the provinces.[80]

The American Revolution likewise was founded on the conception that while people have natural, Lockean liberal rights to their property, undue concentrations of private power and wealth should be discouraged.[81] This view found its expression in the republican creed of civic humanism, which emphasized public virtue as a balance to private rights. A virtuous republic, the Framers believed, was to be free from concentrations of economic power that characterized England in the eighteenth century.[82] Therefore, from the beginning of the Republic, federal and state legislators used taxation to restrict privilege and to "affirm communal responsibilities, deepen citizenship, and demonstrate the fiscal virtues of a republican citizenry."[83] As Dennis Ventry has written,

> The ideal of civic virtue created a unique form of ability-to-pay taxation that was hostile to excess accumulation and to citizens who asserted entitlement through birth. Inherited wealth, as well as gross concentrations of wealth (inherited or not), characterized an aristocratic society, not a free and virtuous republic.[84]

Until the late nineteenth century, these ideals found expression primarily in state taxation of property, including intangible property such as stocks.[85] The short-lived federal income tax of the Civil War era was permitted to expire in 1872. But in the 1890s, it became clear that the state property taxes were unable to reach the large concentrations of wealth and power resulting from industrialization.[86] The Populists in the West and South called for a progressive tax on corporate profits and high incomes to reallocate the tax burden toward corporate monopolies and wealthy shareholders.[87] A progressive income tax was the way to break up

80. *See* ALEXIS DE TOCQUEVILLE, THE OLD REGIME AND THE REVOLUTION (François Furet & Françoise Mélonio eds. & Alan S. Kahan trans., Univ. of Chi. Press 1998) (1856); GEORGES LEFEBVRE, THE COMING OF THE FRENCH REVOLUTION 16-20 (R.R. Palmer trans., Vintage Books 1967) (1939).

81. Ventry, *supra* note 64 (manuscript at 4-5).

82. *See id*. (manuscript at 5).

83. W. Elliott Brownlee, *Economic History and the Analysis of "Soaking-the-Rich" in 20th Century America*, *in* TAX JUSTICE, *supra* note 64 (manuscript at 1, on file with author); Brownlee, *supra* note 4, at 31.

84. Ventry, *supra* note 64 (manuscript at 5).

85. *Id*.

86. The problem with taxing intangible forms of property was that it was difficult in nineteenth-century conditions to find and value them. *See id*. (manuscript at 6-7).

87. *Id*. (manuscript at 7).

undemocratic concentrations of economic power.[88] This point is emphasized by the most prominent historian of U.S. income taxation, Elliott Brownlee:

> [S]upport for a radical progressive income tax had far more to do with the search for social justice in an industrializing nation than with the quest for an elastic source of revenue. The progressive income tax became an integral part of democratic statism—a radical program of invoking instruments of government power to create a more democratic social order by redistributing wealth. Democratic statism represented a new kind of liberalism—the adaptation to industrial conditions of classic nineteenth-century liberalism and the commonwealth tradition of early republicanism, which had included a distrust of commerce.[89]

The result of this reconceptualization of the republican ideal was the federal income tax of 1894, which was struck down by the Supreme Court in 1895 before it became effective,[90] and ultimately the Sixteenth Amendment[91] (1913) and the modern U.S. federal income tax. The Sixteenth Amendment was ratified (to the surprise of its supporters and opponents alike) primarily because of the presidential campaign of 1912, in which Woodrow Wilson, Theodore Roosevelt, and Eugene Debs all emphasized the need for a federal attack on monopoly power.[92]

Until World War II, high exemptions meant that the federal income tax was primarily an instrument for taxing the rich, and it was conceived of primarily as a means for curbing the economic power of the rich and of large corporations.[93] In the years immediately following 1913, there was an increase in the concentration of income earned by the best paid individuals

88. Brownlee, *supra* note 4, at 36; Ventry, *supra* note 64 (manuscript at 7).

89. Brownlee, *supra* note 4, at 36.

90. Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601 (1895). The Supreme Court held by a 5-4 majority that the federal income tax was a tax on the underlying property and therefore unconstitutional because it was not apportioned. "What, in fact, is property, but a fiction, without the beneficial use of it? In many cases, indeed, the *income* or *annuity* is the property itself." *Id*. at 626. The decision has been much maligned, but it comports well with modern financial theory, which points out that the value of property is but the present value of expected income flows from that property. The decision was also justified if one believes that the purpose of the income tax was to attack concentrations of wealth.

91. U.S. CONST. amend. XVI.

92. Brownlee, *supra* note 4, at 40.

93. The initial exemption was $3000 for singles and $4000 for married couples; the result was that only 1.5% of households paid income tax in 1913, and only 2% paid income tax on average from 1913 to 1915. *Id*. at 41-42; Ventry, *supra* note 64 (manuscript at 49 n.4). The richest one percent paid 80% of federal income tax revenues in 1918. Brownlee, *supra* note 4, at 44; Ventry, *supra* note 64 (manuscript at 9). But the income tax became a mass-based tax as exemptions were cut back during World War II (which also saw the introduction of wage withholding and estimated tax payments). In 1939 four million Americans paid tax; the number grew to forty-three million by 1945, an increase that was made possible by the introduction of Social Security numbers. Ventry, *supra* note 64 (manuscript at 13).

and by large corporations. Redistributive taxation was seen as a way of curbing such undue power.[94] Similarly, the New Deal tax increases in the 1930s were seen by FDR as a way to attack concentrations of wealth. In his 1934 message to Congress, FDR explained that accumulations of wealth meant "great and undesirable concentration of control in relatively few individuals over the employment and welfare of many, many others."[95] The resulting 1935 Revenue Act, which the press called the "Wealth Tax," increased the top marginal rate to seventy-seven percent, made the estate tax more progressive, and created a graduated tax on corporations.[96]

There was another agenda at play as well in the early years of the federal income tax: the desire to use progressive taxation as a way to "stave off more radical calls for industrial democracy."[97] This explains why even some high-income Republican groups supported the Sixteenth Amendment.[98] Andrew Mellon, Secretary of the Treasury in the 1920s and one of the wealthiest Americans, "believed that keeping tax schedules graduated (albeit flatter) would mitigate radical demands for restructuring the capitalist system."[99] This agenda was similar to the one adopted by Bismarck, the creator of the modern welfare state financed by progressive taxation, whose explicit aim was to counter the appeal of the Communist call for an even more radical redistribution of resources.[100] Even Friedrich Hayek supported progressive taxation for its symbolic value, although he emphasized that taxing the rich was merely an illusion:

> Indeed, it seems more than likely that the illusion that by means of progressive taxation the cost of additional expenditure can be raised from the rich has made such expenditure much more attractive and that as a result even the poor now have to give up a larger proportion of their income than they would have consented to do.[101]

These historical reflections may explain how the progressive individual income tax (as well as the estate tax and the corporate tax) came into being in the United States, and "a page of history is worth a volume of logic."[102] But Holmes also said that historical explanations have no normative

94. Brownlee, *supra* note 4, at 42-43; Ventry, *supra* note 64 (manuscript at 10).
95. Brownlee, *supra* note 4, at 52; Ventry, *supra* note 64 (manuscript at 11).
96. Ventry, *supra* note 64 (manuscript at 11-12).
97. *Id.* (manuscript at 8).
98. *Id.*
99. *Id.* (manuscript at 11).
100. Slemrod, *supra* note 2, at 9.
101. Friedrich A. Hayek, *Progressive Taxation Reconsidered*, *in* ON FREEDOM AND FREE ENTERPRISE 265, 273 (Mary Sennholz ed., 1956).
102. N.Y. Trust Co. v. Eisner, 256 U.S. 345, 349 (1921) (Holmes, J.).

power.[103] Is there anything that can be deduced from the historical background regarding the question of why the rich should be taxed today?

I would argue that the answer is yes, because the United States in the early twenty-first century is facing a similar phenomenon to the one that occurred a hundred years earlier: a huge increase in inequality and the rise of new concentrations of wealth and power, fueled this time by the information revolution of the late twentieth century. It is well documented that the 1980s and 1990s witnessed a significant increase in inequality of both income and wealth.[104] Indeed, the entire period from 1968 to 1998 was characterized by increased income inequality. Census data indicate that the share of before-tax family income decreased for families below the eightieth percentile of the income distribution, while the share of income for the top twenty percent of families increased by an average of 14%, and the richest five percent received a 33% increase.[105] From 1983 to 1998, the same data indicate that the after-tax share of income of the wealthiest twenty percent increased by 5%, and of the richest five percent by 16%, while the income of all other households decreased.[106] The explanation for this increase in inequality is complex, relating to the increased rewards to highly skilled types of work (the "symbolic analysts," to use Robert Reich's term) and the decreasing reward for everyone else.[107] Technological change is usually seen as the main reason for this gap,[108] although globalization and the ability of corporations to seek the cheapest source of labor overseas also has some role to play.[109]

But why should Americans care if their society is becoming more unequal? From a consequentialist perspective, the answer is that across countries, increased inequality is usually associated with lower growth rates.[110] There are several explanations for this phenomenon, all of which receive some empirical support. Inequality may engender political instability, which reduces investment and growth. Inequality may also reduce investment in human capital among those with little wealth, which may reduce growth. And inequality may increase fertility among the

103. Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 469 (1897).

104. *See, e.g.*, LISA A. KEISTER, WEALTH IN AMERICA (2000); EDWARD N. WOLFF, TOP HEAVY: A STUDY OF THE INCREASING INEQUALITY OF WEALTH IN AMERICA (1995); Edward M. Gramlich et al., *Growing Inequality in the 1980s: The Role of Federal Taxes and Cash Transfers*, *in* UNEVEN TIDES: RISING INEQUALITY IN AMERICA 225 (Sheldon Danziger & Peter Gottschalk eds., 1993); Keith Bradsher, *Gap in Wealth in U.S. Called Widest in West*, N.Y. TIMES, Apr. 17, 1995, at A1.

105. Stephen B. Cohen, *Vanishing Case for the Flat Tax: Growth, Inequality, Saving, and Simplification*, 86 TAX NOTES 675, 685 (2000); Ventry, *supra* note 64 (manuscript at 35).

106. Cohen, *supra* note 105, at 681. These figures do not reflect the 2001 stock market drop, which presumably somewhat narrowed the difference.

107. ROBERT B. REICH, THE WORK OF NATIONS 177 (1991).

108. DANI RODRIK, HAS GLOBALIZATION GONE TOO FAR? 12 (1997).

109. *Id.* at 16.

110. Slemrod, *supra* note 2, at 16.

nonwealthy, which also decreases per capita growth.[111] On the other hand, inequality may also be argued to reduce growth if it leads to redistributive fiscal policies that overtax the rich, but there is little empirical evidence for this view.[112]

In my view, however, the best argument in favor of taxing the rich is not that inequality may threaten growth, or even threaten revolution. Rather, it is the argument that underlay attempts to tax the rich from the beginnings of the American experiment: that there is something inherently undemocratic in extreme concentrations of wealth and power.[113]

There are three arguments why extreme concentrations of wealth are undemocratic. The first two are obvious: In the American system of government, great wealth can buy political favors (often at minuscule expenditures) and finance runs for office (at somewhat greater but still quite limited costs).[114] The third is more subtle—that vast inequality of wealth is socially destructive because it degrades relationships among people (cultural, social, and political) and eventually undermines the sense of community on which a democratic polity must rest.[115] This argument is particularly true in a country like the United States, which is not bound together by ties of ethnicity, culture, or language.[116]

The recent experience of the United States government in trying unsuccessfully to limit the power of the richest man in the world and of the corporation he controls is a good reminder that the problems that led to the adoption of the Sixteenth Amendment are still with us.[117] The belief in progressive income taxation (as well as estate and corporate taxation) must

111. *See* Klaus Deininger & Lyn Squire, *New Ways of Looking at Old Issues: Inequality and Growth*, 57 J. DEV. ECON. 259, 260-61 (1998); Roberto Perotti, *Growth, Income Distribution, and Democracy: What the Data Say*, 1 J. ECON. GROWTH 149, 150-54 (1996).

112. Slemrod, *supra* note 2, at 16; *see also* Torsten Persson & Guido Tabellini, *Is Inequality Harmful for Growth?*, 84 AM. ECON. REV. 600, 617-18 (1994) (arguing that postwar OECD data weakly support this view). All of these studies are complicated by the fact that there are inherent problems in attempting to separate out the effects of tax policy on prosperity and the extent to which prosperity facilitates tax collection. Slemrod, *supra* note 2, at 17.

113. This was the viewpoint of Sidney Ratner, the first historian of American income taxation, who viewed progressive income taxation "as preeminently fit for achieving and preserving the economic objectives of democracy." Brownlee, *supra* note 83 (manuscript at 4) (citing SIDNEY RATNER, TAXATION AND DEMOCRACY IN AMERICA 14 (1980)). Ratner wrote from a Cold War perspective, and subsequent historians have tended to disagree, but his writing still has persuasive force today.

114. See, for example, the recent presidential runs of Ross Perot and Steve Forbes. These problems can conceivably be addressed by comprehensive campaign finance reform, but such reform will not address the economic and social power of the rich.

115. For the importance of civic engagement and "social capital," see ROBERT D. PUTNAM, BOWLING ALONE (2000).

116. This viewpoint is shared by writers in the communitarian tradition (which stems ultimately from the republican views of the Founders), such as Walzer and Sandel, as well as by writers in the British socialist tradition. *See, e.g.*, R.H. TAWNEY, THE ACQUISITIVE SOCIETY 1-8, 180-84 (1920) (arguing for a community-based view of efficiency and equity).

117. *See* United States v. Microsoft Corp., 253 F.3d 34 (D.C. Cir. 2001).

ultimately rest on the same conviction that animated the reformers of the 1890s: that extreme concentrations of power resulting from extreme concentrations of wealth in the hands of private individuals who are unaccountable to the majority is an unhealthy phenomenon in a democracy. Such private individuals exercise degrees of power and influence that run counter to the ability of the government of the people to govern the country in accordance with the people's wishes, as expressed in democratic elections. It is these observations, and not merely some aesthetic objection to inequality, that underlie the drive toward keeping the progressive individual income tax (as well as the corporate tax and the estate tax) in place.[118]

IV. CONCLUSION: TOWARD A NEW BALANCE BETWEEN EQUITY AND EFFICIENCY

Even if one supports, as I do, the ideal of progressive income taxation as a way of reducing inequalities of wealth and power, it is still necessary to balance these goals with the need to maintain a healthy growth rate for the economy. While the conclusions of Slemrod's book indicate that for most real activities such as savings rates or the labor/leisure tradeoff there is little evidence of an adverse impact of current tax rates on the rich, one must remember that these rates (even before the 2001 tax cut) were quite low by historical standards. A return to the seventy percent or ninety percent top tax rate of the period from 1935 to 1980 is not in the cards, because it may well have an adverse impact on actual labor supply and saving. In addition, such high rates lead to enormous pressure on taxpayers to devise ways of reducing their tax liability, which in turn lead to deadweight losses in the form of unproductive investments in various tax avoidance schemes.[119]

118. This is not to say that there is no place for other kinds of taxes as well. It is precisely because I view the income tax primarily as a means for limiting the power of the very rich (top one percent) that I would support proposals made by Michael Graetz to relimit the reach of the income tax to the rich and to impose a value added tax (a type of consumption tax) on everybody else. *See* GRAETZ, *supra* note 4, at 264-66. But this is a very different notion from abandoning the income tax in favor of a consumption tax that would tax Mr. Gates only on the minuscule fraction of his wealth that he consumes.

In addition, an analysis of the income tax that focuses on reducing power differentials as its main goal can have interesting implications for various tax policy debates. For example, such a view suggests that although the deductions for medical, casualty, and state and local tax costs are acceptable because the outlays reduce private power, the deductions for personal interest (including home mortgage interest) and charitable contributions should be curtailed at top income levels because both borrowing and giving to charity increase the social power of the rich. Such an analysis also has implications for the corporate tax, which I hope to address in a future project.

119. Given the constraints imposed by efficiency concerns, one may ask whether the income tax can ever be an effective vehicle for reducing power differentials. In theory, one can construct an income tax similar to the one expounded in Henry C. Simons's classic *Personal Income Taxation*, SIMONS, *supra* note 38, in which all accessions to wealth (including gifts and bequests) are included in the base and the top marginal tax rate can be as high as ninety-four percent. Such

Thus, in the current state of our knowledge, I would not call for drastic top marginal rate increases, although I would support reversing the 2001 top marginal rate cuts and not allowing the estate tax to expire.[120] Fundamentally, given the constraints imposed by the need to maintain economic growth, the income tax by itself cannot curb the economic power of the rich sufficiently to maintain a democratic community. But some combination of the income tax, the estate tax, and direct regulation of political and economic activities via campaign finance reform and antitrust enforcement might. This was the belief that underlay the original enactment of the income tax, and in my view it is still valid today.[121]

This Review, however, also has a simpler practical point: to call for a rebalancing between efficiency and equity considerations in the current legal tax literature. It is fair to say that since the 1950s, and even more so since the 1980s, academic legal writing on taxation has been dominated by efficiency issues and by the optimal tax approach.[122] This reflects changes in public economics, which, during the same period, shifted its attention to focus primarily on efficiency and growth.[123] These changes in turn reflect the view that was also expressed by Simons, Blum, and Kalven, and still resonates in Slemrod's book—that issues of distribution are a matter of aesthetics or political value judgments and therefore beyond the purview of economic analysis.[124] Economists generally believe that they "have no

an income tax could have very significant redistributive effects but would probably lead to unacceptable reductions in economic growth and efficiency losses from tax avoidance schemes. But even an income tax that is acceptable from an efficiency point of view (e.g., with a top rate of fifty percent) can have significant redistributive effects if coupled with an estate tax and a corporate tax. In fact, the income tax was seen by the progressives of the late nineteenth century as only one vehicle in curbing the power of the rich, together with the corporate tax and antitrust enforcement. Brownlee, *supra* note 4, at 38-39.

120. With state taxes and the phase-out of exemptions and deductions, the pre-2001 statutory top rate of 39.6% could approach a real top marginal rate of almost 50%, which seems intuitively to be about the most one can expect to collect in tax without running into major incentive problems. In any case, we know from experience that the U.S. economy did very well in the 1990s with a top rate of 39.6%, so reversing the 2001 tax cuts seems a safe bet. Both the 2001 marginal rate cuts and repeal of the estate tax are set under current law to reverse in 2011. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150.

121. In general, the tradeoff between efficiency and equity is more complicated than would appear at first glance. Some policies adversely affect both (e.g., policies causing recession and throwing the poor out of work), and some help both (e.g., investment in infrastructure and education, and other beneficial social outlays). At the extremes (confiscatory taxation, excessively generous welfare programs), there is a tradeoff, but there is a wide range of policies (and tax rates) at which no tradeoff can be shown. *See* ROBERT KUTTNER, THE ECONOMIC ILLUSION 3 (1984).

122. Some have even argued that fairness has no place in legal theory. *E.g.*, Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 967 (2001).

123. Ventry, *supra* note 64 (manuscript at 36-44). *Compare* RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE 5, 19 (1959) (emphasizing both equity and efficiency), *with* HARVEY S. ROSEN, THE THEORY OF PUBLIC FINANCE (1999) (emphasizing efficiency).

124. *See* Slemrod, *supra* note 2, at 19-20; Ventry, *supra* note 64 (manuscript at 37).

special competence in determining which distribution of resources is appropriate."[125] As Slemrod writes,

> The approach of mainstream modern public finance economics to these issues has been to accept, for the sake of argument, the right of government to redistribute income through the tax system (and other means); to sidestep the ethical arguments about assessing the value of a more equal distribution of economic outcomes; and to instead investigate the implications of various value judgments for the design of the tax system.[126]

Such an attitude to distributive issues may be fine for public finance economists, although it did not characterize the economics profession before the 1950s and still does not characterize some of it today.[127] But it does not excuse the abdication of equity in favor of efficiency by most legal tax academics, especially in some of the elite law schools. Most of the writing on distributive issues in these circles has been done within the confining framework of optimal tax theory.[128] Even the debate between income and consumption taxation, which in the 1970s still involved fairness considerations, has recently been waged entirely on technical grounds with little or no explicit consideration of equity issues.[129]

It is time for legal tax academics to redress the balance. Efficiency issues cannot be neglected, but on that ground the last word must depend crucially on empirical evidence that lawyers are ill-equipped to produce. But issues of equity and "tax justice" must be explicitly addressed as well. To do otherwise risks abandoning the field to the many opponents of progressivity in taxation. Slemrod's book is an outstanding contribution to

125. Ventry, *supra* note 64 (manuscript at 45).

126. Slemrod, *supra* note 2, at 10.

127. The new economic historians (such as Douglass C. North) and economists engaged in historical and comparative institutional analysis show that the economics profession (as distinguished from its offshoot in law schools) has not lost its ability to grapple with historical and cultural forces shaping issues such as the rights of the individual vis-à-vis the community. *See, e.g.*, Avner Greif, *Cultural Beliefs and the Organization of Society: A Historical and Theoretical Reflection on Collectivist and Individualist Societies*, 102 J. POL. ECON. 912 (1994).

128. *See* Bankman & Griffith, *supra* note 39; Kaplow & Shavell, *supra* note 122. As Kyle Logue and Ronen Avraham have written in their excellent critique of Kaplow and Shavell, "[M]ost of the leading tax-policy scholars, as well as many prominent law-and-economics scholars, are welfarists." KYLE D. LOGUE & RONEN AVRAHAM, THE TAX SYSTEM VERSUS THE LEGAL SYSTEM: REDISTRIBUTION IN THE WELFARIST STATE (forthcoming 2002) (manuscript at 9, on file with author).

129. *Compare* Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975) (emphasizing fairness), *with* Alvin C. Warren, Jr., *How Much Capital Income Taxed Under an Income Tax Is Exempt Under a Cash Flow Tax?*, 52 TAX L. REV. 1 (1996) (setting forth a purely technical analysis).

the efficiency side of the debate. One can only wish that as good a volume could be produced on the equity side.[130]

130. In fact, two such books are forthcoming—the superb volume edited by Ventry and Thorndike, TAX JUSTICE, *supra* note 64, and the equally outstanding LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP: TAXES AND JUSTICE (forthcoming 2002). But much more work is needed in this direction.