TAXING INCOME AND WEALTH

Ari Glogower[*]

Abstract

Rising economic inequality has led scholars to reassess the base for progressive taxation and to argue that wealth should be taxed in addition to income. This Article begins by grounding the argument for taxing wealth as a factor in economic inequality in the relative economic power theory used by political scientists to explain how inequality generates social and political harm. From this starting point of the relative economic power theory, this Article makes two primary contributions to the literature on wealth taxation. First, this Article demonstrates basic limitations of proposals for separate periodic taxes on income and wealth as factors in economic well-being. Separate income and wealth taxes cannot consistently compare taxpayers on the basis of their total economic well-being during the taxing period and will favor or disfavor taxpayers depending whether their economic well-being results from income, wealth, or a combination thereof.

This argument has additional implications for the choice between taxing wealth or income, and the limitations of both. From the perspective of a periodic tax on economic well-being, a wealth tax is not replicable by a tax on capital income earned from wealth. A wealth tax that accounts for a taxpayer's entire stock of wealth each period overtaxes wealth holders relative to labor income earners, whereas a capital income tax under-taxes wealth holders relative to labor income earners. Finally, from this perspective wealth does not factor equally in each taxpayer's economic well-being, which will vary with the number of periods over which the wealth must be spread.

This Article then introduces a new base for progressive taxation, which is a combined base of economic well-being derived from both income and wealth. This approach first re-characterizes wealth and capital income as an annuity value (the "wealth annuity"), reflecting both capital income earned during the period and a portion of the taxpayer's wealth principal. The wealth annuity is then added to the taxpayer's labor income for the period to yield the combined base, which reflects economic spending power during the taxing period. This combined base allows the tax system to compare taxpayers with different levels of income and wealth, and tailors the progressive tax base to the theorization of how economic inequality causes social and political harm.

---

[*] Assistant Professor, The Ohio State University Moritz College of Law.

Table of Contents

I. Introduction

As Congress and the President pursue tax reform, two pressing challenges confront the tax system. First, the federal government requires additional revenue to fund current programs; to make new public investments in infrastructure, healthcare, and education; and to service the national debt. An estimated $380 billion in additional revenue is required just to stabilize the federal debt at its current share of GDP.[1] At the same time, inequality of both income and wealth are rising, with both measures approaching levels last seen in the 1920's, in the years leading up to the Great Depression.[2] Excessive inequality weakens the economy,[3] threatens democratic governance,[4] and stifles economic opportunity and mobility.[5]

These two concerns—the need to raise revenue and to constrain inequality— have led scholars to reassess the base of progressive taxation and to argue that wealth should be taxed in addition to income.[6] A general line of argument in the

---

[1] Cong. Budget Office, The 2017 Long-Term Budget Outlook 22 (2017), https://www.cbo.gov/publication/52480. Stabilizing the national debt at its 50-year average of 40% of GDP would require additional revenues of $620 billion in 2018. Id. at 29.

[2] See Thomas Piketty, Emmanuel Saez & Gabriel Zucman, Distributional National Accounts: Methods and Estimates for the United States 1, 23 (2017), http://gabriel-zucman.eu/files/PSZ2017.pdf (on current trends in income inequality); Emmanuel Saez & Gabriel Zucman, Wealth Inequality in the United States Since 2013: Evidence from Capitalized Income Tax Data, 131 Q.J.E. 519, 552 (2016) (on current trends in wealth inequality). Since 1980, real pretax income has stagnated for the bottom 50% of earners, while the top 1% has seen their income triple and their share of total national income nearly double. Piketty et al., supra, at 3. The share of wealth held by the top 10% of households has also risen steadily since the 1980s, to an estimated 77.2% in 2012, approaching the previous peak last reached in the late 1920s. Saez & Zucman, supra, at 552.

[3] See Edward D. Kleinbard, Capital Taxation in an Age of Inequality 52-54 (USC Sch. L. Ctr. for L. & Soc. Sci., Leg. Stud. Res. Paper No. 16-29, Dec. 1, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2838532, discussion at Subsection IV.E.2.

[4] See Ganesh Sitaraman, The Crisis of the Middle Class Constitution: Why Economic Inequality Threatens Our Republic (2017); Bruce Ackerman & Anne Alstott, Tax the Wealth: Target the Top of the Pyramid to Protect America's Democracy, Op-Ed., L.A. Times, Sept. 20, 2011, at A11.

[5] A recent study found "systemic and widespread" reductions in the likelihood that children will enjoy a higher standard of living than their parents since the 1940s and that the trend is attributable to rising inequality. Raj Chetty et al., The Fading American Dream: Trends in Absolute Income Mobility Since 1940, 356 Science 398, 398-406 (2017).

[6] As used in this Article, the term "wealth" refers to a stock of nonhuman capital, and income refers to both periodic labor income (the return to human capital) and capital income (the return to wealth). See discussion at Section III.B. For proposals advocating for wealth taxation, see generally Goldburn Maynard, Addressing Wealth Disparities: Reimagining Wealth Taxation as a Tool to Building Wealth, 92 Denv. U. L. Rev. 145 (2014); McCaffery, supra; Beverly Moran, Wealth Redistribution and the Income Tax, 53 Howard L.J. 319, 329-32 (2010); Thomas Piketty, Capital in the Twenty-First Century 515-18, 524-30 (Arthur Goldhammer trans., Harvard Univ. Press 2014) (proposals for global and European wealth taxes); David Shakow & Reed Shuldiner, A Comprehensive Wealth Tax, 53 Tax L. Rev. 499 (1999); Deborah Schenk, Saving the Income Tax with a Wealth Tax, 53 Tax L. Rev. 423 (2000); David J. Shakow, A Wealth Tax: Taxing the Estates of the Living, 53 B.C. L. Rev. 947, 948-50 (2016); Bruce Ackerman & Anne Alstott, The Stakeholder Society 94-112 (1999); Anna Bernasek, Looking Beyond Income, to a Tax on Wealth, N.Y. Times, Feb. 10, 2013 at BU11,

literature justifying a wealth tax[7] proceeds as follows: The purpose of the progressive tax system, which taxes individuals according to their ability to pay,[8] is to raise revenue in a manner that constrains economic inequality.[9] Currently progressive taxation begins and largely ends with the federal income tax.[10] An income tax, however, is inadequate to the task of redistribution because income

---

http://www.nytimes.com/2013/02/10/business/yourtaxes/a-wealth-tax-would-look-beyond-income.html.; Ronald McKinnon, The Conservative Case for a Wealth Tax, Wall St. J., Jan 9, 2012, at A13.

[7] The focus of this Article is proposals for taxing wealth on distributional grounds as a factor in economic well-being and in economic inequality. A complementary but distinct literature justifies taxing wealth as an efficient method of redistribution. See, e.g., David Gamage, The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth, 68 Tax L. Rev. 355, 431-37 (2015) (justifying a wealth tax in light of the different planning responses to taxes on income and wealth); James Banks & Peter Diamond, The Base for Direct Taxation, in Dimensions of Tax Design: the Mirrlees Review 548, 563 (J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba, eds, 2010) [hereinafter "Mirrlees Review"] (justifying wealth taxation on the grounds that saving is a signal of earning ability); discussion at Subsection IV.E.2.

[8] For a discussion of different usages of the term "ability to pay," see note 58.

[9] For early justifications of progressive taxation as a response to economic inequality, see, e.g., R.A. Musgrave & Tun Thin, Income Tax Progression, 1929-48, 56 J. Pol. Econ. 498, 510 (1948); Henry C. Simons, Personal Income Taxation 18-19 (1938); Vickrey, note 17, at 4 ("Progressive taxation may be defined as taxation that tends to promote economic equality.). See also Bernie Sanders, Making the Wealthy, Wall Street, and Large Corporations Pay their Fair Share, https://berniesanders.com/issues/making-the-wealthy-pay-fair-share/ (last visited May 10, 2017) ("At a time of massive wealth and income inequality, we need a progressive tax system in this country that is based on the ability to pay."). Progressivity may also be justified on other grounds. For example, the benefits principle, which assumes a contractual relationship between government and taxpayers, would tax individuals in proportion to the benefits they receive from government. This view justifies progressivity if it is assumed that the benefits of government disproportionately accrue to the rich and increase at a faster rate than the base subject to tax. See Michael J. Graetz & Deborah H. Schenk, Federal Income Taxation: Principles and Policies 31 (7th ed., 2013); Edwin R.A. Seligman, Progressive Taxation in Theory and Practice 77, 80-86, 122 (1894). Progressivity has also been justified under variations of the equal or fair sacrifice principles, which generally seek to preserve a pretax distribution of welfare. See David Kamin, note, What Is a Progressive Tax Change? Unmasking Hidden Values in Distributional Debates, 83 N.Y.U. L. Rev. 241, 272-74 (2008). Equal sacrifice principles imply progressive taxation if it is assumed that money has declining marginal utility, and each individual values relative amounts of money similarly. See Kamin, supra, at 274. A welfarist perspective, in contrast, generally seeks to maximize a weighted function of aggregate social utility. This view may also justify progressive taxation based on an assumption of declining marginal utility of income and on the weight placed on equality of utility in the social welfare function. See, e.g., Louis Kaplow, The Theory of Taxation and Public Economics 57-65 (2008).

[10] See Chris William Sanchirico, Deconstructing the New Efficiency Rationale, 86 Cornell L. Rev. 1003, 1018 (2000) ("The income tax has been and remains the celebrity of redistributional instruments . . ."). In contrast to the relatively progressive federal tax system, state and local taxes are generally proportional or regressive. See Daniel J. Hemel, The Federalist Safeguards of Progressive Taxation 93 N.Y.U. L. Rev. 6*-11* (forthcoming 2018). The estate and corporate taxes are smaller components of the total federal income tax system and consequently have less impact on overall progressivity. See Thomas Piketty & Emmanuel Saez, How Progressive is the U.S. Federal Tax System? A Historical and International Perspective 11, App. Fig. 1 (NBER Working Paper No. 12404, July, 2006), http://www.nber.org/papers/w12404.

alone is an incomplete measure of a taxpayer's economic well-being,[11] and in practice a tax on income alone—at less than confiscatory rates—can only have a limited effect in reducing inequality.[12] Under this view, accounting for a taxpayer's wealth will allow the tax system to more accurately compare taxpayers by their economic well-being and to more effectively constrain rising inequality.

Advocates of wealth taxation consequently propose different combinations of taxes on income and wealth as factors in economic well-being. These proposals for a wealth tax generally share a common feature: an assumption that income and wealth must be taxed under separate instruments with separate rate schedules.[13] For example, David Shakow and Reed Shuldiner's formative and detailed proposal would tax wealth as a replacement for the capital income tax labor income under a separate income tax.[14] Similarly, Bruce Ackerman and Anne Alstott propose a separate tax on wealth,[15] in addition to the current tax on both capital and labor income.[16]

The argument that wealth should be taxed as a factor in economic well-being may be intuitively appealing (or even self-evident) to some readers but also has limited normative guidance, as views on fairness and the proper baseline for redistribution will vary.[17] Furthermore, measures of economic well-being and economic inequality will vary depending upon the purposes for which the terms are used.[18] To add specificity and substance to the argument that wealth should be taxed as a factor in economic inequality, this Article consequently begins, not with subjective arguments regarding fairness but with the theorization of how exactly economic inequality is understood to cause social harm. In particular, this Article first grounds the argument for taxing wealth in the relative economic power theory used by political scientists to explain how economic inequality generates social and

---

[11] See, e.g., Shakow & Shuldiner, note 6, at 503.

[12] See, e.g., Edward J. McCaffery, Taxing Wealth Seriously 6-7 ("The reliance on income taxation to carry the weight of redistribution has been a disastrous mistake."); Ackerman & Alstott, note 4 ("We should be taxing that wealth directly, and not merely focusing on million-dollar incomes."). Studies find that the federal income tax has only a minimal effect on reducing inequality. See Piketty et al., note 2, at 40-41, Tbl. II, Fig. I.

[13] Specifically, references in this Article to proposals where different bases are taxed under separate instruments refer to cases where the rate at which one base is taxed is not affected by the size of the other base.

[14] See Shakow & Shuldiner, note 6, at 540-46, discussion at Section III.D.

[15] Ackerman & Alstott, note 6, at 94-112

[16] The authors propose a coordinating rule whereby a taxpayer pays the lesser of the wealth tax or the capital income tax for assets subject to both. See id. at 107-08 and discussion at Subsection III.C.3.

[17] See, e.g., the characterization of arguments for any specific normative distributional baseline in William Vickrey, Agenda for Progressive Taxation 3-4 (1947) ("More often than not, ability to pay and the equivalent terms "faculty" and "capacity to pay" have served as catch-phrases, identified by various writers through verbal legerdemain with their own pet concrete measure to the exclusion of other possible measures. Ability to pay thus often becomes a tautological smoke screen behind which the writer conceals his own prejudices").

[18] See, e.g., Amartya Sen, On Economic Inequality 25-26 (Enlarged Ed., 2005) (describing different measures of inequality proposed in the literature for different purposes).

political harm, and then considers the implications of this theory for the progressive tax base.[19] As explored in the discussion that follows, this theory implies that the relevant measure for comparing taxpayers' economic well-being is their relative economic spending power during the taxing period.

From this starting point of the relative economic power theory, this Article proceeds to its central argument: Income and wealth should both be taxed as factors in economic well-being, but should be taxed through a combined base of both factors, and not through separate instruments. This argument is developed through two central contributions to the literature. First, this Article identifies a fundamental limitation of separate taxes on income and wealth. Separate income and wealth taxes cannot consistently compare taxpayers on the basis of their total economic well-being during the taxing period from both factors, and will favor or disfavor taxpayers depending whether their economic well-being results from income, wealth, or a combination thereof. This limitation results from the nature of a progressive rate schedule with increasing marginal rates, which will always tax two separate bases at a lower overall rate, when compared to a single tax on a combined measure of both bases. This Article then introduces a new base for progressive taxation, which is a combined base of both income and wealth. This base measures economic well-being from both income and wealth in consistent terms, which may then be summed and taxed under a single progressive rate schedule.   Furthermore, this base measures economic well-being in terms of economic spending power during the taxing period, which is the relevant measure of economic inequality under the relative economic power theory.

This Article's argument has additional implications for the difference between taxing wealth and income, and the limitations of both. First, this perspective highlights how, contrary to a general view in the literature, a wealth tax is not replicable by a tax on capital income earned from wealth.[20] Furthermore, a wealth tax that accounts for a taxpayer's entire stock of wealth each period disfavors wealth holders relative to labor income earners, whereas a capital income tax favors wealth holders relative to labor income earners.[21] Finally, wealth does not factor equally in each taxpayer's economic well-being, and the economic advantage from holding wealth will vary with the number of future periods over which the wealth must be spread.[22] As a result, proposals for wealth taxes impose a greater burden on those who must spread their wealth over a greater number of periods.

The basic limitations of the income tax and the rationale for also taxing wealth can be illustrated through the hypothetical treatment of two taxpayers: a doctor and an investor. The doctor earns a good salary but carries debt from medical school, while the investor has no debt and earns income from investing her

---

[19] See discussion at Section II.B.
[20] See discussion at Subsection III.C.3.
[21] See id.
[22] See discussion at Subsection III.C.2.

wealth. Assume, for example, the doctor has $170,000 of debt[23] and earns an annual salary of $200,000,[24] whereas the investor has $35 million in savings and also earns $200,000 by investing the savings in U.S. Treasury notes.[25]

If we consider their economic circumstances during the taxing period, the investor is better off than the doctor. Although both earn the same income, the investor can also draw upon her saved wealth, whereas the doctor must devote a portion of his income to repaying debt. The federal income tax, however, only compares taxpayers by their annual income and not by their saved wealth or debt. Consequently, both the investor and the doctor will be treated as having similar taxable incomes and will pay similar tax bills.[26]

One simple solution would be to tax the investor's wealth as well, through a separate wealth tax. Separate taxes on income and wealth, however, cannot consistently compare the economic well-being of taxpayers with varying levels of income and wealth. The reason is that a progressive tax on income alone will tax the income under a rate schedule that will not account for the taxpayer's additional economic well-being from wealth, whereas a wealth tax will not account for additional economic well-being from income.

Consider a second scenario involving the following three taxpayers:

Taxpayer 1 has saved wealth but no wage earnings. She begins the year with $1,000,000 of wealth and earns $25,000 of investment income during the year.

Taxpayer 2 is a wage earner with no savings. He begins the year with $0 of wealth and earns $100,000 of labor income during the year.

---

[23] A 2012 study found the median medical student graduated with $170,000 of educational debt. James Youngclaus & Julie A. Fresne, Physician Education Debt and the Cost to Attend Medical School, 2012 Update 3 (Association of American Medical Colleges, Feb. 2013), https://aamc-orange.global.ssl.fastly.net/production/media/filer_public/8d/aa/8daa5c2d-838b-4690-a353-170c7f4a7bab/physician_education_debt_and_the_cost_to_attend_medical_school_2012_update.pdf. The study also found that most students do not make any payments on their education debt during their residency between medical school and practice. Id. at 13-14.

[24] See U.S. Bureau of Labor Statistics, Occupational Employment and Wages, May 2016, https://www.bls.gov/oes/current/oes291069.htm#nat (median 2016 physician salary of approximately $205,000).

[25] Assuming an annual yield of 0.6%. See U.S. Department of Treasury, Daily Treasury Yield Curve Rates, 2016, https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2016.

[26] The definition of the income in Section 61 of the Code, which does not account for saved wealth, and the general rules for deductions from gross income under §§ 161 et. seq., will yield similar net taxable income for both taxpayers. The substantive tax liability of each taxpayer, which is a function of both the taxable base and the applicable rates, may differ. Although the investor is better off than the doctor in economic terms, the investor would be treated *more* favorably if her investment return is earned not as interest income but as qualifying dividends or long-term capital gains taxed at preferential rates under §§ 1(a)-(d), (h). For an account of the capital gains preference as a concession to structural deficiencies in the income tax, see Noël B. Cunningham & Deborah H. Schenk, The Case for a Capital Gains Preference, 48 Tax L. Rev. 319, 350-53 (1993). The example of the doctor and the investor in this Article illustrates how, even without a capital gains preference, a capital income earner would still be favored relative to a worker.

> *Taxpayer 3 is a wage earner with saved wealth. She begins the year with $1,000,000 of wealth and earns $25,000 of investment income and $75,000 of labor income during the year.*

A progressive income tax with an increasing marginal rate schedule treats Taxpayers 2 and 3 equally, notwithstanding Taxpayer 3's additional wealth.[27] A wealth tax similarly treats Taxpayers 1 and 3 equally, notwithstanding Taxpayer 3's additional income. Separate progressive taxes on *both* income and wealth tax Taxpayer 3's income at the same rate as Taxpayer 2's, and Taxpayer 3's wealth at the same rate as Taxpayer 1's, notwithstanding the fact that Taxpayer 3, with both income and wealth, has more economic resources than Taxpayers 1 and 2 during the taxing period. As a result, a progressive tax on economic well-being during the taxing period would require taxing Taxpayer 3 at a higher average rate than either Taxpayer 1 or 2 on both her income and her wealth.

The basic challenge to comparing the three taxpayers is that income and wealth do not measure economic well-being in the same terms. A distance in miles and a distance in kilometers cannot be compared without first translating one measure into the terms of the other. Similarly, income and wealth measure economic well-being differently: Periodic income represents a recurring flow of economic resources,[28] whereas wealth represents a fixed stock, which may be exhausted once. Consequently, for any fixed amount $X of wealth or $X of periodic income, the latter is of greater economic value to the taxpayer.

To resolve the limitation of separate income and wealth taxes, this Article introduces a new base for progressive taxation: a combined base of economic well-being from both income and wealth. The central feature of this combined base translates both wealth and capital income into an annuity value (the "wealth annuity"). The wealth annuity, which has been suggested in the welfare economics literature as a way to translate a stock of wealth into a measure of periodic spending power,[29] is calculated in the same manner as an actual annuity investment. Each period, wealth at the beginning of the period and capital income earned during the period are used to determine a hypothetical annuity payment the taxpayer would receive if this wealth was paid back to the taxpayer in equal amounts over the

---

[27] This simplified example assumes no preferential rate on capital income. Current law would also treat Taxpayer 2 more favorably than Taxpayer 1 if, like the investor in the prior example, Taxpayer 1's $25,000 of investment income qualifies for the preferential rates under § 1(h). See note 26.

[28] For a discussion of non-periodic income, see Subsection IV.C.2.

[29] See generally, e.g., Michael K. Taussig, Alternative Measures of the Distribution of Economic Welfare, Princeton University Industrial Relations Section Working Paper No. 27 (1971), http://dataspace.princeton.edu/jspui/bitstream/88435/dsp01pk02c974k/1/27.pdf; Burton A. Weisbrod & W. Lee Hansen, An Income-Net Worth Approach to Measuring Economic Welfare, 58 Am. Econ. Rev. 1315 (1968). In contrast to the previous applications of the wealth annuity concept in the welfare economics literature, this Article uses the wealth annuity as an element in a new progressive tax base. For a discussion of why the wealth annuity has not been more broadly embraced in the tax literature and why it has heretofore underappreciated relevance for the progressive tax base, see discussion at Section IV.A.

taxpayer's remaining lifetime.[30] In effect, the wealth annuity accounts for a taxpayer's capital income earned during the taxing period (as under the current income tax) and also a portion, but not all, of the taxpayer's wealth stock. The portion of the wealth stock included in the taxable base will vary with the number of periods across which the taxpayer expects to spread their wealth, as well as the taxpayer's decisions whether, and how, to invest this wealth.

The wealth annuity, which reflects both wealth and capital income, is added to a taxpayer's labor income to yield the combined base of economic well-being during the taxing period.[31] The combined base has two key advantages: First, the measure consistently accounts for economic well-being during the taxing period from wealth, labor income, and capital income, and consistently compares taxpayers with different levels of each. As a result, these amounts may be summed and taxed under a single progressive rate schedule, thereby avoiding the limitation of separate taxes on income and wealth. Second, the combined base reflects economic spending power during the taxing period and thereby tailors the progressive tax base to the relevant measure of inequality suggested by the relative economic power theory.

This Article does not resolve other design considerations relevant to any tax on income, wealth, or a combination thereof. First, this Article does not propose specific definitional boundaries for the terms "income" and "wealth," and does not specify particular assets or minimum levels of either base that should be exempt from tax. These exemptions may be set by policymakers on the basis of administrative and other relevant considerations.[32] Similarly, this Article does not prescribe the proper treatment of illiquid, non-traded, and hard to value assets, which pose a challenge to any tax on income or wealth.[33] This Article also does not suggest a specific rate schedule to be applied to each component of the combined base. This determination will depend on the different behavioral responses to taxation of different elements of the base, the amount of revenue to be raised, and the degree of inequality to be constrained. Finally, this Article does not take a position on a separate debate in the literature on the constitutionality of a wealth tax.[34]

The remainder of this Article proceeds as follows. Part II reviews the most common arguments for—and objections to—taxing wealth as a factor in economic well-being and introduces the relative power theory as a theoretical framework for both formalizing these arguments and responding to the objections. Part III

---

[30] See explanation at Section IV.A.

[31] See Section IV.B. This measure is subject to the same real-world measurement constraints and necessary approximations as an income tax base or a wealth tax base. See discussion at Section IV.C.

[32] See discussion at Subsection IV.C.4

[33] See discussion at Subsections III.C.1-2.

[34] Contra, e.g. Miranda Perry Fleischer, Not So Fast: The Hidden Difficulties of Taxing Wealth, Nomos Wealth Volume *23 (broad reading of direct taxes as covering all "property"); Calvin H. Johnson, Apportionment of Direct Taxes: The Foul-Up in the Core of the Constitution, 7 WM. & MARY BILL RTS. J., 1, 4-5, 72 (1996) with Ackerman & Alstott, note 6, at 121-24 (doubting that a Supreme Court would constrain the federal taxing power). A sequel to this Article will address the real-world design of a wealth tax in light of constitutional constraints.

evaluates different proposed tax bases of income and wealth within this framework. Part IV introduces the combined base of economic well-being from income and wealth, and evaluates its role as an alternative progressive tax base. Part V concludes.

II. Why Tax Wealth?

A. Justifications and Objections

A basic consequence of periodically taxing wealth is that a taxpayer pays more tax if she holds her wealth for a greater number of periods. Advocates of taxing wealth argue that this treatment is justified because, holding income constant, a taxpayer with more wealth during the taxing period has a greater ability to pay tax.[35] Critics of wealth taxation object that savings merely represent deferred consumption and a wealth tax thereby disfavors a taxpayer who spends later rather than earlier.[36] As stated by Professor Rakowski:

> What interest does the community have in whether a person consumes post-tax earnings sooner than later, apart from any profits earned on investments? . . . Those who have broadcast his argument offer no answer to this elementary fairness objection, and I cannot write a convincing script for them.[37]

Supplying this missing script, which justifies taxing a saver and not a spender, is therefore a necessary element of any fairness argument for wealth taxation.

One form of the argument for taxing wealth does not directly implicate questions of distributive fairness but rather the nature of revenue collection. Under this argument, the government must collect revenue in the form of money, and consequently the tax base should compare taxpayers according to their actual capacity to pay a monetary tax. Any alternative tax base, such as one that measures subjective well-being or economic earning potential,[38] unduly burdens a taxpayer who cannot fund the resulting liability.[39]

---

[35] See, e.g., Joseph M. Dodge II, The Taxation of Wealth and Wealth Transfers: Where Do We Go After ERTA?, 34 Rutgers L. Rev. 738, 760 (1982) ("Wealth represents ability-to-pay for each taxable period that the wealth is held, and in theory the tax on wealth should increase with the length of the holding period.").

[36] See, e.g., Eric Rakowski, Can Wealth Taxes Be Justified?, 53 Tax L. Rev. 263, 366-372 (1999).

[37] Id. at 366.

[38] For example, a tax on endowment (earning potential) would compel every taxpayer to realize their earning potential, a result that Lawrence Zelenak characterized as "talent slavery." Lawrence Zelenak, Taxing Endowment, 55 Duke L.J. 1145, 1156-59 (2006).

[39] See, e.g., Joseph M. Dodge, The Fair Tax: The Personal Realization Income Tax, 19 Fla. Tax Rev. 522, 558 (2016) ("The notion of ability-to-pay expresses the idea that taxpayers should contribute to government only out of what they can presently contribute to government (namely, cash or its deemed equivalent)"); Alan Gunn, The Case for an Income Tax, 46 U. Chi. L. Rev. 370, 379 (1979) ("A

This basic constraint suggests a literal dimension to the term "ability to pay": The tax base must reflect a measure of *actual* ability to pay. [40] For example, under the income tax base, the taxpayer is presumed to have funds available from which to pay the tax, to the extent income reflects actual funds available to the taxpayer.[41] For the same reason, a taxpayer with greater wealth has greater actual capacity to pay tax, whereas a spender who exhausted their wealth in prior periods does not.

This argument does not, however, provide a positive normative argument for why the tax system *should* distinguish between savers and spenders, beyond the practical need to raise revenue from those who have the funds to pay. A second line of argument in the wealth tax literature therefore points to the additional and immediate advantages of holding wealth, beyond the mere ability to spend in the future. For example, wealth taxation has been justified on the basis of the economic security, social and political influence,[42] and economic opportunities[43] that wealth confers.

This second line of argument has been characterized by objectors to wealth taxation as suggesting that wealth should be taxed on the basis of the subjective or imputed benefits of holding wealth.[44] Characterized thus, the argument may be critiqued on the grounds that there is no reason to tax the benefits of saving more heavily than the benefits of spending[45]—or any other imputed benefits, for that matter. For example, if an individual chooses to spend his wealth earlier instead of saving, the personal benefits of spending earlier presumably outweigh the benefits derived from holding his wealth longer, and there still would be no justification to treat the saver differently from the spender.[46]

B. Relative Economic Power Theory

The relative economic power theory—used by political scientists to explain how economic inequality generates harmful social hierarchies and distorts political outcomes—suggests a different characterization of the "imputed benefits of wealth"

---

tax that required someone to pay more money than he had or could easily get would be unacceptably harsh . . ."); Stephen B. Land, Defeating Deferral: A Proposal for Retrospective Taxation, 52 Tax L. Rev 45, 55 (1996).

[40] This literal connotation of "ability to pay" is also implied in other related terms for defining the progressive tax base, such as the term "contributive capacity" used in Piketty, note 6, at 525 and the term "capacity to contribute" used in Schenk, note 6, at 459.

[41] That is, the taxpayer may presumably fund the tax liability by setting aside a portion of their income and generally plan their budget to account for tax liabilities. See Deborah H. Schenk, A Positive Account of the Realization Rule, 57 Tax L. Rev. 355, 360-65 (2004).

[42] See, e.g., James R. Repetti, Democracy, Taxes and Wealth, 76 N.Y.U. L. Rev. 825 (2002); Schenk, note 6, at 463-70.

[43] See Ackerman & Alstott, note 6, at 96-100 (describing the unequal opportunities afforded to the beneficiaries of wealth).

[44] See, e.g., the characterization in Rakowski, note 36, at 366-67.

[45] See id. at 367-70.

[46] See id. at 368.

argument that is not susceptible to the critique described above. In effect, this theory supplies a script to justify taxing savers differently from spenders, and suggests a specific way to measure income and wealth as factors in economic well-being.

In general terms, the relative economic power theory holds that excessively unequal distributions of economic resources and market power can result in unequal divisions of political and social power as well. This process occurs when the wealthy assert social control and prioritize their own preferences through their ability to exert their market power.[47] Those with fewer economic resources are discouraged from competing with the wealthy or from even attempting to assert preferences they cannot hope to realize. Political scientists use the relative power theory to explain political outcomes that do not reflect voter preferences,[48] but more broadly the theory explains how economic differences produce harmful social hierarchy. The following passage illustrates how the relative economic power effect operates beyond the political arena:

> When inequality is greater, poorer individuals are more often in positions of subservience. At work, the greater threat posed by unemployment means that they must increasingly submit to the demands of their employers. In the marketplace, they must accept that they have no access to goods and services that others enjoy or risk incarceration. For richer individuals, on the other hand, greater inequality means that it is easier to find someone who will promptly and unquestioningly fill their orders—whether to deliver a new luxury automobile or tend to their lawns and gardens. For both richer and poorer individuals, greater economic inequality makes market relations with others much more likely to be characterized by obedience and deference.[49]

The relative economic power theory suggests a different characterization of the argument that wealth should be taxed because of its imputed benefits. Economic power doesn't merely generate subjective well-being to the holder, but also specific and objective social harms resulting from excessive imbalances of economic power at any point in time. From this perspective, the saver is in fact better off than the spender, and the justification for taxing the saver depends not on the saver's own subjective well-being but on the deleterious effect of those with economic power on other members of society.

The relative economic power theory has specific implications for the definition of economic well-being and its comparison across taxpayers. First, the critical factor under the relative power theory is the *ability* of the wealthy to use their market power, which is sufficient to assert their preferences over those with

---

[47] See Frederick Solt, Economic Inequality and Democratic Political Engagement, 52 Am. J. Pol. Sci. 48, 49 (2008).

[48] See id.

[49] Frederick Solt, The Social Origins of Authoritarianism, 65 Political Research Quarterly 703, 704 (2012).

less market power.[50] As a result, those with greater economic power need not spend their economic resources in order to achieve their preferences; a credible ability to do so is sufficient. The relative economic power theory therefore suggests that *economic well-being* should be measured by reference to a taxpayer's *economic spending power*.

Non-market resources or other factors in well-being do not factor similarly into this process because they do not reflect additional spending power. For example, the person who grows vegetables for their own personal consumption does not have the same economic power as someone who earns $100 in cash and can choose whether to use the money to buy either vegetables or politicians. For the same reason, the relative economic power theory does not suggest equalizing utility or sacrifice across taxpayers,[51] but rather reducing economic inequality in absolute terms.

Because the relative economic power relationship depends upon the mere ability to spend, a person who preserves their wealth (and their economic power) across multiple periods benefits from this process for more periods than does a person who spends their wealth earlier. The relative power theory therefore suggests that economic well-being should be measured periodically, rather than on a lifetime basis, and excessive imbalances between taxpayers should be constrained at any point in time.

The relative economic power theory also implies a more nuanced understanding of the distinction between savers and spenders. As described above, the primary objection to a tax on either wealth or capital income is that these instruments unfairly distinguish between taxpayers depending on *when* they choose to spend their resources.[52]   This objection suggests that a tax system should be neutral as to the timing of spending and should not sanction a wealth tax that taxes a saver each period on their savings, while favoring a spender who chooses to consume their wealth earlier. The relative economic power theory, however, suggests a distinction between spending in *previous* periods and spending in *future* periods. A spender who uses their economic resources in previous periods has less economic spending power during a subsequent taxing period than a saver. From the perspective of the relative power theory, a saver who preserved their wealth from prior periods is in fact better off than a spender who did not.

Under the relative economic power theory, however, economic resources *only* reflect greater economic power to the extent that they are in fact credibly expendable in the current period. A pensioner or saver with wealth that must be

---

[50] See Robert Goodin & John Dryzek, Rational Participation: The Politics of Relative Power, 10 Brit. J. Pol. Sci. 273, 276-78 (1980) (arguing that citizens with less economic power therefore behave rationally when they do not challenge the preferences of those with greater power).

[51] The measures of equality that form the basis for other justifications for progressive taxation, as discussed in note 9. That is, the relative economic power theory does not specifically reflect a welfarist perspective which would maximize a weighted function of aggregate social utility. As described in notes 198-199 and accompanying text, however, the relative economic power theory and its implications for the tax base may be incorporated within a welfarist analysis.

[52] See note 37 and accompanying text.

preserved for use in the future cannot credibly threaten to spend it in the current period and therefore cannot claim relative economic power. As a result, the relative power theory implies accounting each period for *prospective* spending needs by savers, as a liability to be applied against current wealth, but not *retrospective* decisions whether a taxpayer saved or consumed in prior periods.

The relative economic power theory also implies reducing unequal economic outcome*s* resulting from market activities and not just unequal opportunities to participate in the market. Advocates of taxing wealth to equalize opportunity argue, in contrast, that economic inequality may be justified as long as the inequality originates from personal choices and effort, not from unequal starting position.[53] Equalizing opportunity but preserving inequality of outcomes, however, will not address the social harms resulting from differences in relative economic power. For example, if the inordinate wealth of both Donald Trump, Jr. and Mark Zuckerberg afforded them asymmetric social and political power, it would not matter if one's wealth was due to a happenstance of birth and the other's to what some may consider socially productive entrepreneurship.

III. Taxing Income and Wealth

This Part evaluates options for the taxation of income and wealth, or both, as factors in economic well-being during the taxing period.   Sections III.A and III.B begin with two preliminary discussions. Section III.A provides a detailed analysis of the functions of the tax base under a progressive rate schedule, and Section III.B reviews basic principles and ambiguities in defining the terms "income" and "wealth."   Section III.C evaluates the choice between taxing income or wealth and demonstrates the limitations of either instrument as a tax on economic well-being. Section III.C also evaluates the taxation of capital income as an indirect tax on wealth.   Finally, Section III.D considers proposals and options for the taxation of *both* income and wealth, through either separate instruments or a single base of income plus wealth.

The key insight in the analysis that follows is that income and wealth each may be available as a base for taxation. If, however, taxpayers should be compared by an underlying measure of economic spending power during the taxing period, then neither income nor wealth fully reflects this measure.[54] Furthermore, taxing

---

[53] A liberal egalitarian view, for example, would allow for redistribution to correct for unequal starting positions but would generally not interfere with inequality resulting from subsequent choices. See, e.g., Ackerman & Alstott, note 6, at 24-25.

[54] Professor Daniel Shaviro similarly compares signals of well-being to turtles in the proverbial tower, wherein a "bottom turtle" reflecting an underlying measure of well-being is difficult to ascertain, even if it must exist, and which is the desirable basis for comparing taxpayers. Daniel Shaviro, Endowment and Inequality, in Tax Justice: The Ongoing Debate 123, 124 (Joseph J. Thorndike & Dennis J. Ventry Jr., eds. 2002) (referencing the story of "the woman who claimed that the earth rests on the back of a turtle and, when asked what the turtle rests on, responded that it was 'turtles all the way down'").

both income and wealth separately does not yield the same result as taxing both factors under a single progressive rate schedule, because a progressive rate schedule with increasing marginal rates will always tax two separate bases at a lower overall rate, when compared to a single tax on a combined measure of both bases.

The analysis that follows also highlights different aspects of the challenges in taxing economic spending power by taxing income and wealth. In particular, reconciling income and wealth as factors in economic spending power faces three key considerations: (1) either wealth or human capital may or may not be productively employed to generate market earnings, with consequent effects on economic spending power; (2) labor and capital income measure economic well-being in different terms because labor reflects the return of the entire principal of human capital while capital income generally reflects an investment return in addition to the stock of wealth; and (3) wealth and income also measure economic spending power in different terms as, respectively, a stock and a flow.

A. Two Functions of the Progressive Tax Base

In a progressive tax system, the average rate of tax increases with the amount of the taxable base. A graduated rate schedule, for example, taxes higher amounts of the taxable base at higher marginal rates,[55] which has the effect of taxing the entire base at higher average rates as the size of the base increases.[56] For example, assume a progressive income tax with a graduated rate schedule, in which the first $100,000 of income is taxed at a 20% rate and additional income is taxed at a 40% rate. Assume that Taxpayer A has $100,000 of income and Taxpayer B has $200,000 of income. Taxpayer A will pay a total tax of $20,000, for a 20% average rate, whereas Taxpayer B will pay a total tax of $60,000,[57] for a 30% average rate.

In effect, the base in a progressive tax serves two distinct functions. First, the base serves as a measure for comparing taxpayers—generally referred to as each taxpayer's relative "ability to pay"[58]—and thereby determines the applicable rates

---

[55] For example, see the graduated rates of income taxation in IRC §1(a)-(d).

[56] A graduated rate schedule is not the only way to achieve progressivity. See, e.g., Joseph Bankman & Thomas Griffith, Social Welfare and the Rate Structure: A New Look at Progressive Taxation, 75 Cal. L. Rev. 1905, 1905-16 (1987) (describing the progressive effect of a flat tax plus a cash grant).

[57] 20% of $100,000 plus 40% of $100,000.

[58] Under this meaning of the term, "the" has no normative significance but merely serves as a shorthand for the user's normative basis for comparing taxpayers. Cf. Vickrey, note 17, at 374 ("More often than not, ability to pay turns out to mean just about what the user wants it to mean"); Schenk, note 6, at 469 n.173 ("This phrase is intended as a mere notation for the idea that taxpayers should not bear the revenue burden equally; that is, some taxpayers are able to, and therefore should, shoulder a larger tax burden than others.). For other uses of the term with substantive normative implications, see, e.g., Joel Slemrod, Introduction, in Tax Progressivity and Income Inequality 1, 2 (Joel B. Slemrod, ed., 1996) (using "ability to pay" in reference to a normative principle of equal sacrifice).

at which each should be taxed. For purposes of this discussion, this function is referred to in this Article as the "comparing" function of the base. Second, the base serves as a variable that determines the tax liability due when taxed under the progressive rate schedule. For purposes of this discussion this function is referred to in this Article as the "calculating" function of the base. In other words, the comparing function of the base first determines the applicable tax rate, and then the calculating function determines the tax liability due, when the base is taxed at the applicable rate(s) under the progressive schedule.

In the simple case, a single attribute of the taxpayer is generally sufficient to serve both the comparing and calculating functions.[59] For example, under the federal income tax, the relevant attribute is taxable income, and this generally determines both the applicable tax rate and the tax liability due.[60] A base for the calculating function, however, may not be a sufficient base for the comparing function.[61] For example, if ability to pay is a function of both a taxpayer's income and wealth, then neither base is independently sufficient to measure ability to pay, and therefore to serve in the comparing function.[62]

Income and wealth also cannot be taxed separately as factors in ability to pay. This is because separately taxing different attributes of ability to pay under a graduated rate schedule does not yield the same tax liability as a single progressive tax on an aggregate measure of both attributes. To illustrate this point, assume that two hypothetical attributes, A_1 and A_2, both factor equally into ability to pay[63] and measure ability in units instead of dollars. Assume first that each of attributes A_1 and A_2 are taxed under separate instruments, and each instrument has a graduated rate schedule which taxes the first 100,000 units of ability at \$0.20 per unit and any additional units at \$0.40 per unit. Assume now that Taxpayer A has 100,000 units of ability, all from A_1, and Taxpayer B has 200,000 units of ability: 100,000 from A_1 and 100,000 from A_2. As in the example above, Taxpayer A will pay a total tax of \$20,000, for an average rate of \$0.20 per unit. If attributes A_1 and A_2 are taxed under separate instruments, however, Taxpayer B will pay a total tax of \$40,000 (\$20,000

---

[59] This case can be expressed as $A = C_1 = C_2$, where A is the attribute of the taxpayer, C_1 is the comparing function of the base, and C_2 is the calculating function.

[60] First, income serves the comparing function, as the applicable tax rates are determined under §1(a)-(d) by reference to the taxpayer's taxable income. Income then serves in the calculating function, as the resulting tax liability is determined by taxing this income at the resulting rates. This example is illustrative, and of course, additional factors such as character may also affect the final applicable rates under the income tax. For example, the applicable rate structure for dividends and long-term capital gains is determined separately under § 1(h).

[61] That is, although progressive tax instruments generally adopt a base of a single attribute, such as income in the case of the income tax, there is no reason why an instrument could not tax multiple attributes under a single base, if it were socially desirable to compare taxpayers by reference to multiple attributes. See, e.g., Chris William Sanchirico, Deconstructing the New Efficiency Rationale, 86 Cornell L. Rev. 1003, 1021, 1027-29 (2000). The case wherein multiple attributes are factors in the comparing function of the base can be expressed as $C_1 = f(A_1, A_2, . . .)$, where the series $A_1, A_2, . . .$ refers to all attributes of the taxpayer that are relevant in measuring ability to pay.

[62] The case wherein both wealth and income are factors in the comparing function of the base can be expressed as $C_1 = f(I, W)$, where I is income and W is wealth.

[63] That is, X units of either A_1 or A_2 reflect the same level of ability to pay.

under each instrument), for the same average rate of $0.20 per unit. Taxpayer B has greater ability to pay but still pays tax at the same rate as Taxpayer A.

This example illustrates the practical consequences of the distinction between the comparing and the calculating functions of the tax base. In this case, each of attributes A_1 and A_2 serves the calculating function, as the base of their respective instruments, but neither is a sufficient measure of ability to pay for purposes of the comparing function. As a result, Taxpayer B is not taxed at a higher rate than Taxpayer A, despite Taxpayer B's greater ability to pay. The case is the same for Taxpayers 1, 2, and 3 described above,[64] where Taxpayer 3 has the same wealth as Taxpayer 1 and the same income as Taxpayer 2, and therefore has greater economic well-being than either. Under separate income and wealth taxes, however, Taxpayer 3 would not be taxed at higher rates on her income and her wealth, because neither income nor wealth is a complete base for purposes of the comparing function.

Because each of A_1 and A_2 in the example above is a separate factor in ability to pay, a combined measure of both attributes is needed to perform the comparing function of the base. This combined base may be subsequently taxed under a single progressive rate schedule.[65] In this case, since A_1 and A_2 measure equivalent units of ability to pay, the two attributes may be summed to yield an aggregate measure of ability.[66] Consider the result if this aggregate measure, defined as the sum of both A_1 and A_2, is taxed under a single progressive rate schedule. Taxpayer A will still be treated as having 100,000 units of ability and pay a tax of $20,000, while Taxpayer B will be treated as having 200,000 units of ability (100,000 from each of A_1 and A_2) and will pay a total tax of $60,000,[67] or an average rate of $0.30 per unit.[68] In this case, Taxpayer B is appropriately taxed at a higher average rate, on account of their greater ability to pay.

The distinction between the comparing and calculating functions of the tax base—and the consequences of this distinction for resulting tax liabilities—may be illustrated through an example familiar to the student of an introductory course in federal income taxation: the taxation of married couples. The income of each spouse may be available to serve in the calculating function of the base, to be taxed under a specified rate schedule. If, however, married taxpayers should be compared on the basis of their *total* household income, then the income of each spouse is insufficient for the comparing function of the base. Furthermore, the separate taxation of both

---

[64] See Part I.

[65] Alternatively, separate instruments may be used, if each instrument is cross-dependent and adjusts the rate schedule to account for the amount of the taxable base under the other instrument. For purposes of the discussion that follows, references to separate instruments refer to instruments that are not cross-dependent, and references to a single instrument refers to either cross-dependent instruments or an instrument with a single tax base.

[66] As described in note 61, $C_1 = f(A_1, A_2)$. If ability to pay is defined as the sum of A_1 and A_2, then $C_1 = f(A_1, A_2) = A_1 + A_2$.

[67] ($0.20 x 100,000) + ($0.40 x 100,000).

[68] Stated differently, if $T(x)$ is the progressive marginal rate schedule applied to the tax base x, yielding the tax liability due, then these examples illustrate that $T(A_1) + T(A_2) \neq T(A_1 + A_2)$.

spouses under the specified rate schedule yields a lower total tax liability than the taxation of their combined household income under the same rate schedule.

For example, in 2017 the ordinary taxable income[69] of a married couple is taxed at marginal rates of up to 39.6% on combined income above $470,700.[70] If each spouse has $250,000 of net taxable income and is taxed individually under the same rate schedule, each would pay $57,717, for a total household tax liability of $115,434. The highest rate applied to a portion of each spouse's income is 33%. If the combined household income of $500,000 is taxed under the rate schedule, the total tax liability would be $143,230.80, and the highest rate applied to a portion of the household income is 39.6%. This consequence of the difference between the calculating and comparing functions of the base will arise in any case where progressivity is implemented through a marginal rate schedule, and all such cases follow a general rule: Separate taxes on different factors in the comparing function of the base, under which each factor serves as the calculating function of a different tax instrument, will yield a lesser tax liability than a single progressive tax on a combined base of the same factors.

B. The Definition(s) of "Income" and "Wealth"

As many scholars have noted, there are no objective and generally applicable definitions of the terms "income" or "wealth,"[71] in the same manner that there are different ways to define and measure economic inequality and economic well-being.[72] For example, "income" may refer to a narrow measure of net receipts from market transactions or a broader measure that includes imputed income—benefits that accrue without the mediation of market transactions, such as from self-provided services and from the use of personal property.[73] Similarly, "wealth" may refer to assets with marketable value or a broader measure of all sources of objective and subjective value.[74]

In each case, the normative context in which the terms are used will inform each term's definition.[75] For example, if the metric for measuring income is the effect on the household budget, the term should include both imputed and market income, because it should not make a difference if a person earns $100 with their labor and spends it on vegetables, or if they instead earn imputed income by

---

[69] Taxable income is the net amount of income subject to tax under the rate schedules in §1 after accounting for "above the line" deductions under § 62(a), personal exemptions under §151, and the itemized or standard deductions under §§ 63(a)-(b).

[70] Section 1(a); Rev Proc. 2016-55, at 7 (inflation adjusted brackets for 2017).

[71] See, e.g., John R. Brooks, The Definitions of Income, 71 Tax L. Rev. __, 7*-22* (forthcoming 2017) (describing the long-running and unsuccessful attempt to articulate an objective definition of income by tax theorists); Victor Thuronyi, The Concept of Income, 46 Tax L. Rev. 45, 45 (1990).

[72] See note 18 and accompanying text.

[73] See Brooks, note 71, at 8*-11*.

[74] See Shakow & Shuldiner, note 6, at 526-29 (considering the scope of assets subject to a wealth tax).

[75] See, e.g., Brooks, note 71, at 3* ("Ultimately, 'income' is whatever society wants it to be in order to achieve a result that the democracy believes to be appropriate and just.").

laboring in their garden and growing the vegetables on their own.[76] If, in contrast, the metric for measuring income is accretions to market power, then earning $100 in cash would qualify while growing $100 worth of vegetables for personal use may not.[77]

As described above, the relative economic power theory suggests that taxpayers should be compared by their relative economic spending power during the taxing period. From this perspective, the scope of the income and wealth definitions should reflect measures of economic power or sources of value that reflect the ability of holders to assert their dominance through market transactions. The discussion that follows consequently reviews the roles of income and wealth as measures of economic spending power during the taxing period.

1. Income

In the most general terms, "income" connotes flow of new economic resources during a specified period,[78] which may be either spent or saved.[79] Preexisting wealth is excluded from the income definition, in the same manner as cash pulled out of one's wallet. As described above, the scope of the income definition will depend upon the normative context in which the definition is used. From the perspective of the relative economic power theory, the income definition will depend upon the types of flows that are considered to reflect additional economic spending power. The easiest cases to distinguish are accretions of liquid market resources, such as cash and cash-like payments, on the one hand, and accretions that occur entirely outside of the market such as imputed or subjective benefits, on the other.

In between these two poles lie inevitable definitional ambiguities, such as the increase in value of assets that do not readily trade in the market or that a taxpayer chooses not to monetize. Under the current federal income tax, the general solution for taxing income from such assets is the realization rule, which defers tax until an asset is sold, even if the appreciation occurred in prior periods.[80] This rationale, however, does not justify the current broad application of the realization rule to the appreciation of traded assets and financial instruments. Appreciation of these assets confers immediate economic value, which could be taxed as income each period on a mark-to-market basis.[81]

---

[76] See Thuronyi, note 71, at 80-82.

[77] See id. at 82.

[78] *Income*, Shorter Oxford English Dictionary 1354 (6th ed., 2007).

[79] Cf. the Haig-Simons income definition, as the sum of consumption and net savings (accumulations) during the taxing period. Henry C. Simons, Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy 50 (1938). Scholars have suggested that this definition is similarly "elusive and ambiguous" and will depend on the relevant definitions of "consumption" and "accumulations" under the user's normative view of tax equity. See Thuronyi, note 71, at 46-47, 54.

[80] IRS § 1001.

[81] See Ari Glogower, Taxing Capital Appreciation, 70 Tax L. Rev. 111, 116-21 (2016).

Income may result from the monetization of human capital, in the form of labor income, or the productive investment of nonhuman capital (wealth), in the form of capital income. Capital income and labor income, however, measure economic spending power in fundamentally different terms.[82] A true capital income flow does not reflect a return of the wealth principal but rather an accretion in excess of the starting principal.[83] Consequently, an investor who earns capital income could spend the income each period, while preserving the wealth principal. In the case of labor income, however, the labor income earned reflects the *entire* return of human capital, with none remaining once the taxpayer stops working. In effect, labor income may be understood as a taxpayer cashing out a portion of their balance of human capital each period.[84] The easiest way to illustrate the fundamental difference between the measures of capital and labor income is to consider the results to two individuals, one who earns capital income and one who earns labor income, and who both spend all the income earned each period. The individual earning capital income will still have their principal of wealth intact, while the individual earning labor income will have nothing left.

2. Wealth

Whereas "income" reflects an economic flow during the taxing period from both human and nonhuman capital, "wealth" generally refers to a stock of nonhuman capital.[85] In effect, "wealth" reflects accretions from prior periods that were saved rather than spent in those periods. The difference between wealth as a stock and income as a flow may thus be distinguished on the basis of their treatment of consumption: The income definition not distinguish between the portion of the flow that is consumed and the portion that is saved for the future, whereas the wealth definition necessarily makes this distinction and only measures the latter in subsequent periods.

Like income, the scope of the wealth definition will necessarily depend upon the normative context in which the term is used. From the perspective of the relative power theory, the wealth definition will also depend upon the forms of wealth that are considered to reflect additional economic spending power. The

---

[82] See Louis Kaplow, Human Capital Under an Ideal Income Tax, 80 Va. L. Rev. 1477, 1497 (1994).

[83] "Capital Income" may result from the risk-free return to deferred consumption, compensation for bearing risk, supernormal returns such as those resulting from luck and monopolies, mislabeled labor income and inflation. See Joel Slemrod & Jon Bakija, Taxing Ourselves 302-306 (5th ed. 2017).

[84] See Kaplow, note 82, at 1482-84, 1497 (demonstrating that the return to human capital each year in the form of labor income constitutes the conversion of preexisting capital into a current flow in the same manner as withdrawals of cash from a bank account); id. at 1490 ("One might say . . . that the conventional income tax ignores the "capital" in "human capital.")

[85] See, e.g. the terminology in James B. Davies, Wealth and Economic Inequality, in The Oxford Handbook of Economic Inequality 127 (Brian Nolan, Wiemer Salverda & Timothy M. Smeeding, eds., 2011).

easiest candidates for inclusion in the wealth definition are cash, cash-like assets, and marketable securities. As in the case of the income definition, assets that are nontraded or with market value that a taxpayer chooses not to monetize pose more difficult cases. For such cases, it is possible to structure a wealth tax with a similar solution as the realization rule under the income tax by deferring tax until the time that a nontraded asset's value is monetized through a sale.

Wealth measures economic well-being in fundamentally different terms than both labor and capital income. In contrast to income, which represents a flow of funds over a period, wealth is strictly non-periodic and represents a fixed stock of economic resources, which can only be exhausted once. Furthermore, whereas labor income reflects a return of a portion of the taxpayer's principal of human capital, wealth reflects the entire principal of a taxpayer's nonhuman capital. For the simplest illustration of this difference, contrast a worker, who earns $100,000 each year, and a retired saver, who does not work and has $100,000 in cash and no income. The worker has greater economic spending power in the taxing period, because the worker's labor income reflects only a portion of their total human capital, while the saver's wealth reflects their entire stock of nonhuman capital.

C. Taxing Income or Wealth

1. Taxing Income

An income tax base measures market income each period from both labor and capital.[86] This amount will vary with a taxpayer's human capital and wealth, as well as the taxpayer's decision whether and how to monetize and productively invest both. As described in greater detail below, both capital and labor income will fluctuate from year to year and to this extent will not reflect a recurring flow throughout the taxpayer's lifetime.[87] Even a perfectly recurring income flow, however, is still an incomplete measure of a taxpayer's economic spending power during the taxing period because income alone does not account for a taxpayer's wealth (which reflects additional economic resources) or debt (which will partially or fully absorb the income flow). As a result, income alone is insufficient for the comparing function of the progressive tax base under the relative economic power framework.

For example, consider the doctor and the investor described above,[88] who both earn $200,000 of income during the year. Even a hypothetically precise income tax that accurately measured both capital and labor income would not account for the fact that the investor has an additional $35 million of saved wealth. Conversely, the doctor who earns the same $200,000 must dedicate a portion of his income to servicing their $170,000 debt. For a more specific illustration, assume

---

[86] See, e.g., IRC § 61 (income base for purposes of the federal income tax).
[87] See discussion at Subsection IV.C.2.
[88] See notes 23-25 and accompanying text.

that the doctor's debt accrues interest at a rate of 5.25%[89] and is payable over a 40-year period, generating an interest liability of approximately $8,925 in the current period.[90] The doctor will make annual debt payments (of principal and interest) of approximately $10,000 per year,[91] leaving only $190,000 available from his $200,000 income. In contrast, the investor has no debt obligations to absorb her $200,000 income and has additional available economic spending power from her saved wealth.

As described above, the difference between the incomes of the investor and the doctor may also be understood in terms of the difference between labor income and capital income.[92] The investor's $200,000 of capital income reflects only an investment return but does not account for her $35 million wealth principal that she preserves. The doctor's $200,000 of labor income, in contrast, reflects a return of a portion of his principal of human capital. The easiest way to illustrate their different economic circumstances is to consider the result if the investor and the doctor each consume their $200,000 of earnings each year. At the end of the investor's life, she is left with their $35 million stock of wealth—a large store of remaining economic resources. The doctor, in contrast, has nothing left, because all of his human capital has been fully exhausted and taxed as labor income.

In a similar manner, an income tax does also not account for reduced economic spending power as a result of negative wealth, or debt. Contrast the treatment of the doctor with the treatment of a hypothetical dentist who is fortunate enough to graduate with no debt (but who has no positive wealth) and who has the same $200,000 salary as the doctor. Because the income tax base ignores negative as well as positive wealth, the dentist is treated the same as the doctor and will consequently have the same income tax liability in the taxing period.

2. Taxing Wealth

A wealth tax base, in contrast to an income tax base, measures a stock of net market wealth on a periodic basis.[93] Unlike an income tax base, a wealth tax base only measured accretions from prior periods that were not consumed in those periods, and therefore necessarily distinguishes between prior period savings and

---

[89] The approximate current interest rate on unsubsidized federal Stafford Loans. https://studentaid.ed.gov/sa/types/loans/subsidized-unsubsidized#interest-rates.

[90] 5.25% of the $170,000 balance due.

[91] $10,248.68.

[92] See note 84 and accompanying text.

[93] See, e.g., the wealth tax base proposed in Shakow & Shuldiner, note 6, at 532-38 (encompassing financial holdings, business interests, other investment assets, and consumer durables and real estate above specified exemption levels). Because a wealth tax base measures net worth, the base must be calculated net of a taxpayer's debt. See, e.g., Piketty, note 6, at 537. Accounting for debt is necessary to consistently compare taxpayers under a wealth tax. If the wealth tax base is not calculated net of debt, a taxpayer with $1 million of cash and $1 million of debt would pay the same tax as a taxpayer with $1 million of cash and no debt.

consumption. A wealth tax base thereby accounts for the factor in economic spending power missing from an income tax base: wealth resulting from saving in prior periods. A wealth tax base, however, is limited in other respects, and does not account for three factors in economic spending power that will vary across taxpayers: (1) differences in labor income, which results from monetizing human capital; (2) differences in capital income, which results from the productive investment of the wealth; and (3) differences in the number of periods over which the wealth must be spread.

First, a wealth tax base does not account for differences in taxpayers' economic spending power from labor income. Recall Taxpayers 1 and 3 described above, the former with $1,000,000 of wealth, $25,000 of investment income, and no labor income, and the latter with the same $1,000,000 of wealth and $25,000 of investment income, but also $75,000 of labor income.[94] Although the two taxpayers have the same wealth stock and capital income earned thereon, Taxpayer 3 has greater overall economic spending power on account of her additional labor income.

Second, a wealth tax base does not account for differences in taxpayers' economic spending power resulting from different amounts of capital income earned from the wealth. A stock of wealth represents the *potential* to earn capital income but does not indicate how, or whether, taxpayers will realize this potential by investing the wealth.[95] For example, assume two wealth holders each have $1 million. Wealth Holder 1 holds his $1 million in a checking account, which yields a negligible investment return.[96] Wealth Holder 2 invests in a risky investment, which yields an 8% rate of return.[97] The capital income tax, which accounts for differences in *how* wealth is invested, would treat the two taxpayers differently. A wealth tax, in contrast, does not account for this difference.[98]

---

[94] See Part I.

[95] In the same manner, human capital represents potential labor income, but only taxpayers who realize this potential enjoy the resulting increase in economic well-being.

[96] Of course, there may be imputed benefits derived from a checking account, such as increased liquidity. See Yair Listokin, Taxation and Liquidity, 120 Yale L.J. 1682 (2011).

[97] Taxpayers similarly enjoy more or less economic well-being as a result of their decision whether or not to monetize their human capital. Assume, in the alternative, that Taxpayers C and D each have the potential to earn $40,000 a year in labor income, which, at a discount rate of 4%, suggests a stock of human capital with a value of $1 million each. Taxpayer C productively employs this human capital stock and in fact earns $40,000 a year of labor income, whereas Taxpayer D hits the beach and doesn't earn a cent. The income tax, which compares individuals on the basis of their labor earning outcomes and not on the basis of their earning potential, will tax Taxpayer C but not Taxpayer D. In this respect, the treatment of Taxpayers A and C's income, on the one hand, and the treatment of Taxpayers B and D, on the other, is consistent and justified under a base of economic well-being: The former two taxpayers chose to productively invest their wealth to generate market income, whereas the latter two did not. Human and nonhuman capital are equivalent in this respect. In both cases, taxpayers with a stock of either can decide whether to use the stock to generate economic returns.

[98] If Wealth Holder 2 saves her investment return, she will have additional wealth to be taxed in the next period and will pay a higher tax than Wealth Holder 1 in that period. If, however, Wealth Holder 2 spends her investment proceeds in the current period, the wealth tax will treat the two the same in the next period as well. As described above, a basic difference between a wealth tax and an income

Finally, a wealth tax does not account for differences in taxpayers' needs to spread their wealth across future periods. As described above, a basic consequence of a periodic wealth tax is that a single stock of wealth is subject to repeated taxation, as the wealth is held for a larger number of periods.[99] Although this feature is commonly raised as an objection to wealth taxation,[100] periodic taxation of wealth is required from the perspective of the relative economic power theory. If a taxpayer holds the wealth for a greater number of periods, the wealth reflects greater economic power for a greater number of periods, with the consequence of social and political harms for a greater number of periods as well.

The view that wealth should be periodically taxed as a factor in economic spending power, however, does not necessarily imply that the *entire* stock of wealth should be taxed each period. Unlike a recurring income flow, a single stock of wealth may be depended upon to fund consumption across multiple periods, and once the stock is exhausted nothing remains.[101] As succinctly stated by one investment advisor, for retirees, "[their] money is *it*."[102] As a result, the wealth holder's economic spending power will vary with the number of periods across which the wealth must be spread, and a tax on the total wealth stock each period imposes the greatest burden on a pensioner who depends upon the wealth for consumption across a greater number of subsequent periods. To illustrate, consider two retirees:

> *Retiree 1 has $100,000 of savings that earns a return of 2% a year, or $2,000 in the current year. She is 70 years old and expects to live for 10 more years.*

> *Retiree 2 has $100,000 of savings that earns a return of 2% a year, or $2,000 in the current year. He is 60 years old and expects to live for 20 more years.*

A tax on wealth would treat both taxpayers the same, notwithstanding the fact that Retiree 1 depends on her savings to last for 10 periods, whereas Retiree 2 depends on his savings to last for twice that number of periods. Although they have the same stocks of wealth, Retiree 2 must save more of his wealth for the future and therefore has less economic spending power during the current period than Retiree 1.

---

tax is that the latter accounts for economic resources spent during the taxing period. See discussion at Subsection III.B.2.

[99] See Rakowski, note 36, at 337.

[100] See discussion at Section II.A.

[101] In other words, just as a taxpayer's debt may absorb their periodic income, a taxpayer's need to fund consumption in future periods may be considered to absorb their currently saved wealth.

[102] Joanne Kaufman, Fun in Early Retirement Can Be Hard Work, New York Times, Dec. 24, 2016, at B3.

3. Taxing Wealth by Taxing Capital Income

According to a common view in the literature, a wealth tax is redundant with a tax on capital income since wealth is implicitly taxed through a capital income tax.[103] For a simple illustration, assume that a taxpayer has $100,000 of wealth that earns a return of 2% per year, or $2,000. If the wealth is taxed at a 1% rate, the resulting liability would be $1,000. The same liability could be generated by taxing the income from the wealth at a 50% rate.[104] From this perspective, a wealth tax is duplicative with a capital income tax, and more generally an income tax base of both capital and labor income could serve the same function as a wealth tax base of both human and nonhuman capital.

If a tax on capital income is replicable through a tax on wealth and vice versa, the only choice remaining for policymakers is to determine whether it is easier to observe wealth or capital income. Professors Cunningham and Schenk have argued, for example, that the tax on capital income, which is often difficult to measure and subject to tax reduction and avoidance strategies, should be replaced with a tax on a deemed return to the historic cost of wealth, with any additional gain or loss calculated upon a sale, as under current law.[105] Labor income would remain taxed as under current law, since an individual's stock of human capital cannot be measured except with reference to their observed labor income.[106] Effectively, this approach operates as an improved method of taxing the capital income component of the current federal income tax base,[107] rather than a qualitative redefinition of the tax base.[108]

---

[103] See, e.g., Rakowski, note 36, at 286; Schenk, note 6, at 436-38; Shakow & Shuldiner, note 6, at 500.

[104] Assume that periodic income (i), equals the invested wealth (w) times the rate of return (r), or $i = wr$. A wealth tax on the principal (T_w) will yield the same tax liability as an income tax (T_i) when $T_i = \frac{w}{i}T_w$. In effect, converting a wealth tax into a capital income tax is merely a matter of taxing a smaller base (capital income) at a higher rate. The substitutability between wealth and capital income bases is limited, however, in one critical respect. In a progressive tax, the base and the rate are not perfectly interchangeable variables, if it is assumed that the base cannot be taxed at a rate higher than 100%. Cf. Piketty, note 6, at 525-26 (noting the limited redistributive effects of taxing a narrow income base at an extremely high rate). In the example above, a 4% tax on wealth ($4,000) could only be replicated through a 200% tax on the $2,000 annual return on the wealth. That is, if ability to pay is measured with reference to the taxpayer's annual income, imposing a $4,000 tax liability on $2,000 of income would ask the taxpayer to pay more than they are considered able to pay.

[105] See Cunningham & Deborah H. Schenk, Taxation Without Realization: A "Revolutionary" Approach to Ownership, 47 Tax L. Rev. 725, 735-36 (1992); Schenk, note 6, at 446. For example, if a taxpayer purchases stock for $10,000, and the deemed return is 1%, the taxpayer is taxed on $100 of appreciation at the end of Year 1, and her basis in the stock increases to $10,100. If the taxpayer sells the stock the following year for $12,100, she pays tax on the remaining $2,000 of gain, in a manner similar to the calculation under current law.

[106] Schenk, note 6, at 465-66.

[107] In particular, this method avoids both the administrative costs of measuring actual capital accretions each year and the tax planning that arises from the current realization-based system.

[108] See Rakowski, note 36, at 362 (describing this approach as an "improved income tax").

Setting aside the separate question of whether it is more accurate to measure actual capital income or a deemed return to cost, the analysis of this improved income tax base as a measure of economic spending power during the taxing period would be similar to analysis of the current income tax base.[109] Recall the investor and the doctor described above. Assume that, under the deemed return to cost method, the investor is taxed on an imputed annual return of 0.6% on her $35 million of saved wealth, the same rate that she actually earns by investing in U.S. Treasury notes,[110] for annual taxable income of approximately $200,000.   The doctor is taxed on his $200,000 of labor income, as under the current income tax. Although taxing the investor on the imputed income return may achieve the same substantive result in this case as a capital income tax, this approach does not yield a taxable base that measures the investor and the doctor's economic spending power in similar terms. Both are treated as having the same $200,000 of income for the year, with no separate accounting for the investor's additional spending power from her wealth.

As this example illustrates, there is no metaphysical or definitional sense in which wealth and capital income necessarily overlap. From the relative economic power perspective, both wealth and capital income measure different factors in economic spending power during the taxing period. Wealth at the start of the period measures economic spending power resulting from prior period accumulations.   Capital income earned during the period reflects additional economic spending power resulting from a taxpayer's decision whether and how to productively invest their starting period wealth. For a simple example of this difference, consider a taxpayer who begins the year with $1000 of wealth, and invests this wealth for nearly the entire year at a 1% return, or $10, and spends the entire $10 on December 31 of that year. A wealth tax will account for the $1000 of starting period wealth, but not the $10 of capital income earned, whereas a capital income tax will account for the $10 of capital income earned but not the starting period wealth.   From the perspective of the relative economic power theory, however, the taxpayer enjoys greater economic spending power during the taxing period from both factors: her starting period wealth as well as her capital income earned during the period.

Previous treatments in the literature have been more troubled by the practical—rather than the theoretical—effects of taxing both wealth and capital income. Even at low rates, taxing both a taxpayer's entire stock of wealth each period, as well as her capital income, can have a cumulatively confiscatory effect over time.[111] For example, assume that a taxpayer invests $1000 for ten years, at a 4% annual pretax rate of return. In the absence of taxes on either wealth or capital

---

[109] See Subsection III.B.1.

[110] See note 25 and accompanying text.

[111] See, e.g., Ackerman & Alstott, note 6, at 107 ("Although a wealth tax is not economically identical to an income tax, both fall on capital investments. And in some cases, the combined rate could be high . . .").

income, the taxpayer will have approximately $1480 after ten years.[112] If capital income is taxed each period at a 20% rate, the taxpayer will have approximately $1370 after ten years,[113] or 93% of the pretax total.[114] If, in contrast, starting period wealth is taxed each period at a 2% rate (but capital income is not taxed), the taxpayer will have approximately $1209 after ten years,[115] or 82% of the pretax total.[116] If, finally both starting period wealth is taxed each period at a 2% rate, *and* capital income is taxed each period at a 20% rate, the taxpayers will have approximately $1119 after ten years,[117] or only 76% of the pretax total.[118]

D. Taxing Both Income and Wealth

As described in the previous section, neither income nor wealth is independently sufficient to compare taxpayers by their total economic spending power during the taxing period. An income tax does not account for differences in spending power during the taxing period that result from taxpayers' saved wealth. In effect, an income tax understates the value of capital income relative to labor income. A wealth tax, in contrast, does not account for differences in spending power that result from labor income, the productive investment of wealth, or the number of years across which a stock of wealth must be spread.

To account for the limitations of both measures as factors in economic well-being, proposals in the literature would tax both income and wealth. For example, David Shakow and Reed Shuldiner propose taxing wealth under a wealth tax and labor income under a separate income tax.[119] This proposal excludes capital income from the income tax base, on the grounds that the wealth tax operates in lieu of a tax on capital income.[120] In effect, this rationale mirrors the rationale in the proposal by Schenk and Cunningham for a tax on capital income in lieu of a tax on wealth[121] and a separate tax on labor income.[122]

---

[112] The wealth will appreciate untaxed according to the formula $V = P(1 + i)^t$, where (V) is the final value, (P) is the principal, (i) is the pretax annual (or periodic) return, and (t) is the number of years (or periods). Thus $V = \$1000(1 + 0.04)^{10} = \$1480.24$

[113] In this case the wealth will appreciate according to the formula $V = P[1 + (1 - T_C)i]^t$, where T_C is the tax rate on capital income. Thus $V = \$1000[1 + (1 - 0.2)0.04]^{10} = \$1370.24$.

[114] $1370.24 / $1480.24

[115] In this case the wealth will appreciate according to the formula $V = P(1 - T_W)^t(1 + i)^t$, where T_W is the tax rate on wealth. Thus $V = \$1000(1 - 0.02)^{10}(1 + 0.04)^{10} = \$1209.47$.

[116] $1209.47 / $1480.24

[117] In this case the wealth will appreciate according to the formula $V = P(1 - T_W)^t[1 + (1 - T_C)i]^t$. Thus $V = \$1000(1 - 0.02)^{10}[1 + (1 - 0.2)0.04]^{10} = \$1119.59$.

[118] $1119.59 / $1480.24.

[119] See Shakow & Shuldiner, note 6, at 538-44 (describing generally the authors' proposal for separate labor income and wealth taxes).

[120] See id. at 500-501.

[121] See discussion at Subsection III.C.3.

[122] From this perspective, the biggest difference between an imputed return to historic cost and a direct wealth tax is that the latter will account for actual changes in market value in years prior to a realization event. See Schenk, note 6, at 446.

The analysis of the separate bases of wealth and labor income as measures of economic spending power during the taxing period begins with the same considerations in the analysis of a tax on wealth above.[123] A tax on wealth alone, without regard to capital income earned from the wealth, will not account for taxpayer decisions whether, and how, to productively invest their wealth. Consequently, taxpayers with the same wealth and different amounts of capital income resulting from the investment of their wealth are treated similarly.[124] Furthermore, a wealth tax will not account for capital income consumed during the taxing period, which is an essential component of the income tax base. Finally, a wealth tax will not account for differences among taxpayers in their needs to spread their wealth across different numbers of periods and will consequently disfavor the pensioner who must preserve their wealth for longer.

If wealth, capital income, and labor income all independently factor into economic well-being, an alternative method would be to tax all of these factors through a comprehensive income tax (on both capital and labor income) and a separate wealth tax. The advantage of taxing both wealth and a comprehensive income base is that these bases cumulatively account for all of the factors in economic well-being described above, which is necessary to consistently compare taxpayers by their economic spending power during the taxing period and to avoid favoring capital income relative to labor income.

Taxing these factors under separate instruments, however, faces an additional and fundamental limitation to any attempt to tax total economic well-being by separately taxing the different factors in economic well-being. For the reason described in Section III.A above, progressively taxing these bases under separate instruments is not equivalent to progressively taxing economic well-being from all factors under a single rate schedule. Stated in the terms of this Article, either base can serve in the calculating function of the progressive tax base, but neither is sufficient to serve in the comparing function. Consider again Taxpayers 1, 2, and 3 described above, where Taxpayer 1 has $1,000,000 of wealth, $25,000 of capital income, and no labor income; Taxpayer 2 has no wealth, no capital income, and $100,000 of labor income; and Taxpayer 3 has $1,000,000 of wealth, $25,000 of capital income, and $75,000 of labor income.[125] Irrespective of the rate schedule chosen for each instrument, a separate tax on wealth will treat Taxpayer 3 the same as Taxpayer 1, while a separate income tax will treat Taxpayer 3 the same as Taxpayer 2.[126] As a result, Taxpayer 3's income and wealth are taxed at the same rate as those of Taxpayer 1 and 2, notwithstanding the fact that Taxpayer 3 has greater economic well-being (measured as economic spending power during the

---

[123] See Subsections III.B.1-2.

[124] As noted above, the most likely practical reason this approach is not favored in the literature is because of the cumulatively effect of taxing both capital income and wealth. See discussion at notes 111-118 and accompanying text.

[125] See discussion at Part I.

[126] Or better, if capital income is taxed at a preferential rate. See note 26.

taxing period) than either Taxpayers 1 or 2,[127] and therefore should be taxed at a higher average rate on both her income and her wealth.

The three taxpayers can only be treated consistently if their economic well-being from income and wealth are taxed under a single progressive rate schedule. The problem, however, is that income and wealth cannot be simply summed and taxed under a single instrument, because the two factors measure economic well-being in different terms.[128] As described above, income indicates a periodic flow of economic resources, whereas wealth reflects a fixed stock.[129] Therefore, for any fixed amount $X of wealth or $X of periodic income, the latter signals greater economic well-being, and simply adding income and wealth yields inaccurate results. For example, if income and wealth were both summed for each of Taxpayers 1 and 2, Taxpayer 1 would inaccurately be treated as having more than ten times the economic spending power of Taxpayer 2.[130]

IV. A Combined Base of Income and Wealth

This Part introduces a new base for progressive taxation, which is a combined base of economic well-being from both income and wealth. A central feature of the combined base is the wealth annuity, derived from both wealth and capital income. The wealth annuity offers a middle path between favoring wealth by only taxing capital income and including the full wealth stock in the tax base each period. The wealth annuity value is added to a taxpayer's labor income during the period to yield the combined base of economic well-being. In effect, this combined base would be a limited intervention to the tax system, which would preserve the current income taxation of both labor and capital income and then add to this base a portion, but not all, of a taxpayer's wealth.

This combined base resolves the core concerns of this Article. First, the combined base more accurately reflects economic spending power during the taxing period than either wealth or income. As a result, the combined base serves as a

---

[127] The analysis in this case is the same as the analysis of the limitations of separately taxing different attributes described in above in Section III.A. Assume that C_1 is the measure of taxpayer's economic well-being during the taxing period and that, from a perspective of limiting inequality of economic power, taxpayers should be compared by this measure. If income (I) and wealth (W) are both factors in economic well-being, then $C_1 = f(I, W)$. Under a progressive rate schedule with increasing marginal rates, separate taxes on I and W are not equivalent to a single tax on C_1. Using the notation in note 68 above, this may be expressed as $T(I) + T(W) \neq T(C_1)$.

[128] That is, C_1 is a function of income and wealth, or $C_1 = f(I, W)$, but the function is not the simple sum of the factors, as was the case in note 66 where $f(I, W) = I + W$.

[129] See Subsections II.C.1-2.

[130] The sum of Taxpayer 1's income and wealth is $1,025,000, while Taxpayer 2's is only $100,000. Taxpayer 1 does not have ten times the economic spending power of Taxpayer 2, since Taxpayer 1's $1,000,000 of wealth is a stock that will be exhausted if spent in the taxing period, while Taxpayer 2's $100,000 of income will recur to the extent this amount represents a periodic income flow. Stated differently, if Taxpayer 2 has additional earning ability in subsequent years, his stock of human capital is greater than $100,000.

more appropriate base for reducing inequality under the relative economic power theory. Second, the combined base harmonizes the treatment of capital and labor income and allows for comparing taxpayers with different levels of income and wealth in equivalent terms. As a result, economic well-being from both factors can be consistently taxed under a single progressive rate schedule.

Sections IV.A and IV.B describe, respectively, the wealth annuity and the combined base of income and wealth. Section IV.C addresses real-world considerations in calculating the combined base. Section IV.D compares the combined base of income and wealth to two other alternative tax instruments: a wealth transfer tax, such as an estate or inheritance tax, and a consumption tax. Finally, Section IV.E addresses in greater detail two common objections to taxing either income or wealth, on fairness and efficiency grounds.

A. The Wealth Annuity

As described above, income and wealth cannot be taxed under a single progressive tax instrument until they are translated into terms that measure economic well-being consistently. Labor income reflects a return of a portion of taxpayer's principal of human capital.[131] Capital income, in contrast, generally measures an investment return but not a return of the principal.[132] Finally, a wealth stock represents a taxpayer's entire wealth principal.[133]

These differing measures can be reconciled by translating a taxpayer's wealth at the beginning of the period and capital income earned during the period into a hypothetical annuity value.[134] The wealth annuity value converts a fixed wealth stock into a periodic flow over a number of periods, such that an equal amount would be returned each period.[135] In effect, this measure reflects the amount of periodic income the wealth would be expected to generate over the

---

[131] See Subsection II.C.1.

[132] See id.

[133] See Subsection II.C.2.

[134] Cf. the methodology in Taussig, Weisbrod & Hansen, note 29. A wealth annuity concept has been previously suggested in the welfare economics literature, but it has not been generally accepted as a measure of economic well-being and has not been proposed as a base for progressive taxation. In both causes, the most likely explanation for its lack of broader application in the tax literature prior to this Article is due to the fact that the wealth annuity, like any wealth measure, distinguishes between consumption in different periods and therefore does serve as a measure of economic well-being over the course of one's lifetime. See, e.g., the passing dismissal of this concept from a lifetime perspective in Victor Thuronyi, The Concept of Income, 46 Tax L. Rev. 45, 98 (1990). The relative economic power theory, however, is concerned with differences in economic spending power each period and not on a lifetime basis. See discussion at Section II.B. Within this framework the wealth annuity concept has new relevance and application for the definition of the progressive tax base.

[135] The formula for calculating the periodic annuity return A derived from a stock of wealth W is $A = W \left[\dfrac{r}{1 - \left[\frac{1}{(1+r)^n} \right]} \right]$, where r is the taxpayer's positive rate of return on saved wealth and n is the number of periods the annuity is paid. Cite to basic corporate finance textbook.

annuity holder's remaining lifetime. Each year, an actual annuity holder receives back a portion of their principal, as well as an investment return on their outstanding principal. At the end of the annuity period, the entire principal has been returned, and no additional value remains. Similarly, the wealth annuity value used in the combined base estimates the amount of principal that would e returned each year if an actual annuity were purchased by the taxpayer.

For example, if Taxpayer 3 has $1,000,000 of wealth, and earns $25,000 of capital income in the year, implying a 2.5% rate of return for the year, the annuity value over 11 years is approximately $100,000.[136] In the first year, the annuity amount equals the sum of the $25,000 of capital income earned during the year and a return of $75,000 of the wealth principal. In subsequent periods, the annuity value would be recalculated based on the taxpayer's starting wealth and capital income in those periods, in the same manner that income and wealth are recalculated each period under income or wealth taxes.

The wealth annuity reflects a partial return of capital, as well as an investment return on the principal balance. As a result, the wealth annuity tax base differs from both the capital income tax base and from a wealth tax base in critical respects. First, and unlike a wealth tax base, the wealth annuity accounts for capital income earned during the year and therefore distinguishes between taxpayers with different decisions on whether, and how, to invest their wealth.

The wealth annuity accounts for both wealth and capital income but does not account for the entire stock of wealth in any single year, as a portion of the wealth principal is excluded to account for hypothetical annuity payments in future periods. As a result, the wealth annuity also distinguishes between the amount of a taxpayer's wealth considered disposable during the taxing period and an amount preserved for future periods.[137] For the same reason, the size of the wealth annuity value varies with the number of periods the wealth is expected to last and distinguishes between taxpayers with different needs to save their wealth for the future.

From the perspective of the relative economic power theory, the wealth annuity therefore yields a more accurate measure of economic spending power during the taxing period. As described in Section II.B, the relative economic power theory depends upon the credible threat by those with greater economic power to expend their resources to assert their own preferences. The pensioner with wealth that must be saved for the future cannot credibly make this threat and to this extent should not properly be considered to have greater economic power as a result of her wealth. In contrast, a taxpayer with greater disposable wealth in the current period will have greater economic power.

The wealth annuity measures how much economic power is available from a given stock of wealth by distinguishing between wealth that is available in the

---

[136] $102,542.40.

[137] The wealth annuity is not meant to predict the amount of wealth that will actually be used by the taxpayer. Rather, the wealth annuity compares relative spending power during the taxing period.

current period and wealth that must saved for the future. Under the wealth annuity, a pensioner who must save for the future will only be treated as having a portion of the principal available in the current period. If the pensioner expects to live for longer, and therefore must save their wealth for a greater number of periods, then even less of the wealth will be considered disposable in the current period.

As a point of clarification, the purpose of the wealth annuity calculation is not to factually predict the future economic experience of the taxpayer.   In future periods a taxpayer may earn a different rate of return, or they may have more or less wealth, and each of these changes will affect the annuity value in those periods. In a similar manner, observing a taxpayer's annual income or wealth alone during the taxing period does not predict their economic circumstances in future periods.[138] Rather, the purpose of the wealth annuity is to measure the taxpayer's economic spending power each period from wealth and capital income, using the available data points of wealth at the beginning of the period and capital income earned during the period.

B. The Combined Base

The combined base is the sum of the wealth annuity plus the taxpayer's labor income during the taxing period. For example, Taxpayer 3's $100,000 wealth annuity value[139] would be added to her $100,000 of labor income, and this $200,000 sum would be taxed under a single progressive rate schedule.   In effect, the combined base begins with the same base of both labor and capital income taxed under the current federal income tax base and then adds a portion of the taxpayer's wealth.

Under the combined base, taxpayers are treated consistently regardless of whether their economic well-being derives from income, wealth, or both. Consider the treatment of Taxpayers 1, 2, and 3 under a single progressive tax on the combined base. Assume that the instrument taxes the integrated base according to the following rate schedule: 20% of the first $100,000, plus 40% of any additional amounts.[140] Taxpayers 1 and 2 are each treated as having a taxable base of $100,000 for the period (Taxpayer 1 derives her economic well-being from wealth, and Taxpayer 2 from labor income), for a tax liability of $20,000 each and an average tax rate of 20% each. Taxpayer 3 will be treated as having a taxable base of

---

[138] Similarly, one can imagine additional factors that affect a taxpayer's economic well-being and that are not easily accounted for in the tax system. For example, a taxpayer may have other future financial obligations that are not currently observable as debt (negative wealth) and are more appropriately analogized to contingent liabilities. Another taxpayer may reasonably anticipate a future stock of wealth in the form of a gift or bequest. These assets and liabilities can only be observable in future periods once they are realized.

[139] See note 136 and accompanying text.

[140] The rates used here are purely illustrative, and will depend on the degree of aversion to inequality and the different behavioral responses to the taxation of different components of the base.

$175,000 for the period, resulting from both her income and wealth.[141] Taxpayer 3 will pay a total tax of $50,000 on this base—20% on the first $100,000 and 40% on the remaining $75,000—for an overall average rate of approximately 28%.[142] Taxpayer 3 is appropriately taxed at higher average rates on both her income and her wealth, on account of her greater economic power during the taxing period.

The combined base also allows for more consistent treatment of negative wealth, or debt. Recall the doctor described above,[143] who has negative wealth from medical school debt and must make a payment of $10,000 each year.[144] This payment reflects a portion of the debt principal and interest paid on the outstanding balance.   The amortization payments owed on negative wealth reflect reduced economic spending power in the taxing period, in the same manner that the wealth annuity from positive wealth reflects increased economic spending power in the taxing period. Under the combined base, the doctor would be treated as having only $190,000 of available economic spending power in the taxing period.[145] The doctor will pay a total tax liability of $56,000,[146] for an overall average rate of approximately 29%.[147] Compare the treatment of the doctor to the dentist, who has $200,000 of income and no debt.[148] The dentist will pay a total tax liability of $60,000, for an overall average rate of approximately 34%.[149] Although both earn the same income, the dentist will pay more in tax because they do not also have debt.

The combined base also accounts for differences in economic spending power among taxpayers with similar amounts of savings but who expect to spread the wealth across different numbers of future periods. Consider the pensioners example above,[150] where Retiree 1 and Retiree 2 each have $100,000 of savings, and each earns a return of 2% a year. Retiree 1, however, is expected to live for 10 more years, whereas Retiree 2's savings must stretch for an expected 20 years. The wealth annuity quantifies the difference between the retirees' economic circumstances. With respect to Retiree 1, $100,000 of savings generating a 2%

---

[141] The sum of Taxpayer 3's $75,000 labor income and approximately $100,000 annuity value from wealth and capital income. See note 136 and accompanying text.

[142] 28.57%.

[143] See notes 23-25, 88-89 and accompanying text.

[144] Of course, a particular debt obligation is likely to have a shorter repayment period than the taxpayer's expected lifespan. Under a wealth tax, this problem does not arise because a wealth tax fails to account for number of periods across which the wealth must be spread. Recall, however, that the purpose of the wealth annuity is not to predict actual economic events in subsequent periods but rather to more consistently compare taxpayers in the current period. It would be administratively unfeasible to separately account for the payment terms of every financial instrument and investment. This limitation may be considered an example of the general principle that the tax system cannot account for all factors that affect a taxpayer's economic well-being. See note 138.

[145] The labor income of $200,000 less the negative annuity value of ($10,000) on account of the doctor's negative wealth.

[146] 20% of $100,000 plus 40% of $90,000.

[147] 29.47%.

[148] See Subsection III.B.2.

[149] 34.29%.

[150] See Subsection III.B.2.

annual return would yield an annuity of approximately $11,000 per year[151] over a 10-year period. With respect to Retiree 2, the same savings and return would yield an annuity of approximately $6,000 per year[152] over a 20-year period. Because Retiree 1's savings are expected to be spread over fewer years, Retiree 1 has a higher taxable base under the combined base.

If a saver also has labor income, they will appropriately be treated as having greater economic spending power, holding constant the amount of savings and the life expectancy. Consider an additional taxpayer, Worker 1 who, like Retirees 1 and 2, has $100,000 of savings that earns a 2% annual return and who, like Retiree 2, expects to live for 20 more years. Worker 1, however, also earns $10,000 of labor income each year. Worker 1 is treated as having available economic spending power of $16,000 in the taxing period, resulting from the $10,000 of labor income and the $6,000 annuity value from saved wealth, and would consequently be treated as having greater economic spending power than Retiree 2 who has the same wealth but not labor income.

Finally, consider the different treatment of the doctor and the investor, which represents a case of income equality but substantial wealth inequality. To hold life expectancy constant, assume that both are expected to live for another 40 years. As described above, the doctor will have net income of $190,000 for the year, after making the $10,000 debt payment.[153] The investor's $35 million wealth, assuming investor's investment return of 0.06%, would yield an annuity of approximately $980,000 per year over a 40-year period.[154] Once the investor's wealth is translated to an annuity value, the investor's much greater economic well-being is evident. If the combined base is taxed at the rate schedule specified above, the doctor pays the total tax liability of $56,000 described above, for the overall average rate of approximately 29%.[155] The investor will be treated as having available economic resources of $980,000,[156] and will consequently pay a total tax liability of $372,000,[157] for an overall average rate of approximately 38%.[158]

---

[151] $10,914.37.

[152] $5,995.76.

[153] After the debt is paid off in 10 years, the doctor will no longer have negative wealth and consequently will be treated as having greater economic well-being in those taxing periods, the same as if the doctor had no debt to begin with but increased his savings during that time.

[154] $980,920.32.

[155] See notes 146-147 and accompanying text.

[156] See note 154 and accompanying text.

[157] 20% of $100,000 plus 40% of $880,000. This amount approximately equivalent to the liability resulting from a 1% wealth tax on the investors $35 million in wealth, or half of Professor Piketty's proposed top marginal rate. See Piketty, note 6, at 517. Although the rates used in this example are hypothetical, this example illustrates how, unlike periodic taxes on both capital income and a taxpayer's entire wealth stock, a tax on the combined base can result in a lower cumulative tax liability, even if the portion of the wealth principal is taxed at a higher rate than the rates proposed in the literature for a tax on the taxpayer's entire wealth stock. See discussion at notes 111-118 and accompanying text (on the cumulative effect of taxing both the entire wealth stock and capital income each period). The simple reason for this difference is the combined base will generally use a smaller wealth base than under a full wealth tax.

[158] 37.96%.

C. Real-World Considerations

This section addresses real-world considerations in taxing income and wealth, or the combined base of both. In general, calculating the combined base of economic well-being generally requires the same basic information as required under income and wealth taxes: the taxpayer's stock of wealth at the beginning of the year and their capital and labor income during the taxing period.[159] The rate of return on the taxpayer's wealth, for purpose of determining the wealth annuity, is derived from the data points of starting period wealth and capital income earned during the period.

A common theme in the discussion that follows is that any base of income, wealth, or a combination thereof will encounter complications in measuring and characterizing different elements of the tax base. In many cases, these complications can be addressed, at a cost of additional administrative complexity. The question of whether these complications should be resolved at additional administrative cost, however, is in many cases a separate policy determination from the choice between taxing income and wealth. This is because, as described below, many of the same measurement complications present under either an income tax or a wealth tax. As a result, the presence of these complications does not necessarily imply that policymakers should prefer one base to the other, and for the same reason should neither favor nor disfavor the combined base of both.

1. Observing and Measuring Income and Wealth

Scholars divide on the question of whether it is easier to observe and measure a base of income or wealth.[160] Whereas the income calculation necessitates determinations of timing and character, the measurement of wealth is theoretically simpler, since the only determination necessary is the asset value.[161] In effect, however, the most significant administrative challenge to a wealth tax base is the same challenge to an income tax base: the treatment of irregularly traded assets without discernible market value. Under a wealth tax, cash and financial assets are easily valued,[162] in the same manner as the appreciation of financial

---

[159] The final data point required to calculate the wealth annuity, the taxpayer's life expectancy, is discussed below at Subsection IV.C.3.

[160] Contra, e.g., Kleinbard, supra, at 600 (arguing that capital income flows are often easier to measure) with Shakow, note 6, at 951 ("After more than one hundred years of experience with the income tax, that presumption is worth reexamining. Although it may still seem difficult to evaluate everyone's wealth, the growth in size and complexity of the federal income tax suggests that measuring income may not be as easy as was first believed.")

[161] Shakow, note 6, at 950.

[162] Fleischer, note 34, at 16-17.

assets under an income tax.[163] Non-traded or unique assets, however, may be difficult or impossible to value for purposes of a wealth tax,[164] for the same reason that the appreciation of these assets is difficult to determine for purposes of an income tax.

As described above in Section III.B, the definition of both income and wealth will also depend on a normative determination of the sources of value that should factor into economic well-being. In this case, however, the normative boundaries of the income and wealth definitions accord with the administrative challenges of measuring asset values and appreciation, since the assets that are easiest to value are also the clearest indicators of economic spending power. As described above, appreciation of regularly traded assets is readily observable,[165] and therefore an mark-to-market income tax on this appreciation would not pose significant administrative challenges. For the same reason, the valuation of these assets for purposes of a wealth tax would be administrable. In the case of nontraded assets, a rule deferring taxation until a sale or other realization event—with an appropriate interest charge to account for the benefit of deferral—would be equally advantageous for both an income and a wealth tax.[166]

The challenges to defining and observing income and wealth are no easier, and no harder, under the combined base of both. In the case of irregularly traded assets, a similar retroactive method may be used to determine the tax liability due upon a sale. Upon realization, the asset value and rate of appreciation over the asset's holding period may be determined, which provides sufficient information to retroactively determine the annuity value from holding the asset for each year and to tax these annuity values under the applicable rates for these years, with an interest charge to account for the deferral benefit.[167]

2. Nonperiodic Income

As described above, the basic distinction in the literature between wealth and income is that wealth is a fixed stock and income a periodic flow.[168] In the real world, however, income is seldom perfectly periodic. A taxpayer may lose their job,

---

[163] See Glogower, note 81, at 128-29. That is, if the value of an asset is readily observable each year, for the purposes of measuring a wealth tax, changes in the asset's value are similarly observable, for purposes of measuring an income tax.

[164] See Fleischer, note 162, at 17-18.

[165] See note 81 and accompanying text.

[166] See, e.g., the method described in Glogower, note 81, at 146-47.

[167] As described above, Professors Cunningham & Schenk propose imputing an annual return to cost for certain capital assets and taxing any residual gains or losses gains upon disposition See note 104 and accompanying text. This same insight could also be incorporated into the combined base calculation, in a slightly different fashion. Instead of taxing the owner under an income tax base, on an imputed return to cost, the imputed return to cost may be used under the integrated base to estimate the annuity value. The additional gains or losses, upon a subsequent disposition, will adjust the annuity valuation in that year, in the same manner that the income amount is adjusted under Professor Cunningham & Schenk's income tax base.

[168] See Section III.B.

receive a raise or a demotion, or retire. The most consistent comparison of taxpayers would account for the degree to which their labor income is periodic. This information, however, is not available until the end of a taxpayer's life, for the same reason that their total stock of human capital is not observable until that time.[169]

This problem of "lumpy income" poses a challenge to any tax base that includes labor income. Under a progressive income tax, the problem is limited to the effect that the progressive marginal rate schedule imposes a larger tax burden on taxpayers with intermittent periods of higher income than on those with steadier and more modest income flows of equal cumulative value.[170] The problem can be more pronounced, however, under a system with separate taxes on labor income and wealth, such as under the proposal by David Shakow and Reed Shuldiner.[171] This is because a taxpayer with a high labor income that is not likely to be repeated will need to save a portion of their income to compensate for the expected shortfall in subsequent years. As a result, the taxpayer will be taxed on their entire labor income in the first year under the income tax, as well as the wealth saved from the income in subsequent years under the wealth tax. In contrast, a taxpayer with an equal amount of labor income earned over a period of years (and spent each year) will only be taxed on the income and will not face an additional wealth tax liability. The same problem presents under the combined base, although not to the same degree as a system that fully taxes labor income as well as a taxpayer's entire wealth stock each period. This is because only a portion of the taxpayer's wealth is included in the tax base each period, whereas the portion of wealth treated as saved for future periods is exempted from future taxation.

The impossibility of predicting the periodicity of labor income in advance leads to a range of imperfect options for any tax base that measures economic well-being. The first option is to avoid exacerbating the penalty to lumpy income by ignoring the role of wealth entirely. While this approach limits the penalty to taxpayers who earn a high income and subsequently save a portion for future lower-earning years, omitting wealth from the tax base also will also generally disfavor all labor income earners relative to wealthy investors. Taxing a taxpayer's entire stock of wealth each period under a wealth tax results in the greatest adverse treatment of taxpayers who earn lumpy labor income. From this perspective, the combined base offers a middle ground that mitigates, but does not eliminate, the disfavored treatment of lumpy income, without entirely ignoring the role of wealth as a factor in economic well-being.

---

[169] Of course, labor income partially indicates periodic earning capacity. In many cases, taxpayers may also be able to smooth their labor income flows across periods. For example, a taxpayer may be able to purchase wage or disability insurance, find stable employment, or "anchor" their salary in future positions on the basis of their salary in prior positions.

[170] This long-recognized concern was addressed in the writings of William Vickrey, who advocated for a solution that accounted for cumulative income flows across a taxpayer's lifetime. See William Vickrey, Averaging of Income for Income-Tax Purposes, 47 J. Pol. Econ. 379 (1939).

[171] See discussion at Subsection III.C.3.

3. Uncertain Life Expectancy

In order to convert the stock of wealth into a periodic flow, the wealth annuity accounts for the taxpayer's life expectancy. Any number used will be necessarily imprecise, but such calculations are regularly undertaken to calculate actual annuity values under current law. Section 7520 of the Code requires the IRS to publish actuarial tables and to value annuities, life interests, and reversionary interests[172] under the estate, gift, and income taxes. These tables could be easily repurposed in order to calculate the wealth annuity component of the combined base.

Taxpayers who outlive, or predecease, their expected lifetime can both be treated equitably under the combined base. First, a taxpayer who has the misfortune to die sooner will have been treated as having less economic well-being and therefore a lower tax liability in prior years than the liability indicated by their actual lifespan. This result is unlikely to be objectionable to taxpayers, as this case mitigates the tax liability for those who die unexpectedly early. The more inequitable case is where a taxpayer outlives their expected lifespan and as a result pays too much in tax in prior periods, on the basis of higher assumed annuity values in those years. Such a taxpayer is already at a greater risk of outliving their savings, and this financial strain would be increased if the taxpayer faces a higher tax liability. In this case, the government could issue a refundable credit to taxpayers living beyond their expected lifespan for the excess taxes paid in prior years.

4. Exemptions

Policymakers can also set minimum exemption levels under an income tax, a wealth tax, or under the combined base. Under the federal income tax, the personal exemption under § 151 exempts the first $4,050 of income for each individual in the taxpaying unit.[173] The personal exemption originated in the notion that taxpayers should only be taxed on "clear income" above a level devoted for basic necessities.[174] Proposals for a wealth tax have similarly included a minimal exemption level, so that wealth is only taxed above a level of savings necessary for basic financial security.[175]

---

[172] IRC § 7520(a)(1). For the current actuarial tables, see IRS, Actuarial Tables, https://www.irs.gov/retirement-plans/actuarial-tables (last visited May 19, 2017); see also IRS, Publication 1457: Actuarial Valuations (2009), https://www.irs.gov/pub/irs-pdf/p1457.pdf.

[173] IRC § 151(a), (c); IRS Rev. Proc. 2016-55 at 18, https://www.irs.gov/pub/irs-drop/rp-16-55.pdf (inflation adjustments for 2017). The exemption phases out above a threshold of adjusted gross income. IRC § 151(d)(3).

[174] See Edwin R.A. Seligman, Progressive Taxation in Theory and Practice 80-81, 129-30, 159-61 (1894).

[175] See, e.g., Shakow & Shuldiner, note 6, at 547 (proposing an exemption on the first $40,000 of net wealth in 1999 dollars).

Exemptions for basic levels of income and wealth may also be incorporated into the base calculation under the combined base. The combined base also offers policymakers additional flexibility in structuring exemption levels, since exemptions can be made on a separate basis for minimal amounts of income or wealth as factors in the combined base, or on a combined basis as an integrated exemption for both. Under separate income and wealth taxes, in contrast, an integrated exemption cannot be consistently applied, for the same reason that income and wealth cannot be consistently compared and taxed across taxpayers through separate instruments.[176]

The combined base can also accommodate asset-specific exemptions, to alleviate perceived hardship on taxpayers or advance other policy goals. For example, the income tax base currently excludes up to $500,000 of gains from the sale of a primary residence,[177] and allows a deduction for mortgage interest paid.[178] These preferences have been justified as a subsidy to home ownership and asset values, and to alleviate the compliance burdens faced by taxpayers.[179] Either a wealth tax base or the combined base of income and wealth could similarly exempt a minimum amount of net wealth attributable to a taxpayer's primary residence from the base calculation.

D. Contrasted with Other Tax Bases

1. An Estate or Inheritance Tax

Wealth transfer taxes such an estate or inheritance tax limit the accumulation and transmission of dynastic wealth across generations, and the role of privilege and the lottery of birth in economic inequality.[180] An estate tax is calculated by reference to the decedent's estate, while an inheritance tax is

---

[176] For example, Professors Shakow & Shuldiner suggest integrating a $5000 exemption under the labor income tax with the $40,000 exemption under the wealth tax by use of a unified credit against the tax liability from both. As described above in Section III.D, however, without first translating income and wealth into consistent measures of economic well-being, there is no way to consistently tax both as factors in economic well-being under a progressive rate structure. For the same reason, a credit against the cumulative tax liability cannot consistently exempt a minimum level of economic well-being from both factors.

[177] IRC § 121.

[178] IRC § 163(h).

[179] See, e.g., Staff of the Joint Comm. on Tax'n, 104th Cong., General Explanation of Tax Legislation Enacted in 1997, at 54-55 (Comm. Print 1997) (concern for compliance burden on taxpayers from calculating gain on sale of residences.).

[180] See Thomas Nagel, Liberal Democracy and Hereditary Inequality, 63 Tax L. Rev. 113 (2009).

calculated by reference to the amount received by each beneficiary of the estate.[181] Scholars favoring an inheritance tax to an estate tax argue that the latter only provides a "rough justice" of distributional equity because it does not account for different the amounts received by different estate beneficiaries.[182] In contrast, an inheritance tax would tax inheritances received by each beneficiary[183] and thereby account for the actual economic benefit received by each.

The critical distinction between a periodic wealth tax, one the one hand, and either an estate or inheritance tax, on the other, is that the latter instruments are one-time levies upon the transfer of wealth across generations. Neither an estate tax nor an inheritance tax accounts for the number of periods the wealth is held. As a result, neither instrument will continuously constrain economic inequality during a taxpayer's lifetime, which is implied under the relative economic power framework. Both estate and inheritance taxes also imply that death is a uniquely appropriate time to assess taxes. This feature invites common characterization of the current estate tax as a "death tax"[184] that is exogenous to the normal tax rules that operate during the wealth holder's life. The "death tax" label renders such instruments politically vulnerable[185] and obscures the continuous role of wealth as a factor in inequality throughout the holder's life.[186]

The combined base of income and wealth can prevent the perpetuation and transmission of dynastic wealth without the need for a separate estate or inheritance tax. Furthermore, the combined base would constrain excessive economic inequality continuously, rather than once each generation upon the transmission of wealth from a decedent to beneficiaries. Near the end of a taxpayer's life, the combined base effectively operates as gradual estate tax by including increasing amounts of saved wealth in the taxable base each period, while ensuring that the taxpayer will never exhaust their savings through tax payments before the end of their life. From the perspective of the estate beneficiaries in the next generation, the combined base operates in a parallel fashion. An heir who begins life in a position of privilege from inherited wealth will similarly begin life by paying taxes each period on this inheritance through the wealth annuity component

---

[181] See Lily L. Batchelder, What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax, 63 Tax L. Rev. 1 (2009). For 2017, the federal estate tax rate is 40% of gross estates and gifts above an exemption level of $5.49 million. IRC § 2001, 2010.

[182] See Batchelder, supra, at 53-56 (on the inequitable and inconsistent treatment of individual heirs under an estate tax).

[183] For example, Professor Batchelder's proposal would include inheritances above $1.9 million as taxable income, taxed at the ordinary income rates plus a 15% surcharge. See id. at 58-67.

[184] See, e.g, House GOP, A Better Way: Our Vision for a Confident America: Tax 16 (June 24, 2016), https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf (proposal to repeal the estate tax and the generation skipping transfer tax "so that the death of a family member or loved one no longer will be a taxable event").

[185] See Michael J. Graetz & Ian Shapiro, Death by a Thousand Cuts: The Fight Over Taxing Inherited Wealth (2006).

[186] See discussion at note 53 and accompanying text.

2. A Consumption Tax

Whereas a tax base of income and wealth taxes individuals in accordance with their power to consume, a consumption base taxes individuals in accordance with their actual consumption.[187] A consumption base could increase, rather than reduce, the harms resulting from economic inequality under the relative economic power framework.[188] Taxpayers are encouraged to preserve economic power by saving and investing instead of spending, thereby amplifying differences in relative economic power.

It may be argued that a progressive consumption tax achieves the same practical result of reducing disparities in spending power by minimizing wealthy taxpayers' purchasing power.[189] Three considerations, however, minimize the effect of a consumption tax as a tool to reduce disparities in relative economic power by reducing purchasing power. First, to the extent that consumption taxes are not salient and taxpayers anchor economic ability by reference to pretax rather than after-tax prices, a consumption tax will not diminish the social effects of relative economic power.[190] Second, a consumption tax will only have the effect of minimizing purchasing power if it can convincingly be implemented in perpetuity. Otherwise, taxpayers will benefit by saving and deferring their consumption until tax rates are reduced in the future.

E. Additional Objections to Taxing Wealth

This Section addresses in greater detail two common objections to taxing wealth, on fairness and efficiency grounds.[191] Under the first objection, a tax on wealth penalizes the choice to save, and thereby frustrates individual agency and liberty. Under the second objection, a tax on wealth harms the economy by inefficiently discouraging savings and capital formation. The discussion that follows first questions the conclusory forms of these objections and then argues, counter-intuitively, that setting bounds on the degree of economic inequality resulting from

---

[187] For arguments favoring a progressive consumption tax, see Daniel Shaviro, Replacing the Income Tax with a Progressive Consumption Tax, 103 Tax Notes 91 (Apr. 5, 2004); Robert H. Frank, Why have weddings and houses gotten so ridiculously expensive? Blame inequality, Vox, (Jan. 16, 2015), https://www.vox.com/2015/1/16/7545509/inequality-waste.

[188] See Schenk, note 12, at 456 (on ability of a consumption tax to increase wealth disparities).

[189] That is, a consumption tax reduces purchasing power by reducing the amount of goods and services that may be acquired after consumption taxes are paid.

[190] See Raj Chetty, Adam Looney & Kory Kroft, Salience and Taxation: Theory and Evidence, 99 Am. Econ. Rev. 1145, 1146 (2009) (finding that consumers underreact to taxes that are not included in the posted price of goods).

[191] To the extent a tax on capital income, wealth, or the wealth annuity all burden savings, the general form of these objections will apply to all of these bases, even if the effect of the savings disincentive will vary with the scope of the base definition. See, e.g., Banks & Diamond, note 7, at 553 (analyzing the economic consequences of capital income taxation instead of wealth taxation because it is assumed that annual measurement of wealth is not available).

individual choices made in the market is in fact necessary to preserve individual liberty and an efficient free market.

1. Penalizing Choice

A tax on economic well-being, whether from income or wealth, distinguishes between taxpayers on the basis of their personal choices—in particular the choices whether, and how, to preserve and increase economic resources. The labor income tax base, for example, disfavors the choice to work, whereas the tax bases of wealth and capital income disfavor foregone consumption and successful investment decisions. Milton Friedman distilled the objection from a classical liberalism perspective to redistributing the outcomes from such personal choices with the following example:

> Consider a group of individuals who initially have equal endowment and who all agree voluntarily to enter a lottery with very unequal prizes. The resultant inequality of income is surely required of individuals to make the most of their initial equality. Redistribution after the event is equivalent to denying them the opportunity to enter the lottery.[192]

This lottery example illustrates the general objection in abstract terms, but the same logic may be extended to oppose redistribution of outcomes resulting from other personal decisions, such as the choices whether to work and to save.[193]

Redistribution that completely obviates the role of choice is different, however, from moderate redistribution to reduce excessive inequality. Even strident advocates of personal choice and entitlement theories of distributive justice generally accept a minimal degree of redistribution from the responsible and the lucky to the irresponsible and the unlucky. For example, whereas the logical conclusion of Friedman's lottery example suggests that an individual who gambles away their last dime should face the consequences and perish, even Friedman contemplates redistribution to alleviate poverty and a progressive exemption for minimal levels of income.[194] A similar logic may be extended to redistribution to alleviate extremes of inequality: Unequal outcomes may be accepted to reward personal choice and even good fortune but still limited in the cases where excessive inequality becomes harmful to society.[195]

The relative economic power theory suggests a more fundamental reason why a constraint on the degree of economic inequality resulting from Friedman's

---

[192] Milton Friedman, Capitalism and Freedom: Fortieth Anniversary Edition 162 (2002).

[193] See, e.g., id. at 174.

[194] See id. at 175, 190-95.

[195] Alternatively, turning the question around would require an advocate of a choice or entitlement view to identify the degree of unequal market outcomes, if any, that *would* be considered unduly excessive.

lottery is necessary to preserve the objective of individual liberty championed in his work. As described above, under the relative economic power theory excessive economic inequality suppresses the preferences of those with less economic power. In effect, consecrating the choices of some by permitting limitless accumulations of economic power results in limiting the agency and autonomy of others.

2. Incentives and Efficiency

Any tax on economic outcomes may be expected to discourage productive economic activity.[196] A tax on labor income may discourage labor effort, whereas a tax on wealth or capital income may discourage the decisions to save and invest. From this perspective, under an optimal tax theory framework any benefits of redistribution by taxing economic outcomes must be weighed against possible efficiency costs.[197]

As an initial point of clarification, the purpose of this Article is not to evaluate the efficiency consequences of taxing income or wealth, or a particular combination thereof. Rather, this Article addresses the antecedent question of the basis for redistribution, or the criterion of inequality, against which efficiency costs should be weighed.[198] From the perspective of the relative economic power theory, the

---

[196] See Daniel Shaviro, The Economics of Tax Law, in The Oxford Handbook of Law and Economics Volume 3: Public Law and Legal Institutions (Francesco Parisi, ed., 2017).

[197] See, e.g., Slemrod, note 58, at 3-4 ("The modern approach to evaluating progressivity focuses on the tradeoff between the potential social benefit of a more equal distribution . . . and the economic costs caused by the disincentive effects of the high marginal tax rates required by a redistributing tax system."); Joel Slemrod, Optimal Taxation and Optimal Tax Systems, 4 J. Econ. Perspectives 157, 158 (Winter 1990).

[198] Whether the normative distributional baseline is a first-order consideration, to be constrained by second-order efficiency considerations, or vice versa, notions of fairness are central to tax design in all events. Scholars disagree on usefulness of approaching questions of tax design by reference to a normative distributional baseline, given the fact that different tax instruments and choices for the tax base will have different efficiency consequences. Contra, e.g., Banks & Diamond, note 7, at 555 ("'[T]axable capacity' always turns out to be very difficult to define and to be a matter on which opinions will differ rather widely'. We conclude that the consideration of an ideal tax base lends itself to too many concerns and conflicting answers to be viewed as a good starting point for the consideration of taxation. An alternative start is by examining the economic equilibria that occur with different tax structures."), *with* John Kay, Commentary, in Mirrlees Review, supra, at 656, 663 ("My assessment is that this puts the role of equity and efficiency in the choice of the main household tax base the wrong way round. One should begin by seeking a measure of taxable capacity, with the measurement of taxable capacity constrained by administrative and operational issues and by considerations of efficiency."). In effect, however, neither view suggests that the normative baseline has no relevance for tax design. Even if dismissed as a starting point against which efficiency costs should be weighed, the concept of a normative distributive baseline is necessarily reintroduced in the optimal tax policy literature to preclude a tax base that is efficient but violates intuitions of fairness. See, e.g., Banks and Diamond, supra, at 612. ("[S]ome aspects of horizontal equity may best be addressed by viewing them as a limitation on allowable tax tools. . . . We accept the view that tax tools should be limited by such considerations and that policies should be restricted to ones which are uniform over their stated tax base."). For example, Banks and Diamond reject a tax system that

relevant criterion is equality of economic spending power. Absent efficiency considerations, this perspective suggests that all factors in economic spending power should be taxed equivalently, while departures from this presumption may be justified based on the efficiency consequences of taxing specific factors. Stated differently, the distributional baseline of periodic economic spending power described in this Article may be incorporated within an optimal income tax analysis as implying a marginal social welfare weight placed on equality of economic spending power each period.[199]

First, the efficiency cost of taxing wealth is likely overstated in all events. A growing body of work in the optimal taxation literature argues that wealth is an efficient additional base for taxation, as either a signal of earning ability[200] or in light of the different planning responses to taxes on income and wealth.[201]

Wealth taxation may also be justified on efficiency grounds in light of the negative externalities resulting from economic inequality, which can impede— rather than encourage—economic growth.[202] Studies have found, for example, that excessive economic inequality can result in inefficient political and market capture and underinvestment in human capital.[203] Other works have suggested that excessive wealth concentrations destabilize free markets initially characterized by mutually advantageous exchanges, as the benefits of market transactions increasingly accrue to the wealthy.[204] In each of these cases, wealth taxation that

---

differentiates individuals on the basis of height, even if justified in an optimal taxation framework, on the grounds that doing so would be politically and publically unacceptable and, without further elaboration, on the grounds that such a tax would violate "ethical underpinnings of taxation." Id. at 592.

[199] Emmanuel Saez and Stefanie Stantcheva propose a general framework that can account for a broad range of ethical principles and distributional baselines within the optimal tax framework, by translating these principles into marginal social welfare weights. See Emmanuel Saez & Stefanie Stantcheva, Generalized Social Marginal Welfare Weights for Optimal Tax Theory, 106 Am. Econ. Rev. 24 (2016).

[200] See Banks & Diamond, note 7, at 563.

[201] See Gamage, note 7, at 431-37.

[202] See, e.g., Heather Boushey & Carter C. Price, How Are Economic Inequality and Growth Connected? A Review of Recent Research 3 (2014), http://d3b0lhre2rgreb.cloudfront.net/ms-content/uploads/sites/10/2014/10/100914-ineq-growth.pdf; Int'l Monetary Fund, Redistribution, Inequality, and Growth 5, 7-9 (2014), http://www.imf.org/external/pubs/ft/sdn/2014/sdn1402.pdf; Int'l Monetary Fund, Fiscal Policy and Long-Term Growth 30-31 (June 2015), https://www.imf.org/external/np/pp/eng/2015/042015.pdf; OECD, In It Together: Why Less Inequality Benefits All 60-80 (2015), http://www.oecd.org/social/in-it-together-why-less-inequality-benefits-all-9789264235120-en.htm; Standard & Poor's Financial Services, How Increasing Income Inequality Is Dampening U.S. Economic Growth, and Possible Ways To Change The Tide (2014), https://www.globalcreditportal.com/ratingsdirect/renderArticle.do?articleId=1351366&SctArtId=255732&from=CM.

[203] See OECD, note 202, at 60.

[204] See generally Bruce M. Boghosian, Adrian Devitt-Lee, Merek Johnson, Jie Li, Jeremy A. Marcq & Hongyan Wang, Oligarchy as a Phase Transition: The effect of wealth-attained advantage in a Fokker-Planck description of asset exchange, 476 Physica A: Statistical Mechanics and its Applications 15 (2017) (describing the effects of a bias in favor of the wealthy in asset-exchange models that ultimately leads to "wealth condensation" above a critical level of wealth inequality); Bruce M.

reduces excessive economic disparities can eliminate barriers to economic growth and a functioning free market.[205]

V. Conclusion

Income and wealth taxation are premised on the same notion: Taxpayers should be periodically compared, and taxed, on the basis of their economic circumstances. This Article fills a gap in the literature by examining the relationship between income and wealth as measures of economic well-being, and the consequences for progressive tax design. First, this Article formalizes the argument for taxing income and wealth as factors in economic inequality through the relative economic power theory. This theory, in turn, has specific implications for the measurement of economic well-being and inequality, and consequently for the design of a progressive tax base that operates to constrain inequality. In particular, the relative power theory implies that taxpayers should be compared by their relative economic spending power during the taxing period.

The Article proceeds to identify fundamental limitations in the taxation of income and wealth as factors in economic well-being through separate instruments. If wealth should be taxed in additional to labor income, neither a wealth tax nor a capital income tax is the proper instrument. A wealth tax is a blunt tool that treats all savers equally, whereas a tax on capital income is an insufficient measure that fails to fully account for wealth as a factor in economic well-being. Furthermore, the taxation of both income and wealth through separate instruments cannot consistently compare taxpayers' relative economic well-being from both factors.

The Article subsequently introduces a combined base of economic well-being, as an alternative to either an income or a wealth tax. The combined base, defined as the sum of the taxpayer's wealth annuity value and labor income during the taxing period, yields a more consistent basis for comparing individuals' economic well-being from both income and wealth, and consequently for progressive taxation. This measure also quantifies economic well-being in terms of economic spending power during the taxing period and consequently tailors the progressive tax base to the theorization of how economic inequality causes social and political harm.

Boghosian, Adrian Devitt-Lee & Hongyan Wang, The Growth of Oligarchy in a Yard-Sale Model of Asset Exchange: A Logistic Equation for Wealth Condensation, https://arxiv.org/pdf/1608.05851.pdf.

[205] See the general statement of this consideration in Shaviro, note 196, at 6 (wealth taxation is positively correlated with negative externalities resulting from wealth inequality).