Capital Taxation in an Age of Inequality

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Abstract

The standard view in the U.S. tax law academy remains that capital income taxation is both a poor idea in theory and completely infeasible in practice. But this ignores the first-order importance of political economy issues in the design of tax instruments. The pervasive presence of gifts and bequests renders moot the claim that the results obtained by Atkinson and Stiglitz (1976) counsel against taxing capital income in practice.

Taxing capital income is responsive to important political economy exigencies confronting the United States, including substantial tax revenue shortfalls relative to realistic government spending targets, increasing income and wealth inequality at the top end of distributions, and the surprising persistence of dynastic wealth. It also responds to a new strand of economic literature that argues that “inclusive growth” leads to higher growth.

A flat-rate (proportional) income tax on capital imposed and collected annually has attractive theoretical and political economy properties that can be harnessed in actual tax instrument design. As a proportional tax, it applies at the same marginal and effective rates to both income and losses, thereby preserving the symmetry on which rests the theoretical analysis of returns to risk. A progressive consumption tax, by contrast, abandons this, and in doing so can burden the returns to waiting. Moreover, a flat-rate capital income tax is a progressive tax in application: because only high-ability taxpayers or those who are the beneficiaries of gifts and bequests can afford to defer consumption indefinitely, the increasing “tax wedge” on savings over time introduces a measure of top-bracket progressivity along the margin of time. In other words, what some see as the fatal flaw of capital income taxation in fact is a feature, not a bug.

The separation of a taxpayer’s income into capital and labor components, and
the application of separate rate schedules to each, are hallmarks of “dual income tax” instruments, of the sort explored in practice most comprehensively by several Nordic countries. Building on earlier work on dual tax systems and capital income tax structures, I propose a novel and reasonably accurate flat rate tax on capital income that builds on well-understood tax policies, that achieves integration between corporate and investor income, and that successfully distinguishes capital from labor income. I term this tax instrument the Dual Business Enterprise Income Tax, or Dual BEIT. Its virtues also include minimizing the relevance of the realization doctrine, eliminating distinctions across different forms of capital investment, and offering business enterprises a profits (consumption) tax environment in which to operate.

To make the project more tractable, the two themes just advanced – the why and the how of the Dual BEIT – are each the subject of a separate paper. This is the “why” paper. Together, the two demonstrate that the Dual BEIT satisfies theoretical concerns, once those are filtered through the political economy imperatives of the quotidian world, and is straightforward to implement and administer.
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EDWARD D. KLEINBARD *

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INTRODUCTION

A. THE PROJECT’S AGENDA

An old story recounts two old ladies sitting down to dinner at Grossinger’s, the long-defunct Catskill resort beloved of generations of New Yorkers. “Feh,” says the first, “the food here is terrible.” “Yes,” replies the second, “and such small portions, too.”

So it is with the standard view in the tax law academy of capital income taxation: it is a poor idea in theory—and completely infeasible in practice, too.1 This consensus view holds that the principal difference between ideal income taxes and ideal consumption taxes is that only ideal income taxes burden normal returns to capital—the dull, plodding returns that one might expect, for example, from an investment in government securities.2 In turn, continues the analysis, public finance economics

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1. Daniel Shaviro, Beyond the Pro-Consumption Tax Consensus, 60 STAN. L. REV. 745 (2007), is an exception in that it explores theoretical reasons derived from the new, dynamic public finance literature for taxing capital income. Other exceptions are David M. Schizer, Between Scylla and Charybdis: Taxing Corporations or Shareholders (or Both), 116 COLUM. L. REV. 1849 (2016) and David Gamage, The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth, 68 TAX L. REV. 355 (2015). Among other points, the latter two papers argue that multiple tax instruments with different tax bases are less susceptible to the deadweight loss of tax-avoidance strategies than is reliance on one tax instrument.

2. Intro.B, infra, discusses normal returns, including risk-adjusted normal returns, in more detail.
research, principally a landmark paper by Anthony Atkinson and Joseph Stiglitz, as well as important contributions by Christophe Chamley and Kenneth Judd, confirm in a rigorous manner the intuition dating back at least as far as John Stuart Mill that taxing normal returns is undesirable because it is economically inefficient—the same revenues can be raised with less deadweight loss by forgoing the taxation of normal returns.

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

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

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

6. Consistent with other legal academic work in this area, this Article refers to the Atkinson–Stiglitz result as the “A–S Theorem.”
7. See infra Part II.C.
8. Mark P. Gergen, How to Tax Capital, 70 TAX. L. REV. (forthcoming 2017) (on file with author) relies on political economy realities to motivate recommendations for taxing capital. In brief, Gergen recommends an annual wealth tax on publicly traded securities, and a compensatory tax
As developed in a 2015 book by the economist Dani Rodrik, the science of economics is encapsulated in the development of new mathematical models of economic behavior, each in turn illuminating different aspects of the world not fully explored in earlier models. But the art of economics—and very much a part of the job of an economist who offers policy advice—is picking the right model for the task at hand. The legal academy was quick to admire the elegance of the Atkinson–Stiglitz result, which, unlike some other economic models, could be explained through metaphorical arguments, but was a bit less deft at the art of deciding whether its assumptions mapped well onto actual political economy concerns.

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

The separation of a taxpayer’s income into capital and labor components and the application of separate rate schedules to each are hallmarks of “dual income tax” instruments, of the sort explored in practice most comprehensively by several Nordic countries. It is possible to design a comprehensive and reasonably accurate flat-rate tax on capital modeled on the Business Enterprise Income Tax (“BEIT”) for privately traded firms. See id. (manuscript at 28–37). While embracing Gergen as a fellow traveler along the path to less distortionary capital taxation, and grateful for his endorsement of the BEIT (albeit in restricted circumstances), this Article and its companion come to different recommendations in two principal respects. First, as discussed in Intro.D, the Dual BEIT is expressly designed to pass muster as a constitutional income tax rather than a direct tax on property. Second, the Dual BEIT rejects any recommendation to provide different regimes for public and privately traded firms as inducements to highly distortionary tax gaming behaviors.


income that is administrable, that builds on well-understood tax policies, that achieves integration between corporate and investor income, and that successfully distinguishes capital from labor income. I term this tax instrument the Dual Business Enterprise Income Tax, or Dual BEIT (where “BEIT” is pronounced “bite,” as in a tax bite). Its virtues also include minimizing the relevance of the realization doctrine, eliminating distinctions across different forms of capital investment, and offering business enterprises a profits tax environment in which to operate.

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

This is the “why” Article.11 More specifically, this Article makes the following claims:

First, the Atkinson–Stiglitz result is premised on the absence of preexisting capital acquired through gratuitous transfers—that is, on the idea that all capital is labor income stored in one period and consumed by the same individual in another. But the capital stock is not simply the result of lifetime consumption smoothing (that is, stored labor); instead, a substantial portion of the existing capital stock has been acquired through gratuitous transfers (that is, gifts and bequests). In fact, about one-half of the existing capital stock in the United States is held by virtue of such gratuitous transfers, and much of that wealth is extremely concentrated in its ownership.12 Economic models that assume that capital income is simply the byproduct of lifetime consumption smoothing—including, in particular, the Atkinson–Stiglitz result—thus are inapposite to the world we inhabit.

The pervasive presence of gratuitous transfers in the distribution of capital does not mean that the Atkinson–Stiglitz result is a second-best heuristic that remains approximately relevant to policy: instead, it means

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12. See infra Part II.A.
that this model has no practical lessons to teach for tax instrument design. Atkinson and Stiglitz have both said as much.13

Second, many observers are greatly troubled by the increasing concentration of income and wealth (and therefore capital income) across the income distribution of individuals.14 In contrast to the next point, which emphasizes the need for revenues to bolster investment and insurance programs that principally benefit less affluent taxpayers, this concern focuses on the very top end of the income distribution and accepts that there are independent social concerns raised by this increasing concentration. In the absence of some form of fiscal intervention, income and wealth inequality becomes a heritable gene (over and above any intergenerational gratuitous transfers) by virtue of the private educational market investments in human capital that wealth can purchase for the next generation.15 Capital taxation in some form responds directly to these concerns.

Third, the United States requires substantially higher levels of tax revenues than it currently raises, both to fund current government operations and to enable larger government investment and insurance programs that would augment the welfare of most Americans.16 Capital income taxes today are a significant fraction of total tax revenues, and replacing them would not be easy as a political economy matter. Those capital income taxes are baked into today’s prices for capital assets, so that radical changes will bring with them windfall gains and losses to affected taxpayers.

Fourth, important new publications by the International Monetary Fund (“IMF”) and the Organisation for Economic Co-operation and Development (“OECD”), among others, have reshaped the relationship between taxation and growth. These studies demonstrate that “inclusive growth” leads to higher growth, and therefore recommend a larger role in advanced economies for “redistributive” fiscal policies that bolster investment in the human capital of lower-income citizens.17 Standard neoclassical microeconomic models that view capital taxation as inimical to growth miss this critical channel. Further, those models appear inapposite at a time when governments and firms alike can borrow at

13. See infra Part II.C.
14. See infra Part II.A.
15. See infra Part II.
16. See generally EDWARD D. KLEINBARD, WE ARE BETTER THAN THIS: HOW GOVERNMENT SHOULD SPEND OUR MONEY (2014) [hereinafter KLEINBARD, WE ARE BETTER THAN THIS].
17. See infra Part III.D.
negative interest rates, which implies that the supply of capital is not a constraint on growth. 18

Fifth, a flat-rate (proportional) capital income tax that is measured and collected annually has attractive theoretical and political economy properties that can be harnessed in actual tax instrument design. As a proportional tax, it applies at the same marginal and effective rates to both income and losses, thereby preserving the symmetry on which rests the theoretical analysis of returns to risk. And as a political economy matter, a flat-rate capital income tax actually is a progressive tax in application: because only high-ability taxpayers, or those who are the beneficiaries of gratuitous transfers, can afford indefinite deferral of consumption, the increasing “tax wedge” on savings over time introduces a measure of top-bracket progressivity along the margin of time. In other words, what many economists view as the fatal flaw of capital income taxation (the increasing tax wedge over time) in fact is a feature, not a bug. 19

Sixth, annual capital income taxation has practical advantages over estate and gift taxation, or other taxes that effectively are paid in arrears (such as capital gains tax). The nominal tax rate required to have the same present value revenue impact can be lower, the opportunities for outright evasion are reduced (because capital flows leave a more visible contrail than does capital stock), transition issues are more tractable, and the system is less vulnerable to “one-time” tax holidays of the sort witnessed in the international tax arena in 2004. 20

Seventh, the tax law literature generally recognizes that a proportional consumption tax is a poor tax instrument for “redistributing” top-end income and wealth. 21 In response, the consensus recommendation is that the most efficient tax that also addresses top-end distributional concerns is a steeply progressive consumption tax. 22 But a progressive consumption tax structure vitiates many of the efficiency claims made for ideal consumption taxes (which claims generally rely on proportional tax rate structures). A

19. See infra Part IV.B.
21. See infra Part I.B. As developed in KLEINBARD, WE ARE BETTER THAN THIS, supra note 16, at 341–46, this concern is overstated when applied to investment and insurance programs addressed to lower-income recipients. When applied to most citizens, the spending side of the ledger is so progressive in its distributional impact that this fact dominates the design of the regressive tax system that raises the requisite revenue.
22. See infra Part I.B.
low, flat capital income rate imposed annually thus may offer some efficiency gains when compared with an “ideal” progressive consumption tax straw man, while still being progressive in fact.

Eighth, there is no reason, beyond pure coincidence, why an ideal income tax should burden labor income and capital income under the identical rate schedule. To the contrary, and as suggested above, a flat (proportional) tax on capital income can operate as progressive along the relevant margin of time, while an explicit progressive tax rate structure on labor income can both raise substantial revenues and do so in a way that satisfies political economy redistribution concerns.\footnote{See infra Part IV.B.}

In short, and without regard to new developments in the theoretical literature, the prevailing advice in the U.S. tax law academy not to tax capital income is inapposite, in first-order ways, when the exigencies of current social structures and political economy issues are squarely confronted. Once one focuses on the central importance of gifts and bequests in explaining the distribution of capital (and with it, capital income), the social policy issues of wealth and income inequality, and the utility of a symmetrical capital tax that applies the same effective and marginal tax rates to gains and losses, a tax on capital income becomes a much more rational policy instrument than much of the literature in the tax law academy of the last few decades would acknowledge.

The second of these twin articles makes the case that the Dual BEIT is an administrable and effective approach to taxing capital income that is both mindful of economic efficiency concerns and responsive to the political economy issues that confront the United States today.\footnote{Kleinbard, \textit{The Right Tax at the Right Time}, supra note 11 (manuscript at 3–4).} Section D of this Introduction briefly summarizes how the Dual BEIT would operate.

The Dual BEIT’s dual income tax structure requires the development of a new tax tool, namely a “labor-capital income tax centrifuge,” to tease apart labor and capital income when the two are hopelessly intermingled, as in the case of the owner-entrepreneur of a closely held business. One of the contributions of the companion article is to specify a feasible implementation of such a centrifuge.\footnote{Id. (manuscript at 40–46).}
B. TERMINOLOGY

1. The Components of Capital Income

Throughout this Article, I use the term “capital income” to comprise all returns to capital, in the narrow, traditional sense of that term. Capital income, of course, is not synonymous with “capital gain”; the latter is just one instance of capital income. Capital income includes, by way of example, interest and dividend income, property rental income, royalties, capital gains, and the imputed rental income of owner-occupied housing. Capital income also includes most net business income. Firms bring both labor and capital to bear in generating net income; at least in the case of publicly held corporations, however, the labor component is fully compensated and deducted from the business tax base. As a result, the remaining business tax base contains only capital income. (The problem of the closely held business—where an owner-entrepreneur puts both capital and labor to work, and where the net income of the firm cannot through simple inspection be divided into labor and capital income components—is addressed through the new “labor-capital income centrifuge” discussed in the companion article.)

Economists often equate capital (and therefore the measurement of returns to capital) with “real” assets employed in a business, by which they mean investments in tangible, greasy machinery or buildings or land, or even intangible assets like patents, trademarks, or goodwill, but not financial assets such as stocks and bonds. In a more quotidian sense, capital income is earned in respect of investments in both real assets and financial assets that, in the broadest sense, are indirect claims on those real assets.

Coordinating the taxation of returns to real and financial assets is one of the great challenges in designing an income tax on capital. Therefore, throughout this Article, “capital” comprises both real and financial assets.

The standard presentation in the legal tax literature basically divides the returns to capital into three categories. First are “normal” returns,

26. Thus, as used in this Article, the term “capital” does not include human capital.
usually (incompletely) explained as the pure return to waiting, or time-value-of-money returns. These represent the core risk-free return from postponing consumption of one’s wealth. These are the dull, plodding, interest-like returns that one might expect to earn, for example, by investing in a Treasury bond. To an economist, all capital earns at least this return.

Second are risky returns, the higher returns that one expects to obtain as compensation for accepting the risk of uncertain rewards. From an ex ante perspective, risky returns are measured by the risk premium associated with an investment, as reflected in its expected return less the risk-free normal return. Actual ex post risky returns, of course, will vary considerably from this expected return, and often will be negative.

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

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

28. See Robert H. Wessel, A Note on Economic Rent, 57 AM. ECON. REV. 1221, 1223 (1967) (“The traditional rent concept also enables us to divide, conceptually at least, factor compensation into two parts, payments which induce factors to work and surplus which only confers a greater reward for work which would have been done anyway.”).
both are marginal returns to a $1,000 marginal investment in their respective risk categories.29

As a result, in a world of perfectly efficient markets, ex ante risky returns to marginal capital investments are simply normal returns by another name. The practical utility in characterizing returns to risk as a separate category is that, first, tax systems burden ex post results, not ex ante expectations, and second, the category includes returns to pure bets (for example, many derivative instruments), where capital is not explicitly invested in the instrument at the start.30

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

For a business enterprise, the risk-free return is largely meaningless, just as its own cost of capital will never equal the government’s risk-free rate. A firm operates in a world of marginal investments with risk-adjusted normal returns whose ex ante expected returns substantially exceed the risk-free rate. For a firm to invest in risk-free assets would be to engage in negative arbitrage.31 And from the firm’s perspective, its cost of capital (which is to say, the minimum return demanded by investors in the firm) is an existential imperative. This distinction between risk-free and normal returns becomes important when implementing the Dual BEIT.32

30. Where the other side of the bet is also held by a U.S. taxpayer, both taxpayers face the same tax rates, and net losses are fully refundable (all assumptions in the standard tax presentation), the aggregate tax collected on such bets should be zero.
31. An exotic exception would be a securities dealer borrowing on a short-term basis to hold government bonds and using secured “repo” financing, which has a special creditor-friendly status under bankruptcy law, to do so.
32. In the language of the next subsection, the issue is relevant to the implementation of any profits-only tax through a mechanism that replaces the scaling-up framework of much of the literature, in which government can be viewed as purchasing a share of each asset outright, with a direct
2. Ideal Tax Norms

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

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

In the U.S. tax law academy, at least, any tax that by design does not burden normal returns often is swept up in the term “consumption tax.”

government subsidy for the marginal cost of capital expended to acquire the asset, as in a capital account allowance framework (including the capital account allowance type mechanism employed by the Dual BEIT) or, for that matter, an allowance for corporate equity, which provides a firm with full interest deductions plus an additional allowance in respect of its equity capital.

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

34. The apparent progressive rate structure of I.R.C. § 11(b)(1) (2012) is clawed back by the flush language at the end of that paragraph.

35. STAFF OF J. COMM. ON TAXATION, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART II, at 6–7 (Comm. Print 2007). See infra Part III.A.

36. Cf. Anthony B. Atkinson, Inequality: What Can Be Done? 309 (2015) (“Capital income is income generated by the ownership of an asset, and includes interest income, dividends on shares, rent, and capital gains/losses; it may include part of the income accruing to a person who owns a business . . . .”).

This would include a value-added tax, a wage tax, or a cash-flow tax. An ideal firm-level cash-flow tax looks very much like an income tax, except that firms are permitted an immediate deduction for any business investments that they make and must include in income all returns in respect of that investment, including the return of the original amount invested. Under the well-known “Cary Brown Theorem,” this seemingly innocuous step is understood to exempt from tax the normal returns on a taxpayer’s investment. A cash-flow tax thus is a profits tax (a tax on economic rents) because a well-designed one does not burden normal returns.

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

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

38. Noël B. Cunningham & Mitchell L. Engler, Prescription for Corporate Income Tax Reform: A Corporate Consumption Tax, 66 TAX. L. REV. 445 (2013) is a helpful summary comparison of different implementations of consumption taxes. The authors’ ultimate recommendation, for a corporate-level consumption tax (what this Article terms a profits tax) and individual investor income tax, id. at 484–85, points in the same general direction as does the Dual BEIT introduced in this Article and discussed at length in the companion article, Kleinbard, The Right Tax at the Right Time, supra note 11. The principal difference is that the proposal made herein contemplates a much more tightly integrated design for the investor taxation component so that the combination of investor and firm taxation yields a consistent flat-rate tax on capital income, measured and collected annually.

39. See infra Part I.A. A cash-flow tax is described in the literature as an R base cash-flow tax if it ignores financial flows entirely (such as borrowing money, paying interest thereon, and ultimately repaying the loan), and as an \( R + F \) base if financial flows are included in income when received (for example, when borrowing money) and deducted when repaid. INST. FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION 230–33 (1978).

40. John Brooks specified in more detail the key terms of the idealized income tax that most authors appear to assume. Brooks, supra note 27, at 263.
A cash-flow tax is simply one mechanism for implementing a profits tax while still preserving income tax-like optics (in particular, annual tax returns that look to receipts and expenses to determine a tax base). Another approach to designing a profits tax base for firms is to introduce a new tax deduction that is designed explicitly to exempt a normal return from tax.\footnote{DAVID F. BRADFORD, THE X TAX IN THE WORLD ECONOMY: GOING GLOBAL WITH A SIMPLE, PROGRESSIVE TAX 26–30 (2004).}

Under the standard interpretation of the components of capital income (as described in Part I), a deduction that offsets a firm’s normal returns from invested capital leaves only profits (rents) in the tax base because, under the standard interpretation, pure ex post returns to risk, in the form of capital-free bets, are taxed by neither an income nor a profits tax.

These cash-flow equivalent forms of profits taxes rely on a “capital account allowance,” “allowance for corporate equity” (“ACE”), or the like.\footnote{“Capital account allowance” is the terminology used, for example, in ROBIN BOADWAY & JEAN-FRANÇOIS TREMBLAY, CORPORATE TAX REFORM: ISSUES AND PROSPECTS FOR CANADA 45 (Mowat Centre, Sch. of Pub. Policy & Governance, Univ. of Toronto, Mowat Research No. 88, 2014). Other authors use synonymous terms, like “allowance for corporate capital.” E.g., OECD, OECD TAX POLICY STUDIES NO. 16, FUNDAMENTAL REFORM OF CORPORATE INCOME TAX 11 (2007). For reasons of personal history and idiosyncratic preference, I use “cost of capital allowance” (“COCA”).}

In the case of an ACE, for example, the combination of a firm’s deduction of its actual interest expense plus a notional deduction for a deemed normal return on the firm’s equity capital is designed to shelter a firm’s normal returns from tax. Several European countries have adopted ACE regimes as their corporate tax model.\footnote{The history of natural experiments in implementing ACE regimes is summarized in the companion paper, Kleinbard, The Right Tax at the Right Time, supra note 11 (manuscript at 21–22 & nn.21–22).}

A capital account allowance dispenses with a deduction for interest expense, and instead provides a single tax deduction for all of a firm’s invested capital, whether financed through debt or equity.

Most U.S. tax work in recent decades takes the cash-flow tax (or its economic equivalent, implemented through a capital account allowance), and in particular a progressive cash-flow equivalent tax along the lines of David Bradford’s X Tax, as its preferred instantiation of a consumption tax.\footnote{See generally, e.g., BRADFORD, supra note 41; ROBERT CARROLL & ALAN D. VIARD, PROGRESSIVE CONSUMPTION TAXATION: THE X TAX REVISITED (2012); Itai Grinberg, Implementing a Progressive Consumption Tax: Advantages of the VAT Credit-Invoice Method System, 59 NAT’T L. TAX J. 929 (2006); Shaviro, supra note 27; David A. Weisbach, Does the X-Tax Mark the Spot?, 56 SMU L. REV. 201 (2003).}

The X Tax actually is two taxes presented as one—a firm-level, single-rate, cash-flow equivalent tax coupled with a separate, progressive-rate, annual tax on labor income (for which the usual shorthand is
“wages”). The tax is “cash-flow equivalent” in that Bradford’s preferred implementation contemplated a capital account allowance mechanism rather than a simple cash-flow measure.

Because a cash-flow or cash-flow equivalent tax reaches rents, but not normal returns, the X Tax imposes a time-invariant flat-rate tax on consumption funded out of economic rents (because normal returns on investment are not taxed) and a progressive-rate tax on consumption funded out of wages. To prevent gaming of the personal tax rate schedule through corporate retained earnings, the X Tax’s cash-flow equivalent tax is set at the maximum personal wage tax rate, which has its own political economy issues in the current environment. Because the household-level tax is a wage tax, the X Tax can ignore financial flows, including borrowing and repayment of debt. Bowing to convention, this Article refers to the X Tax as a unitary progressive consumption tax.

A wag might suggest that the X Tax can be understood as the Dual BEIT Lite. Both impose the equivalent of a flat cash-flow (economic rents) tax on firms and a progressive tax on wages. To this, the Dual BEIT adds a flat-rate household-level tax on normal returns to business capital (as well as income from non-business investments, like government bonds). The Dual BEIT by design is an income tax, not a consumption tax—and this third component brings into the tax base the normal returns excluded by a consumption tax. This Article’s purpose is to justify doing so.

The Dual BEIT has many similarities to the “Growth and Investment Tax Plan” proposed in 2005 by former President George W. Bush’s Advisory Panel on Federal Tax Reform. As explained in Part I and in the

45. Robert Carroll and Alan Viard label the two components as the “household wage tax” and the “business cash-flow tax.” CARROLL & VIARD, supra note 44, at 25.
46. Shaviro, supra note 27, at 94.
47. Both Bradford’s X Tax and the Dual BEIT actually employ a COCA rather than cash-flow treatment to exempt firm-level normal returns from tax. Bradford stresses the utility of this approach in minimizing the consequences of tax rate changes over time. BRADFORD, supra note 41, at 28–29. For the Dual BEIT, the same COCA does double duty because it also serves as the means to measure normal returns at the investor level. Both the X Tax and the Dual BEIT thus are exposed to the risks of systematically mismeasuring the statutory COCA rate. These themes are discussed in the companion paper, Kleinbard, The Right Tax at the Right Time, supra note 11.
The Dual BEIT’s taxation of capital income is more tightly integrated than in the 2005 proposal, without relying on express dividend imputation schemes or the like. 49

The X Tax’s chief competitor in the legal academy is a progressive personal expenditure tax, where firm level income is untaxed, and individuals are taxed at progressive rates on their annual expenditures for personal consumption purposes. 50 In brief, under this tax, all individual financial inflows (including borrowings) would go into the tax base, and all savings outflows (including debt repayment) would be deductible. The difference corresponds to annual consumption.

The key difference between these two consumption taxes is that the X Tax employs a progressive annual labor income tax, while the progressive personal expenditure tax directly measures and taxes on a progressive schedule annual personal consumption. Alternatively, one can phrase the difference as analogous to that between a Roth Individual Retirement Account (“IRA”) and a conventional IRA—the personal tax component of the X Tax includes wages and ignores subsequent financial flows, including borrowing and repayment of debt, as well as returns to after-tax wage income. On the other hand, the personal expenditure tax includes financial returns (and borrowings) and deducts savings (including debt repayment). 51 Following a pioneering study by J.E. Meade and colleagues, the former design is referred to as an R-based approach (where R stands for real, as opposed to financial, assets), and the latter a (R + F) tax base. 52

Under certain assumptions—in particular, constant tax rates and the absence of economic rents—a Roth IRA and a conventional IRA yield equivalent outcomes. In the same way, both the X Tax and a progressive personal expenditure tax exempt normal returns from tax and point roughly in the same direction. 53 In their simplest forms, however, the two can lead to different lifetime tax burdens, depending on the interaction of annual

49. The 15 percent investor tax in the 2005 plan was not specifically designed to impose a single uniform tax on capital income (by taxing only normal returns to investors); individuals apparently would have had reason to stuff capital into business entities to benefit from the profits-only tax environment and deferral of the individual level of tax. See id.


51. CARROLL & VIARD, supra note 44, at 36–37.

52. INST. FOR FISCAL STUDIES, supra note 39, at 230–33.

53. In the X Tax, rents are captured at the firm level, and so they generally do not escape tax. (This also is true in the current income tax.) An individual investor with superhuman investment prescience would prefer the X Tax environment to that of a progressive personal expenditure tax.
wage levels and consumption against the backdrop of the progressive rate structure.\textsuperscript{54}

The standard consumption tax terminology sometimes can confuse, particularly when looking at firm-level taxes alone. A value-added tax, for example, is similar to a cash-flow tax in exempting a firm’s normal returns to capital (the return to a marginal investment), but it is different in a fundamental respect, which is that the value-added tax directly burdens labor income as well as economic rents (which is basically to say, all consumption), while the base of a business cash-flow tax by itself includes only economic rents. The distinction is important when looking past the effective marginal tax rate on investment to the distributional impact of a tax.\textsuperscript{55} This Article therefore generally restricts the use of “consumption tax” to instances where the tax base includes labor income as well as economic rents (treating the X Tax as a single tax on labor income and rents for this purpose).

Finally, the Article uses the term “mark-to-market” rather than “accruals” accounting to avoid confusion with cash versus accrual methods of income tax accounting.

\textbf{C. OUTLINE OF REMAINDER OF ARTICLE}

Making the case for taxing capital at all is a logical prior to developing a practical mechanism for doing so. The standard analysis in the tax law academy, relying on early important theoretical work by Atkinson and Stiglitz, rejects the proposition that normal returns to capital should be taxed and recommends instead reliance on progressive consumption taxes. Part I briefly summarizes this standard presentation. Part II responds by

\textsuperscript{54} See infra Part IV.A. The X Tax theoretically could be converted to a progressive personal expenditure tax, and thus track more closely annual consumption, by building into it a conventional IRA-type mechanism, under which wages contributed to an IRA account would be deducted from current wage income, and withdrawals from the account to fund current consumption would be taxed as additional wage income. This, however, would require a layer of complexity that proponents of the X Tax have preferred to avoid.

\textsuperscript{55} It is true, of course, that a firm-level profits tax and a complementary tax directly on labor income can be designed to reach the same tax base as a classic consumption tax, like the value-added tax. David Bradford’s X Tax is one example, albeit one that exposes labor income to graduated tax rates (as opposed to a flat rate identical to that imposed on economic rents, as in a value-added tax). BRADFORD, supra note 41, at 3–5. The Dual BEIT also is designed to incorporate individual-level progressive labor taxation in its reach, but unlike the X Tax, the Dual BEIT deliberately taxes individual investors on normal returns, so as to make the overall system an income tax. In considering revenue legislation, Congress generally looks at the revenue and distributional consequences of individual- and firm-level taxes separately.
demonstrating that, once one considers the pervasive presence of gratuitous transfers (gifts and bequests) in the distribution of wealth, the Atkinson–Stiglitz result is rendered moot as a policy guide. It therefore no longer serves to scold academics who venture to suggest that capital income is not such a bad idea after all—as Atkinson and Stiglitz themselves both agree.

Part III shifts the focus to explore the implications of the distribution of capital ownership, regardless of its mode of acquisition. Part III reminds readers that capital income and wealth are highly concentrated at the very top end of the distribution and that this concentration of income and wealth in all probability has increased in recent decades. This concentration incurs important social costs. Moreover, even today’s highly imperfect capital income tax system raises substantial revenues, and it is difficult to imagine, as a practical matter, how those revenues could be replaced, much less increased, through progressive consumption taxes alone. Finally, important recent research has demonstrated that economic inequality inhibits economic growth. Taxing capital in a coherent fashion (and investing the revenues in the human capital of lower-income citizens) responds to all three concerns.

Part IV makes the case that capital income taxes should retain their role as the most important form of capital taxation and that a flat-rate capital income tax, combined with a progressive tax rate on other income, has practical and efficiency gains over the usual ideal of a single progressive income tax. Moreover, a flat-rate tax on capital income, measured and imposed annually, in fact operates as a progressive tax over the relevant margin, which is time. A progressive consumption tax, by contrast, is poorly targeted at the political economy issues motivating this Article, and it abandons its proponents’ own claims of efficiency gains by virtue of its asymmetrical treatment of returns to risk. The flat-rate capital income tax is the better tax instrument for real-world tax policy.

Theory suggests that economic rents can bear higher tax rates than normal returns, but in practice it is much more difficult than is commonly appreciated to distinguish among normal returns, returns to risk, and rents. A firm’s rents, for example, are normal returns in the hands of a recent purchaser of the firm’s equity. Part V develops this proposition and concludes that a flat rate on all instances of capital income (normal returns, returns to risk, and rents) is the best compromise between competing efficiency and political economy demands.
D. HIGH LEVEL SUMMARY OF THE DUAL BEIT PROPOSAL

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

The Dual BEIT employs a capital account allowance to create a profits tax base for a firm’s business income. But unlike a standalone profits tax, the Dual BEIT is designed as a true income tax. The missing piece that must be added to economic profits (rents) to turn a profits-only tax into an income tax—basically, normal returns—is accomplished by requiring investors in business enterprises to include deemed normal returns in income every year. This is the unique feature of the Dual BEIT: a profits-only tax at the firm level, combined with a correlative tax only on normal returns at the investor level, equals an income tax on capital income. I use the term “cost of capital allowance” (“COCA”) to describe the Dual

56. The details of the Dual BEIT, as summarized here and further developed in the companion article, in particular, the dual income tax structure, supersede those presented in these earlier contributions. I first presented the BEIT and COCA ideas in 2007; their embryonic forms date back to 1989. See EDWARD D. KLEINBARD, REHABILITATING THE BUSINESS INCOME TAX 5 (Hamilton Project, Brookings Inst., Discussion Paper No. 2007-09, 2007) [hereinafter KLEINBARD, REHABILITATING THE BUSINESS INCOME TAX]; Kleinbard, Designing an Income Tax on Capital, supra note 27, at 179; Edward D. Kleinbard, Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System, 67 TAXES 943, 946–47 (1989) [hereinafter Kleinbard, Beyond Good and Evil Debt].

For readers familiar with the earlier papers, the major developments include:

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

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

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

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

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

57. A capital account allowance has the advantage over an allowance for corporate equity in not encouraging the issuance of equity-flavored debt instruments. And cash-flow equivalent taxes in general have the advantage over cash-flow taxes of easier transitions from current law because existing investments in assets—that is, tax basis—at the time of transition does not become useless in the new regime and because they are less susceptible to windfall gains and losses through the timing of investments as tax rates change. David F. Bradford, Transition to and Tax-Rate Flexibility in a Cash-Flow-Type Tax, 12 TAX POL’Y & ECON. 151, 152–53 (1998); Christian Keuschnigg & Martin D. Dietz, A Growth Oriented Dual Income Tax, 14 INT’L TAX & PUB. FIN. 191, 197 (2007).
BEIT’s firm-level capital account allowance. Importantly (and again, uniquely), the same COCA rate is applied at the investor level to measure investors’ deemed normal returns on their investments in business capital.58

Congress today is riven by different views on how to structure corporate income tax reform, including, in particular, the international income of U.S.-based multinational enterprises.59 As a political economy matter, the Dual BEIT largely dissolves these differences—and does so in a way that declares most everyone a winner. U.S. businesses will operate in a profits tax environment, and less-leveraged firms will no longer be at a competitive disadvantage to aggressively-leveraged ones in respect of their income tax burdens. The “missing” revenue that would follow from adoption of a true profits tax is not missing at all, but rather is taxed at the level of investors, who in general are much less mobile than are firms.

The Dual BEIT looks superficially much like the current income tax. The Dual BEIT taxes all business operations identically (by taxing all enterprises, regardless of legal form, as taxpaying entities, and subjecting them to the same rules).60 At its simplest, the Dual BEIT imposes a firm-level flat-rate profits-only tax, implemented through its COCA, which is a deduction equal to a statutorily set rate (as an arbitrary example, one-year Treasury Bills plus 300 basis points)61 applied to all of a firm’s business capital, whether actually financed by debt or equity.62 In other words, at the firm level, the COCA deduction is a capital account allowance mechanism. The COCA deduction replaces deductions for interest, rent, and royalty expenses, and, because it applies to the entirety of a firm’s business capital, it renders moot for tax purposes the firm’s capital structure.63 At the business enterprise level, then, the Dual BEIT operates as a profits tax

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58. I first deployed the term in 1989. See generally Kleinbard, Beyond Good and Evil Debt, supra note 56.
60. The importance of this foundation is described in KLEINBARD, REHABILITATING THE BUSINESS INCOME TAX, supra note 56, at 14, and Kleinbard, Designing an Income Tax on Capital, supra note 27, at 179. Exceptions would be made for genuinely micro-scale businesses.
61. The reasons why the COCA rate should be a risk-adjusted normal return, rather than a risk-free normal return, are discussed in the companion article. Kleinbard, The Right Tax at the Right Time, supra note 11 (manuscript at 46–58).
62. KLEINBARD, REHABILITATING THE BUSINESS INCOME TAX, supra note 56, at 11–14; Kleinbard, Designing an Income Tax on Capital, supra note 27, at 180–89. See supra note 45 and accompanying text as to the continuing relevance of these.
63. KLEINBARD, REHABILITATING THE BUSINESS INCOME TAX, supra note 56, at 17; Kleinbard, Designing an Income Tax on Capital, supra note 27, at 180.
through the mechanism of a capital account allowance rather than through expensing of all investments.

The Dual BEIT taxes investors in business enterprises each year at a flat rate on a deemed normal return on their business investments (“Includible Amounts”), again regardless of how those investments are denominated.64 The deemed normal return is the same COCA rate—but now applied as an income-measuring device in respect of an investor’s investments in firms. Cash returns on investments are ignored except insofar as they are treated as reductions in invested capital (that is, tax basis).

At the investor level then, the COCA mechanism functions much like original issue discount: investors include in income the statutory COCA rate, and if that amount is not paid in cash, investors add the income to their investment (tax basis). All cash flows received in respect of an investment in a business enterprise, however denominated, simply reduce the investor’s unrecovered investment for purposes of applying the COCA rate in subsequent periods.

Ideally, these rules would apply to institutions that today are tax exempt as well as to individual investors. I recognize, however, that this is not a probable practical outcome. To the extent such institutions remain tax exempt, one can nonetheless take comfort in the fact that the effective marginal tax rate on firms’ leveraged investments in equipment, where the leverage is provided by tax exempts, will have been brought up from negative tax rates (that is, circumstances where after-tax returns exceed pretax returns) to zero, and current law creative debt or other structures designed to strip out economic rents to tax-exempt investors will face a positive tax liability at the firm level.

A U.S. investor will be taxed under the Dual BEIT’s investor rules in respect of investments in foreign businesses so that there is no incentive to favor foreign over domestic firm investments (or vice versa). Since the Dual BEIT does not require any information to pass from firm to investor in order for the investor to calculate tax liability, this is perfectly feasible.

Current law will continue to measure the amount of an investor’s non-business interest income, which in turn will be taxed at the same flat capital income tax rate as is applied to investor-level business capital income.

64. KLEINBARD, REHABILITATING THE BUSINESS INCOME TAX, supra note 56, at 12–13; Kleinbard, Designing an Income Tax on Capital, supra note 27, at 182–84.
Thus, interest income from Treasury securities would be measured under current law. The Internal Revenue Code in fact does a very credible job of applying original issue discount principles consistently to such securities. All other instances of capital income (rents or royalties, for example) would be deemed to arise in the conduct of a business, and thus fall under the Dual BEIT’s two-level tax environment. Miscellaneous income today considered capital gains (e.g., gains from sales of art or collectibles) would be taxed at labor income rates.

An income inclusion equal to a specified interest rate applied to a taxpayer’s investment in a financial asset, which in turn is taxed at a specified tax rate, could alternatively be expressed as a simple annual wealth tax on that asset at a wealth tax rate equal to the deemed return rate, multiplied by the income tax rate on that deemed return. It is likely, however, that an actual annual wealth tax, even if limited to a taxpayer’s business investments, would be viewed as a “direct” tax, as that term is used by the U.S. Constitution. In turn, any “direct” tax must be apportioned among the states in proportion to their populations. This requirement is impossible to satisfy in practice because it would impose different tax rates on residents of different states, depending on their relative wealth. Whatever optimism one might have had in years past that the Supreme Court might adopt a narrow reading of the direct tax clause largely has been overwhelmed by the vituperative debate surrounding the constitutionality of the Affordable Care Act.


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

68. Nat’l Fed’n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566, 2608 (2012) (5-4 decision) (upholding constitutionality of the Affordable Care Act as a tax); Jasper L. Cummings, Jr., The Supreme Court, Federal Taxation, and the Constitution 230 (2013) (“The most important aspect of [the majority opinion in Sebelius] is the ‘dog that didn’t bark’ (or perhaps barked softly): the Chief Justice did not go out of his way to extol the federal taxing power, in contrast to statements made by even conservative Justices of the past in describing the federal taxing power.”). Remember as well that Chief Justice Roberts, in the majority opinion in Sebelius, was careful to cite Pollock v. Farmers’ Loan & Trust Co., 158 U.S. 601, 618 (1895), and he implied that it remained good law. See Sebelius, 132 S. Ct. at 2598 ("In 1895, we expanded our interpretation to include taxes on personal property and income from personal property, in the course of striking down aspects of the federal income tax."
This presents a special issue for the investor-level taxation contemplated by the Dual BEIT because its annual "income" in the form of a deemed return on investment might be at risk of being characterized as an indirect means to an impermissible direct tax on property.\(^{69}\) The response is to permit an investor who sells an investment at a loss relative to the investor’s adjusted tax basis to claim a loss deduction (at the capital income tax rate) up to the amount of prior deemed income inclusions. Losses beyond this amount (losses of principal) would be ignored, just as capital gains are ignored.

This loss-allowance rule should be sufficient to distinguish the Dual BEIT from an explicit or stealth wealth tax. In the latter case, diminutions in value do not trigger rebates of prior taxes on the property’s former higher value. The loss-allowance rule also can be justified as a normative matter because the imputed return mechanism of the Dual BEIT is meant to serve as an administrable approximation of the normal returns that an investor expects to earn; where the expectation is definitively unmet, reversing the prior inclusions is appropriate.\(^{70}\) As a result, while the Dual

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\(^{69}\) _Pollock v. Farmers’ Loan & Trust Co._, 158 U.S. 601, 618, 15 S. Ct. 912, L. Ed. 1108 (1895). That result was overturned by the Sixteenth Amendment, although we continued to consider taxes on personal property to be direct taxes. _See Eisner v. Macomber_, 252 U.S. 189, 218–219, 40 S. Ct. 189, L. Ed. 521 (1920).\(^{7}\) By contrast, Gergen, _supra_ note 8 (manuscript at 1–5) argues in favor of periodic federal wealth taxation. Gergen acknowledges the constitutional issue, and essentially does not address it. _Id._ (manuscript at 2 n.2). This author, at least, has little enthusiasm for developing a new tax instrument that on its face would precipitate a similar tsunami of constitutional criticism.

\(^{6}\) That decision has been vigorously criticized from the day it was handed down, _e.g._, _id._ at 638 (Harlan, J., dissenting); the best response to the majority’s reasoning would have been that framing matters, particularly when dealing with terms that have no real substantive meaning in economics. The particular issue, of course, was resolved through the adoption of the Sixteenth Amendment, authorizing a federal income tax. U.S. CONST. amend. XVI.

For all the criticism leveled at the case, it has never been overruled. In the absence of a loss deduction, the fact pattern here, where the income in question is completely notional in its measurement, surely would be at risk.

_Schenk, supra_ note 65, at 441–42 speculates that an income tax on notional risk-free returns might, or might not, survive a constitutional challenge as an unapportioned direct tax. This points in the direction of the Dual BEIT, but, as explained in the text, the Dual BEIT makes one critical move that I believe resolves any constitutional ambiguity, which is that it permits a loss deduction if the deemed returns are never actually realized. In addition, the Dual BEIT applies to business investments only, and in that context, is part of a larger fabric to ensure that business income is taxed once and only once.

By relying on a deemed return to capital for one part of its income tax, the Dual BEIT materially attenuates the importance of the realization doctrine. I therefore submit that the Dual BEIT in fact responds to Schenk’s challenge that “[t]he realization requirement essentially makes the tax on capital income avoidable and so far no one has offered an effective stratagem to limit this.” _Id._ at 424.

\(^{70}\) The coexistence of a business enterprise net operating loss and an investor-level loss is not necessarily a double deduction. The former typically would arise from expensing (or the equivalent, in
BEIT’s investor-level tax is in economic substance close to a periodic tax on domestic owners of capital, it remains a constitutional whisker away.

The incidence of the Dual BEIT should fall predominantly on domestic capital owners (the investors in financial claims against firms) because firms themselves face a zero effective marginal tax rate on new investments yielding normal returns. Like any tax on savings, the investor component of the Dual BEIT conceivably might affect total savings by domestic owners of capital, depending on competing income and substitution effects. Nonetheless, an individual-level tax of this sort does not necessarily create a capital vacuum for investments in attractive U.S. business opportunities because foreign investors (to whom the income inclusion rules would not apply) will make up any shortfall in domestic savings.71

The combination of the firm-level profits tax base and the investor-level tax on normal returns is a single tax on capital income (again, relying on the standard view summarized in Part I that returns to risk-taking are not burdened by flat-rate income or profits taxes). The Dual BEIT taxes all capital income once, and only once, without cumbersome (and frequently abused) integration schemes or the like. Economic profits are taxed to the enterprise, and normal returns to investors. The Dual BEIT thus replaces the disarray of current law’s taxation of capital income with a coherent regime in which all capital income, regardless of legal label, is taxed once and only once at a consistent rate, without any need for explicit coordination, “franked” dividends, or the like.

Using the same COCA rate for firm deductions and investor inclusions of normal returns has felicitous political economy ramifications. So long as the commitment to preserve the identity between the two rates is maintained, any legislative impulse to over-endow firms with capital allowance deductions would imply overtaxing investors to the same extent.

The “dual” part of the Dual BEIT contemplates that capital income will be taxed at a flat rate so that business enterprises and investors alike will pay the same rate on their respective tax bases—again, by way of arbitrary example, 25 percent. Choosing a moderate rate mitigates the distorting effects of high marginal rates on some capital income, but nonetheless should collect substantial tax revenues—especially when compared with Congress’s current partiality to bonus depreciation and similar incentives that distort the allocation of capital, along with essentially unlimited interest deductions. It falls to this Article to make the case that a flat-rate tax on capital income is appropriate as a matter of political economy and tax theory.

As with the X Tax, labor inputs are fully deductible to a business enterprise and taxable to individuals under a progressive tax rate schedule. The top tax rate on labor and miscellaneous income would exceed the moderate rate specified for capital income under the Dual BEIT—for example, 40 or 45 percent in the case of labor and miscellaneous income, in contrast to a flat 25 percent tax rate applied to firms and investors under the Dual BEIT. The following Section briefly describes some of the tradeoffs implied by this and other plausible rate structures.

The Dual BEIT is an administratively feasible tax, even for a large modern economy like the United States’. Its components are analogous to features of the current income tax (interest expense deduction, inclusion of original issue discount income), save for the new labor-capital income centrifuge, even though the combined effect of these component parts is a single tax on capital income, measured with greater accuracy than under current law. The flat-rate capital income tax structure means that the tax burdens imposed by the Dual BEIT in many instances are more neutral than those of a progressive-rate cash-flow tax because it applies symmetrically to gains and losses from risky investments. The tax can easily accommodate ordinary lifetime consumption smoothing goals, through mechanisms such as IRAs, but they would be capped at a reasonable amount of deferred income. The resulting capital income tax accordingly becomes a tax instrument addressed to holders of substantial capital.

The Dual BEIT neutralizes the importance of different depreciation or capitalization regimes, automatically coordinates firm-level and investor-level incomes, and attenuates (but does not wholly eliminate) the consequences of the realization doctrine. The tax liabilities of investors are driven by the capital they invest, not the label of the instruments they hold.
What is more, the Dual BEIT moves a large fraction of capital income to the level of investors, rather than firms—a development that has important political economy ramifications in light of the relative international capital mobility of firms compared with people. Further, the capital account allowance mechanism mitigates transition issues when compared with a cash-flow tax.\[supra\] note 41, at 28–30.

The Dual BEIT also eliminates enormous layers of firm-level tax rule complexity, such as the debt-equity distinction, the multiplicity of rules for different forms of business organization, the consolidated return rules, and the elaborate “tax-free reorganization” (merger) rules. All that legal infrastructure can be discarded. The result is a relatively featureless tax topography, with few conceptual peaks or chasms where the tax analysis suddenly shifts from one mode to another.

Finally, the Dual BEIT, although an income tax, offers corporate managers a profits (consumption) tax environment in which to conduct business. This is a very attractive feature of the Dual BEIT from a political economy perspective and should resonate with managers who today express concern about international “competitiveness.” Their firms will face a narrower tax base, in which marginal investments are subject to an effective marginal tax rate of zero.

For all these reasons, the Dual BEIT is the right direction in which capital income taxation should head.\[supra\] note 57, at 192 propose a roughly analogous dual income tax, also emphasizing the efficiency gains relative to current law. As in the Dual BEIT proposal, Keuschnigg and Dietz contemplate a firm-level profits-only tax, in their case implemented through an allowance for corporate equity, rather than a uniform allowance for corporate capital; the difference is simply that the former contemplates keeping interest deductions, while the latter replaces interest deductions with the uniform capital allowance. Id. at 193. Unlike the Dual BEIT, however, the Keuschnigg and Dietz proposal retains the realization principle for income inclusions at the investor level and, in turn, relies on retrospective interest charges (analogous to the U.S. rules for gains from passive foreign investment companies) to remove the benefit of deferral. Id. at 196. The Keuschnigg and Dietz proposal also does not cap investor-level tax at normal returns, thus setting up possible double-tax scenarios. Finally, the sum of firm-level and investor-level taxes on capital income in the Keuschnigg and Dietz proposal is intended to be the same as the top rate of labor income, id. at 208, thereby avoiding the necessity to design a labor-capital income centrifuge, but arguably taxing capital income at too high a rate to achieve all the efficiency goals it sets for itself.

\[E.\] Tradeoffs in Tax Rate Structures

The Dual BEIT’s tax rate structure employs a flat moderate tax rate on all business capital income (for example, 25 percent) and progressive tax rates on labor and miscellaneous income that reach a higher ceiling (for
example, 40 or 45 percent). The Dual BEIT’s suggested tax rate structure thus differs from that of the 2005 President’s Advisory Panel’s Growth and Investment Tax or David Bradford’s preferred instantiation of his X Tax. Both of these proposals contemplated a firm-level profits tax imposed at a rate equal to the highest labor income tax rate, while the Dual BEIT taxes firm-level profits (economic rents) at the same middling rate as the rate imposed on individuals’ normal returns. There are complex tradeoffs underlying either approach, and deciding which to adopt rests in large measure on pragmatic political economy considerations.

The Growth and Investment Tax and the X Tax can be said to tax economic rents more appropriately, in that rents in theory can absorb higher tax rates than the middling rate adopted by the Dual BEIT. From the other direction, however, it is much more difficult to identify rents in the field than is sometimes appreciated. One rebuttal is that the difficulty relates to distinguishing returns to risk from rents; so long as the firm tax is a flat rate and losses are fully refundable, the difference should not affect behavior, for the reasons developed in Part I. But in reality, no legislature is likely to adopt a tax system with immediate refunds of losses. Given this reality, the likelihood of asymmetrical after-tax payoffs to risk looms large, particularly if the value of those losses disappears upon a firm’s bankruptcy. Faced with this reality, the theoretical case for taxing a firm’s profits at the highest labor income rate becomes less compelling.

The Growth and Investment Tax and the X Tax do not require a labor-capital income centrifuge to tease apart labor from capital income in the case of the owner-entrepreneur of a closely held firm. Instead, self interest will do the trick: the owner-entrepreneur will not leave money inside her firm as a tax planning device when the tax rate on firm income is at the maximum marginal labor tax rate. On the other hand, these two taxes encourage owner-managers to compensate themselves up to that maximum rate, so as to fill the bucket of all the lower marginal labor income tax brackets. Neither proposal has any mechanism to address excess compensation beyond case-by-case litigation.

By contrast, a dual income tax does require the introduction of a labor-capital income centrifuge to tease apart labor and capital income when

74. These are similar to the tax rates adopted in Norway’s first-generation dual income tax. Kleinbard, An American Dual Income Tax, supra note 10, at 55.
75. See infra Part V.
76. See id.
those two factors are intermingled. The companion article takes up the challenge of describing the design of such a labor-capital income centrifuge.

Most important, the lower firm rate of the Dual BEIT reflects the practical reality that, whatever the theory, current U.S. policy debates point unequivocally in the direction of lower headline business enterprise tax rates. In large part, this reflects the “competitiveness” rhetoric in which our Congress and chief executives wallow. Recent policy debates surrounding the “destination-based cash-flow tax” described in the companion article demonstrate that headline rates matter to policymakers, regardless of how carefully one explains that a higher rate on a profits-only base really is a lighter burden. The Dual BEIT thus will be attractive to firm managers precisely because it imposes a lower headline rate than the current corporate income tax; the smaller base adds to its attractiveness, but the headline rate matters disproportionately to its substantive significance.

The attractions of moderate business enterprise headline rates also reflect, however, a more nuanced view that firms and their global capital allocations are much more mobile than are individuals and their savings; in a world awash in stateless income tax planning by multinational firms, the smart move is not to imagine that transfer pricing gaming can be controlled, but rather to tax firms more lightly and shift more of the burden to less mobile individual investors.

The Dual BEIT adopts a quasi-origin-based international tax system (to use value-added tax terminology) in the form of worldwide tax consolidation for U.S.-based firms coupled with a per-country foreign tax credit. In income tax terms, it can be viewed as a residence-based tax system or, alternatively, as a territorial system coupled with an anti-abuse rule in the form of a per-country soak-up minimum tax, the rate of which is the same as the domestic tax rate.

77. See id.
80. Kleinbard, The Right Tax at the Right Time, supra note 11 (manuscript at 58–68). This admittedly puts pressure on the definition of what constitutes a U.S.-resident firm, but the companion article argues that this is a very overstated concern.
81. Id. at 61.
Worldwide tax consolidation is an effective response to the stateless income tax gaming that dominates the taxation of foreign direct investment today, and as to which David Bradford struggles to develop a very convincing solution for his origin-based X Tax. But this solution requires a moderate tax rate—first, to minimize deadweight loss through the imposition of higher tax rates on real business activity in low-tax jurisdictions and, second, to address the concerns of the “competitiveness” lobby, who will discount the importance of moving to a firm-level profits tax in their demands for lower headline rates.

Foreign investors in U.S. firms will obtain the full benefit of U.S. profits-only business taxation because that is the base of the business enterprise tax. (The direct U.S. taxation of such foreign investors on their U.S.-source income—for example, through compensatory U.S. withholding taxes—is a separate question.) This makes investment in U.S. domestic business operations attractive to foreign investors and U.S. investors alike—particularly if the U.S. profits-only tax rate is in the range suggested by this Article (around 25 percent).

Moreover, the Dual BEIT contemplates that the same tax rate will apply to individual investors and to firms. While it is possible to use the Dual BEIT to impose a higher tax rate on firm-level profits than on normal returns to individuals (or vice versa), doing so puts substantial additional stress on getting the COCA rate correct to avoid systemic under- or overtaxation. Given that the COCA mechanism promises rough justice and no more, it also counsels in favor of the same moderate business enterprise tax rate as the income tax rate imposed on investors. Finally, the identity of tax rates gives political comfort to each side that the compromises reached when legislation is adopted are likely to stick. Even if one could distinguish firm ex post returns to risk from rents, practical concerns along these lines...
lead to the conclusion that steeply higher tax rates on rents probably are infeasible.

A tax burden on normal returns of around 25 percent can be understood at least as moving in the direction of a pure profits-only tax, even if such a system does not fully achieve all the purported efficiency ends of taxing normal returns at zero.85 Importantly, a low, flat-rate tax on normal returns does so while largely avoiding the extraordinarily difficult transition issues that would be raised by the replacement of an existing capital income tax with a consumption tax.86

I. THE (NON)LESSONS OF OPTIMAL TAX THEORY

Writing two long articles on the institutional engineering required to implement a successful income tax on capital presupposes a commitment to either the wisdom or the necessity of capital income taxation. This Part I begins to make that case. The focus here through Part III is on why capital taxes that burden normal returns are not proscribed by the reading of optimal tax theory prevalent in the legal academy and why capital taxation responds to important political economy exigencies. Part IV continues the argument by demonstrating why capital income taxes (as opposed to other capital tax instruments) should remain the most important form of capital taxation in the United States.

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

85. See Sijbren Cnossen, Taxing Capital Income in the Nordic Countries: A Model for the European Union?, in TAXING CAPITAL INCOME IN THE EUROPEAN UNION 180, 187 (Sijbren Cnossen ed., 2000) (explaining that it “should be possible to tax capital income positively, but that moderation is advisable”).

A. IDEAL INCOME AND CONSUMPTION TAXES

There is a vast literature exploring the taxation of capital income under idealized tax systems, both from a tax law and a public finance economics perspective.\(^{87}\) Painting with a broad brush, much of the literature begins with the standard decomposition of capital income into normal returns, risky returns, and rents, and then proceeds to consider how each of these types of returns is taxed under an ideal income tax or, alternatively, an ideal profits tax implemented as a cash-flow tax.\(^{88}\)

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

The standard analyses of the tax burdens imposed on stylized income and cash-flow (or other profits) taxes hinge on a common strategy of “scaling up” (or, alternatively, “grossing up”) an investment to obviate the tax burden on certain returns, in whole or in part.\(^{89}\) The application of this principle in the cash-flow tax context is usually traced to Cary Brown, who demonstrated that expensing an investment that yielded normal returns was the same as exempting the investment’s yield.\(^{90}\) This of course exactly


\(^{88}\) This convention is not unique to the tax law literature. See generally JAMES MIRRLEES ET AL., TAX BY DESIGN (2011); Peter Birch Sørensen, Can Capital Income Taxes Survive? And Should They?, 53 CESIFO ECON. STUD. 172 (2007) for examples in the public finance tradition.

\(^{89}\) Alvin C. Warren, Jr., How Much Capital Income Taxed Under an Income Tax Is Exempt Under a Cash Flow Tax?, 52 TAX L. REV. 1, 15–16 (1996) explores the two different applications of the scaling-up principle to show how a cash-flow tax exempts normal returns and to explain how ex post returns to risk are not taxed under an ideal income or profits-only tax.

\(^{90}\) E. Cary Brown, Business-Income Taxation and Investment Incentives, in INCOME, EMPLOYMENT AND PUBLIC POLICY 300, 309–10 (1948). What is today called the Cary Brown Theorem
describes how a cash-flow tax operates: by expensing all investments, therefore, it is said that a cash-flow tax exempts from tax the normal return on those investments.

Cary Brown’s insight is sufficiently straightforward, such that it is taught in many introductory income tax courses. An investor permitted to expense an investment—that is, an investor operating in a cash-flow tax environment—receives an immediate cash refund of the tax benefit of that deduction, which can be used to buy more of the same investment (the simplest assumption being that, since the investment yields only normal returns, there should be infinitely inelastic supply), which in turn generates a second deduction, and so on, until the investor has a total investment, not of her original pretax investment of \( I \), but rather of \( I / (1 - T) \), where \( T \) is the tax rate. The cash-flow tax applied to this scaled-up investment yields a return, \( r \), equal to the investor’s pretax rate of return: that is, \( r (1 - T) \times I / (1 - T) = rI \). In short, the tax deduction afforded by the immediate write-off of investments under a cash-flow tax means that government theoretically funds the scaling up of the investor’s investment without cost to the investor, thereby immunizing the investor from any tax burden on normal returns.

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

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92. Another formulation of the same point is that the government has purchased an undivided partial interest in the investment, so that the investor’s after-tax investment (immediately following an original investment) is simply smaller than the pretax investment, and the investor therefore can acquire more of the asset than would be possible in a tax-free environment, using the government’s money to do so. A third formulation is that the government can be described as making an interest-free loan to the investor, repayable when the investment is sold. All are simply different phrasings of the same phenomenon. But see Brooks, *supra* note 27, at 258 (arguing that the scaling-up story is incomplete, in that it does not properly account for risk aversion).

difference between a well-designed income tax and a cash-flow (or other profits-only) tax: by design, the former taxes normal returns, whereas the latter exempts them from the tax base. The measure of success of a capital income tax under this view is its ability to measure and tax normal returns consistently. ⁹⁴

Rents are taxed under both a cash-flow tax (or other profits tax) and an income tax. In the income tax case, rents simply are taxed as income. In the profits tax case, whether implemented as a cash-flow tax or otherwise, those returns either are taxed directly or fund consumption (which is all that money is supposed to be good for), which in turn is taxed. The critical assumption here is that an investor has already exploited all the rents available, and that under a cash-flow tax, the investor therefore can expect to earn only normal returns on a government-funded additional investment. Because rents cannot be scaled up (there being no additional rent-bearing investments to make), rents are taxed under the ideal cash-flow tax. Taxing rents is viewed as unproblematic because, even after a substantial tax burden, rents are more desirable than the next best alternative (investing in generally available marginal returns). ⁹⁵

B. THE THEORY OF WHY IDEAL CONSUMPTION TAXES DOMINATE INCOME TAXES

Under the consensus tax law academy analysis, the difference between an ideal income tax and an ideal consumption (profits-only) tax is that only the former burdens normal returns. But this does not answer the question: is burdening normal returns to capital a good idea or a bad one?

The Atkinson–Stiglitz result (“A–S Theorem”) offers a clear answer to this important question, viewed from within the Theorem’s assumptions. The clarity of the A–S Theorem’s answer and its susceptibility to presentation through easily understood metaphors explain its continuing hold over the tax law academy.


⁹⁵. Bankman & Griffith, supra note 93, at 406 (arguing that taxation of economic rents is “much less troublesome” than taxation of normal returns).
In a nutshell, the A–S Theorem holds that, if an optimal progressive wage tax is an available tax instrument for government to deploy, and if certain conditions are satisfied (which conditions either do or do not approximate reality, depending on which strand of the post-A–S Theorem literature one prefers), then there is no reason to employ differential commodity taxation on top of that progressive wage tax, whether for revenue or “redistributive” purposes. The conditions underlying the A–S Theorem include the absence of inheritances (so that wage rates and hours worked alone determine income); that individuals differ only in their wage rates (earnings ability); and that individuals with the same wage incomes have the same consumption preferences (including the preference to defer current consumption for future consumption), even if one, for example, must work twice as many hours as the other to earn that income, and therefore has fewer hours available for leisure (This last assumption is termed the “weak separability of leisure.”)

The A–S Theorem effectively treats the taxation of normal returns as a form of (undesirable) differential commodity taxation. The Theorem does so by considering future consumption goods (tomorrow’s apples) as just more potential consumption goods arrayed today on the buffet table of a consumer’s life, along with present-day consumption goods (today’s apples). To buy tomorrow’s apples, an individual with a fixed budget constraint must forgo today’s apples (or tomatoes, or whatever) and invest the savings at normal rates of return. When an individual does so, her budget in the future reflects the interest return on her savings as well as today’s forgone consumption. An individual’s “purchase” of tomorrow’s apples, by forgoing current consumption, signals that the slightly larger quantity of apples she can buy tomorrow with the interest on her forgone consumption compensates her today for deferring the pleasure of biting into a juicy Red Delicious right now.

A tax on an individual’s returns on savings serves to increase the after-tax price of tomorrow’s apples relative to today’s, when compared to the relative prices of the two goods in a world without taxes. This distortion in relative prices through the introduction of a tax on returns to savings therefore operates as a differential commodity tax. By contrast, a wage tax

96. See infra Part II.B.
98. Kaplow, supra note 97, at 1239.
reduces an individual’s budget constraint, but does not distort the relative prices of the consumption goods arrayed before her. 100 In other words, inside the A–S Theorem, a flat-rate wage tax is the equivalent of a flat tax on lifetime consumption, because the timing of consumption decisions does not change the present value of a taxpayer’s lifetime tax burdens. 101

From this follows the fundamental conclusion that consumption taxes dominate income taxes. Since the source of all consumption inside the model ultimately relates back to the agent’s wages (because there is no wealth inside the model at the outset), the income tax imposes two forms of deadweight loss on the agent—the unavoidable distortion of the agent’s labor-leisure tradeoffs (because leisure is not taxed in the model any more than it is in the real world) and a second distortion in the relative prices of current and future consumption goods. The wage tax, by contrast, preserves the pretax relative prices of current and future consumption goods without imposing any additional burden on the labor-leisure tradeoff. 102

In the U.S. law school academy, the analysis of the wisdom of capital income taxation has been dominated for many years by the pathbreaking work of Joseph Bankman and David Weisbach, 103 who introduced to tax law academics the A–S Theorem. 104 The A–S Theorem has been described as “arguably the most relevant result for policy purposes to emerge from

100. Kaplow, supra note 97, at 1237.
102. That is, it is a categorical error to argue that two smaller taxes might be less distortive than one larger one that raises the same revenue, when in fact the incidence of both smaller taxes ultimately falls on the same thing—labor inputs. Gamage, supra note 1 is best seen here as a commentary on the deadweight losses associated with real-world taxes, not ideal ones.
104. See generally Atkinson & Stiglitz, supra note 3. U.S. law school academics have not emphasized the alternative argument for zero taxation of capital income that follows from Chamley, supra note 4, and Judd, supra note 5, probably because the key assumption in those models of infinitely lived agents with perfect foresight and supreme rationality does not map well onto the experience or training of lawyers. The A–S Theorem, by contrast, has the quality of a simple and elegant syllogism (which lawyers can enjoy) that does not on its face make heroic assumptions about human nature (although in fact, the assumptions that are made arguably are stronger than sometimes appreciated).
This Article argues that, in retrospect, this is damning it with faint praise.

Within the tax law literature, Chris William Sanchirico vigorously contests the invocation of the A–S Theorem to conclude that an ideal consumption tax invariably dominates an ideal income tax. Sanchirico essentially argues that the A–S Theorem’s assumptions map poorly onto reality. His challenges did not go unanswered, and the result has been a volume’s worth of attacks, defenses, rebuttals, and surrebuttals between Sanchirico and Bankman and Weisbach.

Notwithstanding this heroic debate, in American law schools, at least, the A–S Theorem retains its position as the paramount guide for actual policy in the (non)taxation of capital income. The usual recommendation that follows is the adoption of a “progressive consumption tax” of the cash-flow type. (Following the terminology preferred in this Article, this is a progressive profits tax.)

There are two principal responses to this consensus. The first, developed in Part II, is that the pervasive presence of gratuitous transfers of capital through gifts and bequests undercuts the application of the A–S Theorem’s findings to actual policy. The other, developed in Part IV, is that many authors who state their preference for an ideal cash-flow tax over an ideal income tax, and who then go on to express a preference for greater “redistribution” through the instrument of the tax system, elide too quickly over the fact that their preferred solution for redistributive reasons—a cash-flow tax with a progressive rate structure—in fact undercuts much of their own theoretical argument in favor of consumption taxes. A progressive

108. Shaviro, * supra note 1, at 747; Sims, supra note 87, at 3 nn.2–3, 4 nn.4–5. One perfectly fair reason to deprecate capital income taxation that falls squarely within the domain of legal academics is that as a matter of institutional design, we have failed so miserably at the task for so many decades. The Dual BEIT is responsive to these institutional failures, and I therefore ask readers inclined to be skeptical about the institutional ability of government to tax capital income to hold this objection in abeyance until they have the opportunity to read the companion article.
consumption tax (unlike a flat-rate one) imposes anomalous tax burdens on normal returns, depending on a taxpayer’s consumption patterns, and produces predictably inefficient results when applied to risky returns.  

By contrast, a flat-rate capital income tax has desirable political economy implications when applied to normal returns and is neutral when applied to risky ones.

II. POLITICAL ECONOMY IMPLICATIONS OF MODES OF CAPITAL ACQUISITION

Part II.A briefly reviews some of the data on the importance of gratuitous transfers to the distribution of capital in modern society; it demonstrates the prevalence of capital received through gratuitous transfers in the nation’s capital stock, as well as its apparent concentration. Part II.B continues with some of the policy implications to be drawn from this critical fact. Finally, Part II.C contrasts the actual policy recommendations of Anthony Atkinson and Joseph Stiglitz with the standard inferences drawn in the legal academy from the A–S Theorem.

Part III then shifts the focus from the prevalence of capital received through gratuitous transfers to the extraordinary concentration of capital held by the most affluent Americans. A fair inference, consistent as well with the family wealth data summarized in Part II.A, is that gratuitous transfers are not merely prevalent, but highly concentrated among the very top of the wealth distribution. This in turn adds even greater urgency to the importance of taxing capital income.

A. CAPITAL IS NOT SIMPLY LIFETIME CONSUMPTION SMOOTHING

The A–S Theorem rests on the foundation of a world without gifts and bequests, in which capital simply represents labor stored from one period to the next to fund consumption in that second period. That assumption is useful in an abstract model, but departs so fundamentally from reality as to

110. Edward J. McCaffery and Lawrence Zelenak, among others, have considered, to some extent, whether progressive tax rate structures affect the conclusions reached under proportional cash-flow and income taxes, respectively. See generally McCaffery, supra note 103; Zelenak, supra note 27. Zelenak describes how a progressive income tax, which already burdens normal returns, can burden risky returns as well, but his argument applies with equal vigor to a progressive profits tax. See Zelenak, supra note 27, at 880–81. Parts III.B and III.D return to these points.


112. See supra note 97 and accompanying text.
render the model unfit for policy advice—a conclusion to which both Atkinson and Stiglitz subscribe.  

Thomas Piketty considers in detail the prevalence of gratuitous transfers in explaining the distribution of a nation’s capital stock in *Capital in the Twenty-First Century*. He has good quality data to work with, from France in particular, and finds that inherited wealth accounted for about two-thirds of all wealth held by the living in France in 2010. Piketty and other researchers have much poorer-quality data for the United States.

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113. See infra Part II.C.
115. Id. at 402.
116. Piketty and Zucman describe some of the U.S. data limitations bedeviling researchers: only a few thousand estate tax returns are filed annually (and even those are obscured by elaborate tax planning), lifetime gifts often are unreported, and self-reported estimates of wealth in response to government surveys (for example, the Survey of Consumer Finances) are systematically downward-biased. Thomas Piketty & Gabriel Zucman, *Wealth and Inheritance in the Long Run*, in 2B HANDBOOK OF INCOME DISTRIBUTION 1303, 1342 (Anthony B. Atkinson & François Bourguignon eds., 2015). See infra note 182 (discussing some of those methodological limitations). For these reasons, the authors essentially decline to provide an estimate for the United States. Piketty & Zucman, supra, at 1326 fig.15.16.

Estate tax data would seem ideally suited to estimating the share of wealth held by the living that was received by gift or bequest. Relying principally on estate tax data, for example, Lena Edlund and Wojciech Kopczuk find that the share of inherited wealth as a fraction of total household wealth peaked in the 1970s, and has since declined. Lena Edlund & Wojciech Kopczuk, *Women, Wealth, and Mobility*, 99 AM. ECON. REV. 146, 173 (2009). See also Wojciech Kopczuk & Emmanuel Saez, *Top Wealth Shares in the United States, 1916–2000: Evidence from Estate Tax Returns*, 57 NAT’L TAX J. 445, 468 (2004) (“[T]he surge in top wages since the 1970s did not lead to a significant increase in top wealth holdings.”). The conclusion of Edlund and Kopczuk rests in part on some gender distinctions that are susceptible of different inferences and, more importantly, on the parameters chosen to extrapolate from the population of decedents in a year to the population of the living in that year (for example, whether one can assume that the life expectancy of the rich tracks that of low or median wealth households). Edlund & Kopczuk, supra, at 146–47.

As Kopczuk acknowledges, estate tax data can be confounded by tax planning and evasion, but he observes that “[a]t the same time, this phenomenon is not new, and there is no clear argument for why estate tax avoidance would have increased over time.” Wojciech Kopczuk, *What Do We Know About the Evolution of Top Wealth Shares in the United States?*, 29 J. ECON. PERSP. 47, 54 (2015). I resist the claim that the magnitude of estate tax avoidance can be assumed to be a constant over time without a great deal more work being done on the evolution of estate tax planning. Moreover, the minimum size of an estate subject to the estate tax increased dramatically over the last several years (from $1 million in 2012 to about $5.5 million at the time of this Article’s publication), the top estate tax rate has been scaled back (from 55 percent in 2002 to 40 percent at the time of this Article’s publication), and the estate tax itself was briefly, optionally repealed for 2010—all of which surely had some effect on administrative enforcement and rulemaking efforts. Kopczuk relies on one paper from the 1970s by an economist for the proposition that estate tax planning was prevalent then, but he makes no effort to inquire about changing tax avoidance technologies or the magnitude (as opposed to the prevalence) of the savings achieved through those strategies. Kopczuk, supra, at 54. “Perpetual dynasty trusts” are but one example of novel estate tax planning techniques with far-reaching consequences. It is
In *Capital in the Twenty-First Century*, Piketty estimates that inherited wealth in the United States as a share of total wealth held by the living in 2010 was somewhat lower than in France, but that the general pattern over time was similar.¹¹⁷ A working paper by Facundo Alvaredo, Bertrand Gabinti, and Piketty develops a benchmark estimate for the United States in 2010 that gifts and bequests accounted for about 55 percent of total wealth held by the living.¹¹⁸ This figure is slightly higher than their estimate for Europe as a whole.¹¹⁹ The finding that more than one-half of aggregate household wealth is received through gratuitous transfers requires a radical reexamination of the role of capital taxation in our political economy analyses.

Recent work in the area has focused more on the distribution of wealth in the United States than the fraction of the wealth of the living that comes from bequests and gifts.¹²⁰ Nonetheless, the data are suggestive. The Congressional Budget Office (“CBO”), for example, estimates that net household wealth in 2013 amounted to $67 trillion, which was roughly four times national gross domestic product in that year.¹²¹ The CBO finds that families in the top 10 percent of the wealth distribution held more than three-quarters of the country’s wealth in 2013, up from about two-thirds in 1989.¹²² It is possible that this $50 trillion in marketable wealth held by the top 10 percent in 2013 will all be dissipated by riotous living and extraordinary end-of-life medical care, but a more realistic working assumption would be that great sums will be passed on to younger generations.

In a 2013 study, Steven Kaplan and Joshua Rauh explored the sources of wealth among the *Forbes* 400 list of the wealthiest individuals in the

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¹¹⁹. *Id.*
¹²⁰. See * supra* note 116; *infra* Part III.A.
¹²². *Id.* at 4. The CBO declined to examine higher fractiles than the top 10 percent, perhaps due to concerns over the limits of the data.
United States in each decade from 1982 to 2011. Using public information to obtain biographical data, they coded the Forbes 400 individuals as having grown up in households that either were wealthy, had some wealth, or had little-to-no wealth. For example, Bill Gates, whose father was a founding partner at a large and successful law firm, was coded as having grown up in a household with “some” wealth.

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

The Kaplan and Rauh paper has been cited in some popular media as proving that wealth inequality in the United States has diminished over time, or that the United States is “part of a world-wide rise of the self-made among the world’s super rich.” But it takes a narrow construction of “self-made” to conclude that individuals born into significant wealth owe their success solely to their personal moxie. As Kaplan and Rauh note:

Entering the elite group of the wealthiest individuals no longer requires having grown up rich, but having some wealth confers advantages, particularly in access to education. The wealthiest individuals increasingly comprise individuals who accessed this education while young and then implemented their skills in the most scalable industries, where increasing technology and returns to skill allow for the greatest generation of wealth.

124. Id. at 159.
125. Id.
126. Id.
127. Id.
129. Kaplan & Rauh, supra note 123, at 160–61. Similarly, Gregory Clark and Neil Cummins find a strong correlation of wealth across generations “mainly because of the inheritance of educational and
Kaplan and Rauh conclude that such individuals have “scraped their way onto [the] list through their own efforts,” but having a father who is a founding partner at a profitable and prestigious law firm—with a net worth presumably in the millions of dollars—still means that one starts life with much greater investments in one’s human capital, and a much more secure safety net of family affluence to encourage risk-taking, than are available to a typical child born to parents of modest means.

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

More generally, the study of the role of gifts and bequests in top-end wealth requires a shift in focus from individuals to families. By definition, the importance of gifts and bequests can only be seen through the lens of multigenerational wealth accumulations. In addition to publishing its annual Forbes 400 list, that journal has begun to profile American dynastic wealth in an annual list of America’s richest families. The list includes only multigenerational wealth, and thereby excludes individuals like Bill Gates or Warren Buffett.


134. See id.
By comparing the *Forbes* 400 list of wealthy individuals with the same journal’s list of wealthy families, a very different picture of wealth accumulation in America emerges than is visible in the *Forbes* 400 list by itself. Interleaving the two lists together for 2015, five of the top twelve spots are held by intergenerational families:

- Walton family $149 billion
- Koch family $86 billion
- Mars family $80 billion
- Bill Gates $76 billion
- Warren Buffett $62 billion
- Larry Ellison $48 billion
- Jeff Bezos $47 billion
- Cargill-MacMillan family $45 billion
- Mark Zuckerberg $40 billion
- Michael Bloomberg $39 billion
- Cox family $35 billion
- Larry Page $33 billion

The Cargill-MacMillan family is instructive here. As individuals, its highest-ranking member is number 90 in the *Forbes* 400 list, yet the family’s wealth is the eighth-largest concentration of personal wealth in the country, exceeding that of Mark Zuckerberg and other well-known “self-made” individuals in that year. Seven of the twenty-five wealthiest families in America today have been among the most affluent for over a hundred years, including the DuPorns, Rockefellers, Busches, Pulitzers, and Mellons. Wealth in the United States today is not a simple story of self-made scrappers.

137. See supra note 135 and accompanying text.
B. RECENT ECONOMIC WORK

The policy recommendations drawn from the A–S Theorem do not dominate tax policy as it is lived, in that capital income in general is taxed in almost all developed economies. They further have surprisingly little sway over the policy recommendations of working public finance specialists, if a recent survey of members of the National Tax Association is to be believed. Moreover, at least some recent theoretical public finance literature has explored new economic models whose results imply that the A–S Theorem might not necessarily yield robust guides to policy.

As nicely laid out in a 2009 paper by Gregory Mankiw, Matthew Weinzierl, and Danny Yagan, “the central problem” in optimal tax theory is that in the face of significant wage taxation, a high wage-rate individual might choose to work less (to mimic a low wage-rate person, in the unfortunate framing of the literature), and the government is unable directly to observe ability or work effort. Government therefore cannot impose taxes on high-ability individuals that are measured directly by those abilities rather than incomes in order to fund “redistribution” to lower-ability individuals. Instead, government, constrained by its information vacuum, must “provide[] sufficient incentive for high-ability taxpayers to keep producing at the high levels that correspond to their ability,” which translates to lower tax rates on high-ability individuals than would be the case if their abilities were fully transparent to government.

This formulation of the central problem of optimal tax theory ties into the A–S Theorem because, as Mankiw and colleagues explain, the A–S Theorem rests on the assumption that “there is no information about unobserved ability in an individual’s consumption choice that is not also revealed by the individual’s income.” (This is what the weak separability of leisure assumption means—low-ability, long-hour workers have the same consumption preferences as high-ability individuals who “mimic”)

141. Mankiw, Weinzierl & Yagan, supra note 139, at 170.
142. Id.
143. Id. at 150.
144. Id. at 165.
them by working fewer hours.) But what if the act of saving itself is a marker of a high-ability person? Then the A–S Theorem no longer holds, and taxing those savings is a way of increasing the tax burden on high-ability taxpayers, just as optimal tax theory might suggest. This is one of several points made by James Banks and Peter Diamond in their 2010 comprehensive review of the literature for the Mirrlees Review, which concludes that there in fact is room for capital income taxation in optimal tax theory.  

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

145. James Banks & Peter Diamond, The Base for Direct Taxation, in Dimensions of Tax Design: The Mirrlees Review 548, 549–50 (Stuart Adam et al. eds., 2010). The Mirrlees Review is a comprehensive rethink by some of the world’s leading public finance economists, chaired by Sir James Mirrlees, of the lessons for actual tax policies to be drawn from the current state of the art in public finance economic analyses. The summary volume published by The Mirrlees Review, Tax By Design, summarizes these arguments and acknowledges their theoretical strength but, for reasons that are not fully articulated, concludes that they are not sufficiently robust to change the standard recommendation that capital income (that is, normal returns) not be subject to taxation. James Mirrlees et al., Tax By Design: The Mirrlees Review 307–17 (2011) (concluding that the efficiency arguments for taxing returns to household savings ultimately are not convincing).


147. Id. at 167.
148. Id. at 179–81.
149. Id. at 181–82.
150. Id. at 182–83.
151. Id. at 182. See generally, e.g., Shaviro, supra note 1.
circumstances, taxing savings can encourage such individuals to keep their noses to the collective grindstones.152

In a similar vein, Peter Birch Sørensen observes that in many cases the consumption of leisure increases with age.153 This means that leisure in fact is complementary to capital income, and taxing capital income therefore is justified even under a straightforward reading of the A–S Theorem.154

Thomas Piketty and Emmanuel Saez also come to this conclusion, albeit framed primarily in terms of the desirability of directly taxing bequests, or capital income as a surrogate.155 The authors’ basic point is that in a world imbued with both imperfect capital markets and bequests, made in differing amounts, an individual’s stock of capital depends in part on the heterogeneous abilities of an individual’s predecessors and those predecessors’ heterogeneous tastes for bequests.156 As a result, a realistic model of lifetime income must consider two factors, not one—one’s own labor productivity and effort, and one’s inherited capital.157 But because of the heterogeneity of prior generations’ abilities and tastes for bequests, the two factors are weighted differently in different people today—someone in the 95th percentile of inheritance receivers is not necessarily in the 95th percentile in labor income earnings ability: “with inheritances, labor income is no longer the unique determinant of life-time resources”; and in contrast to Atkinson and Stiglitz, “two-dimensional inequality,” that is, different distributions of inheritances and ability across a population, “requires two-dimensional tax policy tools.”158

152. Diamond & Saez, supra note 146, at 183. Because this last set of arguments is counterintuitive and seemingly inconsistent with U.S. social norms about personal liberties, I do not emphasize it.


154. Id. at 235–37.


157. Id. at 1864.

158. Piketty & Saez, A Theory of Optimal Capital Taxation, supra note 155, at 2. The published paper makes the same point with less rhetorical flourish: “[I]n our model with bequests, inequality is bi-
Because inherited (starting point) capital is highly concentrated relative to earnings abilities, differential taxation of capital (measured either as stock or flows) and labor income becomes useful. Piketty and Saez therefore develop a model that reflects variation in inheritances, in turn not linked to earnings ability. The model effectively treats bequests and capital income as economic equivalents of each other because in the model, each generation has a specified term and does not overlap with other generations, and returns on capital are normal returns.159

The Piketty–Saez model does not assume that the rich get better educations and therefore operate at a higher functional level of ability than do those deprived of those educational opportunities. Instead, it assumes that the total lifetime returns to inherited capital are simply financial returns on that capital. In practice, of course, the connection between inherited capital and higher wage rates through greater investment in human capital would only increase the robustness of the conclusions reached by Piketty and Saez. The inclusive growth literature described in Part III.D explores this line of analysis.

The Piketty–Saez model yields an important result: across many plausible assumptions, social welfare is maximized with a significantly positive tax on bequests or, alternatively, on annual capital income.160 Because the government revenue requirement is fixed, taxing bequests reduces the need for revenues from a labor income tax, and thereby improves the welfare of those receiving no or small bequests. Taxing bequests at 100 percent and redistributing the revenues is undesirable because even those who inherit nothing can believe they will pass on substantial assets to their heirs, but overall social welfare is enhanced by a significant capital income or bequest tax, deployed to reduce labor income tax burdens.161

dimensional and earnings are no longer the unique determinant of lifetime resources. As a result, the famous Atkinson and Stiglitz (1976) zero tax result breaks down.” Piketty & Saez, A Theory of Optimal Inheritance Taxation, supra note 155, at 1853.  
159. Piketty & Saez, A Theory of Optimal Inheritance Taxation, supra note 155, at 1880 (“In our one-period life model, a capitalized inheritance tax . . . is actually equivalent to a pure capital income tax . . ., so that our results can also be interpreted as a theory of capital income taxation. In practice, capital income and wealth taxation is much more significant than bequest taxation.”).  
160. See id. at 1867–73.  
161. Piketty and Saez conclude that for a given total government tax take, the mix of the bequest tax rate and the labor income tax rate will vary, depending on three factors: the “bequest flow” (that is, the percentage of annual national income that is inherited by the next generation), the rate of growth in national incomes (G), and the prevailing returns to capital (R). Id. at 1864. “[T]here is really no general reason why . . . inheritance would be taxed more or less than labor income. Any situation can be optimal, depending on parameters.” Piketty & Saez, A Theory of Optimal Capital Taxation, supra note
It might be argued that, because capital transferred by gift or bequest can be traced back to someone’s labor at some past date, the labor income distortion thesis remains valid, but simply pushed back in time. Under this reading, the efficiency case for not taxing income on capital received as a gift or bequest mutates into the more attenuated argument that the original generator of excess labor stored as capital would have behaved differently had he known that one day it would be subject to tax. But given that large accumulations of capital can affect top-end distributions of capital and capital income for generations, this argument seems strained in practice, whatever its power in models of agents with perfect foresight.\(^\text{162}\)

What is more, from the perspective of donors, there are nonmarket payoffs to savings, which payoffs themselves operate as forms of current consumption; exempting these forms of consumption from tax actually would be inconsistent with the A–S Theorem, thereby further muddying any claim that taxing the returns to capital transferred through gifts and bequests unequivocally introduces deadweight loss. The best evidence here lies in the fact that bequests dominate inter vivos gifts, for reasons difficult to explain as the accidental outcomes of lives, interrupted.\(^\text{163}\) The most plausible inference is that savers derive independent utility from possessing savings, and that utility is a form of consumption. One such example is the direct power that a saver can exert over family members angling for bequests (what Barbara Fried describes as the “exchange motive”).\(^\text{164}\) This rebuts the claim that any power or prestige that comes with savings rests simply on the ability to consume in the future, because however this form of utility is described, it exists in the present, not the future.\(^\text{165}\)

\(^{155}\), at 21. High national income growth rates imply lower bequest flows (bequests as percentage of national income) just because the denominator is outstripping the numerator. And high \(R\) relative to \(G\) (a “rentier” society) implies that bequest flow rates are increasing. See id. at 38–39. In the former fact pattern, the case for taxing bequests (or annual capital income) is weaker. In the latter, it is stronger. These last conclusions should be familiar to readers of Piketty, supra note 114.

\(^{162}\). See generally Piketty, supra note 114, at 377–429. In a 2015 study, Gregory Clark and Neil Cummins follow the wealth of families with rare last names in England from 1890 to 2012 and find that the share of inherited wealth is between 18 and 48 percent. Clark & Cummins, supra note 129, at 541. Clark and Cummins find a strong persistence of wealth across generations, with the rich surname subgroup being significantly wealthier than average, despite a regression of wealth toward the mean. Id. at 528–29 & tbl.3. See supra Part II.A.


\(^{165}\). For an example of the standard view, see David A. Weisbach, The Case for a Consumption Tax, 110 Tax Notes 1357, 1358 (2006) (“Perhaps savings bring benefits beyond consumption—say,
In sum, the A–S Theorem holds, within its assumptions, that taxing capital income distorts an agent’s intertemporal consumption decisions with respect to labor income, which introduces deadweight loss that can be avoided by relying solely on a progressive wage tax as a tax instrument. But once gifts and bequests are considered, capital in the real world cannot be explained as simply the taxpayer’s own stored labor. This fundamental premise of the A–S Theorem no longer holds, and as a result, the A–S Theorem’s conclusions cannot be mapped onto tax instrument design. 166 For this reason, and because they are increasingly concerned with the political economy crisis of rising income and wealth inequality, many sober-minded economists—including, as it happens, Atkinson and Stiglitz—urge that capital in fact be taxed, either directly or through capital income taxation.

C. LIFE Imitates ART: ATKINSON AND STIGLITZ SPEAK

In the movie Annie Hall, Woody Allen is able to set the record straight on the meaning of Marshall McLuhan’s work by suddenly producing McLuhan from behind a screen to deliver a lecture to an incredulous pundit standing in a movie line behind Allen. 167 In the same vein, I am able in this Part II.C to let Anthony Atkinson and Joseph Stiglitz speak for themselves on the contemporary policy relevance of the A–S Theorem.

Most tellingly, Atkinson and Stiglitz have both argued for capital taxes as a necessary response to the crisis of escalating top-end income and wealth inequality. In his 2015 book, Inequality: What Can Be Done? 168 the late Anthony Atkinson made three tax proposals that are relevant here. First, Atkinson proposed a steeply graduated rate structure for personal income tax, with a top marginal rate of 65 percent. 169

Second, Atkinson recommended imposing steeply graduated gift and estate taxes in the form of a capital receipts tax (that is, a tax on the receipt of gifts and bequests, rather than a tax on the donor or estate):

[Notes]

166. See, e.g., Cremer, Pestieau & Rochet, supra note 105, at 783 (claiming it is not difficult “to show that Atkinson and Stiglitz’s result does not in general hold” when agents are heterogeneous in their starting period wealth).
167. ANNIE HALL (United Artists 1977).
168. ATKINSON, supra note 36.
169. Id. at 187–88.
The idea of such a tax is not revolutionary; it was proposed more than 100 years ago by John Stuart Mill: there should be “a heavy graduated succession duty on all inheritances exceeding [a] minimum amount, which is sufficient to aid but not supersede personal exertion.” Under such a tax, every legacy or gift received by a person would be recorded from the date of initiation of the tax, and the tax payable determined by the sum received to date. The tax would include all gifts inter vivos above an additional modest annual exemption. Transfers between spouses or persons in civil partnerships would not be taxed. 170

According to Atkinson, a progressive rate structure for bequests would incentivize people to spread their wealth so as to avoid tax, thus theoretically accomplishing redistribution goals. 171

Atkinson also championed an annual wealth tax, although he was less specific here as to the details of his proposal. 172 He wrote:

Among the reasons for considering an annual wealth tax more favourably in the UK today than forty years ago are the much higher level of income inequality and the rise in the ratio of personal wealth to Gross Domestic Product. There have been major changes in this ratio over the postwar period. In the immediate postwar decades the ratio fell, but from the early 1980s it began to rise again, and personal wealth in the 2000s was some five times the Gross Domestic Product. 173

Not to be outdone, in his 2012 book, The Price of Inequality, Joseph Stiglitz argues for higher taxes on capital gains, a more robust corporate income tax, and a more robust estate tax. 174 Putting matters succinctly, Stiglitz writes: “Some earlier, idealized economic models suggested that it was optimal not to tax interest income (income from capital), but subsequent research showed that this result was not robust: capital taxation is desirable.” 175

Stiglitz points out that the bottom 90 percent of the population earns less than 10 percent of all capital gains. 176 Indeed, in any given year, less than seven percent of households earning below $100,000 recognize any capital gains at all. 177 Meanwhile, the top 400 households receive 73
percent of their income from either capital gains or interest and dividends. Stiglitz argues that the effect is that the wealthiest Americans face a lower effective tax rate than do most taxpayers, who rely primarily on labor income, further increasing the rate of wealth accumulation at the very top of the distribution.

And Stiglitz has written in a 2015 article:

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

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

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

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

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

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

See also Joseph E. Stiglitz, Reforming Taxation to Promote Growth and Equity (2014), http://rooseveltinstitute.org/reform-taxation-promote-growth-and-equity/. In this paper, Stiglitz recommends higher top individual income tax rates, the introduction of a value-added tax to
In sum, the A–S Theorem is a vitally important economic model, but like all such models, it must be interpreted judiciously before drawing policy lessons from it. In particular, the model’s assumption of a world in which all capital constitutes an agent’s stored labor is fundamentally inapposite to the world we inhabit, where gratuitous transfers of capital play a large role in its distribution, and therefore in the distribution of capital income.

As Atkinson and Stiglitz both agree, the pervasive presence of capital stocks received through gratuitous transfers does not mean that the A–S Theorem should be relegated to a second-best heuristic that still is approximately right, even if not perfectly true. This central political economy reality means that the A–S Theorem is simply orthogonal to real world tax instrument design. Theory does not stand implacably opposed to capital income taxation in practice.

finance the exemption of the first $100,000 of income from the income tax, the elimination of the home mortgage interest deduction, and the elimination of any preferential rates for dividends or capital gains. He also recommends higher corporate income tax rates (including on the international income of U.S. multinational enterprises) coupled with tax incentives for investments in the United States. He further advocates new taxes on the financial sector, including a financial transactions tax. To achieve integration of corporate and individual taxes, Stiglitz proposes a dividends-paid deduction coupled with a withholding tax that would effectively impose tax on tax-exempt institutions.

David Kamin, How to Tax the Rich, 146 TAX NOTES 119 (2015) offers slightly different prescriptions. Kamin analyzes different proposals for raising additional revenue by taxing the rich, whom he defines as individuals that earn at least $1 million per year. He concludes that raising the capital gains rate, taxing capital gains as ordinary income, or imposing additional minimum taxes are not viable options for raising a significant amount of revenue because individuals will manipulate their tax returns by delaying the realization of gain on assets. In addition, he does not believe that creating an annual wealth tax or using broad mark-to-market accounting will be practical due to valuation and administrative considerations. Kamin describes what he believes to be more viable options for raising revenue, such as expanding transfer taxes, increasing the tax rate on ordinary income, limiting itemized deductions and exclusions, and taxing unrealized gains at death or gift. I have no quarrel with any of these recommendations, and indeed I have made similar ones. See generally, e.g., Edward D. Kleinbard & Joseph Rosenberg, The Better Base Case, 135 TAX NOTES 1237 (2012). Nonetheless, the Dual BEIT’s annual tax on capital income is more responsive to the political economy exigencies of the moment and raises more revenues than these proposals are likely to do.

181. Cf. Rodrik, supra note 9, at 8 (“We cannot look to economics for universal explanations or prescriptions that apply regardless of context. The possibilities of social life are too diverse to be squeezed into unique frameworks.”).
III. POLITICAL ECONOMY IMPLICATIONS OF CAPITAL OWNERSHIP DISTRIBUTION

A. CAPITAL OWNERSHIP IS HIGHLY CONCENTRATED

In addition to the central importance of capital accumulated through gratuitous transfers, the political economy case for taxing capital in general, and capital income in particular, relies on the fact that wealth, however obtained, is highly concentrated—much more so than income—because most Americans spend all their incomes on current consumption. Moreover, the persistence of great family fortunes, as described in Part I.A, is consistent with the inference that a large share of wealth at the top end of the distribution is itself the result of gratuitous transfers.

Conclusions here must be tempered by the problems inherent in different sources of wealth data, but there does appear to be a consensus that wealth concentration in the United States is high and increasing. Beginning with the most anodyne research, the nonpartisan CBO, due in part to its close working relationship with the nonpartisan staff of the Joint Committee on Taxation (“JCT”), has access to unparalleled microdata on family finances. As previously noted, the CBO estimates that families in the top 10 percent of the wealth distribution held more than three-quarters of the country’s wealth in 2013, up from about two-thirds in 1989.

Similarly, in joint work by the CBO and JCT, those organizations find that only 15 percent of families in 2010 held any corporate stock as a capital asset (that is, outside retirement accounts). Only 36 percent held any kind of capital asset other than a personal residence. Taxpayers with incomes in that year of $1 million or more (the top 0.4 percent—four out of

182. Recent papers have explored in detail the methodological problems inherent in studying the distribution of wealth in the United States; while not directed at the question of the share of household wealth attributable to the receipt of gifts and bequests, these inquiries nonetheless help to frame the limits of our current knowledge. See generally, e.g., Kopczuk, supra note 116; Jesse Bricker, Allison Henriques, Jacob Krimmel & John Sabelhaus, Measuring Income and Wealth at the Top Using Administrative and Survey Data, BROOKINGS PAPERS ON ECON. ACTIVITY, Spring 2016, at 261. These papers consider, among other sources, the relative utility of data derived from the Survey of Consumer Finances, capitalization of income tax data, and estate tax data. There is general agreement across the different methodologies that top-end wealth concentration has increased in the United States in recent decades, but there is disagreement about the magnitude of the increase, particularly at higher fractiles (for example, the top 1 percent or the top 0.1 percent). See Bricker, Henriques, Krimmel & Sabelhaus, supra, at 261–62.

183. See supra note 122 and accompanying text.

one thousand) held 16 percent of all capital assets; the average value of their holdings was $16.5 million.\textsuperscript{185} To the same effect, Martin Sullivan, working with Internal Revenue Service (“IRS”) data for the 2013 tax year, shows that tax units with incomes exceeding $1 million earned 49 percent of all capital gains and dividend income recognized in that year.\textsuperscript{186}

Other CBO studies also demonstrate that capital income is very top weighted in its income distribution, and that it constitutes a large fraction of top incomes. Thus, in 2011, the second, third, and fourth quintiles of households (ranked by market incomes) all earned 8 percent or less of their total market income from businesses they owned, portfolio capital income, and capital gains.\textsuperscript{187} By contrast, the top 1 percent of households—whose median income was sixteen times that of the median household in the fourth quintile—earned 22 percent of their income from directly owned businesses and 36 percent from portfolio capital income.\textsuperscript{188} More remarkably, the share of market income represented by labor income in 2011 was about the same for households in the fourth quintile of market incomes and for taxpayers in the 91st–95th percentiles. It is only above that level that one observes a significant drop in labor income as a share of that group’s total market income and a concomitant rise in capital income and business income.\textsuperscript{189}

Additional CBO work shows the increasing share of market incomes earned by the top 1 percent of the income distribution. For example, the real market incomes of the top 1 percent of households increased 188 percent from 1979 to 2013 (the most recent year for which the CBO has updated its analysis), and far more than that if the clock is stopped in 2007, the last year before the financial crisis.\textsuperscript{190} The real incomes of the bottom four income quintiles, by contrast, rose less than one-tenth as much.\textsuperscript{191} Patrick Driessen, a public finance economist and former senior revenue estimator for Congress’s JCT, has written persuasively that these data greatly understate the relative gains of the top 1 percent with respect to

\begin{itemize}
\item 185. \textit{Id. at 12.}
\item 186. Sullivan, \textit{supra} note 179, at 904 fig.2.
\item 188. \textit{Id.}
\item 189. See \textit{id.}
\item 191. \textit{Id.}
\end{itemize}
capital income shares because the CBO data ignore undistributed corporate earnings and unrealized capital gains.192

It must be acknowledged that some indeterminate fraction of capital income, as defined by the CBO, would be taxed under a profits tax—as comprising rents and ex post returns to risk.193 A better way of getting a handle on the distribution of normal returns to capital across households would be to examine directly the distribution of wealth, since investable wealth by definition attracts normal returns. Here, the data become less reliable because government agencies do not directly collect data on the wealth of all households; but one study by Emmanuel Saez and Gabriel Zucman, relying on capitalized values of observable or imputable income flows, concludes that wealth in the United States is highly concentrated at the top end, and has become more so over recent decades.194

Saez and Zucman conclude that in 2012, the top 1 percent of families earned about 42 percent of all taxable capital income in the United States, and that the wedge between these families’ share of all national income and their share of all labor income has grown (which is to say, their share of capital income has grown more rapidly than their share of labor income).195 The methodology employed by Saez and Zucman is controversial, but again, the point here simply is to suggest that it is reasonable to conclude that wealth, returns to capital (in the broad sense), and normal returns to capital all are extremely concentrated at the very top end of distributions.196

To the same effect, in a 2015 study, Thomas Piketty and Gabriel Zucman conclude that wealth in the United States in 2010 (indeed, in the entire period between 1970–2010) was more concentrated than in Europe.197 They find that in 2010, the top 10 percent in the United States


193. The consensus theory of capital income taxation laid out in Part II argues that risky returns are not taxed under an ideal tax, but some scholarship has challenged the viability of that analysis, and, more importantly, the current tax system is far from ideal in that it does not provide for the refundability of tax benefits from losses—or even their accretion at a rate of return. It therefore is fair to suggest that risky returns today are taxed, at least to some extent, under our income tax and are likely to be taxed tomorrow under a progressive profits tax. See generally, e.g., Brooks, supra note 27; Sims, supra note 87.


195. Id. at 520.

196. See supra note 182 regarding the literature on competing methodologies for measuring wealth distribution.

197. Piketty & Zucman, supra note 116, at 1325, 1326 fig.15.16.
held about 75 percent of the country’s wealth, while the top 1 percent held about 40 percent.198

A 2016 paper by Jesse Bricker, Alice Henriques, Jacob Krimmel, and John Sabelhaus relies on a combination of data sets to reach somewhat less dramatic conclusions with respect to wealth and income inequality, but ones that do not differ from the work of Piketty, Saez, and Zucman by an order of magnitude.199 In contrast to the studies by Piketty, Saez, and Zucman, which infer wealth based on capitalizing administrative income tax data, Bricker and his colleagues combined several data sets to impute data not visible in any single data set, in an effort to reflect more comprehensively household wealth and income.200 Although Bricker and his colleagues’ preferred estimates of wealth and income inequality are lower than those of Piketty, Saez, and Zucman,201 the results still support the idea that inequality as reflected in top wealth and income shares has risen substantially in recent decades.202 Indeed, Bricker and his colleagues summarize the results reached by the different methodologies by observing that “[i]n all the estimates discussed here, the top income shares in the United States are high and have been increasing over time.”203

Finally, a working paper prepared under the aegis of the IMF examines the fraction of national after-tax, after-transfer payment incomes captured by high-income, middle-income, and low-income households, respectively (“income shares”).204 (The income share concept reflects both the number of households in each category and the average incomes of

198. Id. at 1325.
201. Saez and Zucman have examined how their findings can be reconciled with the Survey of Consumer Finances data on which Bricker and his colleagues heavily rely. Saez and Zucman conclude that differences in estimates of capital income inequality are due in large measure not only to missing Forbes 400 data (which the Bricker “preferred” methodology does add back), but also to sampling and non-sampling errors, including response rate discrepancies between wealth strata and the tendency to understate income in the Survey of Consumer Finances compared to what is reported to the IRS. Saez & Zucman, supra note 194, at 565–69.
203. Id. at 301.
such households; the number of households in each income share is not held constant.) In 1970, the income shares of high-income and middle-income households were very close to one another, each just below 50 percent of the total. (Of course, the number of households in each category differed.) By 2014, however, high-income households captured 60 percent of national income, and middle-income households, only 35 percent. (Low-income households continued to account for about five percent of national income shares.)

In short, the work of many academic researchers and important nonpartisan organizations with unique access to granular-level data (particularly, the CBO) all point in the direction that inequality in market incomes and wealth have increased at the top end in recent decades, particularly in the United States. In We Are Better Than This, I review more research on these trends in greater detail. These arguments are sufficiently well known and have achieved sufficient (if not unanimous) acceptance, as not to require further elaboration here.

B. THE SOCIAL COSTS OF CAPITAL OWNERSHIP CONCENTRATION

To summarize, it turns out that the rich own much more capital than do the poor, which surely is a tautological observation, and there is substantial evidence that the concentration of capital income and wealth at the very top end of the distribution has increased significantly in recent

205. Id. at 8 & fig. 5.
206. Id. at 8 fig. 5.
207. Id.
208. Id.
210. Glenn Hubbard argues that the data in fact are more ambiguous in showing a trend of increasing capital income relative to national incomes. Glenn Hubbard, Taking Capital’s Gains: Capital’s Ideas and Tax Policy in the Twenty-First Century, 68 Nat’l Tax J. 409, 410 (2015). But many recent studies suffer from the problem that the terminal date for their data falls in a period still affected by the large capital losses incurred in 2008–2010 and since largely recovered. Estate tax data are similarly fraught because the estate tax is famously susceptible to tax avoidance planning. See supra note 116. In any event, the question whether capital income represents an increasing share of national income is different from the question here, which is whether there is evidence of increasing concentration of wealth at the top end.

Admittedly, there are interesting distinctions that can be drawn between wealth and capital (meaning, in the latter case, wealth invested in productive enterprises). See, e.g., J. Bradford DeLong, Mr. Piketty and the “Neoclassics”: A Suggested Interpretation, 68 Nat’l Tax J. 393, 405 (2015) ("[P]roductive capital . . . is only one of the forms in which the rich accumulate and inherit wealth."); Stiglitz, supra note 180, at 431 ("It is a mistake to confuse capital with wealth."). Wealth invested in “sterile” assets like art or wine, or even owner-occupied housing, in this sense is not part of productive capital.
decades. The question for tax instrument design is: why should these facts trouble us?

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

Many readers do not need to be reminded, but gifts and bequests are more than just another source of income and wealth inequality. Put simply, gifts and bequests provide the recipient with a profound economic head start—hence the joke about the heir who declared he hit a home run when he was born on third base. In a country where investment in human capital is extremely important, but is not a public good, money in the heir’s bank account translates into greater human capital investment simply because the heir can afford those private costs, including the opportunity cost of not contributing to a family’s income while attending university.

Lifetime incomes are closely correlated with educational attainment. Through the mechanism of systematically greater private investment in the human capital of their offspring—and easier access to elite institutions in the first place—the affluent can turn today’s wealth into a hereditable gene, wholly apart from any gratuitous transfers that the fortunate offspring may receive. From the other direction, financial anxiety is itself a debilitating.
quasi-disease that unproductively absorbs a significant fraction of the sufferer’s cognitive bandwidth at any time.213

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

*We Are Better Than This* develops these points in more detail. The point here is simply that a desire for a fiscal system consonant with core American values like equality of opportunity must confront a world in which inherited private wealth explains half or more of the country’s entire stock of capital—and in which that capital can be put to work to generate higher levels of labor income (through investment in human capital), capital income, and welfare than can be achieved by an otherwise-identical agent who starts without that advantage.214

C. WE NEED THE EGGS

Part II demonstrated that the pervasive presence of gifts and bequests should vitiate the policy relevance of the A–S Theorem, even in its last redoubt, the law academy. Part III.B argued that taxing capital responds to the social issues posed by increasing income and wealth inequality, and in particular, the social costs of allowing wealth to become a hereditable gene. In this Part, I make two less dramatic points. First, we need more tax revenue, not less, to fund the government we in fact demand. Second, we collect substantial tax today from capital income—but not from gifts and bequests. Those income taxes are reflected in asset prices, and preserving a capital income tax in some form therefore creates fewer windfall winners and losers than does its wholesale replacement with profits and consumption taxes.

Like the fellow who delayed seeking medical attention for his wife, who thought she was a chicken because they needed the eggs, the United States needs the eggs. Deficit financing is an important political economy constraint on government policy. A new profits-tax-only environment with equivalent present value revenues to those raised by capital income

214. *Id.* at 267–371.
taxation today would be heavily backloaded as a cash-flow matter. This in turn would have important practical repercussions for the role of government, in light of vigorous political debates around current-year deficits (which have great policy resonance, even though they are simplistic cash-flow measures). There are also, of course, the exhaustively studied transitional and distributional issues associated with substituting profits or consumption taxes for capital income taxes.

The CBO projected in August 2015 that, based on current tax laws, federal government deficits will total about $7 trillion over the 2016–2025 period, and that U.S. Treasury debt held by the public will grow from 73 percent of gross domestic product (“GDP”) in 2018 to about 77 percent of GDP in 2025. Many public finance economists and policy analysts are troubled by that trend. Discussions of replacing current capital income taxation with profits or consumption taxes therefore must begin from the proposition that our existing revenue base is inadequate to fund the government we have today.

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


217. See generally *KLEINBARD, WE ARE BETTER THAN THIS*, supra note 16.

218. See generally id.

219. *Id.* at 354.
We Are Better Than This demonstrates that we can raise sufficient revenues to accommodate these objectives within the confines of existing tax instruments, without resorting to extraordinary increases in top marginal individual income tax rates. One can of course hypothesize one’s way to other solutions—for example, through national sales taxes or much higher marginal tax rates on labor incomes—but the path of least resistance is to follow the maxim that an old tax is a good tax and, therefore, to continue to rely on capital income taxation to generate an important stream of government revenues, which in turn can fund highly redistributive government investment and insurance programs.

Capital income taxation in the United States today is poorly implemented, but even so, it raises substantial revenues. Capital income now accounts for about 40 percent of gross domestic income in the United States: pragmatic political constraints on tax rates suggest that it would be extraordinarily difficult to envision tax rates sufficiently high on a narrower base to hold tax revenues constant on a present value basis. Admittedly, this figure includes economic rents and some labor income disguised as small business income. Nonetheless, it suggests that we intuitively can expect the taxation of capital income to be highly relevant as a matter of government revenues.

The CBO projects that for fiscal year 2016, the federal corporate income tax by itself will raise some $445 billion in revenues—about 12.7 percent of all federal tax revenues projected to be collected. (Over the ten-year period 2016–2025, the figure is $4.4 trillion.) In turn, the corporate income tax essentially is a tax on capital income; the overwhelming bulk of the tax is paid by public companies, where labor inputs generally are fully compensated as such, given the difference between ownership and labor contributions. Moreover, these revenue projections understate matters because they reflect the revenue losses attributable to aggressive stateless income tax planning by U.S.-based
multinational firms, through which about $2.6 trillion of low-taxed foreign income, untaxed by the United States, sits in offshore affiliates. 223

It is true, of course, that the corporate income tax base includes not only returns to marginal investments, but also ex post returns to risky ones, as well as rents, and that rents at least also would be taxed by a well-designed profits tax. 224 As a result, this observation should not be misconstrued as suggesting that the revenues today collected through the corporate tax would entirely disappear in a profits tax. Nonetheless, it is a helpful place from which to start.

The IRS publishes aggregate data from tax returns. For 2014—the most recent year available—the IRS preliminary data show total adjusted gross incomes (net of losses) reported on personal income tax returns of $9.8 trillion, of which current-year wages and salaries plus current-year retirement benefits comprised $7.9 trillion. So, without more, one can see that income from sources other than explicit labor incomes amounted to $1.9 trillion in that year. 225 Again, the point is to remind readers of the enormous amounts of capital income actually subject to tax today and to suggest that it might behoove us to do a better job of taxing these large sums in a consistent manner.

One cross-national study concluded that in 2004, when corporate income taxes amounted to 8.7 percent of all tax revenues in the United States (federal, state, and local), personal capital income taxes amounted to another 7.5 percent, for a total of 16.2 percent of all tax revenues collected in the United States. 226 And a paper by Joel Slemrod summarizing his work with several colleagues concludes that, in pure revenue terms, federal revenues collected in 2004 in respect of marginal returns to capital—which his team measured by calculating the excess of the revenues collected by

226. Sørensen, supra note 88, at 194 tbl.2.
the actual income tax then in effect (including the expiration of the 2003 bonus depreciation rules) on marginal investments (that is, excluding rents) over the revenues that would have been collected by an ideal profits-only tax—amounted to about $89 billion for that one year. 227 (Slemrod estimates the effective marginal tax rate on capital income to be in the neighborhood of 14 to 23 percent.) 228 I would submit that the difference in taxes that might be collected from an actual income tax when compared to an actual profits tax (were such a comparison feasible) might be greater than that sum.

Moreover, through the phenomenon of tax capitalization (implicit taxation), capital income taxation is baked into the price levels of financial investments today. 229 As a result, after-tax returns should be in equilibrium across all capital investments with comparable risk profiles, and the consequences of capital income taxation (including its uneven application today) should be evidenced in the social misallocation of investments, not in their after-tax returns. This means that a comprehensive move away from capital income taxation will create windfall winners and losers. This is an underappreciated reason for preserving the taxes we know, at least in broad outline.

The point of all this is that even our badly implemented capital income tax today carries considerable water for us. We can imagine a world in which we remove a large fraction of our national income from the tax base and make up for it by a national value-added tax or substantially higher labor income taxes, but straightforward political economy considerations counsel holding onto the revenues we currently collect, rather than imagining their wholesale replacement by new taxes.

In contrast to capital income taxes, the federal gift and estate taxes are inconsequential as a matter of tax revenue. The estate tax raised only $16.4 billion in 2014 from about 12,000 estate tax returns filed in that year. 230 The gift tax added another $1.7 billion in revenue from fewer than 3,000 returns. 231 Estate and gift taxes have been whittled into insignificance

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227. Slemrod, supra note 224, at 13–16. The Slemrod analysis is particularly interesting in its demonstration that the U.S. tax burden on capital income has fluctuated very substantially over the last couple of decades. Id. at 26–27 n.14 (reporting a swing in incremental income tax collections over ideal consumption tax collections from negative $15.2 billion in 1983 to positive $108.1 billion in 1995).

228. Id. at 16.


231. See INTERNAL REVENUE SERV., GIFT TAX RETURNS FILED IN 2014: TOTAL GIFTS OF DONOR,
through both tax planning and the very large exclusions provided by Congress. In 2015, for example, an estate tax return was required to be filed only for gross estates exceeding $5.4 million, up from $2 million in 2006.\(^{232}\) By virtue of the spousal exemption and “portability,” a married couple today effectively can leave almost $11 million to heirs tax-free. To be sure, the estate and gift taxes have deadweight losses not captured by these figures, such as in respect of the complex planning devices adopted by many wealthy taxpayers to avoid their reach, but they remain a trivial revenue source to government.

D. INCLUSIVE GROWTH IS HIGHER GROWTH

An important additional reason to retain capital income taxation in particular as a fiscal policy instrument is the exciting work undertaken in recent years by the IMF, the OECD, and academics on the theme of “inclusive growth.” Much traditional policy literature addressing economic growth starts from the premise that capital taxes are bad for growth because they reduce capital stock. At its extreme, this literature reduces to a bizarre cheerleading for the United States to prevail in an imagined GDP Olympics, in which more sophisticated measures of welfare (including social cohesion, environmental sustainability, and many other factors) are ignored in favor of a single highly imperfect metric.\(^{233}\)

The inclusive growth literature responds directly to these traditional models that posit a tradeoff between efficiency and equity—without tumbling all the way down the hill to Gross National Happiness formulations. The first point is that the United States, along with most other advanced economies, is held back by weakness in demand, not capital supply. Given that interest rates today often are below zero, even in the case of some corporate borrowers, this cannot be wholly off the mark. The second is that inequality hurts an advanced economy’s most important capital stock, which is its investment in human capital. And this is before considerations of the corrosion of social bonds promoted by fiscal policies that emphasize lower taxes on capital supply and fiscal consolidation measures.

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\(^{233}\) KLEINBARD, WE ARE BETTER THAN THIS, supra note 16, at 120–21.
As the IMF, hardly a hotbed of Marxist economic thought, has written:

Income equality can lead to higher long-term growth through faster human and physical capital accumulation. . . . Recent studies indicate that high levels of inequality are, overall, harmful for the pace and sustainability of growth. Education and health outcomes of the poor tend to be better in a more equal society, due to higher personal income, larger transfers from the government, and/or better public services. This can lead to a faster accumulation of human capital. In addition, higher income equality can expand the size of domestic demand and support higher physical capital accumulation.\(^{234}\)

The IMF’s institutional change of heart in large measure is attributable to an important Staff Discussion Note that it published in 2014, by Jonathan Ostry, Andrew Berg, and Charalambos Tsangarides. The paper concludes:

\[L\]ower net inequality is robustly correlated with faster and more durable growth, for a given level of redistribution. . . . [Further], redistribution appears generally benign in terms of its impact on growth; only in extreme cases is there some evidence that it may have direct negative effects on growth. Thus the combined direct and indirect effects of redistribution—including the growth effects of the resulting lower inequality—are on average pro-growth.\(^{235}\)

To the same effect, the OECD has released a series of book-length publications on the social and economic costs of inequality. In one such publication, the OECD summarizes its findings as follows:

Beyond its impact on social cohesion, growing inequality is harmful for long-term economic growth. The rise of income inequality between 1985 and 2005, for example, is estimated to have knocked 4.7 percentage points off cumulative growth between 1990 and 2010, on average across OECD countries for which long time series are available. The key driver is the growing gap between lower-income households—the bottom 40% of the distribution—and the rest of the population.

A main transmission mechanism between inequality and growth is human-capital investment. While there is always a gap in education outcomes across individuals with different socio-economic backgrounds, the gap widens in high-inequality countries as people in disadvantaged


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households struggle to access quality education. This implies large amounts of wasted potential and lower social mobility.\textsuperscript{236}

Together, the conclusions reached by the IMF and OECD are remarkable, and they represent a virtual reversal of course from their standard analyses of a decade ago. These policy statements stand in sharp contrast to neoclassical microeconomics models that still dominate much academic and policy discussion in the United States. Further, their conclusions have not yet been reflected in legal academic literature. The implication of the IMF and OECD analyses is that capital taxes (which, by virtue of the concentration of capital income shares at the top end, fall largely on the most affluent) can lead to higher growth if used to fund investment in the human capital of lower-income households.

E. THE RICH ARE DIFFERENT FROM YOU AND ME

Whatever else one might think of the highly affluent, we all can agree that they have more money than do the rest of us, which is reflected in the fact that capital shares are even more top-weighted than are income shares. Concerns over social cohesion imply that disproportionate growth in top-end incomes and wealth has important negative externalities. Our inefficient and poorly implemented current capital income tax system nonetheless raises substantial revenues from the most affluent (as the owners of most capital) and is baked into the prices of financial assets; eliminating a large fraction of that capital income base would precipitate a revenue shortfall and transition winners and losers. Our existing revenue base is too small for the government we in fact demand, and the need to invest in the human capital of lower-income citizens—which leads both to welfare gains in the broader sense and to enhanced economic growth in the narrower sense, along with other social investment opportunities (for example, infrastructure or basic research)—requires that still more revenue be collected.

Capital income taxation responds to all these imperatives. A moderate annual tax on capital income (after an exclusion for a reasonably-capped IRA) raises revenue in a progressive way, by virtue of both the distribution of capital across society and the fact that a flat-rate capital income tax operates as a progressive tax along the dimension of time (the subject of Part IV). Such a tax faces neither the tax evasion deadweight losses nor the political economy headwinds implied by steeply higher labor income tax

\textsuperscript{236.} OECD, IN IT TOGETHER: WHY LESS INEQUALITY BENEFITS ALL 15 (2015).
rates, and does not create windfall winners and losers. At the same time, such a capital income tax mitigates the growth in top-end inequality and, by providing a larger revenue base, enables government to invest in the human capital of lower-income citizens, thereby obviating the risk that today’s top-end inequalities will become hereditary genes.

Taxing returns on capital received as a gift or bequest is not a distortionary and unnecessary tax on the labor income of the recipient, and the impact of such taxation on the donor’s behavior is at best ambiguous—particularly given that the original accumulator of capital might have lived several generations ago. From the perspective of the recipient, gifts and bequests are pure windfalls, and the recipient’s claim to that capital, therefore, is highly contingent as a matter of economic efficiency, in the same way that it is a claim to rents. In each case, the recipient is unambiguously better off with the tax-reduced windfall, and as a result, the recipient’s behavior is not affected by any taxation.

As a matter of moral philosophy, the recipient’s claim to windfall gifts and bequests also rests on unstable ground. The starting stock of capital delivered through gratuitous transfers permits recipients a head start in human capital investment, in emotional security, and in myriad other real payoffs.

Money, of course, is fungible. Once received, the fruits of gratuitous capital transfers cannot readily be distinguished from the returns to capital derived from lifetime labor earnings representing deferred consumption. At most, one can suggest that, if lifetime income smoothing is thought to be normatively desirable (and not, for example, a signifier of superior earnings ability), then IRA-type mechanisms (reasonably capped in size) have a continuing role in the capital tax instrument design. Beyond that, the efficiency case for exempting normal returns from tax largely evaporates in practice.

To be clear, the distributional consequences of government spending dominate those of any plausible tax regime. Even mildly regressive taxes can fund very progressive fiscal systems, provided only that the overall fiscal system is sufficiently large. It is a category error to debate the distribution of taxes alone; the handprint of government on the lives of its citizens can only be captured by considering the distributional consequences of the fiscal system as a whole.

237. KLEINBARD, WE ARE BETTER THAN THIS, supra note 16, at 55–62.
238. Id. at 335–71.
As a result, a larger government can make social investments that respond directly to some important centrifugal forces that define our country today, and which will have profoundly important distributional payoffs for lower-income citizens. But in the end, large-scale social investment will mean that those with more income or assets will invest in those with less. The political economy virtue of flat-rate capital income taxes in this regard is that the absolute magnitude of the incremental tax revenues required to pursue these opportunities to invest in the human capital of all citizens and other social investment opportunities can be kept to a minimum. That is, capital income tax rates can be set at lower levels than top labor income marginal tax rates while still operating as highly progressive in practice, by virtue of both the distribution of capital shares and the progressive operation of such a tax along the dimension of time.

A value-added tax combined with government investment can yield the same net fiscal impact as can a capital income tax, but it requires a larger absolute tax take, because, in the value-added tax case, the less affluent must pay tax with one hand, only to recoup that contribution with the other. With a capital income tax, by contrast, the fiscal system can be made substantially more progressive from both directions: the tax itself, while low-rate in nominal terms, actually is progressive in application, and the government investment programs that those revenues fund are themselves highly progressive in their distributional impact. This means that the aggregate size of government must be larger than if a capital income tax instrument is employed. As a result, a capital income tax is efficient along the political economy margin of minimizing government gross revenues and spending.

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

This Part IV starts from the premise that the political economy arguments laid out in Parts II and III make the case for some sort of sensible capital taxation. Part IV first explores the relative practical advantages of wealth and capital income taxes, concluding that capital income is a better base for accomplishing most of the political economy agenda that motivates this Article. It then argues the case that a flat-rate capital income tax has both practical and theoretical advantages over a progressive consumption tax—including the fact that it is a progressive tax in application along the relevant margin of time. Part V considers the theoretical decomposition of capital income into normal returns, risky
returns, and rents, and asks how realistic those categories are when applied in the field. The Dual BEIT proposal allocates the taxation of these components among business enterprises and investors in a novel way, but for simplicity, this Part IV ignores the design of the Dual BEIT to concentrate instead on why a flat-rate capital income tax, including on normal returns, is a useful policy instrument.

A. NIBBLED TO DEATH BY DUCKS

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

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

To be clear, one tax instrument need not be chosen to the exclusion of others: there are good reasons to rely on several tax instruments here, as elsewhere. For example, if extraordinarily large concentrations of wealth are viewed as having important negative externalities, a functioning gift and estate tax will constitute one element of a policy response. But one

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240. Bankman & Shaviro, supra note 65, at 515–16 (arguing that a tax on capital income is the "most obvious solution" to growing wealth concentration, despite perceived normative and efficiency-based drawbacks).

241. See McCaffery & Hines, supra note 50, at 1097.

242. See generally Gamage, supra note 1; Schizer, supra note 1.
does need to decide which instrument will do the bulk of the heavy lifting, and in this Part IV I argue that a flat-rate capital income tax has desirable properties in this regard.

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

I do not consider in this Article or its companion a tax on wealth as such, on the theory that in the United States, federal direct wealth taxes can be ruled out simply by virtue of the constitutional proscription against “direct” taxation except by apportionment among the states in proportion to their populations. As a practical matter, therefore, the important tax instruments directly related to capital are a gift and estate tax and a capital income tax, including the investor component of the Dual BEIT.

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

243. See supra Intro.D.
245. See supra notes 230–232 and accompanying text.
imagine that it would largely replace the much larger sums raised even today by capital income taxation.

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

Second, flows leave behind them a more visible contrail than do stocks. Virtually all portfolio capital income earned by individuals passes through one financial institution or another, which reports those amounts to investors and the IRS. By contrast, there is no systematic information reporting system in the United States for capital (in the narrow, productive investment sense) or wealth more generally, and it is not easy to see how one would be created out of whole cloth.

Small business net income is a principal exception to the rule that capital flows are readily visible, in that tax compliance rates are notoriously low in this area. But the same is true of any gift and estate tax in respect of investments in such activities. One must battle both creative planning efforts to pass small business wealth to the next generation free of gift and estate tax and the overwhelming congressional impulse, as seen in “family farm” exceptions today, to excuse small business from any intergenerational transfer tax inconvenience.

Third, a gift and estate tax, like taxes on capital gains, dividends, or the distribution of the retained earnings of foreign subsidiaries of U.S. corporations (so-called permanently reinvested earnings), operates essentially as an excise tax: the imposition of the tax is delayed until the event triggering it occurs. One consequence is that, as the untaxed reservoir of income or capital fills up behind the dam of the triggering event, the tax becomes more and more vulnerable to a one-time, never to be repeated tax holiday, of the sort actually adopted by the United States in 2004 in respect of the permanently reinvested earnings of U.S. multinational companies.

247. See, e.g., Paul Sullivan, Small, Private Insurers Face Increasing Scrutiny on Avoided Taxes, N.Y. TIMES (Jan. 15, 2016), https://nyti.ms/2kG9mn3 (detailing purported “captive insurance companies” established by small businesses to move wealth between generations).

248. See Blatt, supra note 246, at 339–40.

In that instance, income that ordinarily would have been taxed by the United States at the 35 percent corporate income tax rate (subject to a foreign tax credit) was eligible for one year to be taxed at a 5.25 percent rate (subject to a prorated credit). The purported reasons for doing so—to encourage investment and employment in the United States in the face of a mild recession—were not realized, but about $310 billion in incremental dividends from foreign subsidiaries to U.S. parent companies were paid in the holiday year.250

A progressive consumption tax has the same risk: the commitment to tax the reservoir of capital income when finally consumed will, on occasion, be breached by the exigencies of the moment, such as a major recession. In such circumstances, the cry to offer a one-time tax holiday on consumption to stimulate the economy will be difficult to resist. Can anyone imagine that, if this country relied on a progressive cash-flow tax model, in which individuals held all their savings in tax-deferred accounts, Congress in the midst of the 2008–2010 financial crisis would have been able to withstand the temptation to offer a one-time, never to be repeated, tax holiday on that pool of savings to jump start consumption?

Finally, like the nibbling of ducks, an annual tax on capital income can raise the same present value of tax revenues in respect of the returns on capital over time as does a gift and estate tax, capital gains tax, or other quasi-excise tax imposed on future transfers, while employing a lower nominal tax rate. The reason is simply that the tax deferral implicit in any excise tax, when compared with an annual income tax, operates to exempt from tax not the base returns on capital (those, indeed, are taxed when the tax ultimately is triggered), but the internal compounding of those base returns over the term of the deferral.251

By way of an example, imagine that a taxpayer today creates an investment account containing $1,000. The account earns 5 percent per annum (compounded annually), and the earnings (but not the original investment) are subject only to a 40 percent flat tax in thirty years. (One can imagine this setting either as a capital gains/dividend tax, or alternatively, as a gift and estate transfer tax on those earnings alone, in either case imposed at the end of thirty years.) The account will grow to

$4,322 at the end of year thirty; $3,322 represents the return over that time. A 40 percent tax on that return is $1,329, which would leave the taxpayer with $1,993 in after-tax return ($2,993 in total, including principal). This amount, in thirty years, is equivalent to a 3.72 percent return on $1,000 over the thirty years, which is another way of saying that an annual income tax imposed at a roughly 26 percent rate would equate to the 40 percent transfer tax on the income earned by the account thirty years out. The greater the deferral period or the higher the pretax yield of the investment, the lower the equivalent annual income tax rate needs to be.

In this example, I excluded from tax the original $1,000 in capital. If the original investment also were subject to the 40 percent transfer tax, as would be true in an ideal gift and estate tax, then the taxpayer would be left with $2,593 after the transfer tax, and the equivalent income tax rate on the return on the investment (but not on the capital itself) would need to be about 36 percent. A politically salient way of describing this outcome is that, for a 10 percent (not percentage point) lower nominal tax rate, I have solved the problem of the apparent double taxation implicit in all gift and estate taxation—once as capital income is earned, and again when it is transferred.

An excise tax-like structure, including the misnamed “income” tax on recognized capital gains or dividends, as well as transfer taxes like the gift and estate tax, exempts the internal compounding of returns from tax. Annual income taxation eliminates the tax exemption of the internal compounding of returns implicit in any such ex post excise tax structure.

A more general description is that deferral—that is, an excise tax structure payable in arrears, by whatever name—provides a taxpayer a pretax return on after-excise tax cash flows.252 This is easily seen by imagining that a taxpayer divides up each flow as received into an amount sufficient to pay the excise tax due in the future and a remainder. Both will grow at the pretax rate of return. For example, as noted, the $1,993 after-tax return at the end of year thirty in the first case represents an internal yield of 3.72 percent. This figure can be decomposed into a 5 percent (that is, pretax) rate of return on the taxpayer’s base after-excise tax income of 3

252. STAFF OF J. COMM. ON TAXATION, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART II, at 6–7 (Comm. Print 2007). As that pamphlet explains, the case considered here, the time value of deferring compensation income, and many other time-value-of-money inquiries, all can be understood by applying this same methodology of visualizing a prefunding of the flat-rate toll charge, whether denominated a dividend tax, a capital gains tax, or an income tax payable only at some future date.
percent (40 percent of 5 percent), payable annually.253 In the second case, $2,593 represents an effective 5 percent return compounded for thirty years on the after-excise tax remainder of $600.

B. PROGRESSIVE CONSUMPTION TAX OR FLAT-RATE CAPITAL INCOME TAX?

Proponents of consumption taxes recognize that a flat-rate consumption tax raises less revenue than does an income tax with the same nominal tax rate, and therefore would require a higher nominal rate to raise the same present value of tax revenues. Proponents of consumption taxation further appreciate the distributional implications of a flat-rate consumption tax regime, under which the majority of taxpayers, who of necessity spend what they earn, would face those higher nominal rates each year.254

The proposal to address these issues typically is couched as a progressive wage tax, as explained by the X Tax, or alternatively, as a progressive personal expenditure tax.255 These are argued to address both revenue and distributional concerns. In the view of some, the progressive personal expenditure tax also has useful normative elements, simultaneously rewarding income smoothing and punishing excessive sumptuary spending in any year.256

This Part IV.B argues that flat-rate capital income taxation dominates a progressive consumption tax in three important respects. First, the smaller tax base of a progressive consumption tax requires implausibly high nominal tax rates when compared with an otherwise similar income tax. Second, a progressive consumption tax is not invariant to circumstances, but rather imposes effective lifetime tax rates on labor income or spending that depend on the pattern of that income or spending over time. And third, when applied to ex post returns to risk, progressive taxes violate the symmetry between income and loss that is a necessary precondition to achieving neutral (non)taxation of such returns.

A flat-rate annual capital income tax has one other crowning virtue, which is that the effective tax rate increases with the passage of time. The ability to defer consumption (that is, to hold capital) for long periods is a

253. That is, a thirty-year annuity of $30 per year, compounded at 5 percent, equals $1,993.
254. See, e.g., Shaviro, supra note 27, at 92.
255. See supra Intro.B.2.
256. See, e.g., McCaffery, supra note 102, at 814–16.
luxury afforded only to the most affluent, and a flat-rate capital income tax thus operates in practice as a highly progressive tax instrument over the relevant margin of time.

A progressive consumption tax like the X Tax or a progressive expenditure tax begins with a significantly smaller tax base than does an income tax because normal returns to capital are excluded; as a result, revenue-neutral tax legislation that adopts a progressive consumption tax base requires a significantly higher tax schedule than does an income tax. X Tax proponents, for example, patiently (and correctly) explain that the difference is only optical because the entire system operates like a giant Roth IRA, so that higher nominal wage tax rates compensate for the release from double taxation of savings; but in politics, optics matter a great deal. One can easily predict that a progressive consumption tax with significantly higher nominal tax rates than those of the personal income tax it replaces would prove to be a very difficult story to sell to a skeptical Congress.257

As developed in Part IV.A, an annual capital income tax can raise the same present value in revenues as a transfer or realization tax with a higher nominal rate while avoiding the rhetorical argument that an individual’s capital has been taxed twice, assuming long enough deferral periods or high enough returns. And as noted earlier, a capital income tax can accommodate an allowance for reasonable amounts of lifetime consumption smoothing in the form of a capped IRA—that is, a limited profits-only tax nested inside the capital income tax. In practice, then, accommodating university professors saving a bit in a rainy day fund is not the basis for preferring consumption taxation. The real differences come from the treatment of large incomes and great wealth.

At a more fundamental level, a progressive consumption tax also can impose different lifetime tax burdens on different taxpayers with the same present value of lifetime earnings, depending on their patterns of annual earnings and consumption and the degree of the tax system’s progressivity. These timing issues are widely understood and are present in any progressive tax rate structure. Nonetheless, the problem deserves emphasizing here because it undercuts any suggestion that a progressive consumption tax invariably leads to a constant present value of lifetime personal tax liabilities, which is this tax instrument’s ultimate desideratum.

257. Shaviro, supra note 27, at 97 acknowledges this issue.
Looking to the X Tax, different patterns of wage earnings lead to different present values in lifetime tax burdens. For example, a professional athlete with very high earnings over a relatively short period of life might well find that lifetime tax burdens are lower under a traditional income tax than under the revenue-equivalent X Tax. Again, a progressive income tax is subject to the same observation; the point, however, is not to assert the superiority of the latter in this regard, but rather to tamp down claims for the former.

Meanwhile, a progressive personal expenditure tax actually can lead to anomalous burdens on normal returns to capital, rather than the imposition of tax at zero rates. A flat-rate capital income tax, divorced from a progressive-rate labor income tax—which is to say, a dual income tax structure—cuts this Gordian knot, and it does so in ways that can actually impose more neutral burdens on returns to risk than does the progressive personal expenditure tax. 258

For example, imagine a low wage earner under a progressive personal expenditure tax. The individual scrimps and saves for years to enjoy an orgiastic experience in Las Vegas to celebrate his sixtieth birthday. This individual obtains a low tax rate benefit in respect of his annual deductions for savings, but he suffers a high tax rate on his big-ticket spending spree. This fact pattern violates the Cary Brown Theorem’s scaling-up mechanism (which relies on a constant tax rate to show that deducting investment is identical to exempting the normal return from tax) 259 in a direction that in retrospect, imposes a significant tax burden on the normal returns to waiting of the now sadder, but wiser, individual’s normal returns.

From the other direction, imagine a high wage earner who saves every year and who then constrains her consumption patterns in her dotage. She actually finds her normal returns subsidized in the progressive personal expenditure tax, by virtue of a large tax benefit from her peak year savings and her modest consumption in her later years. 260 That is, her first dollar of...

258. The examples that follow would apply with equal force to an X Tax that included a conventional IRA-type mechanism as an income-averaging device.
259. See supra Part I.A.
260. Edward McCaffery acknowledges that the combination of a postpaid consumption tax and progressive rates of tax on the amount consumed in a year can be viewed as taxing normal returns in a year of outsize consumption when compared with the results reached under a “steady state” consumption model, in which savings are used to smooth lifetime consumption, rather than to finance a single year of consumption run riot. McCaffery, supra note 102, at 809–18. McCaffery, however, seems to see these results as a feature, rather than as a bug, because he relies less than do other authors on a rigorous application of the theoretical reasons to prefer a...
savings is a deduction against her highest dollar of income in her peak years, but her consumption in later years is taxed at lower rates because her wage income has disappeared. Again, a progressive personal expenditure tax leads to an anomalous outcome when applied to normal returns earned in a realistic scenario.

Independent of the three points just made, the efficiency claim for cash-flow or other consumption taxes—that they do not burden ex post risky returns because taxpayers can scale up their investment to return themselves to the same after-tax position they were in before tax—depends critically on that cash-flow tax employing a flat tax rate. The taxation of returns to risk is an exercise in correlating ex post actual returns to ex ante risk-adjusted normal ones. The most important institutional design criterion for the taxation of risky returns is symmetry: that is, the government as silent partner should absorb losses on a current basis, just as it takes its share of winnings, and further should absorb the same share of each. This approach avoids introducing any tax distortion between ex ante expectations and after-tax ex post outcomes: the deal that offers the marginal ex ante return to risk also will be the marginal investment after taxes are considered. For that matter, the same point can be made about progressive capital income tax rate schedules: both cases introduce unnecessary allocative distortions. For this reason, both the Dual BEIT and the X Tax adopt flat-rate cash-flow taxation of returns to capital.

This point can be made more salient by returning to a point made in the Introduction, which is that what the tax law literature calls risky returns in many cases actually are risk-adjusted normal returns. A $1,000 investment in Treasury securities yielding 2 percent and a $1,000 marginal investment in an operating business yielding 8 percent have identical values because each bears the marginal rate of return for an investment in that risk category. If a progressive rate structure is imposed in the form of a progressive cash-flow tax at the firm level, the investment with the consumption tax, and therefore, he is more tolerant of its failures in periods of high consumption. Instead, underlying his work is a strong normative bias against binging. Economic theory, however, usually is understood to privilege agents’ preferences, not to embed a particular normative view as to appropriate and inappropriate spending patterns.

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

261. The same argument could be applied to a progressive personal expenditure tax at the household level.
higher expected risk-adjusted normal return will be systematically disfavored relative to the lower-risk investment. In both a progressive capital income tax and a progressive cash-flow tax, losses or deductions will not necessarily be tax-effected at the same rates that apply to gains.

Similarly, differences in patterns of losses (or expenses) and gains over time can affect the tax burden imposed. A progressive-rate cash-flow or capital income tax would disproportionately tax highly successful winners, given that an investment’s upside is unlimited, while its downside is capped at the amount invested. The ex ante positive expected return to risk means that the after-tax value of losses will systematically fall short of compensating firms for the higher tax burdens imposed on gains. Both a flat-rate profits-only tax (as in the X Tax) and a flat-rate income tax on capital have the desirable property of preserving symmetry in tax burdens on ex ante risk-adjusted normal returns, provided that each contemplates the immediate refundability of losses, which admittedly is not the norm in current practice.

A flat-rate capital income tax collected annually is not only symmetrical (thereby not distorting risk decisions), but it also has the virtues of not backloading government revenue collections—with attendant political economy repercussions in a world dominated by simplistic cash-flow accounting under government accounting standards—and of not being susceptible to the kind of “one time only” tax holidays described earlier, in which a reservoir of untaxed income bearing a deferred tax liability is suddenly released from behind the tax dam at discounted rates to respond to the exigencies of the moment.

Most important, a flat-rate capital income tax collected annually is progressive in its distributional implications, because its effective tax rate rises the longer the capital is invested. In other words, a flat-rate capital income tax

262. Lawrence Zelenak develops this argument in the context of progressive income taxation, but his reasoning applies with equal force to a progressive consumption tax. Zelenak, supra note 27, at 896–99.

263. A second-best resolution is to permit net operating loss carryovers that, if unused, increase in value each year by a specified interest charge, to reflect the fact that the government effectively has borrowed from the taxpayer when the government does not absorb its share of losses on a current basis. It has been suggested that this second-best solution requires ultimate refundability of unused losses on the winding up of a failed company, but again this is wholly implausible in practice. I further would argue that that it is not strictly necessary, at least when viewed from the firm’s perspective, because from that point of view, winding up is a post-mortem experience. The firm’s existential imperative is to remain a functioning enterprise, and it therefore makes investments on the basis that it will endure forever. When that premise fails, its past risk calculus becomes essentially irrelevant.
income tax is progressive in its distributional implications along the relevant margin, which is time.264 Many describe this as a fatal defect in capital income taxation.265 This Article, by contrast, sees the increasing tax wedge (that is, an increasing effective tax rate) as a feature, not a bug.266

For example, imagine that an investment yields 5 percent per annum pretax and is subject to tax at a 40 percent tax rate, so that it yields 3 percent after tax.267 In the first year, the effective tax rate is 40 percent. After five years, the effective tax rate over the life of the investment rises to 48 percent. And after thirty years, the tax wedge rises to 61 percent. After one hundred years, the nominal 40 percent tax wedge reaches 87 percent of the aggregate pretax return. If one thinks in more geological time frames, the effective tax rate rises asymptotically toward 100 percent. The reason is simply the difference over time in compounding at different rates—5 percent in the pretax case and 3 percent in the after-tax case; the former exponentially outstrips the latter over time.

This ever-increasing effective tax rate on deferred consumption is the intuitive, popular explanation for the results reached about thirty years ago in important articles by Christophe Chamley and Kenneth Judd.268 In a

264. See Shaviro, supra note 27, at 97–98 (“In effect, by taxing returns to saving, the income tax imposes, in present value terms, an increasingly steep rate on current earnings as the time when the earnings will be consumed grows more deferred.”).

265. Robert E. Lucas, Jr., Supply-Side Economics: An Analytical Review, 42 OXFORD ECON. PAPERS 293, 300 (1990) (“Ramsey’s analysis is that goods that appear symmetrically in consumer preferences should be taxed at the same rate—taxes should be spread evenly over similar goods. In this application, this principle means that taxes should be spread evenly over consumption at different dates. Since capital taxation applied to new investment involves taxing later consumption at heavier rates than early consumption, this second principle implies that capital is a bad thing to tax.”); Ludwig Straub & Iván Werning, Positive Long Run Capital Taxation: Chamley–Judd Revisited 28 (Nat’l Bureau of Econ. Research, Working Paper No. 20441, 2014), http://www.nber.org/papers/w20441 (“Judd (1999) also offers an intuitive interpretation for the Chamley–Judd result pointing out that a tax on capital is equivalent to an increasing tax on consumption. This casts indefinite taxation of capital as a villain, since increasing and unbounded taxes on consumption do not seem intuitively reasonable and seemingly contradict standard commodity tax principles . . . .”).


267. The example assumes annual compounding.

268. Chamley, supra note 4; Judd, supra note 5. For an accessible summary, see Optimal Capital Income Taxation, WIKIPEDIA, https://en.wikipedia.org/wiki/Optimal_capital_income_taxation (last visited Mar. 24, 2017) (“The Chamley–Judd zero capital income tax result—developed in Chamley (1986) and Judd (1985)—states that in a dynamic Ramsey model featuring agents with infinite lives, an asymptotically zero tax on capital income is optimal. The result is based upon the intuition that the growth of the tax wedge between current and future consumption is related to the growth of the time horizon. So as to avoid unlimited growth in tax compounding as the horizon extends, the optimal
world with infinitely lived agents (which implies, among other consequences, no inheritances), they argue that the steady-state, long-run tax on normal returns should be zero, though the starting tax rate need not be.269 Indeed, the Chamley result in particular argues for very high initial capital taxation; the zero-tax result applies only in the long-term balanced growth path.270

Unsurprisingly, the first half of this thought is often neglected in popular articles calling for lower capital income taxes.271 As Peter Diamond and Emmanuel Saez explain:

Another straightforward conclusion coming out of the Chamley–Judd model is that it is better to tax existing wealth rather than future capital income because a tax on current wealth is lump-sum, while a tax on future capital income distorts intertemporal choices. While the asymptotic zero capital income tax result has drawn great attention, the initial result is largely ignored for policy purposes . . . . However, taxing initial wealth as much as the available tax tools allow (whether as a wealth tax or a capital income tax) strains the relevance of the assumption that the government is committed to a policy that this taxation of wealth will not be repeated [because it is committed to reducing capital income taxes to zero in the long run]. Without a credible commitment (which may not be possible), confiscatory wealth taxation would adversely affect saving behavior and have serious efficiency costs because of concerns that such taxation will return. In short, we do not believe that the modeling assumptions behind the Chamley and Judd results are strong enough to support drawing policy lessons about the appropriate taxation of capital.272

Again, the most straightforward objection to the Chamley–Judd model is not to its internal logic, but rather to the premise (although papers have in average capital rate approximates zero.” (footnotes omitted)).

269. E.g., Kenneth L. Judd, Optimal Taxation and Spending in General Competitive Growth Models, 71 J. PUB. ECON. 1, 1 (1999).
270. Lucas, supra note 265, at 300, 312.
271. See, e.g., Garett Jones, Living with Inequality, REASON (Apr. 26, 2014), https://reason.com/archives/2014/04/26/living-with-inequality (“The Boston University economist Christophe Chamley and the Stanford economist Kenneth Judd came up independently with what we might call the Chamley–Judd Redistribution Impossibility Theorem: Any tax on capital is a bad idea in the long run, and that the overwhelming effect of a capital tax is to lower wages. A capital tax is such a bad idea that even if workers and capitalists really were two entirely separate groups of people—if workers could only eat their wages and capitalists just lived off of their interest like a bunch of trust-funders—it would still be impossible to permanently tax capitalists, hand the tax revenues to workers, and make the workers better off.”).
272. Diamond & Saez, supra note 146, at 179.
We do not live the lives of gods, blessed with perfect foresight and infinite life. Once attention shifts to the world we inhabit, one of imperfect clairvoyance and all-too-short lifespans, we must address the welfare of the living as well as the infinite future and consider the political economy implications of a world where a large fraction of the total stock of capital is the result of gifts and bequests. The ability to invest in one’s own human capital at no cost beyond forgone returns on the capital dropped in one’s lap by itself puts the lie to important political nostrums like equality of opportunity. And to be told that in the long run we all will be better off if wealth were allowed to compound indefinitely ignores the fact that the we who hear the message will not in fact be here to see the result of the natural experiment. It also leaves unanswered how exactly that future world might look, in light of important and distressing recent investigative work showing profound, and not necessarily constructive, imprints of the application of wealth to current political processes.

Enormous concentrations of wealth are susceptible to compounding for many decades (or, as the Forbes family wealth compilation demonstrates, for centuries) without being drawn down for current consumption. Under these facts, a low flat-rate capital income tax nonetheless operates as a progressive one in application, provided the tax is well designed (so that it in fact reaches annual accretions of normal returns), for the simple reason that its effective tax rates rise along the margins of time. Owners of dynastic levels of wealth thereby contribute to general government resources at higher effective rates than do owners of


274. See generally Piketty & Saez, A Theory of Optimal Inheritance Taxation, supra note 155 (developing a formal framework for analyzing optimal tax policies in light of this critical fact).


276. A retrospective capital income tax has similar properties, provided that the tax bill reflects a compounding “interest” charge over time. The United States has some experience with such a tax under the passive foreign investment company rules. That experience suggests that as a political economy matter, very high nominal tax bills relative to realized gains are nearly impossible to explain as a fair tradeoff for having deferred that bill for an extended period.
modest levels of capital and, in doing so, reduce the need for taxing less affluent taxpayers’ labor incomes, which is efficiency-enhancing.277

At the same time, the incremental tax revenues derived from a capital income tax that is progressive over the relevant margin of time can help to fund a level of government able to make public investments in education, science, and infrastructure, to the betterment of the great preponderance of citizens.278 Finally, perceived fairness is satisfied by the idea that tax policy results in those able to devote their private wealth to investment in their own human capital helping their fellow citizens who must rely on public investment to realize the potential of their human capital.

By design, a flat-rate capital income tax burdens returns to savings—deferred consumption—at increasing effective tax rates the longer the deferral period, thereby making it a progressive tax when viewed from the perspective of the operation of capital accumulation. Once the increasing tax wedge over time is understood as a political economy virtue, then, if a labor-capital income centrifuge is available, the tax rate on capital income can be divorced from consideration of labor income rates. The assumption made in most of the ideal income tax literature that a single rate structure applies to all forms of income is neither necessary nor desirable.

Particularly if one assumes that ordinary-course retirement savings out of lifetime wage earnings in amounts sufficient to achieve the retirement objectives of university professors would continue to be shielded from current taxation (as, indeed, the Dual BEIT contemplates), capital income taxation in practice becomes the concern only of the affluent. And in turn, the ability to defer consumption for extraordinarily long periods of time is an attribute of the most affluent. A flat-rate capital income tax burdens an attribute of consumption that ordinarily is an indicium of great affluence, but it introduces no other consumption distortions through bunching or stretching out consumption decisions.

278. This is a principal theme of KLEINBARD, WE ARE BETTER THAN THIS, supra note 16, at 390–402.
V. TEASING APART RENTS FROM NORMAL AND RISKY RETURNS

A. A FIRM’S RENTS ARE AN INVESTOR’S NORMAL RETURNS

Economists generally agree that economic rents can bear much higher tax burdens than can risk-adjusted normal returns because even after tax, economic rents offer higher returns than the next-best alternative. As previously described, maintaining tax neutrality in respect of returns to risk requires flat capital tax rates; nonetheless, it might be argued that rents can be taxed at a higher flat tax rate, or even a progressive rate structure, over and above returns to risk and normal returns. In this Part V.A, I argue that, whatever the theoretical reasons to tax rents at higher rates, in practice, it is not feasible to tease apart the components of capital income along the lines that the theoretical literature lays out. What is more, larger political economy constraints suggest that a feasible tax along the lines of the Dual BEIT must accept a lower flat-tax rate on rents than the literature might imply.

Much of the applied public finance literature (and, in particular, the tax law literature) assumes that economic rents are as scarce as hen’s teeth, but in practice the economy seems to be a toothy fowl. Joseph Stiglitz, for example, has emphasized the central role of rent-seeking in explaining income inequality trends.279 And in an important 2015 paper, Jason Furman and Peter Orszag outlined the indirect evidence for the pervasive role of rents in the American economy.280 They show that the distribution of annual returns on equity across the firms comprising the S&P 500 in 2014 was heavily skewed to the high end of the distribution (significantly more so than in 1996).281 Similarly, data on the return on invested capital across publicly traded nonfinancial firms demonstrate that the 90th percentile of this distribution has grown substantially over the last twenty-five years so that the ratio of returns on invested capital for firms in the 90th percentile to those in the 50th percentile has increased over that period from

279. STIGLITZ, supra note 174, at 28–51 (adopting a broad reading of “rents” to encompass rent-seeking in the political science sense); Stiglitz, supra note 180, at 443.
280. Furman & Orszag, supra note 211, at 2–3. See also Robin Boadway, Tax Policy for a Rent-Rich Economy, 41 CANADIAN PUB. POL. 253 (2015); Power & Frerick, supra note 211. But see Gravelle, supra note 37 (arguing that rents are not as large a feature in the economy as is suggested by Furman and Orszag).
281. Furman & Orszag, supra note 211, at 9 & fig.7.
approximately 3:1 to 10:1.282 What is more, there is evidence of persistence in such returns over time, so that, among firms with a return on invested capital above 25 percent in 2003, 85 percent remained in that category in 2013.283

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

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

For example, assume that Microsoft’s original development of its Office suite was an exercise in risk. Once that original highly risky investment in a complex new suite of computer applications proved to be hugely successful, the Portuguese-language implementation of Office presumably was a straightforward extension of Microsoft’s existing cluster of Office-related intangible assets (including global market share), on which Microsoft presumably captured rent-type returns.

Finally, rents logically evolve toward normal returns in the secondary markets. Continuing with Microsoft by way of an example, once Office’s global dominance was ensured, a subsequent purchaser of Microsoft stock would expect, and pay for, the relatively predictable stream of revenue attributable to that product. Earlier investors would see their returns to risk eventually spawn rents from the extension of the original investment, and later investors would pay for a lower risk stream of future revenues

282. Id. at 9–10.
283. Id. at 11.
protected to a large extent by Office’s market dominance. Microsoft itself thus can continue to show rent-like returns to invested capital while new investors in Microsoft stock enjoy utility-like, relatively safe returns.

These observations become highly relevant when fashioning an income tax on capital because they mean that it is very difficult in practice to distinguish among the usual categories of returns to risk, rents, and normal returns. Risk begets rents, as firms extend successful returns to risk in straightforward ways, and a mature firm can be said to earn either rents or normal returns on equity, depending on whether the perspective is that of the firm or its owners (as they turn over). The theoretical case for taxing rents remains, but in practical application it is far more difficult to identify rents than is sometimes appreciated.

It is true that the consensus view in the theoretical literature is that returns to risk are not taxed, so long as the tax is a flat-rate one and losses are refundable, thanks to the scaling-up hypothesis described earlier. This would suggest that the distinction between ex post returns to risk and rents is unimportant, and one could impose a relatively high tax rate on the amalgam of the two. But we know as a political economy matter that losses will not be fully refundable in any real-world tax system, and we suspect that businesspeople may not always practice the full scaling up that the nontaxation of risk theory contemplates. Further, a necessary vice of the Dual BEIT or any other capital account allowance system is that the allowance itself will be imperfect: of necessity, it will represent a national average of returns to business marginal investments. The imperfection is magnified the greater the tax rate, and with it, the greater the gross up required to keep returns of risk untaxed.

A flat-rate tax on capital income is simple, progressive as applied to normal returns, and neutral as applied to the ex post returns from ex ante risk-adjusted normal returns. Perhaps this is as much as one can ask from a practical tax instrument.

B. ENTREPRENEURIAL UNCERTAINTY

The concept of risk itself is as slippery as is the category of rents. As John Brooks has shown, much of the tax law literature in this field, perhaps

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284. As noted earlier, “risk” in the way used in much of the literature ought to be subsumed within a larger category of risk-adjusted normal returns.
286. See supra Part I.A.
287. See Brooks, supra note 27, at 256–57 (arguing that risk aversion leads in practice to a less-than-optimal level of scaling up).
overreading the seminal paper by Evsey Domar and Richard Musgrave,288 equates risk with simple variance of returns. Modern finance theory, by contrast, when measuring risk, weights the risk of loss more heavily than the risk (that is, prospect) of gain.289 The consequence of this understanding of risk as inherently asymmetrical is that the standard scaling-up story may rest on a false model of human behavior. When loss aversion is properly considered, it is rational to expect risk takers not to scale up perfectly; as a result, risk taking is not untaxed after all.

Further, much of the tax law literature conceives of risk either through the metaphor of coin tosses or through similar exercises where all possible outcomes are known with absolute certainty.290 The literature further generally assumes that markets are complete, so that every form of risk is owned and priced in efficient markets.291

To a businessperson, this construction of risk as a good accurately priced in complete markets seems woefully unsophisticated. To paraphrase Frank Knight, a businessperson might argue instead that what the standard presentation labels returns to risk in many cases are returns to uncertainty.292

Knight’s prose is dense, sometimes internally inconsistent, and often vague, even as he lectures the reader about the necessity for precision. The result is an entire corner of literature devoted to explaining what he really meant, at least to each writer. In my reading, Knight tried to establish a class of returns to capital exposed to uncertainty, which he labeled “profits,” that he distinguished from returns to risk and economic rents.293

289. Brooks, supra note 27, at 258.
290. E.g., Cunningham, supra note 27, at 32; Warren, supra note 89, at 7; Weisbach, supra note 27, at 2.
291. Hasen, supra note 87, at 40–42.
293. More specifically, Knight outlines three types of probability situations. The first is “a priori” probability. A priori probability entails exact determination of the proportion of distribution among the different possible outcomes. The classic example is a calculation of the probability that a die will come out a certain way. If the die is perfect, a “mathematician can easily calculate the probability that any proposed distribution of results will come out of any given number of throws.” FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT 215 (1964). Much of the tax law literature on risk focuses on a priori probability.
He then related profits to the role of the entrepreneur, as the party willing to bear uncertainty in return for these profits.  

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

The key idea is that business involves accepting an unavoidable residuum of risk whose magnitude (or, alternatively, whose returns thereon) is not susceptible of pricing through the workings of a market’s price mechanism. That unavoidable residuum exists because some risks are uninsurable or unhedgeable, or because the risk itself is unknowable, or because the dispersion of returns on that risk are so difficult to measure that reasonable people throw up their hands at pricing the risk. Knight usefully labels this unavoidable residuum of risk as “uncertainty.”

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

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

The business man himself not merely forms the best estimate he can of the outcome of his actions, but he is likely also to estimate the probability that his estimate is correct. The “degree” of certainty or of confidence felt in the conclusion after it is reached cannot be ignored, for it is of the greatest practical significance. The action which follows upon an opinion depends as much upon the amount of confidence in that opinion as it does upon the favorableness of the opinion itself. Id. at 226–27. Estimates are used when evaluating circumstances “so entirely unique that there are no others or not a sufficient number to make it possible to tabulate enough like it to form a basis for any inference of value about any real probability in the case we are interested in.” Id. at 226. Thus, a priori or statistical probability often cannot be applied to such circumstances. Id. at 231.

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

Knight does not do himself much of a favor when he describes this residual risk as what today would be called “tracking error”—positive or negative returns associated with imperfect hedges or insurance. That is a trivialization of his own insight.
In turn, the entrepreneur is the person who is willing to absorb the unavoidable residuum—the uncertainty—in return for the possibility of profits. The entrepreneur has unique foresight and managerial skill, along with confidence in her judgment and the “disposition to ‘back it up in action’.”²⁹⁷

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

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

If, however, the basic story of entrepreneurship is that of irrational optimism, then it follows that, from the perspective of the entrepreneur, the interposition of a silent partner is fundamentally unfair because the entrepreneur (irrationally) values the silent partner’s absorption of a percentage of possible losses much less than the entrepreneur values the silent partner’s slicing off a share of profits. The optimism leads to an asymmetrical view of risk and, therefore, of the cost to the entrepreneur of the silent partner (the tax system). Instead of loss aversion leading to less scaling up, as under the alternative criticism of the scaling-up premise as not reflecting loss aversion, this mode of thought emphasizes that the entrepreneur responds like Achilles sulking in his tent, refusing to take on uncertainty when a silent partner comes along for a share of the upside.

In other words, in a Knightian world, uncertainty, unlike coin tossing, either is not scalable by the entrepreneur (because the entrepreneur’s

²⁹⁷. *Id.* at 269–70. For a study positing similar motivations, see Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 577–79 (2016) (describing the entrepreneur as gripped by unshakable confidence in an “idiosyncratic vision”).
particular insight cannot simply be replicated) or, alternatively, loses its appeal once the free-riding government comes in for its share. Without scaling, the nontaxation of returns to uncertainty is not achieved.

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

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

Perhaps intuitions along these lines explain the broadly shared view among policymakers that entrepreneurship is special (in a good way) and has positive externalities. The common view of the positive externalities of entrepreneurship and the heroic nature of the entrepreneur standing firm in the face of the void of unknowns lead to the universal instinct among policymakers (but not economists) that positive entrepreneurial returns should be taxed more lightly than returns from nonentrepreneurial endeavors to create a “neutral” investment horizon for this special class of cockeyed people. This usually is phrased as a plea for the tax system in some way to “reward” entrepreneurial returns relative to other returns. The cult of “small business” among many policymakers might in fact be a misphrasing of what the proponents really admire, which is entrepreneurship.

If one accepts the policy bias in favor of entrepreneurship, there is a fundamental tension in practice between getting correct the taxation of

rents, on the one hand, and entrepreneurial returns, on the other. One points in the direction of high tax rates; the other, in the direction of concessionary low rates. But because returns to uncertainty in turn can beget rents, distinguishing between the two seems impossible in any reasonably implementable capital income tax. And again, a firm’s rents can simultaneously be an equity investor’s normal returns.

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

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

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