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**Should We Adopt William Vickrey's Cumulative Averaging Income Tax System?  
Progressivity and Simplicity in Tax Reform**

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## **Introduction: Vickrey, Values, and Tax Reform**

The topic of fundamental tax reform is once again back on the political agenda. In November 2005, a report was issued by a presidential panel that had been created specifically to recommend a path toward a better tax system.<sup>1</sup> Although the panel's report thus far seems not to be generating political action, the very fact that a highly-respected group of scholars, policymakers, and tax professionals was asked to weigh in on the topic attests to the enduring importance of the issue. We can be confident that, even if the panel's proposals are not adopted in their current form, the pervasive dissatisfaction with our current tax system that led to the creation of the panel in the first place will continue to fester and lead to future proposals for reforms large and small.

While most tax reform discussions have revolved around proposals for changing the current federal income tax system into some form of a consumption tax (a national sales tax, the so-called Flat Tax, a value-added tax, etc.),<sup>2</sup> it is important also to consider whether it is possible to enact fundamental reform that would preserve the traditional

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<sup>1</sup> The President's Advisory Panel on Federal Tax Reform, *Simple, Fair & Pro-Growth: Proposals to Fix America's Tax System* (2005), available at <http://www.taxreformpanel.gov/final-report/>.

<sup>2</sup> See, e.g., John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals In The United States: A Tax Policy Discussion Of Fundamental Tax Reform*, 88 Cal. L. Rev. 2095 (2000).

income tax base yet improve upon our current system—and most importantly, that would maintain and enhance the redistributive role served by the current income tax. A system long advocated by the late Columbia University Economics professor William Vickrey known as “cumulative averaging” (or “income averaging,” or simply “averaging”) might be one such system. Vickrey argued that his system would tax income in a more accurate sense than the current tax system does, offering a possible alternative to the array of consumption tax proposals in policy debates over fundamental tax reform.<sup>3</sup>

The current U.S. personal income tax, which assesses taxes on an annual basis in a system with graduated tax rates, contains within it the potential for unfairness, treating taxpayers differently based on the volatility or smoothness of their earnings streams. A taxpayer who earns large amounts of income in one year and low amounts in other years might pay significantly more total tax over those years than another person who earns the same total amount of income but whose annual income is relatively constant. In other words, two people who earn equal amounts of income over the space of years can be treated quite differently by our tax system. The fundamental appeal of taxing average income is that it can address this potential inequity.

All inequities are not created equal, however. No system is perfect, and any particular imperfection is only worthy of our attention—and the expenditure of effort to enact new policies—if its continued existence meaningfully compromises important values or goals of society. This article, therefore, takes an approach that is to my

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<sup>3</sup> See Sec. III below for a description of the mechanics of Vickrey’s cumulative averaging system.

knowledge unique in the literature on income averaging. Most importantly, I ask whether we should even be concerned about the inequity that cumulative averaging would mitigate. I conclude that we should not, except for a very limited part of the problem that affects lower-income Americans and that could be fixed by a rather straightforward alternative policy.

In reaching that conclusion, I first discuss in quite basic terms the purposes of a tax system, from the standpoint of society and the democratic system. I do so at some length to ground the discussion of tax inequities in the realm of social goals rather than in the abstract design of tax systems. I then turn to the social goal that has held greatest sway over U.S. tax policy for the last century—progressivity. While volumes have been written about progressivity in tax policy, I deal here only with two justifications for progressivity: the most familiar arguments based on Judeo-Christian concerns for the poor, and a rather new and perhaps less familiar argument (known as “winner-take-all markets”) based on a unique efficiency concern that arises from the negative consequences of extreme income inequality.

Having laid this groundwork regarding the social purposes of taxation and the use of progressive taxation for egalitarian ends, I then describe the Vickrey tax system and assess that system based on the two criteria that Vickrey endorsed: progressivity and simplicity. Much of the problem that would be addressed by Vickrey’s system is an inequity at the high end of the income spectrum, as described above: people who earn very high incomes due to short-term success pay taxes as if their high incomes were a permanent part of their lives. While this is an undeniable inequity in the system, I argue that it is not a major policy concern. It is somewhat unfortunate and would not exist in a

perfect world, but it does not offend any serious egalitarian concern about the least fortunate in society, and I show that there might even be an efficiency gain from keeping the current system intact for this group of earners.

For low-income earners, though, the concern raised by volatile earning streams can be very real and serious. Fortunately, the problems in this area can be addressed by a targeted system that allows the least well-paid workers to avoid the inequities in the current system.<sup>4</sup> This solution can be implemented, moreover, as a discrete policy measure rather than as part of a plan to completely rewrite the tax code.

If progressivity is not meaningfully improved by adopting a tax system with widespread income averaging, what of Vickrey's other goal: simplicity? With so little to gain on the equity front, there needs to be a strong case indeed that the plan would simplify matters significantly. I complete my analysis by suggesting that the Vickrey system is, unfortunately, likely to be perceived as quite complicated and that it is also likely to create several problems that could increase the complexity of any real-world implementation of the system. Furthermore, the most important potential sources of simplification in Vickrey's system are not unique to it and could be adopted independently. Adopting them without the Vickrey plan would, in fact, be the best approach.

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<sup>4</sup> Specifically, I endorse the proposal outlined in Lily L. Batchelder, *Taxing the Poor: Income Averaging Reconsidered*, 40 Harv. J. on Legis. 395 (2003), discussed in Sec. IV below.

I thus conclude that taxes should continue to be computed on an annual basis except for low-income citizens, who should be allowed to elect a simple plan that would prevent arbitrary tax penalties that might otherwise flow from uneven earnings patterns. While other scholars should certainly look anew at Vickrey's proposal and potentially challenge the analysis and conclusions presented here, my best assessment is that Vickrey's cumulative averaging system is not an appealing template for fundamental tax reform. Progressivity and simplicity should remain central concerns for tax reform, but the full-scale program that Vickrey recommended, in particular its key component of cumulative income averaging, is not a promising avenue toward either goal.

#### **A. In Memory of William Vickrey**

In 1996, after a long and distinguished career as a public finance economist, William Vickrey was awarded the Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel,<sup>5</sup> commonly known as the Nobel Prize in Economics.<sup>6</sup> Only a few days

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<sup>5</sup> Vickrey shared the prize with James Mirrlees. The Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel 1996, available at <http://nobelprize.org/economics/laureates/1996/index.html> (identifying Mirrlees and Vickrey each as winners of one-half of the prize “for their fundamental contributions to the economic theory of incentives under asymmetric information”).

<sup>6</sup> While commonly used, this term is not strictly correct. The Nobel Prizes are separate and distinct from the economics award. The Nobel Prizes were first awarded in 1901 and are called “The Nobel Peace Prize” and “The Nobel Prize in \_\_\_\_\_” (Physics, Chemistry, Medicine, or Literature), whereas the economics award was first awarded in 1969 and carries the somewhat ungainly name noted in the text. *See,*

after learning that he had been selected for this honor, he died while driving to an economics conference.<sup>7</sup> He was thus prevented from receiving his prize in person and from enjoying the acclaim that he so richly deserved.

Prior to his death (and several months prior to his recognition by the prize committee), I had the good fortune to speak privately with Professor Vickrey about his body of work.<sup>8</sup> During one conversation, I took the opportunity to ask him a straightforward question: “Do you wish that any of your work had had a greater impact than it has had?” His answer was simple: “Yes, cumulative averaging.” He noted that much of his earlier work no longer interested him and seemed rather trivial, such as his work on auction theory, which was later mentioned specifically in his award citation (and

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*e.g.*, <http://nobelprize.org/physics/> (“The Nobel Prize in Physics”). For a critique of the economics prize and an argument that the award should be abolished, see Barbara Bergmann, *Abolish the Nobel Prize for economics - How Fair Is the Nobel? Challenge* (March-April 1999). In any case, the award is highly prestigious, and Vickrey’s recognition in receiving the award was very welcome.

<sup>7</sup> Janny Scott, *After 3 Days in the Spotlight, Nobel Prize Winner Is Dead*, N.Y. Times, Oct. 12, 1996, § 1, at 1.

<sup>8</sup> This truly was a matter of good fortune. I had not been one of Vickrey’s students (indeed, my Ph.D. work was at Harvard rather than Columbia), nor was my dissertation focused on the design of the tax system. I was at that point a resident scholar at a small research institute, and I happened to meet Vickrey at a series of conferences. I do not, therefore, pretend to be uniquely situated to discuss Vickrey’s “true views” or to have special insight into his mode of analysis. Rather, I took seriously the points that he made to me, took note of his obvious passion on the subject of his cumulative averaging system, and resolved that at some point I would give his proposal a careful look.

which is sometimes known by the eponymous term Vickrey Auctions).<sup>9</sup> Instead, he was most keenly interested in macroeconomic issues and government debt finance, especially as they related to the employment situation.<sup>10</sup>

Even so, Vickrey continued to be intensely concerned with the problem of tax reform. He spoke ruefully of the failure of the economics profession and the policy community to take up his cumulative averaging proposal, a proposal that he had first outlined more than fifty years earlier.<sup>11</sup> He provided me with a then-recent unpublished

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<sup>9</sup> *Press Release: The Sveriges Riksbank (Bank of Sweden) Prize in Economic Sciences in Memory of Alfred Nobel for 1996* (Oct. 8, 1996), available at <http://nobelprize.org/economics/laureates/1996/press.html> (describing the work for which the winners of the prize were being honored, including Vickrey's work on auctions).

<sup>10</sup> William Vickrey, *Meaningfully Defining Deficits and Debt*, 82 *American Economic Review* 305, 308 (1992) (“At present, resources of both labor and productive capacity are woefully underutilized.”).

<sup>11</sup> William Vickrey, *Averaging of Income for Income Tax Purposes*, 47 *Journal of Political Economy* 379 (1939) (hereafter “Averaging of Income 1939”), reprinted as a chapter in William Vickrey, *Agenda for Progressive Taxation* (1947) (hereafter “Agenda 1947”). Vickrey further discusses these issues in William Vickrey, *Tax Simplification Through Cumulative Averaging*, 34 *Law & Contemp. Probs.* 736 (1969), William Vickrey, *Cumulative Averaging After Thirty Years*, in *Modern Fiscal Issues: Essays in Honor of Carl S. Shoup* 117, 133 (Richard M. Bird and John G. Head eds., 1972) (hereafter “After Thirty Years 1972”), William Vickrey, *An Updated Agenda for Progressive Taxation*, 82 *American Economic Review* 257 (May 1992) (hereafter “Updated Agenda 1992”), and William Vickrey, *Simplification, Progression, and a Level Playing Field* (March 11, 1995) (unpublished manuscript, on file with author) (hereafter “Level Playing Field 1995”).

manuscript outlining his current thinking on the proposal.<sup>12</sup> While this later paper covered a wide range of subjects, cumulative averaging was the central policy proposal in that paper.

In a system of cumulative averaging, taxpayers would pay tax not on their annual income but on their cumulative average incomes over the course of their lifetimes. While I will outline the details of the Vickrey plan further below (with citations),<sup>13</sup> it is helpful here to summarize the proposal very briefly. Vickrey's plan would tax about 90% of all taxpayers at a single rate, under what he called the "normal tax." The highest income taxpayers would pay an additional, progressive surtax. Importantly, the surtax would be refundable if a person's subsequent earning went down, with taxes (or refunds) in any given year being determined by applying the tax rate schedule to each taxpayer's average lifetime income to date.

In this article, I describe Vickrey's system in detail and assess whether his system would be a worthy alternative to our current, highly imperfect tax system. Despite my great respect for Professor Vickrey and his passionate advocacy of this proposal, a system of cumulative income averaging seems unnecessary to the achievement of either progressivity or administrative efficiency. I thus tentatively conclude that averaging would not be a wise policy choice for the United States tax system.

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12 Vickrey, *Level Playing Field* 1995, note \_\_\_.

13 *See* Sec. III.A.

Vickrey was, first and foremost, committed to the goal of progressivity in taxation.<sup>14</sup> Therefore, before describing Vickrey's cumulative averaging system, I summarize below several prominent arguments that support the idea of progressivity in the tax code. Most of these ideas are undoubtedly familiar to tax policy scholars, but others might be less so. I then discuss the issues raised by Vickrey's cumulative averaging plan and evaluate its strengths and weaknesses.

## **B. The Goals and Effects of the Tax System**

The recent report by the president's tax reform commission<sup>15</sup> is only the latest event in an extended debate about the structure of the U.S. tax system. Each new election campaign, it seems, brings renewed calls to correct some fundamental flaw in the federal tax system.<sup>16</sup> We are promised that changes in the tax system will lead to greater simplicity, higher growth, enhanced international competitiveness, and a host of other appealing economic goals.<sup>17</sup>

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<sup>14</sup> For a book-length exposition of his early ideas on the importance and achievability of tax progressivity, *see* William Vickrey, *Agenda*, note \_\_\_.

<sup>15</sup> See note \_\_\_.

<sup>16</sup> For a good description of the basic tax plans that have been floated in the U.S. over the last decade or so, *see* McNulty, note \_\_\_. Though published in 2000, McNulty's article still covers the territory in terms of current tax reform proposals.

<sup>17</sup> The purported macroeconomic benefits of tax reform are discussed critically in Neil H. Buchanan, *Taxes, Saving, and Macroeconomics*, 31 *J. Econ. Issues* 59 (March 1999).

One of the most potent tools at the disposal of any government is the tax system. It is, therefore, not surprising that governments use the tax system to try to achieve social goals. Faith in democracy is based in part on the belief that the people know best how to define the “good society.” While the definition of that concept is constantly changing, some over-arching ideals can form the basis for evaluating any change in government policy. In the context of tax policy, no social ideal is more fundamental than the hard-to-define and shifting concept of fairness.

Even on such strictly economic issues as the definitions of income and consumption and what should be taxed, the ethics of society and its definition of fairness not only define what is acceptable but define it differently in different situations. Unpaid labor provided at home, for example, has thus far not been defined as income for the purpose of calculating taxes, despite this being rather obviously a form of income.

A recent political debate in the state of Utah nicely illustrates the point. There, a politically conservative governor came into office in early 2005 and immediately put the issue of state tax reform on the table.<sup>18</sup> With the Flat Tax being a favored policy by many conservatives, it appeared to some observers that a state-level flat tax was a “slam dunk.”<sup>19</sup> Because a pure flat tax system has no charitable deductions, whereas the state’s dominant Mormon “church reiterated its ‘support of retaining a state tax deduction for charitable giving,’”<sup>20</sup> the political decision was clear: “There will not be a pure flat tax in

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18 Paul T. Mero, Editorial, *Cross Country: In Utah, the Flat Tax Doesn't Have a Prayer*, Wall St. J., Oct. 27, 2005, at A21.

19 *Id.*

20 *Id.*

Utah [because] a flat tax with no deductions, exemptions or credits simply does not reflect the values and priorities of Utahns.”<sup>21</sup>

As the editorialist describing the Utah debate summed it up: “Here in Utah, good public policy is more than efficient policy. Good public policy will actually reflect the values and priorities of the people it serves.”<sup>22</sup> One might well add that that is as true in every other state as it is in Utah. It cannot be otherwise. The relative influence of different religious organizations, the variety of extant belief systems, and different personal and social priorities will lead to different outcomes in each debate, but the issues are always framed by a full range of social goals and moral concerns.

It is very much the point of policy analysis to scrutinize these social decisions and to suggest changes in the decisions that have been made (in many cases implicitly and without debate). However, it would impoverish the analysis to start from the presumption that tax policy’s only goals should revolve around those efficiency-related variables mentioned above (growth, international competitiveness, etc.).<sup>23</sup> Economic efficiency or prosperity cannot be the only goal of tax policy. If the people, through their elected representatives, choose to operate a tax policy that is plainly inefficient, that is their right.<sup>24</sup>

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21 *Id.*

22 *Id.*

23 *See* note \_\_.

24 It is surely the case, in fact, that some of the most important public policy decisions in our history have been made without reference to efficiency concerns. An analysis of whether it was economically efficient to raise the national debt to fight World War II, which was fought against enemies that relied on

In particular, it is *always* the case that changes in tax policy have the intended or unintended effect of changing society, that is, of being at least inadvertent acts of social engineering. Every definition of income, every exclusion, every attempt to simplify, involves choices as to what should be encouraged and what discouraged. In this broad sense, therefore, we cannot have a neutral tax system. The most honest way to evaluate proposed changes to a tax system is to ask two questions: 1) What are you trying to socially engineer? and 2) Are the trains running on time (i.e., are you a good engineer)?

This article looks at both administrative efficiency and progressivity in the tax code. Regarding progressivity, I ask why it is an appealing goal for tax policy, leaving aside the macroeconomic effects of tax reform. Like Vickrey, I embrace the notion of progressivity. As discussed further below, it is important to keep an eye on how the tax system affects the level of inequality in society. Even though I ultimately cannot recommend Vickrey's system, therefore, that conclusion certainly does not imply that the goal of progressivity should be abandoned or de-emphasized.

### **C. Possibilities for Fundamental Tax Reform**

Vickrey's proposal would completely replace the current U.S tax system with his preferred ideal alternative. Such full-scale plans for fundamental tax reform have been widely discussed for a number of years—though such plans are more often (but certainly not always) advanced by those on the conservative side of the political aisle.<sup>25</sup> Vickrey

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private markets (the Axis powers of Germany, Italy, and Japan) and with an ally that promoted global communism (the Soviet Union), was never explicitly made, so far as I am aware. Fascism was viewed as wrong; and political and economic decisions flowed from that moral judgment.

<sup>25</sup> Two articles summarizing of the some politically prominent plans in the 1990's, both of which criticize the plans themselves and question the wisdom of such root-and-branch approaches to tax reform,

consciously advocated his cumulative averaging plan in the years immediately preceding his death as a progressive alternative to those plans: “[I]t is possible to achieve practical simplicity and a reduction in perverse incentives to a far greater degree than under any of the ‘flat-rate’ proposals being advanced, without significant sacrifice of progressivity.”<sup>26</sup>

From this perspective, it is refreshing to consider a plan that directly attempts to separate simplicity from flatness or from changing the tax base. Vickrey makes the point that, for those who are willing to take the leap and completely rewrite the tax code, there are progressive alternatives. Indeed, on a panel discussing “Tax Reform for Lower-Income Taxpayers” at the annual meetings of the American Association of Law Schools, I started my remarks by saying: “I am here to advocate something that I do not actually believe in.”<sup>27</sup> Explaining this seemingly self-negating statement, I suggested that—even for one who is highly skeptical of the wisdom of all-at-once tax reform—one could at least offer Vickrey’s plan *arguendo*, as something to put on the table, should large-scale reform become politically possible.

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are McNulty, note \_\_\_, and Neil H. Buchanan, *A User’s Guide to Proposals to Replace the U.S. Tax System and Strangle Fiscal Policy*, 31 J. Econ. Issues 505 (September 1999) (hereafter “User’s Guide”).

<sup>26</sup> Vickrey, *Level Playing Field* 1995, note \_\_\_, at 1.

<sup>27</sup> Neil H. Buchanan, “Progressive Income Taxation and the Vickrey Cumulative Averaging System,” Tax Section, Association of American Law Schools annual meeting, San Francisco, Jan. 5, 2005 (unpublished manuscript on file with author), and notes on file with author.

Ultimately, though, it is almost surely true that “[l]ifetime taxation is not a practical proposal.”<sup>28</sup> Moreover, as I have argued elsewhere, even if a pure system were put in place, it would take no time at all for the system to be amended and altered, perhaps beyond recognition.<sup>29</sup> Talk of fundamental reform is intellectually engaging, but at some point it becomes more important to discuss realistic reforms.

## **I. Progressivity as a Goal of Tax Policy**

This section looks directly at the question of progressivity in the tax code—why it is good and how to achieve it, leaving aside the economic or administrative effects of tax reform.<sup>30</sup> In a strict definitional sense, tax progressivity is a question of simple arithmetic: a tax system is progressive if the fraction of income paid in taxes rises as income rises. Of course, it is possible for this fraction to rise and fall in different ranges of the income distribution, so that an entire tax system might exhibit progressivity, regressivity, and proportionality in different segments of the income range.

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28      Batchelder, note \_\_\_, at 416.

29      Buchanan, User’s Guide, note \_\_\_.

30      Although it may go without saying, it cannot hurt to note that the term “progressivity” is somewhat misleading in the context of tax policy, because of the increasing use of the word “progressive” as a synonym for left/liberal political thought. While many (if not most) people who identify themselves as politically progressive also support a progressive tax system, not all do; nor do all non-progressives reject tax progressivity. Similarly, even those who support progressivity need not support a progressive tax on an income base. See Edward J. McCaffery and Richard E. Wagner, *A Bipartisan Declaration of Independence from Death Taxation*, Tax Notes (August 7, 2000), where McCaffery identifies himself as a liberal who supports a highly progressive consumption tax.

In evaluating a *change* in the tax system, a policy is progressive if it increases the difference in the fraction of income paid in taxes as income rises, with regressivity and proportionality defined analogously. In other words, it is possible to propose a system that, in the strict sense, is progressive; but the change from the old system to the new one can still be a regressive change if the difference in the proportion of taxes paid by rich and poor is smaller than under the old system. For example, moving from a system with a range of average tax rates between 0% and 50% to system where the range (over the same income levels) is 15% to 16.9% is a regressive change from a more progressive system to a less progressive system.

As noted, progressivity was a core focus of Vickrey’s analysis. “[T]he personal income tax [should not be] forced to yield place to arbitrary or regressive forms of taxation. [C]umulative averaging may well be the essential key in retaining for the personal income tax its proper role in an adequately progressive revenue system. More than ever it merits first place in any ‘Agenda for Progressive Taxation.’”<sup>31</sup>

Why should the government attempt to redistribute money from the successful to those who are less so? There are, of course, a number of moral and philosophical traditions that attempt to answer that very question, and the literature on this issue is vast. A very good addition to that literature which also reviews the vast literature on tax justice in a comprehensive and comprehensible manner is the recent book by Murphy and Nagel.<sup>32</sup> As they argue, issues such as tax incidence are of only instrumental importance,

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<sup>31</sup> Vickrey, *After Thirty Years* 1972, at 133, note \_\_\_.

<sup>32</sup> Liam Murphy and Thomas Nagel, *The Myth of Ownership* (2002).

with the real goal being to know “whether a given change in the tax law will increase or reduce inequality, the level of welfare of the worst off, equality of opportunity, and so on.”<sup>33</sup>

One can also put the point as simply as saying that extreme inequality is “unjust or unlovely” and that a progressive income tax is a good way to reduce inequality.<sup>34</sup> This does not, of course, purport to be an argument but simply expresses moral revulsion at inequality in an especially memorable way.

### **A. Judeo-Christian Morality**

For all of the discussion of changing our tax system to some non-progressive alternative,<sup>35</sup> the basic and continuing commitment to progressivity has been notable in the U.S. federal tax system. Where does this consensus come from? The basis for this broadly-held opinion is quite likely the Judeo-Christian emphasis on compassion for the poor, which can manifest itself as a concern about some members of society being “too rich.” Such terms as “grotesque” and “obscene” are commonly used to describe overt

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<sup>33</sup> *Id.* at 131.

<sup>34</sup> Herbert Stein, *Regarding Henry ...*, Wall St. J., Jan. 30, 1996, at A24 (describing the views of Henry Simons).

<sup>35</sup> *See generally* McNulty, note \_\_.

displays of wealth.<sup>36</sup> These terms might be invoked when arguing, for example, that it is simply unacceptable to have poor mothers choosing between feeding their children or buying them medicine while others in the society choose between Porsches and Mercedes.

Susan Pace Hamill recently published an law review article discussing scriptural bases for tax progressivity, focusing on tax inequities in her home state of Alabama.<sup>37</sup> Looking at both the Old and New Testaments, Hamill notes: “From these biblical texts two broad moral principles of Judeo-Christian ethics emerge, ... forbidding the economic oppression of low-income [persons] and requir[ing], not only that their basic needs be met, but also that they enjoy at least a minimum opportunity to improve their economic circumstances and, consequently, their lives.”<sup>38</sup>

Hamill points out that the ability-to-pay principle is supported by her scriptural sources: “[W]hen distinguishing ethical from unethical tax structures, Judeo-Christian ethics use broad principles similar to traditional tax policy theory, both indicating that tax burdens should be apportioned according to some measure of the taxpayer’s ability to pay.”<sup>39</sup>

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<sup>36</sup> Clearly, however, this conflicts with other tenets of the American psyche, that “more is better” and that winners are better than losers. If one recognizes that high tax rates do not actually make rich people poor, however, perhaps this is not a contradiction at all.

<sup>37</sup> Susan Pace Hamill, *An Argument of Tax Reform Based on Judeo-Christian Ethics*, 84 Ala. L. Rev. 1 (2002). See also Adam Chodorow, *Tax Reform: What Would God Do?* Tax Notes, Sep. 5, 2005, at 1167.

<sup>38</sup> *Id.* at 8.

<sup>39</sup> *Id.* at 4.

The poor occupy a central place in Hamill’s summary of Judeo-Christian ethics. More than anything else, she says, the poor must occupy our attention in designing tax policies: “At a minimum, the income tax structure must be reformed to raise the exemptions to a sufficient level so that individuals and families below the poverty line do not pay any income taxes.”<sup>40</sup>

It is extremely important to note that this moral position does *not* rely on the belief that the highest income people did not “earn” their high returns.<sup>41</sup> That is, it is possible to believe that the richest taxpayers should pay a larger share even while believing that they otherwise “deserve” what they have been paid (in the sense that their earnings are not distorted by any market imperfections). This simply means that the highest-income earners will still be asked to pay a higher percentage of their income than the lowest—leaving everyone in the same relative positions that they started from, but closer together in absolute terms.<sup>42</sup> Since this is a moral judgment, it can coexist with the concern that

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40 *Id.* at 77.

41 *Cf., e.g., Tyco’s Former Top Lawyer Says He Deserved Big Bonus*, N.Y. Times, Jun. 25, 2004, at C3 (“Tyco’s former general counsel ... told jurors yesterday that he earned ‘every dollar’ he got from the company, denying a government charge that he stole a \$17 million bonus.”)

42 On the other hand, for those who believe that the reward structure of the economy is well-calibrated to the amount of a person’s talents and efforts, it is possible to argue that high-income earners are “better” members of society than are others who earn less. That is, if a person starts a business, and that business is successful, they have not only bettered their own lives but those of many others. From there, it could be argued that the tax system should be regressive, if not actually exempting high-income people from all taxes outright. The way for society to pay tribute to these people for their extraordinary contributions, so this line of reasoning might continue, is to forgive any tax obligations that their incomes might create. What

progressive taxation somehow “punishes” the most able in the society, since the punishment can be judged to be more or less acceptable, depending on the morals of the particular individual.

However, for those who believe that the market system does not always allocate rewards in perfect proportion to a meaningful notion of productivity, the case for progressivity is even easier to make. If one believes that the wages and salaries determined by the market system are not determined by marginal productivity, for example, it is relatively simple to argue that progressivity is an appropriate goal of tax policy. Quite simply, if rewards do not flow systematically from productivity, it would become the duty of those who *oppose* progressivity to justify the high incomes of the winners, rather than the other way around. If there is a random element to income determination—luck, if you will—then there is nothing morally suspect about taxing people’s income at progressive rates.<sup>43</sup>

## **B. Winner-Take-All Theory**

A more recent argument in favor of progressivity relies on their theory of “winner-

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would remain unclear from such a line of reasoning is why it is only an argument for zero taxes on the rich, rather than outright reverse-Robin Hood strategies, i.e., income-based subsidies to those with incomes above a certain level. This argument is clearly not one that I advocate. It simply reminds us that the notion of “just desserts” can lead us in sometimes surprising directions.

<sup>43</sup> See Hal R. Varian, *Economic Scene: In the Debate Over Tax Policy, the Power of Luck Shouldn't Be Overlooked*, The New York Times, May 3, 2001, at C2.

take-all” markets.<sup>44</sup> The basic idea is that the increasing spread between the enormous rewards to the favored few and the shrinking rewards to the unlucky majority creates an efficiency loss for the economy. In this view, each person has to make a choice in how to spend their time and talents during their lifetimes. If there is an ever-widening spread between the rewards of different activities, more people are encouraged to attempt to compete for this shrinking number of high-paying jobs—leaving behind valuable but less extraordinarily well-paid jobs. Each person, without consideration of the effect of their decision on the overall economy, then causes further inefficiency (beyond misallocating their actual talents) by wasting resources in an effort to gain every advantage possible in the crowded markets.<sup>45</sup>

The net result is that the overall labor force of the economy is less productive than it would otherwise be, and resources are wasted in pursuit of high-paying professions. This is in direct contrast to the notion that high pay is necessary to get people to work hard (i.e., to be productive), with the corollary that higher pay always induces people to work ever harder. It is possible that the extra hard work associated with these “winner-take-all” markets is not productive work at all—even assuming that it is always possible for people to raise their marginal effort.

One policy that this analysis suggests is, obviously, progressive taxation. Anything that narrows the spread between the highest paid (net of taxes) and the lowest

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<sup>44</sup> Robert H. Frank and Philip J. Cook, *The Winner-Take-All Society: How More and More Americans Compete for Ever Fewer and Bigger Prizes, Encouraging Economic Waste, Income Inequality, and an Impoverished Cultural Life* (1995). *See also* Martin J. McMahon and Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive*, 4 Fla. Tax Rev. 1 (1998).

<sup>45</sup> Frank and Cook, note \_\_, ch. 1.

paid will reduce (but not eliminate) the wasteful competition at the higher ends of the pay spectrum.

It is possible, however, that the increase in taxes at the higher end will not result in a reduction in the net pay of the highest paid workers. If these people are able to negotiate a pass-through of their higher tax liability to their employers (a plausible situation for those with the most unique talents), then there will be no compression of the salary structure, and hence no efficiency gain through this effect.

However, if that were the case, the tax would be an extremely effective revenue gainer, since the employers would pay the tax rather than lose the services of the favored workers. This policy is, then, a win-win situation from the standpoint of the economy. Either more progressive taxes will narrow the income distribution and simultaneously generate efficiency gains for the economy, or it will raise large amounts of tax revenue, making the tax burden for the rest of the members of society that much lighter (depending, of course, on the ultimate bearers of the higher costs of paying the rich and famous).

### **C. Progressivity in a Federal Tax System**

The federal income tax is only one part of the federal tax system, and the federal tax system itself is only one part of the entire tax system in the United States. Designing a federal income tax, or even an entire federal tax system, to achieve some ideal level of simplicity and efficiency is made much more difficult when one must consider interactions among taxing jurisdictions.

At the non-federal level, most taxes are levied as sales taxes, which are inherently regressive. In addition, most anti-externality taxes (e.g., taxes on cigarettes, alcohol, and

gasoline) are regressive.<sup>46</sup> Since the rest of the tax system is already regressive, therefore, changing the federal income tax system in a way that leaves it any less progressive will turn the whole system into an even more regressive method of raising revenue.

The goal, therefore, should be to make the Federal tax system as or more progressive than it is today. It is inadequate simply to make the federal tax system technically progressive, since even a range of effective tax rates starting at 10% and rising to 10.1% meets the technical definition of progressivity. To couple that type of federal income tax system with the rest of the tax system, therefore, would make matters worse from the standpoint of inequality.

Even for those who believe in progressivity as a general goal, it is not necessary to believe that there are *no* circumstances in which other values would over-ride concerns for progressivity. For example, as noted above, it is possible for someone who favors tax progressivity to favor taxes on cigarettes and alcohol, even if such taxes are highly regressive, in the belief that the benefits of diminished use of these poisons is worth the lost income to lower-income households.

The point is that progressivity, like all other values, is not an absolute. Rather, it can be thought of as a presumption, i.e., in the absence of affirmative evidence of a

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<sup>46</sup> Of course, these taxes might achieve other positive social results. The point is not that they should be repealed because they are regressive, but rather that their regressivity should be considered when evaluating the tax system.

greater goal being served by a regressive tax change, tax changes should be progressive. This is a goal that Vickrey endorsed, and it will be the basis of much of the analysis to follow.

## **II. Averaging in Practice and in the Scholarly Literature**

Any system that bases its tax assessments on a finite accounting period will inevitably generate results that are arbitrary, because the economic activity that is taxed continues across the arbitrary boundary lines of time created by the tax system. When rates change from year to year, of course, the results are still more arbitrary. This fundamental issue is, therefore, hardly a modern creation or discovery.

Shortly after the adoption of the original Internal Revenue Code, the U.S. Supreme Court was asked to address an unintended consequence of annual accounting. In *Burnet v. Sanford & Brooks Co.*,<sup>47</sup> the court considered the case of a taxpayer who had lost money in several years and later recovered through suit an amount in excess of its previous losses. The taxpayer contended that, in essence, the U.S. income tax system was intended imposed a tax on profitable transactions of companies, not on annual profits. By that logic, the company could go back in time and offset gains in one year with losses in another, so long as the gains and losses were related to the same transaction. Rejecting that argument, the court stated that, even if the net result of combining two years into a single taxable period would show a loss for the company, “it has never been supposed that that fact would relieve him of tax on the first, or that it affords any reason for

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<sup>47</sup> 282 U.S. 359 (1931).

postponing the assessment of tax until the end of a lifetime, or for some other indefinite period.”<sup>48</sup> Since the Congress that enacted the tax code was aware that the common practice in income tax systems was to tax on an annual basis, the court could not conclude that Congress intended otherwise when it created an income tax for the United States.<sup>49</sup>

Since *Sanford & Brooks* was decided, Congress has attempted to mitigate the effects of annual accounting in a number of *ad hoc* ways, which I summarize below.

#### **A. Attempts to Create Limited Relief in the Code**

The current tax code includes several provisions that allow taxpayers to take advantage of losses in one year to offset gains in another. Section 172 allows individual taxpayers to carry forward or carry backward net operating losses on business losses (for twenty years and two years, respectively).<sup>50</sup> This section was created to “ameliorate the unduly drastic consequences of taxing income strictly on an annual basis.”<sup>51</sup> Capital losses may also be carried over.<sup>52</sup>

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48 *Id.* at 365.

49 *Id.*

50 I.R.C. § 172

51 *United States v. Foster Lumber Co.*, 429 U.S. 32, 42 (1976).

52 I.R.C. § 1212.

The “tax benefit rule” allows a taxpayer who has not taken advantage of a tax deduction (and can no longer do so) to avoid paying taxes on a subsequent recovery.<sup>53</sup> This rule is highly incomplete in providing relief, however, because it only protects taxpayers who have received zero benefit from a deduction. If a taxpayer has received any reduction at all in taxes due in one year, it could still be required to pay taxes at a higher rate in a subsequent year.<sup>54</sup>

These limited examples demonstrate that Congress has not systematically undermined the basic annual accounting framework in the current tax code. At one point, however, Congress did enact a system of limited income averaging.<sup>55</sup> Richard Schmalbeck’s landmark article discussing that ill-fated system was actually written in advance of the law’s repeal,<sup>56</sup> though the question of whether his article was the direct cause of the law’s demise is certainly open to speculation. Schmalbeck describes the various provisions of the now-repealed averaging system in admirable (one might even say excruciating) detail, noting *inter alia* that the system was originally set up to allow

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53 I.R.C. § 111.

54 William A. Klein et al., *Federal Income Taxation* 137 (13th ed. 2003).

55 I.R.C. 1301-05 (repealed 1986).

56 Richard Schmalbeck, *Income Averaging After Twenty Years: A Failed Experiment in Horizontal Equity*, 1984 Duke L.J. 509.

taxpayers to average income over the previous four years<sup>57</sup> (later reduced to three years<sup>58</sup>) and that the system did not permit taxpayers to take advantage of averaging when income declines.<sup>59</sup>

As Schmalbeck notes, though, “it is extremely difficult to describe the income averaging computations accurately without falling into the soporific syntax of the instructions found on tax forms: Take the excess of this over twice the amount of that, and multiply the result by some other apparently arbitrary amount.”<sup>60</sup> Fortunately, it is necessary to note here only that the system that existed from 1964-86 was clearly not the lifetime cumulative averaging system that Vickrey envisioned. Learning now whether, for example, nonresident aliens were eligible to elect income averaging<sup>61</sup> would serve as an unnecessary distraction.

## **B. Vickrey and the Tax Policy Literature**

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<sup>57</sup> *Id.* at 510.

<sup>58</sup> *Id.* at 578.

<sup>59</sup> *Id.* at 510 (“averagable income” is the amount by which taxable income in the computation year *exceeds* thirty percent of total income in the base period), 577 (“Congress should . . . make averaging available when a taxpayer’s income declines.”)

<sup>60</sup> *Id.* at 512.

<sup>61</sup> *Id.* at 519 (they were not eligible).

As noted in the Introduction to this article, Vickrey was deeply disappointed that his cumulative averaging proposal did not capture the imaginations of the academic and political communities. An article that he wrote a few years before his death began: “Since the Publication of *Agenda [for Progressive Taxation]* in 1947, remarkably little of its recommendations have seen implementation. . . . While many of the original recommendations remain valid, new circumstances call for a fresh look.”<sup>62</sup>

Vickrey’s assessment of his proposal’s unpopularity appears to have been largely accurate. As Batchelder notes: “Few scholars have systematically analyzed the merits of taxation of lifetime income relative to the annual perspective,” noting only two such pieces over the previous fifty years.<sup>63</sup> Even broadening a search in the legal literature<sup>64</sup> to find articles that refer to Vickrey’s landmark 1939 article on cumulative averaging<sup>65</sup> or to his 1947 book on progressive taxation<sup>66</sup> reveals a relatively small number of citations.

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<sup>62</sup> Vickrey, Updated Agenda 1992, note \_\_\_, at 257.

<sup>63</sup> Batchelder, note \_\_\_, at 399 (citing Schmalbeck, note \_\_\_, and Wilbur A. Steger, *On the Theoretical Equity of an Averaging Concept for Income Tax Purposes*, 13 Tax L. Rev. 211 (1958)).

<sup>64</sup> The search was limited by the coverage of the database to articles published since 1980.

<sup>65</sup> Ten articles cited Vickrey, Averaging of Income 1939, note \_\_\_. The full list is on file with the author. Individual articles mentioned in the text are footnoted below.

<sup>66</sup> Forty-six articles cited Vickrey, Agenda 1947, note \_\_\_. The full list is on file with the author. Individual articles mentioned in the text are footnoted below.

Citations to the Vickrey's work are often referring to some other topic entirely,<sup>67</sup> mention averaging briefly in the context of discussing a related topic,<sup>68</sup> or contrast it with the subject of the author's interest.<sup>69</sup>

The articles that deal most directly with the essence of Vickrey's approach include Soled, who argues for a two-year period of taxation, rather than one,<sup>70</sup> Shakow, who discusses cumulative averaging at length in an article advocating accrual taxation,<sup>71</sup>

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<sup>67</sup> See, e.g., William T. Mathias, *Curtailing the Economic Distortions of the Mortgage Interest Deduction*, 30 U. Mich. J.L. Reform 43, 54 (1996) (citing Vickrey for the proposition that "pure free-market economists argue that government preferences for home ownership lead citizens to divert resources from their most productive uses, thereby reducing economic efficiency and retarding economic growth..")

<sup>68</sup> See, e.g., Stephen B. Land 1996, *Defeating Deferral: A Proposal for Retrospective Taxation*, 52 Tax L. Rev. 45, 62-64 (1996) (referring to Vickrey's lifetime averaging system in the course of discussing "accrual on debt instruments"). See also David M. Schizer, *Realization As Subsidy*, 73 N.Y.U.L. Rev. 1549, 1596-97 (1998) (mentioning Vickrey among a group of authors who have proposed charging interest on taxes deferred due to the realization requirement)

<sup>69</sup> Noel B. Cunningham, *Symposium On Wealth Taxes Part I: Commentary Observations on Retrospective Taxation*, 53 Tax L. Rev. 489, 490 n.16 (2000) (citing Vickrey's averaging plan as a method of retrospective taxation that is an alternative to "most methods," which "deal solely with assumed gains.").

<sup>70</sup> Jay A. Soled, *A Proposal To Lengthen the Tax Accounting Period*, 14 Am. J. Tax Pol'y 35 (1997).

<sup>71</sup> David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation.*, 134 U. Pa. L. Rev. 1111 (1986)

Batchelder, whose work is discussed below,<sup>72</sup> and McCaffery, who spends several pages comparing and contrasting his proposal for a progressive postpaid consumption tax with Vickrey's cumulative averaging plan.<sup>73</sup>

In addition to these published works, several relevant unpublished articles have circulated recently. Liebman derives theoretical conditions under which cumulative taxation could increase social well-being.<sup>74</sup> Fennell and Stark offer a careful analysis of Vickrey's cumulative averaging proposal,<sup>75</sup> followed by their own alternative proposal of a system of "age-based taxation," which adjusts the tax rate structure to take account of age.<sup>76</sup>

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<sup>72</sup> Batchelder, note \_\_. See Sec. IV.

<sup>73</sup> McCaffery, note \_\_, at 880-84.

<sup>74</sup> Jeffrey Liebman, *Should Taxes Be Based on Lifetime Income? Vickrey Taxation Revisited* (July, 2002) (unpublished manuscript, on file with author)

<sup>75</sup> Lee Anne Fennell and Kirk J. Stark, *Taxes Over Time* 22-32 (September 2005), available at <http://ssrn.com/abstract=799354>.

<sup>76</sup> *Id.* at 32-55. See esp. *id.* at 32 ("Age-based taxes take an entirely different approach to the problem of taxation over time than do lifetime averaging proposals. Instead of seeking to effectively level out peaks and valleys in earning patterns, age-based taxes attempt to consciously exploit systemic life cycle patterns, as this Part explains.") and *id.* at 33 ("Our analysis focuses on a more fundamental alteration of the tax rate structure to take account of age.")

Finally, Schlunk proposed a lifetime averaging system for a unique purpose: allowing taxpayers to borrow less money on private markets by shifting their borrowing to the government, which can borrow at lower rates. Thus, even if the taxpayers ultimately reimburse the government for its borrowing costs, they are better off by the amount of the lower interest payments.<sup>77</sup> While an interesting proposal, Schlunk's focus is clearly not on the same issues that motivated Vickrey.<sup>78</sup>

It thus seems fair to say that Vickrey was right in concluding that his plan for cumulative averaging has garnered little support—and apparently no unqualified support—a situation which continues to this day. Schmalbeck and Batchelder deal most centrally with the concept of income averaging in the sense that Vickrey discussed it, but each author rejects to a significant degree Vickrey's policy stance. The current article, it is fair to say, also falls into that category.

### **III. The Vickrey Cumulative Averaging System**

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<sup>77</sup> Herwig J. Schlunk, *A Lifetime Income Tax* (March 2005), available at <http://ssrn.com/abstract=668942>. *See esp. id.* at 2-4.

<sup>78</sup> *Id.* at 30 (“This paper is not directly concerned with the detrimental effects that a progressive income tax regime can have on taxpaying units with wildly fluctuating incomes.”). Schlunk does go on to examine an example of a taxpayer with a volatile income stream, but he concludes that the benefit from the government's lower-cost borrowing is likely to be more important even to a volatile-income taxpayer than any benefits from smoothing tax liabilities. *See id.* at 35.

As noted above,<sup>79</sup> the adoption of an annual system of tax accounting inherently runs the risk of creating arbitrary and thus (horizontally) inequitable results. A more specific problem is created by the interaction of annual accounting periods with graduated rate structures, potentially causing a taxpayer to pay a penalty merely because of the timing of his income stream over the space of a few years. This issue, too, has long been recognized. In his landmark 1939 article, Vickrey could fairly begin by noting that “[i]t has *long been considered* one of the principal defects of the graduated income tax that fluctuating incomes are . . . subjected to much heavier tax burdens.”<sup>80</sup>

Schmalbeck<sup>81</sup> and Batchelder<sup>82</sup> provide stylized examples of the consequences of being pushed into higher tax brackets temporarily. Using rates and deductions relevant to the time when each article was written, each provides examples that show that the penalty associated with volatile income can be very large (Schmalbeck, showing that a middle-income taxpayer can pay nearly sixty percent more in tax due to income volatility than they would have paid otherwise<sup>83</sup>) or quite low (Batchelder, showing a high-income taxpayer whose penalty from having volatile income is to pay a one percent increase in

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79 See Sec. II.

80 Vickrey, *Averaging of Income* 1939, at 379 (emphasis added).

81 Schmalbeck, note \_\_\_, at 510.

82 Batchelder, note \_\_\_, at 406.

83 Schmalbeck, note \_\_\_, at 510.

her average tax rate).<sup>84</sup> Generating yet another such example here is beside the point, so long as it is understood that a graduated rate structure can have the effect of raising the total taxes paid by a taxpayer depending on how smoothly their income stream is earned.

This section focuses on the cumulative averaging plan that Professor Vickrey described in his 1995 manuscript.<sup>85</sup> After delving into those details, it is also worth considering Vickrey's plan not *in toto* but by looking at the elements of the plan that are not actually logically connected to cumulative averaging. It turns out that one could achieve many of Vickrey's apparent goals without necessarily endorsing a cumulative averaging income tax system.

#### **A. The Vickrey Plan**

In describing Vickrey's cumulative averaging proposal, I do not propose specific tax rates or other institutional details, because those details are not the focus of this (or Vickrey's) analysis. For the occasional example, I use specific rates and other details only for illustrative purposes. I also focus on the personal side of Vickrey's system, not on the corporate side.

Under the Vickrey plan, the personal income tax system would have two parts.

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<sup>84</sup> Batchelder, note \_\_\_, at 406 (referring to *id.* at 405 Tbl. 1, which demonstrates a 1% increase in the taxpayer's average tax rate due to having earned \$200,000 one year and \$100,000 the next, rather than \$150,000 each year).

<sup>85</sup> Vickrey, *Level Playing Field* 1995, note \_\_\_.

First, everyone would pay a “normal tax,”<sup>86</sup> which would be applied to all income below a maximum threshold at a flat rate.<sup>87</sup> The normal tax would be withheld from people’s paychecks as well as from interest payments from banks, dividends from stock, etc.<sup>88</sup> This would not require the filing of any individual tax returns. People would tell their employer how many exemptions they qualify for (similar to the current form that everyone fills out on the first day in a new job),<sup>89</sup> but otherwise they would not have to deal personally with income taxes at all.

Vickrey suggested that the normal tax rate should be kept constant over time, “to avoid the pesky problems as to which yearly rate should be applied to a given payment.”<sup>90</sup> If the government needed to raise more revenue, it could change personal allowances or raise the surtax rate.<sup>91</sup>

The second part of the Vickrey system, the “surtax,” is a progressive-rate tax system applied above a certain annual average income level,<sup>92</sup> which Vickrey would

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86 Vickrey, *Level Playing Field* 1995, note \_\_, at 1.

87 *Id.*

88 *Id.* at 2.

89 *Id.*

90 *Id.*

91 *Id.*

92 *Id.*

apply only to about 10% or less of taxpayers.<sup>93</sup> Vickrey argued that the additional record-keeping required by this system (compared to the current system) would be trivial, involving nothing more than carrying over cumulative lifetime income and taxes paid from the previous year's tax return to the current year.<sup>94</sup> The surtax would then be cumulative, such that taxpayers would only pay the surtax if their average income to date was above the cut-off point.

Importantly, the Vickrey surtax would be refundable, rebating taxes paid if a taxpayer's average income fell below the cut-off point.<sup>95</sup> In that way, the system acts like a "wage insurance" plan. For example, suppose that the average annual income cut-off for the surtax was \$100,000. If a person earned \$450,000 per year every year, then she would pay the surtax every year on \$350,000 of her income. But if she earned \$450,000 in year one and \$50,000 every year after that, then she would not only pay no surtax after year one, she would also receive a refund of part of the first year's surtax every year based on her average income, until her average income reached the cut-off point, which would mean that she would have paid only 10% of her lifetime income in taxes. Vickrey argued that this system would be administratively much simpler than the current system for the

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93     *Id.*

94     *Id.* at 5.

95     *Id.*

vast majority of the population, that it would be progressive, and that it would smooth out swings in income.<sup>96</sup>

### **B. Non-Averaging Aspects of Vickrey's Proposal**

All of this is interesting and certainly not often discussed in policy circles. Given that Vickrey was so concerned with simplification, though, it is notable that he identifies a different aspect of his proposal as the principal source of simplification in his system. “The real simplification comes from the fact that the ultimate burden on the taxpayer is largely independent of the time at which he reports his income.”<sup>97</sup> Why? Because Vickrey would continue to allow taxpayers to defer tax payments on gains until realization events occurred, but they would be required to pay interest on the unpaid taxes. “Provided only that all income accruals (including capital gains and losses) are eventually brought to account ... deferral of the realization or reporting of income becomes merely a borrowing of the corresponding tax at an appropriate rate of interest.”<sup>98</sup> Vickrey even suggests that that rate of interest can become a policy tool, whereby

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<sup>96</sup> Vickrey, *Averaging of Income* 1939, note \_\_, at 397; Vickrey, *Level Playing Field* 1995, note \_\_, at 1.

<sup>97</sup> *Id.* at 5-6.

<sup>98</sup> *Id.* at 3.

lowering the rate at which taxpayers “borrow” their unpaid taxes from the government would act like a tax cut.<sup>99</sup>

Vickrey argued that, because of this “real simplification” of the tax system, “some two-thirds of the internal revenue code would become redundant.”<sup>100</sup> This suggests that a large part of Vickrey’s proposed benefits derive not from his normal tax/surtax arrangement but from the requirement that non-realized tax obligations be charged interest. This idea may have merit, but it does not require anything as large-scale as Vickrey proposes.<sup>101</sup>

Similarly, Vickrey proposes to improve the tax system by broadening the income tax base. As he notes, “it is necessary to eliminate many of the bells and whistles that confer benefits on selected constituencies, and to refrain from attempts to use the income tax as a device to encourage particular activities.”<sup>102</sup> That is an outcome for which we can all fervently hope, but the advantage again comes not from the normal tax/surtax approach. Instead, it would arise from a sudden onset of conscience, restraint, and responsibility on the part of Congress.

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99 *Id.* at 6.

100 *Id.*

101 Indeed, this is the context in which Schizer, note \_\_\_, at 1596, cited Vickrey. Schizer points out that a number of other authors have proposed similar interest-charging approaches on unrealized gains.

102 *Id.* at 1.

The larger point here is that the various elements of the Vickrey system are severable. Base broadening is appealing on its own merits. Better treatment of deferral issues is appealing as well. Either or both can be enacted now or in the future, whether or not the rest of the Vickrey package become part of the policy debate. This is fortunate, given that the analysis below ultimately rejects the cumulative averaging aspect of Vickrey’s proposal. While cumulative averaging might have been the heart of the plan in Vickrey’s view, that need not stop us from adopting appealing proposals that are severable from the whole plan.

### **C. Continuous Tax Brackets**

As noted earlier, this article is written with the purpose of both explaining the Vickrey system and exploring variations on that system. In that spirit, it is instructive to consider the possibility that the Vickrey normal-plus-surtax system might be implemented without the normal tax at all (that is, where all income is subject to graduated tax rates applied to cumulative averages) or with a surtax portion that is not designed using the traditional system of discrete graduated tax brackets.

As Vickrey points out, it really does not matter—for simplicity of calculating taxes—how many marginal rate brackets exist: “There need be no concern for the number of brackets in the schedule: the computations required of the taxpayer are the same whether there are two brackets or fifty.”<sup>103</sup> Multiple brackets do not pose a problem even for the average taxpayer, because a taxpayer “merely determines, from the tax table

corresponding to the year his cumulation [sic] began, into which bracket his income falls [and] derives from the table the amount of the tax.”<sup>104</sup>

This opens the possibility of having no discrete brackets at all, but rather having the marginal and average tax rates depend on a taxpayer’s income on the basis of an arithmetic formula. For example, the marginal tax rate could start at zero percent of taxable income and rise linearly to any maximum level. If the maximum statutory rate was 40% for taxable income of \$200,000, for example, the tax rate would be 10% for taxable income of \$50,000, 20% for taxable income of \$100,000, 21% for taxable income of \$105,000, etc.

Indeed, there is not even a theoretical reason why this relationship must be linear, if policymakers wanted to have the degree of progressivity begin slowly at lower incomes and accelerate at higher incomes up to a maximum rate. While it is possible to have discontinuities in such a system, it is difficult to see a policy or political reason not to make the tax rate curve at least continuous, even if it is not linear.

This system has the advantage that it actually removes the possibility of a bracket jump. Such a system does, however, have at least two obvious pitfalls. First, it can be portrayed as too complicated; and second, it might make it difficult to plan for the tax consequences of economic decisions, since it makes it more difficult for a person to

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103 Vickrey, *Level Playing Field* 1995, note \_\_, at 4.

104 *Id.*

know, for example, that their mortgage deduction will save them  $x\%$  on their taxes, where  $x\%$  is their marginal rate. (Of course, this complication also arises under the current system of multiple discrete rates when an economic decision would move a taxpayer into a different bracket.)

Addressing the second pitfall first, a forward-looking taxpayer can plan for the tax consequences of a decision simply by consulting a tax table. For example, if a taxpayer wants to know the value of deducting \$10,000 in property taxes, they can find their likely taxable income on the tax tables and compare the taxes for that amount with the taxes due on ten thousand fewer dollars of taxable income. Doing so is one step more complicated than simply knowing one's marginal bracket and calculating the tax reduction directly, but it is hardly onerous.

Moreover, the exercise of looking at tax tables and computing putative taxable income could have the salutary effect of inducing people to think more clearly about their decisions. As it stands, people can be tempted to simply apply their marginal tax rate to any possible change in their taxable income without considering the possibility of a bracket jump; and it is also easy to forget that some deductions are valueless if total deductions do not exceed the standard deduction. Thus, focusing taxpayers in advance on the real consequences of their decisions could prevent regrets later.

Today, with growing numbers of people (especially those with anything resembling a complicated tax situation) using computer software to calculate their taxes, the situation is even less worrisome. Taxpayers can calculate quite easily the consequences of their decisions using the commercially-available software that contains

the rate structures set by policymakers. Such software can easily handle bracket-free continuous rate structures, allowing a taxpayer to input any set of scenarios they like to consider planning opportunities.

Regarding the initial pitfall, that such a system might be perceived as too complicated, it is true that a system of continuous rates might be described (especially by political opponents) as hopelessly complex. One might not be surprised to hear comments such as: “We’d be going from a system with five brackets to one with an infinite number of brackets!!”

A few responses suggest themselves. First, while any tax plan can be described in sufficient detail to make most eyes glaze over, this plan has the advantage of looking very good next to any system with brackets. Taxpayers will be freed from thinking about brackets directly (and from worrying about bracket jumps), being directed instead to the tax tables. Second, the most obvious response to the claim that this proposal is too complicated is that every other kind of proposal is “too arbitrary.” Why jump from 25% to 28%, rather than to 27%? Continuous rates avoid this arbitrary lumpiness.

Finally, the “too complicated” argument might require a realistic compromise of coupling a constant-rate normal tax with a continuous-rate surtax. Rather than starting at 0% and going to some maximum rate, the system could start at the normal tax rate and rise to a maximum surtax rate. Most people would, again as in Vickrey’s vision, face a relatively simple federal tax structure, while those with higher incomes would face a somewhat more sophisticated system.

The appearance of complexity should not be lightly dismissed. As I discuss below, Vickrey's system of averaging appears simple to Vickrey but complicated to others. If we are thinking in pure terms, though, the concept of continuous rate structures (either as part of a Vickrey system or even as part of our current system) has some obvious virtues.

#### **IV. Critique of Cumulative Averaging, and an Alternative Proposal**

As noted earlier, the conclusion of this article is a somewhat reluctant one: Despite its various attractive attributes, the Vickrey system of cumulative income averaging is not a desirable alternative for tax reform. I should note that I reached this conclusion somewhat by surprise. In 2004, when I reflected upon my earlier conversations with Professor Vickrey and decided to pursue his invitation/request to investigate cumulative averaging, I did so expecting to be an advocate of his proposal, not a critic. Indeed, presenting preliminary thoughts that ultimately led to the writing of this paper, I argued in favor of adopting a system of cumulative averaging in my presentation on the Tax Section panel at the annual meeting of the American Association of Law Schools.<sup>105</sup>

Despite this predisposition in favor of the Vickrey system, it ultimately became clear that the arguments in favor of the system were either unconvincing or weaker than the arguments against it. As I argue immediately below, the ultimate policy concern that cumulative averaging addresses (the unequal effective tax rates faced by those with

volatile incomes, compared to those with stable incomes) is not sufficiently serious to compel large-scale rewriting of the tax code.<sup>106</sup> The unfairness of such an outcome might be somewhat regrettable when viewed in isolation, but as an argument for fundamental change of the very nature of the income tax system, it falls far short of compelling. This is, of course, a judgment call which others are free (indeed, even encouraged) to question.

The issue in any fundamental tax reform, after all, is not: “How would we design a system from scratch?” but: “Given the trade-offs, is it worth trying to change the current system to achieve a specific goal or goals?” We are never writing on a blank slate. “[W]e never face issues of tax design, but rather always issues of tax reform.”<sup>107</sup> Without an extremely compelling case that there is a basic injustice (or inefficiency, or some other important defect) in the current system that must be redressed, any problems of transition—and any complications in the design of the proposal itself—loom very large.

Therefore, this final section first explains why the case that there is a fundamental injustice in the current system is relatively weak, as a threshold issue. I conclude that whatever merits might be associated with cumulative averaging, there is ultimately not a strong case to adopt the system as a whole. Instead, a very limited averaging system for

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105 See note \_\_.

106 See notes \_\_-\_\_ and accompanying text.

107 Murphy and Nagel, note \_\_, at 128 (paraphrasing Martin Feldstein, *On the Theory of Tax Reform*, 6 J. Pub. Econ. 77 (1976)).

the poorest taxpayers would address the most pressing policy concerns.<sup>108</sup> I then describe some complications that would come with the adoption of the Vickrey plan, suggesting that even if we could get past the threshold issue of the desirability of cumulative averaging as an ethical matter, the system might become too complicated to be a viable alternative even to the current system, administratively and certainly politically.

The first question raised by Vickrey's plan, though, relates to the application of a single rate under the normal tax system to 90% or more of all taxpayers.<sup>109</sup> If progressivity is good, why is it only good above a certain income level? It is certainly true that there are compelling arguments for having someone with income of \$600,000 pay a higher rate than someone who makes \$60,000.<sup>110</sup> But if the income cut-off for the surtax were, say, \$120,000 in Vickrey's system, why are we comfortable have someone with \$120,000 in income pay tax at the same normal rate as someone with \$40,000 in

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108 See text accompanying notes \_\_\_-\_\_\_, advocating the policy conclusions in Batchelder, note \_\_\_.

109 Vickrey, *Level Playing Field* 1995, note \_\_\_, at 4.

110 The arguments here do not turn on whether we are discussing annual income or average income, so long as all numerical examples are understood to be measured consistently.

income? Especially because we are now thinking about much larger numbers of taxpayers, this seems an odd choice.<sup>111</sup>

Vickrey's indirect response to this argument is that simplicity trumps progressivity: "The total number of returns processed by the IRS would be reduced by 60 to 80 percent."<sup>112</sup> While such tradeoffs are matters of judgment, it seems at least worth questioning the choice to simplify the system by taxing the near-poor and the upper middle class at the same rate. The idea of fewer people filling out tax forms is, of course, appealing, but at what cost to equity?<sup>113</sup>

#### **A. Does Cumulative Averaging Appropriately Address Fundamentally Important Policy Concerns?**

The more fundamental issue in this analysis is the threshold question of whether, even if there were only minor costs and tradeoffs involved in adopting Vickrey's

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111 Cf. Daniel N. Shaviro, *AEI Tax Reform Panel*, Start Making Sense, available at <http://danschaviro.blogspot.com/2005/06/aei-tax-reform-panel.html> (weblog entry discussing proposal in Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 Yale L.J. 261 (2002)), describing a "dilemma resulting from the basic tradeoff between good distributional results and low-end simplification").

112 Vickrey, *Level Playing Field* 1995, note \_\_\_, at 4.

113 On the other hand, it is at least true that a single rate in the normal tax range eliminates the penalty for income volatility within that range. Making \$100,000 one year and \$50,000 the next would result in exactly the same tax payments as making \$75,000 for both years.

proposal, the gain would be worth even a little bit of pain. It is useful to evaluate the importance of the problem that cumulative averaging would address in the context of the arguments for progressivity discussed above.<sup>114</sup> It turns out that the gains from cumulative averaging generally do not create compelling arguments for change.

Schmalbeck's 1984 paper was most directly focused on the then-current system of income averaging, as discussed above.<sup>115</sup> His analysis "suggest[ed] that outright repeal of the income averaging provisions would save considerable tax revenue, improve the vertical equity of the tax system, and put the horizontal equity of the tax system on a sounder footing by using an annual rather than a multiyear standard of measurement."<sup>116</sup> Not knowing that the averaging system would soon be completely repealed (indeed, viewing immediate and complete repeal as a "somewhat radical suggestion"),<sup>117</sup> Schmalbeck offered a menu of choices to improve the averaging system without completely repealing it.<sup>118</sup>

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114 *See* Sec. I.

115 Schmalbeck, note \_\_\_, at 512-23, 557-64.

116 *Id.* at 564.

117 *Id.*

118 *Id.* at 564-76 (suggesting (1) changes in the statutory formula for computing average income, (2) an option to average when income declines precipitously, and (3) election of a self-averaging device to spread out the taxes due on large, nonrecurrent receipts of income).

With the system that was the object of Schmalbeck's ire now history, though, his paper still provides an excellent critique of the equitable arguments in favor of any averaging system. Using that paper as a touchstone, I discuss here the basic question that Vickrey seems to have taken for granted: Should we really care about the effects of income fluctuations on tax liabilities? Schmalbeck's arguments that the answer is generally "no" remain persuasive today, and there is a basic equity argument to investigate before returning to his important work.

The most basic case for averaging of income proceeds from the undeniable observation that an annual accounting framework is arbitrary and thus that income volatility is likely to have arbitrary effects. Such a result violates the notion of horizontal equity, by which "the system should not burden some individuals significantly more than others on the basis of trivial differences in economic status."<sup>119</sup> The horizontal inequity that would be addressed by cumulative averaging, though, is upon closer inspection not a matter of great concern from the standpoint of addressing inequality.

One source of annual income volatility is, of course, the kind of employment in which a taxpayer is engaged. Many (almost certainly most) types of jobs provide regular paychecks on a weekly, bi-weekly, or monthly basis. Even when there are intense periods of the year and slow periods of the year (for example, when law professors grade exams

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<sup>119</sup> *Id.* at 546.

versus almost any other time of year<sup>120</sup>), employers typically still spread pay out evenly. Even so, not everyone receives income on a regular basis.

It is somewhat surprising, though, that examples of taxpayers whose incomes are likely to be highly volatile on an extended basis are not easy to come by. In colloquia and classroom presentations, the example that I found myself invoking regularly was professional athletes, who have high incomes—sometimes stunningly high incomes—during their very short careers and (except in a tiny number of cases where endorsement deals are available or the young retiree works in broadcasting) have very low earned income thereafter. Entertainers seem to fit the category, too, with the prototype being someone lucky enough to be cast on a successful television program for a few years before sliding into has-been obscurity.

Interesting anecdotes, perhaps; but are there more compelling examples of taxpayers who pay unjustly high taxes for a few years because of our annual system of taxation? Given that a revenue-neutral system would impose higher taxes on everyone else in order to erase this inequity, the answer to this question has direct consequences for everyone. After all, if one of the consequences of choosing the highly uncertain (but apparently quite fulfilling) life of an adored athlete or a pampered actor is that you pay higher taxes because of your volatile income, the difference can easily be dismissed by those who care about progressivity as being not a matter of great moral outrage. The

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<sup>120</sup> As one uncredited wag put it about teaching in law school (and doubtless elsewhere in academia): “They pay us to grade. We teach for free.”

slightly lower after-tax income might even be viewed as the price one pays for actually being able to live one's dream—a dream shared by many but achieved by very few.<sup>121</sup>

Are there other, less easily dismissed, examples? Notably, Vickrey offers only “athletes, authors, and others enjoying a brief bonanza, who would be able to claim a rebate or refund if their income subsequently fell back to a low level.”<sup>122</sup> Schmalbeck discusses the classic example of a novelist who struggles while writing her first book, waiting tables or driving a taxicab and living in “an artsy but essentially deplorable neighborhood.”<sup>123</sup> He demonstrates, in fact, that neither Vickrey nor I are unique in focusing on the actor/athlete/author category for our examples. “Novelists with this approximate career pattern provide a major archetype for advocates of income

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121 Another dream shared by many is winning the lottery. Certainly a lottery win could push a person's income into a higher tax bracket. What Schmalbeck noted in 1984 appears to be just as true today, however: Lotteries at least offer the option for recipients to receive their winnings in annual installments, sometimes over the space of decades. Schmalbeck, note \_\_, at 556 n.167. If that option exists (and especially if it is mandatory), then there is no horizontal equity issue for someone who wins \$1 million in the lottery compared to someone who has the same average income over their lifetime. The lottery winner can pay less tax on their \$1 million, if they care to, by reducing their annual payments in a structured payout. If the gross amount of the lottery jackpot is so large that such a strategy still results in twenty or twenty-five years of being taxed at the maximum rate, then there is little that a lifetime averaging scheme could do to reduce the lucky winner's aggregate tax liability.

122 Vickrey, *Level Playing Field*, note \_\_, at 5.

123 Schmalbeck, note \_\_, at 553.

averaging.”<sup>124</sup> Schmalbeck points out that the novelist archetype is cited in congressional committee reports,<sup>125</sup> congressional testimony,<sup>126</sup> and articles.<sup>127</sup>

Those who make a living writing the occasional book (a book that must, by assumption, be a large enough seller to cover expenses for the years of near-zero income, making them very rare even among would-be career authors) do not seem—even in conjunction with athletes and actors—to offer sufficient reason to re-write the tax code. I am not aware of any polling data on the subject, but if most people would view these successful professionals as among society’s luckiest people, it becomes difficult to see where the political will for this kind of tax reform would lie.<sup>128</sup>

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124 *Id.*

125 *Id.* at 553 n.160 (citing as an example H.R. REP. NO. 749, 88th Cong., 1st Sess. A174, *reprinted in* 1964 U.S. CODE CONG. & AD. NEWS 1313, 1599).

126 *Id.* at 553-54 n.161 (citing, as an example, *Tax Reform: Hearings before the House Comm. on Ways and Means*, 91st Cong., 1st Sess. 1935 (1969) (statement of Michael Waris, Jr.)).

127 *Id.* at 554 n.162 (citing, as examples, Ferguson & Hood, *Income Averaging*, 24 *Tax L. Rev.* 53, 91 (1968), and Smith, *How to Become Miss America Without Achieving Any 'Major Accomplishment' -- Some Thoughts on Income Averaging Provisions of the Internal Revenue Code*, 54 *Marq. L. Rev.* 329, 344 (1971)).

128 Schmalbeck also mentions inventors, lawyers on large contingent fee cases, and entrepreneurs. *See id.* at 554. Perhaps such groups could generate more public sympathy for their situations, though it is

Beyond political will, though, is the question of the reasons that we might change our system of taxes. As discussed in the Introduction and Section I above, tax analysis appropriately includes normative questions of personal and social fairness. Would a policy analyst whose concerns for progressivity arise from a Judeo-Christian perspective, for example, be particularly concerned with this type of injustice?<sup>129</sup> Would Hamill's focus on the plight of the poor be shifted by the plight of those whose incomes are high enough to be subject to a surtax?<sup>130</sup> Given that her concern appears to be aimed at the least among us, it is difficult to picture her being unduly troubled by the inequity that we see here.

The argument in favor of progressivity from the perspective of winner-take-all markets,<sup>131</sup> in fact, directly contradicts the idea that one-shot bonanzas should be given better tax treatment than they currently receive. The concern is that too many people are diverting their time and attention to lottery-like pursuits, decreasing the overall productivity of the economy. Any tax policy that makes such pursuits even more likely is unacceptable from this perspective.

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not clear why people who achieve great financial success in these fields would be any more sympathetic than actors, athletes, or novelists.

129     *See* Sec. I.A.

130     Hamill, note \_\_.

131     *See* Sec. I.C.

Notwithstanding the philosophical arguments regarding progressivity, it turns out that the case for providing relief to the suddenly successful artist is weak on other grounds as well. Schmalbeck does not dwell on the generally unsympathetic position that the archetypal candidate for averaging might occupy, along the lines discussed above. Instead, he points out that the system is already treating such a person fairly well. To begin, given that there is a zero bracket for those with sufficiently low incomes, the future successful author is likely to pay zero, or at least very low, taxes while they live the life of the starving artist.

When success arrives, the income that so eluded her finally flows into the novelist's bank account.<sup>132</sup> She lives the good life, with the opportunity to take trips and to live in conditions that are far from deplorable. She pays more taxes (or maybe even begins to pay federal income taxes for the first time) and at a higher marginal rate. Why does society owe her a break on taxes? Surely not on an ability-to-pay principal, because we have hypothesized that she possesses the ability to pay taxes at a high average and marginal rate.

Moreover, as Schmalbeck notes, successful authors are in a position to control their financial affairs to a substantial degree, engaging in “self-averaging” to mitigate the

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<sup>132</sup> Of course, if success remains a stranger, we are simply looking at—from the standpoint of the tax system, at least—a permanently low-income worker. Unless the frustrated author's meager income is itself derived from a volatile source (which is surely not the case for the classic example of the person who waits

effects of an annual tax system.<sup>133</sup> Now a draw on the lecture circuit, our novelist can decide within limits when to lecture, when to write her next book, when to be paid for it, and whether to take an advance. And she is not alone, given that “a sizable industry exists for no other purpose than to provide ... advice [to] structure her professional life to accomplish a good deal of income shifting or deferral by means of Keogh plans, royalty assignments to trusts, Individual Retirement Accounts, and the like.”<sup>134</sup>

Still, there is something to the argument that, even if a successful author is not a particularly sympathetic subject in the scheme of society as a whole, horizontal inequity exists as between, say, a newly-successful novelist and a novelist who has been successful for a long time. If they both write books in a given year that bring them two million dollars in royalties, why should the more comfortable senior author pay the same tax as the younger author who is only enjoying the first fruits of success?

While intriguing, this argument confuses income and wealth. The senior author’s presumed greater comfort would derive from previous income, which has already been taxed, and from taxable income on accumulated wealth. “[C]omparisons based on wealth

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table or drives a taxicab), income averaging is simply irrelevant. If it is relevant, the very limited system described and endorsed below could deal with the situation.

133 Schmalbeck, note \_\_\_, at 554.

134 *Id.* at 553. Obviously, the menu of tax management devices changes over the decades, but the tax advising field is going strong.

are somewhat inappropriate when one is evaluating an income tax.”<sup>135</sup> (Deleting “somewhat” from the previous sentence might even be more accurate.) The two authors are not, therefore, similarly situated, making the appearance of horizontal inequity an illusion.

In sum, income averaging—especially of the sort that Vickrey proposes, with its emphasis on reducing the tax inequities faced by high-income taxpayers—lacks a strong equity-based argument that resonates with the notion of progressivity that motivates this article (and, indeed, that seems to motivate so much of Vickrey’s work). Yes, there are going to be examples of horizontal inequities in an annual system, and some taxpayers will be less able than others to mitigate those inequities. As a threshold question of tax reform, though, the roughness of this justice does not seem likely to generate widespread moral outrage. It is still easy to agree that “the annual period . . . seems roughly accurate for purposes of computing income.”<sup>136</sup>

### **B. Averaging for the Poor**

Rough justice is always roughest on the poor. Professor Lily Batchelder recently published a brilliant article analyzing the prevalence and consequences of income

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135 Schmalbeck, note \_\_\_, at 555.

136 *Id.* at 552.

volatility among the poor.<sup>137</sup> She concluded that a very limited system of income averaging would generate important benefits to the poorest members of our society.<sup>138</sup> It is for these taxpayers, rather than for the ultimately quite successful artists and inventors affected by the Vickrey surtax, that a careful change in policy would be most appropriate.

The combination of rising out of the zero bracket and losing eligibility for the Earned Income Tax Credit (EITC) creates a potential tax penalty of extremely large proportions for the working poor. Using 2001 rates, Batchelder compared a person earning \$0 one year and \$35,000 the next year with another earning \$17,500 each year. The volatile earner would pay an average of \$624 per year in taxes, while the steady earner would pay no income taxes. More significantly, the volatile earner loses an average of \$3866 per year due to not being eligible for the EITC in either year. Her total loss is \$8,980.<sup>139</sup>

While that example was designed specifically to show the amounts at stake, Batchelder goes on to calculate that “[a]nnual income measurement increases the tax burden on poor taxpayers by an average of 2.0 percentage points compared to long-term income averaging—a tax penalty four times greater than that experienced by high-income

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137 Batchelder, note \_\_.

138 *Id.* at 421 *et seq.*

139 *Id.* at 404.

families.”<sup>140</sup> More bluntly, “[l]ow-income families do not . . . experience the same level of income volatility” as other taxpayers.<sup>141</sup> The relationship between income volatility and income, in fact, is negative.<sup>142</sup> This is a matter of real concern, at least for those who consider the alleviation of poverty to be a major tax policy goal.

In response to this limited but very important (and very solvable) problem, Batchelder proposes a system that she calls “Targeted Averaging,” under which low-income earners would be eligible to take advantage of two very simple tools to reduce the tax penalty on their varying incomes: (1) Averaging incomes for two years in calculating eligibility for the EITC, and (2) Carrying back for one year unused standard deductions and personal and dependent exemptions.<sup>143</sup> Why limit the system to two years? Because most income volatility for the working poor dissipates quickly: “Three quarters of income volatility is gone after one year and nearly all after three to four years.”<sup>144</sup>

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140 *Id.* at 397.

141 *Id.* at 411.

142 *Id.* at 415.

143 *Id.* at 397.

144 *Id.* at 423 (citing William T. Dickens, *The Growth of Earnings Instability in the U.S. Labor Market: Comments and Discussion*, in 2 Brookings Papers on Econ. Activity 262, 265 (1994), in turn citing Robert Moffitt & Peter Gottschalk, *Trends in the Covariance Structure of Earnings in the United States: 1969–1987, 1001–93* (Inst. for Research on Poverty, Univ. of Wisconsin Discussion Paper, 1993)).

Batchelder suggests that although these data (which are at this point somewhat dated) seem to argue in favor of a three-year averaging system rather than a two-year system, the greater simplicity in calculations and record-keeping justifies the tradeoff.<sup>145</sup> Especially for low-income earners, any reduction in compliance burdens is a boon.

The difference between two and three years, though, is of only minor concern here. The more fundamental point is that Batchelder's system would involve only a very small legislative change in a very limited number of sections of the Internal Revenue Code, whereas Vickrey's cumulative averaging plan contemplates wholesale change in the entire code. Targeted averaging, meanwhile, relieves a very real burden on the poorest workers, while cumulative averaging appears to address horizontal inequities among the highly (if sometimes temporarily) affluent. While the problems posed by low-income volatility could potentially also be solved as part of Vickrey's system (though Vickrey does not focus on the issue), the large-scale policy change begins to resemble using a cannon to open a locked door.

### **C. Simple or Complicated?**

Vickrey maintained throughout his life that his cumulative averaging system was a move toward simplification of the tax system.<sup>146</sup> Indeed, he seemed to view simplicity

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145 *Id.*

146 Note, for example, the title of one of his papers discussed here: Tax Simplification Through Cumulative Averaging, note \_\_.

as an independent goal of his proposal, a virtue in itself in addition to progressivity.<sup>147</sup> One might even read him to be saying that progressivity is a secondary virtue of the system that can be compromised in the name of simplicity, as he referred to an “adequately progressive system” at the end of one of his articles.<sup>148</sup> Admittedly, this interpretation might put a bit too much emphasis on the word “adequately,” because Vickrey otherwise seemed quite concerned with progressivity. Nevertheless, it is at least clear that he viewed simplicity as a great virtue of his cumulative averaging plan.

How simple is that plan? In his original article, Vickrey conceded: “Any averaging device will, of course, require a certain amount of record-keeping.”<sup>149</sup> Nonetheless, “[t]he current records required under the present proposal consist of only four items: the year in which the taxpayer commenced to average, the adjusted total income, the total present value of past taxes, and the total value of the capital assets of the taxpayer declared on his latest return.”<sup>150</sup> In his later work, Vickrey had honed down the administrative mechanism for such reporting: “To simplify the processing of returns, it would be possible to attach to each return a coupon on which the taxpayer ID, the initial

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147 Vickrey, *Level Playing Field* 1995, note \_\_, at 1 (“Simplicity and progressivity can be realized ...”)

148 Vickrey, *Cumulative Averaging* 1972, note \_\_, at 133.

149 Vickrey, *Averaging of Income* 1939, note \_\_, at 394.

150 *Id.*

year of cumulation [sic], the cumulated and the cumulated tax would be entered. This coupon could then be certified by the IRS and returned to the taxpayer for use in preparing his next year's return."<sup>151</sup>

Despite his certainty that his system was simple—and his good faith attempts to improve its administrability—Vickrey's system was arguably really quite complicated. McCaffery, for example, says: "Despite Vickrey's frequent protestations to the contrary, the idea is complicated in practice."<sup>152</sup> Interestingly, McCaffery's description of what makes the cumulative averaging system complicated consists of simply describing the system. In substance, McCaffery's summary differs very little from what Vickrey described in claiming that the system is administratively simple:

It entails choosing a certain period for smoothing, adding up cumulative income (or consumption) within the period, subtracting previously taxed income (or consumption) and then applying a rate structure, which could lead to negative taxes (refunds) as well as positive taxes (payments) in the immediate period of the return, depending on how this period fit with the average. Human events such as marriage, divorce, and death were subjects of some concern, and so on.<sup>153</sup>

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151 Vickrey, *Level Playing Field* 1995, note \_\_, at 5.

152 Edward J. McCaffery, *A New Understanding of Tax*, 103 Mich. L. Rev. 807, 880 (2005).

153 *Id.*

To a substantial degree, therefore, what is simple might be merely a matter of taste. When Vickrey's eye beheld his creation, he saw its elegance and logical clarity. When McCaffery—and, to be completely clear, when I—look at the same system, we see something that hardly qualifies as simple. Perhaps more accurately, Vickrey's professional training and interests are likely to cause him to think that “simple” need not mean “easy to understand,” in the sense that the Quadratic Equation and the theory of relativity are simple in an elegant and even beautiful way. While this is a perfectly reasonable definition of simple, and even though it has the added advantage of distinguishing “simple” from “easy,” simplicity is probably best understood—at least in the context of tax reform—not in the mathematical or analytical sense but in the on-the-street sense that a simple tax system is one that is easy to understand, easy to administer, and easy to obey.

For those with training in economic theory, though, it is easy to sympathize with Vickrey's apparent assumption that some things really *ought not* to be so difficult to understand. This assumption is nicely captured by one of the smaller topics in tax policy that Vickrey touched on in one of his final writings. Describing a policy that would promote greater efficiency in the market for parking automobiles in urban centers, Vickrey says:

A more flexible and universal system of parking charges is needed whereby charges would be sufficiently high at times of greatest demand that a few reasonably convenient spaces would nearly always be available to those prepared to pay a market-clearing price, while charges would be reduced for times when demand is lower, being reduced to zero whenever there would be more empty

spaces than is needed for convenience. Many technologies for doing this are available.”<sup>154</sup> *Id.* at 22-23.

Viewed from a theoretical perspective, it is difficult not to nod and exclaim, “Q.E.D.!” for this is clearly a smart idea, one that is not even on the higher end of difficulty as economic concepts go. That this is likely to be viewed as extremely complicated (and potentially unfair) by the driving public seems secondary to the analytical simplicity of the system. Pushing the point further, Vickrey then adds: “More sophisticated systems are feasible that would permit the parking charge to be determined at the end of the parking occupancy at rates that could be varied according to how many nearby spaces have been vacant during the time of parking.”<sup>155</sup> While Vickrey concedes that this is more “sophisticated,” there is notably little if any concern for the perceptions of the public that would actually be subject to such a system. Instead, the focus is on first-best theoretical outcomes: “If properly calibrated, this would automatically keep the charges at close to the market-clearing level, enhance efficiency and raise land values.”<sup>156</sup>

My purpose here is clearly not to impugn Vickrey’s motives or his mode of analysis as a useful step in the process of designing policies. Instead, my concern is that his is not the final step in that process. First, even if the system is “properly calibrated,”

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154 Vickrey, *Level Playing Field* 1995, note \_\_, at 22-23.

155 *Id.* at 23.

156 *Id.*

will the public tolerate a system that is difficult to understand, to the point where it might not even be possible to know in advance how much it will cost to park? Second, what if the rate is not properly calibrated? Can it be so improperly calibrated that the results would be worse than they are today? If so, how likely is such a gross miscalibration?

Again, these arguments go only to the question of whether tax policies are likely to be viewed as simple in the pedestrian sense. When McCaffery says that Vickrey's cumulative averaging plan "is complicated in practice,"<sup>157</sup> he focuses on the question that seems to have frustrated Vickrey: Why was cumulative averaging a non-starter? Even if it is possible to have a system that is less of an administrative challenge than the one that we abandoned in 1986, the problem is that "simple" tax plans might not seem simple to the public at all.

I have, in fact, presented and argued in favor of simplified versions of Vickrey's cumulative averaging plan in appearances before a wide variety of audiences (non-economics professors, students, journalists, etc.), and it is fair to say that none of the audiences came to embrace the plan or saw it as a way to simplify their tax-paying lives. Even after extensive question-and-answer periods, the reaction was most commonly along the following lines: "Seems kind of complicated." "Is that really any better than the current system?" "No one will understand this." While this is hardly definitive proof that it would be impossible to educate the public to accept a Vickrey plan, it at least suggests that the hurdles to acceptance are greater than Vickrey seemed to believe. These

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<sup>157</sup> McCaffery, note \_\_, at 880.

experiences did, in any case, contribute to my change in position from being an advocate of cumulative averaging to being a reluctant critic.

To this point, moreover, the discussion has been based on the “simple” core of the cumulative averaging system. In addition to the basic design, there are additional real-world complexities that will inevitably bedevil any attempt to design a cumulative averaging system for the United States (or any other country). What, then, are these other issues that would multiply the potential complexities in a Vickrey system? An example or two will illustrate the range of issues at stake.

One important question is how to define the averaging period. If any specific number of years is unacceptably arbitrary, presumably we must truly mean “lifetime” averaging. Does that mean that we measure income from birth? This raises the question of whether it is fair to tax one eighteen-year-old who earned \$5000 per year from age 9 onward the same as another who earns nothing until they earn \$50,000 at age 18. If, on the other hand, the averaging period begins upon the initial receipt of income, this could encourage parents to make sure that their children earn some nominal amount of income during childhood, simply to increase the number of years over which income can be averaged. The question might seem narrow, but it is likely to affect many more people than the artists, athletes, and authors for whom averaging seems to provide the greatest benefit.

Furthermore, Vickrey’s system raises the stakes for those who would challenge their tax assessments. If a person’s tax liability is determined by all past income, should

she be able to challenge her income determinations for every year in the averaging period? Would a tax year ever be closed? An arbitrary statute of limitations on tax challenges (such as three years) could be imposed, of course, with the equity concern that a person might not have known of the importance of challenging a tax determination until after the statute has lapsed. On a practical level, if both the taxpayer and the IRS lose the ability to contest results after three years, while legally-binding facts from more than three years ago are used in subsequent tax computations, this would create an added incentive to contest or litigate close calls to guard against losing the right to challenge facts that currently might seem too minor to challenge.

These thumb-nail sketches are obviously meant only to be suggestive, pointing out that real-world implementation issues unique to (or heightened by) a cumulative averaging system could be quite challenging. Other issues surely lurk, but even these brief descriptions demonstrate that the Vickrey system raises more perplexing issues than might initially be obvious.

## **Conclusions**

This paper has focused on William Vickrey's proposal to replace our current annual system of tax assessment with a new tax system that bases assessments on lifetime cumulative average income. After reviewing two key arguments in favor of the social goal of progressivity in taxation (a goal that Vickrey shared), I have examined whether adopting Vickrey's cumulative averaging system would achieve a compelling change in the fairness of the tax system. While the current system undeniably creates a problem of horizontal inequity in that people with similar lifetime incomes can pay different tax rates

based on the timing of those incomes, that inequity is ultimately not compelling enough to justify a significant restructuring of the U.S. tax system. The Vickrey system is, moreover, likely to be perceived as quite complicated by the public.

The poor, however, are uniquely burdened by the volatile nature of their income streams. I therefore endorse a plan recently offered by Lily Batchelder to allow low-income people to smooth their incomes in order to avoid a loss of tax benefits. This plan has the distinct advantage of not requiring a complete restructuring of the tax system, providing targeted relief to the neediest Americans through minimal legislative intervention.

At a minimum, though, the goal here has been to give Vickrey's views on cumulative averaging another hearing. While my assessment has been a negative one, other voices should be heard on these issues. Even as we approach the tenth anniversary of his death, this and other proposals from Professor Vickrey deserve continued study and debate.