Income Tax as Wealth Tax

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In theory, wealth is an attractive basis on which to assess tax distribution. Wealth, rather than income, measures a person's total economic well-being and their ability to pay taxes. Conducting distribution based on wealth, rather than income, would be a more powerful tool for redistributing resources. The distribution of wealth is much more skewed to the high end than the distribution of income, likely with more profound effects on democracy and civic engagement. While income is often a decent proxy for wealth, it fails to take account of the scale of wealth inequality, and also disguises some important margins of inequality, such as by race. African-American households, for example, have significantly less wealth than white households even holding income constant.

The principal challenge is that wealth taxation, in practice, faces substantial administrative (and possibly constitutional) difficulties. Measurement and liquidity are significant barriers. The mobility of capital makes enforcement difficult. Measuring changes in wealth may not take account of wide variations in consumption. And human capital—a significant portion of overall wealth—is likely impossible to measure with any precision. It's largely for these reasons that nations have settled on income taxation, which can take advantage of market transactions and flows for both measurement and enforcement.

So, then, wealth is the better base for assessing distribution, but income taxation remains a valuable policy instrument. But an income tax instrument need not tax "income" in some theoretical sense (in part because there is no pure definition). We thus propose reframing the income tax as a practical device for taxing wealth—the income tax as wealth tax. In this article, we explore several important implications of this idea—changes, both conceptual and legal, for how an income tax could be repurposed to assign tax burdens based on wealth. This would, in essence, allow a government to have its (normative) cake and (administratively) eat it too.

Draft Outline

I. The Importance of Assessing a Distributional Tax Base

-There is a large literature debating what should be the normative tax base, with the "normative tax base" generally understood as a conceptual model for what governments should strive to tax in the absence of political constraints. Yet normative tax base notions are generally based on balancing distributional concerns with the potentially competing concerns of efficiency and administrability.

-In this Part, we argue that it is important for both tax theorists and tax policymakers to have a separate conceptual model for what should be the "distributional tax base." As we define the term, the "distributional tax base" is what governments should strive to tax in the absence of any concerns related to efficiency or administrability. In other words, the distributional tax base is the measurement for assessing equity and distribution.

-Distributional analysis is crucial for understanding a tax system and potential reforms to a tax system. However, current practice often bases distributional analysis on the actual tax base or a close analogue of it. This can produce misleading results because tax-base calculation rules must be designed to balance distributional concerns with competing concerns related to efficiency, administrability, and also interest group political pressures.

-For instance, the realization rule is typically defended on administrative grounds. Yet we often conduct distributional analysis by reference to realized income. This can produce very misleading results.

-Some scholarship is skeptical of distributional analysis, partially based on a view that only overall consequences (tax and non tax) should matter. Yet this view is not widely held by voters or policymakers. Moreover, even accepting some version of this view, distributional analysis is needed to evaluate tax policy in a world of cognitive constraints. Thus, we need to ground distributional analysis with a better understanding of what should be the distributional tax base.

-Distribution also matters in the design of tax-base rules, and it is sometimes important to know what we are aiming for with respect to distribution in order to design tax base rules. Failing to design tax-base rules to promote distribution may leave money on the table, so to speak. (See Gamage's optimal tax articles; contra Weisbach's line drawing paper.)

II. Why Wealth is the Best Distributional Tax Base

-Distribution is typically based on notions of wellbeing or ability to pay. Wealth is strongly connected to these notions.

-Some might argue that utility is a better distributional tax base (although note problems with utility: e.g. utility monsters). Regardless, we cannot meaningfully measure utility, even in the absence of distortionary and administrative and compliance concerns. The happiness studies are woefully inadequate. Wealth is the best proxy for utility that can actually be measured.

-Others—especially some economists—might argue that ability, as in potential earnings, is a more better distributional tax base. Usually, ability is justified based on minimizing distortionary costs. But one could argue for ability even apart from distortionary costs, so as not to penalize meritorious decisions, such as in Rakowski's arguments against a wealth tax. That is, if someone is better off, as in has more wealth, as a result of that person making more meritorious decisions than someone else, why punish the better-off person for their meritorious decisions?

-However, there are strong autonomy based objections to ability as a distributional tax base. Ultimately, most everyone who obtains resources gets these resources from making meritorious decisions, at least to some extent. That meritorious decisions produce the resources they do is partly a result of individuals making these decisions, but is also partly a result of the surplus from cooperation based on social institutions funded and supported by the government. Taxation is thus better understood as the mechanism for the government to take a portion of this surplus, rather than as a penalty.

-Even for those who disagree and think that ability is a better distributional tax base, wealth might still be the best proxy that can actually be measured, perhaps with some adjustments to give credit for meritorious decisions. This raises the issue of the likelihood of disagreement about what decisions are most meritorious, which further supports using wealth rather than ability as the distributional tax base.

-Wealth is a better distributional tax base than income:

-Across time, all wealth has to come from somewhere, so, in a sense, wealth and income are strongly connected—stocks v. flows. But wealth is a broader concept. Certain transfers (such as gifts) and self-created forms of wealth might not be considered income, but these are certainly part of wealth. More generally, at any particular point in time, wealth better measures wellbeing and ability to pay than income, and also better measures utility (and probably also ability, although this is more questionable). Wealth also better measures an individual's surplus from social cooperation and social institutions funded by the government (as in benefit theories of taxation).

-Wealth inequality is a larger concern than income inequality. This is especially so with respect to concerns about concentration of political and social power, and also for racial inequality.

-Wealth is more stable than income. Measuring overall well-being just on the basis of annual income gives disproportionate weight to volatile swings up and down that may not truly capture someone's economic position.

-Wealth is a better distributional tax base than consumption:

-Unconsumed wealth can contribute to wellbeing and utility by increasing options and creating psychic and other benefits.

-Wealth inequality is a larger concern than consumption inequality. This is especially so with respect to concerns about concentration of political and social power.

-Arguably, consumption might be a better proxy for ability, but this is far from certain. Wealth is a better proxy for wellbeing, ability to pay, utility, and benefit received from social cooperation and social institutions.

-Consumption can be out of government transfers, which creates a measurement problem for indirect consumption taxes, like VATs.

-Overall, we thus think wealth is the best distributional tax base, although a case could perhaps be made for consumption, for a hybrid of wealth and consumption, or perhaps for wealth or consumption adjusted to account for measurable tags for ability.

III. Understanding the U.S. Income Tax as a Normative Approach for Taxing Wealth

-While wealth may be a superior distributional tax base, it has serious limitations as a normative tax base, where by "normative" we mean again taking into account efficiency and administrative concerns.

-The primary problems are a) assessing the value of non-cash property and b) the particular problem of measuring human capital.

-Liquidity is sometimes cited as an additional concern, but we believe this is of lesser importance, since a combination of developed capital markets and government interest charges can solve that problem.

-The income tax, as a tax instrument, can be thought of as normative approach for taxing a wealth proxy, by measuring market transactions, either in property or labor.

- -As a first approximation, the value of property is a function of its future cash flows, so an income stream ought to be a proxy for the value of the property.
- -For labor in particular, an income tax may be the only way to effectively levy against human capital.

-Historically, the income tax arose because of these problems with property taxes.

- -Seligman (1914) describes in general terms the shift from general property taxes to early income taxes as being due to:
  - a) differences in productivity of different types of property
  - b) human capital and labor income
  - c) indebtedness and issues of gross vs. net value of property
  - d) problems of consumer durables and property for consumption
  - e) the multiplicity of forms of property in an industrial age
- -Early income taxes in the U.S. colonies were introduced alongside general property taxes, thus showing that they were then conceived of as a second-best way to tax human capital, rather than a first-best independent tax base.
  - -Massachusetts introduced its general property tax in 1646, along with an income tax on "laborers, artificers, and handicraftsman." (Seligman 1914, Einhorn 2006)
    - -18th-century amendments expanded this to business profits, but still described the tax as being on "estates" (property) and income was a measure of the value of "estate[s] not particularly otherwise assessed."
  - -Connecticut similarly added a tax on "tradespeople" as an expansion of its land tax. A 1796 treatise described the tax on tradespeople as "*assessments* proportioned to the estimated gains or profits arising" from business and professions, and this assessment was included in lists of taxable property of "lawyers, shopkeepers, surgeons, physicians, merchants," etc. (Wolcott 1796, Seligman 1914) (emphasis added).
    - -This implies essentially an effort to measure human capital, as well as goodwill and other intangible property.
  - - New Jersey (1684) and Virginia (1777) also introduced an income tax on tradespeople and professionals alongside its general property tax.

-Although the historical narrative does not determine the "right" answer to the question of whether income or wealth is the superior distributional tax base, it does shed light on the development of practical theories of justice in taxation, and also on the deep connection between income and wealth. It also provides some intellectual precedent for thinking of an income tax as a way to use market transactions to measure the underlying value of wealth, especially human capital.

-Some of the reasons summarized by Seligman (1914) for moving away from property and toward income taxes are less pressing today than 100 years ago.

- a) Better functioning markets, especially capital and real estate markets, have improved our ability to assess value.
- b) A developed labor income tax captures human capital without precluding a wealth tax.
- c) Measuring return on equity is a standard tool of financial accounting, so issues of debt and net wealth pose little problem.

d) Post-Henry Simons, it's not clear that a distinction between consumed property and amassed wealth is necessary.
e) Well-functioning capital markets can perform much of the work of assessing the variety of property held by businesses.

-But the efficiency and administrative reasons for using an income tax instrument are still compelling. The problem, however, is that the income tax has reified "income" as the desired distributional and normative tax base, just through accretion of the effort spent by governments, individuals, courts, and scholars to determine what "income" is and how an "income" tax ought to function.

-The emphasis by Simons, Haig, and others on understanding income as accretions to wealth—gain—can be understood in this context. Simons and others were responding to attempts by others to define income without reference to all forms of gain and wealth accretion. Their work underscores that income is more closely tied to, and depends upon, underlying wealth. If all changes to wealth are part of measured income, the distinction between wealth and income is less crucial.
-Haig-Simons is described as a definition of income, but it could also be described as a measure of saved and consumed wealth (income adding to wealth before being consumed).
-Andrews (1972) and others emphasis this view of income—that it matters not in its own right, but because it is a measure of saved and consumed wealth.
-But in practice, income tax law and policy has been more focused on income *qua* income, with less focus on its original connection to wealth.
-We believe this is an error, because it minimizes the role of wealth and separates income from its original purpose of trying to measure wealth.

IV. Implications for Tax Policy Debates

-The implications for policy take two main forms.
-1) Governments and analysts should consider measuring distributional effects of policy changes, include income tax law changes, by reference to wealth, rather than (or in addition to) income.
-2) Specific tax policy reforms.

-With respect to measuring distributional effects on policy changes, just because the tax is on "income" tax does not require that distributional effects be measured against an "income" base.
-Indeed, the CBO already uses a somewhat different income concept than AGI for measuring such changes. This underscores that we are not bound by using a particular base for measuring distributional changes. AGI could be seen as an imperfect income measure (as CBO's measure applies) but it could also be seen, as we have argued, as an imperfect wealth measure. If wealth is actually the better distributional tax base, then policy changes should be judged by reference to wealth.

-With respect to actual reforms to tax law and policy, the changes are less dramatic, and amount to changes in emphasis in a few areas. Some examples at this early stage of our work could include:
-**Capital gain.** More attention should be spent on taxing capital gains more frequently and at a higher rate. The current preferential rate is driven by a combination of administrability arguments and efficiency arguments for a consumption tax base (since a consumption tax

base would not include capital income). Our approach would put some additional weight on the equity arguments, and push us even more toward a mark-to-market or presumptive gain approach.

> -In the absence of mark-to-market, our approach suggests that the inclusion of inflationionary and time-value gains is less of a problem than others suggest, since they can get us closer to taxing the real gross value of the property.
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> -Out approach also may lend support to a Scandinavian-style "dual income tax," as a way to balance equity with efficiency and administrability.

-**Tax expenditures.** Using a wealth tax as the "normal" tax for tax expenditure analysis would change the number and magnitude of many tax expenditures.

-**Gifts and inheritances.** The tax exclusion of gifts is sometimes justified under income tax principles as being income/consumption of the donor, but not the donee. Our approach would imply instead inclusion of gifts in the wealth base of the donee, and a deduction from the wealth base of the donor. That would not necessarily present a problem for distribution if we also had mark-to-market taxation; if not, other second-best changes might be necessary. Furthermore, a wealth tax base approach points toward reforming the estate tax to instead be a tax on inheritances of heirs, as additions to their wealth.

-**Rate structure.** Our approach suggests that, even if the base is "income," that the tax brackets might be determined with respect to, or at least taking account of, wealth. Thus a higher-wealth person might pay a higher rate on the same stream of income than a lower-wealth person.

> -This could raise the same measurement problems as a wealth tax itself, but there may be rough proxies for wealth that could be justified when picking rates even if they would not be justified as a comprehensive measure of total wealth. E.g., taxpayers could be required to report financial, business, and real estate assets without enormous administrative problems.

-**Income averaging.** The volatility of income can make individuals look much better (or worse) off in a given year than they are over the lifecycle. Wealth, by contrast, tends to be more stable. Even if assessing income taxes on the basis of wealth is not feasible, it is feasible to use income averaging (as the Tax Code once did). Assessing tax based on average, rather than annual, income would do a better job of identifying those who likely also have high wealth.