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Introduction of The Honorable Deanell Reece Tacha

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Today, we launch one of the most important programs a young law school can initiate: a distinguished jurist-in-residence program. Traditionally, law schools invite distinguished judges to participate for a few days in the intellectual life and educational mission of their school. A jurist in residence will teach classes, give a school-wide presentation, meet with members of the local judiciary and bar association, and converse with faculty. As a result, the law school community gains access to invaluable insights from those who are shaping the law and providing leadership to our legal institutions. Today, Chapman University School of Law joins this long-standing tradition of merging legal education and judicial wisdom.

Layered on top of the law school tradition is a tradition unique to Chapman University. The University has long identi-

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fied certain "guiding spirits," distinguished role models such as Albert Schweitzer and Martin Luther King, Jr., whose ideals and achievements are models for students, faculty, staff, and alumni. However, the advent of both a law school at Chapman and a distinguished jurist-in-residence program gives us a new opportunity to identify and learn from *living* role models: judges who grapple daily with what it means to live out the principles of justice, truth, and integrity. The prophet Micah identified one of the three primary characteristics of the good life is to "do justly."[1] We at Chapman University School of Law seek to honor and learn from those who actively apply the principles of justice in their professional and personal lives.

We are honored today by the presence of our first such role model, the Honorable Deanell Reece Tacha, Circuit Judge of the United States Court of Appeals for the Tenth Judicial Circuit. With her distinguished record of public service, her commitment to the integrity of the judicial role, and her warm and winsome manner, Judge Tacha is the ideal choice to inaugurate our distinguished jurist-in-residence program.

In 1985, then-President Ronald Reagan appointed Deanell Tacha to a newly-created Tenth Circuit judgeship when she was only 39 years old. Despite her youth, Judge Tacha had already established an impressive record of academic and professional success. Having grown up in a small Kansas town, she attended the University of Kansas, received her Bachelor of Arts degree in American Studies with Honors in 1968, and was elected to Phi Beta Kappa. She received her Juris Doctor degree from the University of Michigan in 1971. She was selected for a prestigious White House Fellowship following graduation from law school, through which she was assigned as a Special Assistant to the Secretary of Labor. Following her year as a White House Fellow, Judge Tacha was in private practice in Washington, D.C., and Kansas. In the fall of 1974, she was appointed to the faculty of the University of Kansas School of Law, eventually becoming Associate Dean of the Law School and, in 1981, the University's Vice Chancellor for Academic Affairs. As a former legal educator and university administrator, Judge Tacha values the role that institutions of higher education play in improving the institutions of justice and preparing the future leaders of the legal profession. In addition to teaching in jurist-in-residence programs at numerous law schools, she has continued to publish articles in a variety of law reviews.[2] Her scholarly writings include thoughtful reflec-

1 *Micah* 6:8 (King James).

2 *See, e.g.*, Deanell Reece Tacha, *Judges and Legislators: Renewing the Relationship*, 52 OHIO ST. L.J. 279 (1991) [hereinafter, Tacha, *Renewing*]; Deanell Reece Tacha, *Tenth Circuit Procedure and Expectations*, 33 WASHBURN L.J. 43 (1993); Deanell Reece Tacha,

tions on the role of the judiciary and the ethical commitments of lawyers and judges.

Judge Tacha is one of the most influential federal appellate judges in the United States for two reasons. First, she served from 1994 to 1998 as a member of the United States Sentencing Commission, which is responsible for the mandatory guidelines governing federal criminal sentencing. Second, Judge Tacha was a key voice of the federal judiciary, before Congress, the legal profession, and the public, at a time when the courts faced crucial needs to fill vacant judgeships and add judgeships under burgeoning case loads, to adequately staff and fund the judicial branch, and to reform procedures and standards.[3] She chaired the United States Judicial Conference Committee on the Judicial Branch from 1990 to 1994, and the Judicial Administration Division of the American Bar Association from 1995 to 1996. In these roles, she was a leader of the long-range planning efforts of the federal judiciary. She was also a strong advocate for both judicial independence and enhanced cooperation between Congress and the federal courts. Her work and her writings have been shaped by an understanding of the legal system as an essential element of our democratic system of governance, requiring dialogue with the executive and legislative branches. Simultaneously, the legal system is a guardian of individual rights and the rule of law, requiring impartiality and freedom from even the appearance of impropriety.[4] Judge Tacha's personal political skills and unquestionable integrity model the necessary balance between the political and apolitical aspects of the courts.

Judges and Legislators: Enhancing the Relationship, 44 AM. U. L. REV. 1537 (1995) [hereinafter, Tacha, *Enhancing*]; Deanell Reece Tacha, *Independence of the Judiciary for the Third Century*, 46 MERCER L. REV. 645 (1995) [hereinafter, Tacha, *Independence*]; Deanell Reece Tacha, *The "C" Word: On Collegiality*, 56 OHIO ST. L.J. 585 (1995) [hereinafter, Tacha, *Collegiality*]; Deanell Reece Tacha, *James K. Logan: Colleague, Mentor, Friend, Jurist, Scholar, Teacher, Small-Town Kansas Kid*, 43 U. KAN. L. REV. 493 (1995) [hereinafter, Tacha, *Logan*]; Deanell Reece Tacha, *"W" Stories: Women in Leadership Positions in the Judiciary*, 97 W. VA. L. REV. 683 (1995) [hereinafter, Tacha, *Women*]; Deanell Reece Tacha, *Serving This Time: Examining the Federal Sentencing Guidelines After a Decade of Experience*, 62 MO. L. REV. 471 (1997).

3 *See, e.g., Hearings on H.R. 4357 Before the Subcomm. on Intellectual Property and Judicial Administration of the House Comm. on the Judiciary*, 103d Cong. (1994) (statement of the Honorable Deanell Reece Tacha on behalf of the Judicial Conference Committee on the Judicial Branch, concerning the Federal Courts Improvement Act of 1994).

4 *See generally* Tacha, *Renewing*, *supra* note 2 (calling for enhanced dialogue between judicial and legislative branches to advance common sense notions of the common good); Tacha, *Enhancing*, *supra* note 2 (discussing ways of enhancing communication between judicial and legislative branches and highlighting the impact of politics on the necessarily apolitical federal courts); Tacha, *Independence*, *supra* note 2 (exploring the contours of judicial independence). *See also Professional Responsibility: Comments on Recusal*, 73 DEN. U. L. REV. 919, 920 (1996) (interview comments of Judge Tacha discussing the standard for recusal as avoidance of the appearance of impropriety).

Judge Tacha's published opinions on the Tenth Circuit reflect a legal pragmatism like that advanced by Justice Oliver Wendell Holmes, Jr.[5] To Judge Tacha, the law is not a test of fidelity to abstract theory or rigid logic. Instead, the law is practical and functional. Application of legal principles depends very much on the social and factual context of the case.[6] Nevertheless, this pragmatism is bounded by Judge Tacha's clear and strong belief that the role of the courts is to adjudicate disputes, not to make policy.[7] The practical insights of judges like Judge Tacha help law schools bridge the gap between legal education and the legal profession.[8]

Judge Tacha also models public service. She is serving or has served on over 30 boards or committees related to the legal profession, the status of women in the legal profession, community and social needs, educational institutions, the arts and humanities, and her church.

Finally, Judge Tacha is ideal to initiate our distinguished jurist-in-residence program because she simply cares so much about people. This quality corresponds to Chapman's commitment to personalized education and ethical lawyering. Judge Tacha has frequently urged lawyers not to become so enthralled with high-

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5 OLIVER WENDELL HOLMES, JR., THE COMMON LAW 1-2 (1923). *See also* Thomas C. Grey, *Holmes and Legal Pragmatism*, 41 STAN. L. REV. 787 (1989). For examples of Judge Tacha's pragmatism, *see* Tome v. United States, 3 F.3d 342, 350-51 (10th Cir. 1993) (determining the relevance of a prior consistent statement under a balancing approach focused on factual context and practical concerns about the propensity to lie), *rev'd*, 513 U.S. 150 (1995); United States v. Soto-Cervantes, 138 F.3d 1319, 1322-23 (10th Cir. 1998) (holding that several factors, each individually insufficient to justify detention of a suspect, may be considered together as reasonable law enforcement suspicion legitimizing investigative stop of suspect); Penry v. Federal Home Loan Bank of Topeka, 155 F.3d 1257, 1262-63 (applying common sense totality-of-circumstances test to review the evidence of hostile work environment, instead of a mechanical approach to reviewing the evidence). *See also* David E. Rovella, *Pleas: Justice or Bribery? 10th Circuit Hears Arguments on Whether to Outlaw Federal Plea Bargains that Require Testimony*, NAT'L L.J., Nov. 30, 1998, at A1 (quoting oral argument questons of Judge Tacha indicating that federal bribery statute's application to plea bargaining must be considered in light of practical and historical need of government to have freedom in charging).

6 For discussions of the contextualism and intrumentalism of pragmatic legal thought, *see* Thomas C. Grey, *Freestanding Legal Pragmatism*, 18 CARDOZO L. REV. 21, 24-26 (1996); Steven D. Smith, *The Pursuit of Pragmatism*, 100 YALE L.J. 409, 411, 448 (1990).

7 *See* United States v. Nichols, 841 F.2d 1485, 1491-92 (10th Cir. 1988) (discussing judicial restraint in statutory interpretation and review for constitutionality). Trujillo v. Grand Junction Reg'l Ctr., 928 F.2d 973, 975-76 (10th Cir. 1991) (refusing to recognize new remedy under 42 U.S.C. § 1981 for discriminatory discharge cognizable under Title VII); Sac and Fox Nation v. Hanson, 47 F.3d 1061, 1063 n.3 (10th Cir. 1995) (refusing to abandon precedent). For a synthesis of pragmatism and judicial restraint, *see* Strickland Tower Maint., Inc. v. AT&T Communications, 128 F.3d 1422, 1426 (10th Cir. 1997) (viewing the economic-duress doctrine as a functional application of business ethics to market transactions, limited by historical practice, the economic value of hard bargaining, and judicial self-restraint).

8 *Cf.* Harry T. Edwards, *The Growing Disjunction Between Legal Education and the Legal Profession*, 91 MICH. L. REV. 34 (1992).

power law practice that they forget the everyday people whom lawyers and legal institutions are supposed to serve.[9]

More importantly, Judge Tacha gives of herself to others. She has written that she regretted not having strong women role models in the legal profession when she was an undergraduate considering law school in the late 1960s.[10] She has also written that she valued the mentorship of the Dean of the University of Kansas Law School, James Logan, later her colleague on the Tenth Circuit, as he encouraged and supported her decision to attend the University of Michigan Law School.[11] These experiences shaped her strong commitment to being a mentor, role model, and friend to students, lawyers, fellow judges, and law clerks. I have been privileged that Judge Tacha has greatly influenced me for the past 16 years, ever since I was a freshman at the University of Kansas. I worked with her on academic issues at KU, and worshipped with her and her family at church. She has given me wise counsel, and inspired and encouraged me to pursue a career in law and legal education, and even successfully nominated me for a national honor from *Time* magazine. When I was a Stanford law student, she offered me a judicial clerkship. I turned it down in favor of an offer from her Kansas colleague on the Tenth Circuit, Judge Logan, who had been her mentor. I did so for one simple and completely selfish reason; if I clerked for Judge Logan, I could have the benefits of both Judge Logan's and Judge Tacha's guidance. Despite my decision, Judge Tacha, with grace and understanding, has remained my mentor, role model, and friend. It is a testament to her giving nature.

Over the next three days, Judge Tacha will have a similarly tremendous influence on many at Chapman University School of Law. In a moment, she will share keen insights about the future of the federal courts in the 21st century, but the greatest insights will come from learning how she lives out the principles of justice as a federal judge and member of the legal profession. For these reasons, we welcome and honor Judge Deanell Reece Tacha as our inaugural Distinguished Jurist in Residence.

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9 *E.g.*, Deanell Reece Tacha, *The Tale of Widget and P: A Story of the Legal Profession*, KAN. J.L. & PUB. POL'Y, Spring 1993, at 127. Judge Tacha has also urged judges to become involved in educating the citizenry about the judiciary and constitutional principles. *See* Deanell Reece Tacha, *The Community of Courts: The Compleat Appellate Judge*, J. KAN. BAR ASS'N., May 1996, at 4.

10 Tacha, *Women*, *supra* note 2, at 683-85.

11 Tacha, *Logan*, *supra* note 2, at 493-94.

The Federal Courts in the 21st Century

*Deanell Reece Tacha**

Good evening. It is a pleasure to be with you at this lively, relatively new law school. I want you to know that it is truly an honor to serve as the inaugural Chapman University School of Law Jurist in Residence. I share your enthusiasm for the potential that inherently resides in a new law school. Although you face all the challenges of a new endeavor, you have the great strength of a fresh beginning. Most law schools throughout this country are strengthened by their history and traditions, but they are also hampered by the same. They find it difficult to break from old ways of doing things, established teaching methods and the long ingrained norms of the profession. The Chapman University School of Law, on the other hand, has begun its *own* traditions with a focused eye to the future. A simple look through your course book, a scan of the faculty profiles, and a quick glance at your student body are enough to get a strong sense of your commitment to educating for a stronger legal profession in the future. I applaud you and I thank you for this opportunity to be with you.

I assume that it is because of this eye toward the future that you have asked me to address tonight the federal courts in the next century. Over the coming year, almost everyone will be, in one forum or another, pulling out their crystal balls and making predictions about just what it will be like in the next century and indeed in the new millennium. Now, I need to say that I have noticed two kinds of people in this millennial furor. The one kind are those that made reservations months ago for Rio or London or Times Square to ensure they are very much a part of the history-making change of the millennium—thus, seeing the occasion in millennial terms. The other kind recognizes that it is but a one-minute change in the hourglass of time, and that grand efforts to philosophize, theorize, and predict are no more than speculation indulging the ongoing curiosity of the human race. I fall in the first category, and my husband is in the latter. I am in what I call the "cataclysm class"—that is, those who cannot resist the urge to feel like the turn of this century is an extraordinary moment in history in which I am so lucky to participate. My husband, on the

* Circuit Judge, United States Court of Appeals for the 10th Circuit. B.A., University of Kansas, 1968; J.D., University of Michigan, 1971.

other hand, is in quite the other category. He refuses to make reservations anywhere and would prefer to be at home with our children, worrying whether they are driving appropriately and doing all of the other rather tradition-laden things that have been a part of our household every New Year's Eve. As I reflect on these two classes of people, I realize that, in some ways, we both reflect what it will take to go bravely into the new century. So it is with the legal profession. This rather stark contrast in the millennial moods has caused me to reflect somewhat more seriously on how the legal profession should approach the next century. I have come to understand that we must see it both as a rare opportunity—an important moment in history—and as a tiny point in an ever-evolving history and tradition that we must preserve. To see the turn of the century, for the law and for the courts, exclusively as a cataclysmic event or exclusively as a nonevent, is a mistake. Instead, it is, just as in my household, a time to reflect on the importance of both perspectives. For, after all, is that not the heart and soul of the common law—gradual change that sometimes has cataclysmic effects? If I were to put my predictions about the future of the federal courts into one phrase, it would be that: gradual change, sometimes with cataclysmic effects.

You have asked me to look into a magic mirror of sorts and consider what the federal courts might be like in the next century: with what cases they will deal, how they will function, and who will constitute the judges, lawyers, and litigants. I wish I had that all-knowing magic mirror that would reflect back to me some images from the future. I do not have such a valuable object. I have only law books of the past, a constitutional republic that has lasted over 200 years, and the bright hopes of new generations of Americans. *That* is the future of the federal courts. For as you look in the Federal Reporters 1st, 2d, and 3d, you see a reflection of that history and those hopes. It will be no different in the next century. Although, I daresay, it will not be in books. It will instead be in a far smaller reporting system.

Thus, tonight, instead of trying to look into some magic mirror, I would like to identify what I consider some predictors of the next century for the federal courts, and talk about how those predictors may give us a glimpse of the substance of the federal courts' work in the next century and how we will conduct that work. Envisioning where the courts will be in the 21st century necessarily entails looking at the past and the present, and then gauging the future by examining current demographic trends. I'll address each in turn.

For my first predictor of the future, I look back. The federal courts, along with the other two branches of the federal government and their counterparts in the several states, have stood the

test of time as the institutional guardians of our constitutional system. Little could those men in Philadelphia in 1787 have known of the challenges that this system of government would confront and survive. When I reflect upon the dynamics that are so much a part of the Constitution and our system of government as it is lived out at the turn of this century, I stand in awe of the idealism, sheer patriotism, and faith in the people of this nation that must have pervaded that Constitutional Convention. That idealism, patriotism, and faith in the people must persist and guide us—their millennial counterparts. Whether one reads the notes from the Constitutional Convention, or any of the historical materials of that day, one is reminded of the robust debate about forms of government and about protection of freedoms. We can be no less robust in our own consideration. Thus, as a predictor of the federal courts in the 21st century, I think we must begin with "first principles." The Chief Justice recently reminded us, in his opinion in *United States v. Lopez*,[1] that we base our entire scheme of government on a set of first principles. They are simple in the saying and enormously complex in the carrying out. They are those basic principles upon which this government was founded.

First and foremost, the sovereignty that is not specifically given to governments resides in the people.[2] Those resounding words that introduce the Constitution, "We the People . . . ," cannot become the hollow beginnings to a historical document. They must instead continue to underlie every action that every branch of government at the federal level and in all the states takes. We must continue to give them meaning in a society where it would be so easy to succumb to the rhetoric that individuals make very little difference. Individual sovereignty is not just an appealing phrase; it is the bedrock of our system of government and a weighty responsibility of the federal courts. It is one of those first principles that we cannot ignore, and one deserving re-emphasis in the clamor and bustle of a technological world.

Another first principle that will play a part in the federal courts is the careful protection of a federalist system[3]—a system where the sovereign states have vibrant, important roles to play in this republic: a place where the demarcations between state and federal action are clearer than I think they are today; a place where we understand that though regionalism may not be a necessity in the modern world, federalism is. Never, in my judgment, has it been more important for some part of government to be close to the people. Much of our population feels disenfranchised, anonymous, and certainly distanced from seats of power. In the

1 United States v. Lopez, 514 U.S. 549, 557 (1995).
2 *See id.* at 552.
3 *See id.*

face of these fears and perceptions, it would be exactly the wrong direction to retreat from the principles of federalism that were so carefully crafted by the Framers of the Constitution. It is no less true today than it was 200 years ago that some things are best done by the federal government and some are best reserved to the states. I worry that we have lost our collective understanding of what falls into which category.

The third first principle that will require vigilant attention is maintaining carefully the boundary lines among legislative, executive, and judicial powers.[4] In those carefully constructed first three articles of the Constitution lie a strength that no other nation in the world enjoys. By making the conscious choice to reject a parliamentary form of government, the Founders of this Constitution somehow had the prescience to know that an independent judiciary was necessary to an ordered government where the individual enjoys many of the accoutrements of sovereignty. I do not here exaggerate the role of the federal courts. Instead, I ask that each of the branches of government understand and carefully protect those time-tested limitations on each other's powers. As Congress has moved into more and more complex legislation-setting policy, it has become very difficult to legislate with precision on everything that is the subject matter of federal statutes. I think the same is true in the states. The result is that much is delegated to the executive branch, and the interstices are filled by the courts. The courts cannot fill those interstices unless there exists a case or controversy.[5] Agencies cannot act within statutes unless there is some directive.[6] Ascribing the best motives to executive agencies, they, along with the courts, inevitably become policy-makers. Somehow, the next century will require that we take a hard look at that first principle of the limitations on the powers of each of the three branches of government.

I add another first principle to this constitutionally based list. I add an educated citizenry—knowledgeable to undertake their citizenship responsibilities—to my list of first principles. I cannot help but think that the men in Philadelphia who crafted this government premised the entire government on what was then, and is now, a very idealistic belief that the citizenry would be both equipped to govern themselves and educated to govern themselves wisely. The anecdotal evidence that Americans are ill-informed, do not understand the courts or any other branch of government,

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4 *See id.*

5 *See, e.g.*, Allen v. Wright, 468 U.S. 737, 750 (1984) ("Article III of the Constitution confines the federal courts to adjudicating actual 'cases' and 'controversies.'").

6 *See, e.g.*, 1 KENNETH CULP DAVIS & RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREASTISE § 3.1 (1994) ("Every agency decision must be anchored in the language of one or more statutes the agency is charged to implement.").

and, worst of all, do not care, deeply troubles me. You all know of current examples—I will not recite them. In an information age, however, when those same voters will see only snippets and sound bytes of their government at work, I think we in the courts, and all of us as citizens, bear a special responsibility to reassert a first principle that the responsibilities of an educated citizenry are the responsibilities of each of us. We cannot hope to have respect for the courts, the rule of law, or government itself, if the people do not understand it nor participate in it. Thus, undergirding the constitutional principles is the guiding belief that the people are their own masters and the government will be only as vigorous as the level of education, interest, and commitment of the citizenry allows.

Let's look now at how these principles might impact the federal courts in the 21st century. The notion of individual sovereignty will be tested sorely in a highly populated and evermore complex society in the 21st century. The effort, for example, to meet the important needs of law enforcement in a sophisticated criminal culture, in which technology makes possible a host of investigative techniques, without trammeling the Fourth Amendment rights of individuals, will result in a challenge of the first order for the courts. Already, in the war against drugs, guns, terrorists, and other organized criminal activity, the federal courts struggle mightily with protecting those important interests of being safe in our homes and also free from unreasonable governmental intrusions. As you look through the Federal Reporters, you will see literally thousands of pages of federal judges struggling with the factual questions that try to draw these important lines between appropriate government activity and protection of individual rights.

In another arena, the glut of information made possible by the communication and technology age will require the courts to try to understand the freedoms of speech, press, and assembly protected in the First Amendment without totally obfuscating the individual sovereignty that resides in the people of this nation. More information means less privacy, which inevitably results in some circumscription of lawful individual activity. "We the People" is both a collective and an individual concept. It will no doubt be left to the courts to try to guard vigilantly that which is reserved individually to each of us as a sovereign person and those activities which are collectively within the realm of lawful federal or state government activity.

I also predict that the federal courts in the 21st century will engage in a century-long debate regarding the proper role of states in a mobile society, in which our economic life knows no state boundaries. Many scholarly debates have occurred in this century

over whether states are an anachronism. I think not. In my judgment, the Founders got it just right. Political subdivisions, in our case states, form the mainstay of a stable national government. To the extent that the activities of the national government render impotent the work of state governments, we will have removed some of the vibrancy from our system of government. I think, therefore, that states, the courts, and the federal government will look increasingly at rational ways to refocus on the role of the states in a federal system and to draw more clearly the lines between the reserved powers of the states and enumerated powers of the federal government.

From the beginning of the administrative state during the New Deal era, through the rest of this century with an ever-expanding reliance upon the Commerce Clause as a vehicle for federal action,[7] the federal government has moved in unprecedented ways in areas that were once understood to be within the reserved powers of the states. Let me give you an example from the criminal law. Until the past few decades, there were relatively few federal crimes on the books. As we developed a *USA Today* and *CNN* mentality that let us know instantly the crimes occurring across the nation, Congress began to make criminal, as a matter of federal law, many things that prior to that time had been matters of state law. There are now over 3000 federal crimes, many of which were added in the last two decades.[8]

The most distinctive feature of recent crime legislation is that the new federal crimes duplicate, to a large extent, offenses already illegal under state and local statutes. Some of that is appropriate. I remind you that, even at the time of the republic's founding, such things as treason on the high seas, piracy, and crimes against national security were matters of federal criminal law.[9] Perhaps large scale trafficking in guns and drugs are their contemporary analogue. The Constitution, however, very specifically reserves the police powers, the public health, safety, and welfare, to the states.[10] With the emerging concurrent jurisdiction of

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7 *See generally* 1 DAVIS & PIERCE, *supra* note 6, §§ 1.4-.7 (tracing the development of federal agencies).

8 *See* Sara Sun Beale, *Federalizing Crime: Assessing the Impact on the Federal Courts*, 543 ANNALS AM. ACAD. POL. & SOC. SCI. 39, 44 (1996); *see also* TASK FORCE ON FEDERALIZATION OF CRIMINAL LAW, AMERICAN BAR ASSOCIATION, REPORT ON THE FEDERALIZATION OF CRIMINAL LAW 7 n.9 (James A. Strazzella rep., 1998) (stating that "[m]ore than 40% of the federal criminal provisions enacted since the Civil War have been enacted since 1970," and more than a quarter of such enactments have occurred since 1980).

9 *See* THE FEDERALIST No. 42 (James Madison) (articulating his view that the federal government should handle only such limited classes of crimes where state laws were impracticable).

10 *See* U.S. CONST. amend. X ("The powers not delegated to the United States, nor prohibited by it to the States, are reserved to the States respectively, or to the people."); *see also* U.S. CONST. art. I, § 8 (enumerating the powers of Congress).

the federal government, particularly in the area of drug enforcement, the role of the states is little different from the role of the federal government. Both the federal and state governments have statutes that allow prosecution of exactly the same defendants for exactly the same crimes in many cases, inevitably obfuscating the lines between those powers reserved to the states and those appropriately enumerated as federal powers. It is time to take a hard look at drawing rather clear lines between what is federal responsibility and what is state responsibility in law enforcement and criminal prosecution.

Both philosophically and pragmatically this line drawing is essential. The federal courts simply cannot adjudicate, nor can the federal criminal justice system handle, the escalating number of federal defendants and prisoners. That is the pragmatic problem. The more important philosophical issue, however, is that local law enforcement is often far more knowledgeable, more efficient, and better equipped to handle local criminal activity. Low level possession of drugs, petty crimes of all kinds, and even violence related to children are often far better handled in local settings by local professionals than when jettisoned to a faraway sovereign.

We have begun in the latter part of this century to witness a renewed focus on the role of states. In the *Lopez* decision, it appears that there may, in fact, be limits to the reach of the Commerce Clause as a threshold for federal activity.[11] Additionally, a recent series of Supreme Court decisions, including *New York v. United States*,[12] *Printz v. United States*,[13] *Seminole Tribe of Florida v. Florida*,[14] and *Idaho v. Coeur d'Alene Tribe of Idaho*,[15] shows renewed attention to the Tenth and Eleventh Amendments. Further, the vibrancy of state constitutions has become a source of considerable scholarly interest in the law.[16] Many state constitu-

11 *See* Unites States v. Lopez, 514 U.S. 549, 567-68 (1995) (striking down federal statute making it illegal to possess a firearm in a school zone because it exceeded Congress' power under the Commerce Clause).

12 New York v. United States, 505 U.S. 144, 177-88 (1992) (invalidating a provision of federal statute requiring states to "take title" to low level radioactive waste or regulate according to Congress' instructions because that provision went outside Congress' enumerated powers and was inconsistent with the Tenth Amendment).

13 Printz v. United States, 117 S. Ct. 2365, 2384 (1997) (finding the Brady Act's interim provision commanding local enforcement officers to conduct background checks on prospective handgun purchasers unconstitutional).

14 Seminole Tribe of Fla. v. Florida, 517 U.S. 44, 72 (1996) (holding that Eleventh Amendment prevents Congress from authorizing suits against States by Indian tribes to enforce legislation promulgated under the Indian Commerce Clause).

15 Idaho v. Coeur d'Alene Tribe of Idaho, 117 S. Ct. 2028, 2043 (1997) (holding, in a highly fractured decision, that an action that was the functional equivalent of a quiet title action did not come within the *Ex Parte Young* doctrine and was barred by the Eleventh Amendment).

16 *See, e.g.*, Nina Morrison, Note, *Curing "Constitutional Amnesia": Criminal Procedure Under State Constitutions*, 73 N.Y.U. L. REV. 880 (1998); Neil Coleman McCabe, *State*

tions provide protections that are not found within the federal constitution,[17] which was exactly the plan of the Founding Fathers. We should allow it to flourish, and we should encourage the laboratories of state governments as variations on the theme of federalism. Even in political rhetoric, we are hearing much about the vitality of state governments and their experiments that inform many public policy issues. No doubt, therefore, the federal courts in the next century will continue to scrutinize carefully the relationships among the various reservation clauses in the Constitution, the Bill of Rights, and the enumerated powers of the federal government.

The offspring of *Marbury v. Madison*[18] constitute one of the first principles that will spawn a constant stream of litigation in the next century, requiring the federal courts to police the boundaries among the three branches of government. Complex society means complex legislation. Complex legislation means much delegation and much court interpretation. There is evidence today that the courts are beginning to ask whether we have effectively carried out our role in the area of agency review. *Chevron*[19] analysis, which, even to the least knowledgeable attorney, is known as a moniker for deference to agency interpretation, has governed the last decade and a half. For all the right reasons, *Chevron* requires that courts defer to agency interpretation when a statute is ambiguous, or does not give specific mandates and leaves to agency discretion the carrying out of the legislative directive.[20] Since the demise of the old nondelegation doctrine[21] and the rise of the deference doctrine, few have questioned how far is too far in deferring to agency expertise. In the last decade, one sporadically sees Supreme Court and other federal court decisions that pay particular attention to the precise statutory language and require agency constraints that are faithful to that basic statutory language.[22] Sometimes the courts have proved the maxim that one judge's certainty is the next judge's ambiguity. Inherent in this

Constitutions and Substantive Criminal Law, 71 TEMP. L. REV. 521 (1998); G. Alan Tarr and Robert F. Williams, *Foreword: Western State Constitutions in the American Constitutional Tradition*, 28 N.M. L. REV. 191 (1998).

17 *See, e.g.*, William J. Brennan, Jr., *State Constitutions and the Protection of Individual Rights*, 90 HARV. L. REV. 489 (1977).

18 Marbury v. Madison, 5 U.S. (1 Cranch) 137 (1803).

19 Chevron v. Natural Resources Defense Council, 467 U.S. 837 (1984).

20 *See id.* at 842-43; *see also, e.g.*, 1 DAVIS & PIERCE, *supra* note 6, § 1.7.

21 *See generally* 1 DAVIS & PEIRCE, supra note 6, § 2.6 (discussing the history of the nondelegation doctrine).

22 *See, e.g.*, City of Chicago v. Environmental Defense Fund, 511 U.S. 328, 334, 339 (1994) (finding municipal solid waste incinerator facility was excluded from hazardous waste regulations, but ash generated by facility was not); Public Employees Retirement System of Ohio v. Betts, 492 U.S. 158, 170-72 (1989) (rejecting agency interpretation of term in Age Discrimination in Employment Act because the interpretation conflicted with term's plain meaning).

renewed attention to agency review lies the question of what is really a subject of agency expertise and what is simply statutory language of common understanding. Recently I have been embroiled in a collegial battle over two different statutes, one of which requires defining "grazing"[23] and one of which requires defining "coal."[24] Both of them, I argue in written opinions, are terms very common to any elected legislator and, therefore, not the kind of term Congress intended to leave to agency definition.[25] Those cases are simply in the "stay tuned" category, but they presage a concern that I see woven through many recent cases about clarifying the breadth of the *Chevron* doctrine. I think this whole area of judicial review of agency action will, no doubt, constitute a lively source of litigation in the next century, as agencies become more and more specialized on more and more technical topics.

A constraint on the federal courts in this area will be their sheer capacity to understand and effectively review some of the issues that come before them. Appropriately, the federal courts have been courts of generalist judges. I firmly believe they should remain so. We have rarely, until very recently, even used special masters or magistrates to try to sort out complex issues. In agency review, as well as in complex civil litigation, the highly technical nature of the issues that judges must decide will present a special challenge to the federal courts. We began to feel these problems in the latter half of this century, as we confronted the effects of asbestos,[26] the ravages of tobacco,[27] and the pricing mechanisms in the deregulation of the energy industry.[28] Those problems will look like very simple fact patterns when compared with the ever-increasing sophistication of the technology that will come to us in the 21st century. For example, Judge Thomas Penfield Jackson, who is hearing the Microsoft antitrust case in the District of Columbia, has had to learn volumes about computer operating systems and software programming and development. That case is just a beginning. Somehow, the federal courts

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23 *See* Public Lands Council v. Babbitt, ___ F.3d ___, 1999 WL 64802 (10th Cir. Feb. 8, 1999).

24 *See* Southern Ute Indian Tribe v. Amoco Prod. Co., 151 F.3d 1251 (10th Cir. 1998), *rev'd*, ___ U.S. ___, 191 S. Ct. 1719 (1999).

25 *See Public Lands Council*, 1999 WL 64802, at *24, 31-33 (Tacha, J., dissenting); *Southern Ute Indian Tribe*, 151 F.3d at 1267 (en banc) (Tacha, J., dissenting).

26 *See, e.g.*, Amchem Prods. Inc. v. Windsor, 521 U.S. 591 (1997), *aff'g* 83 F.3d 610 (3d Cir. 1996).

27 *See generally* Jamey Pregon, *Casualties of the War on Tobacco: Can Farmers Survive the Anti-Tobacco Onslaught?*, 3 DRAKE J. AGRIC. L. 465 (1998) (summarizing the history of tobacco litigation); Richard A. Daynard & Graham E. Kelder, Jr., *The Many Virtues of Tobacco Litigation*, TRIAL, Nov. 1998, at 34.

28 *See* Robert J. Michaels & Arthur S. DeVany, *Market-Based Rates for Interstate Gas Pipelines: The Relevant Market and the Real Market*, 16 ENERGY L.J. 299 (1995).

will have to be equipped to review very complex cases in a meaningful and constitutionally appropriate way.

My final constitutionally based principle is that of an educated citizenry capable of governing itself. Here, although all of us have a role to play, I believe that the courts, and judges particularly, have an especially important one. Although I have not been, and still am not, an advocate of allowing cameras in federal courtrooms, I am a zealot for judges and lawyers taking on a renewed role as advocates for the rule of law. In my view, in the last century, lawyers, for important and correct reasons, became so preoccupied with the financial imperatives of the profession that, to some extent, we retreated from the public lives of our communities. At the turn of this century, and up until World War II, lawyers dotted school boards, city councils, and civic groups of all kinds. It is my belief that, since that time, the numbers of lawyers in active volunteer and elected public service has plummeted. The profession is simply not as active in the civic life of our communities, nor in the lives of our young people, as we once were. Judges share the blame. In the crush of ever-increasing caseloads, and out of a concern for conflicts of interest or appearances of impropriety, we judges have retreated into our courtrooms, and off the highways and byways of the nation. Who better than the lawyers and the judges, who are trained in the law, to begin to re-infuse into the national conscience both an understanding of and a respect for this rule of law and this system of government that has served us so well? We are the best equipped for this public education process. Indeed, many of the Constitution's Framers and first advocates were themselves lawyers,[29] and they made their case for the Constitution in a public manner, through the publication of the *Federalist Papers*. We each must be a millennial Publius.

We need to get back in the schools, back in the Boy Scout and Girl Scout Troops, at the Boys' Clubs and Girls' Clubs, in the Rotary Clubs—everywhere we can be—articulating the basic principles that underlie the important guardians of our system. How many of you have been at cocktail parties or other adult gatherings in which someone voiced the popular view, "How can they let the criminals go?" How many of you articulated the basic principles that underlie Fourth Amendment protections or Sixth Amendment protections or the myriad of constitutional protections that are so important to our freedoms, and yet often entirely unknown or misunderstood by the general population? Similarly, in the wake of highly celebrated trials during which commentators

29 Over 30 of the 55 participants at the Constitutional Convention were lawyers. *See* Irah Donner, *The Copyright Clause of the U.S. Constitution: Why did the Framers Include It with Unanimous Approval?*, 36 AM. J. LEGAL HIST. 361, 374 (1992); FORREST MCDONALD, NOVUS ORDO SECLORUM 220 (1985).

questioned the jury system, how many of us have been in the civic clubs and in the classrooms describing why we have a jury system and what its values are? Our jury system was designed to help guard individual sovereignty. As a nation, we cannot afford to forget the checks and balances built into our system. An educated citizenry has little to do with individual cases, but everything to do with whether the courts and the rule of law can persist through the 21st century. We must see ourselves as civic educators. I say we have a massive undertaking on our hands.[30]

Those first principles were a set of heady historical and constitutional predictors. My next set of predictors derives from the nature of the courts themselves. Courts move at a slow and deliberate pace. Cataclysmic change is rare in the third branch of government. Instead, on a case by case, statute by statute, litigant by litigant basis, the courts have moved the law forward in a gradual, ever-evolving way. Once in a long while this gradual evolution results in cataclysmic change. To get from *Plessy v. Ferguson*[31] to *Brown v. Board of Education*[32] took more than a half a century. We cannot know today precisely what opinions of the latter 20th century will form the beginning steps in an inexorable march to some similar monumental change in our understanding of the law. I am certain, however, that the deliberative pace of change in the judicial branch will not alter greatly in the next century. The work of the courts inevitably follows the work of the other two branches of government, and continues to play out many years after the executive or legislative branches have acted. The 21st century will be no different. Similarly, the personnel in the executive and legislative branches changes rather dramatically every four or eight years. Not so in the courts, for within the judicial branch of the federal government is a check and balance system of its own. Due to lifetime appointments and the political forces in the appointment process, courts are composed of judges appointed by several administrations and confirmed by several different Senate majorities. Often, the leadership in the judiciary was appointed by a President of a different political party than the one currently occupying the office. Thus, a part of the largely invisible vitality of the judiciary is the interplay among different kinds of individuals with different backgrounds who continue to interact in the judicial branch long after those who put them there have disappeared from the political scene—in a sense, keeping the leaders of the recent past in constant, robust conversation with those of the present.

30 *See generally* Deanell Reece Tacha, *Renewing Our Civic Commitment: Lawyers and Judges as Painters of the the "Big Picture,"* 41 U. KAN. L. REV. 481 (1993).

31 Plessy v. Ferguson, 163 U.S. 537 (1896).

32 Brown v. Board of Educ., 347 U.S. 483 (1954).

Although this situation is a result of politics, it is also a counterbalance against prevailing political pressures, and one of the hidden geniuses behind our system of government. The long tenure of most federal judges, particularly as we live longer and longer, gives a continuity and a balance to the third branch of government that rarely moves far off a gradual centrist approach to decisionmaking. Another way of saying it is that the judiciary, by its very nature, is a correction built into the system to calm political winds that might otherwise develop into destructive storms. Some describe the courts as an anchor. De Tocqueville noted that lawyers in the common law system tend to be a stabilizing force;[33] the judiciary serves a similar function for our government. I see no evidence that there is likely to be any change in the basic structure of our judicial branch of government. Thus, we can continue to expect, just as we have for 200 years, that the federal courts will, in their plodding, deliberative way, keep on the same path that was begun with the Constitution and the Judiciary Act of 1789.[34]

Courts will continue to change at a very gradual pace, but we *will* change. Here I look at the way that we do business. I do not have to tell you that the caseload in the federal courts, and in every state court in this nation, is escalating at an almost astonishing rate, without a concomitant rise in the numbers of judges. The political, and even fiscal, ability of the federal Congress and the state legislatures will never be able to add judges, courtrooms, and staff on any formula that is consistent with the growth of the caseload into the next century. Although there will be a gradual increase, as public budgets allow, of these emblems of the judicial branch, the caseload will continue to escalate at an ever-increasing pace, requiring dramatic changes in our methods of operating. Some attempts have been made in this century to begin to address this explosion of litigation. In 1938, reforms in the Federal Rules of Civil Procedure encouraged open communication of evidence and early settlement based on better predictability of trials.[35] The notion of judicial case management began to emerge around 1970.[36] The whole explosion in privatized case management, mediation, arbitration, and alternative dispute resolution of the latter part of this century has been a response to delay and heavy caseloads. Congress passed the Civil Justice Reform Act in 1990

33 *See* ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA 267-70 (J.P. Mayer ed. & George Lawrence trans., Harper & Row, 1st Perennial Library ed. 1988).

34 Act of Sept. 24, 1789, 1 Stat. 73 (1789).

35 *See* Paul D. Carrington, *Virtual Civil Litigation: A Visit to John Bunyan's Celestial City*, 98 COLUM. L. REV. 1516, 1518 (1998).

36 *See id.* at 1519.

in an attempt to address the problems of delay in civil litigation.[37] Videotaped depositions began to be used in federal court in 1993.[38]

Just this last year, my court, the Tenth Circuit, began to experiment with videotaped oral arguments. In a recent law review article, Professor Paul Carrington of the Duke Law School talks about "virtual civil litigation," and speculates that there may come a time when both trial and appellate courts are "virtual courtrooms," where everyone is electronically connected and very little is done on a face-to-face, personal basis.[39] I have great respect for Professor Carrington, but I do not think that our justice system will ever go that far. I know that we will increasingly use technology to try to cut delays, speed the caseload, and minimize costs. After just a few opportunities to be involved in videotaped arguments, I am absolutely certain that the entirely electronic courtroom, where no one actually appears in person, will not be the prevailing model, even throughout the 21st century. That model will, of course, have its place. Videotapes will be commonplace. Faxed and electronically transmitted information, filings, and documents will be the norm. Good litigation skills will be defined quite differently in the 21st century than they are today. In place of the archetypal vigorous advocate before a jury, or analytical and thoughtful argument in an appellate court, the premium will be on precise and focused communication, facility with electronic devices of all kinds, and the use of technology as an advocacy and analytical tool. I am skeptical, however, that technology can ever adequately replace face-to-face contact with juries and judges, for it is in the nature of credibility that we be there at the trial. It is in the nature of an appellate argument that we converse with each other. We can do some of that with videotape. My experience thus far is that videotape is not as informative for the judge, nor as effective for the advocate, as an oral argument presented personally. I also worry about the collegial relationships among appellate judges who are distanced and connected only by three or nine video hookups. In my opinion, collegiality is also an important qualitative factor in our work.

Focusing specifically on appellate courts for a moment, you are no doubt aware that the Commission on Structural Alternatives for the Federal Courts of Appeals, which was appointed by Congress a couple of years ago, and chaired by Justice White, re-

37 Civil Justice Reform Act of 1990, Pub. L. No. 101-650, 104 Stat. 5089 (1990) (codified as amended at 28 U.S.C. §§ 471-482 (1994)) (requiring each federal district court to develop and implement a civil justice expense and delay reduction plan for the purposes of improving case management, reducing litigation costs, and promoting efficiency).

38 *See* Carrington, *supra* note 35, at 1521.

39 *See generally id.* at 1524-37.

cently submitted its report.[40] Concerns about the size of the Ninth Circuit spurred much of this report, but the Commission studied all of the circuit courts in the nation. The recommendations contained in that report underscore my gradual change theory. The Commission recommends no specific changes in the geographic boundaries of circuits,[41] thus confirming my predictor that change in the federal courts will take place gradually. The Commission does, however, recommend that the circuit courts look at new ways of handling en banc proceedings and summary dispositions.[42] All of the recommendations go to more flexibility and more capacity in the federal courts of appeals, without losing the qualitative benefits of collegial courts.

My final set of predictors is much more demographic, much more obvious, and no less compelling. They relate to who we are and how we will live in the 21st century. I have said that the Federal Reporters are filled with the history of the people of this nation, and if one looks carefully at the stories in those cases, one sees a mirror image of life on the highways and byways of America. So we need to look as a predictor at those highways and byways of America in the 21st century. What will we be like? I will not bore you with all the statistics, but I will tell you what you already know. The first is that we will live closer and closer together. It is estimated that by the year 2025, 59% of the world's population will live in urban areas compared with 32% in 1955.[43] The number of mega-cities, that is, populations exceeding 10 million, will increase from one in 1955, to 20 or 30 within the next 15 years.[44] In my part of the country, the number of farms is decreasing at an ever more rapid rate. Thus, we'll rub elbows and shoulders, be in traffic, confront the sanitation problems, and suffer the effects of a growing world population in ways unknown in the 20th century. This forecast has implications for immigration, employment, schools, every aspect of our economy, and how we live together.

Second, information and communication technology will give us the increasing ability to do technologically those things that were unimaginable in this century. That technology will have its extraordinary positive effects and its debilitating negative effects. Federal courts will have to be right there with that development of technology—a challenge we have only begun to face.

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40 COMMISSION ON STRUCTURAL ALTERNATIVES FOR THE FEDERAL COURTS OF APPEALS, FINAL REPORT (1998).

41 *See id.* at 59-62.

42 *See id.* at 62-64.

43 *See* World Health Organization, *Health Futures: Creating a Healthier Future Now*, FUTURIST, Jan. 1999, at 64.

44 *See id.*

The health issues of this population will change enormously. For example, the World Health Organization expects that tobacco will kill 10 million per year by the year 2025.[45] In industrialized countries, heart disease, stroke, and cancer will remain the leading causes of death, although the long-term total deaths from heart disease and stroke will decline while deaths from some cancers, no doubt spurred by carcinogens, will increase. The growing threat of emerging infectious diseases, such as HIV, AIDS, and Hepatitis C, likely will continue to escalate because of antibiotic resistence and changes in human behavior. Technology will dramatically affect issues relating to life's beginning and life's end. Additionally, environmental issues, some of which are known and many of which are not known, will emerge as critical policymaking issues for the future. The continuing deterioration of the environment, along with a lack of adequate water for the world's population and a lack of renewable energy resources, will increasingly drive foreign policy and public decisionmaking generally.

In each of these demographic facts lie legal dilemmas that will be foisted upon the federal courts. The boundaries between ethical choices and scientific decisionmaking will become more and more blurred with the resulting ambiguities in our understanding of that which is right and that which is destructive. Thus, courts will be thrust into the chasm of those ambiguities to try to help society make some of its most difficult decisions.

The inescapable demographic fact is that we will be very diverse. Now, here in Southern California diversity may be the norm already, but in most of the nation and, I think it is true, in many of the power bases of the nation, diversity has not become a reality. Learning to live and govern together in such a heterogeneous society may constitute the greatest challenge of the next century, and we'll see its reflections in the courts. Just as *Brown v. Board of Education* changed the landscape in this century, there will be decisions in the not so distant future that will have a similar millennial cataclysmic effect on the way we live out our national ideals together.

Finally, the days of nations that live their economic lives within their boundaries are over for good. The 20th century has taught us that we could not live within our boundaries in carrying out our relationships with the rest of the world. Instead, we engaged in two world wars, the Korean war, the Vietnam conflict, and hundreds of unnamed skirmishes in the name of freedom and national integrity. Freedom and national integrity will be no less important in the next century, but we will be forced to seek new

45 *See* Lucien J. Dhooge, *Smoke Across the Waters: Tobacco Production and Exportation as International Human Rights Violations*, 22 FORDHAM INT'L L.J. 355, 358 (1998).

ways to relate with each other in an international economic and social culture, while still preserving the integrity of our national systems of government. It is clear from current world events that this will be a challenge indeed. Again, the courts of this nation will feel the effects. Today, in the onslaught of immigration and political asylum cases, we are increasingly feeling the reverberations of unstable economies and governments around the world.

Now let me speculate a bit on what effects these demographic factors will have on the federal courts. Some are so obvious as to seem elementary. We will live in a very crowded society. The effects of crowding alone will have a massive impact on the federal courts. In a crowded society, crime is more prevalent, particularly when that society has an ever-increasing gap between the haves and have nots. Thus, I see no evidence that there will be a tailing off in the 21st century of attention to law enforcement and the consequent adjudication of criminal cases. Today, approximately a quarter of the federal court caseload is devoted to criminal cases and cases brought by prisoners.[46] The proportion of the load of the federal courts devoted to these cases has increased dramatically during the last 20 years. That trend shows no sign of abating significantly.

The effects of crowding are far more expansive than criminal activity. Individuals will seek to vindicate their rights against the government and against each other at an ever-increasing rate. In the last decades of this century, actions are being brought under 42 U.S.C. § 1983 for violations of constitutional rights at an unprecedented rate.[47] In these cases, citizens are alleging that the government, in a myriad of ways, is trampling upon their individual sovereignty. They are claiming constitutional rights, some meritorious and some not, but almost all the result of closer proximity.

We will also be brought closer together with people very different from ourselves, with the resultant ugly side of discrimination, harassment, and intolerance. Through federal antidiscrimination laws, beginning with those famous Reconstruction-era civil rights acts[48] and continuing through the Civil Rights Act

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46 *See Nature and Number of Civil Suits Filed in the Federal Courts in 1995* (chart), NAT'L L.J., Aug. 26, 1996, at A5 (reporting 63,550 prisoner petitions out of 248,335 civil actions filed in federal courts in 1995); *see also* Daniel J. Juceam, *Privatizing Section 1983 Immunity: The Prison Guard's Dilemma After* Richardson v. McKnight, 117 S. Ct. 2100 (1997), 21 HARV. J.L. & PUB. POL'Y 251, 264 n.85 (1997) (noting that in some U.S. district courts, up to 34% of the caseload consists of prisoner lawsuits).

47 Indeed, in 1966, the number of prisoner cases filed was only 218, see William Bennett Turner, *When Prisoners Sue: A Study of Prisoner Section 1983 Suits in the Federal Courts*, 92 HARV. L. REV. 610, 611 (1979) (noting that federal courts did not report this statistic until 1966), compared with 63,550 in 1995, see *supra* note 46, a 2910% increase.

48 *See* The Civil Rights Act of 1866, ch. 31, 14 Stat. 27 (1866) (codified as amended at 42 U.S.C. §§ 1981-1982, 1987-1989 (1994)); The Enforcement Act of 1870, ch. 114, 16 Stat.

of 1964[49] and the Americans With Disabilities Act of 1990,[50] Congress has been active in trying to provide redress for acts of discrimination and harassment. No doubt those statutes and others will continue to be central in the litigation of the federal courts in the next century as we live and work more and more closely with people who are evermore different from each other in language, ethnicity, and personal characteristics.

Perhaps nothing will affect the federal courts more than the explosion of the technological age and the specialization it spawns. From patent and trademark to antitrust, and from securities transactions to tax questions, technology will bring into the courtroom and into appellate records complex factual considerations that will tax the abilities of the federal courts to continue to make informed decisions. The use of experts has become commonplace and will increasingly be a staple of the 21st century courtroom. Drawing lines between the appropriate and inappropriate use of experts, and, at the same time, minimizing the costs of litigation, will be challenges of their own. The Supreme Court's *Daubert*[51] case, which most recently addressed the gatekeeper function of the federal courts in qualifying experts, forms just the beginning of a long and torturous process of attempting to ensure that the decisionmakers receive adequate information for fair and impartial decisionmaking, without escalating the cost and complexity of litigation beyond the capacity of litigants, judges, and juries.[52] Again, the lawyer of the future will necessarily have a new set of skills. She will be one who can simplify explanations, diagram problems, and clarify complex fact situations. For legal education, this new model of the successful lawyer suggests very new educational approaches.

There is a bright light in all of this. One of the reasons I love being a judge, and the reason I hear cited most often by my colleagues, is that we never get bored. Well, the 21st century will present us with such new concepts, facts, and legal situations that it is quite clear that we will never get bored. I think the federal

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140 (1870) (repealed 1894); The Civil Rights Acts of 1871, ch. 22, 17 Stat. 13 (1871) (codified as amended at 42 U.S.C. §§ 1983, 1985-1986 (1994)); and The Civil Rights Acts of 1875, ch. 114, 18 Stat. 335 (1875) (declared unconstitutional in *The Civil Rights Cases*, 109 U.S. 3 (1883)).

49 Civil Rights Act of 1964, Pub. L. No. 88-352, 78 Stat. 241 (1964) (codified in scattered sections of 5 U.S.C., 28 U.S.C. & 42 U.S.C.).

50 Americans with Disabilities Act of 1990, Pub. L. No. 101-336, 104 Stat. 327 (1990) (codified as amended at 42 U.S.C. §§ 12101-12189, 12201-12213 (1994)).

51 Daubert v. Merrell Dow Pharm., Inc., 509 U.S. 579 (1993).

52 The Supreme Court recently held that the gatekeeping function served by the trial judge under Fed. R. Evid. 702 applies to testimony based on technical and other specialized knowledge as well as scientific knowledge. *See* Kumho Tire Co. v. Carmichael, ___ U.S. ___, 1999 WL 152455 (Mar. 23, 1999). Thus, trial judges have the discretion to consider one or more of the *Daubert* factors, and any other appropriate considerations, in determining the reliability of expert testimony.

judiciary is up to the challenge, but it will be a challenge indeed to keep up with subject matter of litigation.

Similar to technological challenges, the health issues of the 21st century will have a predominant place in litigation in the federal courts. We have, in this century, been intimately involved with every development in medical science and research. From reviewing approval procedures in agencies, to determining disabilities, to valuing the catastrophic effects of new procedures gone wrong, the federal courts have been thrust into the middle of the medical and health advances of this century. That trend will only escalate in the 21st century. The spread of new infectious diseases will raise the specter of the injection of government and government agencies into more and more regulation, sanitation, and environmental factor cases.

This century, we dealt with all of the CERCLA[53] and environmental clean-up issues that were the result of our lack of knowledge about the potent dangers of dumping various hazardous substances. The environmental challenges of the next century will make CERCLA cases look easy. The threat of ozone deterioration, climate change, lack of water, loss of species, and rampant carcinogens will be at the forefront of federal court litigation in the next century.

Also related to the health issues will be the inevitable human decisions stemming from advances in technology. Federal courts in this century were the cauldrons in which the questions of abortion[54] and right-to-die boiled.[55] In the next century, those will be but a few of the volumes of new decisions that must be made. Who gets organ transplants, who will make the decisions with respect to genetic selection, what rights does the government have in making choices about drugs, therapies, technologies, and the like will all have to be decided. The implications of cloning and genetic engineering are only beginning to infuse our consciousness. Those decisions will no doubt pervade the lives of the federal courts over the next century. Within the last year, major national conferences were held that brought together scientists from the Human Genome Project and federal and state judges to try to begin to think about the legal principles that might help us to guide the law and the courts into this new world of medical and scientific breakthroughs.[56] At the end of those conferences, I wish you could have

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53 Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 U.S.C. §§ 9601-9675 (1994).

54 *See, e.g.*, Roe v. Wade, 410 U.S. 113 (1973); Planned Parenthood v. Casey, 505 U.S. 833 (1992).

55 *See, e.g.*, Cruzan v. Director, Mo. Dep't of Health, 497 U.S. 261 (1990); Washington v. Glucksberg, 521 U.S. 702 (1997).

56 These conferences include: *The Human Genome Project: Science, Law, and Social Change in the Twenty-first Century*, held on April 23, 1998, in Cambridge, Massachusetts,

seen both the excitement and the sheer terror of both the judges and the scientists as they thought of the implications for humane society that the decisions in this area will have. Indeed, just as science threatens to outrun our ethics, it threatens to outrun the law.

The globalization of the world economy means the 21st century will be the century in which the federal courts finally have to learn international law. As you are no doubt aware, the United States has not been a signatory to many of the major international compacts. Even where we were signatories, these international compacts barely affected the work of the federal courts. Once in a while, we have seen a forum non conveniens case or an international contract. Rarely have we seen the principles of international law, and even more rarely have we applied them. In my view, it is inevitable that just as the Euro has burst upon the European market, international law will burst upon the world. Companies have become multinational and business is globalizing. Though I doubt that we will ever transform totally toward a civil law model, we have gradually done so over this century, moving more and more towards statutory causes of actions and away from the common law model. The infusion of international compacts, treaties, and agreements will no doubt move us even further in that direction. For example, the Vienna Sales Convention of 1980,[57] which the United States has signed, replaces the Uniform Commercial Code in many international business transactions. Whether or not the United States becomes signatory to additional significant international compacts, there is absolutely no doubt that regulatory issues, contracts, and technological exchange will propel even the federal courts of the United States into the world market of ideas and legal principles.

The Internet is a powerful reminder of the international significance of legal principles uniquely national in character. The Internet knows no national boundaries and renders everyone with net access a speaker and a publisher. The leafleting of the constitutional era are the web pages of today. The application of the First Amendment, so sacrosanct in American history, will necessarily impinge upon the people and sovereign powers of nations far beyond our borders. The values related to respect for national integrity will be challenged mightily by the worldwide flow of information.

Finally, to *how* the federal courts will do this work! One prediction I feel reasonably safe in making is that the first few years

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and *Courts and the Challenge of Genetic Testing*, held on Oct. 21-24, 1998, in Snowbird, Utah.

57 United Nations Convention on Contracts for the International Sale of Goods, Apr. 11, 1980, U.N. Doc. A/CONF. 97/18, Annex I, *reprinted in* 19 I.L.M. 668.

of the 21st century, and perhaps the entire century, will be consumed in large measure with trying to promulgate and adopt new rules for electronic courtrooms, virtual trials, and all of the ramifications of technology for the operation of the courts. I am also reasonably certain that, just as the need for big libraries with books will be gone, so will the need for big courtrooms and courthouses. But what a treasure civilization will have lost if we allow ourselves to be captured wholesale by the enticements of a complete transformation to a technological way of doing things. Just as the rare scrolls of long ago have been so important in informing us, so will our books and courtrooms be emblems of this century, of the achievements of civilized society for the future. The courts, I suspect, as they always have been, will be foot draggers—ploddingly, glacially moving into the 21st century in a way that does not produce many cataclysms, but allows the hours to tick forward case-by-case, building upon 200 years of history. That is how we have operated; that is how I predict we will operate. We will, in some ways, be an appropriate drag on the system as we attempt to balance our reliance upon the past with the protection of the dreams of the future.

So who will we be, the judges, the lawyers, and the litigants of the 21st century? We will be the people that Thomas Jefferson, Benjamin Franklin, John Adams, and Abigail Adams, placed their faith in over 200 years ago. We will be the millennial patriots. We will need to recognize that the millennium represents two equally important points in time: the cataclysmic change of a thousand years and the single tick of a minute. The federal courts will be there doing both.

I leave you with an important admonition: we in the federal courts will be able to carry out our historic function only if you will join with us in a profession-wide effort to reinvigorate our national understanding of the "first principles" that have preserved the legacy of freedom that has been ours to enjoy in this century. Some years ago I wrote a poor imitation of a Dr. Seuss poem about the legal profession. In that poem, after reflecting on the evolution of his legal career, the wise old senior partner of a prosperous large law firm flings open the door of his office and regales the young associate with the admonition that I leave you with tonight to take us into the 21st century:

> You lawyers are the keepers of the dreams of the world
> You've watched as repressions and dictators swirled
> You know that the freedoms that served you so well
> Are the words of the story that you now must tell.[58]

58 *See* Deanell Reece Tacha, *The Tale of Widget and P: A Story of the Legal Profession*, KAN. J.L. & PUB. POL'Y, Spring 1993, at 127, 130 (1993).

SYMPOSIUM: FEDERAL TAX POLICY IN THE NEW MILLENNIUM

Introduction

*Frank J. Doti**

Our federal income tax law is under the strongest attack since the Sixteenth Amendment was ratified in 1913. The most vocal assaults began during the 1996 presidential campaign, most notably with candidate Steve Forbes' call for a flat tax to replace the current structure.[1] Voters were told that under a flat tax most taxpayers would be able to file a postcard size tax return each year.[2] The calls for reform peaked when the House of Representatives passed the Tax Code Termination Act of 1998.[3] The Act called for repeal of the tax code by December 31, 2002, provided that an alternative system was in place by July 4, 2002. Although the vote was fairly close at 219-202, and the bill was passed during a congressional election year, the Act is symbolic of the frustrations of Congress with the current federal income tax system.

The federal income tax had a very humble beginning in 1913. The entire law consisted of only 14 pages,[4] and the first individual income tax return (Form 1040) was a mere three pages with one

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1 *See* Ernest Tollerson, *Bowing Out: Forbes Quits and Offers His Support to Dole*, N.Y. TIMES, Mar. 15, 1996, at A26 (recapping Steve Forbes' campaign for the presidency).

2 *See* ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX 52 (2d ed. 1995) (the flat tax proposals of both Steve Forbes and Congressman Armey were based on the Hall and Rabushka proposal).

3 Tax Code Termination Act of 1998, H.R. 3097, 105th Cong. (1998).

4 Tariff of 1913, ch. 16, § II, 38 Stat. 114, 166-81 (1913).

page of instructions.[5] Now there are more than 2,700 pages in the Internal Revenue Code and about 400 schedules and forms.[6] Obviously much has changed since 1913, with the federal government's appetite for revenue significantly enhanced by two world wars, military defense, Social Security and welfare programs, and interest on the public debt from deficit spending.

Since Congress recodified the Internal Revenue Code in 1986,[7] there have been significant amendments in 1990,[8] 1993,[9] 1996,[10] 1997,[11] and 1998.[12] Congress has been extremely active, with major income tax law changes in every year since the 1996 campaign debates about tax reform. Curiously, instead of adopting a revolutionary new tax scheme, Congress has refined the present system and added to its complexity. The system has become so complex that some political pundits have speculated that it is all a ploy by Republican congressional leaders to scuttle the whole system by causing complete exasperation within the populace.[13]

As evidenced by the Tax Code Termination Act of 1998,[14] the political winds of change are in the air as we get closer to the new millennium. Although calls for tax reform have subsided since the November 1998 congressional elections and the preoccupation of Congress with the impeachment process in early 1999, there is little doubt that tax reform will again be a battle cry of politicians during the presidential campaign in the year 2000.

Chapman University School of Law has a mission to develop a tax law concentration of distinction. To that end, Chapman offers a tax law emphasis program as an integral part of the J.D. curriculum. Chapman is also the only law school in California, and one of only 12 American Bar Association-approved law schools in the nation, that participates in the United States Tax Court clinical

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5 *See* Sharon C. Nantell, *A Cultural Perspective on American Tax Policy,* 2 CHAP. L. REV. 33, 90-93 (1999) (Appendix reproducing 1913 Form 1040).

6 *See* U.S. GENERAL ACCOUNTING OFFICE, REPORT NO. GGD-98-37, TAX ADMINISTRATION: POTENTIAL IMPACT OF ALTERNATIVE TAXES ON TAXPAYERS AND ADMINISTRATORS 39-40 (1998).

7 Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

8 Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (1990).

9 Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (1993).

10 Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (1996).

11 Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997).

12 IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (1998).

13 *See* Jonathan Chait, *The Flat Tax Scam: What Dick Armey Doesn't Want You to Know*, NEW REPUBLIC, Dec. 15, 1997, at 24.

14 *See supra* note 3.

education program. Our law students handle actual cases docketed with the court on a pro bono basis.

For a law school with taxation law as a component of its mission statement and curriculum, we accordingly focus this issue of the *Chapman Law Review* on a critical examination of our present federal income tax system and possible alternatives. Chapman is proud to have sponsored the Second Annual Tax Law Institute on November 12-13, 1998. On November 13, 1998, the topic was "Federal Tax Policy in the New Millennium." Distinguished tax law policymakers, professors and scholars from around the country came together to present their ideas, research and analyses with respect to federal tax reform. The participants included Jonathan Talisman, Deputy Assistant Secretary for Tax Policy, Department of the Treasury; Professor Sharon C. Nantell, Chapman University School of Law; Professor Barbara H. Fried, Stanford University Law School; Professor Jonathan Barry Forman, University of Oklahoma College of Law; Professor Edward J. McCaffery, University of Southern California Law Center; Professor Alan Schenk, Wayne State University Law School; and Professor Lawrence Zelenak, University of North Carolina School of Law.

Chapman is pleased to have these respected educators and scholars present their in-depth legal and economic analyses in this law review. We are confident that readers will find these works to be at the cutting-edge of a philosophical and critical study of the alternatives to the most significant tax law in the history of mankind.

Although the scholars may differ on some issues, they all agree that the Congress should carefully explore alternative schemes before scrapping our current income tax law. Our current law is primarily a byproduct of the 1954 Internal Revenue Code, with an inordinate number of refinements since then. Even House Majority Leader Richard Armey, one of the leading advocates of a flat tax, does not support a new tax plan that is entirely free of loopholes.[15] Also, many of his colleagues are critical of any plan to end the deductions for home mortgage interest and charitable contributions.[16] These inconsistencies are just the tip of the iceberg when one tries to sort out the drawbacks of revolutionary tax reform.

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15 H.R. 2060, 104th Cong. (1995) (Congressman Armey's flat tax proposal, excluding investment income from the tax base, and providing for substantial personal and dependent standard deductions).

16 *See, e.g.*, The National Commission on Economic Growth and Tax Reform, *Unleashing America's Potential: A Pro-Growth, Pro-Family Tax System for the 21st Century*, *reprinted in* 70 TAX NOTES 413 (1996) (commonly referred to as the "Kemp Commission Report").

Further confusing the colloquy is a commonly held belief that high income taxpayers are able to shelter much of their income from taxation. In truth, the current income tax law is remarkably efficient in taxing the rich. On December 14, 1998, the nonpartisan Congressional Joint Committee on Taxation released a report showing that individual taxpayers with incomes over $100,000, less than 10% of the total population, are projected to pay 62.4% of the total income tax burden in 1998.[17] The ability of high income taxpayers to shelter their incomes diminished to a great extent as a result of the Tax Reform Act of 1986,[18] followed by further increases in the burden on the wealthy in the 1990 and 1993 tax acts.[19]

Nevertheless, along the way the federal income tax has become a very complex law.[20] Even the experts who make a living interpreting and applying tax law for their clients have voiced frustrations at the inordinate complexities. The American Bar Association and American Institute of Certified Public Accountants have called on Congress on numerous occasions to simplify the income tax law.[21]

Consequently, as we enter a new millennium, we urge the policymakers to study the works in this law review. The current tax law is fundamentally sound in my view, but we need a comprehensive overhaul to eliminate the complexity.[22] Much of the convoluted state of the law is due to tinkering by Congress to placate powerful lobbying groups and satisfy purely partisan political goals. We can only hope that the Congress can at last overcome the pressures of lobbyists and partisanship and erase from the Internal Revenue Code all of the needless complexity.

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17 JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1999-2003, at 25 tbl.2 (JCS-7-98 1998).

18 Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) (major changes included the repeal of income averaging and the regular investment tax credit, new limitations on tax shelters, limitations on the deductibility of nonbusiness interest, and the addition of a new generation skipping transfer tax).

19 Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11101, 104 Stat.1388, 1388-403 to 1388-405 (1990) (increasing the highest individual tax rate to 31%); Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13201-13202, 107 Stat. 312, 457-61 (1993) (increasing the highest individual tax rate to 39.6%).

20 *See, e.g.*, Deborah L. Paul, *The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?*, 76 N.C. L. REV. 151 (1997).

21 *See, e.g.*, Michael C. Durst, *Report of the Second Invitational Conference on Income Tax Compliance*, 42 TAX LAW. 705, 728-30 (1989) (discussing the impact of complexity in fostering noncompliance, and advocating a pilot project with other professional groups to advise Congress of potential problems with complexity of pending tax legislation); *Impact of Complexity in the Tax Code on Individual Taxpayers and Small Businesses: Hearing Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 105th Cong. 31 (1998) (statement of Michael Mares on behalf of the American Institute of Certified Public Accountants); *AICPA Submits Tax Simplification Recommendations*, TAX NOTES TODAY, May 15, 1997, at 25.

22 For a contrary view, see William W. Oliver, *Why We Should Abolish the Income Tax*, TAX NOTES TODAY, Feb. 3, 1997, at 70.

Although it is a cliche, this symposium has truly been a collaborative effort, and there are many people to thank for making this law review a reality. We appreciate the support, encouragement and leadership of Dean Parham Williams and Professor Denis Binder, faculty advisor to the law review. We are very grateful to all the dedicated editors and staff of the *Chapman Law Review* who worked so hard to put the symposium and law review together. A very special thank you should go to Editor-in-Chief Diana Hoffman for putting the project together and keeping it on track. And, of course, we are forever grateful to and honored by the fine contributors to this work.

A Cultural Perspective on American Tax Policy

*Sharon C. Nantell**

I view the role of this article as that of a "warm-up act." The subsequent articles in this journal either raise issues regarding revising the current tax code, or present arguments for or against alternative forms of federal taxation in the new millennium. However, in order to fully appreciate these proposed revisions and alternatives, I believe we need to truly understand and appreciate our current federal income tax system, and, as importantly, how we arrived at where we are today.

I have always been a firm believer in the fact that we cannot truly understand where we are going if we do not understand and appreciate how we got where we are today. A cultural perspective will tell us more than "just the facts." Hopefully, it will illuminate some of the "whys" behind the current federal income tax system. That analysis, in turn, will assist us in determining what paths to take in the future.

I. Introduction: A Personal Perspective

Let me begin with a story. It was 1978. I was 27 years old and had just been accepted into the Masters of Law in Taxation program at Georgetown University Law Center. Washington, D.C., was a new experience for me. Viewing the constant stream of busses to the Capitol, however, I realized that I was apparently the only living person who had never taken a grade school or high school field trip to D.C. So, at 27, I set out to see the sights.

Before I describe what I did on my first self-directed sightseeing trip, I must inform you of my personal historical perspective. By the age of 27, I had already worked for the Internal Revenue Service for three years while attending law school in Cleveland, Ohio.[1] I had also worked in corporate America, in the tax depart-

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1 My three-year stint with the Internal Revenue Service while I attended law school has forever earned me the Scarlet Letter "I" in the eyes of my law students (despite more than two decades of service in the name of the taxpayer).

ment of the Sherwin-Williams Company at the corporate headquarters office. Tax was basically my life. Much to my mother's dismay, I was leaving my Fortune 500 job for the life of a poor law student, to steep myself in the intricacies of the Internal Revenue Code, and I was actually excited about it!

So, where did I go? Not to the Washington Monument, nor the Lincoln Memorial, nor the Capitol Building. Instead, I drove through the nightmarish D.C. traffic to the main Internal Revenue Service Building, not motivated by a belief in the IRS as an institution, but rather by intrigue for the role that taxes played in our American society. Perhaps still flush with some idealism left over from the 1960s, I hoped to make the world a better place, and the tax system a better system. Thus, I was impressed with, and inspired by, the large words inscribed in stone over the entrance to the building:

> *Taxes are what we pay for civilized society.*[2]
>
> —Oliver Wendell Holmes

I believed that statement then and, 20 years later, I tenuously continue to hold on to that belief.

I am now an aging tax professor. I am teaching students who were toddlers when I was at Georgetown in 1978. When I recently read the Holmes quote to one of my classes, the students laughed. I was startled by their response, but mostly I was troubled. What had gone wrong? Or perhaps, more accurately, was it ever right to begin with? If it was, what had changed to so damage or destroy our underlying belief in our federal tax system?

Beliefs and values are the focus of this article, since a cultural perspective on American tax policy necessitates an examination of culture itself. Culture is defined as the integrated pattern of human knowledge, belief, and behavior that depends upon man's capacity for learning and transmitting knowledge to succeeding generations.[3] A college course in cultural anthropology nearly 30 years ago opened my eyes to human cultures throughout the world, and throughout the ages, with respect to social structures, language, law, politics, religion, art, and technology. For example, no matter whether sophisticated or remote, I discovered that every societal group throughout the world had developed religion as an integral part of its culture—a belief in some being or force greater than themselves. Whenever groups of people live together, they develop rules to govern behavior: to encourage certain actions and to discourage other actions. Our choices of language,

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2 Compania General de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

3 *See* WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 314 (1985).

law, politics, and religion are reflections of what our society values and believes.

Why do we choose to live in societal groups? There are simply some things that a group can provide for us that we cannot provide for ourselves. The tangible benefit of protection, for example, and the intangible benefit of social interaction immediately come to mind. The group benefits come to us at some cost; e.g., we must share physical resources and individual skills in order to provide protection for the group.

Thus, a society's choice of a system of taxation speaks volumes about what that society values and believes.[4] In societal groups, humans share. How a particular society chooses to share its resources or revenues among villagers or throughout a nation is reflective of what that society holds dear in its culture. There is both a cost and a benefit to this sharing. The societal objective is to make the benefit outweigh the cost, as perceived by the values and beliefs of that particular society. According to Justice Holmes, in the society of the United States in 1927, the cost of taxes bought the benefit of civilization in the form of goods and services provided by the government.[5]

We tax ourselves as the price for living in a particular civilized society. If a group in a village goes off to hunt or fish and is expected to share its "catch of the day" with others in the village upon its return, then that sharing is, in effect, a tax upon their catch.[6] If we, as a society, choose to tax income at the federal level rather than the transfer of goods and services, through, for example, a national sales tax, then that conscious choice says something about what we believe. The choices we make within the tax system, and continue to make, also reflect the evolving values of our culture.

When we examine our American tax policy from this perspective, what values and beliefs do we find? What do we hold near and dear to our hearts? Have our values changed over the years or

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4 "Ultimately, decisions as to how a polity should finance its public spending reveal as much about the character of the regime as how it chooses to spend the revenue." Sheldon D. Pollack, *Tax Reform: The 1980s in Perspective*, 46 TAX L. REV. 489, 496 (1991). Professor Alice Abreu concludes that our choice of an income tax is not accidental: "tax systems are products of human creation. They exist because they serve human objectives, reflecting the values of their designers. A tax system's design can reveal much about those values." Alice G. Abreu, *Taxes, Power, and Personal Autonomy*, 33 SAN DIEGO L. REV. 1, 16 (1996).

5 *See Compania General de Tabacos de Filipinas*, 275 U.S. at 100.

6 A society in which members are expected to share the proceeds of a hunt with others is, in effect, imposing a tax on that hunt. . . . In the most basic of senses, then, I heartily agree with Justice Holmes that taxes are the price we pay for civilization [citation omitted]. Indeed, I might go even further and say that taxation, that is, the means by which we share resources, is an essential part of civilization.

Abreu, *supra* note 4, at 16 n.34.

are some fundamental, unshakable values still reflected in the tax code today? What behavior is encouraged or discouraged? What "tax culture" are we passing on from one generation to the next? With these questions in mind, our journey begins.

What I will ultimately conclude is that imposing a tax—any tax—is both powerful and manipulative. The focus of our American tax system, from excise taxes and tariff duties in the early years of the nation to the current federal income tax, never has been upon distributive justice, or any kind of justice, for that matter. Since 1789, those with the least power have borne the heaviest burden of taxation in the United States. By 1917, Congress had discovered that very slight changes in the structure of the new federal income tax could reap great quantities of revenue. Deductions, capital gains preferences, and rate changes started early and have occurred often.

Taxes may be the price we pay for civilization, but how civilized is our tax system itself? What values and beliefs are represented in our current structure? Our historical review leads us to an appreciation that, as a society, we may not really believe that the wealthy should pay more, despite our allegedly progressive tax rate schedule. We begrudgingly tax the wealthy at a slightly higher rate mainly because it is both easy and lucrative to do so, and because it makes good political sense from the point of view of a legislator. We are not motivated, and have never been motivated, however, to do so out of some basic sense of justice.

II. Our Federal Tax System: History, Values, and Behavior

The first ingredient to be examined in our cultural tax perspective is knowledge. We must be knowledgeable about our federal system of taxation. The significance of this factor is twofold: (1) knowledge of our tax system itself; and (2) knowledge of our tax history.

With its current complexity, it is all but impossible to "know" the entire Internal Revenue Code. Even alleged tax "experts" will likely admit that they are current in their knowledge of only certain areas of the Code. So, if the experts cannot master the entire Code, what chance do average taxpayers have? The complexity of the Internal Revenue Code has been the topic of discussion of tax reform for many years. No matter how much discussion takes place, however, the Code just keeps growing. In the 1997 revenue act, for example, 825 Code sections were revised and 285 new sections were added to the Code.[7] Taxpayers are overwhelmed and fearful that, without assistance, they will miss tax deductions and

7 *See Early Spring Anxiety*, Providence J.-Bull., Apr. 25, 1998, at A12. There were also 271 new IRS regulations in 1997. *See id.*

credits otherwise available to them. Thus, in 1996, more than 60 million taxpayers, representing one-half of all those filing, paid preparers to fill out their tax returns.[8]

An important fact not to be overlooked here is that whatever knowledge Americans possess about the federal income tax is passed on to succeeding generations. Even if the information we possess is not correct, our perceptions get passed on to our family members. My students come to my federal income tax class, for example, as relative novices to the federal tax system. In fact, it is ironic to teach tax to a group of people who have only liabilities (from their student loans) and no income! Yet, invariably, they already have very definite attitudes toward the federal tax system. Fully 90% of them are fearful of a tax system that impacts their lives and the lives of their soon-to-be clients. The knowledge obtained in the course, however, empowers even the most fearful, even though it barely scratches the surface of the Internal Revenue Code.

The fundamental problem regarding knowledge and the Internal Revenue Code is the amazingly steep tax learning curve. Our students might even call it a slippery slope. As taxpayers, we feel driven to "know what the rich people know." If Code sections are available to us that we do not know about, we feel stupid and taken. We have defaulted money to the federal government that is rightfully ours to keep. Thus, tax planning, tax preparation, and the computer technology associated with self-preparation have become driving forces in our current tax culture.

A final observation regarding knowledge is the difficult task of appreciating the hidden aspects of taxation. We are aware, of course, of the taxes we pay outright, but what about the so-called hidden taxes: the excise taxes on gasoline, cigarettes, and alcohol built into the cost of the goods; the corporate income tax passed along into the economy to be paid by others; and the employer's portion of the Social Security tax?[9] No matter what the tax, whether it is a sales tax, an income tax, a corporate tax, an employment tax, or a tax upon trusts, people, not entities, pay taxes.[10] An in-depth analysis of the issues surrounding the size

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8 In 1996, 60,858,000 individual income tax returns were filed with paid preparer signatures. *See* INTERNAL REVENUE SERVICE, INDIVIDUAL INCOME TAX RETURNS, STATISTICS OF INCOME BULLETIN, Summer 1998, at 177 tbl.22 [hereinafter STATISTICS OF INCOME]. A total of 120,351,208 returns were filed. *See id.* at 150 tbl.3.

9 *See* Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLA L. REV. 1861, 1874-86 (1994).

10 Keep in mind that taxes are borne by *people* . . . . All taxes ultimately translate into changes in individuals' purchasing power. . . . We speak of the 'nominal incidence' of a tax as the measured payments of tax by individuals or institutions. The 'real incidence,' or economic incidence, is the true burden, which can fall only on people.

DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 133-34 (1986).

and complexity of our tax law is beyond the scope of this article, but these issues impact every aspect of our analysis as we examine knowledge, beliefs, and behavior in our cultural perspective on the Internal Revenue Code.

The second primary aspect of knowledge is historical perspective. It is, in my estimation, critical to an understanding of the federal system of individual income taxation that we adequately reflect upon its evolution over the years. How did we originally fund the activities of our early, central federal government? Who in the population bore the primary burden of federal taxation? It was not until 1913, fully 124 years after the Constitutional Convention of 1789, that Congress enacted a relatively straightforward tax upon "income from whatever source derived,"[11] after struggling with the concept in previous decades. The enactment of this federal system of income taxation was made possible only by the passage of the 16th Amendment in February 1913. Thus, the questions become: how and why did we arrive upon "income" as our tax base, what values were reflected in a federal system that taxed income, and what was considered "income" in 1913?

My initial goal is to briefly bring to light the amazing history of the federal system of taxation. This article attempts to illuminate not just the facts, but also the values and beliefs reflected in our tax history, the choices Congress made along the way, and who historically bore the major burden of the federal taxes. Our discovery will be that the road to the federal taxation of income was one of "War and Panic."

A. Knowledge: The Evolution of the Federal Tax System

History, of course, can influence us only if we actually know, understand, and appreciate what happened. Otherwise, our perceptions about history, right or wrong, will dictate our future. What we believe to be true about the evolution of the federal tax system and what actually occurred may be accurate—or not. Noted scholars and historians previously have detailed the history of the federal income tax.[12] My intention in this section is to emphasize cultural perspectives and observations throughout the factual, historical summary.

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11 Section 22 of the Internal Revenue Code of 1913 (now I.R.C. § 61 (1994)).

12 *See, most notably*, RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES (1954); JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX (1985); and ROBERT STANLEY, DIMENSIONS OF LAW IN THE SERVICE OF ORDER: ORIGINS OF THE FEDERAL INCOME TAX 1861-1913 (1993). These authors are extensively cited throughout this section of the article.

1. The Early Federal System: Excise Taxes and Tariffs

When our Republic was formed, the primary societal concern was the preservation of the states. The states were reluctant to relinquish any taxing power to the national government. The colonies had no national system of taxation, and none was established for the national government under the Articles of Confederation.[13] No national tariff could be levied without an amendment to the Articles of Confederation, which required unanimous consent of the states.[14] The new federal government had to rely upon a process of requisitioning the states for revenue in proportion to the value of their lands and improvements.[15] The states viewed these requests as voluntary contributions, which were not paid, and the new government, thoroughly bankrupt, ultimately defaulted on its considerable debt.[16]

The new Constitution adopted in 1789 addressed these financial concerns. In Article I, the Constitution gave Congress the "Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States" and specified that "all Duties, Imposts and Excises shall be uniform throughout the United States."[17] In addition, Article I prohibited a direct tax "unless in Proportion to the Census or Enumeration"[18] and prohibited the federal government from imposing a tax or duty "on Articles exported from any State."[19]

Thus was born a federal tariff[20] and an elaborate and unpopular federal system of excise taxes. Between 1789 and 1800, the initial tax-of-choice of the new centralized federal government was the excise tax. Taxes were imposed on carriages, the sale of certain liquor, the manufacture of snuff, the refining of sugar, auction sales, legal investments and bonds.[21] Congress adopted a stamp tax upon legal instruments as well as "a direct tax upon dwelling houses, land, and slaves, which was apportioned among the states on the basis of population."[22] Open rebellion against the excise tax on whiskey ensued in western Pennsylvania in 1794; federal excise officials were attacked, and President Washington was com-

13 *See* PAUL, *supra* note 12, at 4.

14 ARTS. OF CONFED. arts. VIII, XIII.

15 *Id.* art. VIII.

16 *See* PAUL, *supra* note 12, at 5.

17 U.S. Const., art. I, § 8, cl. 1.

18 *Id.* § 9, cl. 4.

19 *Id.* § 9, cl. 5.

20 The Madison bill, the first American tariff act, became law in 1789. *See* PAUL, *supra* note 12, at 7.

21 *See* PAUL, *supra* note 12, at 5-6.

22 *Id.* at 6.

pelled to send 15,000 federal troops to restore the authority of the federal government.[23]

The Whiskey Rebellion was not an auspicious beginning for the federal taxing power. What cultural observations are we entitled to at this point? Colonial Americans did not react well to a new system of federal taxation. The idea of a centralized government itself was a hard-fought issue among the states, and funding its operation was to be another. It appears that hostilities erupted because the change was simply too much too soon. Resentment arose as a consequence of rapid imposition of excise taxes upon so many items and at rates that were exceedingly high.[24] Early resistance to providing the federal government with any source of revenue at all already existed. A heavy federal tax hand was not reflective of this new collective society of colonies. It seems plausible that there were few believers among the general public in the benefits to be derived from this new, abstract, and remote federal government.[25]

The Jefferson administration (1801-1809) relied upon the tariff as the federal government's primary source of revenue and abolished most of the early system of excise taxes.[26] The need for revenue during the War of 1812, however, brought back both excise taxes and direct but apportioned taxes upon dwelling houses, lands, and slaves.[27] After the war, when heavy trade with England threatened to ruin American manufacturers, the emphasis in tariff planning turned, for the first time, from revenue production to the protection of American industry.[28]

By the 1850s, the federal tax system drew 92% of its total revenue from import duties.[29] Tariff schedules included manufactures, from machine tools to luxury items, raw materials such as mining and agricultural products, and a free list of varying size.[30] Importers initially paid the taxes but passed the cost along to the ultimate consumers by raising the prices on these imported goods. This system was thought to provide a competitive price edge to

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23 *See* STEPHEN B. PRESSER & JAMIL S. ZAINALDIN, LAW AND JURISPRUDENCE IN AMERICAN HISTORY: CASES AND MATERIALS 151 (3d ed. 1995).

24 *See* PAUL, *supra* note 12, at 6. A gallon of whiskey in the early 1790s cost 50 cents; while the maximum whiskey excise tax was 30 cents per gallon. *Id.*

25 It is always dangerous to make generalizations about a society as diverse as the original 13 colonies, just as it is difficult to make generalizations about our current population of more than 270 million Americans. However, throughout this cultural perspective, it will be the questions that we ask and the observations that we make that will inform our discussion.

26 The tariff was a consumption tax initially imposed upon imported luxury items, but ultimately imposed upon hundreds of basic items. *See* PAUL, *supra* note 12, at 6.

27 *See id.*

28 *See id.* at 7.

29 *See* STANLEY, *supra* note 12, at 25.

30 *See* STANLEY, *supra* note 12, at 26 n.38 (citing FRANK W. TAUSSIG, THE TARIFF IN UNITED STATES HISTORY (8th ed. 1967)).

similar goods produced domestically. Thus, the so-called "protective tariffs" were not just a source of federal revenue. These taxes initially reflected attitudes of making the rich pay more than the poor through tariffs on luxury items, with the added benefit that the tariff could, supposedly, stimulate domestic economic growth.[31]

To tax the rich on luxury items may have been the initial rationale for the tariff system. Its base broadened tremendously over the years, however, evolving into a regressive tax system borne heavily by the laboring masses, taxing every imported item from the food they put on the table to the clothes on their backs. It has been convincingly argued that, during this period of tremendous growth, a conscious decision was made to subsidize economic development[32] through the legal system rather than the tax system.[33] Thus, a disproportionate share of the burden of economic growth fell upon the least empowered members of society.

Throughout the 1800s, state governments depended primarily upon the property tax, supplemented by excise taxes on slaves,

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31 *See id.* at 25-26.

32 Indeed, the law of negligence became a leading means by which the dynamic and growing forces in American society were able to challenge and eventually overwhelm the weak and relatively powerless segments of the American economy. After 1840 the principle that one could not be held liable for socially useful activity exercised with due care became a commonplace of American law. In the process, the conception of property gradually changed from the eighteenth century view that dominion over land above all conferred the power to prevent others from interfering with one's quiet enjoyment of property to the nineteenth century assumption that the essential attribute of property ownership was the power to develop one's property regardless of the injurious consequences to others.

MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW: 1780-1860, at 99 (1977).

33 One of the most striking aspects of legal change during the antebellum period is the extent to which common law doctrines were transformed to create immunities from legal liability and thereby to provide substantial subsidies for those who undertook schemes of economic development. . . . What factors led antebellum statesmen generally to turn to subsidization through the legal, rather than the tax, system? One explanation seems fairly clear. Change brought about through technical legal doctrine can more easily disguise underlying political choices. Subsidy through the tax system, by contrast, inevitably involves greater dangers of political conflict. . . . Nevertheless, it does seem fairly clear that the tendency of subsidy through legal change during this period was dramatically to throw the burden of economic development on the weakest and least active elements in the population. . . . There is reason to suppose, therefore, that the choice of subsidization through the legal system was not simply an abstract effort to avoid political contention but that it entailed more conscious decisions about who would bear the burdens of economic growth. It does seem likely, moreover, that regardless of the actual distributional effects of resorting to the existing tax system, a more general fear of the redistributional potential of taxation played an important role in determining the view that encouragement of economic growth should occur not through the tax system, but through the legal system. . . . Thus, whether or not legal subsidies to enterprise were optimally efficient or instead encouraged overinvestment in technology, it does seem quite likely that they did contribute to an increase in inequality by throwing a disproportionate share of the burdens of economic growth on the weakest and least organized groups in American society.

Id. at 99-101.

carriages, and personal property in general.[34] Local governments relied primarily upon the property tax as well. In 1890, the property tax produced 72% of state revenues and 92% of local revenues.[35] In the early 1800s, more than 80% of the populace lived in rural areas; thus a tax levied on the value of land impacted most of the population and had the effect of taxing the holders of the most valuable land most heavily, effectuating an ability-to-pay philosophy.[36]

What does the developing system of taxation in the states tell us about our cultural values and beliefs? First, hard money was scarce, and the voting public was not accustomed to the idea that it should pay any appreciable chunk of their income or wealth to the state.[37] Second, early in the 1800s, wealth was defined in terms of property. As the century progressed, however, dramatic societal changes occurred. New kinds of wealth, in the form of commercial paper, stocks, and other evidences of debt, were expanding but were not being reached by the property tax system.[38] The property tax system also was not reaching salaries. The increase in both mercantile and manufacturing activity brought large new populations to the cities, and these populations depended on salaries for their livelihood.[39] It was more than just coincidence that when the federal government needed more revenue to fund the cost of the Civil War, it turned to the new rising source of wealth: income.

2. The Civil War and the First Federal Income Tax

Robert Stanley provides the following perspective on wealth in the United States just before the Civil War:

> [o]f the adult males living in the ten largest urban counties in 1860, over half owned no property whatsoever, and nearly 60 percent had under $100 worth. Moreover, wealth was more unequally held in the cities than in rural areas. Nevertheless, across the rural/urban dimension the corpus of wealth remained in astonishingly few hands. Nationwide, the top 10 percent of the families owned approximately 72 percent of the gross national wealth in 1860, and the trend was toward greater inequality by 1900.[40]

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34 *See* LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 185 (2d ed. 1985).

35 *See id.* at 567.

36 *See* STANLEY, *supra* note 12, at 25.

37 *See* FRIEDMAN, *supra* note 34, at 567.

38 *See* STANLEY, *supra* note 12, at 25.

39 *See id.*

40 *Id.* at 23 n.32. General observations concerning the Civil War and wealth in 1860 would not be complete without reference to slavery. Any cultural perspective of America, whether tax policy or otherwise, must address our 200-year history of slavery and its lingering societal aftermath.

Congress was desperately in need of revenue to fund the Civil War. In 1861 and 1862, Congress enacted the first income tax legislation. The federal government, however, was still primarily funded through the tariff system on imports, although the sale of federal war bonds provided a substantial surge in federal revenue. Professor Stanley observes that:

> [t]he result of the fiscal decisions made during the early war years was a war effort almost completely dependent upon the investments of private financiers, and the creation of a revenue structure designed to establish credit, to fund ordinary operations including debt maintenance, and to draw taxes through a system acknowledged to be thoroughly regressive and consumption-oriented. Only income taxation seemed to promise that the burdens of the war would not ultimately fall, in the words of John Sherman, "entirely" on the shoulders of "the poorer class."[41]

The basic structure of exemptions, graduated tax rates, and deductions introduced in the income tax law of 1862 still persists in the Internal Revenue Code as we know it today. The $600 exemption level reflected the intention to reach only a tiny, wealthy fraction of the population.[42] The very low and slightly graduated rates—from 3 to 5% on incomes over $600 and $10,000, respectively—reflected the concerns of a leadership reluctant to use the power of the law to affect the wealthiest portions of the population substantially, while at the same time affirming the principle of "ability to pay."[43] Deductions of federal, state and local taxes were

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> The American style of black-white relations can be traced far back into the colonial past. . . . The exact legal origins of slavery are obscure; but clearly it was developing custom that guided the lawmaker's hand. Slavery did not exist in the mother country. Early references to slaves and slavery have a certain vagueness and ambiguity. Yet before the end of the 17th century, slavery had become a definite legal status in both the North and the South; it is peculiarly associated with blacks; it had become a terrible, timeless condition, inherited by children from their mothers. The legal status of the slave, as it took shape in statute books, reflected and ratified social discrimination and race. [citation omitted] . . . Once the fundamental lines of the law were set, the colonies, particularly in the South, carried the logic of slavery to its grim outer limits. The slave was property, a capital asset of his master. He passed by will, was bought and sold, could be seized for his master's debts, and was taxed like other property. . . . Slavery was a coiled spring. In the end, it was a trap for whites as well. The whites, of course, had the upper hand; but even they paid the price in the long run. Slavery was one of the irritants that brought on a great civil war. Hundreds of thousands died, victims in a sense of the South's "peculiar institution."

FRIEDMAN, *supra* note 34, at 85-86, 229. An in-depth analysis of slavery is beyond the scope of this article. For an enlightening collection of works and cases on the subject, see PRESSER & ZAINALDIN, *supra* note 23, at 376-442.

41 Stanley, *supra* note 12, at 32.

42 *See* PAUL, *supra* note 12, at 10. A cashier on the Commissioner of Internal Revenue's staff earned an annual salary of only $1600, for example, while collecting $37 million of taxes in six months. *See id.*

43 *See* STANLEY, *supra* note 12, at 30.

allowed under the 1862 Act.[44] The 1862 Act also imposed an inheritance tax of .75% to 5% on personalty in excess of $1000, depending on the relationship of the heirs.[45]

The income tax was increased in 1864, doubling the top rate to 10%[46] and authorizing deductions of mortgage interest, repairs, and losses from the sale of lands.[47] Income taxes were reduced in 1867, and again in 1870 when the inheritance tax was repealed.[48] By 1869, the yield from the federal inheritance tax had reached more than $3 million, with the greater part of the taxes being collected at the lowest rates.[49] About 55% of the inheritance taxes collected came from New York, Massachusetts, and Pennsylvania.[50]

From 1862 to 1866, no more than 1.3% of the American people ever paid federal income tax.[51] The use of income as the basis of taxation, coupled with high exemption levels, "had the effect of targeting a group drawn primarily from the most heavily urban states and regions of the country, just as opponents of the tax would charge, and gave to the protectionists the 'victims' they sought to hold up before the eyes of the poor, rural, and Western constituents."[52] In 1864, 61.3% of the revenue from the income tax came from taxpayers in just three states (New York, Massachusetts, and Pennsylvania), and together the Northeast yielded about 76% of all income tax revenue.[53] The Civil War income taxes made no attempt to levy a tax upon capital gains, other than capital gains arising from real estate held for a short period.[54]

The federal income tax was allowed to expire in 1872 when the federal government was enjoying large budget surpluses.[55] At the same time, Congress sent additional good news to constituents in the form of the Tariff Act of 1872.[56] The Tariff Act placed popular items such as coffee and tea on the free list, adopted a 10% reduction on major protected items, and expanded the free list slightly with some minor items used by manufacturers.[57]

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44 *See* PAUL, *supra* note 12, at 13.

45 *See id.* at 10.

46 *See* MICHAEL J.GRAETZ AND DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 6 (3d ed. 1995).

47 *See* PAUL, *supra* note 12, at 13.

48 *See* GRAETZ & SCHENK, *supra* note 46, at 6.

49 *See* PAUL, *supra* note 12, at 17.

50 *See id.*

51 *See* STANLEY, *supra* note 12, at 39-40.

52 *Id.* at 40.

53 *See id.* at 40-41.

54 *See* PAUL, *supra* note 12, at 13.

55 *See* GRAETZ & SCHENK, *supra* note 46, at 6-7.

56 *See* STANLEY, *supra* note 12, at 55.

57 *See id.*

Thus Congress abandoned income and returned to consumption as its major source of tax revenue. The year 1872 was not the first time, and certainly would not be the last, that Congress acted to reduce taxes when faced with a strong economy and fiscal surplus.

3. A Tumultuous Time: 1873-1900

Just one year later, the Panic of 1873 caused 5,000 businesses to fail, and 10,478 closed before the country turned a corner in 1879.[58] The Panic of 1873 was "essentially the result of years of over-trading, over-production, over-speculation, over-issues of paper money and inflated prices."[59] Thirty-seven banks and brokerage houses closed on September 18, 1873.[60] Two days later, the Stock Exchange closed for an unprecedented 10 days.[61] Railroads and additional banks were soon forced to shut down, which affected the fortunes of thousands of merchants and farmers.[62]

After the Panic of 1873, the country witnessed a very long struggle against the tariff system of taxation. Between 1873 and 1879, congressmen from the Middle West and the South introduced 14 different income tax bills.[63] In the meantime, the high tariff piled up huge and embarrassing Treasury surpluses. In 1875, a Republican Congress repealed the 10% reduction made in 1872 as a concession to tariff reformers.[64] A Tariff Commission was authorized by Congress in 1882; tariffs, however, remained a protective device to help American business, much to the disappointment of the rest of the world and in spite of the enormous costs to farmers and laborers.[65]

An 1883 act raised duties even higher on protected articles imported in large volume. Grover Cleveland, the Democratic President elected in 1884,[66] called the tariff "ruthless extortion," and unsuccessfully urged tariff reduction.[67] In 1888 Harrison defeated Cleveland, and, with the Republicans back in power elected on a protectionist platform, Congress passed the McKinley Tariff

58 *See* THE ALMANAC OF AMERICAN HISTORY 325 (Arthur M. Schlesinger, Jr. et al. eds., 1993) [hereinafter ALMANAC].

59 *Id.*

60 *See id.* at 324-25.

61 *See id.* at 325.

62 *See id.*

63 *See* PAUL, *supra* note 12, at 30.

64 *See id.* at 31.

65 *See* ALMANAC, *supra* note 58, at 349. President Arthur appointed nine members to the Tariff Commission. John L. Hayes, the Secretary of the National Association of Wool Manufacturers and not exactly a disinterested party, was named chairman. *See id.*

66 *See id.* at 356. Cleveland was the first Democratic President to be elected since James Buchanan, who served from 1857-1861. *See id.*

67 *See* PAUL, *supra* note 12, at 31. The Democratic House was united in support of Cleveland. The Republicans in control of the Senate, however, prevented any action. *See id.*

Act of October 1, 1890, increasing the average rate imposed upon dutiable imports to 48%.[68] According to tax historian Randolph Paul, "[t]his legislation as much as any one fact led to a rout of the Republicans in the 1890 election."[69]

What cultural observations are we entitled to at this point? The political process we choose to govern ourselves is, of course, an integral component of our culture. We are not the world's only democratic society, but our three-part system of executive, legislative, and judicial branches, with its intricate interrelationships, is unique to our American system of government. So how did governmental process respond to the dire poverty, labor unrest, and general economic crisis of this tumultuous period? The historical party system of Democrats and Republicans apparently did not respond well in the eyes of the American people. Farmers[70] and laborers[71] were pitted against merchants and bankers. The Midwest, South, and the West battled with wealthy Eastern capitalists. Noted historian Arthur M. Schlesinger, Jr. offers this sad observation for the year 1880:

> [l]aborer, farmer, city dweller, politician flounder in paradoxes presented to them by new needs. Cherished values and protections of free men are being lost just when a promised better world seems within grasp. Now, when the nation could have profited from vigorous public debate, Congress is dominated by rascally, small-minded men.[72]

Interestingly, the people responded with a number of novel ideas such as new political parties and labor unions. The Greenback Labor Party and the Antimonopoly Party, which supported a graduated income tax, merged to become the relatively influential Populist Party.[73] The Prohibitionist Party held its fourth national convention that same year and nominated a candidate for president.[74] The American Federation of Labor grew out of a national gathering of unions in 1881, fought for the right to collective bargaining and, by the turn of the century, had half a million members.[75] So, although the formal national government seemed mired in a stalemate, much was transpiring at the populist level.

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68 *See id.*

69 *Id.*

70 *See* ALMANAC, *supra* note 58, at 342. As of April 1880, "[t]he farmers' plight has taken on the proportions of catastrophe in the face of high tariffs, flood and drought, unfair railroad rates and high interest on loans and mortgages." *Id.*

71 Railroad labor strikes as well as strikes in the mining industry were common in the late 1870s and severe strikes engulfed the iron and steel industries in the early 1880s. *See id.* at 336, 349.

72 *Id.* at 343.

73 *See id.* at 353-54.

74 *See id.* at 355.

75 *See id.* at 359.

Democrat Grover Cleveland regained the Presidency in 1892. He faced a strong movement in both the Democratic and Populist parties favoring income taxation.[76] Once again, a panic ensued. The Panic of 1893 witnessed the crash of the New York stock market and a massive financial crisis.[77] Unemployment and labor unrest were widespread.[78]

Finally, in August 1894, Congress returned to the income tax as a source of federal revenue when it enacted the Wilson-Gorman Tariff Act.[79] The 1894 federal income tax was directed at taxing only those with vast accumulations of wealth.[80] "Census statistics showed that over 90 percent of the twelve million families of the country owned less than 30 percent of the national wealth,"[81] while the other 10% of the families owned more than 70% of the national wealth. The Act imposed a rate of 2% on incomes in excess of $4000, was scheduled to expire in five years, included gifts and inheritances as well as the proceeds therefrom as income, and imposed a separate tax upon corporations, with major categories of exempt associations.[82]

The 1894 income tax was cut short by the fascinating decision of the U.S. Supreme Court in *Pollock v. Farmers' Loan & Trust Co.*[83] Pollock challenged the constitutionality of the 1894 income tax by instituting a representative stockholder suit against the Farmers' Loan and Trust Company, seeking to enjoin the bank from paying the tax upon his income and the income of various trusts administered by it.[84] The Supreme Court permitted a direct appeal and heard arguments for five days.[85] Historian Lawrence Friedman notes that the eight sitting justices

> held the tax unconstitutional, but only as it applied to income derived from real estate. On the big question, whether the whole law was unconstitutional as a "direct Tax," the Court was evenly divided, four against four. The ninth judge, Jackson, was sick. The case was then reargued—with Jackson present—and this time the Court declared the whole law void, by a bare majority, 5-4.[86]

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76 *See* PAUL, *supra* note 12, at 34.

77 *See* ALMANAC, *supra* note 58, at 376. The Silver Purchase Act had badly drained gold reserves. *See id.*

78 *See id.* at 376-78.

79 *See id.* at 379.

80 The 1880s and 1890s witnessed massive accumulations of wealth in oil, copper, steel, tobacco, and sugar trusts. *See id.* at 350.

81 PAUL, *supra* note 12, at 39.

82 *See* STANLEY, *supra* note 12, at 132.

83 Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895); Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601 (1895).

84 *See* PAUL, *supra* note 12, at 40. Pollock owned only 10 shares of stock. *See id.*

85 *See id.* at 40-41.

86 FRIEDMAN, *supra* note 34, at 566.

It is important to note that, during the 40-year period from 1860 to 1900, 14 million immigrants came to the United States.[87] The face of America was changing dramatically, and urbanization was in full swing. In addition, the antics of the Republicans and the Democrats a century ago seem painfully reminiscent of the political polarization of today. While the Republicans insisted upon the continuance of the tariff system, severely penalizing the poor for consumption of basic goods, massive wealth accumulated in a small percentage of the population. The distance between economic classes of citizens became even greater. Professor Stanley summarizes this period as follows:

> [i]ncome taxation had existed as a symbol of the taxation of accumulated wealth, offering the illusion of a significant contribution toward the overall revenues, and thereby of the potential easing of the cost of living through reductions made possible in the consumption schedules of the tariff. It spoke powerfully to the ability of the Congress to reach especially the pockets of those whose income was not "earned," but existed in investments. The Fuller opinion had specifically prohibited the unapportioned taxation of the most visible, most powerful, most "unearned" income in the nation, thereby wholly compromising the claims to tapping wealth which the Congress might make and ending the law's utility as a pacifier of class animosity. Worse, the Court had happily permitted, as the dissenters pointed out, the unapportioned taxation of "earned" income, that from salaries, professions, and other employments. This was the income of precisely the groups toward whom the symbolism of income taxation was directed: the groups who most needed assurance that the system was, indeed, a fair one.[88]

4. The Early 1900s

In the wake of the Panic of 1907, caused by a shortage of currency from reckless over-capitalization of new enterprises,[89] Congress was forced to make a choice. In 1909, President Taft offered a compromise solution to the congressional debate over new

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When the Court is evenly divided, by custom it does not reveal who voted on which side. When the case was reargued, Jackson, the missing judge, voted to uphold the act. This should have given the law a 5-4 majority; in fact it lost by 5-4. There is a minor historical mystery here, since one of the other four judges in the majority must have changed his mind between the time of the two votes. No one is quite sure which judge is the guilty one.

Id. at n.81. *See also* PAUL, *supra* note 12, at 214-17.

87 *See* ALMANAC, *supra* note 58, at 351.

88 STANLEY, *supra* note 12, at 177.

89 *See* ALMANAC, *supra* note 58, at 414. Professor Stanley observes about the Panic of 1907: "In terms of severity, the depression ranks sixth of fifteen depressions and recessions measured by the average percentage decrease in indexes including imports, clearings, pig-iron production, cotton consumption, railway revenue, and coal production." STANLEY, *supra* note 12, at 184 n.6.

sources of federal revenue. The President made two proposals that ultimately were accepted by Congress: first, an amendment to the Constitution regarding a federal income tax to be submitted to the States; and second, a 2% excise tax on net corporate income.[90]

Between 1909 and 1913, 42 of the 48 states approved the 16th Amendment to the U.S. Constitution.[91] On February 25, 1913, the 16th Amendment to the U.S. Constitution became law:[92]

> [t]he Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

As Professor Stanley points out, the states had little reason to oppose the Amendment. Most of the states already had turned to either the inheritance tax or the income tax at the state level, taxing accumulated wealth by the use of low progressive rates and high exemptions. Thus adoption of the measure addressed "class anxiety."[93]

In addition, the states were possibly operating under their own paradigm when it came to the income tax. Although the Amendment clearly stated that Congress would have the power to tax "income, from whatever source derived," it is doubtful that any of the state legislators ever envisioned the imposition of the income tax upon more than 1% of the population—the "excessively wealthy"—since that is the only population that had ever been taxed in the past. As we are all painfully aware, that is not how the Amendment unfolded over time.

5. The Early Years of the Internal Revenue Code: 1913-1930s

Just one week after the adoption of the 16th Amendment, the first Democratic President since Grover Cleveland, Woodrow Wilson, was inaugurated.[94] Committed in the campaign of 1912 to tariff reform, the incoming Democratic leadership, the first with majorities in the House and the Senate as well as the presidency

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90 *See* PAUL, *supra* note 12, at 94. The amendment to the Constitution proposal was overwhelmingly approved by the Senate (77-0) and by the House (318-14, 55 not voting). *See id.* at 97. The Payne-Aldrich Bill, authorizing the 2% excise tax on net corporate income, was narrowly approved by both the Senate (47-31) and the House (195-183). *See id.* at 96.

91 *See* STANLEY, *supra* note 12, at 178. This 88% approval by the States was six states in excess of the constitutionally required minimum. Of 39 ratifying States for which complete information is available, the mean margin of support in the houses was 94.9% and in the senates was 89.4%. *See id.* at 212.

92 *See* ALMANAC, *supra* note 58, at 422.

93 *See* STANLEY, *supra* note 12, at 178-79.

94 *See* ALMANAC, *supra* note 58, at 422-23.

in 20 years,[95] moved quickly to establish its reformist credentials in the Underwood-Simmons Tariff Act of 1913.[96] President Wilson set about reforming the hitherto intractable tariff and banking systems.[97]

On October 3, 1913, Congress enacted the Underwood-Simmons Tariff Act, the first tariff reform since the Civil War.[98] The Act brought down tariff duties on 958 items, including foodstuffs, clothing and raw material; rates on cotton were cut 50%; and rates on woolens were cut by more than 50%.[99] The Act also introduced the first post-Amendment federal income tax.[100] The tax applied to the income of individuals and corporations, removed the existing $5000 exemption for corporate taxpayers, applied a $3000 exemption to the incomes of individuals, and established two rate scales: a "normal" rate of 1% on taxable income, and an additional tax or surcharge ranging from 1% to 6% on amounts in excess of $20,000.[101]

Contemporary estimates indicated that fewer than 4% of American families received as much as $3000 in income in 1910.[102] Since the tax was imposed upon "taxable income," after taking certain deductions into account,[103] only 1% of the American public was actually subject to the tax. Notwithstanding the small proportion of taxpayers, $71 million was collected from this income tax in 1914, and the amount rose to $80 million in 1915.[104] A copy of the 1913 Federal Income Tax Return is included in the Appendix to this article.

In 1916, the Supreme Court upheld the constitutionality of the new federal income tax.[105] A unanimous Court concluded that the Amendment granted no new taxing power since none had ever been taken away; rather, it removed the necessity of subjecting

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95 "Democrats outnumbered Republicans by 291 to 128 in the House (with 15 Progressives and an Independent), and 51 to 44 in the Senate (with one Progressive)." WITTE, *supra* note 12, at 76.

96 *See* STANLEY, *supra* note 12, at 226.

97 *See* ALMANAC, *supra* note 58, at 423.

98 *See id.* at 424.

99 *See id.*

100 "At the time the tax was accepted as a natural and inevitable culmination of the constitutional amendment. It was not deemed as important as the tariff bill itself. The income tax section occupied only 8 pages of an 814-page report." WITTE, *supra* note 12, at 77.

101 *See* STANLEY, *supra* note 12, at 226-27.

102 *See id.* at 227, n.155.

103 The 1913 Form 1040 Tax Form indicates that six general deductions were available from gross income: 1) business expenses; 2) interest paid on personal indebtedness (thus the home mortgage interest deduction was available from the start); 3) national, state, county, school, and municipal taxes; 4) uncompensated casualty losses; 5) worthless debts; and 6) depreciation deductions. *See* Appendix, *infra*, at 90-93.

104 *See* STANLEY, *supra* note 12, at 227.

105 Brushaber v. Union Pacific Ry. Co., 240 U.S. 1 (1916).

taxes on income to a threshold inquiry into sources, as in *Pollock*, prior to application of the rule of apportionment.[106]

Also in 1916, in yet another search for revenue in the face of a budget deficit of $177 million,[107] Congress increased the maximum income surtax rate from 6% to 13% and enacted a federal estate tax.[108] By 1917, the estate tax rates ranged from .5% on estates above $50,000 to 10% on estates over $10 million.[109] The enactment of a federal estate tax was the culmination of a grassroots effort. The ideas of Theodore Roosevelt and a growing class-consciousness persisted in the early 20th century.[110] Income and wealth disparity was a growing source of social and economic anxiety. The federal income tax system, as revised by Congress, offered little to counter this imbalance.

The congressional trend of increasing tax rates had an early beginning. By 1917, with U.S. involvement in World War I, the top income tax rate (normal and surcharge combined) reached 67%.[111] Just one year later, the top combined rate was increased to 77%.[112] The Revenue Act of 1917 "marked the shift of the finances of the United States from a base of customs and excises to one of income taxes."[113] As tax historian John Witte notes:

> World War I was a shock to government finances that dramatically and permanently affected the internal revenue system in the United States. What began as a modest income tax with a very large exemption, a maximum tax rate of 7 percent, and a negligible share of revenue expanded in four years to a tax accounting for close to 60 percent of all revenue and having a maximum rate of 77 percent.[114]

The decade of the 1920s brought an interesting array of tax legislation to the table. In 1920, there were only 5.5 million taxable returns for a population of 106 million and an estimated labor force of 41.7 million.[115] The Revenue Act of 1921 limited the tax on

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106 *See* STANLEY, *supra* note 12, at 228.

107 *See* WITTE, *supra* note 12, at 81.

108 *See* PAUL, *supra* note 12, at 107-08. The estate tax was imposed on estates in excess of $50,000 at rates ranging from 1% to 10% on amounts above $5 million. *See id.* at 108.

109 *See* WITTE, *supra* note 12, at 84-85.

110 *See* PAUL, *supra* note 12, at 108.

> In 1915 Basil M. Manly, Research Director of the Commission of Industrial Relations, had given as a cause of industrial unrest the unjust distribution of wealth and income as represented by the fact that forty-four families in the country possessed income of at least $50 million a year while the majority of adult, male workers in factories and mines received meager wages of from $10 to $20 a week. Manly urged an inheritance tax as a check upon the industrial feudalism created by the fortunes of the Rockefellers, Morgans, Vanderbilts, and Astors.

Id.

111 *See id.* at 114.

112 *See id.* at 118.

113 WITTE, *supra* note 12, at 84.

114 *Id.* at 87.

115 *See id.* at 86.

net capital gains (on capital assets held for more than two years) to 12.5%[116] but did not provide for any limitation upon the deduction of capital losses.[117] The Fordney-McCumber flexible tariff act became law in September 1922, materially increasing rates.[118] The 1924 Revenue Act placed the first limitation upon capital losses.[119] By 1925, with the heavy influence of then-Secretary of the Treasury Andrew Mellon, the top income tax rate was dramatically reduced to 25%, where it remained until 1932.[120]

During the decade of the 1920s, it can be said generally that the country witnessed a low level of taxation and a period of peace and prosperity. However, such a statement is deceiving. The low level of taxation primarily benefited the wealthy since, under the Mellon Plan approved by Congress, the top rates dropped from 50% to 25%, while the lowest-income taxpayers saw their rates lowered from 4% to 3%.[121] Historian Howard Zinn carefully notes that prosperity was not experienced equally throughout the United States:

> [u]nemployment was down, from 4,270,000 in 1921 to a little over 2 million in 1927. The general level of wages for workers rose . . . But prosperity was concentrated at the top. While from 1922 to 1929 real wages in manufacturing went up per capita 1.4 percent a year, the holders of common stocks gained 16.4 percent a year. Six million families (42 percent of the total) made less than $1,000 a year. One-tenth of 1 percent of the families at the top received as much income as 42 percent of the families at the bottom, according to a report of the Brookings Institution. Every year in the 1920s, about 25,000 workers were killed on the job and 100,000 permanently disabled. Two million people in New York City lived in tenements condemned as firetraps.[122]

The stock market crash of 1929 is generally attributed to wild speculation. People were buying securities blindly, with little if

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116 "It was believed that this provision would stimulate profit-taking transactions, and give relief from the hardship involved in a bunching of income where a gain represented an increase in value accruing over a long period of years." PAUL, *supra* note 12, at 129. Thus the preferential treatment for capital gain income has been an integral part of the Code since 1921. The preference was actually eliminated for a short while by the 1986 Tax Reform Act (when overall rates were also drastically reduced to just two brackets of 15% and 28%) but was almost immediately reintroduced in 1990 and retained in 1993 when the top rate on ordinary income increased to 31%, and again to 36% and 39.6% while the rate of capital gain income remained at 28%. In 1997, the preference became even more enhanced, generally dropping the capital gain tax rate to 20%. *See infra* Part II.A.8.

117 *See* J. MARTIN BURKE AND MICHAEL K. FRIEL, TAXATION OF INDIVIDUAL INCOME 643, 645 (5th ed. 1998).

118 *See* PAUL, *supra* note 12, at 130.

119 *See* BURKE & FRIEL, *supra* note 117, at 646.

120 *See* GRAETZ & SCHENK, *supra* note 46, at 8.

121 *See* HOWARD ZINN, A PEOPLE'S HISTORY OF THE UNITED STATES: 1492-PRESENT 375 (1995).

122 *Id.* at 373-74.

any disclosure. The crash marked the beginning of the Great Depression, bringing the entire economy to its knees. Unemployment reached a peak of 13 million by the end of 1932, and total wages declined by 60% from their 1929 levels.[123] Again, historian Howard Zinn notes:

> [b]ut, as John Galbraith says in his study of that event (*The Great Crash*), behind that speculation was the fact that "the economy was fundamentally unsound." He points to very unhealthy corporate and banking structures, an unsound foreign trade, much economic misinformation and the "bad distribution of income" (the highest 5 percent of the population received about one-third of all personal income).[124]

In the 1930s, Congress increased income tax rates, exacerbating the Great Depression. In addition, with passage of the Smoot-Hawley Tariff Act of 1930, Congress reinstituted high tariffs, prompted both by a nostalgic desire to return to the tariff as the principal source of federal revenue and by an isolationist reaction to the fallout from World War I.[125] By 1932, the Republican majority in Congress, so dominant in the previous decade, was gone.[126] Faced with a mounting federal deficit,[127] Congress increased corporate income tax rates to 14% and upped the surcharge on individuals to 55%.[128] By 1932, there were 2 million taxable federal income tax returns.[129] Beginning with the Revenue Act of 1934, capital losses could generally only be deducted to the extent of capital gains, although up to $2000 of any excess capital losses over gains also could be deducted.[130] In 1935, the top individual income tax rate was increased from 59% to 75% on incomes over $500,000, and the corporate income tax was graduated, with rates ranging from 12.5% to 15%.[131] In addition, taxes on inheritances and gifts were also increased.[132] The most significant tax legislation of this decade was the enactment of the Social Security Act of 1935 and its 1939 amendment, created to provide a federal retirement, disability, and unemployment insurance system.[133]

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123 *See* ALMANAC, *supra* note 58, at 460.

124 ZINN, *supra* note 121, at 377.

125 *See* PAUL, *supra* note 12, at 163. "The effect of the high tariffs enacted was to make it impossible for foreign countries to pay their World War I debts and almost completely to stifle foreign trade." *Id.*

126 *See* WITTE, *supra* note 12, at 97.

127 The deficit was $2.7 billion for 1932. *See* WITTE, *supra* note 12, at 96.

128 *See id.* at 97.

129 *See* PAUL, *supra* note 12, at 319.

130 *See* BURKE & FRIEL, *supra* note 117, at 646.

131 *See* WITTE, *supra* note 12, at 101.

132 *See* ALMANAC, *supra* note 58, at 469.

133 *See* GRAETZ & SCHENK, *supra* note 46, at 9.

Originally, the Social Security tax rate was set at 1 percent of wages to grow to 5 percent, split evenly between employees and their employers. Today the combined tax rate on employers and employees exceeds 15 percent and an additional tax of

Considering the depth of the Depression, it is interesting to note that neither Congress nor the Roosevelt administration turned heavily to the federal income tax for a revenue fix.[134] Meanwhile, labor continued to clamor to be heard and to be seriously addressed. A million and a half workers in different industries went on strike in 1934.[135] In 1936, there were 48 sit-down strikes; in 1937, there were 477.[136] The Fair Labor Standards Act of 1938, which established the 40-hour week and outlawed child labor, addressed some of the workers' concerns, although the minimum wage was set at a low twenty-five cents an hour the first year.[137] Given these statistics, it may not be surprising that, by 1939, only 5% of the population was subject to the federal income tax.[138]

6. The "Taxing of the Masses": The Internal Revenue Code from the 1940s to the Korean War

Revenue Acts in 1941 and 1942 to finance military expenditures during World War II turned the federal income tax into a mass tax. The 1942 Act carried the total number of income tax returns to 37 million, of which almost 28 million reflected a tax liability.[139] Including a Victory Tax,[140] the top income tax rate increased to 90% and the number of taxpayers increased to 50 million.[141] Tax revenues were expected to increase by $9 billion.[142] Of crucial significance, the 1942 Act provided that only 50% of long-term capital gain and loss was to be taken into account in computing net income.[143] The top corporate tax rate rose from 31% to 40%.[144]

The Current Tax Payment Act of 1943 put wage and salary earners on a withholding basis of tax collection.[145] The Revenue Act of 1944 was vetoed by President Roosevelt in February

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nearly 3 percent of wages is imposed to pay for hospital insurance under Medicare. The share of federal revenues supplied by these payroll taxes has grown substantially over time, and they now account for nearly 40 percent of federal revenues. *Id.*

134 Several early pieces of New Deal legislation had tax implications. The Agriculture Adjustment Act, for example, included taxes on food processing, and, more important, the National Industrial Recovery Act levied a 5 percent tax on dividends and revived the wartime excess profits tax at a modest level. WITTE, *supra* note 12, at 98.

135 *See* ZINN, *supra* note 121, at 386.

136 *See id.* at 391.

137 *See id.* at 393-94.

138 *See* TIMOTHY J. CONLAN ET AL., TAXING CHOICES: THE POLITICS OF TAX REFORM 19 (1990).

139 *See* PAUL, *supra* note 12, at 319.

140 The Victory Tax was a 5% tax on all income over $624, to be levied until the war ended. *See* ALMANAC, *supra* note 58, at 490.

141 *See* PAUL, *supra* note 12, at 319.

142 *See* ALMANAC, *supra* note 58, at 490.

143 *See* BURKE & FRIEL, *supra* note 117, at 644.

144 *See* PAUL, *supra* note 12, at 319-20.

145 *See id.* at 348; ALMANAC, *supra* note 58, at 493.

1944,[146] but Congress overrode the veto later that same month.[147] The Act reduced the Victory Tax rate from 5% to 3%, introduced several new deductions and exclusions from gross income, provided numerous benefits for industry, and sent many excise taxes to new high levels.[148] The Individual Income Tax Act of 1944 simplified the income tax for persons with small or moderate incomes.[149] The government raised $380 billion between June 30, 1940, and the end of 1945; of this amount, $153 billion, or about 40%, came from income taxes.[150] At the conclusion of World War II, the Revenue Act of 1945 reduced the income tax burden considerably—12 million taxpayers were removed from the tax rolls, revenue from individuals dropped $3.8 billion, and corporations received a $5.2 billion tax reduction.[151]

The net impact of these wartime tax acts was dramatic. It may best be summarized as follows:

> [t]he number of personal income tax returns filed almost doubled between 1940 and 1941, nearly doubled again by 1942, and then again by 1945. Although marginal rates were raised to as much as 94 percent in the highest brackets, people of more modest means bore most of the cost of the new "warfare state." In 1939 taxpayers with incomes under $3,000 had paid just 10 percent of all income tax revenue. By 1948 they were paying half.[152]

By 1947, the feared post-war recession had not occurred, and the federal government actually experienced a surplus.[153] The quality of life in America, both social and economic, had improved dramatically in the years between 1939 and 1948.[154] The Revenue

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146 *See* PAUL, *supra* note 12, at 371. "This was the first veto of a tax bill in American history." *Id.*

147 *See id.* at 375.

148 *See id.* at 375-79. The changed excise tax rates alone accounted for an increased revenue of more than one billion dollars. *See id.* at 378.

149 *See id.* at 384-86.

150 *See id.* at 394.

151 *See id.* at 420.

152 CONLAN ET AL., *supra* note 138, at 18.

153 *See* PAUL, *supra* note 12, at 479.

> Except for stock market apathy, the year had been a banner year. Industrial production, supported by a record money supply, had risen to a peacetime peak. There had been a boom in exports, a drop in strikes, record corporate profits and dividends, record farm, professional, and proprietors' income, record wage and salary income, record employment, and few business failures. Most extraordinary of all things, there had been at long last a government surplus.

Id.

154 From the middle of 1939 to the middle of 1948 employment had increased 28 percent; the consumer price index for all items more than 70 percent and for food 129 percent; wholesale price indexes 112 percent with agricultural prices in the vanguard of the advance; weekly earnings in manufacturing 118 percent; the gross national product in current dollars about 173 percent; manufacturing sales 231 percent; corporate profits after taxes 272 percent.

Id. at 522.

Act of 1948, enacted over President Truman's veto, provided post-war tax reductions.[155] It reduced individual income tax rates at all levels,[156] increased exemption levels,[157] and instituted the joint income tax return for married couples.[158] In addition, the Act introduced the marital deduction into the estate and gift tax system.[159]

Congress increased the individual income tax to finance the Korean War.[160] By 1950, as much as 59% of the population was subject to the individual income tax and 45% of all federal receipts were from the individual income tax.[161] In 1951, 90 million federal income tax returns were filed.[162] The Revenue Act of 1951 transformed the preference for capital gains into a deduction from gross income equal to 50% of the net capital gain for the taxable year.[163]

7. The 32-Year Reign of the 1954 Code

The Eisenhower administration was effective in shepherding the passage of the Internal Revenue Code of 1954.[164] The new Code extended the 52% corporate income tax rate and enacted numerous revenue-losing provisions that provided benefits to a wide

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155 *See id.* at 493-94. According to Randolph Paul, the breakdown of federal estimated primary sources of revenue in 1948 was:

	Revenue	
Individual income tax	$18.4 billion	46%
Corporate taxes	$8.2 billion	21%
Excise taxes (50)	$6 billion	15%
Estate & gift taxes	$730 million	1.8%
Customs	$517 million	1.3%

Id. at 437.

156 "Before its enactment the actual tax rate started at 19 percent for taxable incomes under $2,000 and increased to 86.5 percent for incomes over $200,000. Under the 1948 act the actual rates ranged from 16.6 percent to 82.1 percent with a maximum effective rate limitation of 77 percent." *Id.* at 494.

157 *See id.*

158 *See id.* at 496.

159 *See id.* at 497.

160 The 1950 tax legislation increased individual and corporate tax rates, closed some tax avoidance opportunities in the area of capital gains, and amended estate and gift tax provisions. *See id.* at 567-70. The 1951 tax legislation slightly increased the capital gains tax rate from 25% to 26%; allowed the gain from the sale or exchange of a personal residence to be offset by the cost of purchase or construction of a replacement residence; and raised corporate income taxes to a new high. *See id.* at 622-23. Regarding the 1951 tax legislation, John Witte observes: "Most important, however, a veritable landslide of special provisions were enacted aiding a wide range of groups." WITTE, *supra* note 12, at 142.

161 *See* CONLAN ET AL., *supra* note 138, at 19.

162 *See* PAUL, *supra* note 12, at 319.

163 *See* BURKE & FRIEL, *supra* note 117, at 644.

164 *See* WITTE, *supra* note 12, at 146.

> [S]taff members from Treasury, the Joint Committee on Taxation, the House Office of Legislative Counsel, and the Office of the Chief Counsel of the Internal Revenue Service . . . were given the responsibility for proposing technical and policy changes and were in constant contact with executive agencies, outside groups, and the staffs of Ways and Means and Finance.

Id.

range of groups and individuals.[165] Eight years passed before another significant piece of tax legislation became law. Revisions enacted in the Revenue Act of 1962[166] and the Revenue Act of 1964[167] significantly reduced taxes and "both the rhetoric and the results were extremely favorable to capital formation and business. The 1969 Tax Reform Act reversed this bias."[168]

President Johnson's Great Society and the Vietnam War[169] combined to influence the 1969 tax legislation, "the most liberal peacetime tax bill ever enacted."[170] Revenue-gaining provisions exceeded revenue loss provisions for both individual income taxpayers and corporations.[171] However, despite its "reform" label, the legislation did little to simplify or streamline the basic structure of the income tax system.[172] As Professor Witte shrewdly observes:

> [f]inally, even though the Tax Reform Act of 1969 was the only major postwar tax bill that increased revenue (at least in its first year), it still provides evidence for the bias of tax politics in favor of tax reduction. The country was in the middle of a war, deficits had been persistent for years, inflation was becoming a continuous concern, and the political mood favored closing loopholes and tax shelters and taxing corporations and the wealthy. And it still took three years of planning and pressure and finally a well-publicized attack on a few people able to avoid taxation completely to stimulate the enactment of reforms. Even then, the provisions were mostly patchwork rules that did nothing to alter the underlying laws that served as a foundation for abuse. At the same time, five new tax expenditure provisions were created to further politically acceptable goals of the time. In the

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165 *Id.*

166 The Revenue Act of 1962 instituted the investment tax credit, revised depreciation schedules, and imposed restrictions upon certain business deductions. *See* WITTE, *supra* note 12, at 156-58.

167 Rates were reduced, particularly for the income groups below $5000; new provisions were added such as moving expense deductions, income averaging, minimum standard deduction, and capital gains exclusion on the sale of a residence by the elderly; and many more provisions were liberalized. *See id.* at 165. "As finally enacted, the legislation offered a 20 percent tax reduction for individuals and corporations, bringing the top personal income bracket down from 91 percent to 70 percent and lowering the bottom rate from 20 percent to 14 percent." CONLAN ET AL., *supra* note 138, at 21-22.

168 WITTE, *supra* note 12, at 172.

169 President Johnson's Great Society and War on Poverty policies were implemented through the creation of the Office of Economic Opportunity and the successful push for enactment of the Civil Rights Act, the Voting Rights Act, Medicare, and the Water Quality Act. However, the President's continued support of U.S. involvement in Vietnam and the heavy financial demands of the war diverted funds away from these domestic goals. *See* ALMANAC, *supra* note 58, at 568.

170 WITTE, *supra* note 12, at 173.

171 *See id.* at 171 tbl.8.2.

172 In a section entitled "Lessons of the 1969 Tax Reform Act," John Witte observes: "Rather than decisive, definitive action to eliminate or curtail basic provisions that erode the tax base, tax reform, true to the incremental approach, often becomes a matter of adjustment and counteradjustment in a cat and mouse game played between clever government experts and tax lawyers." *Id.* at 173.

> end, only a strong threat of veto and Treasury's careful monitoring of Conference Committee actions prevented a bill that would have meant substantial tax reduction.[173]

By 1970, 81% of the population was subject to the individual income tax.[174] Inflation was the driving force behind enactment of the Tax Reduction Act of 1971. Upon enactment, the bill was predicted to reduce revenue by $25.9 billion over three years and its major provisions strongly favored business by reinstating the investment tax credit and initiating a more rapid system of depreciation known as Asset Depreciation Range (ADR).[175]

The 1970s were tumultuous years. Just a smattering of events are referenced to provide a cultural perspective for this time. In just the first few years of the decade, for example, the last U.S. ground forces were withdrawn from Vietnam in 1972 but bombings continued;[176] busing to achieve school integration was a divisive issue;[177] the 1973 landmark decision of *Roe v. Wade* held all state laws that prohibit voluntary abortions before the third month unconstitutional;[178] and the Watergate break-in and ensuing cover-up led to the conviction of six defendants in 1973, plus, in 1974, the unprecedented resignation of a President and the conviction of many of his White House staff members.[179] Voters were registering general disillusionment.[180]

By 1975, the country was in the grips of a steep recession.[181]As historian Howard Zinn notes:

> [t]he Census Bureau reported that from 1974 to 1975 the number of Americans "legally" poor (that is, below an income of $5,500) had risen 10 percent and was now 25.9 million people. Also, the unemployment rate, which had been 5.6 percent in 1974, had risen to 8.3 percent in 1975, and the number of people who exhausted their unemployment benefits increased from 2 million in 1974 to 4.3 million in 1975.[182]

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173 *Id.* at 174-75.

174 *See* CONLAN ET AL., *supra* note 138, at 19.

175 *See* WITTE, *supra* note 12, at 176-79.

176 *See* ALMANAC, *supra* note 58, at 592-93.

177 In 1972 George Wallace ran an impressive race for the Democratic nomination, in part, because of the stress he placed on the busing issue . . . Boston, Massachusetts (1974) and Louisville, Kentucky (1975) were the scenes of bloody confrontations when busing plans were implemented in those cities. . . . By 1976 17,216 white students had left the Boston public schools either for the suburbs or for private schools.

Id. at 588.

178 Roe v. Wade, 410 U.S. 113 (1973).

179 *See* ALMANAC, *supra* note 58, at 597-99.

180 In 1960, 63% of those eligible to vote voted in the presidential election. By 1976, this figure had dropped to 53%. *See* ZINN, *supra* note 121, at 551. Some of this decline may be attributable to the passage of the 26th Amendment in 1971.

181 *See* WITTE, *supra* note 12, at 183.

182 ZINN, *supra* note 121, at 545-46.

Amazingly, the next four years, 1975 through 1978, witnessed annual enactments of tax reduction legislation. Income taxes were again reduced to stimulate a lagging economy with minor Code changes in the Tax Reduction Act of 1975[183] and massive changes in the Tax Reform Act of 1976.[184] Most of the 1976 revenue-gaining provisions (30 changes) affected primarily high-income groups while the revenue-losing provisions (20 changes), with the major exception of the extension of the investment credit, primarily benefited those in the lower-income category.[185]

The 1977 Tax Reduction and Simplification Act did reduce taxes[186] but accomplished little to simplify the growing complexity of the Code.[187] The 1978 Revenue Act reduced taxes across all income levels, but the highest-income taxpayers benefited the most.[188] Thus the 1978 tax legislation marked the beginning of a congressional trend to shift the overall burden of the income tax from the wealthy to the poor, at a time when the skewed distribution of wealth in the country had reached startling proportions.[189]

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183 *See* WITTE, *supra* note 12, at 182-87. One new provision in the 1975 tax-reduction legislation that turned out to be quite significant was the earned income credit. Primarily enacted to provide low-income taxpayers with relief from the growing, regressive effect of Social Security taxes, I.R.C. § 32 has been amended over the years (in 1978, 1980, 1984, 1986, 1990, 1993, and 1996) to now serve as a substantial mechanism for assistance to the poor. *See* Michael J. Caballero, *The Earned Income Credit: The Poverty Program That Is Too Popular*, 48 TAX LAW. 435 (1995); George K. Yin et al., *Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program*, 11 AM. J. TAX POL'Y 225 (1994); and Sharon C. Nantell, *The Tax Paradigm of Child Care: Shifting Attitudes Toward a Private/Parental/Public Alliance*, 80 MARQ. L. REV. 879, 962-64 (1997).

184 *See* WITTE, *supra* note 12, at 195. "[R]eduction was estimated at $15.7 billion for fiscal year 1977 and $11.6 billion for 1978. Of that amount, most came from the extension of the general tax credit and the lowered standard deduction." *Id.*

185 *See id.* at 196.

186 "[T]he estimated reduction in the bill was approximately $11 billion in fiscal year 1978." *Id.* at 202.

187 The New Jobs Tax Credit instituted in this legislation was intended to accomplish a simple purpose: to provide a wage tax credit to induce new employment. Ironically, its language was exceedingly and intentionally complicated, to prevent unfair advantages by either particular businesses or tax conscious employers in general. *See id.* at 203-04.

188 Compared with existing law, the largest cuts in terms of percentages went to those with incomes under $10,000 (since they initially paid very low taxes). However, unlike earlier tax cuts, this one gave all income groups above that level a cut close to the same percentage (around 6.8 percent), with those above $20,000 actually receiving higher percentage reductions than those between $10,000 and $20,000. In absolute dollar terms those in the higher-income groups received much more. Of the total cut, 67 percent went to the 21 percent of the taxpayers who had incomes over $20,000.

Id. at 213.

189 The fundamental facts of maldistribution of wealth in America were clearly not going to be affected by Carter's policies, any more than by previous administrations, whether conservative or liberal. According to Andrew Zimbalist, an American economist writing in *Le Monde Diplomatique* in 1977, the top 10 percent of the American population had an income thirty times that of the bottom tenth; the top 1 percent of the nation owned 33 percent of the wealth. The richest 5 percent owned 83 percent of the personally owned corporate stock. The one hundred largest corporations (despite the graduated income tax that misled people into think-

In addition, the 50% deduction from gross income for net capital gains was increased to 60% and remained at that level until 1986.[190] It must be noted that, during this extended period of "tax reduction," Congress did not actually need to enact new tax legislation to increase federal revenue since steadily rising incomes moved individuals and families into higher tax brackets.[191]

No less than six major tax bills were enacted during the 1980s. Championed by President Reagan and Republican Senator Roth (Del.) and Representative Kemp (N.Y.),[192] the Economic Recovery Tax Act of 1981 provided the largest tax reduction in the nation's history.[193] It reduced the top marginal tax rate for individuals from 70% to 50%, added eight new tax expenditure items, and reduced the projected share of federal revenue from corporations from approximately 13% in 1981 to less than 7% by 1986.[194] However, the drastic tax reduction caused the federal deficit to climb from $79 billion in 1981 to $128 billion in 1982, and up to nearly $208 billion in 1983.[195]

In addition to the deficit woes, the statistics for 1982 were alarming: Census Bureau statistics revealed the U.S. poverty rate to be at 14%, the highest rate since 1967 and a 7.4% increase over 1980; the Labor Department reported a projected 6% rise in the cost of living over a 12-month period, based upon a .5% increase in October; and Federal Reserve Board figures indicated that the nation's factories were operating at 67.8% capacity, the lowest since 1948, when the Bureau first began to compile such records.[196] Congress responded to this fiscal calamity in 1982 with the Tax Eq-

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ing the very rich paid at least 50 percent in taxes) paid an average of 26.9 percent in taxes, and the leading oil companies paid 5.8 percent in taxes (Internal Revenue Service figures for 1974). Indeed, 244 individuals who earned over $200,000 paid no taxes.

ZINN, *supra* note 121, at 558-59.

190 *See* BURKE & FRIEL, *supra* note 117, at 644.

191 In 1965 a family earning the median income was in the 17 percent marginal tax bracket. . . . By 1980 a similarly situated family found itself paying income taxes at the 24 percent rate. For better-off families, those with twice the median income, the increase was even more pronounced. Their tax rate nearly doubled, between 22 to 43 percent from 1965 to 1980.

CONLAN ET AL., *supra* note 138, at 19 (citing JOSEPH J. MINARIK, MAKING TAX CHOICES 37 tbl.4 (1985)).

192 These three espoused a new tax philosophy, believing that existing marginal tax rates had greatly depressed incentives to work, save, and invest. These "supply-siders" argued that high marginal personal income tax rates were the main cause of America's low productivity growth, economic stagnation, and high inflation. According to their theory, if tax rates were reduced, real growth would ensue which, in turn, might make the tax reduction self-financing. Although Congress pursued their theory, recession, not growth, was to be the consequence. *See* Marvin A. Chirelstein, *Back From the Dead: How President Reagan Saved the Income Tax*, 14 FLA. ST. U.L. REV. 207, 218-22 (1986); and CONLAN ET AL., *supra* note 138, at 30-35.

193 *See* CONLAN ET AL., *supra* note 138, at 33.

194 *See* WITTE, *supra* note 12, at 228-35.

195 *See* CONLAN ET AL., *supra* note 138, at 34.

196 *See* ALMANAC, *supra* note 58, at 614.

uity and Fiscal Responsibility Act, the largest peacetime tax increase in the nation's history (until 1993), and with another increase in the Deficit Reduction Act of 1984,[197] restoring annual amounts of $27 billion and $23 billion, respectively, to the Treasury.[198] By 1985, 73% of all federal receipts were from the individual income tax.[199]

8. The Internal Revenue Code of 1986 and Its Aftermath

The 1986 overhaul of the Internal Revenue Code[200] reflected several major and significant shifts in federal tax policy. First, Congress retreated from the age-old graduated rate structure, which had grown to 15 brackets ranging from 11% to 50%, to just two low tax brackets of 15% and 28% by 1988.[201] At the same time, numerous exemptions, credits, and deductions were eliminated, thus broadening the tax base.[202] With the significant reduction in tax rates, Congress decided that the long-standing preferential treatment for capital gain income could be repealed; thus net capital gains were now fully included in gross income.[203] Elimination of the investment tax credit, long favorable to corporations, as well as a new corporate minimum tax, caused projected revenue from the corporate income tax to increase by $120 billion by 1991.[204] The irony of the Tax Reform Act of 1986, so close on the heels of the 1981 Act, was not lost upon historian John Witte:

> [i]t is also important to note that the least reform-minded bill in history was the Economic Recovery Tax Act of 1981, which opened seven new tax expenditures, expanded the benefits of thirty others, and only tightened up two provisions. Thus, separated by only five years, the same president and the same institutional arrangements produced the historic extremes of tax reform and anti-reform legislation.[205]

Congress, in the new decade of the 1990s, was faced with a considerable tax legacy.[206] In addition, in 1989, President Bush had vetoed legislation that would have increased the minimum

197 *See* GRAETZ & SCHENK, *supra* note 46, at 9.

198 *See* CONLAN ET AL., *supra* note 138, at 34.

199 *See id.* at 19.

200 "The 900-page document altered most provisions of U.S. tax law, creating what is now rightly named the Internal Revenue Code of 1986." *Id.* at 1.

201 *See id.* at 2. The top marginal rate of 28% was an astonishing drop from the top rate of 70% when President Reagan took office in 1981. *See id.* at 3.

202 *See id.* For a detailed listing of the items that were reduced, increased, repealed, limited or modified, and retained, see *id.* at 4-5 tbl.1-1.

203 *See* BURKE & FRIEL, *supra* note 117, at 644-45.

204 *See* CONLAN ET AL., *supra* note 138, at 6.

205 John F. Witte, *Congress and Tax Policy: Problems and Reforms in a Historical Context*, 10 AM. J. TAX POL'Y 107, 113 (1992).

206 "As a result of all the tax bills from 1978 to 1990, the net worth of the "Forbes 400," chosen as the richest in the country by *Forbes Magazine* (advertising itself as a "capitalist tool"), was tripled. About $70 billion a year was lost in government revenue, so that in

wage from $3.35 to $4.55 per hour, but a few months later signed a compromise bill that increased the minimum wage to $4.25 per hour by 1991.[207] Tax increases continued in 1990, with the top rate increased to 31%, and in 1993, with a new top rate of 39.6%,[208] to combat large federal deficits; however, net capital gains were still preferentially taxed at only 28%.[209] In 1992, 83% of all of the federal income tax returns filed reflected adjusted gross income below $50,000.[210]

The transformation of the federal system of taxation from a tariff and excise tax based system to an income and employment tax system was startlingly complete. In 1993, the gross collection of internal revenues by source were:[211]

	In Billions	Percentage
Individual income taxes	$586	49.7
Employment taxes	412	35.0
Corporate income tax	132	11.2
Excise taxes	35	3.0
Estate & gift taxes	13	1.1

Effective October 1, 1997, the minimum wage was increased 50 cents per hour, to $4.75, and was automatically increased to $5.15 per hour effective September 1998.[212] The Taxpayer Relief Act of 1997 established a new preferential treatment structure for net capital gain, providing a 20% maximum rate on certain long-term capital gains,[213] and introduced several new provisions into the Code.[214] The IRS Restructuring and Reform Act of 1998 addressed concerns with the Internal Revenue Service enforcement

those thirteen years the wealthiest 1 percent of the country gained a trillion dollars." ZINN, *supra* note 121, at 568.

207 *See* ALMANAC, *supra* note 58, at 629-30. Workers 16-19 years old would be paid only $3.35 per hour during their training period. *See id.* at 630.

208 *See* BURKE & FRIEL, *supra* note 117, at 645.

209 *See id.*

210 *See* BUREAU OF THE CENSUS, ECON. AND STATISTICS ADMIN., U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 346 tbl.534 (115th ed. 1995) [hereinafter STATISTICAL ABSTRACT].

211 *See id.* at 344 tbl.532.

212 *See* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (1996). *See also* Paul Richter & James Gerstenzang, *Clinton Signs Minimum Wage Hike*, L.A. TIMES, Aug. 21, 1996, at A1. Prior to the increase, the minimum wage, adjusted for inflation, had been at its lowest value in 40 years. *See id.* It had not been raised since 1991. *See supra* note 207.

213 *See* BURKE & FRIEL, *supra* note 117, at 645.

214 Two new provisions were of notable consequence. New Section 121 provided an exclusion from gross income of up to $500,000 for married taxpayers realizing gain upon sale of a personal residence. *See id.* at 99-106. The new Roth IRA provided for nondeductible contributions with tax-free qualifying distributions. *See id.* at 132-33.

policies and procedures.[215] Congress and President Clinton are presently grappling with a phenomenon new to politics in the last 30 years—a projected federal surplus—with Republicans and Democrats facing off with respective rhetoric of tax reduction or shoring up the Social Security system.[216]

B. Values and Beliefs: Historical and Cultural Observations

Our cultural perspective of the federal income tax commenced with the first element: knowledge. Armed with a basic knowledge of our tax history, some attention must now be paid to the second fundamental aspect of culture: values and beliefs. What have we learned from our quick historical tour? Remember, the premise of this piece is that how a society chooses to tax itself says something significant about that society.

The importance of cultural beliefs, as opposed to the primary focus upon economics, in the development and acceptance of a tax by a society must be examined. What cultural perspectives do we employ when assessing the viability of our current federal income tax, or any alternative tax system? What is our "tax culture?" This analysis necessitates some reflection upon our values and beliefs, as reflected, or perhaps more significantly, as not accurately reflected, in our current tax code. What follows is a brief and sometimes unsettling assortment of cultural observations and conclusions.

1. The Federal Income Tax: Not an Overnight Event

First, and most significantly, our historical review reveals that the shift from federal reliance upon excise taxes and tariff duties to the individual income tax as the major source of revenue was not a wholesale, overnight event. It required nearly a century for the federal income tax, first imposed upon the wealthiest 1% of the population in 1913, to evolve into a system of taxation upon us all. As the need for revenue increased for a multitude of reasons over the years, Congress gradually shifted away from excise taxes and tariffs to the income-based system of today.

This observation becomes a crucial factor to consider as we evaluate proposed alternatives to the current income tax structure. Too drastic or rapid a change to an alternative federal taxation system could easily meet with fear, resistance, and distrust in the general population[217]—a sense of culture shock. How funda-

215 *See generally* CCH, 1998 TAX LEGISLATION: LAW, EXPLANATION AND ANALYSIS: IRS RESTRUCTURING AND REFORM ACT OF 1998 (1998).

216 *See* Alissa J. Rubin, *Clinton to Propose Tax Breaks to Aid Domestic Agenda.* L.A. TIMES, Jan. 19, 1999, at A1.

217 Remember the Whiskey Rebellion of 1794. *See supra* notes 23-25 and accompanying text.

mental a change the American public will tolerate is unknown. Our historical perspective indicates, however, that an overnight overhaul of the federal income tax system to a consumption-based system of taxation, for example, would not be a likely event.

2. The Legacy of Tax Laws by and for Wealthy White Males

Our tax system, much like the rest of our law, was created by mostly wealthy, mostly male, mostly white individuals. Just a few examples and statistics adequately support this observation.

Most of us are aware of the fact that the early Framers of the Constitution were wealthy, white male landowners.[218] More than 100 years later, wealthy white males were still a dominant force in shaping law in the United States. In 1909, for example, 23 of the 80 U.S. Senators were millionaires.[219] This was at the time when Congress could not agree upon an income tax (as then proposed, to be imposed only upon the wealthiest 1% of the population) and President Taft ultimately had to recommend that a constitutional amendment be submitted to the States.[220] It was also at the time when fewer than 4% of American families received as much as $3000 per year in income.[221] Another notable example of the influence of wealth upon the creation of our tax laws is the fact that, during the presidencies of Harding and Coolidge, Andrew Mellon, one of the richest men in America, served as the Secretary of the Treasury.[222] Noted historian Morton J. Horwitz contends that, as far back as 1895, poignantly illustrated by the

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218 Historian Howard Zinn notes several observations made in the early 20th century by historian Charles Beard (*in* CHARLES A. BEARD, AN ECONOMIC INTERPRETATION OF THE CONSTITUTION (1935)):

> In short, Beard said, the rich must, in their own interest, either control the government directly or control the laws by which government operates. Beard applied this general idea to the Constitution, by studying the economic backgrounds and political ideas of the fifty-five men who gathered in Philadelphia in 1787 to draw up the Constitution. He found that a majority of them were lawyers by profession, that most of them were men of wealth, in land, slaves, manufacturing, or shipping, that half of them had money loaned out at interest, and that forty of the fifty-five held government bonds, according to the records of the Treasury Department. Thus, Beard found that most of the makers of the Constitution had some direct economic interest in establishing a strong federal government: the manufacturers needed protective tariffs; the moneylenders wanted to stop the use of paper money to pay off debts; the land speculators wanted protection as they invaded Indian lands; slaveowners needed federal security against slave revolts and runaways; bondholders wanted a government able to raise money by nationwide taxation, to pay off those bonds. Four groups, Beard noted, were not represented in the Constitutional Convention: slaves, indentured servants, women, men without property. And so the Constitution did not reflect the interests of those groups.

ZINN, *supra* note 121, at 89-90.

219 *See* PAUL, *supra* note 12, at 94.

220 *See supra* Part II.A.4.

221 *See supra* note 102 and accompanying text.

222 *See* ZINN, *supra* note 120-121, at 375. For a discussion of the Mellon Plan adopted by Congress in 1925, see *supra* footnotes 121-22 and accompanying text.

Supreme Court's decision in *Pollock*,[223] the country was committed "to a neutral, non-redistributive state."[224]

No woman served in the House of Representatives until Jeanette Rankin of Montana was elected in November 1916.[225] In the 105th Congress (1997-1998), only nine of the 100 Senators and only 54 of the 435 Representatives (12.4%) were women.[226] Of the 63 women serving in Congress in 1998, 17 (27%) were women of color.[227] Seven states have never sent a woman to either the Senate or the House.[228] Jennifer Dunn (R-Wash.) is only the fifth woman ever to serve on the Ways and Means Committee of the House of Representatives.[229]

The historical statistics for the U.S. Supreme Court and the presidency are dismal for both female and minority representation. Of the 113 Supreme Court Justices who have interpreted our laws for the past two centuries, only two have been women and two racial minorities.[230] No woman or minority has ever served as either President or Vice President in our nation's history.[231]

The data confirm that wealthy, white males have dominated the creation and interpretation of our laws, including our tax laws. The question becomes, is this bad per se? The answer is "yes," for not all of their assumptions about American values and behavior are necessarily reflective of a primarily middle- and lower-class, two-gender, multi-ethnic society. Our historical survey has revealed that we have, over the years, selected a shifting balance and mixture of tariffs, excise taxes, corporate taxes, individual income taxes, and estate and gift taxes. This mixture has reflected a general "tax the lower classes" attitude—first evident with the Federalist excise taxes, then continued with over a century of oppressive tariff duties, and finally reflected today in our income tax system. Such an observation is undoubtedly not

223 Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601 (1895). *See supra* Part II.A.3. for a discussion of this case.

224 MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW: 1870-1960, at 16 (1992). For a thoughtful discussion of the case and its legacy, see *id.* at 19-27.

225 *See* ALMANAC, *supra* note 58, at 431.

226 *See* CENTER FOR THE AMERICAN WOMAN AND POLITICS (CAWP), NATIONAL INFORMATION BANK ON WOMEN IN PUBLIC OFFICE, EAGLETON INSTITUTE OF POLITICS, RUTGERS UNIVERSITY, WOMEN WHO WILL SERVE IN THE 106TH CONGRESS (1998).

227 *See id.* One African American woman served in the Senate, while eleven African American women, one Asian American/Pacific Islander, and four Latinas served in the House. *See id.*

228 Alaska, Delaware, Iowa, Mississippi, New Hampshire, Vermont, and Wisconsin. *See id.*

229 *See* Robert A. Rosenblatt, *Securing the Future for Women*, L.A. TIMES, Jan. 27, 1999, at E1.

230 Sandra Day O'Connor was appointed to the Court in 1981, Ruth Bader Ginsburg in 1993, Thurgood Marshall in 1967, and Clarence Thomas in 1991. THE WORLD ALMANAC AND BOOK OF FACTS 1998, at 89 (1997).

231 *See id.* at 479-80.

unique to societies today, but it is a sad observation for our democratic society.

Our differentiation of income as either "earned" and "unearned" reflects our conflicting attitude toward how wealth is obtained. Income is clearly a matter of what is valued in the market—in our society. The professional athlete, for example, earns far more than the professional teacher.[232] That fact alone says something about us as a society. Labor has, historically, been undervalued in our society. We espouse to a strong work ethic, but employees are generally paid as little as the market will bear. As Professor Kornhauser observes:

> American attitudes about money, spending, and wealth are complicated because money and wealth are not mere commodities. They also signify deep-seated, complex values and beliefs about morality, equality, and the American system of government. The basic traditions of the United States extol individualism and the sacred right to property while simultaneously proclaiming the equality of man and government by and for equals. The former concepts inevitably result in unequal accumulations of wealth, while the latter argue for a more equal distribution.[233]

What could be added to the debate with more representative governmental participants in the decision-making process? A feminist vision of humanity, for example, would contend that "a sense of connectedness with and obligation to others is an intrinsic part of the nature of the individual. Such a view of humanity naturally supports a redistributive progressive income tax."[234] Gender bias throughout the Code has marginalized women and negatively impacted the family.[235] However, commentators over the last 25 years have been largely unsuccessful in effectuating any significant change in the Code due primarily, in my opinion, to the fact

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232 "People rarely appreciate the degree to which wealth is a *psychological* phenomenon. The value of assets depends on what we believe is going to happen in the future. . . . Because wealth is a phenomenon of expectations and beliefs, it is also a function of information." Bradford, *supra* note 10, at 22.

233 Marjorie E. Kornhauser, *The Morality of Money: American Attitudes Toward Wealth and the Income Tax*, 70 IND. L.J. 119, 120 (1994).

234 Marjorie E. Kornhauser, *The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction*, 86 MICH. L. REV. 465, 506 (1987).

235 *See, for example*, EDWARD J. MCCAFFERY, TAXING WOMEN (1997); Alice Kessler-Harris, *"A Principle of Law but not of Justice": Men, Women and Income Taxes in the United States 1913-1948*, 6 S. CAL. REV. L. & WOMEN'S STUD. 331 (1997); Edward J. McCaffery, *Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code*, 40 UCLA L. REV. 983 (1993); Nancy E. Dowd, *Work and Family: Restructuring the Workplace*, 32 ARIZ. L. REV. 431 (1990); Pamela B. Gann, *Abandoning Marital Status as a Factor in Allocating Income Tax Burdens*, 59 TEX. L. REV. 1 (1980); Michael J. McIntyre & Oliver Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 HARV. L. REV. 1573 (1977); Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389 (1975); and Grace Blumberg, *Sexism in the Code: A Comparative Study of Income Taxation of Working Wives and Mothers*, 21 BUFF. L. REV. 49 (1972).

that male legislators have little motivation to revise the laws against their interest.

The most glaring consequence of a system of tax laws created by and for wealthy, white males, however, is the exacerbation of "a growing gap in the relative economic positions between rich and poor, the latter disproportionately represented by women, children and people of color."[236] Tax provisions such as the home mortgage interest deduction and the preferential tax treatment for capital gains primarily benefit taxpayers in the upper-income brackets. As Professor Shurtz notes:

> [t]he disparity in property ownership between white and black people, in concert with numerous tax provisions granting favorable treatment to property owners, such as the untaxed gains on appreciated (but unrealized) assets such as stocks, or on inherited property that acquires a step up in basis but is untaxed, I.R.C. §1014 (1994), has underscored an unwritten but real class and race bias embedded in our tax laws.[237]

To support the contention that we are, after 200 years of struggle, very much a society of rich and poor, I offer data regarding the top 1% of the population by income class. From 1977 to 1989, the income of the top 1% increased by 80.3%, while the income of all families increased by only 15.5%; the income of the lowest 40% of American families actually decreased during this period.[238] In 1992, the top 1% of federal returns included 1.1 million filers earning above $181,713 and, although they paid 27.4% of all taxes, this small group also earned 14.2% of all income.[239] Interestingly, the tax rate for these high-income earners actually declined between 1982 and 1992, from a top rate of 50% to a top rate of 31%, respectively, but their share of taxes paid increased substantially, from 19.0% to 27.4%.[240] This seemingly incongruous result came about because high-income taxpayers still reported a disproportionate share of the total adjusted gross income. While the top 1% of taxpayers earned 8.9% of income in 1982, they earned 14.2% of all income in 1992.[241] In addition, the reported income of the top 10% of all income earners rose from 32.3% of the total in 1982 to 39.2% of the total in 1992.[242] Thus, in 1992, 90% of

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236 Nancy E. Shurtz, *Gender Equity and Tax Policy: The Theory of "Taxing Men,"* 6 S. CAL. REV. L. & WOMEN'S STUD. 485, 528 (and accompanying footnotes) (1997).

237 *Id.* at 528 n.198.

238 *See* Martin J. McMahon, Jr., *Individual Tax Reform for Fairness and Simplicity: Let Economic Growth Fend for Itself*, 50 WASH. & LEE L. REV. 459, 462-63 (citing House Comm. on Ways and Means, 1992 Overview of Entitlement Programs 1454, at 1511 tbl.15, 1513 tbl.16 (Comm. Print 1992)).

239 *See* Chris R. Edwards, *Who Pays Federal Income Taxes?*, 66 TAX NOTES 105 (1995).

240 *See id.*

241 *See id.* at 107.

242 *See id.*

the taxpaying public was receiving 60% of all income, while 10% of the taxpaying public was receiving nearly 40% of the income.

Due to the sharp decline in the progressivity of the tax rates[243] and the plethora of tax expenditure items available to upper-income taxpayers,[244] the lower- and middle-classes[245] in America still bear a substantial portion of the federal income tax burden. In 1996, nearly 22% of the total federal income tax revenue was collected from those taxpayers with adjusted gross incomes below $50,000.[246] Nearly 49% of the total federal income tax revenue was collected from those taxpayers reporting adjusted gross incomes below $100,000. Add into this equation the impact of the Social Security tax, collected on gross wages up to $62,700, and the burden of taxation upon the working class in America is again quite evident. Taxpayers reporting adjusted gross income of $500,000 or more paid slightly more than 21% of the total federal income tax burden in 1996.[247] These figures lead us directly to the next observation: the tax expenditure phenomenon.

3. The Tax Expenditure Phenomenon

Since 1913, within the evolving structure of the federal income tax, and beyond the obvious issues of tax rates, we have made continuous and crucial decisions regarding exemptions, exclusions, capital gains and losses, deductions, and credits. For the last 30 years, the primary tax policy focus has been upon "tax expenditures"—reductions in individual or corporate income tax liabilities that result from special tax provisions or regulations that provide tax benefits to particular taxpayers.[248] Tax expenditures

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243 *See supra* Part II.A.7. & 8.

244 *See infra* Part II.B.3.

245 How we define "middle-income" or "middle-class" is problematic. The higher our income, the greater our tendency to stretch the definition of middle-income to include our own income. *See* WITTE, *supra* note 12, at 340-43.

246 For 1996, $142 billion of the total revenue of $658.2 billion was collected from taxpayers reporting adjusted gross incomes (AGI) under $50,000. Percentages of total tax collected and total number of returns, by AGI, for 1992 and 1996 are:

Adjusted Gross Income	1992 % of Total Tax Collected	1992 % of Total Returns	1996 % of Total Tax Collected	1996 % of Total Returns
0-$49,999	30.4%	82.80%	21.6%	78.18%
$50,000-$99,999	29.4%	13.89%	27.1%	16.72%
$100,000-$199,999	14.1%	2.47%	16.7%	3.83%
$200,000-$499,999	10.9%	.66%	13.3%	1.00%
$500,000-$999,999	5.2%	.12%	6.6%	.18%
$1,000,000 or more	10.0%	.06%	14.7%	.09%

See STATISTICS OF INCOME, *supra* note 8, at 150 tbl.3.

247 *See id.*

248 Defined in the Congressional Budget and Impoundment Control Act of 1974. *See* GRAETZ & SCHENK, *supra* note 46, at 44. The "top 10 tax expenditures" of 1995 as estimated by the Staff of the Joint Committee on Taxation were:

purportedly facilitate congressional pursuit of a strong "stimulate the economy" approach to the Code and tax legislation, encouraging and discouraging specific types of behavior through its coercive and manipulative taxing power. Congress has emphasized more politically palatable tax subsidies (i.e., tax expenditures) rather than politically deadly direct subsidies (i.e., welfare).[249]

The final result is an excessively complex and brutally unfair system of taxation. As Marvin Chirelstein observes:

> [t]ax preferences have grown phenomenally since World War II, and it is not possible today to regard our national tax system as anything but unfair and unequal in its application. The Internal Revenue Code contains a multitude of special interest provisions. Some are "industry specific" concessions to big businesses like extractive industries, defense contractors, and bank and insurance companies, while others benefit investors and high-salaried individuals through reduced tax rates on capital gains, and travel and entertainment expense deductions for executives and professionals. The ideal of a comprehensive tax base—a tax on "all income from whatever source derived"—now really applies only to middle- and lower-income taxpayers who have few opportunities to exploit the preferences which the Code affords to others.[250]

We, as a society, appear to value the importance of choice and, as the federal income tax became a tax upon us all, the importance of individual choice emerged as a prominent aspect of the system. However, as Professor Chirelstein indicates, the matter of choice to exploit tax preference items in the Code is mostly an illusion for individual taxpayers.[251] Not all tax systems empower; the extent to which a tax system empowers reflects and implements important values.[252] Our current tax system generally grants choices to

	In Billions
1. Pensions + IRAs/Keoghs	85.5
2. Mortgage Interest + Property Taxes (homes)	71.3
3. Medical Insurance	50.4
4. Accelerated Depreciation	31.2
5. Charitable Deduction	29.5
6. State & Local Tax Deduction	26.2
7. Social Security (the non-taxable portion of benefits)	24.1
8. Deferral of Gain & Exclusion on Homes	20.4
9. Life Insurance	17.7
10. Medicare	15.3

Id. at 46-47.

249 "[T]ax expenditures make it possible for Congress to give financial aid to specific groups or industries that could never obtain direct appropriations from the government because of the public outcry that would arise. Most people, however, do not recognize tax expenditures as subsidies." THOMAS J. REESE, THE POLITICS OF TAXATION xi (1980).

250 Chirelstein, *supra* note 192, at 210, and accompanying footnotes.

251 More than 78% of all returns filed in 1996 reflected adjusted gross income below $50,000. *See supra* note 246.

252 *See* Abreu, *supra* note 4, at 6.

people who possess material wealth, and it distributes those choices progressively.[253] Professor Chirelstein adds the following sobering observation:

> the investor class, whether by reason of the tax deferral permitted to real estate owners, or by reason of the capital gain preference allowed to security speculators, pays tax at much lower rates on investment income than do those who receive income from personal services. From the standpoint of income tax fairness, not the slightest justification can be offered.[254]

If we are to remain with income as our basic tax structure, then we must return to a broadened income tax base. This goal is, obviously, more easily stated than achieved. The primary difficulty now is that we, as a society, have been conditioned into believing that the Internal Revenue Code, through specific tax provisions, can be the cure-all for nearly every imaginable social and economic ill.[255] Every candidate for political office, from city council to President, includes a tax agenda in his or her platform. Politicians have now maneuvered themselves into a corner. The elimination of tax preference items would be politically controversial, to say the least, and would undermine the alleged basis for their very existence: the stimulation of the economy.

4. Americans: A Source of Frustration to Economists

There is much that can be said about American irrationality. We are an amazing source of contradictory beliefs and irrational behavior—an economist's nightmare. We loan money to our relatives (with a high probability that we will never see the money again). We give money to our children with little control over how they will spend it. We buy items we don't need on the Home Shopping Network®, on credit no less. Sometimes, we even spend more than we earn.[256] Even the renowned tax expert, Boris Bittker, observes: "I will pursue the road of rationality as far as I can trace its tracks; but for me, the final destination is not attained without wandering in the wilderness with only one's soul for guidance."[257]

Despite the core principle of raising revenue, however, viewing our federal income tax system from a purely economic point of view results in major flaws in our analysis, for the economist "only

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253 *See id.* at 9.

254 Chirelstein, *supra* note 192, at 211.

255 *See infra* Part II.B.6.

256 "For the first time since the Great Depression, Americans spent more money in a single month than they earned, driving the personal savings rate into the negative zone." Jonathan Peterson and Stephen Gregory, *Personal Savings Rate in Red, 1st Time Since '30s*, L.A. TIMES, Nov. 3, 1998, at A1.

257 CHARLES O. GALVIN AND BORIS I. BITTKER, THE INCOME TAX: HOW PROGRESSIVE SHOULD IT BE? 28 (1969).

claims to show us how the world works apart from idiosyncrasies of time, place, and individual personality."[258] We need to recognize and appreciate cultural as well as economic factors and influences in our tax Code.[259] One consequence of professional economists holding the high road in tax theory is a general acceptance among them:

> of a certain view of human well being, which translates into assumptions about distributive fairness. Another [consequence] is the indifference of most tax theory to the admittedly unique aspects of the political process through which each country's peculiar tax system is created. This indifference is no doubt a direct reflection of the way in which economists view their discipline as a whole. They typically aspire to produce simple, elegant, strongly explanatory, and in brief, highly general theories of the phenomenon with which they deal. But a corollary is that cultural, partisan, and irrational elements in actual tax systems seem to the economist uninteresting and irrelevant. As a result much of the best work on taxation, done by economists, seems to pay no attention to how tax policy is made in real life. People find this apparent lack of realism puzzling.[260]

Much has been done to the Internal Revenue Code in the name of economics. The rapid-fire, massive changes to the Code in the early 1980s, for example, were prompted by erroneous economic theory.[261] Our historical survey has repeatedly revealed congressional tax action to either increase revenue or to reduce inflation, the federal deficit, or both. Thus, the next observation must, by necessity, address the political process through which our country's peculiar tax system is created.

5. The Not-So-Pretty Political Process and the Congressional Tax Ritual

The political process is not a pretty picture in the context of tax legislation. Thomas J. Reese observed in 1980 (prior to the Tax Reform Act of 1986 but still applicable today) that:

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258 STEPHEN G. UTZ, TAX POLICY: AN INTRODUCTION AND SURVEY OF THE PRINCIPAL DEBATES 73 (1993).

259 My sense is that it is probably better to recognize the legitimacy of cultural factors in tax policy than to treat them as some sort of alien invasion of the economist's territory. This admission need not lead to an academic retreat, nor to an easy acceptance of tax subsidies. Because a factor is nonquantifiable does not mean that it cannot be evaluated. If the cultural value behind a given tax provision can be identified, the importance of that value can be assessed as well as the effectiveness of the provision in advancing that value. This process should by no means replace the economist's art, but it is a vital addition.

Michael Livingston, *Risky Business: Economics, Culture and the Taxation of High-Risk Activities*, 48 TAX L. REV. 163, 229-30 (1993).

260 UTZ, *supra* note 258, at 71.

261 *See supra* footnotes 192-95, and accompanying text.

> [t]ax reformers would prefer to replace this system of high tax rates and loopholes with a system of lower rates and fewer tax expenditures. Although the reformers' position is economically logical, the current system is politically attractive. Politicians can defend the tax system to poor people by pointing to the highly progressive rates. At the same time, wealthy and powerful interests are not upset because there are loopholes to protect them.[262]

The dynamics of tax policy-making have changed dramatically in the last 20 years. The political reality is that congressional and presidential candidates are elected by an ever-decreasing percentage of the population willing to vote.[263] Those willing to participate in the election process thus, by default, wield a significant amount of power. In addition, policy entrepreneurs, tax experts,[264] journalists,[265] the media, policy promoters in Washington think tanks,[266] and public interest groups[267] recently have been added to the traditional mix of congressional tax committees in formulating tax policy.[268] Corporate lobbyists, long a political reality in Washington, are now more organized, and obvious.[269] Additionally, the American two-party political system is at risk of collapse.[270] As Professor Pollack notes:

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262 REESE, *supra* note 249, at xi.

263 For example, only 44.6% of the more than 190 million Americans eligible to vote in the 1994 congressional elections actually voted. *See* STATISTICAL ABSTRACT, *supra* note 210, at 289 tbl.459.

264 While a generation ago, it was judicial gloss upon the barebone statutes that added the real substance to the Code, tax laws now are given their substance by the tax experts in the Treasury Department and Service who issue the regulations and other published authority that guides the actual practice of tax law.

Sheldon D. Pollack, *A New Dynamics of Tax Policy?*, 12 AM. J. TAX POL'Y 61, 72-73 (1995).

265 *See, e.g.*, DONALD L. BARTLETT & JAMES B. STEELE, AMERICA: WHAT WENT WRONG? (1992). The authors, journalists with the *Philadelphia Enquirer*, wrote this book as an expanded version of their nine-part newspaper series originally published in 1991. The book was a best seller.

266 *See, e.g.*, JAMES ALLEN SMITH, THE IDEA BROKERS: THINK TANKS AND THE RISE OF THE NEW POLICY ELITE (1991). The author notes that: "there is something troubling about the relationship among experts, leaders, and citizens that tends to make American politics more polarized, short-sighted, and fragmented—and often less intelligent—than it should be." *Id.* at xxi. *See also* DAVID M. RICCI, THE TRANSFORMATION OF AMERICAN POLITICS: THE NEW WASHINGTON AND THE RISE OF THINK TANKS (1993).

267 *See, e.g.*, JEFFREY M. BERRY, LOBBYING FOR THE PEOPLE: THE POLITICAL BEHAVIOR OF PUBLIC INTEREST GROUPS (1977).

268 *See* Pollack, *supra* note 264.

269 *See, e.g.*, JEFFREY H. BIRNBAUM, THE LOBBYISTS: HOW INFLUENCE PEDDLERS GET THEIR WAY IN WASHINGTON (1992). The author, a reporter for the *Wall Street Journal*, recounts the intense activities of the more than 80,000 corporate lobbyists in Washington D.C. in the years 1989-1990.

270 Perhaps my prediction of "collapse" is overly influenced by the recent, disheartening, partisan activity in President Clinton's impeachment proceedings in both the House and the Senate. However, the general decline in the U.S. political party system has previously been addressed in JAMES L. SUNDQUIST, DYNAMICS OF THE PARTY SYSTEM: ALIGNMENT AND REALIGNMENT OF POLITICAL PARTIES IN THE UNITED STATES (1973). *See also* DAVID S. BRODER, THE PARTY'S OVER: THE FAILURE OF POLITICS IN AMERICA (1971). The *Washington Post* correspondent analyzes the polarization of the party system in the two-decade period

> [t]he proliferation of tax policy entrepreneurs and public interest groups reflects the decline of the party hierarchy in Congress and the weaknesses of the American party system. . . . In other words, the erratic course of tax policy during the 1980s was a product of the continued deterioration in the political process through which tax policy is made. The unstable political framework and the lack of consensus over tax policy resulted in an unusually turbulent decade of tax politics. This unstable politics could produce tax legislation such as Reagan tax cuts in one year and a tax reform bill such as the 1986 Act only five years later. Events in the 1990s already suggest that much the same turbulence continues to haunt federal tax policy.[271]

John Witte's concerns regarding the course of tax policy after the Tax Reform Act of 1986, expressed in 1992, hold true today:

> [r]egardless of how one evaluates the politics of TRA [Tax Reform Act of 1986], two long-standing historical problems with income tax policy persist despite the changes enacted in 1986. The first is the continuing possibility that tax expenditures will again begin to increase, thus narrowing the tax base, increasing specialized benefits, and further complicating the tax code. Despite the landmark nature of the 1986 Act, which eliminated 14 tax expenditures and reduced benefits in 72 other provisions, a vast array of tax expenditures remain. And since 1986 the only serious tax proposals have been to restore benefits curtailed by TRA, e.g., capital gains, IRAs, earned income credit, child care. In part, the current pressure to expand tax expenditures may be a cyclical reaction to the severity of the changes enacted in 1986.[272]

As previously noted, Congress has, as feared, recently expanded tax expenditures by enacting a 20% tax rate preference for capital gains, creating a new Roth IRA, and adding other tax expenditure provisions to the Code.[273]

Although our history reveals that the congressional ritual of considering new tax legislation is not a recent phenomenon, it has accelerated in the past three decades to a nearly annual event. Thus, the public has grown to expect a tax policy position from every candidate running for public office. Our cultural expectations now include an annual dose of tax "reform," "reduction," "relief," "recovery," "simplification," "technical correction," or "restructuring" from an ever more remote, frustrating, and blatantly political process. This reality leads us to a final observation.

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from Eisenhower to Nixon. However, see LARRY J. SABATO, THE PARTY'S JUST BEGUN: SHAPING POLITICAL PARTIES FOR AMERICA'S FUTURE (1988), which provides historical background and then presents a hopeful agenda for party renewal.

271 Pollack, *supra* note 264, at 62.

272 Witte, *supra* note 205, at 113.

273 *See supra* Part II.A.8. and, in particular, footnote 214 and accompanying text.

6. The Allegedly All-Purpose, Cure-All Tax Code

History has established that it is often exceedingly difficult for the political animal that is Congress to accept a major new concept such as the federal income tax or the Social Security tax. However, once the idea morphs through the political process and is finally "put into play" as enacted law, constant congressional tinkering is the norm. As previously discussed,[274] Congress has modified tax rates, exemption levels, and deductions, and added or revised a plethora of tax preference provisions to address both good times and bad, to stimulate the economy or to slow it down, and to encourage business, investment, home ownership and savings. The frightening reality of this "reform," "reduction," "relief," and "recovery" cycle is that no one really *knows* whether any of the tax legislative proposals are capable of remedying the perceived economic or social crisis of the day. Identifying the parameters of the current economic or social dilemma, agreeing upon a politically palatable solution, and predicting the future behavior of 270 million Americans are tasks likely beyond the capabilities of *any* group of individuals. The drive to "fix it," however, whatever "it" might be, through the tax Code is now an innate political instinct comparable to "survival of the fittest."

The result is that the accelerated rate of recent tax legislation is nothing short of mind-boggling. For example, the Tax Reform Act of 1969, which was the first major overhaul of the 1954 Code, affected only 271 Internal Revenue Code subsections.[275] In comparison, the six major tax bills enacted between 1976 and 1984 affected 5815 subsections.[276] And, as previously noted, the recent Taxpayer Relief Act of 1997 alone revised 825 code sections and added 285 new sections to the Code.[277]

I remain unconvinced that the solution to all social and economic ills lies in the Internal Revenue Code. Professor Martin J. McMahon, Jr. observes that:

> [t]raditional tax policy analysis focuses on whether the system (1) raises adequate revenue, (2) in an equitable manner, (3) without undue complexity, and (4) without undue interference with the economic system. Since 1981, however, the dominant characteristic of tax policy debate in the political arena has been the effect of the current rules and proposed changes on economic behavior. When tax reform is considered, the focus rarely is on the tax system as a source of revenues the effectiveness and fair-

274 See *supra* Part II.A.

275 *See* Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913, 922 (1987) (citing Harold Apolinsky, *The Changes Just Cost Money*, WASH. POST, Apr. 6, 1986, at C8).

276 *See id.*

277 *See supra* note 7, and accompanying text.

> ness of which should be measured against the full range of traditional criteria of tax policy. Nor is the redistributive function of taxation considered in a balanced manner. Use of the tax system to redistribute the social product has been decried. Instead, tax policy analysis has been dominated by demands for either investment neutrality or investment incentives, with pseudo-economists somewhat amazingly demanding both simultaneously. Advocates of changing the tax system to encourage economic growth do not seem to view the tax system as a vehicle to collect adequate revenues fairly or to soften the harsh distributional results that capitalism sometimes produces. They evaluate the tax system solely as a tool for managing economic activity, both on a macroeconomic and microeconomic scale. In other words, much of what passes for "tax policy" in the political arena today is in reality "tax expenditure policy."[278]

Is the tax Code tail wagging the economic dog, or vice-versa? It is exceedingly difficult to tell whether Congress believes that the economy wags the Internal Revenue Code or the Internal Revenue Code wags the economy. Those on the lower end of the income spectrum are shaking, nonetheless.

C. The Behavior Factor

The third cultural factor to examine in our income tax perspective is behavior: how the tax system in obvious as well as hidden ways attempts to modify our economic, as well as our personal, behavior. Volumes could be written about this cultural and psychological phenomenon, but my discussion shall be restricted to just a few observations.

The first observation of critical significance is that our tax payments are removed from the behavior that generates the tax liability and "[t]his behavioral, or functional, separation leads us to perceive tax payments as punishment for having succeeded financially."[279] We engage in productive activity that is rewarding and apparently valued by society and yet, at the same time, we are "punished," through taxes, the more successful we become. Thus, observes Professor Rosenberg:

> [u]nfortunately, the imposition of occasional punishment in response to behavior that is generally positively reinforced has been shown not only to generate hostility, but also to literally to [sic] drive subjects crazy. Those who feel they are being punished tend to retaliate by punishing back, and the one at whom they tend to direct their punishment is the one they perceive to

278 McMahon, *supra* note 238, at 461 (and accompanying footnotes).

279 Joshua D. Rosenberg, *The Psychology of Taxes: Why They Drive Us Crazy, and How We Can Make Them Sane*, 16 VA. TAX REV. 155, 183 (1996).

> be punishing them; in this case, the perceived punisher[s] are the Service and taxes in general.[280]

Congress fed into this general hostility toward the Internal Revenue Service with substantial taxpayer testimony relating instances of IRS taxpayer abuse prior to passage of the 1998 IRS Restructuring and Reform Act. The irony of this scenario is that much of the taxpayer hostility was misplaced. Congress creates the tax laws that punish us and drive us crazy; the IRS is merely the visible enforcer. How convenient for Congress that a "fall-guy" was available to receive the taxpayers' wrath.

The second observation is that congressional efforts to alter, encourage or discourage our behavior through the tax code have enjoyed varying degrees of success and failure. As Sheldon D. Pollack observes: "[t]he tax laws have a peculiar impact upon private behavior insofar as they do not strictly prohibit particular private action or conduct, but rather establish a broad framework of incentives and disincentives through which private activity is subtly altered."[281] The following four examples illustrate this point.

The first example is savings. Economists generally are in agreement that Americans need to save more. Changing our income tax system to a consumption tax system, it is argued, would encourage savings behavior because the funds saved during the year would not be subject to tax. However, this argument assumes that Americans are at present not saving because the current income tax system does not strongly encourage it. Other than tax-deferred contributions to pension plans, income from savings is taxed at normal tax rates. However, it might just as easily be plausible that Americans are not saving because they can't afford to save—most need their annual incomes just to make ends meet.[282] As previously noted, 78% of all tax returns filed in 1996 reflected AGI of $50,000 or below.[283] Taking into account the federal as well as state income taxes plus the Social Security tax, this statistic indicates that the majority of Americans are not generating sufficient income to accommodate savings. The issue is not so much the income tax as the ability to generate income.

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280 *Id.* at 185-86 and accompanying footnotes.

281 Sheldon D. Pollack, *Tax Complexity, Reform, and the Illusions of Tax Simplification*, 2 GEO. MASON INDEPENDENT L. REV. 319, 357 (1994).

282 [M]ost Americans would have difficulty recognizing the consumption tax as superior in fairness and equity to a broad-based income tax. The reason for this is that people do not regard saving as an act of self-denial where high-income taxpayers are concerned, or as mere postponed consumption. In our day at least, saving generally appears to take place only after all reasonable consumption preferences have been fully satisfied, and hence sometimes appears to be the ultimate luxury.

Chirelstein, *supra* note 192, 217-18.

283 *See supra* note 246.

The second example is the filing of returns. Filing individual income tax returns gives us a sense of control, although most of us need some assistance in completing our returns.[284] There is a sense of accountability and control that seems important to us. The cultural phenomenon of filing our returns at midnight on April 15th is, in my opinion, more than a media event; rather, it represents a demonstration of individual control over a perceived tax system gone awry. A negative behavioral consequence of our self-reporting process, however, is its inherent unreliability.[285]

A third example is the deadweight loss factor. We spend an inordinate amount of time, energy, and money attempting to avoid the imposition of the tax burden. As David Bradford observes:

> tax rules impose two sorts of burden. One is the transfer of purchasing power from the individual to the government; the other is the effective waste of purchasing power owing to the distorting effects arising from the effort to avoid tax. The latter burden, called by economists the "deadweight loss" due to the tax, represents a gain to no one—neither to other individuals nor to the government.[286]

For illustration purposes, let's examine the situation of a spouse (the wife, for purposes of this example) who would like to go to work to supplement the family's income. Due primarily to the Social Security tax and the fact that the wife's income will be added on top of her husband's income, her additional work income could actually result in less overall income for the family.[287] Numerous devastating social consequences flow from the spouse's decision not to work in order to avoid the cascading impact of the taxes:

(1) the loss to the workplace and the community of the skills of the woman who intelligently decides not to enter the workforce;
(2) the loss to the woman of her opportunity to pursue her career;
(3) the loss to the father of time with his family since he must increase his workplace hours rather than have his wife work outside the home;
(4) the loss to the children of the father who has less time to share in their growing up;
(5) the loss to the children of the mother (whether married or single) who would rather work only part-time but is economically compelled to work full-time; and

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284 *See supra* note 8.

285 *See* Rosenberg, *supra* note 279, at 191. "Self-reporting suffers from an unconscious, and therefore almost inescapable bias, even in the absence of any deliberate effort by the taxpayer to cheat or under-report." *Id.*

286 BRADFORD, *supra* note 10, at 135.

287 *See* Nantell, *supra* note 183, at 894-97.

(6) the stigma placed upon a poor single parent who intelligently decides to accept welfare rather than a minimum wage job which cannot provide her and her children with sufficient resources to cover the necessities of life, including medical and child care costs.[288]

Thus, prudent tax avoidance behavior on the part of a taxpayer results in a multitude of wasted purchasing power—a deadweight loss.

The final example is home purchases and sales. Nowhere is the behavioral impact of the tax code more evident than in the purchase and sale of homes. We often buy homes because we are motivated to take advantage of the home mortgage interest and real estate taxes deductions.[289] Prior to the 1997 tax Code changes, most taxpayers felt compelled under the Code to buy a home more expensive than the one they sold in order to avoid recognition of realized gain upon the sale.[290]

An inherent flaw in the behavior modification aspect of this Code section was magnified by experiences in the early 1990s. As the economy in California declined, many Californians sold their homes at high prices and moved to states with traditionally lower home prices such as Colorado[291] and Utah.[292] The Californians, not wanting to recognize the gain upon the sale of their California residences, built and bought expensive homes in their new states, thus rapidly, and falsely, inflating the value of homes in those states. By 1995 in Colorado, for example, heavy in-migration to the state spurred luxury home construction out of a five-year slump.[293] In Utah, the average home sold for $77,788 in the first quarter of 1991, the second year that the state began seeing heavy

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288 *Id.* at 896.

289 *See* I.R.C. §§ 163 and 164 (1994), respectively. These two benefits combined to a total of $71.3 billion in 1995, thus ranking as the #2 tax expenditure on the "top ten list" for the year. *See supra* note 248.

290 *See* former I.R.C. § 1034 (repealed by the 1997 Taxpayers Relief Act). The impact of § 1034 was to defer the reporting of realized gain on the sale of a residence by reducing the basis of the newly purchased residence. However, in order to qualify for this deferral, the section mandated that the taxpayer "buy-up"—that is, buy a home more expensive than the home he or she sold. The deferral of gain upon sale of a personal residence totaled $20.4 billion in 1995, thus ranking it the #8 tax expenditure on the "top ten list" for the year. *See supra* note 248.

291 *See* Guy Kelly, *State's Explosive Growth Tapering Off*, ROCKY MOUNTAIN NEWS, Jan. 29, 1996, at 4A.

292 "At least 37,000 Californians parked their moving vans at Utah's curbs in the first three years of this decade, according to the best estimates, and they brought more than their belongings." Colleen Diskin, *California Influx Changing the Pace in Laid-Back Utah*, DENVER POST, Jun. 18, 1995, at C7.

293 *See* Michelle Mahoney, *Invasion of the Monster Mansions*, DENVER POST, Aug. 2, 1995, at F1. The managing broker for Devonshire Co. stated: "the home you could buy two years ago for $500,000 is now $750,000." *Id.*

migration from California; but in the first quarter of 1995, the average house statewide sold for $119,653, a nearly 54% increase.[294]

Old section 1034 influenced more than just the inflation of home prices in many states. It also encouraged individuals to invest the gain from the sale of their residences in ever-more-expensive residences, rather than in more productive investments such as retirement savings, insurance, securities, or bonds.[295] The personal, psychological, social, and economic consequences of these "misplaced" funds over five decades can hardly be estimated.

Now, the new exclusion from gross income of gain from the sale of a personal residence, $250,000 for single taxpayers and $500,000 for married taxpayers,[296] is beginning to change property owners' behavior. It has been estimated that the new tax exclusion could have influenced anywhere from 100,000 to 500,000 of 1998's record 4.8 million resales.[297]

The end result of a tax policy comprised of motivation-oriented, behavior-altering provisions is an exceedingly complex set of statutes. Political scientist John Witte observes that "[w]hen it comes to fitting the incentive to a precise type of behavior and population, while at the same time trying to anticipate and thwart the legal maneuvers of those attempting to exploit the provision, what may be simple conceptually becomes unmercifully complex in practice."[298] Drafting tax statutes for 270 million Americans, with the intent of encouraging very specific behavior, is thus doomed to a fate of intricacies and exceptions—our present, unpleasant predicament. Given the fact that no one is actually capable of predicting the exact behavioral consequences of any one, specific tax statute, the existence of our current melange of tax Code provisions is truly frightening.

III. Shifting the Income Tax Paradigm

When the 16th Amendment to the Constitution was approved by Delaware, the 32nd state, on February 25, 1913, my father was 13 *days* old. We tend to think that the adoption of the federal income tax is "ancient history" but, in my family, it is only two generations old.

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294 *See* Diskin, *supra* note 292.

295 *See* Lee A. Sheppard, *Should Sales of Personal Residences Be Exempt From Tax?*, 50 Tax Notes 1433 (1991).

296 *See* I.R.C. § 121 (West 1988 & Supp. 1999).

297 *See* Kenneth R. Harney, *Tax Law Change Gives Boost to Home Sales*, L.A. Times, Jan. 24, 1999, at K1 (Orange County ed.). "The actual cost, at least as measured in new estimates by the congressional Joint Tax Committee, turns out to be substantial: About $31 billion over the next five years. For home sellers, at least, that's a bipartisan $6 billion a year they'd never be able to pocket if they paid capital gains taxes on their profits." *Id.*

298 Witte, *supra* note 12, at 204.

I believe this observation is important for several reasons. First, my parents' generation, and every person born after 1913, has primarily known an income tax system at the federal level. One would need to talk to centenarians in order to record personal reflections regarding the prior, longstanding federal tariff structure.

Second, I believe this observation is important in looking back on the development of the federal income tax system. Those men[299] who created and changed the federal tax Code in the subsequent decades of the '20s, '30s, and '40s, in particular, were certainly influenced by the economies and events of their times. However, they also possessed a personal frame of reference, a personal historical perspective, of a very different tax structure and system.

Third, this observation becomes important because our own personal experiences, our individual historical perspectives, instruct, shape, dictate, and, often, constrain our future decisions to amend or not to amend a system of laws, any laws, whether they be tax or otherwise.

Nearly every individual living in the United States today has only known a system of income taxation at the federal level.[300] It is an accepted part of our lives and an integral aspect of our culture. When I ask my Federal Income Tax students why we have an income tax system as opposed to a national sales tax system, for example, they look at me as if I am from Mars (or is it Venus?).[301] In their personal historical experiences, sales taxes are the domain of state and local governments, as are property taxes. The income tax system is the only federal tax system they have ever known. It is their paradigm, and too drastic a change is simply not trusted as legitimate.

Yet, "Why a federal income tax system?" is the threshold, fundamental question to answer if we are to engage in a meaningful discussion of tax policy. As I have stated, all of our legal rules are reflections of our values and beliefs,[302] and this statement is certainly true in our choice of a tax system.[303] As Professor Pollack observes:

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299 The term "men" is used intentionally. *See supra* Part II.B.2.

300 Certainly immigrants bring their own cultural perspectives regarding taxation with them. However, once here in the United States, the income and employment tax systems are the primary federal tax systems they will encounter, and they will encounter them immediately, with their first paychecks.

301 My apologies to JOHN GRAY, MEN ARE FROM MARS, WOMEN ARE FROM VENUS (1992).

302 *See generally* STEVEN J. BURTON, AN INTRODUCTION TO LAW AND LEGAL REASONING (2d ed. 1995).

303 "[T]ax systems are products of human creation. They exist because they serve human objectives, reflecting the values of their designers. A tax system's design can reveal

> [t]he abandonment of the tariff and the political battle culminating in the adoption of the federal income tax in 1913 as the new (and soon-to-be primary) source of revenue proved to be a watershed event in the development of public finance, as well as a milestone in the development of the national political party system.[304]

This observation leads us to the problem of paradigms. If things have always been done a certain way—if income has always been taxed in our personal experiences—then it is so. The questioning and rationality are often lost in the inevitability of the answer.[305] This paradigm phenomenon occurs within tax policy analysis as well. For example, one of the longstanding tenets of American tax policy is the supposed necessity of a tax system to achieve both horizontal and vertical equity.[306] Under the premise of horizontal equity, taxpayers with equal incomes should pay an equal amount of taxes. Lack of horizontal equity is a major criticism of our current tax system. For example, if Taxpayer A has $50,000 of adjusted gross income and owns a home, then she will receive the benefits of the home mortgage interest deduction and the real estate tax deduction in computing her federal income tax liability. If Taxpayer B has $50,000 of adjusted gross income and pays rent, however, then she will pay more income tax, since she will only be able to utilize the lower standard deduction to shelter her income.

Horizontal equity as an objective of a tax system may have some fundamental flaws.[307] For example, in our previous example, is all $50,000 of adjusted gross income created equal? Assume that Taxpayer A's income came solely from interest and dividends on investments gifted to her by her grandparents, and then assume that Taxpayer B's income came from working 60-hour workweeks at two different jobs. Should the objective of the tax system be to tax them the same?

Vertical equity necessitates that those taxpayers with more income should pay a greater share of the tax burden. The theory is that every added dollar of income means less to a rich person than to a poor person. These concepts of equity have come to be an accepted tax policy paradigm of a supposedly neutral system of

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much about those values. In other words, our choice of an income tax over a head tax as a mechanism for raising revenue is not accidental." Abreu, *supra* note 4, at 16.

304 Pollack, *supra* note 4, at 496 and accompanying footnotes.

305 The phenomenon reminds me of the old (somewhat sexist) joke about the young woman who always cut off the end of the roast before putting it in the oven. When her husband asked her why she did this, she responded, "That is what my mother always did." The young women then asked her mother why she always cut off the end of the roast before cooking. Her answer: "Because my pan was too small."

306 *See generally* GRAETZ & SCHENK, *supra* note 46; *see also* CONLAN ET AL., *supra* note 138, at 26 n.21.

307 *See* BRADFORD, *supra* note 10, at 151.

taxation. However, at their core, such concepts presuppose that all Americans agree that horizontal and vertical equity in a tax system epitomize "fairness" and that all of us are in agreement as to what constitutes "fairness."[308] Furthermore, why must horizontal and vertical equity be fundamental goals of fairness of the federal income tax, but not other tax systems such as the sales tax or Social Security tax?

David F. Bradford concludes that "there is no single measure of fairness. At bottom, an individual value judgment is involved, and it is not realistic to hope for complete consensus on a particular standard. But there is room for reasoned argument on the subject."[309] What specific criteria should we employ to determine when two individuals have equal circumstances? What judgments should we make as to which circumstances are better and which worse, and, further, the degree to which burdens should differ in the different circumstances?[310] Bradford again concludes that "tax burdens should be related to the quality of individuals' opportunities. Those with better opportunities than others should be expected to bear relatively more of the tax burden."[311]

We sometimes are successful in making significant changes in our cultural paradigms. For example, a fundamental tenet of our society is outright ownership of property. The condominium concept, however, has gradually taken root and gained acceptance, where individuals do not actually own the structure itself—a community or association of individual homeowners owns the structure. The trade-off for nonownership is that the "community" pays for outside improvements, landscaping, and general maintenance. There is, apparently, enough of a trade-off to make condominium ownership an acceptable American choice, and choice becomes the key ingredient here. For some, the benefit of condominium living will outweigh the benefit of outright ownership, but, in the end, it is a matter of choice.

An example of a cultural shift that is not working well, in my estimation, due to lack of choice, is the health care HMOs. Operating on the premise of efficient cost management, we are offered only HMOs as our health care choice. Within the HMO, there is little choice, and sometimes, limited benefit. Our personal, historical perspectives tell us that freedom of choice of our physicians and hospitals is of primary importance. Our HMO experience is to

308 For a critical analysis of horizontal and vertical equity, see WITTE, *supra* note 12, at 56-58. *See also* Pollack, *supra* note 4, at 500-02. For a thoughtful discussion of equity in general in the context of our federal income tax system, see Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 574–80 (1965).

309 BRADFORD, *supra* note 10, at 148.

310 *See id.* at 151-52.

311 *Id.* at 148.

the contrary. Thus, resistance and friction are the norm in the managed health care field.[312]

Choice is a matter of "weighing and balancing." What we are willing to adjust to that deviates from our personal, historical perspectives is largely a matter of weighing and balancing the benefits: what will we gain in exchange for what we have to give up?

Is not this weighing and balancing really the basis of all law? Are we not willing to drive the speed limit and stop at stop signs because we believe that the benefits of these rules outweigh the restrictions upon our individual freedom? Are we not willing to line up at airports to have our luggage, as well as our bodies, searched because we believe that the benefit of deterring terrorism is worth this amazing amount of infringement upon our privacy? Our laws reflect our beliefs, and our beliefs are an integral part of our culture.

One of the problems with weighing and balancing the costs and benefits of the federal income tax is that the benefits, at least on a day-to-day basis, are largely invisible to us. In the area of traffic regulations and airport security, we see and experience the benefits obtained when we agree to the personal freedom restrictions. The income tax system, however, is unique, for its benefits are removed, both physically and temporally, from its burdens.[313] Who or what is benefiting when, for example, an individual has to pay up to 40% of his or her gross income every month just to fulfill the obligations of federal and state income tax withholding and the Social Security and Medicare taxes? Where is all of that money going?

The larger the community, the more difficult it is to answer that question. Our community now consists of over 270 million people.[314] Amazingly, 54% of the entire population resides in only 20% of the states.[315] How do we see or experience the benefits of

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312 My own personal, historical perspectives may be coming out here. After all, I remember when our family doctor, James P. Corrigan, M.D., came to the house on a regular basis to care for my two sisters and me.

313 *See* Rosenberg, *supra* note 279, at 179-83.

> Unlike the costs of other laws, the costs of tax payments are neither physically nor temporally contiguous with any benefit, service or product. While our taxes may bring us goods and services throughout the year, no one good or service is either large enough or close enough in time or place to the moment we fill out our tax returns (or become frustrated with the size of our withholding payments) to hold our attention. . . . When we make our tax payments, there is simply no contemporaneous or physically proximate governmental benefit with which to associate those payments.

Id. at 181-82

314 The U.S. population on November 12, 1998 at 4:13:15 A.M. Eastern Time was 270,993,467. U.S. CENSUS BUREAU, THE OFFICIAL STATISTICS (1998).

315 In 1994, the top 10 states in terms of population were: 1) California—31,431,000; 2) Texas—18,378,000; 3) New York—18,169,000; 4) Florida—13,953,000; 5) Pennsylvania—12,052,000; 6) Illinois—11,752,000; 7) Ohio—11,102,000; 8) Michigan—9,496,000; 9) New Jersey—7,904,000; and 10) North Carolina—7,070,000. These states totaled 141,307,000

defense expenditures, Social Security and Medicare costs, and interest payments on the national debt? Yet, 83% of our annual federal budget outlay is for these three benefits alone.[316] Other benefits such as highway costs over 50 states, agriculture and energy regulation, the cost of the federal executive, legislative, and judiciary structures, social welfare costs, and the regulation of the insurance, food and drug, and security industries are only slightly more visible.

These are just the tangible benefits; the benefits that an economist would conclude to be benefits of a tax system. There are, however, numerous cultural, intangible benefits as well: the sense of sharing,[317] the sense that the community is protecting itself against possible harm, the sense that we are providing for our elderly and disabled, and the sense that we are making good on our debts throughout the world. In addition, we have cultural benefits of choice. We are free to make choices of our sources of income—to work or to invest—and to pay the consequences of taxation. We are free to make choices regarding how we spend our money, and whether the cost will be deductible or not. These are also benefits that should not be underestimated in evaluating a tax system.[318]

Is the perception of who or what is benefiting the same as the reality? The reason that the answer to this question is so important is due to the fact that, even if the perception is wrong, the perception becomes part of our cultural paradigm. The perceptions that tax loopholes keep many rich taxpayers from paying any taxes at all, or that welfare payments are only to individual poor people, are part of our belief system. Stating the fact that very few of the wealthy actually pay no federal income tax, or that corporate welfare far exceeds individual welfare, does little to al-

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of the total population of 260,341,000. *See* STATISTICAL ABSTRACT, *supra* note 210, at 28 tbl.27.

316 "Out of the total budget dollar about forty-seven percent is expended for social security, twenty-two percent is for national defense, and fourteen percent is for interest." Charles O. Galvin, *Past, Present, and Future*, 49 SMU L. REV. 83, 93 (1995) (citing the Economic Report of the President, H.R. Doc. No. 103-178, at 361 (1994)).

317 The creation of a tax system is an imperative of group (i.e., societal) living. Although tax systems as we now know them did not exist in aboriginal societies, systems of communal sharing did. Members of numerically small societies share food, protection from the elements, and defense against predators. The existence of an organized society implies, by its very definition, the existence of different roles for different members of it, and the existence of different roles necessitates sharing. A society in which members are expected to share the proceeds of a hunt with others is, in effect, imposing a tax upon that hunt. . . . In the most basic of senses, then, I heartily agree with Justice Holmes that taxes are the price we pay for civilization. [citation omitted] Indeed, I might go even further and say that taxation, that is, the means by which we share resources, is an essential part of civilization.

Abreu, *supra* note 4, at 14-16 n.34.

318 "The decision to adopt a tax system that provides opportunities for taxpayers to exercise choice, and thus allows them to determine their own tax liability, reflects deference to the value of personal autonomy." *Id.* at 16.

ter or erode the paradigm. What we believe to be true influences our reality.

In America, what are our benefit expectations from our government? What do we expect to pay for our civilized society? The answer to these questions may, in fact, vary depending upon our individual historical perspectives.[319]

Anyone 70 years old or older in America today, for example, will have a very different personal, historical and cultural perspective than members of younger generations. These individuals lived through the depths of the Great Depression as youngsters and experienced first hand the implementation of the New Deal. Sacrifice, hunger, and hard work were nothing new to them. They witnessed the horrors of no federal unemployment insurance protection and no federal regulation of pensions, as well as destitution among injured family members who had no access to state or federal disability assistance. In addition, these individuals were witnesses to and participants in a world war fought from both shores. They suffered the loss of nearly 300,000 lives at sea and on foreign soil, and nearly 700,000 of them came home wounded.[320] They endured the mania of Hitler and the decimation of six million Jews. And all of this became a part of their individual, historical perspectives before they were out of their 20s! Obviously, these experiences shaped their attitudes toward government, benefit expectations, and the price that needed to be paid for public welfare and protection.

The next generation, the so-called Baby Boom generation, generally had a better life thanks to the sacrifice and hard work of those who had gone before. Economic depression and world war did not shape the beliefs of the Baby Boomers. They generally experienced less hardship and sacrifice, were the beneficiaries of more government benefits and protections, enjoyed the idealism of the Kennedy era, and suffered through the disillusion of the Vietnam War, assassinations, and Watergate. Now they are heading toward retirement, expecting that the generation immediately behind them will provide for them as they have provided for their parents.

What is the strength of belief of those in their 20s and 30s toward their responsibility for the welfare of the Baby Boomers through the tax system? For the small percentage of the popula-

319 It is always dangerous to attempt to summarize attributes of entire generations of people. For example, the media term "Generation X" has been used to describe an entire generation of people roughly between the ages of 18 and 38, and yet 28-year old author Michele Mitchell detests this term. *See* MICHELE MITCHELL, A NEW KIND OF PARTY ANIMAL: HOW THE YOUNG ARE TEARING UP THE AMERICAN POLITICAL LANDSCAPE (1998); Dennis McLellan, *New Kids in the Bloc*, L.A. TIMES, Sept. 30, 1998, at E1 (Orange County ed.). I will attempt to avoid overly broad statements in my generational observations.

320 *See* STATISTICAL ABSTRACT, *supra* note 210, at 366 tbl.569.

tion today who falls into this age bracket, the responsibility must seem daunting.[321] This generation was bussed to school in order to effectuate integration, or their families moved to the suburbs to avoid the issue. Before they were 20, they experienced America putting a man on the moon, the end of the Vietnam War with neither victory nor defeat, and the only resignation of a President that America has ever known. In their 30s, they witnessed tax reform which, when coupled with the continuation of major federal expenditures, resulted in the ballooning of the federal deficit to its peak of $290.4 billion in 1992.[322] Governmental expectations became entrenched institutions of education and welfare.

What about those under the age of 20 today? They have known only three Presidents—Reagan, Bush, and Clinton. In many respects, this generation is a study in contrasts. For example, a recent survey of our teens indicates that they are dramatically lacking in knowledge of their government and their legal system. Only 41% could name the three branches of government; only 21% knew how many members were in the Senate; and only 2% knew the name of the Chief Justice of the U.S. Supreme Court.[323] These are the same children who have never known a typewriter, and who receive vast amounts of information daily through computers and the Internet.[324] These children have experienced dramatic changes in the stock market and the general resurgence of a vital economy; yet 20% of all children living in America today live in poverty.[325] Nowhere is the line between the "haves" and "have nots" greater than in this age group.[326] The changing concept of family is also dramatically in evidence in this age group. Three out of every 10 children under the age of 18 in America today are being raised in a single-parent household; this figure was just 1.3 out of 10 in 1970.[327]

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321 There are approximately 76 million Baby Boomers. *See* Carolyn Lochhead, *Clash of the Titans: Collision Between Baby Boom Generation and the New Deal,* REASON, Mar. 1997, at 42. *See also* Robert A. Rosenblatt, *Securing the Future for Women,* L.A. TIMES, Jan. 27, 1999, at E1 (Orange County ed.). "The big debate deals with keeping Social Security solvent so baby boomers can get their checks. The crisis year is 2032, when Social Security will have consumed its surplus, and payroll taxes will be sufficient to pay only 75% of benefits promised under current law." *Id.*

322 *See* ECONOMIC REPORT OF THE PRESIDENT 373 tbl.B-78 (1998).

323 *See Teens Know of DiCaprio but Not Rehnquist,* L. A. TIMES, Sept. 3, 1998, at A17.

324 "[T]hree-quarters of young people aged between 15 and 24 are familiar with computers." *Spotlight: Personal Computers,* MKT. WEEK, Feb. 19, 1998, at 38.

325 Poverty rates for all children in 1997 were at 19.9%. *See* JOSEPH DALAKER & MARY NAIFEH, POVERTY IN THE UNITED STATES 1997, at vi (Bureau of the Census Current Population Reports No. P60-201, 1998).

326 "[C]hildren continued to represent a large share of the poor population (40 percent) even though they were only about one-fourth of the total population." *Id.*

327 Only 69% of these children are being raised in two-parent households; 31% are being raised in single-parent households. *See* STATISTICAL ABSTRACT, *supra* note 210, at 61 tbl.71. These figures contrast with 1970 figures of 87% of children living in two-parent households and 13% in single-parent households. *Id.*

What does all of this mean for the issue at hand—that of federal tax policy? I believe it means that we cannot and should not make sweeping generalizations about what Americans want or need when it comes to a federal tax system. We, as tax commentators, need to "keep perspective." We must remain ever vigilant that economics does not so dominate our analysis that we forget we are talking about people and not economic charts and models. We must be ever sensitive to our cultural perspectives—our individual histories, beliefs, and values and our perceptions about those beliefs—when proposing and discussing federal tax policy for the new millennium.

Most importantly, we must be ever vigilant to the fact that wealth, no matter how defined—whether in terms of property or income—equates into opportunity. We tax the wealthy at a greater rate not necessarily because the wealthy derive more governmental benefits, but rather because their wealth affords them so much cultural opportunity.[328] Professors Blum and Kalven observe that:

> the gravest source of inequality of opportunity in our society is not economic but rather what is called cultural inheritance for lack of a better term. Under modern conditions the opportunities for formal education, healthful diet and medical attention to some extent can be equalized by economic means without too greatly disrupting the family. However, it still remains true that even today much of the transmission of culture, in the narrow sense, occurs through the family, and no system of public education and training can completely neutralize this form of inheritance. Here it is the economic investment in the parents

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328 We also must maintain a minimal, less burdensome connectedness to the nonproximate stranger. At this minimal level of care, I need make no great sacrifices to help the unmet others. Moreover, I need respond only to those others' most urgent and basic demands. The basic needs of any person go beyond those of bare survival to include attainment of the preconditions of liberty that allow us to be free, voluntary agents working towards self-fulfillment. These conditions include education and some level of personal safety and comfort. Only when a person has these basics is she able to work towards her potential and self-fulfillment. The minimal level of care, then, requires that I help others attain these basics so that they have an opportunity to achieve self-fulfillment just as I do. Because it involves a minimal level of responsibility, my obligation to help others attain this state of opportunity does not require that I give up my own opportunity, nor even that I constrain it very much. It does require that as my discretionary income grows, I contribute money at a greater rate than previously to help others. This is not an unduly burdensome obligation. It denies me no freedom of action. I can still choose when, where, and how much to work. I am still rewarded for my efforts. The income contribution required of me will not be so large as to unduly handicap my own attempts at self-fulfillment. As my income grows, it is easier for me to contribute more without impinging on my ability to reach my own goals. My minimal obligation to others requires that I contribute that nonintrusive amount. Thus, a progressive income tax rate satisfies my obligation to myself and others. It is not a redistribution of wealth, merely a paying off of my "just debts" to others.

Kornhauser, *supra* note 234, at 510-11.

and the grandparents, irrevocably in the past, which produces differential opportunities for the children.[329]

IV. CONCLUSION

Our initial inquiry may be wrong. We should not be analyzing the tax side of the federal income tax as much as the income side of the equation. For me, the problem is not so much with the federal income tax and its distributional effects, but rather with the issue of income—who has it and who does not, as well as who has an *opportunity* to have it and who does not. The issue is not so much a matter that Americans need less taxes; rather, they need more income.

This conclusion brings us back to our historical and cultural perspective. Historically, Americans were taxed through a consumption-based system of excise taxes and tariffs imposed upon the purchase of goods. These taxes were perceived to be unfair because very few Americans had any income of which to speak. Before the days of government regulation and unions, men, women, and children of all ages slaved in jobs for exceedingly long hours, and under gruesome conditions, and for very little pay. The burden of excise taxes and tariffs fell disproportionately upon the working class. These hardworking Americans were not empowered; they often lacked education, suffered from racial and ethnic discrimination, and initially lacked organization. Most importantly, the burdens of economic development were intentionally thrust upon the unempowered poor.

Thus the problem is, historically, what it has always been: the gross disparity in the distribution of income throughout the U.S. population. This article has repeatedly highlighted the ever-present income disparity throughout our history. Depressingly, the income disparities of today are painfully reminiscent of the statistics of 1860, 1890, and 1920. Our "evolved" Internal Revenue Code does little to remedy this income disparity, but rather exacerbates it with a plethora of tax preference items favoring wealthy owners of capital. At a minimum, Congress needs to return the Code to its original constitutional mandate of taxing "income from whatever source derived," broadening the tax base by eliminating many of the tax preference items that disproportionately favor the wealthy in the name of "stimulating the economy."

Our cultural perspective reveals that we will likely not embrace a wholesale substitution for our current income tax system, that the wealthy, predominantly male politicians will continue to perpetuate their self-preservationist agenda through the tax sys-

329 Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417, 504 (1952).

tem, that tax expenditure items have severely enhanced the disproportionality of income distribution throughout the United States, that a rational, economic solution may not address our basically irrational economic nature, that fundamental reform is not likely to survive the harsh reality of the American political process, and that we have been cajoled into believing that the Internal Revenue Code can cure all social and economic ills. Not an optimistic, uplifting summation, I realize, but a culturally and historically accurate one nonetheless.

Perhaps our system of taxation is not as civilized as we would like because our society is not as civilized as it could be. After all, our system of taxation can only be as civilized as our society. If taxes are, in fact, the price we pay for a civilized society, we are not getting our money's worth under the current federal income tax system.

(TO BE FILLED IN BY COLLECTOR.)

List No. .....

..... *District of* .....

Date received .....

Form 1040.

INCOME TAX.

THE PENALTY
FOR FAILURE TO HAVE THIS RETURN IN THE HANDS OF THE COLLECTOR OF INTERNAL REVENUE ON OR BEFORE MARCH 1 IS $20 TO $1,000.
(SEE INSTRUCTIONS ON PAGE 4.)

(TO BE FILLED IN BY INTERNAL REVENUE BUREAU.)

File No. .....

Assessment List .....

Page ..... *Line* .....

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL NET INCOME OF INDIVIDUALS.

(As provided by Act of Congress, approved October 3, 1913.)

RETURN OF NET INCOME RECEIVED OR ACCRUED DURING THE YEAR ENDED DECEMBER 31, 191__
(FOR THE YEAR 1913, FROM MARCH 1, TO DECEMBER 31.)

Filed by (or for) ..... (Full name of individual.) *of* ..... (Street and No.)

in the City, Town, or Post Office of ..... *State of* .....
(Fill in pages 2 and 3 before making entries below.)

1. Gross Income (see page 2, line 12)	$
2. General Deductions (see page 3, line 7)	$
3. Net Income	$

Deductions and exemptions allowed in computing income subject to the normal tax of 1 per cent.

4. Dividends and net earnings received or accrued, of corporations, etc., subject to like tax. (See page 2, line 11)	$	
5. Amount of income on which the normal tax has been deducted and withheld at the source. (See page 2, line 9, column A)		
6. Specific exemption of $3,000 or $4,000, as the case may be. (See Instructions 3 and 19)		
Total deductions and exemptions. (Items 4, 5, and 6)		$
7. Taxable Income on which the normal tax of 1 per cent is to be calculated. (See Instruction 3)		$

8. When the net income shown above on line 3 exceeds $20,000, the additional tax thereon must be calculated as per schedule below:

	Income.	Tax.
1 per cent on amount over $20,000 and not exceeding $50,000	$	$
2 " " 50,000 " " 75,000		
3 " " 75,000 " " 100,000		
4 " " 100,000 " " 250,000		
5 " " 250,000 " " 500,000		
6 " " 500,000		
Total additional or super tax		$
Total normal tax (1 per cent of amount entered on line 7)		$
Total tax liability		$

2

GROSS INCOME.

This statement must show in the proper spaces the entire amount of gains, profits, and income received by or accrued to the individual from all sources during the year specified on page 1.

DESCRIPTION OF INCOME.	A. Amount of income on which tax has been deducted and withheld at the source.	B. Amount of income on which tax has not been deducted and withheld at the source.
1. Total amount derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid	$	$
2. Total amount derived from professions, vocations, businesses, trade, commerce, or sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, including bonds, stocks, etc		
3. Total amount derived from rents and from interest on notes, mortgages, and securities (other than reported on lines 5 and 6)		
4. Total amount of gains and profits derived from partnership business, whether the same be divided and distributed or not		
5. Total amount of fixed and determinable annual gains, profits, and income derived from interest upon bonds and mortgages or deeds of trust, or other similar obligations of corporations, joint-stock companies or associations, and insurance companies, whether payable annually or at shorter or longer periods		
6. Total amount of income derived from coupons, checks, or bills of exchange for or in payment of interest upon bonds issued in *foreign countries* and upon *foreign mortgages* or like obligations (not payable in the United States), and also from coupons, checks, or bills of exchange for or in payment of any dividends upon the stock or interest upon the obligations of foreign corporations, associations, and insurance companies engaged in business in foreign countries		
7. Total amount of income received from fiduciaries		
8. Total amount of income derived from any source whatever, not specified or entered elsewhere on this page		
9. TOTALS	$	$
NOTE.—Enter total of Column A on line 5 of first page.		
10. AGGREGATE TOTALS OF COLUMNS A AND B		$
11. Total amount of income derived from dividends on the stock or from the net earnings of corporations, joint-stock companies, associations, or insurance companies subject to like tax (To be entered on line 4 of first page.)		$
12. TOTAL "Gross Income" (to be entered on line 1 of first page)		$

3

GENERAL DEDUCTIONS.

1. The amount of necessary expenses actually paid in carrying on business, but not including business expenses of partnerships, and not including personal, living, or family expenses	$			
2. All interest paid within the year on personal indebtedness of taxpayer				
3. All national, State, county, school, and municipal taxes paid within the year (not including those assessed against local benefits)				
4. Losses actually sustained during the year incurred in trade or arising from fires, storms, or shipwreck, and not compensated for by insurance or otherwise				
5. Debts due which have been actually ascertained to be worthless and which have been charged off within the year				
6. Amount representing a reasonable allowance for the exhaustion, wear, and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per cent of the gross value at the mine of the output for the year for which the computation is made, but no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof, for which an allowance is or has been made				
7. Total "GENERAL DEDUCTIONS" (to be entered on line 2 of first page)				

AFFIDAVIT TO BE EXECUTED BY INDIVIDUAL MAKING HIS OWN RETURN.

I solemnly swear (or affirm) that the foregoing return, to the best of my knowledge and belief, contains a true and complete statement of all gains, profits, and income received by or accrued to me during the year for which the return is made, and that I am entitled to all the deductions and exemptions entered or claimed therein, under the Federal Income-tax Law of October 3, 1913.

Sworn to and subscribed before me this _____ day of _____, 191

_____
(Signature of individual.)

SEAL OF OFFICER TAKING AFFIDAVIT.

_____
_____
(Official capacity.)

AFFIDAVIT TO BE EXECUTED BY DULY AUTHORIZED AGENT MAKING RETURN FOR INDIVIDUAL.

I solemnly swear (or affirm) that I have sufficient knowledge of the affairs and property of _____ to enable me to make a full and complete return thereof, and that the foregoing return, to the best of my knowledge and belief, contains a true and complete statement of all gains, profits, and income received by or accrued to said individual during the year for which the return is made, and that the said individual is entitled, under the Federal Income-tax Law of October 3, 1913, to all the deductions and exemptions entered or claimed therein.

Sworn to and subscribed before me this _____ day of _____, 191

_____
(Signature of agent.)

ADDRESS IN FULL _____
_____

SEAL OF OFFICER TAKING AFFIDAVIT.

_____
_____
(Official capacity.)

c 3—7337

[SEE INSTRUCTIONS ON BACK OF THIS PAGE.]

4

INSTRUCTIONS.

1. This return shall be made by every citizen of the United States, whether residing at home or abroad, and by every person residing in the United States, though not a citizen thereof, having a *net income* of $3,000 or over for the taxable year, and *also* by every *nonresident alien* deriving income from property owned and business, trade, or profession carried on *in the United States* by him.

2. When an individual by reason of minority, sickness or other disability, or absence from the United States, is unable to make his own return, it may be made for him by his *duly authorized* representative.

3. The *normal tax* of 1 per cent shall be assessed on the total net income less the specific exemption of $3,000 or $4,000 as the case may be. (For the year 1913, the specific exemption allowable is $2,500 or $3,333.33, as the case may be.) If, however, the normal tax has been deducted and withheld on any part of the income at the source, or if any part of the income is received as dividends upon the stock or from the net earnings of any corporation, etc., which is taxable upon its net income, such income shall be deducted from the individual's total *net income* for the purpose of calculating the amount of income on which the individual is liable for the normal tax of 1 per cent by virtue of this return. (See page 1, line 7.)

4. The *additional or super tax* shall be calculated as stated on page 1.

5. This return shall be filed with the Collector of Internal Revenue for the district in which the individual resides if he has no other place of business, otherwise in the district in which he has his *principal place of business;* or in case the person resides in a foreign country, then with the collector for the district in which his principal business is carried on in the United States.

6. This return must be filed on or before the first day of March succeeding the close of the calendar year for which return is made.

7. The *penalty for failure to file the return within the time specified by law* is $20 to $1,000. In case of refusal or neglect to render the return within the required time (except in cases of sickness or absence), 50 per cent shall be added to amount of tax assessed. In case of *false or fraudulent return*, 100 per cent shall be added to such tax, and any person required by law to make, render, sign, or verify any return who makes any false or fraudulent return or statement with intent to defeat or evade the assessment required by this section to be made shall be guilty of a misdemeanor, and shall be fined not exceeding $2,000 or be imprisoned not exceeding one year, or both, at the discretion of the court, with the costs of prosecution.

8. When the return is not filed within the required time by reason of sickness or absence of the individual, an extension of time, not exceeding 30 days from March 1, within which to file such return, *may be* granted by the collector, *provided* an application therefor is made by the individual within the period for which such extension is desired.

9. This return properly filled out must be made under oath or affirmation. Affidavits may be made before any officer *authorized by law* to administer oaths. If before a justice of the peace or magistrate, not using a seal, a *certificate of the clerk of the court as to the authority* of such officer to administer oaths should be *attached to the return.*

10. Expense for medical attendance, store accounts, family supplies, wages of domestic servants, cost of board, room, or house rent for family or personal use, *are not expenses that can be deducted from gross income.* In case an individual owns his own residence he can not deduct the estimated value of his rent, neither shall he be required to include such estimated rental of his home as income.

11. The farmer, in computing the net income from his farm for his annual return, shall include all moneys received for produce and animals sold, and for the wool and hides of animals slaughtered, provided such wool and hides are sold, and he shall deduct therefrom the sums actually paid as purchase money for the animals sold or slaughtered during the year.

When animals were raised by the owner and are sold or slaughtered he shall not deduct their value as expenses or loss. He may deduct the amount of money actually paid as expense for producing any farm products, live stock, etc. In deducting expenses for repairs on farm property the amount deducted must not exceed the amount actually expended for such repairs during the year for which the return is made. (See page 3, item 6.) The cost of replacing tools or machinery is a deductible expense to the extent that the cost of the new articles does not exceed the value of the old.

12. In calculating losses, only such losses as shall have been actually sustained and the amount of which has been definitely ascertained during the year covered by the return can be deducted.

13. Persons receiving fees or emoluments for professional or other services, as in the case of physicians or lawyers, should include all actual receipts for services rendered in the year for which return is made, together with all unpaid accounts, charges for services, or contingent income due for that year, if good and collectible.

14. Debts which were contracted during the year for which return is made, but found in said year to be worthless, may be deducted from gross income for said year, but such debts can not be regarded as worthless until after legal proceedings to recover the same have proved fruitless, or it clearly appears that the debtor is insolvent. If debts contracted prior to the year for which return is made were included as income in return for year in which said debts were contracted, and such debts shall subsequently prove to be worthless, they may be deducted under the head of losses in the return for the year in which such debts were charged off as worthless.

15. Amounts due or accrued to the individual members of a partnership from the net earnings of the partnership, whether apportioned and distributed or not, shall be included in the annual return of the individual.

16. United States pensions shall be included as income.

17. Estimated advance in value of real estate is not required to be reported as income, unless the increased value is taken up on the books of the individual as an increase of assets.

18. Costs of suits and other legal proceedings arising from ordinary business may be treated as an expense of such business, and may be deducted from gross income for the year in which such costs were paid.

19. An unmarried individual or a married individual not living with wife or husband shall be allowed an exemption of $3,000. When husband and wife live together they shall be allowed jointly a total exemption of only $4,000 on their aggregate income. They may make a joint return, both subscribing thereto, or if they have separate incomes, they may make separate returns; but in no case shall they jointly claim more than $4,000 exemption on their aggregate income.

20. In computing net income there shall be excluded the compensation of all officers and employees of a State or any political subdivision thereof, except when such compensation is paid by the United States Government.

Universal Pensions

*Jonathan Barry Forman**

I. INTRODUCTION

Most Americans are not saving enough for their retirement. According to U.S. Department of Labor Secretary Alexis M. Herman, the average worker should save at least $6444 per year for retirement.[1] Yet, 20% of American workers have saved absolutely nothing toward retirement, and 13% of those who have started saving for retirement have less than $9000 put aside.[2]

Financial planners usually say that an individual needs a retirement income equal to about 60% to 80% of pre-retirement earnings.[3] Achieving that goal depends on building a proverbial three-legged stool consisting of Social Security, private pensions, and private savings. Unfortunately, all three of those "legs" are in trouble today.[4]

First, Social Security is in financial trouble. According to the actuaries, the Social Security trust fund will be depleted by 2032, and the annual tax income of the then-depleted trust fund will only cover about 75% of the cost of benefits payable.[5] As a result, the federal government will need to either raise Social Security taxes or cut benefits, and nobody seems very interested in raising taxes.

Second, private pension coverage has stagnated. More than 50 million Americans—about half of the workforce—have no private pension coverage at all, whether through an employer-pro-

* Professor of Law, University of Oklahoma; B.A. 1973, Northwestern University; M.A. (Psychology) 1975, University of Iowa; J.D. 1978, University of Michigan; M.A. (Economics) 1983, George Washington University. Delegate to the 1998 National Summit on Retirement Savings. Research assistance was provided by Melissa French.

1 Alexis M. Herman, *Uncle Sam Wants You . . . to Save Your Money for Retirement*, WASH. POST NAT'L WEEKLY ED., June 1, 1998, at S1 (Advertising Supp.).

2 *See id.*

3 *See* CHRISTOPHER CONTE, AGENDA BACKGROUND MATERIALS FOR THE NATIONAL SUMMIT ON RETIREMENT SAVINGS: JUNE 4-5, 1998, at 6 (1998).

4 *See* U.S. DEPT. OF LABOR, FINAL REPORT ON THE NATIONAL SUMMIT ON RETIREMENT SAVINGS (1998). *See also* Christopher T. Kelley, Note, *Uncertainty in the Golden Years: The Growing Demands Upon the American Retirement Security System*, 2 ELDER L.J. 225 (1994).

5 *See* SOCIAL SECURITY AND MEDICARE BOARDS OF TRUSTEES, STATUS OF THE SOCIAL SECURITY AND MEDICARE PROGRAMS: A SUMMARY OF THE 1998 ANNUAL REPORTS 7-8 (1998).

vided plan or through individual retirement accounts (IRAs).[6] Workers in small businesses are particularly hard-hit: only about 25% of the workers in these companies are covered by some kind of pension plan.[7]

Third, private savings have also fallen. Americans are saving just 3.8% of their disposable incomes, down from 9.2% in 1946.[8]

Yet, because American workers are living longer and retiring earlier, they will need more savings than ever. For example, a boy born in 1940 had a life expectancy of just 61.4 years, but a boy born in the year 2000 can expect to live 73.2 years.[9] Moreover, a man reaching age 65 in 1940 could expect to live just 11.9 years, but a man reaching 65 in the year 2000 can expect to live another 15.8 years.[10]

Despite these increased life expectancies, Americans are retiring earlier and earlier. The average age at which workers begin receiving Social Security has fallen from 68.7 years old in 1940 to 63.6 in 1995.[11] Also, in 1996, only 16.9% of men and 8.6% of women aged 65 or older were still working.[12]

Of course, it is great that we are living longer, and it is wonderful that we can expect to have long and leisurely retirements, but these developments have led to the current financing problems for Social Security, and compound the shortfalls in private pensions and private savings. By 2020, there will be more than 53 million Americans age 65 and older,[13] but many will not be able to afford to retire.

The time has come to admit that America's current retirement policies are failing. Only then can a new comprehensive retirement policy be developed. The nation needs a retirement system that actually will ensure that all Americans have adequate incomes throughout their retirement years. In short, the country needs a universal pension system that works.

At the outset, Part II of this article provides an overview of the current retirement system, and Part III discusses the need for a universal pension system. Part IV then considers three ap-

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6 *See* Newt Gingrich, *50 Million American Workers Have No Retirement Coverage*, WASH. POST NAT'L WEEKLY ED., June 1, 1998, at S1 (Advertising Supp.).

7 *See id.*

8 *See* CONTE, *supra* note 3, at 10-11.

9 *See* STAFF OF THE HOUSE COMM. ON WAYS AND MEANS, 105TH CONG., 1998 GREEN BOOK: BACKGROUND MATERIAL AND DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS 1031 tbl.A-2 (Comm. Print 1998) [hereinafter 1998 GREEN BOOK].

10 *See id.*

11 *See id.* at 21 tbl.1-2

12 *See id.* at 1032.

13 *See* FRANK B. HOBBES WITH BONNIE L. DANNON, 65+ IN THE UNITED STATES 5-7 (Current Population Reports Special Study No. P23-190, 1996) [hereinafter 65+ IN THE UNITED STATES].

proaches for providing a pension system that would ensure that all Americans have adequate incomes throughout their retirement years. Specifically, Part IV considers how a voluntary and universal individual retirement savings account system might work, how an expanded Social Security system might work, and how a mandatory universal private pension system might work. Finally, Part V considers which of these universal pensions approaches shows the most promise, and Part VI considers some issues that are common to all universal pension systems.

II. An Overview of the Current Retirement System

A. Social Security

The Social Security system includes three programs that provide monthly cash benefits to workers and their families. The Old-Age and Survivors Insurance (OASI) program provides monthly cash benefits to retired workers and their dependents and to survivors of insured workers, and the Disability Insurance (DI) program provides monthly cash benefits for disabled workers under age 65 and their dependents.[14] A worker builds protection under these programs by working in employment that is covered by Social Security and paying the applicable payroll taxes. At present, about 96% of the work force are in covered employment.[15] At retirement, disability, or death, monthly Social Security benefits are paid to insured workers and to their eligible dependents and survivors. In addition, Supplemental Security Income provides monthly cash benefits to low-income elderly Americans.[16]

The OASI program is, by far, the largest of these programs, and it is usually what people mean when they talk about Social Security. In 1997, for example, the OASI program paid more than $316 billion in benefits to almost 38 million Americans, with the average benefit paid to a retired worker being about $765 per month.[17] Consequently, for the remainder of this article, the term "Social Security" will refer to OASI taxes, and the terms "Social Security benefits" will refer to OASI benefits.

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14 *See generally* Social Security Act, Pub. L. No. 74-271, 49 Stat. 620 (1935) (codified as amended at 42 U.S.C. §§ 301-1397f); *see also* 1998 Green Book, *supra* note 9, at 1-99; Soc. Sec. Admin., Soc. Sec. Handbook (13th ed. 1997); and Soc. Sec. Admin., Soc. Sec. Bull., Ann. Stat. Supp. (1997).

15 *See* 1998 Green Book, *supra* note 9, at 10 tbl.1-4.

16 *See id.* at 261-326. In 1997, for example, the maximum federal benefit for an individual was $484 per month, and the maximum federal benefit for couples was $726 per month; however, some states provided small additional supplements. *See id.* at 277.

17 *Current Operating Statistics: List of Tables*, Soc. Sec. Bull., No. 2, 1988, at 43, 45, 47, 48.

1. Social Security Taxes

Social Security benefits are overwhelmingly financed through payroll taxes imposed on individuals working in covered employment or self-employment.[18] For 1999, employees and employers each pay a tax of 5.35% on up to $72,600 of wages earned in covered employment, for a combined OASI rate of 10.7%.[19] Self-employed workers pay an equivalent OASI tax of 10.7% on up to $72,600 of net earnings.[20]

2. Social Security Benefits

Workers over age 62 generally are entitled to OASI benefits if they have worked in covered employment for at least 10 years. Benefits are based on a measure of the worker's earnings history in covered employment, known as the average indexed monthly earnings (AIME). Basically, the AIME measures the worker's career-average monthly earnings in covered employment.

The AIME is linked by a formula to the monthly retirement benefit payable to the worker at normal retirement age, a benefit known as the primary insurance amount (PIA). For a worker turning 62 in 1999, the PIA is equal to 90% of the first $505 of the worker's AIME, plus 32% of the AIME over $505 and through $3043 (if any), plus 15% of the AIME over $3043 (if any).[21] It is worth noting that, on its face, the benefit formula is progressive, meaning that it is designed to favor workers with relatively low career-average earnings.

Dependents and survivors of the worker may also receive additional monthly benefits. These so-called auxiliary benefit amounts are also based on the worker's PIA. For example, a 65 year-old wife or husband of a retired worker is entitled to a monthly spousal benefit equal to 50% of the worker's PIA, and the widow or widower of the worker is entitled to a monthly surviving spouse benefit equal to 100% of the worker's PIA.

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18 In addition, as much as 85% of a taxpayer's Social Security benefits is subject to income taxation. The actual amount to be included is determined by applying a complicated two-tier formula. *See* I.R.C. § 86 (1994 & Supp. II 1996). Basically, single taxpayers with incomes over $25,000, and married couples with incomes over $32,000, must include as much as half of their Social Security benefits in income, while single taxpayers with incomes over $34,000, and married couples with incomes over $44,000, must include as much as 85% of their Social Security benefits in income.

19 The OASI rate represents the lion's share of the total rate of 15.3% that is collected for OASI, disability insurance, and Medicare. *See* 1999 Cost-of-Living Increase and Other Determinations, 63 Fed. Reg. 58,446 (1998) [hereinafter 1999 Social Security COLA Determinations].

20 *See id.*

21 *See id.*

B. Private Retirement Plans

1. ERISA-Covered Plans

Most private retirement plans are governed by the Employee Retirement Income Security Act of 1974 (ERISA).[22] These plans generally fall into two broad categories based on the nature of the benefits provided: defined benefit plans and defined contribution plans.

These private retirement plans typically qualify for favorable tax treatment. Basically, an employer's contributions to a tax-qualified pension plan on behalf of an employee is not taxable to the employee.[23] Nevertheless, the employer is allowed a current deduction for these contributions (within limits).[24] Moreover, the pension fund's earnings on these contributions are tax-exempt.[25] Workers pay tax only when they receive distributions of their pension benefits,[26] and, at that point, the usual rules for taxing annuities apply.[27]

a. Defined benefit plans

Defined benefit plans typically provide each worker with a specific annual retirement benefit that is tied to the worker's final average compensation and number of years of service. For example, a plan might provide that a worker's annual retirement benefit (B) is equal to 2% times years of service (yos) times final average compensation (fac) (B = 2% x yos x fac). Under this formula, a typical worker with 30 years of service would receive a retirement benefit equal to 60% of her preretirement earnings (B = 60% x fac = 2% x 30 yos x fac). Final average compensation is typically computed by averaging the worker's salary over the three years immediately prior to retirement.

b. Defined contribution plans

Under a typical defined contribution plan, the employer simply contributes a specified percentage of the worker's compensation to an individual investment account for the worker. For example, contributions might be set at 10% of annual compensa-

22 Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended in scattered sections of Titles 26 and 29 of the United States Code); *see generally* JOINT COMMITTEE ON TAXATION, 105TH CONG., OVERVIEW OF PRESENT-LAW TAX RULES RELATING TO QUALIFIED PENSION PLANS SCHEDULED FOR A HEARING BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE HOUSE COMMITTEE ON WAYS AND MEANS ON MAY 5, 1998 (Comm. Print JCX-30-98, 1998).

23 I.R.C. § 402 (1994 & Supp. III 1997).

24 I.R.C. § 404 (1994 & Supp. III 1997).

25 I.R.C. § 501(a) (1994).

26 I.R.C. § 402.

27 I.R.C. § 72 (1994 & Supp. III 1997).

tion. Under such a plan, a worker who earned $30,000 in a given year would have $3000 contributed to an individual investment account for her. Her benefit at retirement would be based on all such contributions plus investment earnings thereon. There are a variety of different types of defined contribution plans, including money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans (ESOPs).

Profit-sharing and stock bonus plans may include a 401(k) feature which allows workers to choose between receiving cash currently or deferring taxation by placing the money in a retirement account.[28] Consequently, they are sometimes called cash or deferred arrangements (CODAs). The maximum annual amount of elective deferrals that can be made by an individual in 1999 is $10,000.[29] Elective contributions are subject to payroll taxation, however.[30]

c. Coverage

As of 1993, about 43% of private-sector workers were covered by at least one pension plan.[31] Defined contribution plans comprised 88% of these plans, up from 67% in 1975.[32] Moreover, 42% of the active participants in those private-sector plans had a defined contribution plan as their primary plan, up from just 13% in 1975.[33] Similarly, in 1993, 88% of private employers with only one retirement plan sponsored only a defined contribution plan, up from 68% in 1984.[34] Also of note, 401(k) plans are the fastest growing part of the defined contribution world. Their share of private retirement plans grew from 3% to 14% from 1984 to 1990.[35] At the same time, their share of employer-sponsored retirement plan participants grew from 19% to 46%.[36]

2. IRAs and Roth IRAs

Favorable tax rules are also available for certain individual retirement accounts (IRAs).[37] Under the current IRA rules, al-

28 I.R.C. § 401(k) (1994 & Supp. III 1997).

29 *See* IRS News Release No. IR-98-63 (Oct. 23, 1998), *reprinted at* 25 BNA PENSION & BENEFITS REP. 2501 (1998).

30 *See, e.g.*, I.R.C. § 3121(a)(5) (1994 & Supp. III 1997).

31 *See* EMPLOYEE BENEFIT RESEARCH INSTITUTE, EBRI DATABOOK ON EMPLOYEE BENEFITS 81 (4th ed. 1997).

32 *See id.*

33 *See id.*

34 *See* U.S. GEN. ACCOUNTING OFFICE, MOST EMPLOYERS THAT OFFER PENSIONS USE DEFINED CONTRIBUTION PLANS 4 (Report No. GAO/GGD-97-1, 1996).

35 *See* U.S. GEN. ACCOUNTING OFFICE, IMPLICATIONS OF DEMOGRAPHIC TRENDS FOR SOCIAL SECURITY AND PENSION REFORM 46 (Report No. GAO/HEHS-97-81, 1997).

36 *See id.*

37 *See* I.R.C. §§ 219, 408 (1994 & Supp. III 1997).

most any worker can set up an IRA account with a bank or other financial institution and contribute up to $2000 (or, if less, 100% of compensation) each year to that account. Workers who are not covered by another retirement plan may deduct their IRA contributions. If the worker is covered by another retirement plan, however, the deduction may be reduced or eliminated if the worker's income exceeds $31,000 (in 1999) for a single taxpayer or $51,000 for married taxpayers.[38] Like private pensions, IRA earnings are tax-exempt, and distributions are taxable.

Also, since 1998, individuals have been allowed to set up so-called Roth IRAs.[39] Unlike regular IRAs, contributions to Roth IRAs are not deductible. Instead, withdrawals are tax-free. Like regular IRAs, however, the earnings of these Roth IRAs are tax-exempt.

III. The Need for a Universal Pension System

A. The Need for Adequate Retirement Incomes

Because Americans are living longer and retiring earlier, they will need more retirement savings than ever to ensure that they will have adequate retirement incomes. At the outset, Appendix 1 shows how life expectancies have increased since the turn of the century.[40] Appendix 1 shows, for example, that a boy born in 1940 had a life expectancy of just 61.4 years, but a boy born in the year 2000 can expect to live 73.2 years. A man reaching age 65 in 1940 could expect to live just 11.9 years, but a man reaching 65 in the year 2000 can expect to live another 15.8 years.

Moreover, as the years go by, an increasing percentage of Americans will survive to old age. For example, Appendix 2 shows that just 53.9% of men born in 1875 survived from age 21 to age 65 in 1940.[41] On the other hand, 82.7% of men born in 1985 are expected to survive from age 21 to age 65 in 2050.

Yet, even though life expectancies have increased throughout the century, there has been a trend toward earlier and earlier retirement. For example, Appendix 3 shows that the average age at which workers begin receiving their Social Security retirement benefits has fallen from 68.7 years old in 1940 to 63.6 years old in 1995.[42]

Not surprisingly, a number of analysts have expressed concern about the financial prospects of the elderly retirees in the

38 *See* I.R.C. § 219(g) (1994 & Supp. III 1997).

39 I.R.C. § 408A (West Supp. 1999).

40 *See* 1998 Green Book, *supra* note 9, at 1031 tbl.A-2.

41 *See* C. Eugene Steuerle & Jon M. Bakija, Retooling Social Security for the 21st Century: Right & Wrong Approaches to Reform 41 (1994).

42 *See* 1998 Green Book, *supra* note 9, at 21 tbl.1-12.

21st century.[43] In that regard, it is worth noting that the United States already has around 35 million residents who are age 65 and over, and around four million who are age 85 and over.[44] Moreover, by the year 2020, the United States will have more than 53 million residents age 65 and over, and almost seven million age 85 and over.[45]

The economic problems of these elderly citizens will be of paramount importance to the nation in the 21st century. In that regard, it is worth considering what it will cost to support the retired population. According to Lawrence Thompson, a senior fellow at the Urban Institute, the economic cost of supporting the elderly is best understood in terms of the fraction of society's goods and services that are consumed by the retired.[46] Specifically, "the cost of supporting the retired is simply the product of three different economic and demographic ratios:

(1) the *aggregate consumption ratio*, which is the fraction of total economic activity devoted to producing consumer goods and services;

(2) the *retiree dependency ratio*, which is the fraction of the population that is retired (which is going to be very similar to the aged dependency ratio); and

(3) the *living standards ratio*, which is the ratio of the average consumption of a retired person to the average consumption of all persons."[47]

This formulation can be used to illustrate the rather direct and simple relationships between the ratios and the cost of supporting the elderly.[48] For example, a 10% increase in the fraction of the population that is retired will result in a 10% increase in the

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43 *See, e.g.*, Daniel B. Radner, *The Retirement Prospects of the Baby Boom Generation*, SOC. SEC. BULL., No. 1, 1998, at 3; CONGRESSIONAL BUDGET OFFICE, BABY BOOMERS IN RETIREMENT: AN EARLY PERSPECTIVE (1993); COMMITTEE FOR ECONOMIC DEVELOPMENT, WHO WILL PAY FOR YOUR RETIREMENT?: THE LOOMING CRISIS (1995); RETIREMENT IN THE 21ST CENTURY . . . READY OR NOT . . . (Dallas L. Salisbury & Nora Super Jones eds., 1994); THE FUTURE OF PENSIONS IN THE UNITED STATES (Ray Schmitt ed., 1993); HENRY J. AARON ET AL., CAN AMERICA AFFORD TO GROW OLD?: PAYING FOR SOCIAL SECURITY (1989); NATIONAL COMMISSION ON RETIREMENT POLICY, CAN AMERICA AFFORD TO RETIRE? THE RETIREMENT SECURITY CHALLENGE FACING YOU AND THE NATION (1998).

44 *See* 65+ IN THE UNITED STATES, *supra* note 13, at 2-3, tbl.2-1.

45 *See id.*

46 LAWRENCE THOMPSON, OLDER & WISER: THE ECONOMICS OF PUBLIC PENSIONS 40 (1998).

47 *Id.* In terms of mathematical formula, the *basic formula* is: Cost of Supporting the Retired = Consumption of the Retired ÷ Total National Production. The *expanded formula* is: Cost of Supporting the Retired = ((Total Consumption ÷ Total National Production)(Number of Retirees ÷ Total Population)(Average Consumption of Retirees ÷ Average Consumption of Total Population)). In summary, the *cost of supporting the retired* is simply the product of: the *aggregate consumption ratio*; the *retiree dependency ratio*; and the *living standards ratio. Id.*

48 *See id.* at 41.

cost of supporting the retired.[49] In that regard, only about 12.8% of the U.S. population consists of persons age 65 or over today, but by 2020, 15.7% of the population will be 65 or older.[50] That's almost a 23% increase (122.66% = 15.7% / 12.8%).

Reducing the problem of how to support the elderly to mathematical formulae enabled Thompson to develop a model that can be used to estimate how much must be contributed to pensions in order to assure adequate incomes for the retired population.[51] At the outset, Thompson's simple model assumes that all workers enter the labor force at age 22, work exactly 43 years, retire on their 65th birthday, and die exactly 17 years later on their 82nd birthday. His simple model also assumes that while working, each earns the average wage and that in retirement, each receives a benefit equal to one-half the average wage (indexed to average wage levels).

Using his simple model, Thompson was able to estimate the annual contributions that would be needed to fund the proposed pension benefits (one-half of wages). Specifically, he found that annual contributions of 19.8% of payroll would be needed to provide pension benefits equal to one-half of the average wage.[52] Of particular note, in his simple model, contributions of 19.8% of wages would be required regardless of whether these pensions are provided through an individual savings account arrangement (like IRAs), a pay-as-you-go group pension plan (like Social Security), or an advance funded group pension plan (like traditional pensions).[53]

Of course, the real world is much more complex. A variety of demographic and economic factors can have an impact on the required contribution rate. For example, in the real world not everyone lives to retirement age, let alone to age 82. Incorporating more realistic mortality patterns reduces the contribution rate to 17.4% for a simple pay-as-you-go group pension plan.[54] On the other hand, because assets accumulated in a worker's individual savings account become a part of the worker's estate at death, there would be no such savings for an individual savings account arrangement.

Also, real world pension systems have administrative expenses that necessitate increasing the contribution rate—for example, back up to 17.8% for a simple pay-as-you-go system, but all

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49 *See id.*

50 *See* 65+ IN THE UNITED STATES, *supra* note 13, at 5-4. Similarly, by 2020, fully 2.1% of the U.S. population will consist of persons age 85 and over, up from 1.6% in the year 2000. *Id.*

51 THOMPSON, *supra* note 46, at 97-113.

52 *Id.* at 99.

53 *See id.* at 107. *See* Appendix 4.

54 *See id.* at 105.

the way up to 28.03% for an individual savings arrangement.[55] Moreover, while pay-as-you-go plans typically provide benefits in the form of an annuity, individual savers must pay an extra premium to acquire private annuities that will drive up the contribution rate for an individual savings plan. On the other hand, an increase in the rate of return (interest rates) can reduce the contribution rate for individual retirement savings plans, but such a change would have no effect on pay-as-you-go plans. Finally, changes in the birth rate, life expectancy, the inflation rate, or the rate of growth of wages also could have significant impacts on the contribution rates required under the various funding approaches.

Thompson's research shows that the "optimal" contribution rate will vary depending upon the pension funding mechanism chosen, and upon a host of demographic and economic factors that only can be estimated. Reasonable minds might well differ as to what the optimal contribution rate should be, but Thompson's research makes it crystal clear that the meager contribution rate required by the present Social Security system, a combined individual-employer rate of just 10.7% of the first $72,600 of compensation, cannot possibly fund adequate incomes for the retired population.

B. The Failure of the Current System

1. The Failure of Social Security

The success of the Social Security system is that, since its creation in 1935, poverty rates for the elderly have fallen from an estimated 50% in 1935, to around 11% today.[56] At the same time, however, the failure of Social Security is that it has not solved the problem of poverty among the elderly. Social Security alone cannot provide adequate income for retirees, yet it is virtually the only source of income for the poorest 40% of American retirees.[57]

In particular, women over the age of 65 continue to face a much higher risk than men of poverty in old age.[58] In that regard, it is worth noting that women tend to live longer than men, and that men tend to marry younger women.[59] The typical couple will spend about 15 years together in retirement, and the wife will live

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55 *See id.* at 107.

56 *See* U.S. GEN. ACCOUNTING OFFICE, SOCIAL SECURITY: DIFFERENT APPROACHES FOR ADDRESSING PROGRAM SOLVENCY 2 (Report No. GAO/HEHS-98-33, 1998) [hereinafter SOCIAL SECURITY SOLVENCY].

57 *See* CONTE, *supra* note 3, at 4.

58 *See* NATIONAL ECONOMIC COUNCIL INTERAGENCY WORKING GROUP ON SOCIAL SECURITY, WOMEN AND RETIREMENT SECURITY 5 (1998).

59 For example, the average life expectancy for women age 65 is about 19 years, versus about 15 years for 65-year-old men. *See* 1998 GREEN BOOK, *supra* note 9, at 1031 tbl.A-3.

another six years as a widow.[60] Indeed, women are five times more likely to become widowed,[61] and many of these women will find themselves living below the poverty level.[62] Similarly, elderly divorced women are particularly at risk. They tend to have an exceptionally high incidence of poverty (around 30%), an unusually high incidence of serious health problems, and low Social Security benefits.[63]

2. The Failure of the Private Pension System

The private pension system has failed to pick up the slack left by our inadequate Social Security system. Less than 60% of workers in the private sector are covered by pension plans, and only about 40% are covered by defined benefit plans.[64] Workers in small businesses are particularly hard-hit, with only about 25% of the workers in these companies covered by any type of pension plan.[65] In general, pension coverage tends to decrease as age, job tenure, firm size, and annual earnings decrease, and some industries and sectors are more likely to cover their workers than others.[66] Too many employees have no tax-favored savings vehicle to supplement Social Security beyond do-it yourself $2000-a-year IRAs.[67]

Also, despite their longer life expectancies and consequently greater need for retirement income, women have not found much support in the private retirement system.[68] Indeed, there is a particularly large gender gap concerning private pension income.[69]

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60 *See* Howard M. Iams & Stephen J. Sandell, *Cost-Neutral Policies to Increase Social Security Benefits for Widows: A Simulation for 1992*, SOC. SEC. BULL., No. 1, 1998, at 34, 37.

61 *See* Camilla E. Watson, *The Pension Game: Age- and Gender-based Inequities in the Retirement System*, 25 GA. L. REV. 1, 31 (1990).

62 *See* David E. Ott, *Survivor Income Benefits Provided by Employers*, MONTHLY LAB. REV., June 1991, at 13; David A. Weaver, *The Economic Well-Being of Social Security Beneficiaries, with an Emphasis on Divorced Beneficiaries*, SOC. SEC. BULL., No. 4, 1997, at 3.

63 *See* Weaver, *supra* note 62; Donald T. Ferron, *Social Security Benefits for Women Aged 62 or Older*, SOC. SEC. BULL., No. 4, 1997, at 32.

64 *See* William J. Wiatrowski, *On the Disparity Between Private and Public Pensions*, MONTHLY LAB. REV., Apr. 1994, at 3, 4.

65 *See* Gingrich, *supra* note 6.

66 *See* EMPLOYEE BENEFIT RESEARCH INSTITUTE, *supra* note 31, at 82; Donald O. Parsons, *Recent Trends in Pension Coverage Rates*, *in* PENSION AND WELFARE BENEFITS ADMIN., U.S. DEP'T LAB., PENSION COVERAGE ISSUES FOR THE '90S, at 39 (1994); Mary Ellen Benedict & Kathryn Shaw, *The Impact of Pension Benefits on the Distribution of Earned Income*, 48 INDUS. & LAB. REL. REV. 740, 746 (1995) (The empirical evidence shows that "high-wage workers are more likely to have pensions than are lower-wage workers; the probability of pension coverage is greater for workers in large firms, for men, for unionized workers, for high-tenure workers, and for highly educated workers.").

67 *See* Richard J. Kovach, *A Critique of SIMPLE—Yet Another Tax-Favored Retirement Plan*, 32 NEW ENG. L. REV. 401, 408 (1998).

68 *See* Watson, *supra* note 61.

69 There are many reasons for this gender gap in retirement income. In particular, women tend to earn less than men. Also, women tend to work for smaller companies that

While 46.5% of men over age 65 in 1995 received pension and/or annuity income, averaging $11,460 per year, only 26.4% of women over age 65 received a pension or annuity, and these averaged just $6684 per year.[70] Moreover, women age 50 or over are more likely to receive a pension benefit through their husbands (as spouses or survivors) than through their own savings or employment.[71]

C. Some Recent Efforts to Expand the Retirement System

Concerns about the adequacy of retirement incomes have led to a number of expansions in recent years. These expansions include the introduction of IRAs, Roth IRAs, SIMPLE retirement plans, simplified employee pensions, expanded 401(k) plan eligibility, and simplifications to ERISA.

1. IRAs and Roth IRAs

As retirement savings vehicles go, IRAs, themselves, are a relatively new phenomenon, and almost 80% of taxpayers are eligible to make tax-deductible contributions to them.[72] Moreover, Congress recently increased the amount that could be contributed to so-called spousal IRAs.[73] In addition, since 1998, individuals have been allowed to set up so-called Roth IRAs.[74]

2. SIMPLE Retirement Plans

In an effort to encourage more small employers to adopt retirement plans, the Small Business Job Protection Act of 1996 authorized employers with less than 100 employees to establish SIMPLE plans (savings incentive match plan for employees).[75] SIMPLE plans can be set up either as IRAs or 401(k) plans, and avoid many of the complex rules usually applicable to tax-qualified plans.

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are less likely to have a retirement plan. Women also tend to spend more time away from the workplace to raise a family or care for an aging relative. It has been found that there is a strong association between marital and fertility decisions and pension coverage. On the other hand, because younger women today spend more time in the work force and at more equal salaries, the financial security of women is likely to improve somewhat over time. *See, e.g.*, William E. Even & David A. Macpherson, *Gender Difference in Pensions*, 29 J. HUM. RESOURCES 555 (1994); Robin L. Lumsdaine et al., *Pension Plan Provisions and Retirement: Men and Women, Medicare, and Models*, *in* STUDIES IN THE ECONOMICS OF AGING, 183 (David A. Wise ed., 1994); Sophie M. Korcyzk, *Are Women's Jobs Getting Better, or Are Women Getting Better Jobs? in* PENSION AND WELFARE BENEFITS ADMIN., *supra* note 66, at 61.

70 *See* EMPLOYEE BENEFIT RESEARCH INSTITUTE, *supra* note 31, at 63.

71 *See id.*

72 Paul Yakoboski, *IRA Eligibility and Usage*, EBRI NOTES, Apr. 1995, at 5, 6 tbl.1.

73 *See* Kathy Stokes Murray & Paul Yakoboski, *Congress Considers IRA Expansion*, EBRI NOTES, Apr. 1995, at 1, 2; I.R.C. § 219(c) (1994 & Supp. III 1997).

74 *See* I.R.C. § 408A (West Supp. 1999).

75 I.R.C. § 408(p) (West Supp. 1999) (added by Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1421(a), 110 Stat. 1755, 1792 (1996)).

A SIMPLE plan allows employees to make elective contributions of up to $6000 per year, as long as the employer satisfies one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to 3% of the employee's compensation. Alternatively, the employer can instead make a 2% of compensation nonelective contribution on behalf of each eligible employee. The usual tax rules apply (i.e., the employer deducts and the employee excludes), and all contributions to an employee's SIMPLE account must vest immediately.

3. Simplified Employee Pensions

Simplified employee pensions (SEPs) were added to the Code to provide small businesses with an easy-to-use retirement plan.[76] SEPs have minimal paperwork because they rely on IRAs. To qualify, the employer must make a contribution on behalf of each employee who is at least 21 years old, has performed service for the employer during at least three of the immediately preceding five years, and received at least $400 in compensation from the employer for the year. Employer contributions are limited to the lesser of 15% of compensation or $30,000, and cannot discriminate in favor of highly compensated employees.

4. Expanding Eligibility for 401(k) Plans

Two recent changes have also helped to expand the universe of employees participating in 401(k) plans. First, the Small Business Job Protection Act of 1996 authorized tax-exempt organizations to adopt 401(k) plans.[77] Second, a recent ruling authorizes plan sponsors to automatically include employees in their 401(k) plans unless the employees affirmatively choose not to participate in the plan.[78]

5. Simplifying ERISA

Over the years, there have also been numerous amendments to ERISA. Often these amendments have been for the avowed purpose of simplifying the pension laws,[79] but relatively little simplification has occurred.

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76 I.R.C. §§ 402(h), 408(k) (1994 & Supp. III 1997).

77 I.R.C. § 401(k)(4)(B)(i) (1994 & Supp. III 1997) (added by Pub. L. No. 104-188, § 1704(k), 110 Stat. 1755, 1882 (1996)).

78 Rev. Rul. 98-30, 1998-25 I.R.B. 8.

79 *See, e.g.*, Kovach, *supra* note 67.

IV. Some Universal Pension Options

This Part considers three approaches that might be used to help ensure that all Americans have adequate incomes throughout their retirement years. Specifically, this Part considers how a voluntary and universal individual retirement account system, an expanded Social Security system, and a mandatory universal private pension system might work.

A. A Voluntary Universal IRA System

1. Recent Proposals to Expand IRAs

Over the years, there have been a number of proposals to expand IRAs, and it can be argued that expanding the IRA system would help encourage Americans to save for retirement.[80]

a. Unlimited retirement savings accounts

A number of analysts have suggested unlimited consumption tax treatment for retirement savings in tax-qualified plans and individual retirement savings accounts (IRSAs).[81] This approach would give equivalent tax treatment for all types of retirement savings.[82] Under this approach all individuals would be allowed to save as much of their earnings as they wanted in tax-qualified plans and/or in IRSAs. Not all workers would save, but every worker would have the opportunity to save an unlimited portion of her earned income tax-free.

b. An individual-based limit on retirement savings

A somewhat more restrictive approach would be to limit the total amount that could be deferred by each individual.[83] For example, one might consider limiting each individual's total tax-qualified savings (in whatever form) to the lesser of 15% of compensation or $30,000.[84] Under this approach, every worker would be allowed to save up to 15% of her income tax-free.

c. Mandatory salary reduction agreements

Short of making employers provide pensions to their employees, it might make sense simply to require that employers give

80 This section follows: Jonathan Barry Forman, *The Tax Treatment of Public and Private Pensions Around the World*, 14 Am. J. Tax Pol'y 299, 342-44 (1997).

81 *See, e.g.*, Richard A. Ippolito, Pensions, Economics and Public Policy 226 (1986).

82 *See* World Bank, Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth 20 (1994) [hereinafter Averting the Old Age Crisis].

83 *See* Richard A. Ippolito, An Economic Appraisal of Pension Tax Policy in the United States (1990); Congressional Budget Office, Tax Policy for Pensions and Other Retirement Savings (1987); Kovach, *supra* note 67.

84 *Cf.* I.R.C. § 415 (1994 & Supp. III 1997).

their employees the opportunity to participate in tax-qualified savings arrangements through salary reduction agreements.[85] In a recent study, 79% of the individuals surveyed said that the best way for them to save for retirement is to have money automatically deducted from their paychecks.[86] Thus, simply requiring employers to withhold and forward employee savings to individual retirement accounts, or to 401(k) accounts, could generate a significant amount of new retirement savings.[87]

2. How a Voluntary Universal IRA System Could Work

It would be relatively easy to design a universal IRA system.[88] The IRA mechanism is already well-established. All that would be needed would be to repeal or relax the rules that now restrict contributions. Moreover, it could make sense to require employers to provide salary reduction arrangements, and to exempt these IRA contributions from both income and Social Security taxes.

For example, one approach would be to let every individual contribute and deduct up to 15% of their compensation to IRAs up to, say, $10,000,[89] or $30,000.[90] Perhaps the allowable amount should be reduced for workers who are covered by another retirement plan. Alternatively, a tax could be imposed on pension distributions that are in excess of some reasonably large amount.[91] On the other hand, workers who were late to start saving for retirement might be allowed to make additional contributions to "catch up."[92]

B. An Expanded Social Security System

Expanding Social Security would be an alternative way to provide adequate incomes to the retired population.[93] The expansion could be achieved by expanding the benefits provided under the current system, or by adding another separate program to the

85 *See* CONGRESSIONAL BUDGET OFFICE, *supra* note 83; David Lindeman & Larry Ozanne, *Effects of Tax Policy on Retirement Saving and Income*, PROC. OF THE 80TH ANN. CONF. OF THE NAT'L TAX ASSOC. 98 (1987).

86 PUBLIC AGENDA, PROMISES TO KEEP: HOW LEADERS AND THE PUBLIC RESPOND TO SAVING AND RETIREMENT (1994); *see also Salary Reduction Plans Gain Popularity, Mercer Survey of Employers Shows*, 25 BNA PENSIONS & BENEFITS REP. 1948 (1998).

87 At the very least, it would make sense if a single universal salary reduction plan were available to all employers who wanted to adopt them. *See* NATIONAL COMMISSION ON RETIREMENT POLICY, THE 21ST CENTURY RETIREMENT SECURITY PLAN 21 (1998); Colleen T. Congel, *Pension Simplification: Proposal Mandates Section 401(k) Plans; Bars New Plans under Sections 403(b), 457,* 25 BNA PENSIONS & BENEFITS REP. 2443 (1998).

88 *See especially* Kovach, *supra* note 67, at 420-34.

89 *See id.* at 426.

90 *Cf.* I.R.C. § 415 (1994 & Supp. III 1997).

91 *Cf.* I.R.C. § 4980A (1994) (repealed by Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1073(a), 111 Stat. 788, 948 (1997); Kovach, *supra* note 67, at 427.

92 *See* Kovach, *supra* note 67, at 426.

93 *See* ALICIA MUNNELL, THE ECONOMICS OF PRIVATE PENSIONS 28 (1982).

current system. As more fully discussed below, one of the most common suggestions is to supplement the current Social Security system with a system of individual retirement savings accounts (IRSAs).[94]

1. Recent Proposals to Reform the Social Security System

The Social Security system is also in financial trouble. The Trustees of the Social Security Funds estimate that benefits will exceed income starting around 2013, and the program will be unable to pay full benefits after about 2032.[95] In fact, the Trustees estimate that the deficit over the traditional 75-year projection period is about 2% of payroll. In short, the federal government will either need to raise Social Security taxes, or to cut Social Security benefits. Not surprisingly, Social Security reform has become a hot topic in the past few years.[96]

a. The 1994-1996 Social Security Advisory Council

In January of 1997, the 1994-1996 Social Security Advisory Council issued a long-awaited report on how to reform the Social Security system.[97] The Council members were unable to achieve a consensus, but a majority of the Council agreed that at least a portion of Social Security payroll tax contributions should be redirected into individual retirement savings accounts (IRSAs), which would be invested in the stock market. Under the so-called Individual Accounts (IA) approach, these individual accounts would be held by the government, invested in secure equity funds, and annuitized on retirement.[98] Alternatively, under the so-called Personal Security Accounts (PSA) approach, these individual accounts would be held by financial institutions, and their investment would be directed by individual workers.[99]

Under the Personal Security Accounts (PSA) plan, the current Social Security system would be replaced with a two-tiered system. The first tier would provide a flat retirement benefit for all workers, while the second tier would provide workers with privately owned individual retirement savings accounts, referred to as Personal Security Accounts (PSAs).

Under the first tier, workers under age 25 in 1998, who work at least 35 years in covered employment, would receive a flat dol-

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94 *See* note 124, *infra* and accompanying text.

95 SOCIAL SECURITY AND MEDICARE BOARDS OF TRUSTEES, *supra* note 5.

96 *See, e.g.*, SOCIAL SECURITY SOLVENCY, *supra* note 56.

97 ADVISORY COUNCIL ON SOCIAL SECURITY, REPORT OF THE 1994-1996 ADVISORY COUNCIL ON SOCIAL SECURITY (1997) (2 vols.)

98 *See id.*, Vol. 1, at 28-29.

99 *See id.*, Vol. 1, at 30-33. *See also Report of the Technical Panel on Trends and Issues in Retirement Savings, in id.*, Vol. 2, at 87-90 (discussing individual Social Security retirement accounts).

lar benefit equivalent to $410 monthly in 1996 dollars. These benefits would be financed by employer Social Security contributions. Workers age 25 to 54 would receive a composite tier 1 benefit, which would include their accrued benefit under the current Social Security system, and a prorated share of the new tier 1 flat benefit.

Under the second tier, the plan would create Personal Security Accounts (PSAs) dedicated to retirement savings. These PSAs would be financed by reallocating five percentage points of the employee's share of Social Security taxes. Every worker under age 55 would participate in the 5% payroll reallocation, and receive PSA benefits based on their accumulations plus interest. Individuals could begin withdrawing funds from their PSAs at age 62, and any funds remaining in their accounts at death could be passed on to their estates.

b. The Committee for Economic Development

The Committee for Economic Development recently issued a report on Social Security reform in which it advocated leaving the basic Social Security system pretty much intact, but creating a second tier of privately owned, personal retirement accounts (PRAs).[100] Both employers and employees would be required to contribute 1.5% of payroll to these PRAs, while the self-employed would be required to contribute the entire 3%.

c. The National Commission on Retirement Policy

The National Commission on Retirement Policy recently offered a proposal that would allocate two percentage points of the current 10.7% of payroll tax into Social Security Individual Savings Accounts.[101] In addition, individuals would be allowed to contribute another $2000 per year (net of any IRA contribution) to those accounts. These individual accounts would be administered and invested in a way that is analogous to the Thrift Savings Plan provided to federal employees; that is, employees could choose to invest their accounts among broad-based funds such as a stock index fund, a bond index fund, and a government securities fund.[102]

d. Supplementary Individual Savings Accounts

Similarly, former Social Security Commissioner Robert M. Ball recently suggested adding a voluntary savings plan adminis-

100 COMMITTEE FOR ECONOMIC DEVELOPMENT, FIXING SOCIAL SECURITY: A STATEMENT BY THE RESEARCH AND POLICY COMMITTEE OF THE COMMITTEE FOR ECONOMIC DEVELOPMENT 49-54 (1997).

101 NATIONAL COMMISSION ON RETIREMENT POLICY, THE 21ST CENTURY RETIREMENT SECURITY PLAN 3-4 (1998).

102 *See id.* at 12-14.

tered by the Social Security Administration.[103] Specifically, he would allow wage earners to have an additional 2% deducted from their earnings and forwarded by their employers to the Social Security Administration through the regular withholding process. Each year participants could choose to have that 2% invested by the Social Security Administration in the stock market, in Treasury bonds, or split 50-50 between stocks and Treasury bonds. The funds would be held in so-called "supplementary individual savings accounts" that would follow the usual IRA rules governing the maximum amount to be deducted, the tax treatment of contributions and earnings, the withdrawal rules, and so on. Commissioner Ball argues that with these accounts "workers in small companies and the lower-paid generally would have a real opportunity to build conveniently on top of their assured Social Security benefits and to participate in ownership of equities should they care to do so."[104]

e. President Clinton's proposal for universal savings accounts

Along similar lines, President Clinton recently called for using 62% of the projected federal budget surpluses for the next 15 years, an estimated $2.7 trillion, to save the Social Security system until at least 2055.[105] As part of his plan, President Clinton would use 11% of those surpluses to create "Universal Savings Accounts" (USA accounts) for individuals to supplement their basic Social Security benefits. Under this proposal, the federal government would match a portion of the individual contributions made to these new retirement accounts.[106]

f. Chilean-style privatization

A number of analysts suggest that we should privatize Social Security, specifically by completely replacing the current Social Security system with a system of individual retirement savings

103 Prepared testimony of Robert M. Ball before the Subcommittee on Social Security of the House Committee on Ways and Means (June 3, 1998) (available on LEXIS, NEWS database, CURNWS file); *see also* Jane Bryant Quinn, *What Price Reform?*, NEWSWEEK, June 22, 1998, at 57; Elizabeth A. White, *Former SSA Head Calls for Add-On Accounts, Partial Trust Fund Investment in Equities*, 25 BNA PENSIONS & BENEFITS REP. 1328 (1998).

104 Prepared Testimony of Robert M. Ball, *supra* note 103.

105 *See, e.g.*, Mark Felsenthal, *Clinton Offers Plan to Spend Surplus*, 26 BNA PENSIONS AND BENEFITS REP. 197 (1999); Gene Steuerle, *A Government Match for Private Pension Savings?*, 82 TAX NOTES 891 (1999).

106 *See, e.g.*, Ryan J. Donmoyer, *Clinton's USA Plan: Progressive Personal Retirement Accounts*, 83 TAX NOTES 329 (1999); *cf.* Elizabeth A. White, *"Progressive" Formula for Private Accounts Included in Proposal Santorum to Offer*, 26 BNA PENSION & BENEFITS REP. 575 (1999).

accounts (IRSAs).[107] Proponents of privatization typically point to the country of Chile, which began to privatize its Social Security system in 1981.[108] Under Chile's Social Security system, workers are required to contribute at least 10% of their salary to IRSAs held by private pension funds of their choosing. There are about 20 different companies that manage these new IRSAs, subject to extensive regulation by the government. The Chilean example has been followed by a number of other countries,[109] and it is being promoted by the World Bank.[110] Replacing at least a portion of Social Security with individual retirement savings accounts has also found a good deal of support in Congress.[111]

g. Funded Social Security

Another approach would be to shift from the current pay-as-you-go Social Security system toward a funded system.[112] Funding Social Security would require two essential elements: fund accumulation and portfolio diversification. Fund accumulation would require substantially higher payroll tax rates (or lower benefits), and portfolio diversification would be achieved by having the Social Security Administration invest in the stock market.

The funded Social Security system would not have individual accounts. Indeed, funded Social Security is offered as a "politically *strategic alternative* to individual accounts."[113] Social Security would continue to operate as a defined benefit plan, with the beneficiary's benefits linked by a legislated formula to the retiree's wage history. The principal difference is that Social Security benefits would be paid out of a mix of payroll taxes and portfolio in-

107 *See, e.g.*, Karl Borden, *Dismantling the Pyramid: The Why and How of Privatizing Social Security*, 1 CATO PROJECT OF SOC. SEC. PRIVATIZATION (1995); SOCIAL SECURITY: PROSPECTS FOR REAL REFORM (Peter Ferrara ed., 1985); PETER J. FERRARA & MICHAEL TANNER, A NEW DEAL FOR SOCIAL SECURITY (1998).

108 *See, e.g.*, Joseph L. Scarpaci & Ernesto Miranda-Radic, *Chile*, *in* INTERNATIONAL HANDBOOK ON OLD-AGE INSURANCE 25 (Martin B. Tracy & Fred C. Pampel eds., 1991); Barbara E. Kritzer, *Privatizing Social Security: The Chilean Experience*, SOC. SEC. BULL., Fall 1996, at 45; Robert J. Myers, *Chile's Social Security Reform After 10 Years*, BENEFITS Q., 3d Quarter 1992, at 44.

109 *See, e.g.*, Michael Alan Paskin, *Privatization of Old-Age Pensions in Latin America: Lessons for Social Security Reform in the United States*, 62 FORD L. REV. 2199 (1994); *Chilean Social Security Reform as a Prototype for Other Nations*, EBRI NOTES, Aug. 1997, at 1.

110 *See* AVERTING THE OLD AGE CRISIS, *supra* note 82.

111 *See, e.g.*, BIPARTISAN COMMISSION ON ENTITLEMENT AND TAX REFORM, FINAL REPORT TO THE PRESIDENT 26, 40, 177, 221-22 (1995) (favoring a personal investment plan option for all workers in lieu of 1.5 percentage points of the payroll tax); *Kerry, Simpson Offer Plan to Reform Social Security, Make Other Changes*, 22 BNA PENSIONS & BENEFITS REP. 1243 (1995); Borden, *supra* note 107, at 10-14.

112 *See* Laurence S. Seidman, *Funding Social Security*, 81 TAX NOTES 241 (1998); *see also* Lok Sang Ho, *A Universal Fully Funded Pension Scheme*, CONTEMP. ECON. POL'Y, July 1997, at 13.

113 Seidman, *supra* note 112, at 241.

vestment income, rather than just out of payroll taxes and Treasury debt instruments.

h. Raising Social Security taxes and benefits

Historically, the simplest way to "fix" the Social Security system has been to raise payroll taxes and provide additional Social Security benefits. In the current Social Security reform debate, however, few have argued for payroll tax increases beyond those that might be necessary to meet the benefit levels already promised under the current system.[114]

2. How an Expanded Social Security System Could Work

An expanded Social Security system could take the form of either enhanced benefits under the current system, or a system of individual retirement savings accounts (IRSAs). There does not appear to be much support for expanding the current Social Security system, but it seems quite plausible that a system of IRSAs could be added on top of a reformed current system. These individual accounts could be held by the government and invested in secure equity funds. Alternatively, these individual accounts could be held by financial institutions, with their investments directed by individual workers.

C. A Mandatory Pension System

A final way to help improve the retirement security of individuals would be to mandate private pensions.

1. Recent Proposals to Expand the Pension System

a. Proposals to reform the voluntary pension system

Over the years, there have been a number of proposals to expand participation in employer-sponsored pensions. In particular, many analysts have suggested shortening the vesting period, eliminating or restricting Social Security integration,[115] promoting pension plan portability, and increasing participation (e.g., by covering part-time workers).[116]

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114 Still, in passing, it should be noted that a more generous Social Security system could help meet the retirement income needs of most workers and their auxiliaries. *See, e.g.*, Jonathan Barry Forman, *Promoting Fairness in the Social Security Retirement Program: Partial Integration and a Credit for Dual-earner Couples*, 45 TAX LAW. 915, 948-57 (1992), and sources cited therein.

115 *See especially*, Patricia E. Dilley, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security*, 30 LOY. L.A. L. REV. 1063 (1997).

116 *See, e.g.*, Vicki Gottlich et al., *Ten Pension Guidelines to Prevent Poverty Among Older Women*, 29 CLEARINGHOUSE REV. 616 (1995); Watson, *supra* note 61, at 65-67.

Another alternative would be to allow designated financial institutions to administer defined contribution megaplans for numerous small employers.[117] Employers would contribute to these megaplans; each employee would have her own account, and the financial institution would take on all of the reporting, disclosure, and fiduciary responsibilities.

b. Mandatory private pensions

Another approach would be to mandate private pensions.[118] Depending upon the size of the program, this approach could compel most workers to set aside a large enough share of their earnings over their careers to fund adequate retirement benefits.

For example, in 1981, the President's Commission on Pension Policy recommended adoption of a Mandatory Universal Pension System (MUPS).[119] Basically, the proposal would have required all employers to contribute at least 3% of wages to private pensions for their workers. The proposal drew little interest at the time. Recently, however, there has been renewed interest in mandated pensions.[120]

Relatively few countries presently mandate private pension coverage of workers.[121] Private pension coverage is mandatory in Australia and Switzerland, and industry-wide collective bargaining agreements make such coverage quasi-mandatory in Denmark and the Netherlands.[122] Chile requires its workers to contribute at least 10% of their wages to the privately managed individual retirement savings accounts that have replaced that country's social security system.[123] Most private pension systems, however, are voluntary.

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117 *See, e.g.*, Lindeman & Ozanne, *supra* note 85, at 102.

118 *See, e.g.*, AVERTING THE OLD AGE CRISIS, *supra* note 82, at 74; Estelle James & Dimitri Vittas, *Mandatory Saving Schemes: Are They the Answer to the Old Age Security Problems?*, *in* SECURING EMPLOYER-BASED PENSION: AN INTERNATIONAL PERSPECTIVE 151 (Zvi Bodie et al. eds., 1996). In fact, it seems clear that nothing close to universal private pension coverage will occur under a voluntary private pension system. *See* Daniel I. Halperin, *Special Tax Treatment for Employer-Based Retirement Programs: Is It 'Still' Viable as a Means of Increasing Retirement Income? Should It Continue?*, 49 TAX L. REV. 1, 35 (1993).

119 PRESIDENT'S COMMISSION ON PENSION POLICY, COMING OF AGE: TOWARD A NATIONAL RETIREMENT POLICY (1981); Lee A. Sheppard, *Toward a Rational Pension Policy*, 37 TAX NOTES 235, 237-38 (1987); Jim Wright, *Pension Reform Will Require Radical Change*, DALLAS MORNING NEWS, Dec. 15, 1987, at A19; Thomas C. Woodruff, *Employer Mandates to Increase Private Pension Portability and Participation*, *in* SOCIAL WELFARE POLICY AT THE CROSSROADS: RETHINKING THE ROLES OF SOCIAL INSURANCE, TAX EXPENDITURES, MANDATES, AND MEANS-TESTING 69 (Robert B. Friedland et al. eds., 1994).

120 *See supra* note 118.

121 *See* AVERTING THE OLD AGE CRISIS, *supra* note 82, at 165.

122 *See id.* at 166-67.

123 *See supra* note 108 and accompanying text.

2. How a Mandatory Pension System Could Work

The simplest design for a mandatory pension system would be to piggyback a system of individual retirement savings accounts (IRSAs) onto the existing Social Security withholding system. For example, both employers and employees could be required to contribute 1.5% of payroll to these IRSAs (and the self-employed could be required to contribute the entire 3%).[124] These accounts could be held by the government and invested in secure equity funds, and annuitized on retirement. Alternatively, these individual accounts could be held by financial institutions, and their investment could be directed by individual workers.

A different approach would be for the government to mandate that employers provide a suitable defined benefit plan for their employees. In that regard, the government might authorize employers to use a central clearinghouse where employers could send pension contributions on behalf of their employees. Over the course of her career, each worker would earn entitlement to a defined benefit, which, at retirement, would supplement Social Security.

V. CHOOSING BETWEEN THE ALTERNATIVES

A. Mandatory Versus Voluntary Pensions

Without a doubt, the most important choice to be made with respect to universal pensions is whether they should be voluntary or mandatory.[125] This choice brings into conflict two principles that we hold dear: the principle of individual autonomy and the principle of retirement income adequacy.

On the one hand, we believe that the government has no business telling individual workers what to do with the money that they earn. In our *laissez-faire* system, workers can save or spend their earned income in any way they please. This is the principle of individual autonomy. At bottom, the principle of individual autonomy suggests that it is really none of the government's business if workers spend their money on a refrigerator, or a vacation, or invest their money in a bank or the stock market.

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124 *Cf.* COMMITTEE FOR ECONOMIC DEVELOPMENT, *supra* note 100.

125 *See, e.g.*, EMPLOYEE BENEFIT RESEARCH INSTITUTE, GOVERNMENT MANDATING OF EMPLOYEE BENEFITS: EBRI-ERF POLICY FORUM (1987); EMILY S. ANDREWS, PENSION POLICY AND SMALL EMPLOYER: AT WHAT PRICE COVERAGE?: AN EBRI-ERF POLICY STUDY 154-63 (1989); Marvin H. Kosters, *Mandated Benefits—On the Agenda*, REGULATION, No. 3, 1988, at 21; Lawrence H. Summers, *What Can Economics Contribute to Social Policy? Some Simple Economics of Mandated Benefits*, 79 AM. ECON. REV. 177 (Papers & Proceedings, 1989); Dwight R. Lee, *Why Workers Should Want Mandated Benefits to Lower Their Wages*, 34 ECON. INQUIRY 401 (1996).

On the other hand, we believe that, left to their own devices, many individuals will not save enough for their own retirement.[126] Consequently, we have empowered our government to enact paternalistic Social Security and pension policies to ensure that workers will, in fact, save for their own retirements.[127] This is the principle of retirement income adequacy. For example, Social Security collects payroll taxes from virtually all workers and uses those receipts to pay benefits to virtually all retirees and their dependents. Private pension policy also has many paternalistic features.[128] For example, the limitations on early withdrawals and loans help ensure that retirement savings will be available to meet retirement needs, and the qualified joint and survivor annuity rules help ensure that both participants and their spouses will have adequate incomes throughout their retirement years.[129]

The present system balances these two competing principles by having a nearly universal Social Security system, and a voluntary private pension system that covers about half of all workers. Unfortunately, the present system does not ensure that the elderly will have adequate incomes throughout their retirement years. In particular, a voluntary private pension system is unlikely to ensure that low-income and moderate-income workers will save enough for retirement.[130]

On the other hand, if retirement income adequacy were the only principle guiding government action, it would be relatively easy to ensure that every American would have an adequate retirement income. This goal could be achieved either by expanding the current Social Security system, or by mandating some type of universal private pension system. In the end, the fact that the government has not mandated an adequate universal pension system may turn out to be just a perverse tribute to our belief in the importance of the principle of individual autonomy.

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126 *See* THOMPSON, *supra* note 46, at 25-36.

127 Thompson notes that there are four common reasons for mandatory pensions: (1) individual myopia; (2) protection of the prudent; (3) income redistribution; and (4) insurance market failure. *Id.* at 28-32. *See also* Deborah M. Weiss, *Paternalistic Pension Policy: Psychological Evidence and Economic Theory*, 59 U. CHI. L. REV. 1275 (1991); Alice G. Abreu, *Taxes, Power, and Personal Autonomy*, 33 SAN DIEGO L. REV. 1 (1996); Peter J. Wiedenbeck, *Paternalism and Income Tax Reform*, 33 U. KAN. L. REV. 675 (1985); Edward J. Gac & Wayne M. Gazur, *Tapping "Rainy Day" Funds for the Reluctant Entrepreneur: Downsizing, Paternalism, and the Internal Revenue Code*, 86 KY. L.J. 127 (1997-1998); Gregory S. Alexander, *Pensions and Passivity*, 56 LAW & CONTEMP. PROBS. 111 (1993).

128 *See, e.g.*, Joseph Bankman, *Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Desirable?*, 55 U. CHI. L. REV. 790 (1988).

129 *See* Jonathan Barry Forman, *Protecting Spousal Rights in Private Pensions*, J. OF COMPENSATION AND BENEFITS, Mar.-Apr. 1999, at 5, 8.

130 In fact, it seems clear that nothing close to universal private pension coverage will occur under a voluntary system. *See* Halperin, *supra* note 118.

B. Defined Benefit Versus Defined Contribution Plans

Another important public policy choice with respect to any universal pension system is to decide between a defined benefit plan and a defined contribution plan.[131] Table 1 shows some examples of the various combinations. For example, individual retirement accounts (IRAs) are defined contribution-like plans that are almost universally available on a voluntary basis. Traditional pension plans are typically defined benefit plans that are almost universally available to employers. Social Security is an almost universal, mandatory defined benefit system. Finally, many proposals to fix Social Security would mandate individual retirement savings accounts (IRSAs), which would be structured like defined contribution plans.

TABLE 1. A MATRIX OF PENSION CHOICES

	VOLUNTARY	MANDATORY
DEFINED CONTRIBUTION	IRAS, 401(K)S	MANDATORY INDIVIDUAL RETIREMENT SAVINGS ACCOUNTS (IRSAS)
DEFINED BENEFIT	TRADITIONAL PENSION PLANS	SOCIAL SECURITY

1. Influence on Worker Behavior

Pension benefits accrue differently under defined benefit and defined contribution plans. In particular, under a defined benefit plan, benefit accruals increase significantly the closer a worker gets to retirement. On the other hand, under a defined contribution plan, benefits accrue at a constant rate (e.g., 10% of annual compensation). Consequently, defined benefit and defined contribution plans result in different incentives that can affect employee decisions about work and retirement.[132]

131 Recall that a typical defined benefit plan might provide that a worker's annual retirement benefit is equal to 2% times years of service times final average compensation (B = 2% x yos x fac). Under this formula, a typical worker with 30 years of service would receive a retirement benefit equal to 60% of her preretirement earnings (B = 60% x fac = 2% x 30 yos x fac).

On the other hand, under a typical defined contribution plan, the employer simply contributes a specified percentage of the worker's compensation to an individual investment account for the worker. For example, contributions might be set at 10% of annual compensation. Under such a plan, a worker who earned $30,000 in a given year would have $3000 contributed to an individual investment account for her. Her benefit at retirement would be based on all such contributions plus investment earnings thereon.

132 *See, e.g.*, RICHARD A. IPPOLITO, PENSION PLANS AND EMPLOYEE PERFORMANCE 10-17 (1997); IPPOLITO, *supra* note 81, at 133-50; JOSEPH F. QUINN AT AL., PASSING THE TORCH: THE INFLUENCE OF ECONOMIC INCENTIVES ON WORK AND RETIREMENT (1990); THOMPSON,

In particular, defined benefit plans typically create "windows" of retirement opportunity that push older workers out of the work force between early retirement age and normal retirement age.[133] After all, once a worker is eligible to receive full retirement benefits, delaying retirement can actually be quite costly. Those who delay retirement lose current benefits, and the increase in benefits that can result from an additional year of work rarely compensates for the benefits lost.[134]

2. Investment and Risk

One of the biggest problems with defined contribution plans is that individuals, rather than professional money managers, control investments. Individuals tend to invest too conservatively, especially toward the end of their working careers. Moreover, many individual investors are unsophisticated, and some may even end up being bilked by con artists.

On the other hand, defined benefit plans are able to pool investments and achieve superior returns and efficient fee structures through professional managers. Unlike individual investors, pension fund managers invest for the long haul, and do not panic when the market becomes volatile.

Still another problem for defined contribution plans is uncertainty. Financial planning is difficult because the value of the ultimate benefit is unknown. For example, because of stock market volatility, workers who retire when the market is up will have higher pensions than those who retire when it is down. Moreover, under a defined contribution plan, the responsibility for purchasing an annuity is borne by the individual worker. Unfortunately, there is just not much of a market for private annuities, and the costs are often prohibitive.[135]

A final problem with defined contribution plans is the relatively longer life span of women. Because women tend to live longer than men, they are more likely to outlive their retirement

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supra note 46, at 71-83; ALAN L. GUSTMAN & THOMAS L. STEINMEIER, PENSION INCENTIVES AND JOB MOBILITY (1995); Michael D. Hurd, *Research on the Elderly: Economic Status, Retirement, and Consumption and Saving*, 28 J. ECON. LIT. 565 (1990); Alan L. Gustman et al., *The Role of Pensions in the Labor Market: A Survey of the Literature*, 47 INDUS. AND LAB. REL. REV. 417 (1994); Michael V. Leonesio, *The Economics of Retirement: A Nontechnical Guide*, SOC. SEC. BULL., Winter 1996, at 29; THOMPSON, *supra* note 46, at 78 (noting that labor force decisions are influenced by such factors as: the age of the individual, the availability of retirement benefits, the individual's health, the level of the retirement benefits to which the individual is entitled, other sources of income, and any earnings limitations imposed as a condition for receiving benefits).

133 *See* Jonathan Barry Forman, *Reforming Social Security to Encourage the Elderly to Work*, 9 STAN. L. & POL'Y REV. 289, at 292-93 (1998).

134 And those who work until they drop often leave nothing behind for their estates.

135 *See* THOMPSON, *supra* note 46, at 162-64.

savings.[136] This life span difference is less of a problem for beneficiaries of defined benefit plans because distributions usually take the form of lifetime annuities.

3. Inflation

Another problem with both defined benefit and defined contribution plans is that inflation after retirement can erode the value of accrued pension benefits.[137] Currently, Social Security benefits are adjusted for inflation each year.[138] On the other hand, relatively few private-sector defined benefit plans provide for cost-of-living adjustments for inflation, and postretirement inflation is always a problem for defined contribution plans.[139]

4. Leakage and Distributions

Another major problem with defined contribution plans is that they are "leaky." While defined benefit plans typically provide lifetime annuities for retirees and their spouses, defined contribution plans typically allow participants to withdraw all or a portion of their individual accounts, and many plans allow them to borrow against their accounts. In 1995, for example, about 47% of the savings and thrift plans of medium and large businesses permitted withdrawals, and 44% permitted loans.[140] Unfortunately, a significant portion of these distributions and loans may end up being dissipated, sometimes even before retirement.[141] A recent study suggests that 60% of the lump sum distributions made to job changers from large plans are not rolled over into Individual Retirement Accounts (IRAs) or other retirement savings plans.[142]

C. Public or Private

Another policy choice is whether or not the enhanced retirement system should be public or private. For example, a system of

136 *Cf.* Janet C. Boyd, *When Is a Girl Not a Girl and a Boy Not a Boy*, 80 TAX NOTES 729 (1998) (discussing a similar problem when defined benefit plans are allowed to make lump sum distributions in lieu of annuity payments).

137 *See* PRESIDENT'S COMMISSION ON PENSION POLICY, *supra* note 119, at 32.

138 *See* 42 U.S.C. § 415(i) (1994).

139 *See, e.g.*, Mark J. Warshawsky, *The Market for Individual Annuities and the Reform of Social Security*, BENEFITS Q., 3d quarter 1997, at 66 (discussing how the private sector might provide inflation-adjusted annuities).

140 *See* BUREAU OF LABOR STATISTICS, DEPT. OF LABOR, EMPLOYEE BENEFITS IN MEDIUM AND LARGE PRIVATE ESTABLISHMENTS 1995, at 132, 138 (1998).

141 Dissipation of retirement savings is also a problem for IRAs, as preretirement distributions may be used for education, health, and first-time homebuyer expenses. *See* I.R.C. § 72(t)(2) (West 1988 & Supp. 1998).

142 *See* PAUL J. YAKOBOSKI, LARGE PLAN LUMP SUMS: ROLLOVERS AND CASHOUTS (EBRI Issue Brief No. 188, 1997); *see also* G. LAWRENCE ATKINS, SPEND IT OR SAVE IT? PENSION LUMP-SUM DISTRIBUTIONS AND TAX REFORM (1986); John R. Woods, *Pension Vesting and Preretirement Lump Sums Among Full-Time Private Sector Employees*, SOC. SEC. BULL., Fall 1993, at 3.

individual retirement savings accounts (IRSAs) could be managed by the Social Security Administration. Alternatively, IRSAs could be held and managed by private-sector employers or financial institutions, subject to regulation by the government. By itself, this particular aspect of IRSAs may not make much difference.

It may make a great deal of difference, however, if the investment decisions are made in the private sector (either by individuals or investment firms), or by the Social Security Administration. The danger always exists that public pension funds might undertake imprudent investments for political reasons.[143]

VI. OTHER ISSUES

A. Participation and Vesting

At the outset, it is worth noting that participation in private pension plans is far from universal, and even those employers who maintain pension plans can currently exclude part-time workers, and workers who have not yet reached the age of 21 or have not been with the employer for at least one year.[144] Similarly, it currently takes 10 years to become vested (fully insured) under Social Security,[145] and it often takes five years to vest under the typical private pension plan.[146]

If retirement income security is the principal goal, then it would make sense for any universal pension system to have universal participation and immediate vesting for all employees, including part-time workers. One way to avoid burdening private employers would be to allow them to piggyback their contributions onto their existing Social Security withholding obligations.

B. Mandatory Annuitization

Another issue for any universal pension plan is the form of distribution. By spreading payments over a period of years, annuitization helps ensure that retirees have adequate retirement incomes throughout their lives. Similarly, annuitization over the joint lives of a participant and spouse can help ensure that both have adequate retirement incomes. On the other hand, there is a

143 *See e.g.*, Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993); ROBERTA ROMANO, POLITICS AND PUBLIC PENSION FUNDS (1994); David L. Gregory, *The Problematic Status of Employee Compensation and Retiree Pension System: Resisting the State, Reforming the Corporation*, 5 PUB. INTEREST L.J. 37 (1995); Ridgeley A. Scott, *A Skunk at A Garden Party: Remedies for Participants in State and Local Pension Plans*, 75 DEN. U.L. REV. 507 (1998); Holman W. Jenkins, *Business World: The Rise of Public Pension Funds*, WALL ST. J., Apr. 16, 1996, at A15.

144 *See* I.R.C. § 410(a) (1994).

145 *See* 42 U.S.C. § 414(a) (1994).

146 *See* I.R.C. § 411(a)(2)(A) (1994).

good deal of evidence that lump-sum distributions are quickly dissipated.[147]

Social Security pays out benefits in the form of a joint and survivor annuity covering the retired worker and spouse. Many pension plans also pay out benefits in the form of an annuity. In particular, most defined benefit plans pay benefits in the form of a single life annuity covering the retiree, or in the form of joint and survivor annuity covering the retiree and spouse. Some defined benefit plans, however, allow the retiree to receive a lump-sum payment instead of an annuity. In fact, about 15% of the defined benefit plans of medium and large businesses allow the retiree to select a lump-sum distribution.[148]

On the other hand, few defined contribution plans or IRAs provide for annuities. In 1995, for example, only about 17% of the savings and thrift plans of medium and large businesses allowed the participant to select annuity distributions, and only 30% even allowed them to select installment distributions.[149]

If retirement income security is the principal goal, then it could make sense for any universal pension system to mandate that benefits take the form of a mandatory annuity.[150] Moreover, it is less expensive to provide adequate income for the retired population through annuities than through alternative investment strategies. For example, ignoring administrative costs, a 65-year old man could buy a lifetime annuity indexed to the inflation rate for 11 times the desired annual benefit (see Appendix 5).[151] Thus, it would cost him $220,000 to purchase an annuity that paid him an indexed $20,000 a year for life.

On the other hand, alternative investment strategies would require the accumulation of more funds to protect him against the risks of outliving his life expectancy (here assumed to be 16.3 years), and the risk of unanticipated inflation. The simplest way to avoid outliving one's resources is to live off the interest and never spend the principal. Under reasonable assumptions, however, this investment strategy would necessitate accumulating 40 times the desired annual benefit if the funds are to be invested in government bonds, or 23.5 times the desired annual benefit if he is willing to invest half the funds in the stock market.[152] Consequently, to get $20,000 a year under a live-off-the-interest strategy would require an accumulation of $800,000 (or $470,000).

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147 *See* citations, *supra* note 142.

148 *See* DEPT. OF LABOR, BUREAU OF LABOR STATISTICS, *supra* note 140, at 114.

149 *See id.* at 145.

150 *See, e.g.*, SOCIAL SECURITY SOLVENCY, *supra* note 56, at 64-66.

151 *See* THOMPSON, *supra* note 46, at 162, 168. A joint and 75% survivor annuity would cost about 15% to 25% more. *Id.*

152 *See id.* at 161, 168.

Still another alternative would be to adopt a rule of thumb. If he were willing to draw down 5% of his portfolio accumulation each year, he would run only one chance in 30 of running out of money in less than 30 years.[153] Still, under this rule-of-thumb-investment strategy, he would need to accumulate 20 times the desired annual benefit ($400,000).

Of course, an individual cannot actually buy the type of hypothetical annuity described above. In the absence of a universal mandatory annuity arrangement, each individual would have to pay a premium of as much as 25% over the cost of the "pure" annuity.[154] The sellers of such annuities must charge more because they can rationally conclude that the buyers of such annuities have reason to believe that they will outlive the average life expectancy. On the other hand, under a universal mandatory annuity system, like Social Security, all risks are pooled, and the life expectancy of each generational cohort of retirees should be fairly close to the predicted number.

In short, a universal mandatory annuity strategy is the least expensive way to provide adequate income to the retired population. The other approaches require significantly more "ambitious" goals for retirement saving[155] and presumably result in significant bequests to subsequent generations of workers.

C. Spousal Rights

Another issue is what, if any, rights a nonparticipant spouse should have in the retirement plan of the covered worker.[156] Under current law, the answer can vary dramatically depending on the type of retirement plan in which the worker participates. Widely different rules apply to Social Security, to pension plans, to profit-sharing and stock bonus plans, and to IRAs.

Social Security, for example, pays benefits to married couples in a way that mimics a joint and two-thirds survivor annuity, and divorced spouses can also receive annuity-like benefits. Moreover, Social Security benefits are indexed for inflation.

On the other hand, most private pension plans are required only to offer a joint and survivor annuity option to married couples,[157] and most profit-sharing and stock bonus plans can avoid even that requirement if the balance of the account is paya-

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153 *See id.*

154 *See id.* at 105-06.

155 *See id.* at 161.

156 *See generally* Forman, *supra* note 129; and Jonathan Barry Forman, *Whose Pension Is It Anyway? Protecting Spousal Rights in a Privatized Social Security System*, 76 N.C. L. REV. 1653 (1998).

157 *See* I.R.C. §§ 401(a)(11), 417 (1994); 29 U.S.C. § 1055(a) (1994).

ble to the spouse at the participant's death.[158] Moreover, IRAs are not required to provide any spousal guarantees at all. Divorcing spouses of private retirement plan participants, however, can secure an interest in the participant spouse's pension by obtaining qualified domestic relations orders (QDROs) (or similar orders with respect to IRAs).[159]

All in all, if the government is concerned about ensuring adequate retirement incomes for the beneficiaries of a universal pension system, then it might want to mandate that at least a portion of the couple's retirement plan accruals be paid out in the form of a joint and survivor annuity, perhaps even one that is indexed for inflation.[160] Beyond the amount of retirement savings necessary to purchase this basic annuity, however, more relaxed distribution rules might apply.

For example, at retirement, couples might be required to purchase an indexed joint and survivor annuity that, together with Social Security, would provide the equivalent of an indexed annuity that is targeted to, say, at least 125% of the poverty level.[161] Consequently, assuming a 125-percent-of-the-poverty-level target, a married couple retiring this year would need the equivalent of an indexed annuity that paid $13,825 this year ($13,825 = 125% x $11,060), and appropriately adjusted amounts in future years. For many couples, Social Security would provide a good chunk of this minimum 125-percent-of-the-poverty-level benefit, leaving only the balance to be made up from the couple's other retirement plans.

Similar protections could be designed to protect spouses of workers who die before retirement, and divorcing spouses. The key would be to design benefits that generally ensured that surviving spouses and ex-spouses are assured an adequate income throughout their retirement years.

D. Loans And Early Distributions

Two other issues for a universal pension system involve the permissibility of loans, and preretirement distributions.[162] On the one hand, allowing loans and preretirement distributions may en-

158 Specifically, profit-sharing and stock bonus plans are not subject to the automatic survivor benefit rules if the plan provides that the spouse of a participant is the beneficiary of the participant's entire account under the plan, the participant's benefit is not paid in the form of an annuity, and the participant's account does not include amounts transferred from another plan that was subject to the automatic survivor benefit rules. 29 U.S.C. § 1055(b) (1994); I.R.C. § 401(a)(11)(B) (1994).

159 *See* I.R.C. §§ 401(a)(13)(B), 408(d)(6) (1994).

160 *See* Forman, *supra* note 129, at 9.

161 In 1999, the poverty level for a married couple was $11,060. *See* Annual Update of the HHS Poverty Guidelines, 64 Fed. Reg. 13,428 (1999).

162 *See* citations, *supra* note 142.

courage greater elective contributions to retirement plans. On the other hand, retirement savings may be dissipated and retirement income security threatened if loans and preretirement distributions are permitted. All in all, it is difficult to tell just what the right policy is, but it seems likely that at least some restrictions on loans and preretirement withdrawals are needed.

E. The Tax Treatment of Mandatory Pensions

Theoretically, tax incentives are not needed if there is a mandatory pension system. It could make sense, however, to offer some tax breaks. The simplest approach would be to tax all retirement plans under a consumption tax approach that exempts contributions and pension fund income from tax, but taxes benefits.[163]

F. Redistribution

Almost all pension systems redistribute economic resources. That is, they take money from certain workers and give it to others. Social Security, for example, is wildly redistributive. There are clearly winners and losers.[164] In particular, Social Security favors current retirees over future retirees, low-earners over high-earners, larger families over smaller families, married couples over unmarried individuals, one-earner couples over two-earner couples, and elderly retirees over elderly workers.[165] In short, not everyone gets his or her "money's worth" out of Social Security.

The private pension system also has redistributive aspects.[166] Current participants in private pension plans, for example, tend to pay less taxes than those who lack the opportunity to participate. Defined benefit plans also tend to "redistribute" money from those who die to those who survive, although we typically call this

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163 *Cf.* Forman, *supra* note 80, at 341-50.

164 Indeed, the link between the Social Security retirement taxes paid by workers and the Social Security retirement benefits that they can expect to receive is actually quite loose and can vary dramatically based on such factors as family status, income, and age. *See, e.g.*, Michael J. Boskin et al., *Social Security: A Financial Appraisal Across and Within Generations*, 40 NAT'L TAX J. 19 (1987). That is, relative to a program in which each worker earned an actuarially fair rate of return on payroll taxes paid, the current Social Security retirement program results in significant transfers that favor some workers over others.

165 *See, e.g.*, Forman, *supra* note 114, at 937-48.

166 *See, e.g.*, Benedict & Shaw, *supra* note 66. Their results suggest that private pension plans increased annual income inequality (relative to the inequality observed in the distribution of wage income) by about 2% among all employed individuals, but by 21% among unionized workers. This inequality appears to be largely the result of the increasing rate of return to tenure through pension "backloading" and the increasing incidence of pensions with age. *Id. See also* Edward Lazear & Sherwin Rosen, *Pension Inequality*, *in* ISSUES IN PENSION ECONOMICS 341 (Zvi Bodie et al. eds., 1987) (finding that pensions increased income inequality, particularly between blacks and whites and between black men and black women).

insurance. Moreover, ERISA-covered plans mandate "redistribution" to spouses, via the qualified joint and survivor annuity rules for pension plans, and the death benefit for spouses required of most profit-sharing and stock bonus plans.

Redistribution is not *per se* bad, but the government does bear the burden of justifying its redistributive mandates. Redistribution on the basis of need seems the most justifiable; that is, it can make sense to redistribute economic resources from rich to poor. But neither a payroll tax system, nor a private pension system, seems to be an appropriate vehicle for such redistribution. For example, why should high-wage earners be compelled through the payroll tax system to subsidize the Medicare benefits of low-wage earners and their spouses, while, at the same time, "coupon-clipping trust fund brats" can avoid the payroll tax altogether. When redistribution is called for, it would seem to be more appropriate to use the income tax system or a wealth tax system to achieve that redistribution, rather than the payroll tax system[167] or the compensation-based private pension system. Indeed, it may well be that concern about the redistributive nature of Social Security is one of the principal reasons why there is so much resistance to simply raising Social Security taxes, and why there is so much support for creating some kind of a system of individual retirement savings accounts.

VII. CONCLUSION

America's current retirement policies are failing, and the time has come to adopt a universal pension system that will ensure adequate incomes for the retired population. It seem unlikely that an expansion of the voluntary pension system can achieve the goal of retirement income adequacy. Instead, the time is ripe to adopt a mandatory universal pension system. The consensus seems to favor developing a system of individual retirement savings accounts (IRSAs) that piggybacks on the current Social Security payroll withholding system. But, no doubt, the devil will be in the details.

167 *Cf.* Jonathan Barry Forman, *Reconsidering the Tax Treatment of the Elderly: It's Time for the Elderly to Pay Their Fair Share*, 56 U. PITT. L. REV. 589 (1995).

APPENDIX 1. LIFE EXPECTANCY FOR MEN AND WOMEN, 1900-2070

	Year	Life expectancy at birth		Life expectancy at age 65	
		Male	Female	Male	Female
Actual:					
	1900	46.4	49.0	11.4	11.7
	1910	50.1	53.6	11.4	12.1
	1920	54.5	56.3	11.8	12.3
	1930	58.0	61.3	11.8	12.9
	1940	61.4	65.7	11.9	13.4
	1950	65.6	71.1	12.8	15.1
	1960	66.7	73.2	12.9	15.9
	1970	67.1	74.9	13.1	17.1
	1980	69.9	77.5	14.0	18.4
	1990	71.8	78.9	15.0	19.0
Projected:					
	2000	73.2	79.7	15.8	19.3
	2010	74.7	80.5	16.2	19.6
	2020	75.5	81.1	16.6	20.0
	2030	76.2	81.8	17.0	20.4
	2040	76.8	82.4	17.5	20.9
	2050	77.5	82.9	17.8	21.3
	2060	78.1	83.5	18.2	21.7
	2070	78.6	84.0	18.6	22.1

Note.—The life expectancy for any year is the average number of years of life remaining for a person if that person were to experience the death rates by age for that year.
Source: STAFF OF THE HOUSE COMM. ON WAYS AND MEANS, 105TH CONG., 1998 GREEN BOOK: BACKGROUND MATERIAL AND DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS 1031 tbl.A-2 (Comm. Print 1998).

APPENDIX 2. HISTORICAL AND PROJECTED IMPROVEMENTS IN LIFE EXPECTANCY

Year Cohort Turns 65	Percentage of population surviving from age 21 to age 65	
	Male	Female
1940	53.9	60.6
1950	56.2	65.5
1960	60.1	71.3
1970	63.7	76.9
1980	67.8	80.9
1990	72.3	83.6
2000	76.0	85.5
2010	78.4	87.1
2020	79.3	88.1
2030	80.4	88.8
2040	81.8	89.5
2050	82.7	90.0

Source: C. EUGENE STEUERLE & JON M. BAKIJA, RETOOLING SOCIAL SECURITY FOR THE 21ST CENTURY: RIGHT & WRONG APPROACHES TO REFORM 41 tbl.3.1 (1994).

APPENDIX 3. PERCENTAGE OF WORKERS ELECTING SOCIAL SECURITY RETIREMENT BENEFITS AT VARIOUS AGES, SELECTED YEARS 1940-95[1]

Year	Age 62	Ages 63-64	Age 65	Ages 66+	Average Age
1940	[2]	[2]	8.3	91.7	68.7
1950	[2]	[2]	23.1	76.9	68.5
1960	10.0	7.9	35.3	46.7	66.2
1970	27.8	23.2	36.9	12.1	64.2
1980	40.5	22.2	30.7	6.6	63.7
1990	56.6	20.2	16.6	6.7	63.6
1995	58.3	19.5	16.3	6.0	63.6

[1] Excludes conversions at age 65 from disability to retirement rolls.
[2] Retirement before age 65 was not available.
Source: STAFF OF THE HOUSE COMM. ON WAYS AND MEANS, 105TH CONG., 1998 GREEN BOOK: BACKGROUND MATERIAL AND DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS 21 tbl.1-12 (Comm. Print 1998).

APPENDIX 4. ADJUSTING CONTRIBUTION RATES FOR REALISTIC MORTALITY ASSUMPTIONS, PROGRAM ADMINISTRATIVE EXPENSES, AND ADVERSE SELECTION COSTS

Base Scenario	
PAYG	19.77%
IS	19.77%
Advance GP	19.77%
Above Plus Administrative Costs	
(2% of contribution for PAYG; 8% of contributions + 0.9% of assets for IS; 0.5% of assets for advance funded group plan)	
PAYG	20.17%
IS	28.03%
Advance GP	22.94%
Above Plus Annuity Fee	
(15% of assets for IS only; 0% for PAYG, advance funded group plan)	
PAYG	20.17%
IS	32.98%
Advance GP	22.94%
Above Plus Early Mortality	
(Uses U.S. life table for males born in 1960)	
PAYG	17.80%
IS	32.98%
Advance GP	*

Assumptions: Birth rate is constant; wage growth = 0; real interest = 0
* Depends on how plan treats preretirement death

Note: The base scenario assumes that all workers enter the labor force at age 22, work exactly 43 years, retire on their 65th birthday, and die exactly 17 years later on their 82nd birthday. While working, each earns the average wage. In retirement, each receives a benefit equal to one-half the average wage (indexed to average wage levels). The calculations assume that all payments are made once a year on the final day of the year. PAYG denotes the contribution rate required under a pay-as-you-go, defined benefit pension plan; IS denotes this for advance funded, individual savings plans; and Advance GP denotes this for advance funded (defined benefit), group plans.

The second set of calculations incorporates all of the assumptions outlined above except that the contribution calculations are adjusted to show the gross contribution needed to pay a benefit of 50% of average wages and also cover the administrative costs associated with each plan. The cost assumptions are shown in the table.

The third set is a recalculation of the second set using a real life table (U.S. males born in 1960). The sample life table used previously assumed all retirees lived through retirement and died at age 82. In using the real life table, some workers will die prior to retirement. This lowers the pay-as-you-go contribution rate 2.4% from the preceding example.

Source: LAWRENCE THOMPSON, OLDER & WISER: THE ECONOMICS OF PUBLIC PENSIONS 107 tbl.1 (1998).

APPENDIX 5. ASSETS REQUIRED UNDER DIFFERENT RETIREMENT INCOME STRATEGIES
(RATIO OF ASSETS AT RETIREMENT TO INITIAL INCOME)
ASSUMES INCOMES ADJUSTED FOR INFLATION AFTER RETIREMENT

Strategy	Ratio
Live Off the Interest	
Government Bonds	40.0
Bond/Equity Mix	23.5
Rule of Thumb	
4% Drawdown	25.0
5% Drawdown	20.0
Pure Annuity	
65-Year-Old Male	11.0
65-Year-Old Female	12.8
Assumptions	
Inflation (%)	6.1
Average Real Bond Returns (%)	2.5
Average Real Equity Returns (%)	6.0
Life Expectancy at 65	16.3
Males	20.6
Females	

Source: LAWRENCE THOMPSON, OLDER & WISER: THE ECONOMICS OF PUBLIC PENSIONS 168 tbl.A (1998).

Radical Tax Reform for the 21st Century: The Role for a Consumption Tax

*Alan Schenk**

I. INTRODUCTION

The end of the millennium is a time to reflect on the past and make proposals for the future. Politicians and commentators have been active in proposing ways in which Congress can radically change the federal tax system. Members of Congress held public hearings outside Washington, D.C., to hear complaints on claimed abuses in the IRS's treatment of taxpayers. These Members then coupled taxpayer discontent over the existing system with proposals to replace some or all of the income taxes, and maybe some other federal taxes as well. A variety of federal taxes on consumption have been proposed to raise the lost revenue. If the United States were to completely replace the federal income taxes with a tax on consumption, indeed, the United States might become the most attractive tax haven in the world.[1]

This article begins with a brief review of the changes in federal, state and local taxes up to World War II, and then in the last half of the century. This review is followed by a discussion of how the United States has not followed the movement toward consumption taxation taking place in other highly industrialized nations, in developing nations, and in the emerging economies of Eastern Europe. The major radical tax reform proposals in the United States in the 1990s are then reviewed, with the article focusing on those that use revenue from two forms of value added tax (VAT) to take a projected 100 million taxpayers off the federal income tax rolls.

II. TAXATION IN THE TWENTIETH CENTURY

A. Tax Systems in 1902

The tax structure in the United States is radically different near the end of the millennium than it was at the beginning. If we step back to the beginning of the twentieth century, we see a tax system without any federal, state or local income taxes imposed on

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1 *See* MICHAEL GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX 273 (1997).

individuals and businesses. State and local governments relied heavily on property taxes, which accounted for about 82% of their total tax collections in 1902.[2] The composition of the 1902 tax regime in the United States was as follows:

TABLE 1. FEDERAL AND NON-FEDERAL TAX SOURCES IN 1902[3]
(FIGURES IN MILLIONS OF DOLLARS)

	Federal	State & Local
Income	0 (0%)	0 (0%)
Consumption	487 (95%)	28 (3%)
Property	0 (0%)	706 (82%)
Other	26 (5%)	126 (15%)
TOTAL	513 (100%)	860 (100%)

Of the $487 million in federal revenue obtained from items of consumption, customs levies accounted for approximately 40%, and alcohol and tobacco taxes about another 40%, with most of the rest coming from postal services.[4]

In 1902, state and local tax revenue came mainly from property taxes and select excise taxes.[5] Starting in 1911, states began to introduce individual and corporate income taxes.[6] Sales taxes were introduced as a desperation measure during the Depression era, with 24 states adopting general sales taxes (in contrast to selective excise taxes on particular products or services) by 1938. Now, 45 states and the District of Columbia rely on general sales taxes.[7]

At the federal level, the income tax on corporations was reintroduced in the 1910 fiscal year, and the income tax on individuals was introduced in the 1914 fiscal year. In the history of federal taxation, the twentieth century can be characterized as the period that witnessed the development, refinement, and, some would claim, the near collapse of the income tax on individuals and businesses.

2 *See* TAX INSTITUTE OF AMERICA, FEDERAL-STATE-LOCAL FISCAL RELATIONSHIPS 10 tbl.7 (1968).

3 *See* J. ROBERT ARONSON & JOHN L. HILLEY, FINANCING STATE AND LOCAL GOVERNMENTS 238 tbl.A-2 (4th ed. 1986). The percentage of total revenue is in parentheses.

4 *See* U.S. DEP'T OF COM. & LAB., STATISTICAL ABSTRACT OF THE UNITED STATES: 1903, at 29-40 tbl.7 (1904).

5 *See* ARONSON & HILLEY, *supra* note 3.

6 By 1919, eight or nine states had income taxes. The number grew to 31 states by 1940, and now totals 44 states. *See* ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, SIGNIFICANT FEATURES OF FISCAL FEDERALISM: BUDGET PROCESSES AND TAX SYSTEMS 32-33 tbl.12 (1995) [hereinafter ACIR REPORT].

7 *See id.*

B. Post-World War II Changes in the U.S. Economy and in Federal, State and Local Tax Systems

At the close of World War II, the United States had a production economy, and American businesses exported technology to the war-torn regions of the world. Currency rates were fixed, and the United States was on the gold standard, with the value of gold set at $35 per ounce.

The changes in the U.S. tax system since World War II, while significant, are less dramatic than those that occurred from 1900 to 1945. The change in the federal tax structure from 1945 to 1997 is as follows (figures in parentheses represent the percentage of total budget receipts accounted for by each line item for each fiscal year):

TABLE 2. FEDERAL TAX STRUCTURE IN 1945 AND 1997[8]

	1945	1997
Individual income	$18.37 billion (40.7%)	$737.46 billion (46.7%)
Corporate income	15.99 billion (35.4%)	182.29 billion (11.5%)
Payroll taxes	3.45 billion (7.6%)	539.37 billion (34.2%)
Excise taxes	6.27 billion (13.9%)	56.92 billion (3.6%)
Other	1.08 billion (2.4%)	63.24 billion (4.0%)
TOTAL	$45.16 billion (100%)	$1579.28 billion (100%)

The comparisons, as a percentage of gross domestic product, are more revealing. The individual income tax has remained remarkably constant, while corporate income taxes have declined almost as much as payroll taxes have increased. The comparative data are as follows:

TABLE 3. FEDERAL TAXES AS A PERCENTAGE OF GNP/GDP[9]

	1945	1997
Individual income	8.3%	9.3%
Corporate income	7.2%	2.3%
Payroll	1.6%	6.8%
Excises	2.8%	0.7%
Other	0.5%	0.8%

In 1945, the federal government took 20.4% of GNP in taxes. The figure for 1997 was 19.9% of GDP.

8 The information in this chart is taken from EXECUTIVE OFF. OF THE PRESIDENT OF THE UNITED STATES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1999, HISTORICAL TABLES 27-28 tbl.2.1, 29-30 tbl.2.2 (1998) [hereinafter 1999 BUDGET].

9 *See id.* at 31-32 tbl.2.3. The United States used gross national product, rather than gross domestic product, in 1945.

The post-war period witnessed a substantial expansion of the state and local sector, its revenue and programs. In 1945, about 20% of tax revenue at all levels of government came from state and local taxes.[10] After the war, property taxes had become largely a local tax,[11] and 31 states and Hawaii had imposed a state or local tax on the income of individuals or corporations.[12] State retail sales taxes were imposed mainly on sales of goods, with only select services subject to tax. By the mid-1990s, state and local taxes increased to about one-third of the total revenue at all levels of government.[13] Property and sales taxes then accounted for about 64% of total state and local revenue.[14] Over this 50-year period, sales tax revenue dropped from 25% to 20% of state and local revenue, ignoring revenue-sharing.[15]

There has been a dramatic change in revenue-sharing and other federal transfers back to the state and local governments over the past five decades. In 1945, federal grants to state and local governments amounted to 0.9% of federal outlays.[16] The estimate for 1998 is 15% of federal outlays.[17]

The composition of our personal consumption expenditures also changed during this period. In 1945, of total personal consumption expenditures of $119.7 billion, $79.9 billion (67%) was for durable and nondurable goods,[18] and $39.8 billion (33%) was for services.[19] By 1997, total personal consumption expenditures were $5.5 trillion. Durable and nondurable goods dropped to 41%, and services almost doubled to 59%.[20] This change in the nature of the economy has prompted some states to expand their sales tax bases to include more services.[21]

Some congressional proposals for radical tax reform during the waning years of this millennium tap into perceived public discontent with the individual income tax return filing requirements that many taxpayers fear they cannot complete without the assistance of tax return preparers. As a prelude to the later discussion

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10 *See* ECONOMIC REPORT OF THE PRESIDENT 305 tbl.B-67 (1969) [hereinafter 1969 ECONOMIC REPORT].

11 *See* J.F. DUE & J.L. MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 2 (2d ed. 1994).

12 *See* ACIR REPORT, *supra* note 6, at 32-33 tbl.12.

13 *See* ECONOMIC REPORT OF THE PRESIDENT 378 tbl.B-83 (1998) [hereinafter 1998 ECONOMIC REPORT]. The state and local portion excludes federal grants.

14 *See id.* at 381 tbl.B-86.

15 *See id.*

16 *See* 1999 BUDGET, *supra* note 8, at 203-04 tbl.12.1.

17 *See id.*

18 "Durable goods" include motor vehicles and parts, furniture and household equipment, while "nondurable goods" include food, clothing and shoes, gasoline and oil, and fuel oil and coal. *See* 1998 ECONOMIC REPORT, *supra* note 13, at 300 tbl.B-16.

19 *See* 1969 ECONOMIC REPORT, *supra* note 10, at 239 tbl.B-10.

20 *See* 1998 ECONOMIC REPORT, *supra* note 13, at 300 tbl.B-16.

21 *See* DUE AND MIKESELL, *supra* note 11, at 90, 319.

of proposals to take 100 million taxpayers off the income tax rolls, it is helpful to look at tax return data over the last six decades. World War II is generally viewed as the event that converted the federal individual income tax from a tax imposed only on high income individuals to a tax imposed on the masses.[22]

In 1939, 6% of the population filed 7.6 million individual income tax returns.[23] By 1945, about 50 million individual income tax returns were filed, representing about 35% of the total population of 140 million.[24] In contrast, in 1995, over 118 million individual income tax returns were filed,[25] representing about 45% of the total population of 263 million.[26]

III. United States Watches World Tax Systems Shift to Value Added Taxes

A. Introduction

During the last several decades of the twentieth century, the most dramatic change in tax systems around the world has been the conversion of turnover and other national sales taxes to value added taxes (VATs).[27] The movement began with the adoption of a limited form of a VAT in France in 1954.[28] France eventually extended the tax down to the retail stage.[29]

The Treaty of Rome, which created the European Economic Community, requires all member states to adopt a VAT as a condition of membership.[30] The expansion of the European Union thus increased the number of nations with a VAT. In addition, the International Monetary Fund has assisted many developing countries in drafting VATs to provide the revenue needed to place themselves on a sounder financial footing. The emerging countries of the former Soviet Union followed this trend and adopted

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22 *See* Graetz, *supra* note 1, at 266.

23 *See* Bureau of the Census, U.S. Dep't of Com., Statistical Abstract of the United States: 1949, at 337 tbl.368 (1950) (number of tax returns) [hereinafter 1949 Statistical Abstract]; Bureau of the Census, U.S. Dep't of Com., Statistical Abstract of the United States: 1952, at 5 tbl.2 (1953) (population interpolated from decennial Census figures) [hereinafter 1952 Statistical Abstract].

24 *See* 1949 Statistical Abstract, *supra* note 23; 1952 Statistical Abstract, *supra* note 23.

25 *See* Internal Revenue Service, U.S. Dep't of the Treas., Stat. of Income Bull., Spring 1998, at 12 fig.A.

26 *See* 1998 Economic Report, *supra* note 13, at 321 tbl.B-34.

27 For a discussion of the nature of value added taxes, *see infra* Part IV.

28 The 1954 VAT covered only the industrial sector of the economy. *See* Jean-Pierre Balladur & Antoine Coutiere, *France, in* The Value Added Tax: Lessons from Europe 19 (Henry J. Aaron ed., 1981).

29 The VAT was expanded to the retail level in 1969. By 1979, the VAT covered virtually all economic activities, with permanent exemptions for the medical, educational, artistic and sporting professions. *See id.* at 20.

30 *See* Treaty Establishing the European Economic Community, Mar. 25, 1957, art. 99, 298 U.N.T.S. 11, 76.

VATs.[31] New Zealand, Canada, and Japan enacted VATs to replace other forms of sales tax.[32] The Australian government is committed to replacing its single stage sales tax with a VAT.[33] Once Australia enacts a VAT, the United States will have the distinction of being the only country of the large industrialized nations that form the Organization for Economic Cooperation and Development (OECD) that does not levy a VAT at the national level.[34] There are now about 100 countries with VATs.

Consistent with their obligations under the World Trade Organization (formerly the General Agreement on Tariffs and Trade), WTO member nations can impose border tax adjustments (BTAs) for indirect taxes. Nations with VATs impose the VAT on imports and rebate the tax on exports.[35] Countries like the U.S., which rely on direct taxes like income taxes, cannot rebate those taxes on exports.

B. Congressional Proposals to Board the Global VAT Rocket

In 1970, the Nixon administration considered, but did not propose, a value added tax to fund a revenue-sharing program aimed at forcing states to reduce reliance on property taxes to fund education.[36] House Ways & Means Committee chair Al Ullman proposed a value added tax in 1979 and 1980 to finance reductions in federal income and payroll taxes.[37] Nevertheless, it was not until the 1990s that politicians from both major parties made proposals for radical tax reform that attracted significant public attention.[38]

Recent congressional proposals to radically change the federal tax system are marked by the use of the revenue from a new broad-based tax on consumption, either to close down the Internal Revenue Service and have the states administer the new tax, or to abolish federal income taxes (and reduce or abolish payroll taxes). These proposals create revenue-neutral shifts in taxes, and are discussed next. Two proposals which do not propose the replacement of all or part of the current federal income tax system, and

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31 *See* ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, CONSUMPTION TAX TRENDS 11 (1995) [hereinafter CONSUMPTION TAX TRENDS].

32 *See id.*

33 A New Tax System (Goods and Services Tax) Bill 1998 (House of Representatives, Austl.).

34 *See* CONSUMPTION TAX TRENDS, *supra* note 31, at 11.

35 *See* Protocol Amending the General Agreement on Tariffs and Trade, Mar. 10, 1955, § 1(L), 8 U.S.T. 1767, 1777, 278 U.N.T.S. 168, 184 (added art. XVI(4)) [hereinafter GATT].

36 *See* Eileen Shanahan, *Nixon's Property-Tax Cuts Rejected by Advisory Group*, INT'L HERALD TRIBUNE, Dec. 16-17, 1972, at 3.

37 H.R. 5665, 96th Cong. (1979); H.R. 7015, 96th CONG. (1980).

38 There was a proposal for a sales-subtraction VAT, called the Business Transfer Tax (BTT), in 1985 by Senator Roth, with the tax creditable against the employer's share of its FICA tax. It was described by Senator Roth as a tax on net business receipts. 131 CONG. REC. S5675 (daily ed. May 8, 1985) (statement of Senator Roth upon the introduction of S. 1102).

which are, therefore, not discussed further, use a new VAT as a source for additional federal revenue.[39]

IV. Brief Review of Proposals for a VAT and Other Taxes on Consumption

Most of the proposals for a national tax on consumption contain value added tax elements. A value added tax is a multistage sales tax imposed on goods and services. Like a retail sales tax, a VAT is collected by businesses and is expected to be shifted forward to consumers in product prices. In fact, the degree of forward shifting depends on competitive forces and a firm's competitive position in its industry.

A retail sales tax (RST) is a single stage tax imposed on the value of taxable goods and services purchased by consumers at the retail stage. A VAT, on the other hand, is imposed on the value added by a taxable firm at each stage of production and distribution as goods are produced and services are rendered. The components of "value added" are wages (the largest element in most businesses), profit as calculated for VAT purposes,[40] rent expenses, and interest expenses.[41] In simplified terms, a firm's value added is the difference between its taxable sales and its taxable purchases used in making those taxable sales. Since the seller can recover VAT paid on its taxable purchases, there is no cascading of tax as goods go through several stages of production and distribution. The taxes remitted at each stage should add up to an amount equal to the retail prices paid by consumers for taxable items multiplied by the tax rate. If it works properly, the VAT should raise the same revenue, and consumers should pay the same tax-inclusive price under a VAT, as under a single-stage RST imposed on the same tax base at the same rate.

For example, if a lawyer purchases a computer, software, desks and office supplies, and pays rent and other utility bills, totaling $14,000, and charges legal fees of $25,000 in a single tax period, then with a 10% European-style VAT imposed on tax-exclusive prices, the lawyer will charge $2500 VAT on his fees (re-

39 H.R. 16, 106th Cong. (1999) (the Dingell bill to finance national health care); S. 237, 104th Cong. (1995) (the Hollings bill to finance national health care and to fund reductions in the national debt).

40 With a consumption-style VAT like that used almost universally, depreciation is added back and the cost of capital goods are deducted. Under the income tax in the U.S., items of inventory are charged to cost of goods sold in the year of sale. Under a VAT, a business can deduct purchases of inventory at the point of purchase, not when the purchased items are sold.

41 Rent and interest expenses are included in the tax base of the user of these services if rent and interest are not taxable to the provider of these services. These four factors of production (wages, profit, rent and interest) represent the elements in an addition method VAT. *See* Carl Shoup, *Theory and Background of Value-Added Tax*, 1955 Proc. of 48th Ann. Conf. on Tax'n of the Nat'l Tax Ass'n 7.

ferred to as output tax), will credit against his output tax liability the $1400 VAT listed on his purchase invoices (referred to as input tax), and will remit $1100 net VAT liability to the government, calculated as follows:

Output tax	
$25,000 fees x 10% VAT	$2500
Input tax credit	
$14,000 purchases, on which $1400 tax is paid	(1400)
Net VAT liability	$1100

If these legal fees are paid entirely by a single client, who is a retailer, and the retailer makes taxable sales of $300,000 and has other taxable purchases of inventory and other inputs of $160,000, the retailer's net VAT liability is $11,500, calculated as follows:

Output tax		
Taxable retail sales $300,000 x 10% tax		$30,000
Input tax credit		
Legal services $25,000, on which $2500 tax is paid	(2500)	
Other taxable purchases $160,000, on which $16,000 tax is paid	(16,000)	(18,500)
Net VAT liability		$11,500

Consumers who purchase from the retailer will be charged VAT equal to $30,000 (10% of the pre-tax retail price) and will pay a tax-inclusive price of $330,000. This is the same amount that they would have paid under a 10% retail sales tax imposed on the $300,000 pre-tax retail price.

The consumption tax proposals made by members of Congress and presidential candidates in the mid-1990s were mainly forms of a value added tax or a retail sales tax. A European-style VAT, like the one described above, was proposed by Senator Hollings, Congressman Dingell, and Professor Michael Graetz.[42] Most of the remaining VAT proposals were for a sales-subtraction VAT, which is buried in product prices. The other consumption tax proposals were for a flat tax (a bifurcated VAT) and a national retail sales tax. A sales-subtraction VAT is described first.

Unlike the transactional European-style VAT, which is imposed on each taxable sale and generally is listed on sales invoices, the sales-subtraction VAT is a period tax, which is buried in product prices. The sales-subtraction VAT is generally calculated from account totals for taxable sales and taxable purchases for each tax period. These totals are tax-inclusive, and the tax, therefore, is imposed on tax-inclusive prices. To raise the same

42 On the Hollings and Dingell VATs, *see supra* note 39. The Graetz proposal is discussed later in this section. *See infra* notes 61-65 and accompanying text.

revenue as a 10% VAT imposed on tax-exclusive prices, the sales-subtraction VAT rate is 9.0909%. Applying the sales-subtraction VAT to the above example, the lawyer will remit the same net VAT liability of $1100 and the retailer will remit the same net VAT of $11,500, calculated as follows:

Lawyer	
Taxable sales at tax-inclusive prices	$27,500
Less taxable purchases at tax-inclusive prices	(15,400)
Tax base	12,100
Tax rate	9.0909%
Net VAT liability	$1100
Retailer	
Taxable sales at tax-inclusive prices	$330,000
Less taxable purchases at tax-inclusive prices	
Legal services	(27,500)
Other taxable purchases	(176,000)
Tax base	126,500
Tax rate	9.0909%
Net VAT liability	$11,500

As the above examples illustrate, consumers pay the same $330,000 tax-inclusive prices under the sales-subtraction VAT as under the European VAT, assuming that the entire VAT is shifted forward to purchasers under both forms of VAT.

As a tax buried in product prices, this VAT does not handle exemptions well.[43] Indeed, if the tax is not imposed at a single rate on a comprehensive base, the sales-subtraction VAT "breaks down."[44] The VAT proposed by Congressman Gibbons is free of exemptions and is imposed at one rate, but it has not been subjected to the legislative process.[45]

Congressman Armey's flat tax,[46] proposed in 1995, is in essence a tax on consumption, with a tax base that in theory resembles the sales-subtraction VAT just described. The flat tax base, however, is bifurcated into a business tax (BT) and an income tax (IT). In contrast to a pure VAT, which imposes tax on the value added by a business from labor, profit, rent and interest expenses,

43 Unless a system of distinguishing exempt from taxable sales and disallowing deductions for exempt purchases exists, the revenue lost on the exempt sale is difficult to recoup from the business using the exempt item.

44 *See* CHARLES E. MCLURE, JR., THE VALUE-ADDED TAX: KEY TO DEFICIT REDUCTION? 71 (1987). For other differences between the European VAT and the sales-subtraction VAT, *see id.* at 71-86.

45 The Gibbons proposal is discussed in detail later in this section. *See infra* notes 51-60 and accompanying text.

46 H.R. 2060, 104th Cong. (1995). The Armey Flat Tax was patterned on the flat tax proposed by two senior fellows at the Hoover Institution. *See* ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d ed. 1995).

the BT gives a business a deduction for wages paid to workers and contributions by the business to employee retirement plans. The "wage" portion of the base is reportable by, and taxable to, workers. Workers must file IT returns, reporting their wages and distributions from retirement plans (along with any unemployment compensation). Even so, the combined BT and IT would be equivalent to a VAT base, except that a worker subject to the IT portion of the flat tax can claim a standard deduction linked to her filing status and family size. This deduction is designed to provide some progressivity to the flat tax system, but it distorts the tax base.[47] The taxation of international transactions under the flat tax also departs from the principle used in the VAT and other consumption tax proposals. It relies on the origin principle to tax international transactions. Unlike the universally used destination principle for a VAT, which taxes imports and removes tax from exports, the flat tax taxes exports and does not tax imports.[48]

A national retail sales tax was proposed in 1996 by Congressman Schaefer.[49] His proposal would replace the federal income taxes, estate and gift taxes, and some excise taxes with a 15% retail sales tax that would be administered by conforming states. To be a conforming state, a state must have a retail sales tax that is harmonized with the new federal retail sales tax. Proponents of this sales tax claim that their proposal would permit the shutdown of the IRS.[50]

The remainder of this article focuses on the specifics of two reform proposals that rely on revenue from a new VAT to take 100 million individuals off the individual income tax rolls. These proposals represent a middle ground between retaining the existing income taxes and repealing the income taxes entirely. The proposals were made by Congressman Sam Gibbons and Professor Michael Graetz. The Gibbons legislative proposal, discussed first, recommends the replacement of about 90% of current federal

47 The standard deduction is based on the taxpayer's filing status and the number of dependents. *See* H.R. 2060 § 101 (proposed I.R.C. § 63).

48 The origin principle may have been selected, in part, to avoid conflict with U.S. obligations under the World Trade Organization rules that allow border tax rebates only for indirect taxes on product prices. *See* GATT, *supra* note 35. Some commentators claim that under certain conditions, where relative wages and prices or exchange rates are flexible, in the long term, the origin and destination principles have similar effects on trade. *See* Martin Feldstein & Paul Krugman, *International Trade Effects of Value-Added Taxation*, *in* TAXATION IN THE GLOBAL ECONOMY 263 (Assaf Razin & Joel Slemrod eds., 1990); Victoria P. Summers, *Book Review of Gary Clyde Hufbauer, assisted by Carol Gabyzon, Tax Reform and Border Tax Adjustments*, 49 NAT'L TAX J. 687 (1996).

49 H.R. 3039, 104th Cong. (1996).

50 This claim that the IRS can be shut down is exaggerated. For example, there are several states without retail sales taxes. It is unlikely that these states would set up the apparatus to collect the federal sales tax. In addition, under the Schaefer bill, there is a mechanism for the federal collection of sales tax from businesses that operate in multiple states. *See id.* § 4 (proposed I.R.C. § 33).

taxes.[51] Congressman Gibbons, before his retirement, proposed a 20% sales-subtraction VAT to replace much of the individual income tax, the corporate income tax, and the Social Security and Medicare taxes. A central feature of his plan is to remove most individuals from the income tax rolls, leaving the individual income tax as a tax only on high income individuals.[52]

Congressman Gibbons' proposal is designed to be revenue neutral and to achieve roughly the same distribution of tax burden among income groups as the existing federal tax structure.[53] His five principles of fundamental tax reform are:

(1) Revenue neutrality,

(2) Fairness as reflected in the equitable distribution of tax burden,

(3) Simplicity, "thereby avoiding the ill will and skepticism generated by the current Federal tax system,"

(4) Economic efficiency "to minimize interference in economic markets," "encourage economic growth," and "promote the vigor and competitiveness of American companies," and a

(5) Border adjustable tax that "promote[s] the competitiveness of American companies."[54]

To maintain the current degree of progressivity and distribution of federal tax burden, referred to by Mr. Gibbons as "tax fairness," he proposes tax burden adjustments. The tax burden adjustments consist of a tax rebate to low-income individuals with incomes up to $30,000, and a "burden assessment" that taxes individuals on incomes above $75,000.[55] In 1996, about 42 million taxpayers that fit between $30,000 and $75,000 in income would neither receive a rebate nor be subject to the tax imposed on higher-income individuals. The tax burden for these 42 million taxpayers would be limited to the 20% VAT that they would pay on their taxable purchases.

The tax rebate (which is designed to reimburse low-income individuals for some or all of the VAT that they pay on purchases) would be available to the estimated 50 million taxpayers in 1996 who had annual adjusted net income of no more than $30,000.[56]

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51 *See* 142 CONG. REC. E1572 (daily ed. Sept. 11, 1996) (introductory statement by Rep. Gibbons).

52 *See* H.R. 4050, 104th Cong. §§ 101-102 (1996).

53 *See id.* § 1(c).

54 *See id.* § 1(b).

55 *See id.* § 301 (proposed I.R.C. §§ 1601-1602 and 1611-1612).

56 *See* 142 CONG. REC. E1573 (daily ed. Sept. 11, 1996). A married couple must file a joint return to qualify for the rebate. *See* H.R. 4050 § 301 (proposed I.R.C. § 1601(c)). The rebate is equal to the applicable percentage of the portion of the adjusted net income that does not exceed $30,000. *See id.* (proposed I.R.C. § 1601(b)(1)). The "applicable percentage is 20 percent reduced (but not below zero) by 2/3 of 1 percentage point for each whole $1,000 of the individual's adjusted net income." *Id.* (proposed I.R.C. § 1601(b)(2)). The adjusted net income is net income (adjusted gross income with some modifications) plus the

The rebate is phased out as individuals approach $30,000 in income. The rebate may be made by direct government payment to the individual, by payment incident to federal transfer payments or social security benefits, or by payment with wages by an employer to employees with eligible certificates.[57]

The burden assessment on high-income individuals includes a 17% tax on the net income of an assessable person in excess of the threshold amount, which generally will be $75,000 for an individual and zero for a trust.[58] For these persons, most of the current individual income tax rules will remain, although some will be repealed and some new rules will have to be added.[59] Net income is adjusted gross income with additions for certain items excludible under the current income tax.[60]

The Gibbons VAT is broadly based and covers businesses with annual gross receipts of $12,000 or more. Isolated or infrequent sales by individuals, such as garage sales, are not taxed. As a tax on sales of goods and services, the proposed VAT does not tax busi-

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value of certain federal transfer payments (including aid to families with dependent children, food stamps, and certain other federal assistance). *See id.* (proposed I.R.C. § 1601(b)(3) & (4)).

57 *See id.* (proposed I.R.C. §§ 1601(f) & 1602). Payments by employers are treated as payments of VAT, not payments of compensation. *See id.* (proposed I.R.C. § 1602(d)).

58 *See id.* (proposed I.R.C. § 1611(a) & (d)). The threshold for an individual is zero if the person is married, does not file a joint return, and does not live apart from his or her spouse. An assessable person is an individual, estate or taxable trust. *See id.* (proposed I.R.C. § 1611(b)). Congressman Gibbons estimated that there were 17.5 million taxpayers (16% of current taxpayers) in this group in 1996. 142 CONG. REC. E1573 (daily ed. Sept. 11, 1996).

59 An individual, estate or taxable trust that owns stock in specified corporations must include as dividend income the amount the person would have received if the corporation had made a pro rata distribution of certain of its undistributed income to shareholders on the last day of the corporation's taxable year. Undistributed income is net income reduced by certain corporate distributions to its shareholders during the taxable year. *See* H.R. 4050 § 301 (proposed I.R.C. § 1612(c)(1)). The amount that the person would have received if the corporation had distributed pro rata is "an amount which bears the same ratio to the undistributed income of the corporation for the taxable year as the portion of such taxable year during which such corporation is an applicable corporation bears to the entire taxable year." *Id.* (proposed I.R.C. § 1612(a)). This rule applies to a corporation operating a service-related business and to a closely held C corporation. *See id.* (proposed I.R.C. § 1612(b)(1)). A service-related business is any trade or business within I.R.C. § 1202(e)(3)(A). *See id.* (proposed I.R.C. § 1612(b)(2)). A closely held C corporation is "any C corporation if, at any time during the last half of the taxable year, more than 50 percent in value of its outstanding stock is owned, directly or indirectly through the application of section 544, by or for not more than 10 individuals." *Id.* (proposed I.R.C. § 1612(b)(3)). An applicable corporation does not include a corporation exempt from tax. *See id.* (proposed I.R.C. § 1612(b)(1)).

60 *See id.* (proposed I.R.C. § 1611(c)). Net income is determined the same way as taxable income under chapter 1 in effect on the day before this section is enacted. *See id.* (proposed I.R.C. § 1612(c)(2)). Net income is calculated without the exclusions under §§ 911, 931, 933, 457, and the 402(g)(3) elective deferral. Tax-exempt interest must be added back to AGI, and deferred compensation is included in gross income in the first taxable year when there is no substantial risk of forfeiture within § 457(f)(3), but this rule does not apply to a plan or contract under § 457(f)(2). Gross income of a trust or estate is to be determined under § 67(e). *See id.* (proposed I.R.C. § 1611(c)(2)-(4)).

nesses on income earned on income-producing property, such as interest on bonds and dividends on stock.

In his 1997 book, *The Decline (and Fall?) of the Income Tax*, Professor Michael Graetz outlined the broad principles of his proposal to use a European-style VAT to replace the income tax for an estimated 100 million individual tax filers with adjusted gross income of less than $75,000, making "the federal tax system much more economically efficient and friendlier to savings and capital formation without introducing the inherent unfairness of completely substituting a consumption tax for income taxation."[61] According to Professor Graetz, his plan "would return the income tax to its pre-World War II status, when it supplied progressivity to the United States tax system by limited application only to people at the top of the income tax scale."[62] An option that he suggests is to tax income exceeding $75,000 or $100,000 at a flat 20% rate.[63] Graetz disagrees with those who would use the replacement of the income tax with a VAT as the opportunity to repeal the estate and gift taxes as well.[64] He offers an alternative that radically changes the estate and gift taxes, but still taxes the transfer of wealth during life or at death. Gifts and inheritances would be taxable as income under his proposed income tax system, imposed only on high income individuals, so that "transfers to people without substantial other income" would be exempt and other transfers that now may be subject to a 55% estate and gift tax rate would be taxable at the 20% rate applicable to taxpayers with adjusted gross income above $75,000.[65]

V. Comparison of European and Sales-Subtraction VATs

There are differences between the Graetz and Gibbons proposals to use new VAT revenue to remove all but high income individuals from the income tax rolls and make other changes in the federal tax system. For example, there are differences in the taxes that would be replaced. There are also differences between a European invoice VAT (the Graetz proposal) and a sales-subtraction VAT (the Gibbons proposal). If the impact of a federal VAT on

61 Graetz, *supra* note 1, at 265. For the 1996 tax year, of the 121 million returns filed, 12 million were from taxpayers with adjusted gross income of $75,000 and above. The Graetz plan has other noteworthy features. The plan would allow the taxation of individuals with incomes above $75,000 at a flat 21% rate. "By applying the current minimum-tax rules to these people or slightly increasing their tax rates, deductions for charitable contributions, medical expenses, and home mortgage interest could be allowed. Alternatively, broadening the tax base by eliminating other tax breaks might permit retention of these deductions without increasing the tax rate." *Id.*

62 *Id.* at 266.

63 *Id.* at 265.

64 *Id.* at 267.

65 *See id.* at 268.

state and local tax and on taxpayer compliance costs could be ignored, the European VAT would be the better choice.

The European VAT, which is imposed on each taxable sale (a transactional tax), typically is stated separately on sales invoices. This kind of VAT permits more precise border tax adjustments, and more easily accommodates changes in the tax rate as well as grants of tax exemptions for political, economic or other reasons. It also provides a useful audit trail to cross-check taxable sales by sellers with claims of input credits by purchasers.

The sales-subtraction VAT, a period tax buried in product prices, more easily operates alongside state sales taxes, and, because of the distortions and complexities they cause, this form of VAT deters both changes in the tax rate and the grant of exemptions for particular goods and services. These limits on the flexibility of a sales-subtraction VAT may be viewed by some as its greatest strength. A few of the differences between the Graetz and Gibbons VAT proposals are discussed next.

A. Taxes Replaced and VAT Rates

Gibbons proposed the replacement of much of the individual income tax, the corporate tax, the Social Security tax and the Medicare tax with a VAT. According to Gibbons, a 20% VAT rate is needed to finance these changes, including rebates to an estimated 50 million individuals with adjusted gross income under $30,000. The proposal also includes a 17% income tax imposed on "net income" above $75,000.

The Graetz alternative discussed here contemplates a 20% VAT to replace fewer taxes. Graetz would replace the individual income tax for filers with adjusted gross income of less than $75,000 or $100,000, and would impose a higher 20% income tax on those with incomes above the threshold. He does not propose any rebates to low-income families. Instead of repealing the estate and gift taxes, he would require donees and devisees to include gifts and inheritances in income, taxable only to those high income individuals who are subject to the 20% income tax. An option also discussed in the Graetz plan was to increase the VAT rate by 2% in order to cut the corporate income tax to 20%.[66]

B. Border Tax Adjustments

The European VAT proposed by Graetz permits fairly precise border tax adjustments (BTAs), compatible with the BTAs used by many of our trading partners. The tax is separately stated on invoices at each stage of production and distribution, so the input

66 *Id.* at 266.

tax credit can be calculated with precision. Exports are free of tax. No tax is imposed on export sales and the exporter can claim a credit for all VAT paid on purchases attributable to the exports. Imports are fully taxed at the VAT rate.

If Congress adopts a sales-subtraction VAT like the Gibbons proposal, the rebate of tax on exports will depend on estimates of the VAT element in exported goods and services. This need to use estimates arises because the VAT is a period (not transactional) tax, which is buried in product prices. While the tax base can and should be the same for a European and sales-subtraction VAT, the Gibbons VAT deviates from a pure VAT. To be comparable, the Gibbons VAT should limit deductions for purchases to the cost of purchases that were subject to VAT. However, in the Gibbons sales-subtraction VAT, a business also can deduct the cost of purchases from exempt small businesses.[67] The imposition of tax on imports also should depend on estimates of the tax burden on domestically produced goods and domestic services, so that the same burden is imposed on the imports. The Gibbons VAT is imposed on the full value of all taxable imports.

The use of estimates, rather than precise BTAs, opens the possibility that our trading partners will de-couple the precise VAT element in their exports and the BTAs that they authorize for exports. At least one country, Japan, currently relies on estimates (or intentionally allows rebates exceeding the tax element in exports) for its BTAs.[68] The Japanese Consumption Tax (CT), like the Gibbons VAT, allows input tax credits for presumed tax on purchases from small businesses exempt from VAT. To date, Japan's trading partners have not objected.

Some commentators have questioned if BTAs for a sales-subtraction VAT are compatible with our obligations under the WTO rules that restrict border tax adjustments.[69] The WTO permits the rebate of indirect taxes on exports, but not direct taxes.[70] The method of calculating VAT liability does not alter the economic effects of the tax. If a European VAT is compatible with WTO, the sales-subtraction VAT imposed on the same base should be as well. "If, however, Congress approaches the BAT [business activities tax] like an income tax and grants or denies deductions for

67 *See* H.R. 4050, 104th Cong. § 201 (1996) (proposed I.R.C. §§ 10014 on deductions, and 10041 on the small business exemption). With a nominal $12,000 small business exemption, distortion in prices or distortions in BTAs likely will be minimal.

68 During the years that the European countries relied on turnover taxes, they based BTAs on estimates that were less precise then the estimates required under the Gibbons VAT.

69 For example, according to JOINT COMMITTEE ON TAXATION, FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES, (JCS-6-91), May 30, 1991, at 304: "there is considerable uncertainty as to whether a subtraction-method VAT would be legal under GATT."

70 *See* GATT *supra* note 35.

economic, administrative, or political reasons, [Congress could] . . . change the nature of the tax so substantially that our trading partners may successfully claim that the tax no longer is an indirect tax that is border adjustable under GATT [WTO]."[71]

C. Fiscal Federalism

A sales-subtraction VAT may be more compatible with state sales taxes than a European VAT. Both proposals, however, may have a significant effect on state and local revenue and administration. State and local governments now raise about 20% of their revenue from sales tax and 15% from individual and corporate income taxes.[72] If state and local sales tax and the Graetz-proposed European VAT are separately stated on invoices and are added at the cash register, the high total rate may affect the states' ability to increase their sales tax rates in the future. If the Graetz or Gibbons proposal removes 100 million taxpayers with adjusted gross income of not more than $75,000 from the federal income tax rolls, these taxpayers still must calculate their income in order to file their state and local income tax returns. As a result, the Graetz and Gibbons proposals may not significantly reduce taxpayer compliance costs for individuals exempt from the federal income tax. Graetz acknowledges this problem.[73] States would no longer be able to rely on federal tax data and federal audits to help enforce state and local income taxes on these 100 million individuals who are no longer on the federal individual income tax rolls. It is not clear whether states could afford to increase their audits of these taxpayers, many of whom would have relatively small state and local tax liabilities.

> It is not clear that radical federal tax reform will spawn radical state tax reform. On a more modest level, when Congress repealed the federal individual income tax deduction for state and local sales tax, some commentators speculated that states would

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71 Oliver Oldman & Alan Schenk, *The Business Activities Tax: Have Senators Danforth & Boren Created a Better Value Added Tax?*, 10 TAX NOTES INT'L 55, 62 (1995). The Gibbons bill itself gives some advance indication of the temptation of members of Congress to treat the sales-subtraction VAT like an income tax. The bill denies deductions for purchases that violate federal, state or local law. H.R. 4050 § 201 (proposed I.R.C. § 10015). In contrast, the European VAT, under the Sixth VAT Directive, disallows deductions for items that represent final consumption. Sixth Council Directive of May 17, 1977, On the Harmonization of the Laws of the Member States Relating to Turnover Taxes — Common System of Value Added Tax: Uniform Basis of Assessment, 1977 O.J. (L 145) 1, *explored in detail in* B.J.M. TERRA AND JULIE KAJUS, A GUIDE TO THE EUROPEAN VAT DIRECTIVES (1994). For example, the Sixth Directive, Art. 17(6) disallows deductions for luxuries, amusements and entertainment.

72 *See* 1998 ECONOMIC REPORT, *supra* note 13, at 381 tbl.B-86.

73 GRAETZ, *supra* note 1, at 262.

> shift from nondeductible sales taxes to deductible income and property taxes.[74] This shift has not occurred.[75, 76]

If states are pressured into piggybacking their individual income taxes on a reformed federal individual income tax with a $75,000 exemption, the states somehow must recoup the revenue now raised from the income groups excluded from that tax, a potentially difficult task for those states with an aversion to sales taxes or with a commitment to providing a favorable tax climate for business.

If Congress adopts a VAT like the harmonized VAT used in the European Union, the tax base will be broader, and the timing and reporting rules may differ significantly from those in use under most state and local retail sales taxes.

The Canadian experience operating a European VAT (the Goods and Services Tax, or GST) at the national level and retail sales taxes at the provincial level may be predictive of problems that the United States might face if Congress adopted the Graetz proposal. Public opposition in Canada to the introduction of the GST resulted in part from the sticker shock experienced by consumers in provinces with retail sales taxes when the 7% GST was coupled with the provincial sales tax (typically 8%), both being added at the cash register. This public discontent arose even though the Canadian shift from the outdated manufacturer's sales tax to the GST was revenue-neutral.

The Canadian response to the opposition to the GST was to harmonize the provincial sales tax and the GST in those provinces that were willing to defer to the federal GST base and rules. The combined tax is the Harmonized Sales Tax, which eventually will be administered by a new customs and revenue agency.[77] Equally significant, the GST, or the HST, ultimately will be buried in product prices, even though merchants will be required to disclose the tax or tax rate on sales invoices.[78] The Graetz VAT also could be buried in retail prices, but as a transaction-based tax, businesses still must comply with two transaction-based sales taxes imposed on different bases in states with state retail sales taxes. The com-

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74 *See* Charles E. McLure, Jr., *State and Local Implications of a Federal Value-Added Tax*, 38 TAX NOTES 1517, 1526 (1988).

75 *See, e.g.*, NATIONAL CONFERENCE OF STATE LEGISLATURES & NATIONAL GOVERNORS' ASS'N, FINANCING STATE GOVERNMENT IN THE 1990S 10 (Ronald Snell ed., 1993).

76 Alan Schenk, *A Federal Move to a Consumption-Based Tax: Implications for State and Local Taxation and Insights From the Canadian Experience*, 3 ST. & LOC. TAX LAW. 89, 107 (1998).

77 For a discussion of the lessons the United States can learn from the Canadian harmonization effort, *see id.* at 111-17.

78 *See id.* at 113. The tax-inclusive pricing has been delayed until "provinces together having at least fifty-one percent of the total population" of certain provinces have tax-inclusive pricing. Excise Tax Act, R.S.C., ch. 10, § 242(1) (1997) (Can.) (adding Division XI).

pliance burden may be increased if a business makes sales both at retail and pre-retail stages.

The Gibbons VAT will have some, but not all, of the same effects. There will not be the sticker shock at the check-out counter, because only the state sales tax, not the VAT, will be added there. The sales-subtraction VAT is a period tax, not a transactional tax, and therefore is not calculated and added to the price of each taxable sale at the cash register. The Gibbons VAT still represents a second sales tax with a tax base different than state RSTs. The Gibbons VAT, like the Graetz proposal, may pressure state and local governments to remove individual income tax from taxpayers deleted from the federal income tax rolls because they have adjusted gross income of not more than $75,000.

Japan relies on a VAT, called a Consumption Tax (CT), which is a European-style credit method VAT, except that it does not rely on tax invoices. A detailed examination of the CT is beyond the scope of this article, but it deserves serious exploration as a possible better alternative to handle the federal-state issues, without some of the disadvantages of the sales-subtraction VAT.[79] In structure, the CT resembles the European VAT, with input tax credited against tax on taxable sales, rather than the sales-subtraction VAT, which allows deductions from taxable sales to obtain the tax base subject to tax. Congress, therefore, might not be tempted to grant tax exemptions or deductions with a Japanese-style CT like those that have riddled the income taxes. A central feature of the European VAT is its reliance on "tax invoices" issued by registered traders who must separately state the VAT charged on the sale. Input credits are available only for the VAT listed on the tax invoices. The tax invoice, however, is not central or even required under the Japanese CT, since input credits can be calculated from the tax-inclusive costs of taxable purchases recorded in purchase records. It is, therefore, more compatible with state RSTs than the European VAT.

VI. A Consumption Tax for the 21st Century

The following is a brief summary of selected issues that will affect any effort to replace various existing federal taxes with a VAT. Most need further study.

A. Trigger for Radical Tax Reform

Experience with tax legislative changes since 1913 indicates that, in the absence of shocks to the economy like a major war or a depression, Congress tends to change the tax system incre-

79 For a discussion of the Japanese CT, see Alan Schenk, *Japanese Consumption Tax After Six Years: A Unique VAT Matures*, 69 Tax Notes 899 (1995).

mentally. It is not clear that public discontent with the individual income tax is sufficient to provide the broad-based support needed for radical reform. Indeed, Congress may not take the lead on controversial radical tax reform without support from a popular President.

B. Pressure to Simplify the Income Tax

The claim that a move to a VAT is a move to simplify the federal tax system is an exaggeration, especially if the tax is broadly based and covers such items as real property, financial intermediation services, and services rendered by government agencies and nonprofit organizations. Any "simplification" resulting from the Graetz or Gibbons proposals really represents a shift in the tax compliance burden. The 100 million individuals who will be removed from the individual income tax rolls may have little or no contact with the Internal Revenue Service, unless they have to file for the tax rebates under the Gibbons plan, but without corresponding reform at the state and local levels, individuals still must maintain records and calculate income tax liabilities for subnational income taxes. On the other hand, the new VAT will subject almost all businesses, large and small, to reporting, collection and payment obligations under the VAT. These compliance costs (as a percentage of sales) are much higher for small businesses.[80]

C. Remove Tax From Returns to Savings

The proposals to move from the individual income tax to a VAT represent a major shift in tax policy. Since the inception of the income taxes, the tax base has included returns on investments, whether in the form of interest on loans, dividends on stock, or gains from the sale of investment assets. These returns on savings are not included in the VAT base.

Pressure to reduce tax on returns to savings is designed to encourage investment in new or expanding businesses. A shift to consumption-based taxation tends to encourage savings over consumption, a goal that has attracted support inside the Beltway, on Wall Street and in the boardrooms. It is not clear, however, if a proposal to reduce taxes on interest, dividends, and capital gains to zero will receive the broad-based support of American taxpayers on Main Street that may be needed to enact such dramatic changes in our federal tax system.

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80 *See generally* William J. Turnier, *Accommodating to the Small Business Problem Under a VAT*, 47 TAX LAW. 963 (1994).

D. Pressure to Increase Social Security Benefits May Change

The current system, which nominally links Social Security benefits to payroll tax revenue, imposes half of the FICA tax on employers and half on employees. This scheme provides a workable balance between the interests of workers to increase retirement benefits and the interests of employers to restrain the rate on their share of the tax. This balance between competing constituencies would no longer exist if, as Gibbons proposes, Congress replaces the FICA tax with a VAT.

E. Transition and Reaction to a Consumption-Based Tax

The taxation of existing capital and the tax burden on various age groups raise significant transitional issues if Congress replaces taxes levied on an income base with a tax on consumption, especially if this change occurs without a lengthy phase-in period. Many of these issues have been explored elsewhere and will not be discussed in any detail here.[81]

Public reaction to radical tax reform may depend upon the taxes that are repealed and upon the transitional adjustments, if any, provided. The implications will be severe if Congress follows the Gibbons proposal, which repeals the corporate and part of the individual income tax, and the Social Security and Medicare taxes, rather than the Graetz plan, which retains the payroll taxes, keeps the corporate tax but with some possible rate change, and keeps the individual income tax structure intact for the high income taxpayers who are to be subject to the new flat income tax rate. For example, businesses with capital goods that are not fully depreciated when the VAT becomes effective will feel disadvantaged if the VAT replaces the income tax on business and they cannot recoup the remaining cost of the capital goods for tax purposes. The "Baby Boom" generation may object to the introduction of a VAT, especially if it replaces payroll taxes, because they financed their parents' Social Security and Medicare benefits with their payroll tax payments during their working years, and they will be required to finance their own Social Security checks with the VAT that they pay as they use their savings and retirement benefits on consumption during their retirement years.

F. Progressivity of the Federal Tax System

Dr. Carl Shoup's message to post-war Japan resonates today. To paraphrase him, ultimately a tax system, to have public support, must represent the shared values of the taxpaying public as

81 *See, e.g.*, Avishai Shachar, *From Income to Consumption Tax: Criteria for Rules of Transition*, 97 HARV. L. REV. 1581 (1984) (discussing a transition from an individual income tax to a cash-flow, consumption-based income tax).

to what is fair.[82] In the United States, the concept of vertical equity (taxpayers with unequal incomes should pay unequal taxes) has been reflected in our support for progressive taxes. The individual income tax provides much of the progressivity in the federal system.

Over the past 60 years, while the individual income tax represented a significant source of federal revenue, the degree of progressivity in the tax rates fluctuated significantly. In 1939, the top combined normal tax and surtax rate was 79%.[83] The top rate peaked at 91% until the Kennedy tax cuts in the early 1960s reduced it to 70%.[84] The top rate was cut back further in stages, until it bottomed out at 28% with the 1986 reforms, and then rose again during the 1990s to 39.6%.[85] This fluctuation suggests that our view about the appropriate degree of progressivity has changed during this period.

If Congress decides to maintain a progressive tax system, a direct and individualized tax like the existing individual income tax or a cash-flow income tax imposed on a consumption base can accomplish that goal more efficiently than an indirect tax like a VAT. If a VAT is chosen to replace most or all of the individual income tax, progressivity, if desired, should be achieved outside the VAT system through devices such as the Gibbons-proposed tax rebate to lower-income households or with adjustments in government transfer payments to low-income families.

G. Relation Between Taxes and Trade

In an earlier era of fixed currency exchange rates, changes in domestic taxes that have an impact on product prices could alter a nation's competitive position in international markets, and thereby affect its balance of trade. Then and now, many of our trading partners rely on border adjustable indirect taxes—turnover taxes and later, VATs. These BTAs, imposing a VAT on im-

82 According to Shoup, a nation's "tax system must satisfy the deep, widespread feelings of the people as to what is fair." 1 SHOUP MISSION, GEN. HEADQUARTERS, SUP. COMMANDER ALLIED POWERS, REPORT ON JAPANESE TAXATION 17 (1949) (four-volume report). Indeed, "no one remains in the tax field for long without realizing that nothing he recommends will stand up unless it meets the test of fairness in the distribution of the tax burden." *Id.* at 16.

83 *See* Internal Revenue Code of 1939, Pub. L. No. 76-1 § 10, 53 Stat. 1, 5-6 (1939) (Codified as I.R.C. §§ 11-12).

84 *See* Revenue Act of 1964, Pub. L. No. 88-272 § 111, 78 Stat. 19, 19-23 (1964) (reducing the top rate to 77% for taxable years beginning on or after Jan. 1, 1964, and reducing the top rate further to 70% for taxable years beginning after Dec. 31, 1964).

85 *See* Tax Reform Act of 1986, Pub. L. No. 99-514 § 101(a), 100 Stat. 2085, 2096-99 (1986) (reducing the top rate to 28% for tax years beginning after Dec. 31, 1986); Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 §§ 13201-13202, 107 Stat. 312, 457-61 (1993) (increasing the top rate to 39.6% for tax years beginning after Dec. 31, 1992).

ports and rebating it on exports, are consistent with member nations' obligations under GATT (now WTO) rules.

The impact of BTAs in the current international economic climate of floating exchange rates is less clear.[86] First, the U.S. dollar serves as more than just our national currency. Businesses around the world hold U.S. dollars as reserve assets. Second, the new currency adopted by several members of the European Union, the Euro, is expected to join the U.S. dollar as a reserve asset. The impact of the Euro on the dollar's function in international currency markets is not yet clear.

If a congressional replacement of income taxes with a VAT produced a significant improvement in our balance of trade that was not corrected by a change in the value of the U.S. dollar, it is likely that our trading partners would take action to offset the effect of this U.S. tax shift. No country has used VAT revenue to replace all income tax revenue. The potential impact on the domestic economy and on international trade is subject to speculation only. This major tax shift may prompt copycat legislation or retaliatory action by our major trading partners. Whatever the asserted trade benefits of shifting from income to consumption taxes, Congress should not make radical changes in the domestic tax structure just to obtain possible short-term balance of trade advantages.

VII. Conclusion

If Congress decides to increase reliance on consumption as the base upon which federal taxes are levied, its options include a flat tax, a national sales tax, and a VAT, all of which have been proposed in the last decade of this century. If Congress rules out the origin-based flat tax with its uncertain effects on domestic prices and international competition, and rejects the national sales tax to be administered by the states as a system that may be administered unevenly across the country, it is left with several varieties of VAT. This article focused on the European VAT proposed by Professor Graetz and the sales-subtraction VAT proposed by Congressman Gibbons. The Graetz and Gibbons proposals are designed to take about 100 million taxpayers off the federal income tax rolls, but presumably would retain the current complex individual income tax system for millions of high income taxpayers. The removal of these 100 million taxpayers from the federal income tax rolls could make it more difficult for states to continue taxing those taxpayers under state income tax laws.

Were it not for the operation of a federal VAT alongside state and local sales taxes, the Graetz European VAT proposal would be

86 *But see supra* note 48.

preferable. It would maintain the tradition in the United States of transparent sales taxes, which are separately stated on sales invoices. The Canadian experience with this system, however, makes a VAT buried in product prices, like the Gibbons sales-subtraction VAT, a more acceptable option to operate alongside state retail sales taxes. Negative aspects of the Gibbons VAT include the fact that it is not transparent and it appears, in statutory form, more like a tax on business income. BTAs may be imprecise because the tax is buried in product prices, and if Congress views the VAT as a tax on business, it may distort the tax with exemptions and deductions improper for a broad-based tax on consumption. It is possible to bury a European VAT in retail prices to prevent the sticker shock from two sales taxes being added at the cash register. However, the difference between a period tax (the sales-subtraction VAT) and a transaction tax (the European VAT) still remains.

Radical tax reform should be gradual, occurring in small steps rather than in a "big bang." The core of the Gibbons and Graetz proposals is the enactment of a VAT to fund the removal of 100 million taxpayers from the federal income tax rolls (although for many of those taxpayers, the current income tax system is not unduly complex). Each proposed VAT is collected and remitted by businesses and is expected to be borne by consumers when they purchase taxable goods and services. These proposals represent a shift in tax compliance burden from individuals subject to the income tax to businesses responsible for the VAT record keeping and reporting requirements. The compliance costs imposed on businesses will escalate further for retailers in states with RSTs imposed on different bases if Congress selects a European VAT that is added at the cash register.

Progressivity is retained in both plans with the income tax on high income taxpayers and, under the Gibbons plan, tax rebates to those with low income. There will be winners and losers in the battle over the allocation of the federal tax burden, both among income and age groups.

If Congress embraces the goal to use a VAT to take 100 million taxpayers off the income tax rolls, it should consider the Japanese style VAT as an alternative to both the Gibbons and Graetz VATs, especially at the outset. While it is not an ideal VAT, it contains features that simplify compliance for businesses and make it fit more comfortably alongside state RSTs. Moreover, it is less likely than the Gibbons VAT to be viewed by Congress as a tax on business income susceptible to lobbying pleas for tax exemptions or special deductions.

Radical proposals, such as the complete replacement of federal income taxes, should not be dismissed just because they have

not been tried elsewhere. However, it is not clear that there is public support for the kind of radical tax reform contemplated by the proposals discussed in this article, especially the tax exemption for interest, dividends, and other returns to savings implicit in a tax imposed on a consumption base. Ultimately, any tax reform plan must represent the shared values of the taxpaying public as to what is fair.

The Puzzling Case for Proportionate Taxation

*Barbara H. Fried**

I. INTRODUCTION

Over the past half century, the view that the only fair tax is a flat-rate tax has attracted support from a surprising range of political philosophers and pundits, including Friedrich Hayek,[1] Ludwig von Mises,[2] Milton Friedman,[3] John Rawls,[4] and Richard Epstein,[5] along with Walter Blum and Harry Kalven in their famous 1952 essay.[6] Notwithstanding trenchant critiques, the view not only has persisted, but (over the past decade) has gained enormous popularity in political and academic circles. In their 1995 book, *The Flat Tax*, Robert Hall and Alvin Rabushka defended their version of a flat tax with the Grimmsian pronouncement that a flat-rate tax is "the fairest tax of all."[7] In the same year, Richard Epstein declared, "[f]rom the Lockean perspective, a strong case can be made that . . . the flat tax is the only acceptable [tax]."[8] Similar pronouncements can be found throughout the current political debates, as well as more serious philosophical considerations of the just distribution of tax burdens. There is some nontrivial chance that, over the next few years, that sentiment could carry the day in Congress.

It is, of course, impossible to evaluate these extravagant claims on behalf of proportionality except in reference to a theory of fairness. It goes without saying that these odd bedfellows can-

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1 FRIEDRICH A. HAYEK, THE CONSTITUTION OF LIBERTY (1960).

2 LUDWIG VON MISES, HUMAN ACTION (1949).

3 MILTON FRIEDMAN, CAPITALISM AND FREEDOM (1962).

4 JOHN RAWLS, A THEORY OF JUSTICE (1971).

5 RICHARD A. EPSTEIN, TAKINGS (1985) [hereinafter TAKINGS]; Richard A. Epstein, *Taxation in a Lockean World*, *in* PHILOSOPHY AND LAW 49 (Jules Coleman & Ellen Frankel Paul eds., 1987) [hereinafter *Taxation*].

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

7 ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX 3 (2d ed. 1995).

8 *Taxation*, *supra* note 5, at 68. *See also id.* at 70: "The flat tax . . . is an indispensable part of the Lockean program of taxation."

not all have the same theory in mind. What follows is an attempt to sketch out plausible intuitions of fairness on which these claims might rest, and ask whether any of them supports it. I conclude not.

Let me be clear what I am not arguing. I am not arguing that some version of a flat-rate tax scheme cannot be defended as a sensible policy solution on any other grounds, including administrative convenience, political compromise between warring considerations, or our best guess as to how to achieve a distributive end resting on firmer philosophical grounds. Perhaps it can be so defended. I mean only to try to dislodge the apparently intractable notion that it deserves to be adopted because it is "fair" in itself, or because it is an obvious instantiation of some other fairness principle. I am also not arguing in favor of progressivity, regressivity, or any other rate structure on fairness grounds. The deeper moral is that no sensible theory of distributive justice would fix on rate structures themselves as fair or unfair. Rate structures are just a means to operationalize other prior, moral commitments about the proper role of government. The case for any particular rate structure must stand or fall on how well it realizes those prior commitments. An examination of plausible, prior moral commitments, however, suggests that, of all possible rate structures, proportionality may be the hardest to derive from any coherent theory of fairness.

In the first part of the paper, I consider the case for proportionate taxation in the context of two broad views of governmental power in fiscal matters. The first, an essentially libertarian view of the state, takes the proper role of government to be limited to solving the collective action problems that prevent private actors from spontaneously reaching optimal outcomes through voluntary agreements. While tolerating whatever minimal redistribution might occur as a consequence of solving collective action problems, the libertarian view generally rules out income redistribution as a motive for state action. One recent proponent of that view has located that prohibition in the Constitution, through an expansive interpretation of the Takings Clause.[9] Most have simply deduced it from natural law principles.[10] In tax theory, the clear corollary to libertarianism is the so-called "benefits" theory of taxation. I start with libertarianism, because it is the premise from which most of those who advocate flat-rate taxes on fairness grounds seem to be starting.

The second, a social welfarist view of the state, accepts that income redistribution for the express purpose of improving the

9 *See* TAKINGS, *supra* note 5, at 99-100, 295-303.

10 *See, e.g.*, HAYEK, *supra* note 1, at 315-18; *Taxation, supra* note 5.

welfare of the less well-off in society is a legitimate part of the state's job, although there is obviously much disagreement about the optimal extent and form of redistribution. While there are no clear corollaries to the social welfarist view of the state in tax theory—something that I think is not coincidental—"ability to pay" and "minimum sacrifice" arguments undoubtedly reflect that view in inchoate form.

Other views of the legitimate role of the state in fiscal affairs are, of course, possible, but most that are offered in tax debates, when pushed hard enough, end up being some version of one of these two views.

Both of the foregoing views evaluate taxation in the context of a comprehensive system of government (re)distribution. In the last part of the paper, I take up a number of defenses of a flat-rate tax viewed in isolation from the uses to which tax revenues are put. These include the widespread view that a flat-rate tax vindicates some important notion of equality; that it leaves individuals' choices among various activities undistorted; and that it limits the (unfair) expropriation of the wealthiest classes by the majority. Finally, I consider two other positive explanations for the popular convergence on proportionate taxation. The first is that its apparent properties of mathematical simplicity and certainty have made it a Schelling-like focal point solution to the problem of appropriate tax rates. The second is that its popularity, particularly among libertarians, is a product of political framing—of the fact that, at least in recent history, no one would have considered a regressive rate structure for our broad-based income tax to be a politically viable alternative. Were that fact to change, it seems quite likely that many who support proportionate taxation on libertarian grounds would find regressivity, on reconsideration, a more plausible expression of libertarian ideals.

II. LIBERTARIAN (BENEFITS) THEORY

In contemporary debate, the most vociferous advocates of a flat-rate tax—Friedman,[11] Hayek,[12] Epstein,[13] and Gauthier,[14] to name some prominent examples—have been animated by liberta-

11 *See supra* note 3.

12 *See supra* note 1.

13 *See supra* note 5.

14 DAVID GAUTHIER, MORALS BY AGREEMENT (1986).

rian impulses.[15] The same is true of earlier defenders.[16] In such a view, the just limits of state power derive from an essentially Hobbesian and Lockean social contractarian view of the state, in which the state exists solely to provide services that, for a variety of reasons of market failure, cannot be provided optimally by private, voluntary agreement. As has been noted, that view implies a quid pro quo relationship between the taxpayer and the state, in which taxes function as the shadow price for goods or services that the state provides.[17] Hayek provided the classic argument for deriving proportionate rates from a benefits theory of taxation: "a person who commands more of the resources of society will also gain proportionately more from what the government has contributed" to the provision of those resources, and taxation ought to be levied in proportion to the benefits so provided.[18]

The first big problem in assessing the case for proportionate taxation under a social contractarian view of the state is that almost none of the proponents of proportionality on (vaguely) libertarian grounds, from Adam Smith on down, have in fact supported proportionate taxation. A true flat-rate tax would tax all income (or consumption, as the case may be) starting with the first dollar,

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15 For other, recent expositions of a social contractarian justification for a flat tax, see James A. Dorn, *Introduction: The Principles and Politics of Tax Reform*, 5 CATO J. 361 (1985); Richard E. Wagner, *Normative and Positive Foundations of Tax Reform*, 5 CATO J. 385 (1985). A number of other libertarians, while not explicitly defending proportionate taxation, limit their attacks on redistributive ("discriminatory") taxation to progressivity, thereby, at least by implication, treating proportionate taxation as nondiscriminatory, and hence fair. *See, e.g.*, VON MISES, *supra* note 2, at 803-05, 851-54; HARVEY LUTZ, GUIDEPOSTS TO A FREE ECONOMY 73-82 (1945).

16 For a summary of the proponents of proportionate taxation through the early part of the 20th century, see EDWIN R. SELIGMAN, PROGRESSIVE TAXATION IN THEORY AND PRACTICE 148-84 (1908). Notable early proponents included Hobbes, Locke and (somewhat more ambiguously) Adam Smith. For Smith's famous support of proportionate taxation on fairness grounds, see ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 945 (Regnery 1998). For the contrary impulse, in the context of a tax on house rents, see *id.* at 966, arguing that "[i]t is not very unreasonable that the rich should contribute to the public expence, not only in proportion to their revenue, but something more than in that proportion."

17 *See* RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE 62 (1959).

18 HAYEK, *supra* note 1, at 316. For similar statements, see *Taxation*, *supra* note 5, at 74; FRIEDMAN, *supra* note 3, at 175; ANTONIO DE VITI DE MARCO, FIRST PRINCIPLES OF PUBLIC FINANCE (Edith Paolo Marget trans., 1936), *cited in* MUSGRAVE, *supra* note 17, at 72-73; SMITH, *supra* note 16, at 945. Among proponents of a flat-rate tax on (vaguely) libertarian grounds, Blum and Kalven strongly dissent from a "benefits taxation" justification for flat rates, on both empirical and normative grounds. They conclude, as an empirical matter, that the distribution of benefits among income classes is so indeterminate that it is pointless to defend either progressivity or proportionality on these grounds. If forced to guess, they would guess that all citizens benefit approximately alike, leading to a head tax rather than a flat tax. Blum & Kalven, *supra* note 6, at 455. On normative grounds, they adopt the view of Mill that "to assert that individuals receive significantly different benefits from living in a particular society is in effect to assert that there is something seriously wrong with that society." *Id.* The latter objection seems silly, if it refers to unequal levels of utility derived from government-provided services (why should everyone value all government services the same?), as opposed to unequal access to those services.

at the same rate. Instead, they have supported a so-called degressive version of a progressive tax, in which the first x dollars of income or consumption, sufficient to cover basic needs, is taxed at a zero rate, and all income or consumption above that is taxed at the same positive rate.[19]

The political advantages of a degressive tax over a proportionate tax are obvious, and hardly lost on its supporters.[20] There is little public support for a true proportionate tax that contains no exemption for basic income. It is hard to overstate, however, the difficulties that that concession entails for those whose opposition to any greater degree of progressivity via a graduated rate structure is based on the fact that such progressivity is motivated by purely redistributive concerns. If all of us earning income above the exemption level have an obligation to pick up the tab for government services provided to the poor, simply because they are poor and we are not, why stop there? Why not tax the rich for government services at an even higher rate than the middle class, simply because the rich have more money than everyone else and hence can better afford to defray the cost? Or, for that matter, why not raise the exemption level to, say, $30,000 for a family of four, raise the flat rate tax from, say, 19% to 25%, and use the excess proceeds to finance a guaranteed minimum income to all?[21] At that point, "proportionate" taxation would start looking mighty attractive to the sorts of welfare state liberals who would reject the libertarian premises of benefits taxation out of hand. Surely Frank Taussig was right in declaring many years ago that "[t]he demand for the exemption of the lowest tier of incomes results from the same state of mind as the advocacy of progressive taxa-

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19 Under the Hall/Rabushka version of a flat tax, for example, exemption amounts range from $9500 for a single person to $25,500 for a family of four; amounts in excess of that are taxed at a 19% rate. HALL & RABUSHKA, *supra* note 7, at 144.

20 For Blum and Kalven's astonishingly bare concession to exemptions, see Blum & Kalven, *supra* note 6, at 420: "It is almost unanimously agreed that some exemption keyed to at least a minimum subsistence standard of living is desirable. Since such an exemption will necessarily result in some degree of progression among taxpayers above the exemption level, and since this degree of progression appears inescapable, the real issue is whether any added degree of progression can be justified." *See also* 2 FRIEDRICH A. HAYEK, LAW, LEGISLATION AND LIBERTY 87 (1976), endorsing in a slightly different context a uniform minimum income "to all those who, for any reason, are unable to earn in the market an adequate maintenance"; SMITH, supra note 16, at 992-94 (opposing taxes on the wages of laborers), 999-1003 (opposing taxes on "necessaries").

21 For a proposal along these lines, see Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905, 1950-55 (1987). Those who oppose progressivity via graduated rates, but support progressivity of a degressive sort, have long seen the potential for the latter to approach the results of the former if exemption levels get high enough. *See, e.g.*, Blum & Kalven, *supra* note 6, at 513. They have erroneously assumed, however, that the two could not converge, because they have ignored the government's redistributive arsenals on the transfer side. *See id. See also infra* note 69.

tion [through graduated rates]."[22] If there is some principled basis for absorbing redistributive motives into benefits theory to the extent of basic needs, *but no further*, libertarians have yet to articulate it.[23] Until such time as they do, those few hearty libertarians who have rejected an exemption for basic income as inconsistent with conventional libertarianism seem to have the better of their libertarian fellow travellers, and are to be commended, from the point of view of principle, at least, for sticking to their libertarian guns here.[24]

For the balance of the discussion, I set that difficulty aside, to turn to the central question. If, as benefits theorists argue, taxes ought to function as the shadow price for goods or services that the state provides, how do we set that price? The logical place to begin is with a determination of what a well-functioning private market would have charged for those goods or services. As Musgrave stated many years ago, "[s]ince the relation is one of exchange, the rules of the public household are taken to be more or less the same as those of the market."[25] What then are the rules of the (private) market—or more precisely, which of the rules of the private market do we think ought to be transported to the public household, and once transported, what do those rules imply about appropriate tax rates?

The uncontroversial starting point for analyzing the fairness of the market is the requirement of strict paretianism: the re-

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22 FRANK TAUSSIG, PRINCIPLES OF ECONOMICS 499 (1911), *quoted in* Blum & Kalven, *supra* note 6, at 509 n.229.

23 The familiar argument along these lines, going back at least to Adam Smith, is that there is no point in taxing the poor, because (1) we can't get blood from stone, and/or (2) we will only end up supporting the poor anyway through some kind of welfare system. The second argument misses the boat entirely, since it assumes an obligation to support the poor through affirmative transfers—an obligation that most true libertarians would reject. The first argument has some force, but does not explain our failure to exclude the "deadbeat" poor from those public benefits that are not true public goods, and hence from which exclusion is possible, such as public schools and health care.

Hayek has sought to distinguish a degressive version of a progressive tax from a graduated rate version, on the ground that the former constitutes "a majority's taxing itself to assist a minority," while the latter constitutes the much more egregious decision of a "majority [to] impos[e] upon a minority whatever burden it regards as right." HAYEK, *supra* note 1, at 314. For similar sentiments, see sources quoted in Blum & Kalven, *supra* note 7, at 435. I take up this political process argument in another context below. *See* notes 98-101, *infra*, and accompanying text. For now, I note only that the argument responds to those, like Hayek, who are most concerned with class warfare qua classes, and is not an adequate response to the more conventional concerns of libertarians that the rich are entitled to be protected from expropriation not only by the poor, but also by their fellow, more beneficent rich, on behalf of the poor.

24 See, for example, TAKINGS, *supra* note 5, at 297, supporting a tax that takes "a constant percentage of net income . . . from the first dollar of net income to the last." *See also* ROBERT NOZICK, ANARCHY, STATE AND UTOPIA 169 (1974) (equating taxation of wages with forced labor); Jeffrey A. Schoenblum, *Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 AM. J. TAX POL'Y 221, 270-71 (1995) (advocating a head tax as the only fair tax).

25 MUSGRAVE, *supra* note 17, at 62.

quirement that every trade leave no side worse off, and at least one side better off. This requirement is assumed to be met automatically by any voluntary market transaction. Strict paretianism, however, is a minimally exacting standard, which gives little guidance in resolving the central problems in assigning the tax costs of providing public benefits.

First, the pareto principle provides no guidance on the level of aggregation at which the "betteroffness" from being in society is to be judged. If the level of aggregation is great enough—at the extreme, for example, if we test the pareto superiority of the benefits/taxation deal each American is offered at the level of the decision whether to exit this society or not—then there is almost no redistributive mischief that cannot be justified. At the other extreme, if we insist that *each* government program satisfy strict paretianism, then almost no program can be justified, since there will always be individuals under any feasible tax scheme who are paying more for a particular public good, such as a road through the middle of Kansas, than the benefit they derive from it.

In practice, libertarian benefits theorists seem to employ a mixed criterion, along the following lines. First, strict paretianism is used to judge the aggregate deal each of us has gotten from being in society rather than out of it.[26] This standard will almost always be met if we are comparing any plausible configuration of tax burdens in America circa 1999 to our likely individual positions in some hypothetical Crusoeian state of nature, and, indeed, is met automatically as long as there is a meaningful opportunity for exit from society. Second, a potential pareto (that is, Kaldor-Hicks) test is used to judge expenditures at the maximally disaggregated level. Thus, each particular road through Kansas must be justified by showing that the social gains from building it outweigh the social costs entailed. However, one need not show that each citizen derives benefits from that particular road at least equal to her share of the social costs of building it.[27] Finally, strict

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26 *See, e.g.*, *Taxation*, *supra* note 5, at 53. Both Nozick's "liability rule" compensation scheme for private protective agencies banished by the ultraminimal state, and his justification of private appropriation out of the commons whenever nonowners are better off with a private property regime than they would be in a state of nature, rely on strict pareto compensation for rights lost in the creation of the Lockean state. *See* NOZICK, *supra* note 24, at 78-84, 174-77. For a similar argument justifying private appropriation of the commons with a liability rule of compensation, see GAUTHIER, *supra* note 14, at 291-92.

27 Epstein's position on this question is unclear, or at least inconsistent. He invokes strict paretianism at the individual program level to bar "the redistribution of income through the tax system." *Taxation*, *supra* note 5, at 68. At some points, he appears to revert implicitly to a Kaldor-Hicks criterion to judge the acceptability of the remaining programs. TAKINGS, *supra* note 5, at 201. At others, however, he suggests he will require strict paretianism for *every* government program. (See *Taxation*, *supra* note 5, at 55-56, arguing that the system should "tr[y] to insure that every public expenditure is worth more to every party taxed than the revenues that are lost."). *See also* RICHARD EPSTEIN, BARGAINING WITH THE STATE, 82-86 (1993). For a similar insistence on strict paretianism at the

paretianism is used to test the tax/benefits deal over some representative class of incremental public goods being considered. That is to say, in a just state, over a representative period, each individual in the state will derive benefits from government services that are at least equal to the cost she bears for them. This formulation is just a guess, however, since most proponents of a benefits theory of taxation are unclear or inconsistent on the point.

Second, the pareto principle requires only that tax prices be set so that no one is made worse off by the compulsory purchase of public goods. It says nothing about the proper distribution of surplus above that—that is, about distribution of the gains from trade.

In private competitive markets, both of these problems—the level of aggregation on which to test pareto improvements and the just division of gains from trade—are automatically resolved through equilibrium prices. When dealing with public goods, they are not. Since in the latter case we are dealing with hypothetical and not actual markets, and moreover hypothetical markets in which the government operates as a monopoly supplier who can compel payment at dictated prices, we have enormous theoretical latitude in constructing the hypothetical exchange between government as supplier and citizens as consumers. In particular, we have enormous latitude in resolving the two questions above: the level of aggregation at which to bundle goods or services in judging the pareto fairness of our tax scheme, and the just division of surplus value. Depending upon the resolution of both these questions, there is an enormous range of acceptable distributions of tax burdens to finance public goods, within the constraints of paretianism.

At one extreme, imagine the state as monopolist with perfect information about people's reservation prices for public goods, and hence the ability to perfectly price discriminate in setting tax prices for those goods. Consistent with the pareto principle, the state could tax each person in society at a rate that appropriates 100% of the surplus value of public goods. On a broad view of public goods or benefits that should be counted in setting tax rates, including not merely traditional public goods or services, but all the benefits of being in our organized society rather than on a Crusoeian island or in war-torn Rwanda, this broad power to expropriate surplus value would authorize something close to a confiscatory tax on almost everyone.

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level of every individual program ("interaction"), see GAUTHIER, *supra* note 14, at 258. Given that no government expenditure could pass this test, it seems unlikely that either of the foregoing authors really means to require it.

At the other extreme, suppose that the benefits that can be counted are limited to identifiable costly goods or services provided by government, and suppose further that the government must act as a supplier in a private competitive market would act; that is, it is compelled to charge a uniform per unit price for all goods consumed. The most likely outcome of benefits theory on those suppositions is a highly regressive tax.

For the balance of the discussion, I will focus on the second question: how prices for public goods should be set, within the constraints of strict paretianism, and hence how the surplus value generated by public goods should be divided. As the discussion that follows makes clear, neither the libertarian literature approaching the benefits question from the perspective of distributive justice, nor the public economics literature approaching it from the perspective of allocative efficiency, gives a determinate answer to that question.

A. The Lessons of the Private Market

There is a fatal ambiguity running through the benefits theory literature about how benefits ought to be measured. This ambiguity is reflected in Hayek's statement that "a person who commands more of the resources of society will also *gain* proportionately *more* from what the government has contributed" to the provision of those resources.[28] Does Hayek mean by "gain . . . more" that the rich consume a proportionately greater *quantity* of public goods, or that the rich derive proportionately greater *utility* from public goods?

Taking the private competitive market as the benchmark, one is pushed to the former interpretation. In a purely competitive market, all consumers face the same per unit price, set by the equilibrium price for the good. Suppliers cannot price-discriminate based on consumers' different reservation prices for the goods, because any effort to set a higher price for any consumer will be undercut by another supplier. As a consequence, the relative prices that consumers pay for a given good depend solely on the relative quantities of the good they consume. Whatever consumer or producer surplus is generated by trades at that price lies where it happens to fall. Assuming a conventional downward-sloping demand curve and an upward-sloping supply curve, equilibrium prices, reflecting the marginal utility or cost of the last unit consumed, will leave each consumer or producer with surplus from all but the last unit consumed or sold. The precise amount of the surplus depends on the fortuitous shape of individual and aggregate demand and supply curves.

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28 HAYEK, *supra* note 1, at 316 (emphasis added).

Under this interpretation, benefits theory leads to proportionate taxation if and only if the quantity of public goods that people consume is proportionate to income. As even proponents of a proportionate tax concede, this premise is highly implausible.[29] The premise is doubtful for many public goods, such as roads, fire protection, and garbage collection. It is clearly wrong for others, including true public goods (for example, clean air, defense, and broadcast spectra), one of the defining characteristics of which is that they are jointly consumed, with the result that everyone consumes the same quantity (or has the same quantity available for consumption). In the end, such a measure of benefits is much more likely to lead to a highly regressive tax.

If, on the other hand, what Hayek and others mean by "gains more" is that people ought to be taxed in proportion to the utility that they derive from public goods, the implications for appropriate tax rates are much less clear. Indeed, the question is probably completely unresolvable, both because of the impossibility of measuring the relative utility levels each income class derives from public goods, and because of conceptual problems in deciding what one ought to be measuring. If, for example, Bill Gates's immense wellbeing is a joint product of publicly provided goods and a host of other factors such as social opportunities, talents, and hard work, and each of these factors is a but-for cause of his wellbeing, then how much of his wellbeing gets credited to publicly provided goods, and how much to other sources?

The choice between these two interpretations of "gains more" boils down to the question of what is so great about market-based distribution, beyond its guarantee of strict paretianism. In particular, is there any normative reason to preserve (or mimic) the haphazard distribution of gains from trade that happens to result from uniform, equilibrium pricing in competitive markets, when we move from the private market to the shadow market for public goods? Here, we encounter a wide range of views from the libertarian camp that don't lead to any obvious conclusion.

Most libertarians treat as sacrosanct the division of surplus that happens to result from market prices, with exceptions often made for privately appropriated, scarce natural resources and other monopoly goods. There is little agreement among libertarians, however, as to *why* market prices are sacrosanct.[30] Moreover,

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29 A "not clearly inappropriate assumption" is the best that Milton Friedman can do. FRIEDMAN, supra note 3, at 175.

30 Some libertarians, such as Nozick and Hayek, appear to regard market prices as sacrosanct *not* because such prices effect a just division of the surplus, but because they are a necessary byproduct of freedoms independently worth protecting. In Nozick's case, the relevant freedom is the freedom of the buyer to give away her money to whomsoever she wishes. *See* Barbara Fried, *Wilt Chamberlain Revisited: Nozick's "Justice in Transfer" and the Problem of Market-Based Distribution*, 24 PHILOSOPHY AND PUBLIC AFFAIRS 226, 233

many of the arguments offered for not disrupting the actual, haphazard assignment of surplus in a well-functioning competitive market do not translate well to public goods. Still others have explicitly treated some or all of the gains from trade, or rents, as morally up for grabs. Among contemporary libertarians, David Gauthier is a leading exponent of that view.[31] Hobbes was as well, maintaining in effect that all individual gains from moving from a Hobbesian state of nature to civilization are expropriable by an all-powerful sovereign. If we are to read Hayek's statement above in the second way, to mean that it is permissible to tax people in accordance with the utility they derive from public goods rather than the quantity they consume, then he, and all others who subscribe to that view, ought to be counted in the Hobbesian camp as well.

When dealing with private, competitive markets, most defenders of the free market would argue that it is unnecessary to resolve these internecine disagreements about the *justice* of market-based distribution. However morally arbitrary the market's division of gains from trade might be, the efficiency costs of the government's trying to alter it through price regulation or other means are simply too great to justify the effort. As one commentator has stated: "[h]ow the gains from trade are distributed [by the market] is determined arbitrarily, but since this distributional issue is resolved as a by-product of a process benefitting all parties, it need not become a bone of contention."[32] When dealing with publicly provided goods, however, that response is not available. The government must set shadow prices in the first instance. As a monopoly supplier with the power to coerce payment through tax-

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n.20 (1995). In the case of Hayek, it is the freedom of the seller of goods or services to "use his knowledge for his own purposes." HAYEK, *supra* note 20, at 69.

Others have defended market-based distribution as just in itself, because it rewards all individuals in accordance with their marginal product—that is, with the value they have bestowed on others. For a discussion of John Bates Clark, a prime expositor of this view, and his critics, see BARBARA H. FRIED, THE PROGRESSIVE ASSAULT ON LAISSEZ FAIRE 131-45 (1998).

31 Gauthier's position on rents is at least confusing, if not confused. At one point, he defines the rents that are up for grabs to include any excess paid to a factor of production over the next best price offered—a measure that would confiscate the incremental scarcity rents paid in moving from the second best to best offer, but not those inherent in the second best offer. GAUTHIER, *supra* note 14, at 272-73. At other times, he argues that everyone is entitled to, and only to, their marginal product in a competitive market with no negative externalities—a measure that would confiscate all scarcity rents in noncompetitive markets but not inframarginal rents in competitive markets. *Id.* at 90, 91-92, 95-98. Still elsewhere, however, he suggests that everyone is entitled only to the "full cost of supply for the factor services she provides"—a standard, equivalent to reservation price, that would eliminate a right to inframarginal rents as well. *Id.* at 97-98. Without some clearer view of *why* Gauthier believes that any portion of the market return is sacrosanct, it is difficult to choose among these conflicting measures. The reasons Gauthier suggests, however—some combination of optimization and a desire not to distort choices among activities on libertarian grounds (*see id.* at 93-94)—push towards the last view.

32 DENNIS C. MUELLER, PUBLIC CHOICE II 37-38 (1989).

ation, it *could* price-discriminate if it wished to, without being undercut by competitors. Finally, unlike in the competitive market, price discrimination may well be dictated by *efficiency* considerations, at least in the case of true public goods. I turn to the last point now.

B. Pricing True Public Goods

A true public good is one that exhibits two characteristics. It is jointly consumed, and exhibits nonexcludibility, meaning that it is either technologically infeasible to exclude people from use (the case, for example, with clean air or defense), or inefficient to do so because the incremental cost of *not* excluding is very low or zero, and/or the cost of monitoring use in order to exclude very high, such as with roads or TV airwaves. Because of the problem of nonexcludibility, a private market cannot provide such goods. From a libertarian point of view, true public goods are the only goods that *ought* to be publicly supplied; that is, the sole justification for coercive government is to correct market failure that would preclude optimal coordination in the absence of coercion. How such goods would or should be priced in the absence of a functioning market is therefore a critical question for any benefits theorist, and a notoriously difficult one.

An extensive literature in public economics over the past 80 years has been devoted to devising a theoretical solution to the problem of optimal output and optimal pricing of true public goods. Since the literature is almost exclusively concerned with efficiency questions—that is, how to determine the optimal output of public goods from an efficiency point of view—in one sense it is all beside the point here. In a couple of other senses, however, it is not. First, the implicit or explicit indifference of the public economics literature in this area to the distributional consequences of optimal pricing schemes undercuts any claim that there is some broadly compelling view about the just distribution of surplus. Second, many of the optimal pricing solutions proposed on efficiency grounds have determinate distributive outcomes that are hard to square with anything resembling a proportionate tax scheme. That means, at the very least, that benefits theorists who are drawn to proportionality on fairness grounds may have to be willing to pay a theoretical price on efficiency grounds.

1. Lindahl/Bowen/Samuelson Solutions

The central problem in determining optimal output of true public goods derives from the problem of nonexcludibility: because we cannot exclude anyone from using true public goods, we cannot rely on a decentralized price system automatically to re-

veal true demand for the goods.[33] Eighty years ago, Erik Lindahl proposed a theoretical solution to this problem, subsequently reworked in a general equilibrium framework by Paul Samuelson. His solution remains the starting point for any analysis of public goods.[34]

The mechanics of Lindahl-type solutions are somewhat complicated, but the basic intuition behind them can be stated simply. To achieve an efficient allocation of all resources, we want every consumer to equate her marginal rate of substitution between all commodities, whether privately or publicly supplied. In a competitive market, where everyone faces the same price for goods, that equilibrium is reached by each consumer varying the *quantity* of each good she purchases until the marginal utility of each good equals its set price. In true public goods, where everyone must consume, or have available for consumption, the same quantity of the good, that equilibrium is reached by varying the *price* each consumer pays for the good, until the price equals the marginal utility she derives from that set quantity of the public good.

The hypothetical mechanics for reaching a Lindahl equilibrium quantity and price are as follows. Each citizen, in effect, submits bids, revealing the marginal price she would be willing to pay for a given public good at each plausible quantity of that good.[35] A combined social demand curve for that good is created by adding up the marginal unit price bids from all citizens at each quantity level.[36] The optimal level of supply is the equilibrium point where the combined demand curve, equal to the combined marginal prices for a given quantity of goods, intersects with the supply schedule for that good, equal to marginal cost of production.

Once the equilibrium quantity is determined, each citizen is assigned a tax share to pay for the cost of the goods. That tax share is equal to the marginal price she bid at what turned out to

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33 For a classic statement of problem, see Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. & STAT. 387, 389 (1954), *reprinted in* KENNETH J. ARROW & TIBOR SCITOVSKY, READINGS IN WELFARE ECONOMICS 179, 182 (1969). *See also* MUELLER, *supra* note 32, at 123.

34 For an overview of Lindahl's solution and the variants on it proposed by Bowen and others, see MUELLER, *supra* note 32, at 43-50; ANTHONY B. ATKINSON & JOSEPH E. STIGLITZ, LECTURES ON PUBLIC ECONOMICS 487-89 (1980); and MUSGRAVE, *supra* note 17, at 74-80. For Samuelson's general equilibrium version of the Lindahl solution, see Samuelson, *supra* note 33.

35 The marginal price at any given quantity represents the marginal utility of the last unit of that good at that quantity. In Lindahl's formulation, the bids reflect the percentage of the cost at any specified quantity that each individual is willing to pay. In Bowen's formulation, the bids reflect the absolute dollars at a specified quantity that each individual is willing to pay.

36 Thus, while in private goods contexts we add up demand horizontally to ascertain the total quantity demanded at a given price, in public goods contexts we add up demand vertically to ascertain the total amount that all individuals are willing to pay for a given quantity of public goods. This difference simply reflects the difference in what we take as given in the two contexts—price v. quantity.

be the equilibrium quantity, times that equilibrium quantity. The result is a set of personalized prices, such that, at those specified prices, everyone demands the same level of each public good.[37]

What are the distributive effects of Lindahl tax shares? They mimic the effects of the competitive market in one respect: they divide the inframarginal surplus from public goods in a haphazard fashion. Each citizen's Lindahl tax price for a public good reflects the utility of the *marginal* unit value of that good at equilibrium output, times the total agreed-upon output. Assuming a downward sloping demand curve, each citizen will therefore realize inframarginal surplus, i.e. gains from trade, on all but the last unit consumed. As in competitive markets, however, the amount of that surplus is arbitrarily fixed by the shape of the individual's demand curve for that good relative to the equilibrium price.[38] In another respect, however, Lindahl tax prices differ from conventional prices in a competitive market: Lindahl tax prices are proportionate to the *marginal utility* each individual derives from a given quantity of a public good, rather than to the quantity of that good consumed. In contrast, in the competitive market, total prices spent on a good would be proportionate to quantity consumed, since, facing a constant price, consumers vary their quantity until the last unit purchased generates marginal utility equal to that price.

Just as it is unclear what Hayek's "total utility" metric for tax shares may imply about tax rates, it is also unclear what Lindahl's "marginal utility" metric for tax shares implies about tax rates. For some true public goods, marginal utility seems unlikely to be positively correlated with income, suggesting a highly regressive tax rate. For others, it might be positively correlated with income, but whether that measure would lead to proportionality seems much more doubtful.

2. Demand-Revealing Price Structures

As numerous commentators have noted, Lindahl-type solutions, which tie the ultimate tax shares to stated preferences, all have a central flaw. Since the government cannot exclude individ-

37 *See* ATKINSON & STIGLITZ, *supra* note 34, at 509-12. The solution parallels the optimal solution for pricing jointly produced products, where the shared fixed costs of production are allocated between the products in proportion *not* to their respective variable costs, but in proportion to respective demand. In the public goods context, rather than facing two products with shared fixed costs, we face one product with shared benefits. The solution is the same, however: the costs of the product are allocated among consumers who share the benefits in proportion to their demand schedule for the product.

38 *See* T. Nicolaus Tideman, *Ethical Foundations of the Demand-Revealing Process*, 29 PUBLIC CHOICE 71, 74 (1977) ("if cost shares exactly equalled benefit shares . . . redistribution would be confined to that induced by the relatively arbitrary sharing of gains from trade under Lindahl taxes").

uals from using true public goods, whatever their stated preferences, such solutions—which, in effect, require each individual bidder to put her money where her mouth is—create an incentive for individuals to understate their preferences in the bidding process, thereby leading to the suboptimal production of public goods.[39]

Over the past 35 years, a number of public economists have proposed ingenious modifications to Lindahl's basic scheme to solve this central problem.[40] The modifications take different forms, but most share one key feature: the tax share that people ultimately will pay for each public good is decoupled from their stated preferences for that good, in order to induce true revelation of preferences. In most models, that result is accomplished by a two-level pricing system: (1) a first-level tax is imposed to cover the full costs of producing a public good at a given level, with the tax shares assigned independent of each person's true demand schedule for that good; and (2) a supplementary tax is imposed, the sole purpose of which is to force the true revelation of preferences. This latter tax is not used to pay for the public good in question.[41] The level of this supplementary tax in most schemes is loosely correlated with preferences, since it may, and in some cases certainly will, impose some cost on each individual to move the outcome in her preferred direction.[42] To that extent, the supplementary tax may reflect a loose quid pro quo for benefits received. The correlation, however, is loose at best. In the case of the leading schemes, once a large number of voters is introduced, the tax disappears entirely.

What does the foregoing imply about the appropriate tax rates to finance true public goods? The critical feature of all of these proposals is that each individual's tax share must be unrelated to that individual's revealed demand for the good, and hence the level of utility she derives from consumption. This requirement rules out, at least in strict form, the one criterion for assigning tax shares, *quid pro quo* on an individual basis, that a benefit theory insists upon. Many of these schemes contemplate that the first-level tax will be apportioned among individuals on a

39 *See* MUSGRAVE, *supra* note 17, at 80; Samuelson, *supra* note 33, at 888-89, 182: "it is in the selfish interest of each person to give *false* signals, to pretend to have less interest in a given collective consumption activity than he really has." For a summary of the other reasons to anticipate that Lindahl's strategy would not achieve an optimal solution, see MUSGRAVE, *supra* note 17, at 79.

40 Most of these demand-revealing solutions are traceable back to Theodore Groves, *Incentives in Teams*, 41 ECONOMETRICA 617 (1973).

41 In some models, the supplementary tax is not paid in dollars at all, but instead in scarce voting points; in others, it is paid in dollars, but the dollars are wasted, or at least not returned in any systematic fashion to the individual voters (if they were, that would undermine motives for honest revelation).

42 *See* MUELLER, *supra* note 32, at 145.

per capita basis, a solution that would obviously be highly regressive. For some schemes, the per capita charge is a necessary feature, while for others, it is not. In the latter cases, it is theoretically possible that, once optimal output, and hence full costs, are determined, one could distribute that tax burden by income class or other measurable and taxable voter characteristics in a fashion that approximates what Lindahl taxes for that group would look like.[43] That decision, however, is independent of the efficiency concerns that are driving the models, and would be dictated by wholly external distributive concerns, which require independent justification.

C. Epstein's "Tale of Two Pies"

These and all other attempts to solve the problem of optimal output and pricing in the true public goods context are concerned only with efficiency. Thus, they take the background distribution of wealth as just, and disregard whatever incidental distributive effects their solution might entail. In recent years, some prominent libertarians have directly addressed the question of the just distribution of surplus from public goods and the tax costs of financing them. Two notable recent examples are Richard Epstein's *Takings*[44] and David Gauthier's *Morals by Agreement*. Both arguments attempt to develop a theory of the just distribution of surplus value created by the existence of an organized society, and both purport to derive proportionate taxation from that theory. Many of the intuitions that drive these two pieces seem to be widely shared in libertarian defenses of proportionate taxation, including Hayek's quoted above.[45]

I have explored both arguments in greater length elsewhere.[46] In the interests of economy, I will limit discussion here to Ep-

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43 For such a suggestion, see Tideman, *supra* note 38, at 74. The logic here is that, while taxpayers might still have a mild incentive to depress their income levels to avoid Lindahl taxes, they have no incentive to lie about their true preferences, since their individual, truthful revelation has virtually no effect on aggregate output, and hence on the absolute amount of the Lindahl share their income class will bear.

44 Epstein's arguments in TAKINGS (*supra* note 5) are prefigured in an earlier piece, *Taxation in a Lockean World* (*supra* note 5).

45 *See supra* note 28 and accompanying text.

46 Barbara Fried, Why Do Libertarians Love Proportionate Taxation? Epstein's Tale of Two Pies and Other Puzzles (draft manuscript) (copy on file with *Chapman Law Review*). Gauthier's convoluted theory of just distribution is not easy to summarize. In brief, he argues that the surplus value from society ought to be divided among all the cooperators who produced it in accordance with his principle of "minimax relative concession" (MRC). MRC requires that surplus be divided among members of a society so as to equate the ratio of (1) the total amount of surplus that each person actually gets from any cooperative venture in which he is a participant, to (2) the largest amount of surplus he could have plausibly claimed from that cooperative venture. Gauthier's verbal formulation is different, but amounts mathematically to the same thing. GAUTHIER, *supra* note 14, at 136-40. The largest amount he could have plausibly claimed, in turn, is the amount left over after fellow cooperators' costs are covered; that is, after cooperators are left no worse off than under

stein's, the more conventional of the two. Epstein, consistent with conventional libertarian premises, limits the state's taxing powers to raising funds to finance true public goods, explicitly precluding any spending motivated by redistributive intent.[47] That constraint, however, leaves open the question of how precisely that revenue is to be raised, and hence how any surplus value generated by the existence of the minimal state—with surplus implicitly defined here as the total value of society net of the tax costs of providing it—is to be distributed among citizens.

For Epstein, all roads, whether constitutional, Lockean rights theory or utilitarian, lead to the same two-part answer to the question, "'Who gets the surplus?'"[48] First, the surplus should be divided in proportion to the value of each citizen's "private holdings," which Epstein defines as the property she would have held in a state of nature (SON), under just (Lockean) principles of acquisition.[49] Second, such proportional division of surplus will naturally, if not definitionally, lead to proportionate taxation.

Both halves of the argument have some surface plausibility. At least so one is led to conclude by the long list of people who have subscribed to them. The more one ponders them, however, the less plausible they seem. I take up each half in turn.

1. Why Should the Surplus Value Created by the Existence of Organized Society Be Distributed in Proportion to the Value of Rights Individuals Have Brought into Society?

As noted above, Epstein purports to defend this proposition from three different vantage points: constitutionalism, utilitarianism, and a Lockean, natural rights, perspective. For present purposes, I want to set the first two to the side, and examine the

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noncooperation. *Id.* at 137-39. As Gauthier ultimately acknowledges, this formula dictates an equal division of surplus among all participants in each cooperative venture, assuming each makes the largest plausible claim he could. *Id.* at 151-54, 277. In Gauthier's view, this equal division may be deviated from, under a Rawlsian minimax principle, where all will be benefitted by the deviation. What it implies about the division of surplus at the societal level is much less clear. Gauthier argues that it logically leads to proportionate taxation. For reasons I have explored elsewhere, that argument must rest on assumptions about the distributive effects of pretax prices that are wildly implausible on their face, and impossible to reconcile with other aspects of Gauthier's argument. *See id.*

In the end, proportionate taxation is such an implausible expression of Gauthier's view of distributive justice that his enthusiasm for it, like Rawls's, is interesting chiefly as an illustration of the strength of the irrational pull proportionality exerts on the imagination.

47 TAKINGS, *supra* note 5, at 163-64.

48 *Id.* at 162.

49 *Id.* at 3-5, 163-64. See also *Taxation*, *supra* note 5, at 52-53, "noting that the *baseline* against which 'being better off' is measured gives to each person only his natural rights to liberty and property, and not the fruits acquired by theft, aggression, or deception." For Gauthier's similar conclusion, see GAUTHIER, *supra* note 14, at 254, arguing that each share in the joint gains from society should be "proportioned to the contributions of its recipients."

question only from the third; the perch shared by most of his fellow libertarians.[50]

Locke's state, like Hobbes's, Epstein argues, gets its legitimacy from the strict pareto-superiority of the deal it offers its members: give up the formal freedom you possessed when locked in your war of each against all, in return for constraints of law that will leave all of you at least as well off, and some of you better off, than you were in the SON. For Hobbes, that guarantee of strict paretianism defined the full extent of the sovereign's obligations to its citizens. For Locke, however, it merely set a floor on those obligations. While Hobbes's sovereign was free to appropriate virtually all the surplus value of civilization, Locke's was not: "[i]n the Lockean world, . . . the sovereign is to be fully constrained, so that the lives, liberties, and estates of the citizens may be preserved. The tangible measure of that constraint is that principled . . . limits are placed upon the appropriation of surplus by the sovereign."[51]

As Epstein acknowledges, Locke himself did not supply those principled limits. Epstein does so in his stead, concluding that the surplus "should be divided among all citizens, pro rata in accordance with their private holdings."[52] Why? Epstein, along with nu-

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50 Epstein's idiosyncratic constitutional argument for dividing surplus in proportion to rights in a state of nature, in brief, is as follows: (1) the just compensation clause extends to taxation as well as conventional takings; (2) the "public use" requirement in the just compensation clause mandates proportionality between the benefits and burdens of any public taking; and (3) the requirement of proportionality mandates that all surplus value created by the state be distributed in accordance with the value of assets people bring into the state. His utilitarian argument for pro rata division of the surplus, in brief, is that such division "does not skew the incentives of private parties in the choice between public and private control over human affairs. For example, if each person received an equal portion of the general gain, there would be an incentive for persons with smaller shares to force matters into the public arena, where they would be relative gainers." TAKINGS, *supra* note 5, at 163. The utilitarian argument fails for the same reasons that the Lockean one does: the private market does not reward individuals in proportion to the value of their rights in the state of nature, and such pro rata division of the surplus would not, in any event, give rise to a proportionate tax.

51 *Id.*

52 *Id.* For those familiar with *Takings*, that conclusion is presented in the pie chart of two concentric circles that opens the book. *Id.* at 3-6. The view that the surplus value created by a Hobbesian state ought to be divided pro rata in accordance with individuals' SON holdings is fundamental to Epstein's view of a just society. *See id.* at 3, 5: "The implicit normative limit upon the use of political power is that it should preserve the relative entitlements among the members of the group, both in the formation of the social order and in its ongoing operation. . . . Each gain from public action therefore is uniquely assigned to some individual, so that none is left to the state, transcending its citizens." Epstein asserts it largely as fiat in *Takings*. In *Bargaining with the State*, he defends it with a number of arguments, including that a vastly unequal division of surplus will be an unstable solution and a pro rata division a stable one, an argument reminiscent of Gauthier's game-theoretic arguments for pro rata division; that it minimizes the chance that some party will be left in a pareto-inferior position by the taxes-for-civilization deal, and that it (tautologically) "leads to the *automatic* proration of the surplus among all contenders." EPSTEIN, *supra* note 27, at 90-91, 95-97. The first two arguments rest on empirical premises that seem doubtful, or at the very least in need of some defense.

merous others with libertarian leanings going back to Adam Smith, appears to derive that conclusion from an unexamined analogy to private partnerships.[53] The general line of argument goes as follows. Think of society as an n-person joint venture, in which we all bring to the table our SON assets, which we agree to pool in this collective venture called the state in return for our aliquot share of the returns to investment, or surplus, that our cooperation generates. If this were a private partnership between two persons, one putting up $60,000 of capital and one putting up $40,000, it is perfectly clear that the two partners would and should agree to split the profits from their venture 60/40, in accordance with their contributions. There is no reason for that conclusion to change when we move from a two-person private partnership to an n-person public one.

There are a number of serious problems with the analogy.[54] The first is: how do we value SON assets for purposes of calculating what would be a fair (pro rata) return on them? As Epstein concedes, his two-pie structure "presupposes that we have a very clear sense of what counts as individual rights."[55] Much of the criticism of Epstein's *Takings*, along with Nozick's *Anarchy, State, and Utopia* and other libertarian schemes, has sought to argue that such a "clear sense" is impossible to come by, and that what Epstein et al. take to be the boundaries simply reflects conventional Anglo-American property arrangements that would be impossible to deduce from any deep-seated theory of natural rights. I want to set those objections aside for the moment, and suppose

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Some notion of equal proportionate division of surplus is fundamental to Gauthier's view of a just society as well, although the precise notion is less clear. As noted below, Gauthier suggests in passing the standard solution by analogy to partnerships—returns-in-proportion-to-investment—proposed by Epstein and others. But the version he develops in depth in *Morals by Agreement*, under the rubric "minimax relative concession" (MRC), rejects that model entirely. For further discussion of these matters, see FRIED, *supra* note 46.

53 *See* SMITH, *supra* note 16, at 945: "The subjects of every state ought to contribute towards the support of the government . . . in proportion to the revenue which they respectively enjoy under the protection of the state. The expense of government to the individuals of a great nation, is like the expence [sic] of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate." Among contemporary libertarians, see, for example, GAUTHIER, *supra* note 14, at 140-41, 152, 254. "[T]he ratio between the benefit [each member of society] receives and the contribution she makes is, so far as possible, constant, the same for all." *Id.* at 152. Gauthier's actual scheme for dividing the surplus value generated by society, however, abandons that principle entirely. *See supra* note 46.

54 For these purposes, I accept the conventional libertarian premise that individuals are entitled to what they have acquired by Lockean principles in the SON. To the extent one rejects that premise, because, for example, one does not regard as just the natural distribution of talents, or the distribution of resources by grab in the SON, SON entitlements lack justificatory significance, and as a consequence, arguments for distributing surplus pro rata in accordance with those entitlements will lack justificatory weight as well.

55 TAKINGS, *supra* note 5, at 5.

that we could come up with some formal boundaries on such natural rights. The question is: what are they worth in the SON?

Epstein concedes that the value of rights in the SON may be low, due to uncertainty and insecurity.[56] That concession, however, is hardly damaging to his argument. The real problem is, how would we determine the value in the SON to begin with? Rather than hazarding an answer—a daunting thought experiment—Epstein simply assumes that the value of rights in the SON are a scaled-down version of the value of rights in society. Thus, if Brains is earning 100 times more than Brawn in America circa 1999, we are to assume that the use value of Brains's human capital in the SON was 100 times higher than the use value of Brawn's. As discussed below, this assumption that people's endowments retain the same relative values in moving from SON to society is critical to Epstein's argument for proportionate taxation; it also seems completely unfounded.

The second problem is, what portion of the surplus value generated by civilization is subject to division by collective decisionmaking? In the typical private joint venture envisioned in the 60/40 partnership example above, the answer is relatively clear. First, the boundaries between the partnership's activities and the separate activities of each partner are typically clearly demarcated, and hence that portion of social wealth attributable to the returns to the partnership's activities clearly demarcated as well. In committing their respective $60,000 and $40,000 to their joint venture, each partner implicitly commits to dividing those returns by some collectively agreed-to decision rule.

The answer to the question, however, is far from clear in the context of the Lockean social contract. What exactly are the boundaries of the partnership we are embarked upon here? Does it extend only to the creation and operations of the formal state, or does it extend to social organization in any form? Epstein and others appear to make the latter assumption, in assuming that the entire (aggregate) increase in wealth we all realized in moving from the SON to America circa 1999 is subject to division by collective decisionmaking. That broad view, of course, implies that the enormous gains society bestows on those whose natural talents have little use value on their Crusoeian island are all up for grabs. One *could* take this view of our implicit (Lockean) social contract, pursuant to which all the gains that, say, Wayne Gretsky realizes by moving from being Wayne Gretsky alone on a desert island, thinking of inventing a game called hockey if he could ever find ice, eleven other players, and an audience to pay to watch, to being Wayne Gretsky in late twentieth-century America

56 *Id.* at 3.

earning $20 million a year, are thrown into a common pool for division in accordance with some norm of just distribution. This is certainly a plausible moral view, with a number of respectable adherents.[57] But it seems like an odd concession to collectivist ethics for libertarians to make. One would expect them to insist that a smaller portion of the gains to Gretsky from civilization is fair game for redivision among all citizens.[58] Limiting what is up for grabs to that portion of private gains directly attributable to the provision of specific, costly, public goods, is one possibility—a view that implicitly limits the scope of the social contract to the operations of the formal state. Nozick and others have suggested another: that the only thing that should be up for grabs is that portion of income that exceeds what the best endowed could have gotten, *not* by staying in the SON, but instead by seceding from the existing state and forming a new state whose membership was limited to the best endowed.[59]

Third, assuming that America circa 1999 represents one great joint venture, with each participant entitled to some share of the aggregate returns to civilization, how are those returns to be divided among the participants? A pro rata division, in accordance with the value of assets contributed, is an obvious solution only if one is dealing with inputs that have an opportunity cost (expected return outside the partnership) equal to their value inside the partnership. That condition is presumably met in the 60/40 partnership example above, if we assume the partners' only contributions are (fungible) cash, which is receiving a marginal (competitive) return. In such a case, the constraints of the market—the opportunity cost of capital—dictate a pro rata division of the partnership's income, whatever justice might require, and most people would take that result to be consonant with what justice in fact requires.

But in the Lockean social contract, the value of each person's assets is (by hypothesis) greater if exploited within the joint venture of civilization than it is outside of that joint venture in the SON. That is to say, the Lockean social contract resembles an n-person multilateral monopoly rather than a competitive equilibrium. Imagine, for example, that in our two-person partnership, partner A contributes a really good idea, which requires $100,000 in ready cash to exploit, and partner B contributes the $100,000—the only person, as it turns out, that was willing to come up on the

57 *See, e.g.*, RAWLS, *supra* note 4, at 520-29; KENNETH J. ARROW, SOCIAL CHOICE AND JUSTICE 188 (1983).

58 This position is, of course, just a variant of the point made above, concerning the level of aggregation at which to test the pareto-superiority of civilization.

59 NOZICK, *supra* note 24, at 192-93. For a similar argument implicit in his parable of the greens and the purples, see GAUTHIER, *supra* note 14, at 284-86.

spot with the required cash. Now, there are gains from cooperation in excess of the returns available to either partner from her next best available opportunity. To that extent, they are, with respect to each other, locked in a bilateral monopoly. How should returns from our grand joint venture be divided now?

The problem presents one instance of the allocation-of-common-costs problem that has been subject to extensive analysis in the game theory literature. The question is, how should the common costs of a value-enhancing cooperative venture be allocated among the cooperating parties? While a detailed treatment of the issue is beyond the scope of this paper, a brief overview may be helpful in framing the problem.

In game-theoretic analyses, the possible solutions ("core") of the common-costs problem are taken to include all allocations that give each player in the cooperative game a payoff at least as great as the greater of (1) what she could have secured through a non-cooperative strategy, and (2) what she could have achieved as a member of the most profitable coalition of players that could secede from the group to pursue their own cooperative strategy.[60] Clearly, condition (1) requires that each person get a return from civilization (net of taxes) at least equal to the value of her assets in the SON—that the choice be individually rational. (This, of course, correlates with the minimal pareto condition imposed at the maximum level of aggregation.) Condition (2) adds the additional requirement of group rationality; it just restates in a slightly different form Nozick's secession thought experiment, described above.[61] Nozick is concerned with defining the extent of private gains that are up for grabs at all; condition (2) is concerned with defining how such gains should be divided. But the two are just different paths to the same conclusion: the best endowed group in society (and by extension each lesser endowed group in turn) will claim for itself, at a minimum, that portion of the gains from social cooperation that it could have achieved by seceding from America circa 1999 and forming a new state whose membership is limited to the best endowed.

What if anything do the above conditions imply about the appropriate division of surplus from society? First, the strict requirement of individual or group rationality holds as a descriptive matter—that is, predicts the actual outcomes in allocating common costs—only where exit from the group is possible and

60 For a discussion of this "stand alone property," see Lewis Kornhauser, *Fair Division of Settlements: A Comment on Silver and Baker*, 84 VA. L. REV. 1561, 1568-72 (1998); HERVE MOULIN, AXIOMS OF COOPERATIVE DECISIONMAKING, 89-95 (1988). I am indebted to Lewis Kornhauser for pointing out the relevance of the standard allocation-of-common-costs analysis to the problem at hand.

61 *See supra* note 59 and accompanying text.

costless. To the extent that it is costly for the best endowed members of society (and by extension any other subgroup) to secede from America circa 1999 to form their more perfect union, the gains they could have realized in that more perfect union are, as a purely positive matter, expropriable by the less well-endowed majority. This, of course, describes to a considerable extent the situation facing the very rich in this society.[62] In such a case, what, if any, normative force does condition (2) carry? Are we required to abide by the distributive results the best endowed could have obtained for themselves were exit costless, even though it is not, and if so, why?

Assuming that we are, in fact, morally required to abide by condition (2) (the results of the Nozickean thought experiment), what does it imply about the appropriate division of surplus from society? As Kenneth Arrow has argued, if there are no increasing returns to scale for society and no externalities, in a large enough economy where no individual is large on the scale of the economy, "the core shrinks to the competitive equilibrium."[63] That is to say, condition (2) leads to whatever division of surplus happens to result from market prices, and there is, as Arrow states, no problem of social justice left at all.[64] In such a world, taxation is presumably relegated to a pure benefits tax, with rates set to mimic (as far as possible) the prices the market would itself set for publicly provided goods or services.

If there *are* increasing returns to scale from organized society, generating significant gains from nonsecession for any subgroup, including the best-endowed, the range of solutions in the core is less clear.[65] Contrary to Epstein's, Gauthier's, and others' apparent assumption, however, there is unlikely to be any unique solution to the problem, and an allocation that assigns surplus (net of taxes) in proportion to the value of SON assets is not necessarily even in the core of the game.[66]

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62 Given the inherent administrative limitations of an income tax, which does not tax leisure, the rich do of course have a less costly means of exit available to them if tax rates get high enough: to trade off productive labor for (untaxed) leisure. As a practical matter, that form of exit is likely to constrain political choice far more than the more extreme sort of exit contemplated here.

63 ARROW, *supra* note 57, at 188.

64 *Id.*

65 For the thoughtful argument that there *are*, in a deep sense, such increasing returns to scale from organized society, see ARROW, *supra* note 58, at 188. I am indebted to Marvin Chirelstein for bringing this passage to my attention.

66 For a proof of the latter proposition in the context of joint litigation costs, see Lewis Kornhauser, *Control of Conflicts of Interest in Class Action Suits*, 41 PUBLIC CHOICE 145 (1983).

2. Would Pro Rata Division of the Surplus Value of the Social Contract, in Proportion to the Value of Individual Rights in a SON, Lead to Proportionate Taxation to Finance the Cost of Public Goods?

Epstein, along with numerous others, presumes the answer to the above question is yes. In fact, the answer is no, unless two conditions are met: everyone must derive utility from the creation of the minimal state in proportion to the value of his or her rights in an SON, *and* the utility each person derives must all be reflected in income (or whatever other tax base we use). It is extremely unlikely that *either* of these conditions will be met, let alone both.

A simple example will illustrate the problem. Suppose we have a two-person SON society. Person A, a hunter, has rights, in the form of human capital, with a market value of $10. Person B, a gatherer, has rights, in the form of human capital, with a market value of $20. The two enter into a compact to create a Nozickean/Lockean minimal state, pursuant to which they forswear Hobbesian aggression against each other, agree to hire a mercenary police force and army to enforce their Hobbesian contract against mutual aggression and to defend themselves jointly against outside aggression, and agree to create a variety of pure public goods, including a lighthouse, a TV broadcasting system, and roads. All of these goods and services together cost $100 to supply.

Due to the advances that civilization has brought, person A is now able to give up hunting and become a taxi driver for visiting tourists. She spends her spare time watching television. The total subjective value to her of her rights in civilization is equal to $230, of which $140 is attributable to income generated by driving a cab and $90 to the pleasures of watching TV. Person B, in the meantime, becomes a television technician. He works all the time, generating a total subjective value to him of $260, equal to the total market earnings he realizes.

Thus, in our simplified example, the total costs of civilization are equal to $100, and the total benefits of civilization are $460 ($490 total utility in civilization, minus $30 total utility in the SON), yielding a net surplus value from civilization of $360. How is the $100 cost of producing that $460 benefit to be divided through the tax system? Epstein would argue it should be divided such that A ends up with one-third of the total $360 surplus value, or $120, and B ends up with the remaining $240. But, as the chart below indicates, that result would mean that A must bear the entire $100 cost of public goods, and B nothing. In con-

trast, a proportionate tax on earned income (which in this example totals $400) would take 25% of the earned income from each of the two, producing a $35 tax bill for A (.25 x $140) and a $65 tax bill for B (.25 x $290).

EPSTEIN'S TALE OF TWO PIES

	A Hunter Turned Taxi Driver	B Gatherer Turned TV Repairman
SON (wealth)	$10	$20
LS (wealth)	$230 ($140 income and $90 imputed income)	$260 (income)
Epstein tax allocation	$100	$0
After-tax wealth	$130	$260
Net of rights in SON	–$10	–$20
After-tax share of surplus	$120	$240
Tax allocation under 25% proportionate tax on income	$35	$65

Thus, Epstein's "proportionate division of the surplus" rule clearly produces results that are wildly removed from a proportionate tax on income. In this particular example, it produces a tax scheme in which 100% of the tax burden falls on the person with the lower earned income. While that particular result is an artifact of the numbers chosen, the more general conclusion is not. Indeed, only by the most implausible coincidence would Epstein's rule *ever* produce something approximating proportionality.

To drive the point home, imagine we expand the example to a four-person SON society, in which, in addition to A and B above, we also have C, a wily but puny hunter, whose brains compensate only partially for her absence of brawn, leaving her slightly worse off than A; and D, a 7 foot 6 inch gatherer whose freakish height is on the whole a disadvantage for his chosen profession in the SON economy, leaving him slightly worse off than B. In the Hobbesian minimal state circa 1999, C becomes a well-paid law professor, the income from which far outstrips A's or B's, and D becomes a basketball superstar, the income from which dwarfs A's, B's and C's. The relative gains to C and D—whose distinguishing talents were completely worthless in the SON—from entering into civilized society are wildly disproportionate to their relative positions in the SON. As a consequence, a tax designed to return C and D to their same SON positions relative to A and B must necessarily fall in a confiscatory manner on C and D.

III. Social Welfarist/Consequential Theories of Distributive Justice

The intuition that tax burdens should be set in a fashion that minimizes the aggregate burden they entail has long held appeal. For the latter part of the nineteenth century and first half of the twentieth, that intuition was most frequently embodied in the notions that tax burdens ought to be allocated in accordance with "ability to pay," or to "minimize sacrifice." For reasons thoroughly rehearsed elsewhere, neither "ability to pay" nor "minimum sacrifice" theories have moral coherence as freestanding principles of distributive justice.[67] They are incomplete intuitions of a deeper, unarticulated (social welfarist) theory of distributive justice, in which the state has an obligation to use its fiscal powers to further the aggregate welfare of society, aggregated in accordance with some implicit or explicit social welfare function.

Viewed in that larger context, the social welfarist case for *any* tax structure judged in isolation is inherently unsatisfactory, for reasons that critics of "ability-to-pay" and "equal sacrifice" theory on the right and the left have long recognized. Once we admit that the redistribution of income for social welfarist ends is a legitimate role for the government, it is morally incoherent to isolate the tax side from the transfer/expenditure side of the fiscal ledger. As Wicksell commented many years ago, there is no point in achieving "a just part in an unjust whole."[68] It is operationally incoherent to isolate the tax side of fiscal affairs as well, for the simple reason that we can undo any tax distribution on the transfer side. Take the following, simple example. Suppose we have a two-person society in which Poor earns $1000 and Rich earns $10,000. Suppose we impose a flat tax of 45% on both Poor and Rich, thereby reducing Poor's after-tax income to $550 and Rich's to $5500. Suppose we then take the resulting $4950 in tax revenues, and distribute them in-kind and in cash entirely to Poor. One would be hard-put to disagree if Rich is heard to complain that the net result of all this fiscal legerdemain is a confiscatory tax on Rich for the purpose of achieving absolute income equality between Rich and Poor.[69]

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67 *See* Musgrave, *supra* note 17, at 90-115.

68 Knut Wicksell, Finanztheoretische Untersuchungen und das Steuerwesen Schweden's 143 (Jena 1896) *quoted in translation in* Musgrave, *supra* note 17, at 72. See also Edgeworth's and Pigou's observations to the same end, both *cited in* Musgrave, *supra* note 17, at 111; discussion in Fried, *supra* note 30, at 154-55.

69 The potential for undoing any tax distribution on the transfer side has not been lost on the right, although proponents of proportionality on libertarian grounds probably have underestimated the extent to which it undercuts any fairness arguments for proportional tax rates judged in isolation. *See, e.g.*, Hayek, *supra* note 1, at 307 (recognizing the potential for effecting radical redistribution through use of proportionate tax and differential transfers to the lower classes, but assuming that potential is limited in practice by the

What an optimal tax-and-transfer scheme would look like under a plausible range of social welfare functions giving priority to the needs of the worst-off has been much debated. The central problem, of course, is how to balance welfare gains (assuming a declining marginal utility of income) from redistributing income to the poor, against welfare losses from the distortionary effects of taxes required to finance the redistribution. It has been suggested that a degressive tax, or even a tax rate structure that declines slightly at the top, may well be optimal *if combined with* substantial lump-sum transfers (so-called demogrants).[70] The intuition behind flattening rates at the top is that the last, or marginal, incremental decision to work or save is *most* sensitive to tax rates. In a world with perfect information, each person would have her own optimal tax schedule, with rates set very high on inframarginal earnings, and declining, ultimately to zero, on the last (marginal) dollar earned. In our actual world, where we cannot observe people's true preferences, a degressive tax structure might best approximate that ideal result. More recent work has cast doubt on the efficiency arguments for a degressive tax, suggesting that, at least in some contexts, in particular, in winner-take-all markets and contexts where work and savings decisions are driven by a desire for relative status, steeply graduated rates may well be *more* efficient than flat rates.[71] The larger point, however, remains clear. The case for any tax structure on social welfarist grounds is purely derivative of prior moral commitments to a particular social welfare function, and empirical hunches about the combination of tax and transfer schemes that will best effect it.

Notwithstanding the foregoing, many thoughtful people, proceeding on social welfarist premises, have found it irresistible to assess the desirability of a given tax arrangement in isolation from the transfer side of fiscal affairs. This approach is perhaps an inevitable occupational hazard for professional tax types, whose habitual frame of reference and claims to expertise both push toward that partial view. It may also, in some cases, sensibly reflect political exigencies. If a decisionmaker is limited, as a political matter, to affecting the distribution of tax burdens, then it is perfectly sensible for her to take all other variables as given.

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inflexibility of in-kind transfers as a tool for income redistribution). Of course, once one admits the possibility of straight cash transfers, that problem goes away.

70 *See* Bankman & Griffith, *supra* note 21, at 1955-58.

71 For a very suggestive treatment of these issues, see ROBERT H. FRANK AND PHILIP J. COOK, THE WINNER-TAKE-ALL SOCIETY (1995), and Robert H. Frank, *Progressive Taxation and the Incentive Problem*, Working Paper no. 98-4 (Off. Tax Pol'y Res., U. of Mich. Bus. Sch., 1998). For a much earlier treatment of the relative status problem along the same lines in a slightly different context, see A.C. PIGOU, A STUDY IN PUBLIC FINANCE 90 (3d rev. ed. 1947).

The tendency for social welfarists to assess the fairness of tax burdens, divorced from the government's other fiscal functions, extends far beyond the foregoing situations, however, to include those who are trying to work out a just scheme of income distribution *de novo*. Perhaps the most recent striking example is Rawls.

In *A Theory of Justice*, Rawls suggests that the fairest tax scheme for raising funds to "provide for the public goods and make the transfer payments necessary to satisfy the difference principle" would be a proportional consumption tax.[72] Rawls offers the suggestion in passing, as a part of a hodgepodge of proposed fiscal arrangements to effect a just state, and it seems doubtful that he has thought through the implications of any of these institutional arrangements very clearly.[73] At any rate, one suspects he would think better of many of them on further reflection.

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72 RAWLS, *supra* note 4, at 278-79.

73 Following Musgrave, Rawls divides the government into four functions: the allocative, stabilization, transfer, and distribution branches. For our purposes, only the latter two are relevant. The transfer branch Rawls defines as concerned with guaranteeing a social minimum, provided either piecemeal by family allowances, special payments for sickness, and employment, or more systematically by a negative income tax. RAWLS, *supra* note 4, at 275. He subdivides the distribution branch into two functions: (1) regulating intergenerational transfers, through gift and estate taxes and restrictions on rights of bequests, in order to "prevent concentrations of power detrimental to the fair value of political liberty and fair equality of opportunity," *id.* at 277; and (2) raising tax revenues necessary to "provide for the public goods and make the transfer payments necessary to satisfy the difference principle," *id.* at 278.

There are a number of peculiarities here. First, it would seem that the guaranteed minimum income that is the focus of the transfer branch should be subsumed under transfers necessary to satisfy the difference principle, the task of the second leg of the distribution branch. Rawls himself seems to concede as much, in stating that "[o]nce the difference principle is accepted, however, it follows that the minimum is to be set at that point which, taking wages into account, maximizes the expectations of the least advantaged group." *Id.* at 285.

Second, it is not clear why the first and second legs of the distribution branch should be treated as distinct. Why single out intergenerational transfers as a unique violation of the just state that need to be dealt with through their own institutions, rather than simply treating them as one of many possible sources of inequality that all require governmental correction in accordance with the difference principle? One customary reason for distinguishing intergenerational gratuitous transfers from other sources of wealth, such as labor income and returns to one's own lifetime savings, is because the former is regarded as uniquely "unearned" and hence undeserved. *See* FRIED, *supra* note 30, at 97-99; ERIC RAKOWSKI, EQUAL JUSTICE 158-62 (1991). Whatever the problems with this view—and they have been much debated over the centuries—the view is clearly not one congenial to Rawls. Rawls, consistent with his broad view of undeserved privilege, explicitly states that "[t]he unequal inheritance of wealth is no more inherently unjust than the unequal inheritance of intelligence," and that "as far as possible inequalities founded on either should satisfy the difference principle." RAWLS, *supra* note 4, at 278. This statement suggests that wealth from inheritance should be treated like wealth from any other source, presumably all under the second distribution branch. The second danger that Rawls suggests is posed by inherited wealth—that when it creates inequalities in wealth that exceed a certain limit, it threatens "the fair value of political liberty and fair equality of opportunity" in society, *id.* at 277—likewise suggests no ground for separating inherited wealth from any other source of wealth. If the concentration of wealth is what matters, the source should not.

Finally, Rawls's hostility to intergenerational transfers is hard to reconcile with the solicitude he shows to savers in supporting a consumption tax in place of an income tax.

In defense of a proportional rate structure—the element of the scheme of relevance here—Rawls notes only that "it treats everyone in a uniform way (. . . assuming that income is fairly earned)."[74] At the outset, Rawls's argument runs smack into the same difficulty faced by most libertarian defenders of a flat-rate tax: the tax rate structure Rawls supports is, in fact, not a proportionate one, but a degressive one, since Rawls, like most other proponents of proportionality, would permit the "usual exemptions for dependents."[75] Whatever other merits such a scheme might have, it surely lacks the virtue of "uniformity" as that word is used here. Setting that difficulty aside, the form of uniformity or equality that Rawls implicitly champions here, equal percentages of income taken, is hardly an obvious solution to the question, "equality of what?," a matter to be returned to shortly. That point is underscored by noting that the difference principle Rawls would use in setting transfers adopts a quite different notion of uniformity: uniformity of absolute income levels after tax and transfer, subject to the exception for inequalities that help the least well off.

That last observation brings us to what is surely the greatest oddity of Rawls's championing of a flat-rate tax. In the context of the overall Rawlsian scheme, the right not to have one's income taxed at a higher marginal rate than one's neighbor's stands as an island of deontological rights swamped by a sea of redistribution. As the above example of Rich and Poor illustrates,[76] if the proceeds of a Rawlsian tax are used to finance the transfers to the least well off required by the difference principle, the fact that the rich are treated "uniformly" with the poor on the tax side should be cold comfort to them, and a matter of total moral indifference to a Rawlsian.

Indeed, the same criticism Rawls rightly makes at "traditional criteria" for fair taxation, ability to pay and benefits theory, can be made of Rawls's proposed tax scheme: it does not "take a

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The salient difference between a consumption tax and an income tax is the treatment of savings: a consumption tax exempts from taxation at least some forms of capital income currently taxed under our income tax. *See* Joseph Bankman & Barbara H. Fried, *Winners and Losers in the Shift to a Consumption Tax*, 86 GEO. L.J. 539, 540-42 (1998). In defense of a consumption tax base, Rawls appeals to the "common sense precepts of justice," precisely the ones that appealed to Hobbes some three hundred years ago, that "it imposes a levy according to how much a person takes out of the common store of goods and not according to how much he contributes (assuming here that income is fairly earned)." RAWLS, *supra* note 4, at 278. Whatever the merits of this position, the statement is hard to reconcile with Rawls's position on intergenerational transfers. Given that a significant portion of lifetime savings, at least among the wealthy, is destined for intergenerational transfer through inter vivos gifts and bequests, the choice to protect the return to savings, via a consumption tax, during a taxpayer's lifetime, while burdening the same decision heavily upon death, seems to require some justification.

74 RAWLS, *supra* note 4, at 278-79.

75 *Id.* at 278.

76 *See supra* note 69 and accompanying text.

sufficiently comprehensive point of view" of the government's role in securing a just distribution of income.[77]

As a final oddity in Rawls's defense of proportionality, Rawls suggests that flat rates are obviously fair only in an already just world. Given the injustice of existing institutions, Rawls argues, there may be a role for "even steeply progressive income taxes."[78] By "injustice," Rawls appears to mean here a world in which not all income is "fairly earned."[79] It is hard to figure out what this essentially Nozickean principle of rectification is doing in a Rawlsian world. Given Rawls's view that talents, including a taste for hard work, are undeserved, and hence the income derived from those talents undeserved, what could it mean to Rawls for a person to earn income fairly, such that it was *not* up for grabs under a steeply progressive income tax?

In the end, the impossibility of making any logical sense, in the context of his larger aims, of Rawls's positions on tax policy in general, and rate structures in particular, makes those positions of more than common interest—not in justifying those positions, but in appreciating the breadth and strength of the irrational pull they exert. If Rawls, of all people, could think a flat tax a just tax because "it treats everyone in a uniform way," surely there is some powerful instinct at work here that resists logic. What is it?

IV. Equality of Tax Burdens as a Percentage of Income as a Default Position

Rawls may be the most surprising expositor of the view that a flat tax is the fairest tax of all, but he is hardly alone. Many people believe (1) that one can assess the fairness of a tax system in isolation from government expenditures or any other government policies affecting the distribution of wealth, and (2) that viewing our tax system from such a perspective, a proportionate tax scheme is the self-evidently fairest one, because, in the words of Rawls, "it treats everyone in a uniform [that is, equal] way."[80] Indeed, for many, flat rates (or more precisely a degressive rate structure) appear to be the *only* feature of the tax system that is mandated on fairness grounds.[81]

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77 Rawls, *supra* note 4, at 280.

78 *Id.* at 279.

79 Or so I infer from his repeated insistence on this qualification on his support for a flat-rate consumption tax in the preceding passage. *Id.* at 278-79. Rawls doesn't state explicitly what injustices he has in mind here.

80 *Id.*

81 Epstein, for example, treats all other fundamental choices in tax system, including the choice of a taxable base, double taxation at the corporate level, the realization requirement, the home mortgage interest deduction, and the preferential treatment of capital gains, as normatively discretionary calls, on the empirical assumption that the resolution of each of these questions will have little systematic impact on the distribution of surplus.

Everyone is in favor of equality. The question, of course, is "equality of what?" Why this particular version of equality, taking an equal percentage of everyone's income, has had such widespread and persistent appeal is something of a mystery. It has history on its side, of course, in the biblical tradition of tithing, but that merely pushes the mystery one step back.

To take the case for proportionality in its most sympathetic posture, let us assume that the beneficiaries of public expenditures are absolutely impossible to trace, thereby precluding any benefits-theory-based defense for any rate structure. We can invoke here Blum and Kalven's helpful suggestion that we treat the collection of taxes "as though it were only a common disaster—as though the tax money once collected were thrown into the sea."[82] Let us also assume that the state has no legitimate, social welfarist interest in redistribution, and that we take the background distribution of pretax incomes as just. In this limited context, in which the fairness of tax burdens is to be judged completely in isolation, can we say anything at all about their just distribution?

For most people, the default assumption in such a case, where taxes are, in Blum and Kalven's words, "a necessary evil falling upon a distribution of money . . . which is otherwise acceptable,"[83] is that the tax burden ought to be shared equally by all taxpayers. This view is obviously reflected in the longstanding argument, going back at least to Mill, for "equal sacrifice" in taxation.[84] That argument, however, simply raises the question adumbrated above, equality of what?

TAKINGS, *supra* note 5, at 300-02. That assumption is almost certainly wrong with respect to many of these items, given the highly skewed distribution of capital income in this country. The only other tax policy choice attracting constitutional scrutiny from Epstein is industry-specific tax breaks like percentage depletion for oil and gas.

Others, of course, notably including Rawls, have argued that the choice of tax base (consumption versus income) raises fundamental issues of fairness. That argument is conspicuously absent, however, from most contemporary defenses of the so-called Hall/Rabushka flat tax championed by Steve Forbes and adopted as the model for the Armey/Shelby plan now pending before Congress. The Hall/Rabushka plan, along with most so-called flat tax schemes, adopts a consumption tax base in place of an income tax base, in addition to shifting from a graduated to a degressive rate structure. Notwithstanding that fact, as Larry Zelenak argues at length in his piece for this symposium, most proponents of the plans on fairness grounds are conspicuously silent about the former change. Lawrence Zelenak, *The Selling of the Flat Tax: The Dubious Link Between Base and Rate*, 2 CHAP. L. REV. 197 (1999). Hall and Rabushka themselves, for example, completely ignore the consumption tax feature of their proposal in their 30-page defense of the fairness of their flat tax. HALL & RABUSHKA, *supra* note 7, at 23-51.

82 Blum & Kalven, *supra* note 6, at 517.

83 *Id.* at 460.

84 For typical expressions of that view, see *Taxation*, *supra* note 5, at 73-74 (where the benefits and other costs of government are hard to assess, "a test of equal treatment across taxpayers becomes the next best alternative"); Blum & Kalven, *supra* note 6, at 460 (if taxes are a necessary evil falling on a distribution of income otherwise just, the object is "to leave all taxpayers equally 'worse off' after taxes").

Now, we are plunged into a long-running dispute, well-documented elsewhere, and I do not propose to rehash it at length here.[85] In brief, commentators have disagreed about the proper meaning of both equality and sacrifice, in interpreting "equality of sacrifice." Two principal measures of equality have been proposed: equal absolute sacrifice, and equal proportionate sacrifice (in proportion, that is, either to income or to any substitute taxable base).[86] Two principal measures of sacrifice have been proposed: that sacrifice should be measured by the *utility of dollars* relinquished, and that it should be measured by *dollars* relinquished.

The resulting four-cell matrix obviously yields four different interpretations of "equality of sacrifice." Of the four, only one—equal *proportionate* sacrifice measured by *dollars* relinquished—unambiguously (indeed, definitionally) leads to a flat-rate tax. Equal *proportionate* sacrifice measured by the *utility of dollars* relinquished under most plausible utility schedules for money would yield a progressive rate structure. Equal *absolute* sacrifice measured by *dollars* relinquished obviously yields a highly regressive head tax. Equal *absolute* sacrifice measured by the *utility of dollars* relinquished is the most ambiguous: under differing but plausible assumptions about the declining marginal utility of income, it could imply a regressive, proportionate, or progressive rate structure.[87]

What, then, explains the apparently widely shared intuition that the equality principle should be interpreted to require equal proportionate sacrifice, measured by dollars relinquished? The choice to use dollars, rather than the utility of dollars, as a measure of sacrifice, does not seem hard to defend. Indeed, the contrary choice, adopted by numerous tax theorists over the last century, is much harder to understand.[88] We customarily measure the price exacted for goods or services by nominal dollars paid, not by the subjective disutility to the payor of relinquishing those dollars. Opting for the latter measure here—a measure

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85 *See* Blum & Kalven, *supra* note 6, at 455-65; MUSGRAVE, *supra* note 17, at 90-98; FRIED, *supra* note 30, at 153-54.

86 The third measure proposed by Mill, equimarginal sacrifice, was rightly dismissed by friends and foes alike as nothing more than a stand-in for utilitarian concerns. *See* FRIED, *supra* note 30, at 154-55.

87 *See* MUSGRAVE, *supra* note 17, at 99-100; Blum & Kalven, *supra* note 6, at 458-59. David Gauthier, to take one recent example, assumes that the measure (which he supports in a convoluted fashion) would result in a flat-rate tax. GAUTHIER, *supra* note 14, at 272. There is clearly no more empirical, or even strong intuitive, support for that conclusion, however, than for the alternative Friedmanesque assumption, which Gauthier rejects, that the *quantity* of public goods people consume is proportionate to their income. *Id.* at 271.

88 *See, e.g.*, Antonio de Viti de Marco, *cited in* MUSGRAVE, *supra* note 17, at 73; FRIED, supra note 30, at 154-55, 301 nn.261-62. For a more recent defense of utility as a measure of sacrifice, see GAUTHIER, *supra* note 14, at 271-72.

that, under conventional assumptions of the diminishing marginal utility of wealth, is inversely correlated with initial wealth—is hard to explain except as an indirect way to smuggle in the very redistributive objectives that we ruled out of bounds at the start of this inquiry, when we took the background pretax distribution of incomes as just.[89]

The former choice, however—the choice of *proportionate* over *equal absolute* sacrifice—seems much harder to defend. Probably the most famous, albeit indirect, brief for proportionate taxation, Blum and Kalven's "Uneasy Case," has only two things to say on behalf of the fairness of flat rates in the course of its 100-page assault on graduated rates. The first is that "[a]s a principle of justice [proportionate sacrifice] is intuitively attractive."[90] The second is that the "virtue of the proportionate sacrifice formula is that it remains neutral as to the relative distribution of satisfactions among taxpayers."[91] Virtually all defenses of proportionality ultimately boil down to some variant of the former "I know fairness when I see it" claim, or the latter tautology. In the tautological vein, for example, consider Hall and Rabushka's argument that "[t]he principle of equity embodied in the flat tax is that every taxpayer pays taxes in direct proportion to his income."[92] Or consider Hayek's: while progression represents "discrimination against the wealthy,"[93] proportionality "raises no problem of a separate rule applying only to a minority."[94]

Can we do no better than this? The usual starting point for implementing equality-based norms is that people who are identical *in relevant respects* should be treated identically. The case for

89 Gauthier attempts to justify a utility measure of sacrifice as not redistributive in intent here by reference to his notion of "minimax relative concession" (MRC). GAUTHIER, *supra* note 14, at 271-72, and note 46, *supra*. In brief, MRC requires an equal division of the joint gains from cooperation, including gains from the cooperative provision of public goods. Gauthier argues that a head tax will violate the requirements of MRC, because under a head tax "a person with fewer resources will lose a greater proportion of the gain he would realize were he to obtain the good at no [tax] cost." *Id.* at 272. Presumably, this result follows in Gauthier's mind from the declining marginal utility of income: since dollars are worth more to the poor, a head tax strips from them more absolute utility, and hence a greater absolute share of the surplus. But if the utility of tax dollars given up to purchase public goods is greater, so also, presumptively, is the utility of public goods retained, net of taxes (that is, the poor's share of the surplus from cooperation less their share of the tax costs). If so, Gauthier's requirement that surplus be divided equally, in utility terms, seems more plausibly to lead to a steeply regressive tax than a flat tax. At any rate, it requires some odd assumptions about the shape of marginal utility curves over the relevant ranges to conclude otherwise. In the end, Gauthier's inclination to measure gain by utility, like his inclination to equalize the division of surplus under MRC, seems hard to explain except as an expression of egalitarian impulses that are uneasily reconciled with the libertarian premises of his project.

90 Blum & Kalven, *supra* note 6, at 460.

91 *Id.*

92 HALL & RABUSHKA, *supra* note 7, at 27.

93 HAYEK, *supra* note 1, at 313.

94 *Id.* at 314-15.

any tax rate structure that is tied to the level of income, be it progressive, proportionate or even regressive, thus depends on showing that income levels are morally relevant in setting differential tax burdens. In the case of benefits theory or social welfarist approaches, the claim for moral relevance of income levels is obvious. In the case of benefits theory, income is taken as a proxy for benefit levels; in the case of social welfarist approaches, whether embodied in inchoate form in "ability to pay" arguments or full-blown optimal tax analyses, income (or capacity to generate income, as reflected in actual income) is taken as the prime measure of welfare. If the justice of tax burdens is really to be judged in isolation from either the distribution of government benefits or the desired end-state distribution of income, however, it is difficult to see why income levels would ever be relevant in measuring equal treatment. The far more plausible measure of equality under those conditions would seem to be equal treatment of individuals, a premise that would seem to lead to a head tax. Indeed, Blum and Kalven argue as much in another context, in attacking Mill's "equimarginal sacrifice" as a plausible interpretation of equality. If we are really confining discussion to how we should allocate a burden, and are ignoring benefits and distributive concerns, Blum and Kalven argue, the principle of equimarginal equality "seems not a little absurd. . . . [I]t is strange indeed to have [two men] share a common burden by putting all of it on the wealthier man."[95] It is no less absurd in principle, although less extreme in degree, to put more of it on the wealthier man than the poorer one just because he is wealthier. At least, it is hard to see how the absurdity could ever be removed, except by reference to either benefits theory or social welfarist concerns.

V. Taxes Should Be Levied so as to Leave People's Choices Undistorted

A number of commentators with libertarian sympathies have argued for proportionality on the ground that it would leave people's choices undistorted from what they would have been in a no-tax world.[96] Minimizing tax-induced distortion in behavior is, of course, the goal of much of public economics, on efficiency grounds. For Epstein, Gauthier and others, that ideal appears to have libertarian roots, of a Randian/personalist sort. As Epstein put it:

> The creation of a system of government should strive not to reduce the scope of permissible individual choice from what it was before. Accordingly, no person or group should be able to use the tax system to change the pattern of preferences of other in-

95 Blum & Kalven, *supra* note 6, at 470-71.

96 *See Taxation*, *supra* note 5, at 74; Gauthier, *supra* note 14, at 272-73.

> dividuals. If A ranks a set of (noncoercive) alternatives 1 to n before taxation, then A's ranking of those alternatives should remain 1 to n, without alteration, after the tax is imposed.[97]

This statement is hardly a universally shared interpretation of the requirements of libertarianism. It treats individual liberty as residing in undistorted individual choice among actions, rather than, for example, the utility any particular choice generates. Thus, nothing in Epstein's example would preclude a near-confiscatory tax on earnings from any source, provided only that it did not reverse rank orderings of choices. Be that as it may, contrary to Epstein's assumption, the requirement that we preserve the rank orderings of choices—including both the choice among kinds of work and the choice between work and leisure—does not lead in the first instance to either proportionate taxation or, what Epstein erroneously takes to be the same thing, a tax system that leaves the relative wealth of taxpayers constant.[98] It leads to a highly regressive head tax, endowments tax, or some other form of pure lump-sum taxation. As a second-best alternative, where lump-sum taxation is politically infeasible or distributionally undesirable, it leads to a Ramsey-type optimal tax on labor or capital, in which tax rates are set in inverse proportion to the elasticity of supply, in order to have the tax burden fall, as far as possible, on suppliers' rents. As discussed above, what precisely such an optimal tax scheme implies about the rate structure in a broad-based income tax has been much debated, without any definitive conclusion. A case can be made for a degressive, or even a regressive rate structure at the top of the income scale, on efficiency grounds.[99] But the choice to opt for any broad-based income tax in preference to lump-sum taxation in the first instance must be driven by distributional concerns that are hard to reconcile with the Randian libertarianism driving Epstein's argument here, or the more conventional, property rights-based libertarianism reflected in benefits theory.

VI. Political Economy Arguments for a Flat Tax

Proponents of proportionate taxation have offered a variety of political economy arguments on behalf of flat rates. Perhaps the most prominent is an argument, chiefly associated with Hayek but espoused by many others as well, that proportionality, as a rule of

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97 *Taxation*, *supra* note 5, at 55. For similar comments from Gauthier, *see* Gauthier, *supra* note 14, at 272-76.

98 "If tax neutrality [in this sense] could be perfectly achieved, the laws would act as a prism which magnified equally all preexisting endowments. The nature of private activities would not change, nor would the relative endowments of private persons." *Taxation*, *supra* note 5, at 56. The former conclusion is true; the latter is decidedly not.

99 *See supra* note 70 and accompanying text.

general application, precludes the majority from imposing upon "a minority a rule which it does not apply to itself."[100] Such an imposition, Hayek argues, "is an infringement of a principle much more fundamental than democracy itself, a principle on which the justification of democracy rests."[101]

Hayek's argument for proportionality here, of course, depends on the fact that in raising rates on the minority rich, the majority also raises rates on themselves. Whatever merits the argument might have as an empirical or normative matter, however, the property Hayek seizes on here is hardly unique to proportionate taxation. It is even more true of a head tax, in which any rate increase imposed on the minority rich will fall on the majority even more heavily than in a proportionate scheme, a fact Epstein inadvertently surfaces, in mistakenly defending a flat tax on the grounds that "[a] rule that says you must pay a dollar for the dollar that you wish to exact from your neighbor" is an important constraint on political intrigue.[102] Indeed, the same property holds for *any* rate structure, including a highly progressive one, in which the rates of each income group are a positively correlated arithmetical function of the rates imposed on others. With little ingenuity, one could accommodate virtually any level of progression within that constraint.

There is, however, a further problem with Hayek's argument. It presumes, as Epstein argues, that "[t]he flat tax gives the government only one degree of freedom: what is the level of the revenues and, hence, of [the tax rate]?"[103] That conclusion is true, however, only if a flat tax, once enacted, cannot be repealed. If it can—and unless constitutionalized, it formally can as easily as the progressive rate structure it has hypothetically replaced—then at any time after a flat-rate structure has been enacted, the government has not one degree of freedom, but as many as it ever had, since enactment of a flat-rate structure does not itself preclude the bottom 51% of the population from sticking it to the top 49% at any time, simply by voting to abandon flat rates in favor of progressive ones. The Hayekian argument, to make any sense, must therefore depend upon a further assumption: that if one can persuade people to go for a flat-rate structure to begin with, one has a higher than (politically) customary chance of persuading

100 HAYEK, *supra* note 1, at 314. For similar sentiments, see sources cited in Blum & Kalven, *supra* note 6, at 435 n.60; *Taxation*, *supra* note 5, at 70.

101 HAYEK, *supra* note 1, at 314. Epstein trumpets the same property of proportionality for a different reason, arguing that by limiting political choices to one tax rate that applies to all, proportionality reduces the opportunities for, and hence transactions costs of, factional fighting. *Taxation*, *supra* note 5, at 53, 57.

102 *Taxation*, *supra* note 5, at 70.

103 *Id.*

people to adhere to it going forward. On what could such an assumption be based?

VII. Flat Rates as a Schelling-Like Focal Point

One possible answer lies in the suggestion that the broad appeal of proportionate taxation is attributable less to any easily explicable moral theory than to its operating as a Schelling-like focal point for people; that is, a solution that is psychologically prominent because of its apparent mathematical certainty, along with its apparent properties of equality.[104] I say apparent mathematical certainty and simplicity, because one can achieve equal or greater simplicity with other schemes—a head tax, for example—and equal mathematical certainty from *any* mathematically determinate function that correlates the tax rates of different income groups. But that logical quibble is in a sense beside the point here—the point being that, for *whatever* psychological or historical reasons, this particular relationship among tax burdens has a strong pull on the popular imagination.

There is much, particularly in Hayek's writings, to support the focal-point explanation. It may explain why people as divergent in their political commitments as Rawls and Hayek might fix on such a solution in good faith to begin with, as unselfconscious participants in a Schelling-like convergence. It also explains why proponents of less progressivity than now exists would fix on it as a strategic matter, as a political solution that is both obtainable and sustainable. Hayek himself seems to concede as much, when he acknowledges that he is seeking a principle "which has [a] prospect of being accepted and which would effectively prevent those temptations inherent in progressive taxation from getting out of hand," and rejects as an alternative solution "setting an upper limit which progression is not to exceed."[105] The problem with such a solution, notes Hayek, is that "[s]uch a percentage figure would be as arbitrary as the principle of progression and would be as readily altered when the need for additional revenue seemed to require it."[106] Of course, as noted above, a flat-rate scheme could be altered at will as well, to revert back to a progressive rate structure. But Hayek has perhaps got hold of a psychological truth here: a flat-rate structure has a psychological prominence that may make it easier to sell to voters in the first instance than many other possible rate structures that are less progressive than

104 *See* Bankman & Griffith, *supra* note 21, at 1914. The certainty of a proportionate rate structure is a recurrent argument offered in its favor. *See, e.g.*, Hayek, *supra* note 1, at 313-14; Blum & Kalven, *supra* note 6, at 430-35, 511; Lutz, *supra* note 15, at 70, 73-76.

105 Hayek, *supra* note 1, at 323.

106 *Id.*

the current one, and may make it more likely, once enacted, to stick.

VIII. Political Framing

Finally, the convergence on proportionate taxation seems to be, in significant part, a product of political framing. Benefits theory, at least under the strict construction of benefits that seems most congenial to libertarian premises, would almost certainly lead to a highly regressive tax structure. Most opponents of progressivity on fairness grounds specifically reject that outcome as politically unpalatable and hence infeasible. Blum and Kalven, for example, take a regressive tax off the table, as they took off the table a tax that does not exempt basic income, not because it is unpersuasive, but because "[i]t is so clear no one today favors any tax because it is regressive . . .[that] a regressive tax on income is not a serious [policy] alternative."[107] Richard Epstein takes a head tax off the table without any justification whatsoever.[108]

That decision permits opponents of a graduated rate structure to narrow and restate their position as follows: "[o]n what grounds is a progressive tax on income to be preferred to a proportionate tax on income?"[109]—or more precisely, for the overwhelming majority of flat-rate proponents who also support an exemption for basic income, "[o]n what grounds is a progressive tax on all incomes over a minimum subsistence exemption to be preferred to a proportionate tax on all incomes over a minimum subsistence exemption?"[110] Once regressivity is off the table as a viable alternative, along with a true proportionate tax, a degressive tax becomes the best available alternative to those who are hostile to the degree of income redistribution effected at the top of the income scale by a graduated rate structure. Indeed, the whole structure of Blum and Kalven's implicit argument for proportionality depends on getting regressive taxes off the table, because almost all of the arguments they make against progressivity, to the extent they are persuasive, would more naturally lead to a highly regressive tax structure than a degressive one. (It might also be noted that once a regressive tax and a true flat tax are off the table, proponents of a degressive, rather than graduated, rate structure have narrowed the choice to two alternatives that are so close to each other in so many respects that it seems implausible that the differences between them will be dispositive under most theories of distributive justice.)

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107 Blum & Kalven, *supra* note 6, at 419.

108 *Taxation*, *supra* note 5, at 68: "(I ignore here capitation taxes that call for all persons to pay a fixed amount of taxes, regardless of income.)."

109 Blum & Kalven, *supra* note 6, at 419.

110 *Id.* at 420.

We have lived with a progressive tax rate structure for so long that we are all accustomed to think regressivity unthinkable. As Thatcherite England makes clear, however, the unthinkable can become thinkable. If it did here—if the political landscape changed enough to make a regressive tax rate structure, or at the extreme even a head tax, a politically plausible alternative—then there is every reason to expect that the odd convergence on a flat tax as "the fairest tax of all" would dissipate. Whatever Rawls and other social welfarist participants in that convergence might make of their inexplicable enthusiasm on second thought, one would surely expect defection in the libertarian ranks. For libertarians, a regressive tax seems the more likely logical outcome of their philosophical precommitments.

The Selling of the Flat Tax: The Dubious Link Between Rate and Base

*Lawrence Zelenak**

I. INTRODUCTION

There may yet be a flat tax in your future. Although the flat tax issue did not carry Steve Forbes to the White House,[1] there is still strong support—among politicians and among the public—for radical tax reform. Recent opinion polling indicates almost no one thinks the current income tax is "basically fine,"[2] and in two recent polls the flat tax has defeated the income tax by a margin of two-to-one.[3] Republican politicians are pushing the issue in various ways. On June 17, 1998, the House of Representatives passed the "Tax Code Termination Act," which would scrap the Internal Revenue Code on December 31, 2002.[4] Although the bill does not specify the details of the replacement tax, it does indicate that the replacement should not be progressive and should be imposed on a consumption base.[5] In 1997, Representatives Dick Armey and Billy Tauzin embarked on a national debate tour; they agreed that the income tax should be scrapped, but Armey would replace

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1 *See* Ernest Tollerson, *Bowing Out: Forbes Quits and Offers His Support to Dole*, N.Y. TIMES, Mar. 15, 1996, at A26 (summarizing Forbes' presidential campaign).

2 *See* Susan Page & William M. Welch, *Things-to-do 1998: Tax Reform Tops List*, USA TODAY, Dec. 22, 1997, at A1 (reporting results of USA Today/CNN/Gallup Poll, that 5% of those surveyed consider the current system "basically fine," and 95% want change).

3 *See NBC News/Wall Street Journal Poll*, survey ending Oct. 28, 1997, *available in* Nexis RPOLL file, accession number 0291157 (asked their opinion of replacing the income tax with a flat tax (at 17%), 61% were in favor and 32% opposed); Ann Reilly Dowd, *Get the Facts on Tax Reform*, MONEY, Jan. 1998, at 86 (reporting result of Nov. 1997 Money/ICR Research poll, in which two out of three respondents favored Dick Armey's version of the flat tax).

4 *See* Ryan J. Donmoyer, *In Election Year Gambit, House Votes to Scrap Code*, 79 TAX NOTES 1533 (1998); H.R. 3097, 105th Cong. (1998) (Rep. Largent). The House-passed bill was referred to the Senate Finance Committee on June 18, 1998. 144 CONG. REC. S6563 (daily ed. June 18, 1998). It languished there until the end of the legislative session.

5 H.R. 3097, 105th Cong. §§ 3(a)(1) (the replacement tax system should "appl[y] a low rate to all Americans"), 3(a)(4) (the new system should "eliminate[] the bias against savings and investment") (1998).

it with the flat tax, Tauzin with a national sales tax.[6] Republicans are committed to making fundamental tax reform a key issue in the 2000 elections.[7]

Two recent developments have shortened the life expectancy of the income tax. The 1997 Senate Finance Committee hearings on Internal Revenue Service abuses generated a tremendous public response, and hostility toward the IRS readily translates into hostility toward the Internal Revenue Code.[8] The prospect of budget surpluses may be even more significant. If tax reform must be revenue neutral, there will inevitably be taxpayers who will pay more under the new system, and who will therefore oppose reform. Budget surpluses remove the revenue neutrality constraint, making it possible to compensate those who would otherwise be losers under tax reform.[9] It may now be possible to buy off the opposition.[10]

Although there are several candidates for successor to the income tax, the most prominent is the "flat tax," designed by economists Robert E. Hall and Alvin Rabushka,[11] and championed by Dick Armey[12] and Steve Forbes.[13] The naming of the proposal

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6 *See* Dick Armey & Billy Tauzin, *Flat Tax or Sales Tax, A New System Should Have a Single Rate and Shouldn't Favor Any One Type of Income*, L.A. TIMES, Oct. 5, 1997, at M5 (announcing the "Scrap the Code Tour").

7 *See* John Machacek, *Paxon, Oklahoman Offer Bill Setting Deadline for Abolition of Tax Code*, GANNETT NEWS SERVICE, Jan. 22, 1998 (*available in* Nexis CURNWS file) (Representative Bill Paxon predicts fundamental tax reform will be a major issue in the 2000 presidential election); Jonathan Chait, *The Flat Tax Scam*, NEW REPUBLIC, Dec. 15, 1997, at 23 ("Republicans intend for this new campaign to build through the 1998 or 2000 elections and culminate in the abolition of the progressive income tax"). As two leading tax economists have noted, "The odds are that we're in for a tremendous battle over our tax system . . . at some time in the near future." JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES 14 (1996).

8 *See* Ronald Brownstein, *GOP Lawmakers Are Counting on Making Taxes Pay in 1998 Agenda*, L.A . TIMES, Dec. 1, 1997, at A5 ("Republicans sensed renewed opportunity in taxes this fall after the spectacular public response to the Senate Finance Committee hearings on Internal Revenue Service abuses"). Alvin Rabushka, co-inventor of the flat tax, recently described attacking the IRS as "a strategy that helps sell the [flat tax] issue." Ryan J. Donmeyer, *Flat Tax Strategy: The IRS as Poster Boy for Tax Reform*, 77 TAX NOTES 1305 (1997). Conservative economist Lawrence Kudlow agreed that flat tax proponents should "use the IRS abuses as a launching pad." *Id.*

9 *See* Dean Foust, *The Partisan Battles Are on Their Way Back*, BUSINESS WEEK, Dec. 29, 1997, at 80 (quoting an unnamed White House advisor, that "[t]he big political change [in tax reform] is that you can think about buying off the losers with the surplus").

10 A third development may also bode ill for the income tax. Although the Taxpayer Relief Act of 1997 (Pub. L. No. 105-34, 111 Stat. 788 (1997)) appears to be a step away from fundamental tax reform, some reformers see it as the beginning of the end for the income tax. In their view, the complexity added by the new law "will sow the seeds of the income tax code's final destruction." *Simple, No?*, ALL THINGS CONSIDERED Transcript # 97080511-212, Aug. 5, 1997 (*available in* Nexis NPR file) (reporting opinion of Rep. Tauzin).

11 ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d ed. 1995) [hereinafter FLAT TAX I].

12 Freedom and Fairness Restoration Act of 1995, H.R. 2060 and S. 1050, 104th Cong. (1995) (sponsored by Rep. Armey and Sens. Shelby, Craig and Helms).

13 A poll taken in late 1997 asked respondents to choose between the current tax system and the flat tax, and between the current system and a national retail sales tax. The

makes it a curiousity among taxes. Every other tax—income, sales, property, estate, gift, value-added—is named after what it taxes. Only the flat tax is named after its rate structure, with no hint as to *what* it might be flatly taxing.[14] This approach is not an accident. Diverting attention from base to rate is good strategy. The idea of a single rate of tax has considerable appeal to the American public, but a consumption tax base may be difficult or impossible to sell on its own. This is especially true of the flat tax's version of a consumption base, under which individuals pay tax on wage income but not on investment income.

It is clear why flat taxers believe there is political advantage to linking a consumption base to a flat rate, and to downplaying base while emphasizing rate. If one wants to sell a move to an unpopular tax base, the best approach might be to link the base to a popular flat rate. But is there any justification beyond politics for the linkage? As a technical matter, the consumption base and flat rate features of the flat tax are completely separable.[15] There is no technical barrier to either a flat income tax or a progressive consumption tax. If the linkage is justified, it must be because there is some logical or philosophical reason why support for a flat tax implies support for a consumption base.

This article examines the politics and the merits of the case for linkage. It begins with a brief explanation of the Hall-Rabushka-Forbes-Armey flat tax, placing it in the context of other (less prominent) proposals for replacing the income tax with a consumption tax. It next examines the politics of presenting the flat tax's base and rate as a package. The Article then turns to the merits of the link. It considers the argument that an overriding concern for efficiency dictates both a consumption base and a flat rate, a similar argument that an overriding concern for simplicity dictates both the base and the rate, and more technical arguments that certain desirable forms of tax neutrality—between present and future consumption, and among persons with different lifetime earnings patterns—can be achieved only with a flat rate consumption tax. The conclusion is that there is no persuasive case

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flat tax beat the current system by almost two-to-one (61% to 32%), but the retail sales tax barely edged out the current system (47% to 43%). *NBC News/Wall Street Journal Poll*, survey ending Oct. 28, 1997, *available in* Nexis RPOLL file, accession numbers 0291157 (flat tax) and 0291158 (sales tax).

14 In fact, it is taxing consumption.

15 The flat tax also involves a third innovation, the elimination of personal deductions, which is also fully separable as a technical matter from the other two changes. However, the separability of the deduction issue is widely understood, while the separability of the base and rate issues is not. *See, e.g.*, The National Commission on Economic Growth and Tax Reform, *Unleashing America's Potential: A Pro-Growth, Pro-Family Tax System for the 21st Century*, *reprinted in* 70 TAX NOTES 413, 424-26 (1996) [hereinafter Kemp Commission] (insisting that tax reform must include both a consumption base and a single rate of tax, but agnostic as to whether the home mortgage interest deduction should be retained).

for linking the base and rate issues, and that a well-informed public debate on tax reform requires that each issue be discussed on its own merits. The likely result of uncoupling the two issues will be a public rejection of a consumption tax base, at least in its flat tax form.

II. THE FLAT TAX AND OTHER CONSUMPTION TAX PROPOSALS

A. The Many Faces of Consumption Taxation

Under a comprehensive income tax, income is subject to tax whether it is consumed or saved. Under a consumption tax, only consumed income is subject to tax. The actual United States "income" tax occupies a middle ground between a pure income tax and a pure consumption tax. There is no general exemption for saved income, but there are important instances in which saved income is not taxable—two of the most prominent being the deferral of tax on unrealized appreciation and the deferral of tax on qualified retirement savings.[16]

A consumption tax can take many forms. Recent proposals to replace the income tax have advocated four forms of consumption taxes with very different appearances, despite their underlying kinship.[17]

The USA (Unlimited Savings Allowance) Tax, proposed by Senators Nunn, Kerrey, and Domenici, most closely resembles the income tax.[18] As a "cash flow" version of a consumption tax, it computes its tax base in the same manner as an income tax, except that it allows a deduction for all saved income (and taxes all spending out of savings).[19] Since income must be either consumed or saved, when savings are deducted from income what remains as the tax base is necessarily consumption. The USA Tax is unique among recent major consumption tax proposals in that it is not flat—its marginal rates range from 19% to 40%.[20] The relatively high marginal rates may explain the failure of the USA Tax to generate great interest with either Congress or the public.

It is possible to tax consumption without involving individuals directly in the process. In theory, at least, a broad-based retail sales tax (RST) would have the same aggregate tax base as a cash

16 I.R.C. §§ 1001(a) (taxable gains with respect to property occur only upon a "sale or other disposition" of the property), 219 (individual retirement accounts), 401-420 (tax-favored employer-provided pensions and individual retirement accounts) (1994 & Supp. III 1997).

17 *See* SLEMROD & BAKIJA, *supra* note 7, at 196 ("Since these four alternatives appear on the surface to be very different, their essential similarity is often completely misunderstood.").

18 USA Tax Act of 1995, S. 722, 104th Cong. (1995).

19 *Id.* § 50.

20 *Id.* § 1.

flow individual-based consumption tax, without requiring individuals to file tax returns. A national RST has been proposed as a replacement for the income tax, and has been mentioned approvingly by Ways and Means Chairman Bill Archer.[21] A value-added tax (VAT) resembles an RST, except that a portion of the tax is collected at each stage of the production process, instead of the entire tax being collected at the point of retail sale. In a subtraction method VAT, a business would pay the tax on its total sales, reduced by deductions for purchases of inputs from other firms, and for purchases of plant and equipment.[22] By the time the sale to the consumer is complete, the value subject to tax is the same amount that would be taxed at the cash register under an RST. Chairman Archer has also expressed interest in replacing the income tax with a VAT.[23]

Because neither individuals nor families are taxable units under an RST or a VAT, those taxes cannot be imposed at a higher rate on the consumption of more affluent persons or households. For this technical reason, an RST or a VAT—unlike an income tax or cash flow consumption tax—must be flat.

The flat tax of Hall, Rabushka, Forbes, and Armey is a variation on a VAT. The flat tax splits the VAT into a two-part tax base. The business tax portion is the same as the tax base of a VAT, except that it also allows a deduction for wages and salaries paid.[24] The wages deducted from the business tax are included in the wage tax portion of the flat tax.[25] Since the same flat rate (19% in the Hall-Rabushka version) applies to both the business tax and the wage tax, at first the bifurcation of the VAT base seems pointless. Why remove wages from the base of one 19% tax, only to tax them at the same 19% rate under another tax?

Actually, the bifurcation serves an important function—exempting subsistence wages from tax. In the Hall-Rabushka proposal, the tax-free allowance for wages is $16,500 for a married couple, $9500 for a single person, and $14,000 for a single head of household, with an additional $4500 for each dependent.[26] A married couple with two children, for example, could earn $25,500 free of the wage tax. To Hall and Rabushka, the complication of a bifurcated tax base is justified by two effects of the exemption

21 *See* Stephen Moore, *The Economic and Civil Liberties Case for a National Sales Tax*, 71 TAX NOTES 101 (1996); Dan Balz, *Lugar Calls for a National Sales Tax to Replace Federal Levy on Income*, WASH. POST, Apr. 6, 1995, at A9; Clay Chandler, *Archer Calls for End to Income-Based Tax*, WASH. POST, June 6, 1995, at D1 (Archer undecided between national sales tax and some combination of sales tax and VAT).

22 *See* CHARLES E. MCLURE, JR., THE VALUE-ADDED TAX 89 (1987).

23 *See* Chandler, *supra* note 21.

24 *See* FLAT TAX I, *supra* note 11, at 55-57.

25 *See id.*

26 *Id.* at 59, 144. All allowances would be indexed for inflation.

levels—the insulation of poor wage earners from tax, and the average rate progressivity produced by putting a flat rate on top of a zero bracket (wages sheltered by the exemption being taxed at a zero rate).[27] Although bifurcation of the tax base would make graduated rates on wages technically feasible, the flat wage tax—in keeping with its name—has only a single rate above the tax-free allowances.

B. The Flat Tax, Consumption Taxes, and Wage Taxes

There is a close resemblance between the effects produced by a consumption tax and the effects of a stand-alone wage tax (as opposed to the wage tax of the flat tax, which is only part of the total tax base). Suppose a taxpayer has $10,000 in wages, which he intends to invest at 10% for one year, in anticipation of a consumption binge next year. The tax system is a flat 20% cash flow tax. Because amounts saved are not subject to tax, he can invest the entire $10,000. After one year, the savings will have grown to $11,000. After paying a tax of $2200,[28] he can consume $8800. If the tax system is, instead, a 20% flat wage tax, he will owe $2000 tax in the first year, and will be able to invest $8000 at 10%. The $800 investment income is tax-free under the wage tax, so he can consume $8800 next year—the same result as under the cash flow tax.

There are several caveats to the equivalency between a cash flow tax and a wage tax. For the equivalency to hold, the tax rate must remain constant, and the rate of return on the $8000 investment under the wage tax must be the same as the pre-tax rate of return on the $10,000 investment under the cash flow tax.[29] Most significantly, the equivalency holds only if there is no existing wealth (old capital) at the time the tax system is introduced.[30] A wage tax imposes no burden on existing wealth; the wealth may generate income free of tax, and it may be consumed free of tax. A cash flow tax, by contrast, does impact wealth in existence at the time of enactment. Consumption of that wealth—and of income generated by that wealth—will be subject to tax.

How does the flat tax fit into this analysis? Because it has a wage tax portion, which is much more visible than the business tax portion, the flat tax is easily misunderstood as a wage tax.

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27 *Id.* at 89, 123 (exempting the poor from the wage tax), 55 (average rate progressivity). As I have explained elsewhere, essentially the same results could be obtained with a value-added tax combined with universal cash rebates equal to the tax on subsistence consumption. Lawrence Zelenak, *Flat Tax vs. VAT: Progressivity and Family Allowances*, 69 TAX NOTES 1129 (1995).

28 Twenty percent of $11,000; the tax base is tax-inclusive.

29 *See* Michael J. Graetz, *Expenditure Tax Design*, *in* WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 161, 172-73 (Joseph A. Pechman ed., 1980).

30 *See id.* at 172.

Considering both parts of the tax together, however, it is a consumption tax, and as a consumption tax it imposes a burden on old capital. Although the expensing of post-enactment investment is the equivalent of exempting from tax the return on that investment,[31] the business tax *does* impose a burden on the return on old capital.[32] In other words, the flat tax amounts to a wage tax plus a tax on old capital. The burden on old capital could be lessened or even eliminated by special transition relief, but Hall and Rabushka would prefer, with perhaps too little regard for political reality, no transition relief.[33]

III. POLITICS: THE SELLING OF THE FLAT TAX

A. Hiding the Base Behind the Rate

Despite the tradition of naming a tax after its base, Hall and Rabushka have chosen to name their tax after its rate structure.[34] The name has succeeded, in the sense that public debate on the proposal has paid more attention to the question of rate structure than to the question of tax base design. That result is ironic because their proposed tax base is more innovative than their proposed flat rate.[35] Ironic though it may be, the diversion of attention from base to rate is good politics. Flatness is popular; exempting investment income from tax is not.

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31 More precisely, it is the equivalent of exempting the normal (risk-free) rate of return on investment. It is not the equivalent of exempting economic rent, monopoly profits, compensation for risk-taking, and rewards for entrepreneurial effort. *See* Richard Musgrave, *Clarifying Tax Reform*, 70 TAX NOTES 731, 735 (1996).

32 *See* SLEMROD & BAKIJA, *supra* note 7, at 205 (the business component of the flat tax makes the system a consumption tax, not a wage tax).

33 FLAT TAX I, *supra* note 11, at 78-79. They are open to the possibility of allowing businesses to continue to take depreciation deductions to which they would have been entitled if the income tax had not been replaced. If businesses were allowed to expense all income tax basis in business assets, in the year in which the flat tax became effective, that would completely remove the tax burden on existing capital. In that case, however, a wage tax would more simply accomplish the same economic effects as the bifurcated tax with complete transition relief for old capital. *See* SLEMROD & BAKIJA, *supra* note 7, at 175 ("the more transition relief that is provided to existing assets in the switch to any consumption tax, the more it becomes like a wage tax").

34 Slemrod and Bakija suggest that a consumption tax base can be considered flat because it "imposes a uniform, call it flat if you like, tax on current consumption and future consumption." SLEMROD & BAKIJA, *supra* note 7, at 167. They concede, however, that a consumption base "is not commonly associated (by noneconomists) with flatness." *Id.*

35 *See* DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 76 (1986) [hereinafter BRADFORD I] (noting, during the early years of the discussion of the flat tax, that "[t]he quality of flatness seems to be principally responsible for the considerable journalistic attention" received by the proposal, and remarking that flatness has "unfortunately diverted attention from its innovations other than flatness"); Gerard M. Brannon, *What's with this Jazz about Tax Overhaul?* 71 TAX NOTES 260, 262 (1996) (the flat tax's elimination of the personal tax on investment income is "a little-noticed feature as well as a big one"); John S. Nolan, *The Merit of an Income Tax Versus a Consumption Tax*, 71 TAX NOTES 805, 806 (1996) ("the political rhetoric focuses upon the flatness of the rate of tax, but that is a red herring"); SLEMROD & BAKIJA, *supra* note 7, at 167 (the switch to a consumption base is a "more dramatic and unprecedented" change than amending the rate structure).

In some opinion surveys taken during the 1996 presidential campaign, most respondents with opinions favored the idea of a single rate of tax.[36] National opinion was not clearly in favor of a single rate, however. A poll taken after Steve Forbes' withdrawal from the campaign found an even split on "a flat-tax system, where everyone pays the same tax rate no matter what their income."[37] When survey participants were given an explicit choice between "a graduated income tax system, in which people with higher incomes pay a higher tax rate, or a flat tax system, in which everyone pays the same rate of tax regardless of income," the flat tax lost by 15 percentage points.[38] More recently, a poll taken in late 1997 gave respondents a choice between the "current system in which someone with more money pays a higher percentage of their [sic] income in taxes" and a "flat tax system in which all Americans would pay the same percentage of their income in taxes." The "current system" won a narrow victory, 51% to 45%.[39]

As is often true in polling, subtle differences in the wording of questions lead to major differences in results. The flat tax polls better against the "current system" than against a hypothetical "graduated income tax."[40] Jonathan Chait has suggested an interesting explanation of this phenomenon. According to Chait, many people believe—incorrectly—that the current system has so many loopholes that it is effectively regressive, despite its nominal progressivity.[41] Ironically, they favor a flat tax because they think

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36 Asked whether they favored or opposed "a flat tax system, in which all but low-income Americans would pay the same percentage of their income in taxes, regardless of how much money they make," 48% of American adults were in favor and 42% opposed. *Time/CNN/Yankelovich Partners Poll*, survey ending date Jan. 18, 1996, *available in* Nexis RPOLL file, accession number 0250300. Asked whether they favored "a flat tax—with a single low rate for federal income taxes and all or most deductions removed," 50% of American adults were in favor and 32% were opposed. *Princeton Survey Research Associates/Newsweek Poll*, survey ending date Jan. 26, 1996, *available in* Nexis RPOLL file, accession number 0250604.

37 The flat-tax system was supported by 48% of respondents and opposed by 48%. *ABC News/Washington Post Poll*, survey ending Aug. 5, 1996, *available in* Nexis RPOLL file, accession number 0268293.

38 The graduated income tax was the choice of 54%, and the flat tax of 39%. *NBC News/Wall Street Journal Poll*, survey ending Mar. 5, 1996, *available in* Nexis RPOLL file, accession number 0252528. A different survey, asking an almost identically worded question at about the same time, found 54% favoring the graduated tax and 45% favoring the flat tax. *ABC News/Washington Post Poll*, survey ending Mar. 17, 1996, *available in* Nexis RPOLL file, accession number 0260264.

39 *USA Today/CNN/Gallup Poll*, survey ending Nov. 23, 1997, *available in* Nexis RPOLL file, accession number 0288901.

40 *See* SLEMROD & BAKIJA, *supra* note 7, at 10-11 (citing polling results).

41 Chait, *supra* note 7, at 24. In fact, the current income tax *is* effectively progressive. Whether average rate progressivity is measured with respect to adjusted gross income or a more comprehensive measure of income, analysis of income tax burdens at different income levels reveals significant progressivity. *See* CONGRESSIONAL BUDGET OFFICE, ESTIMATES OF FEDERAL TAX LIABILITIES FOR FAMILIES BY INCOME CATEGORY AND FAMILY TYPE FOR 1995 AND 1999, at 10 tbl.3, 14-15 tbl.4 (1998).

that it would *increase* the tax burden on the wealthy by closing loopholes.

While it may not be easy to sell the American public on a flat rate of tax, it appears impossible to sell the American public on the Hall-Rabushka consumption tax base if the base issue is considered separately from the rate issue and from loophole closing. Asked in June 1996 whether they preferred "an income tax system that taxes both income from investments and income from wages equally, or a system with higher taxes on income from wages but no taxes on income from investments," those surveyed preferred taxing both sources of income, 53% to 31%.[42] Interestingly, when the same question had been asked five months earlier—before Steve Forbes' strong showing in several primaries had focused national attention on the flat tax—taxing both sources of income had been favored by a margin of only 41% to 36%.[43] The Hall-Rabushka tax base did not gain in favor as it gained in familiarity.

In light of the polling data, the decision by flat tax proponents to sell the rate rather than the base is clearly correct. "The flat tax" may have a chance with the American public; "the wage tax" (or even "the wage and business tax") does not. The flat tax proponents have exhibited political savvy in hiding the consumption tax base behind the flat rate.

B. All Things to All People

Perhaps recognizing that the consumption base issue cannot be hidden entirely, Hall and Rabushka have also sown confusion about the nature of the base. Marketing their plan as all things to all people, they claim that their system "puts a low tax rate on a comprehensive definition of *income*,"[44] and that it "moves toward the goal of taxing all *income* once . . . and achieving a broad *consumption* tax."[45] Politicians echo their claims. Dick Armey describes the base of the flat tax as embodying the policy that "[a]ll

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42 *NBC News/Wall Street Journal Poll*, survey ending June 25, 1996, *available in* Nexis RPOLL file, accession number 0259677. The phrasing of the question may be somewhat unfair to the flat tax; it ignores the tax burden imposed on old capital by the business portion of the flat tax. On the other hand, the phrasing of the question is consistent with the likely public perception of the flat tax as simply a wage tax. The business portion of the tax is hidden from public view.

43 *NBC News/Wall Street Journal Poll*, survey ending Jan. 16, 1996, *available in* Nexis RPOLL file, accession number 0249730.

44 Robert E. Hall & Alvin Rabushka, *The Flat Tax: A Simple, Progressive Consumption Tax*, *in* FRONTIERS OF TAX REFORM 27 (Michael J. Boskin ed., 1996) [hereinafter *Flat Tax II*] (emphasis added).

45 FLAT TAX I, *supra* note 11, at 63 (emphasis added). Herbert Stein has noted that the flat tax can be analogized to either an income tax or a sales tax, and that "the two different possible pictures probably contribute to the salability of the plan—one picture being appealing to those to whom income tax is a bad name and one to those to whom sales tax is a bad name." Herbert Stein, *The Uneasy Case for a Flat Tax*, *in* FAIRNESS AND EFFICIENCY IN THE FLAT TAX 102, 108 (Robert E. Hall et al. eds., 1996).

income should be taxed only once."[46] Michael Graetz has complained that the base of the flat tax amounts to putting "dark glasses and a false mustache" on a consumption tax to make it look like an income tax.[47] Graetz thinks that it would be difficult or impossible to sell the American public on the replacement of the income tax with a value-added tax, and that the bifurcated base has "deflected the public from realizing that the Forbes-Armey flat tax is a kind of value-added tax."[48]

Just as they claim that their tax base is at once income and consumption, Hall and Rabushka claim that their rate structure is at once proportional and progressive: "The good news is that the flat tax is progressive in that families with higher incomes pay a larger fraction of their income in taxes."[49] Their claims are technically accurate. When the focus is on marginal rates, a tax system with one rate above an exemption level is flat; when the focus is on average rates, the same system is modestly progressive. What is odd about their claims to both flatness and progressivity is that they never explain why it is "good news" that the tax is both flat and progressive. Not only do they never explain why average rate progressivity is desirable,[50] they offer a defense of flatness under which average rate progressivity is objectionable: "The principle of equity embodied in the flat tax is that every taxpayer pays taxes in direct proportion to his income. As incomes double, triple, or grow tenfold, tax obligations double, triple, or rise tenfold."[51] Since average rate progressivity violates this "principle of equity," one would expect Hall and Rabushka to believe it is *bad* news that higher income families would pay a larger fraction of their income in taxes. Instead they find it good news, perhaps because it allows them to obfuscate the rate issue as well as the base issue.

In any event, it is clear as a matter of marketing that the rate structure—in its something-for-everyone guise as the progressive flat tax—is the attraction and that the base of the tax could not be sold on its own (not even with obfuscation). The political link between base and rate calls for an examination of whether there is an underlying logical or philosophical link as well. Does a consumption base somehow imply a flat rate? Does a flat rate some-

46 Armey & Tauzin, *supra* note 6.

47 MICHAEL J. GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX 216 (1997).

48 *Id.* at 219. Hall and Rabushka claim that the bifurcation of the base is necessary so that personal exemptions can be introduced into the wage tax. FLAT TAX I, *supra* note 11, at 55. As noted earlier, however, the same basic results could be obtained with a VAT and cash rebates equal to the tax on subsistence consumption. Zelenak, *supra* note 27.

49 FLAT TAX I, *supra* note 11, at 124.

50 They do indicate that it is desirable to have exemptions so that the poor pay no tax. *Id.* at 52, 89, 123. The flat rate on top of the exemptions produces average rate progressivity, but this makes average rate progressivity merely a side effect of tax exemption for the poor, not a policy objective in its own right.

51 *Id.* at 27.

how imply a consumption base? Or is there some overriding principle that implies both? If the answer to those questions is no, the public debate on tax reform would be better served by separating the base and rate issues, and considering each on its own merits.[52]

IV. Does an Overriding Concern for Efficiency Dictate Both a Consumption Base and a Flat Rate?

A. Taxes and Deadweight Loss: The Current Income Tax

Taxing any activity drives a wedge between the social value of the activity and its private value to the actor, and that wedge is a source of inefficiency. The income tax creates two such wedges—one for paid labor, and one for saving for future consumption. Consider first the labor-leisure distortion. If a taxpayer's (T's) labor is worth $100 a day, as measured by an employer's willingness to pay, a 20% wage tax makes T's labor worth only $80 to T. If he values tax-free alternative uses of his time (leisure or producing tax-free "imputed income") at $85, the tax will cause him to choose an alternative use. By causing T to choose an untaxed use of his time worth only $85, instead of a use worth $100, the tax has caused a $15 deadweight loss (also known as an excess burden).[53] An income tax also distorts the choice between present and future consumption, again resulting in deadweight loss. Suppose a taxpayer has $1000 to consume now, or to invest for greater consumption next year. The social value of investing $1000 for one year is $100, as measured by the pre-tax rate of return the taxpayer can obtain. If the tax rate is 20%, his choice is between consuming $1000 now and consuming $1080 next year. If he is indifferent between consuming $1000 now and $1085 next year (i.e., if he requires $85 compensation to defer his consumption for one year), the tax on investment income will change his decision from investment to current consumption. Again, the result is a deadweight loss.[54]

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52 *See* Charles E. McLure, Jr. & George R. Zodrow, *A Hybrid Approach to the Direct Taxation of Consumption*, *in* Frontiers of Tax Reform, *supra* note 44, at 70-71 (describing the base and rate structure of the flat tax as "two distinct and separable features," and setting aside the rate structure to concentrate on the tax base question).

53 Another way of understanding the same phenomenon is to think of the $20 tax revenue that would be produced by T's labor as a positive externality of T's work. Because T cannot capture the externality, he produces less than the socially optimal amount of paid labor when he chooses the tax-free alternative.

54 Both examples in the text illustrate the substitution effect—i.e., the tendency of taxpayers to substitute untaxed activities for taxed activities. In behavioral terms, the substitution effect may be partly or wholly counteracted by the income effect—i.e., the tendency of taxpayers to work or save more when they are taxed, to make up for the loss of wealth caused by the tax. It is often assumed, incorrectly, that a tax causes no deadweight loss if the two effects are behaviorally offsetting—if a tax on labor income causes no change in hours worked, or if a tax on investment income causes no change in savings rates. In

A progressive rate structure has an efficiency cost of its own. Because deadweight loss from taxation is proportional to the square of the marginal tax rate,[55] the most efficient rate structure is perfectly flat (for any given tax base and revenue goal). In moving from a perfectly flat rate structure to an equal-revenue structure with progressive marginal rates, the increased deadweight loss from higher marginal rates on more affluent taxpayers will exceed the decreased deadweight loss from lower marginal rates on poorer taxpayers.

B. Taxes and Deadweight Loss: The Flat Tax

Thus, there are serious efficiency critiques of both the base and the rate structure of the current income tax. Efficiency is very important to Hall and Rabushka, and they invoke it to justify both their consumption tax base and the flat rate.[56] How well does the flat tax fare on efficiency grounds? Consider first the base of the flat tax. It deals with the two tax distortions—between labor and leisure, and between present and future consumption—very differently. By not taxing the return on savings,[57] the flat tax eliminates tax distortion in consumption timing decisions. Because the flat tax continues to tax wages, however, it does *not* eliminate distortion in labor supply decisions. The flat tax does not achieve efficiency nirvana, or even approach it very closely.

Any tax based on behavior will distort behavior, with resulting deadweight loss. A tax not based on behavior would be the choice of an efficiency purist. The standard example of such a tax is a head tax, imposed in an equal amount on each person solely on account of existence. In addition to being politically impossible, however, a head tax sufficient to fund the federal government would not really be perfectly efficient. The tax could be avoided by having no income (or assets) with which to pay it, and thus at low income levels the tax *would* be based on behavior. The efficiency costs of what amounts to a 100% tax on low wage earners could be substantial. Nevertheless, a head tax approaches efficiency nirvana much more closely than does a consumption tax.

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fact, however, the deadweight loss is solely a function of the substitution effect, and may be substantial even if there is no change in observed behavior. *See* HARVEY ROSEN, PUBLIC FINANCE 310-12 (4th ed. 1995).

55 *See* JOSEPH STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 376 (1st ed. 1986).

56 FLAT TAX I, *supra* note 11, at 40-41, 70-72, 86-87 (consumption tax base), and at 84-86 (flat tax on wages).

57 Although the business portion of the flat tax nominally taxes investment income, expensing of investment under the business tax has the same effect as exempting from tax the normal return to capital on new investment. *See* Musgrave, *supra* note 31, at 735. Whether a version of the flat tax with graduated rates on wages would distort consumption timing decisions is discussed *infra* text accompanying notes 127-38.

Even with a head tax ruled out, and with the stipulation that the choice must be some form of income or consumption tax, a consumption tax is not the clear winner on efficiency grounds. Recall that there are two sources of inefficiency in an income tax—the labor-leisure distortion, and the present consumption-future consumption distortion.[58] A consumption tax can eliminate only the latter. An equal-revenue *income* tax would have a broader base, which means it could meet the government's revenue requirements at a lower rate. Compared to the consumption tax, the lower rate income tax would lessen deadweight loss from the labor-leisure distortion, at the cost of some deadweight loss from the distortion of consumption timing.

Which system would have less total deadweight loss is an empirical question. The key issue is not, as one might suppose, the responsiveness of savings to tax rates. Rather, it is whether individuals have utility functions separable between leisure and other commodities.[59] A pure consumption tax will minimize deadweight loss only if people "can be described as separating their work and savings decisions, first deciding how much to work and then how much of earnings to allocate to provision for the future."[60] If that is not how people behave, then the taxation of investment income will be necessary to minimize deadweight loss. Although some economists suspect the condition for optimality of consumption taxation comes close to existing in the real world,[61] the case has not been proven. Until it is, even efficiency purists must withhold judgment on the superiority of a consumption tax to an income tax; the efficiency link between a flat rate and a consumption base is not established. It is true that the flat tax involves only one kind of distortion, while a lower rate income tax involves two, but the efficiency goal is not to have the fewest *kinds* of distortion. Rather, it is to have the least *total* distortion. By that standard, a consumption tax is not a clear winner over an income tax.

What about the efficiency case for the rate structure of the flat tax? Despite its name, the flat tax is not really flat. It actually has two rates–a rate of zero on the wages exempted from the wage tax, and a single positive rate applied to the rest of the base. A *truly flat* flat tax would be more efficient. Eliminating the exemptions under the wage tax would make it possible to raise the same

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58 *See supra* text accompanying notes 53-54.

59 *See* David F. Bradford, *The Economics of Tax Policy toward Savings*, *in* THE GOVERNMENT AND CAPITAL FORMATION 11, 24-28 (George M. von Furstenberg ed., 1980) [hereinafter Bradford II].

60 *Id.* at 64.

61 *See id.*; Martin S. Feldstein, *The Welfare Cost of Capital Income Taxation*, 86 J. POL. ECON. S29 (1978).

amount of revenue with a significantly lower positive tax rate.[62] The increased marginal rate on the poor would cause less deadweight loss than the loss avoided by the decreased marginal rate on everyone else. Hall and Rabushka understand this proposition, but nevertheless call for large exemptions and a correspondingly higher flat tax rate. Their justification for the high exemption levels of the wage tax is their conception of fairness.[63]

Having made this efficiency concession in the rate structure in the interests of fairness, and having offered little more than intuition in support of their notion of fairness,[64] Hall and Rabushka have opened the door to others whose ideas of fairness[65] are different from their own, and who would strike a different balance between efficiency and fairness—perhaps involving graduated tax rates.[66] There is no reason to defer to Hall and Rabushka; nothing in their work indicates that they have any special expertise in deciding what is fair, or in balancing fairness against efficiency.

In sum, a single-minded concern for efficiency cannot justify the flat tax's linkage of a consumption base with a single positive

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62 FLAT TAX I, *supra* note 11, at 81 (indicating the same amount of revenue could be raised by various combinations of exemption levels and flat rates; as the exemption level decreases, the revenue-neutral tax rate also decreases).

63 *Id.* at 52, 55, 59.

64 *Id.* at 25-29 (discussion of fairness in taxation). This discussion is one of the weaker portions of the entire book. Three paragraphs consider the implications of various dictionary definitions of "fair" (*id.* at 25-26), as if Noah Webster were the leading authority on fair tax rates. Hall and Rabushka also offer standard conservative rhetoric likely to persuade only those not in need of persuasion. For example, "Politicians and intellectuals who support high tax rates to redistribute income to attain their egalitarian goals threaten individual freedom and self-reliance." *Id.* at 28. Their notions of fairness are entitled to little deference, especially since they contradict themselves on the crucial question of whether fairness requires progressive or flat average tax rates. *See supra* text accompanying notes 49-51.

The discussion of fair tax rates in the Report of the Kemp Commission is equally unsatisfying. The Report asserts that "graduated marginal rates violate the principle of fairness—that if a law applies to citizen A, it must equally apply to citizen B." Kemp Commission, *supra* note 15, at 424. The authors of the Report do not appreciate the vagueness of the application of this principle to the question of tax rate structure. Under one interpretation of the principle, it would merely require horizontal equity—that two taxpayers with the same earnings pay the same taxes. A graduated rate structure satisfies that requirement. Under another interpretation of the principle, it would require that everyone pay exactly the same dollar amount of tax. *See* Jeffrey A. Schoenblum, *Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 AM. J. TAX POL'Y 221 (1995) (arguing the only fair tax is a head tax). The Report explains neither why proportionality of tax burden is the proper interpretation of the fairness principle, nor why an exemption is fair despite the fact it makes average tax rates non-proportional.

65 "The case for drastic progression in taxation must be rested on the case against inequality—on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely." HENRY SIMONS, PERSONAL INCOME TAXATION 18-19 (1938).

66 In any event, the efficiency cost of modest rate graduation—for example, the cost of having a 15% bracket and a 25% bracket, instead of a single 20% rate—is likely to be insignificant. *See* SLEMROD & BAKIJA, *supra* note 7, at 165.

tax rate. From an efficiency standpoint, a consumption base is not clearly superior to an income base, and it is inferior to a head tax, or the nearest practical approximation thereof. As for rate structure, a flat rate above a large zero bracket is less efficient than a lower flat rate with no zero bracket. A relentless pursuit of efficiency cannot explain either the base or the rate of the flat tax, let alone establish a link between them.

V. Does an Overriding Concern for Simplicity Dictate Both a Consumption Base and a Flat Rate?

Simplicity is a major virtue to Hall and Rabushka, and they claim for the flat tax a decisive simplicity advantage over the income tax.[67] They are correct that the flat tax would be simpler than current law. What they do not say, however, is that the bulk of the simplification comes from the change in the base of the individual tax, and not from elimination of graduated rates. A graduated rate version of their tax base would be nearly as simple as their proposal. Moreover, their decision to bifurcate the tax base to make exemptions possible is a major sacrifice of simplicity in the interests of fairness; once the decision has been made to have a bifurcated base and exemptions, the additional complexity of graduated rates is minor.

A. Simplification: A Question of Base or Rates?

Why are Hall and Rabushka able to fit their tax return on one side of a postcard, when the current Form 1040 requires two sides of a full-sized sheet of paper, or many more sides of paper for taxpayers required to use attachments? It is not because of flat rates. Of the 69 lines on the 1998 Form 1040, exactly one (line 40) is devoted to deriving tax liability from taxable income. Most of the lines are dedicated to the determination of taxable income. Taxing individuals only on wages, rather than on all sources of income, *is* a major simplification.[68] There are three caveats, however. First, for the 45 to 50 million taxpayers using Form 1040A or Form 1040EZ, current filing already approaches postcard simplicity.[69] Second, a substantial part of the simplification of the tax base comes from the elimination of deductions, which is a separate issue from both income versus consumption taxation and flat versus graduated rates. A graduated income tax without personal deductions would also be simpler than current law. Finally, the tax base of the flat tax, although simpler than current

67 Flat Tax I, *supra* note 11, at 5-6 (the income tax is "a nightmare of complexity"), 59 (the flat tax's postcard return), 132 (the flat tax will eventually become law "because of the American taxpayer's demand for a true simplicity").

68 This is conceded by critics of the flat tax. *See, e.g.*, Graetz, *supra* note 47, at 227.

69 *See id.* at 259.

law, has its share of complexities. They include: distinguishing between wage income subject to the personal tax and capital income not subject to the tax,[70] the definition of dependents for purposes of the family size adjustments in exemption levels,[71] the need for individuals to file the more complicated business returns for their small businesses (which could be as small as renting out a room in one's home),[72] the need on business returns to distinguish non-deductible personal consumption from deductible business expenses,[73] the need on business returns to distinguish between taxable sales and nontaxable interest income,[74] the need for rules on the aggregation or disaggregation of businesses for return filing purposes,[75] and the need for complex rules for the carryover of business tax "losses" caused by the expensing of large investments.[76]

With these caveats, the simplification of the tax base of personal tax returns still would be substantial. By contrast, the simplification achieved by flatness would be less impressive,[77] and the nature of the simplification gains from flatness probably would surprise most people. The difference in the amount of arithmetic required to apply one rate or more than one rate to the tax base is trivial—especially since the tax tables do the arithmetic for most taxpayers.[78] It may be, however, that a math-phobic public wrongly supposes the complexity of the income tax flows largely from the arithmetic of graduated rates. If so, the flat tax label is well-chosen to take advantage of that misapprehension.

A nontrivial simplification that would follow from a single rate tax is an end to taxpayers' incentive to shift income among family members and controlled entities to achieve taxation at lower rates.[79] This gain would be modest, however, for two reasons. First, current law has already taken most of the fun out of

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70 *See* Musgrave, *supra* note 31, at 734.

71 *See* GRAETZ, *supra* note 47, at 227.

72 *See id.* at 229.

73 *See id.* at 230; Alan L. Feld, *Living With the Flat Tax*, 48 NAT'L TAX J. 603, 607, 613 (1995).

74 *See* SLEMROD & BAKIJA, *supra* note 7, at 216.

75 *See* Feld, *supra* note 73, at 609-10.

76 Loss carryovers cause complications under the existing income tax (I.R.C. § 172 (1994 & Supp. III 1997)), but they would be a bigger problem under the flat tax, for two reasons. First, expensing of investment will make losses more common. Second, achieving the flat tax goal of neutrality between saving and consumption requires adjustment of loss carryforwards to reflect the time value of money and inflation. *See* Charles E. McLure, Jr., *The Simplicity of the Flat Tax: Is It Unique?* 14 AM. J. TAX POL'Y 283, 294-95 (1997).

77 *See* Stein, *supra* note 45, at 103 (flat tax "simplification results almost entirely from the redefinition of the base and hardly at all from the flatness of the tax").

78 "I have sometimes remarked that, given the existence of rate tables that cover the vast majority of individual taxpayers, graduated rates should pose a problem primarily for those with astigmatism." McLure, *supra* note 76, at 289 n.13.

79 *See* GRAETZ, *supra* note 47, at 231.

income-shifting,[80] through the "kiddie tax"[81] and the compressed tax rate schedule for trusts.[82] Second, only a true single rate tax—with no zero rate due to exemptions—can eliminate all opportunity for income-shifting. Because of the zero bracket, some incentive for income-shifting would remain under the flat tax.[83]

There is another kind of income-shifting—between years rather than between taxpayers. Because of the time value of money, this form of shifting does not require rate differences to be attractive. Even if the tax rate is the same in all years, there is incentive to shift income to later years. Hall and Rabushka hint that the flat tax would put an end to income-shifting between years,[84] but that is simply not true.[85]

In any event, playing income-shifting games makes sense only for high bracket taxpayers—a small percentage of all taxpayers—for whom the tax savings justify the transaction costs. Even for these taxpayers, the complexity is in the nature of a self-inflicted wound. The complaint of Hall and Rabushka about the "nightmare of complexity"[86] of current law is that it makes "the ordinary citizen [feel] overwhelmed and threatened by the Internal Revenue Service."[87] The "ordinary citizen," however, is unaffected by the complexities of income-shifting.[88]

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80 *See id.* at 231.

81 The "kiddie tax" taxes unearned income of children under 14 at their parents' marginal rate. I.R.C. § 1(g) (1994 & Supp. III 1997). Hall and Rabushka might respond, however, that the kiddie tax is itself a moderately complex provision. By contrast, the flat tax reduces the incentive for income-shifting without the need for a special and somewhat complex provision.

82 The compressed rate schedule taxes all trust income over $8450 at 39.6%. I.R.C. § 1(e) (1994); Rev. Proc. 98-61, 1998-52 I.R.B. 18, § 3.01 (inflation adjustment).

83 In addition, income shifting to entities exempt from tax (either de jure or de facto) would remain. These include charities, foreign businesses, and businesses with loss carryforwards.

84 "Because it is high-income taxpayers who have the biggest incentive and the best opportunity to use special tricks to exploit tax-rate differentials, applying the same tax rate to these taxpayers for all of their income *in all years* is the most important goal of flat-rate taxation." *Flat Tax II*, *supra* note 44, at 28 (emphasis added). This is a strange argument in another respect. It does not say that graduated rates are wrong in principle; it merely complains that the rich are *sometimes* able to avoid them. It is not obvious that the best response to that problem is to change the law so that the rich are *always* able to avoid them.

85 *See* GRAETZ, *supra* note 47, at 232.

86 FLAT TAX I, *supra* note 11, at 5.

87 *Id.* at 6.

88 As others have demonstrated, it is possible to achieve tremendous simplification for the majority of taxpayers, within the context of a graduated income tax. *See, e.g.*, GRAETZ, *supra* note 47, at 259-60; Jonathan Barry Forman, *Simplification for Low-Income Taxpayers: Some Options*, 57 OHIO ST. L.J. 145, 197-200 (1996) (describing a return-free income tax system for millions of taxpayers); Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121 (1989); SLEMROD & BAKIJA, *supra* note 7, at 246-48 (describing a proposal by Representative Gephardt for an income tax system that would be return-free for most taxpayers).

Charles McLure claims another simplification advantage for a single rate tax system—that it makes surrogate taxation of investment income more attractive.[89] For example, McLure describes the treatment of interest payments under the flat tax—nondeductible to borrowers and nontaxable to lenders—as a "flipping" of current treatment. As long as interest rates adjust to reflect the tax regime, taxpayers should be indifferent between the current rules (of deductibility and taxability[90]) and the flat tax rules (of no tax consequences), *if* borrowers and lenders pay the same tax rate.[91] Thus, a flat rate facilitates a most simple tax treatment of interest payments, under which denying a deduction to the borrower serves as a surrogate for taxing the lender. Similarly, using a tax on business as a surrogate for a tax on dividends received by business *owners* is more attractive if individuals and businesses are taxed at the same rate.[92]

The problem with the surrogate taxation case for a single rate tax is that surrogate taxation can be used even if the rates of the wage tax are graduated. David Bradford's "X tax" has the same bifurcated base as the flat tax, but a different rate structure.[93] The X tax has a graduated rate wage tax, and a flat business tax with a rate equal to the top wage rate. It achieves precisely the same simplification from surrogate taxation as does the flat tax. It does so at the cost of arguable unfairness to low bracket owners of capital, for whom the surrogate business tax rate is higher than their own wage tax rate.[94] If little capital is owned by low bracket taxpayers, however, and if the equity gains from a graduated wage tax are deemed substantial, that may be a price worth paying. In any event, the choice of the flat tax over the X tax as a means of implementing surrogate taxation must be made on debatable equity grounds; both taxes can achieve the same simplicity gains.

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89 *See* McLure, *supra* note 76, at 289-90. McLure's analysis is consistent with Hall's and Rabushka's description of the business tax as a surrogate tax on the investment income of individuals: "The interest, dividends, and capital gains received by individuals . . . have already been taxed under the business tax." FLAT TAX I, *supra* note 11, at 125.

90 I.R.C. §§ 163 (providing for the general deductibility of interest expense, but with important exceptions), 61(a)(4) (including interest payments in gross income) (1994 & Supp. III 1997).

91 *See* McLure, *supra* note 76, at 289.

92 *See id.* McLure correctly notes that the simplicity advantage of surrogate taxation has nothing to do with the choice between income and consumption tax bases. A flat rate facilitates surrogate taxation under either tax base. *Id.*

93 David F. Bradford, *What Are Consumption Taxes and Who Pays Them?* 39 TAX NOTES 383, 385-86 (1988) [hereinafter Bradford III].

94 The X tax reaches correct surrogate tax results, of course, for all capital owned by top bracket individuals. Even for an individual not in the top wage tax bracket, the overtaxation under the surrogate tax is minor, if she has large amounts of investment income. In that case, if the investment income were taxed directly to her, most of it would be taxed in the top bracket.

B. Straining at Gnats and Swallowing Camels: A *Really* Simple Tax

Hall and Rabushka have intentionally passed up the opportunity to make their tax really simple, and they have done so because they believe a really simple tax would not be fair. The flat tax is a bifurcated version of a value-added tax.[95] It would be possible to use a plain, nonbifurcated VAT to tax all consumption at a single rate. Compared to the flat tax, this would have the huge simplification advantage of not requiring any individual tax returns. Hall and Rabushka concede that a VAT would be a "really simple tax," even compared to the flat tax, but they reject a VAT because the absence of exemptions (i.e., the zero bracket of the wage tax) means it would not be fair.[96] They even say that a tax without the average rate progressivity created by exemptions would be unfair.[97] Although the difference between a simple VAT and the flat tax *appears* to be one of base, it is better understood as a difference in rate structure. The *base* of both systems is consumption; the difference is that the bifurcated flat tax applies a *rate* of zero on subsistence consumption financed out of current wages.

Given that many taxpayers will find even a postcard return daunting, the bifurcation of the base of the flat tax is a major compromise of simplicity.[98] Having swallowed this camel of complexity in the name of fairness, they are poorly positioned to object to the gnat of additional complexity associated with graduated rates.[99] They can argue that an exemption is fair but graduated rates are not. The argument must then be waged not over simplicity, however, but over competing concepts of equity. If Hall and Rabushka are willing to give up the simplicity of a VAT in the service of their idea of fairness, they cannot hope to convince those

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95 *See supra* text accompanying notes 24-27.

96 FLAT TAX I, *supra* note 11, at 55.

97 "[A] value-added tax is unfair because it is not progressive." *Id.* This is a surprising claim, given their earlier assertion that proportionality of tax burdens is a "principle of equity." *Id.* at 27. Perhaps what they really believe is that fairness requires a tax exemption for subsistence wages, and that average rate progressivity is a side effect of a subsistence exemption. Or perhaps fairness is not really the main point of bifurcation. In a question-and-answer section at the end of the second edition, Hall and Rabushka mention another reason for bifurcation: "If individuals did not file returns, advocates of more government spending could promise voters new benefits without higher costs." *Id.* at 121.

98 Other commentators have noted that any tax that requires individual returns will be much more complex—in the view of tens of millions of middle-class taxpayers—than a VAT or a retail sales tax. *See, e.g.*, GRAETZ, *supra* note 47, at 206; Musgrave, *supra* note 31, at 732-33.

99 *See* SLEMROD & BAKIJA, *supra* note 7, at 138 (including individuals in the tax collection process is significantly more complicated than collecting all taxes from businesses, but taxing individuals at graduated rates does not by itself "contribute any significant complexity").

who believe in the fairness of graduated rates that progressive marginal rates are ruled out by complexity.

It would be easy to convert the flat tax to a tax with the same bifurcated base, but with graduated rates applied to the wage portion of the base.[100] This approach has been suggested by David Bradford, and by Charles McLure and George Zodrow.[101] If one believes that that system would be fairer than the flat tax, the almost trivial additional complexity is not a substantial objection.

C. Simplicity and a Flat Income Tax

As the preceding discussion has demonstrated, there is no convincing simplicity link between the Hall-Rabushka tax base and a flat rate tax. Even if one is persuaded—in part because of simplification—that the Hall-Rabushka tax base should replace the income tax, the question of the rate structure of the wage tax remains open. A desire for simplification does not dictate the answer. A person who values tax simplification might rationally support a graduated rate version of Hall-Rabushka. The other way of unlinking the base and rate reforms would be a flat income tax. If there is no compelling simplicity-grounded objection to a consumption base without a flat rate, is there any compelling simplicity objection to a flat rate without a consumption base? The Hall-Rabushka proposal could be converted to a kind of income tax by replacing the business tax's expensing of investments with economic depreciation. Expensing of investments under Hall-Rabushka is the economic equivalent of exempting the return on the investments from tax; allowing only economic depreciation would eliminate the exemption, thus making the system a form of income tax. Although this form of an income tax could have graduated rates on wages, a flat version of the tax has the arguably attractive feature of taxing labor income and capital income at the same rate. Interestingly, for all their emphasis on the importance of taxing consumption rather than income, Hall and Rabushka mention partial expensing of investment (presumably with depreciation of the remaining cost) as an acceptable variation on their

100 It would not, however, be practical to graduate the business tax in a way that made policy sense—i.e., in accordance with the income levels of business owners. Michael Graetz questions "why wages but not investment income should be subjected to progressive tax rates." GRAETZ, *supra* note 47, at 219. Rough justice might be achieved, however, by setting the rate of the business tax equal to the top rate of the wage tax, on the assumption that most business income accrues to high-income persons. *See* the discussion *supra* text accompanying notes 93-94.

101 BRADFORD I, *supra* note 35, at 76-82, 329-34; Bradford III, *supra* note 93, at 384-85; McLure & Zodrow, *supra* note 52, at 72.

proposal.[102] Partial expensing results in a hybrid income-consumption tax.[103]

Replacing expensing with depreciation would complicate the business tax, especially if depreciation deductions are adjusted for inflation.[104] All the increase in complexity would be on the business tax side, however. If the main point of simplification is making taxes simpler for the typical wage earner—as Hall and Rabushka suggest it is—then this innovative version of a flat rate income tax would be almost as simple as the flat tax itself.

D. Summing Up

The flat tax linkage of consumption base and flat rate is not explained by an overriding concern for simplicity. A true overriding concern for simplicity would produce some form of consumption tax not requiring individual returns. The flat tax itself has no significant simplicity advantage over two competing tax systems, neither of which links a flat rate with a consumption base: the flat tax base with graduated rates on wages, and a flat rate form of income tax derived from the flat tax.

VI. Consumption Taxes, Flat Taxes and Two Versions of Neutrality

The two strongest technical arguments for why a consumption tax should also be a flat tax relate to two neutralities. The first argument is that a cash flow version of a consumption tax must have a flat rate if it is to achieve neutrality between present and future consumption. The second argument is that a tax on labor income must have a flat rate if it is to achieve neutrality between persons with equal labor endowments but different lifetime earnings patterns. Both arguments are examined in this section, as are the implications of those arguments for the unusual Hall-Rabushka bifurcated tax base, which is neither a traditional cash flow tax nor a simple wage tax. Although the arguments create a stronger link between a consumption base and a flat rate than the simplicity and efficiency arguments, in the end they are not persuasive.

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102 Flat Tax I, *supra* note 11, at 82 (explaining that partial expensing, rather than full expensing, would make possible a reduction in the revenue-neutral flat tax rate).

103 *See* Arnold C. Harberger, *Tax Neutrality in Investment Incentives*, *in* The Economics of Taxation 299, 307-09 (Henry Aaron & Michael Boskin eds., 1980).

104 Charles McLure rightly points out that although "[t]he idea of replacing expensing with depreciation allowances is 'straightforward'; implementation of it is not, given our ignorance of economic depreciation rates." McLure, *supra* note 76, at 293 n.21.

A. A Cash Flow Consumption Tax and the Timing of Consumption

1. The Case for a Flat Tax

Until they were recently overshadowed by the flat tax, the most prominent proposals for replacing the income tax with a consumption tax followed the cash flow model.[105] The USA Tax is the leading current cash flow proposal.[106] Under a cash flow tax, all sources of income are subject to the individual tax, but only if consumed rather than saved.

A common argument against the income tax, discussed earlier in this Article,[107] is that it distorts individuals' choices between current consumption and saving for future consumption. The tax on investment income drives a wedge between the social return on investment and the individual investor's return on investment.[108] It is not clear that this distortion should be eliminated, when the cost of doing so is greater distortion of labor-leisure decisions.[109] Assuming the desirability of the goal, however, the distortion can be removed in one of two ways. A wage tax—which imposes no tax on investment income—obviously eliminates the wedge, and thus the distortion. A cash flow consumption tax can also eliminate the distortion, but only if it taxes an individual's consumption at the same rate, regardless of when it occurs. If the tax rate on future consumption out of savings is higher than the rate on present consumption, then a cash flow tax shares the income tax's vice of distorting consumption timing decisions. Living frugally now, in order to consume at a higher level later, is discouraged by a progressive cash flow tax.

Suppose a taxpayer earns $30,000 in wages this year (period 1) in a tax-free utopia. After spending $20,000 on her basic needs, she has $10,000 of discretionary income. She may decide to consume that $10,000 now, or she may decide to invest the $10,000 with an eye toward increased consumption in period 2. If she invests the $10,000 at the going rate of return, it will grow to $15,000 by period 2. Her choice is between consumption now, or 50% greater consumption later. To put the same point differently, the choice is between consumption in period 1 of $10,000, or consumption in period 2 with a present value, when viewed from period 1, of $10,000.

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105 *See, e.g.*, William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); DAVID F. BRADFORD AND THE U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 101-128 (2d ed. rev. 1984) [hereinafter BLUEPRINTS].

106 *See supra* text accompanying notes 18-20.

107 *See* note 54, *supra* and accompanying text.

108 *See supra* text accompanying note 54; BLUEPRINTS, *supra* note 105, at 46-47.

109 *See supra* text accompanying notes 58-61.

Now suppose there is a cash flow tax, imposed at a flat rate of 20%, with a $20,000 exemption. After spending $20,000 on her basic needs, the taxpayer has $10,000 of discretionary income. If she saves none of it, she will pay $2000 in tax, and be able to consume $8000. She may decide instead to invest the entire $10,000. No tax is currently due if the $10,000 is saved. The $10,000 will grow to $15,000 by period 2. If her period 2 consumption is subject to the same 20% tax rate, the savings will enable her to consume $12,000 in period 2 (after paying a $3000 tax). As in the no-tax world, her choice is between consumption now, or consumption of equal present value later. Although the tax has reduced her opportunities for both present and future consumption, it has not distorted the choice.

But now suppose that the rate structure is progressive, so that if the taxpayer goes on a consumption binge in period 2—spending the savings on top of her period 2 wages—the marginal tax rate on her $15,000 dissavings will be 40%. The after-tax consumption from the savings will be only $9000.[110] In present value terms, the choice is between $8000 consumption now, or consumption with a present value of only $6000 later.[111]

2. The Objections to the Case

If avoiding distortion in the timing of consumption decisions is the reason one wants a cash flow consumption tax, it has commonly been thought that the tax must have a single rate, which remains constant over time.[112] Notice, however, that graduated rates in a cash flow tax have two effects, only one of which is objec-

110 This $9000 is only 12.5% more than the alternative of $8000 consumption in period 1. The progressive cash flow tax has driven a large wedge between the 50% social return on savings and her 12.5% private rate of return. This wedge may have two behavioral effects on the taxpayer, pushing in opposite directions. The low after-tax return on savings may discourage her from saving. This is the substitution effect—the substitution of lightly taxed current consumption for heavily taxed future consumption. But if she is a "target saver"—i.e., if she is saving in order to be able to consume a specific dollar amount in period 2—the increased tax burden will cause her to save more to meet her goal. This is the income effect. Economic theory cannot predict which effect will dominate. The greater tax burden on future consumption may decrease savings, increase savings, or leave savings unchanged. The inefficiency resulting from taxation, however, depends solely on the distortion caused by the substitution effect. Thus, a graduated cash flow tax may cause substantial deadweight loss even if the net result of the income and substitution effects is no change in observed behavior. *See* ROSEN, supra note 54, at 310-12.

111 By hypothesis, the present value in period 1 of consumption in period 2 is two-thirds of the amount consumed in period 2.

112 Edward McCaffery goes so far as to say that the potential of a progressive cash flow tax to penalize savers vis-a-vis consumers makes a progressive cash flow tax "not really a pure consumption tax." Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283, 350 (1994).

Of course, one may support a cash flow tax for reasons that have nothing to do with neutrality toward the timing of consumption decisions, in which case there would be no particular reason the tax should be flat. McCaffery, for example, advocates a cash flow tax for reasons unrelated to timing neutrality; his tax would have graduated rates. *Id.* at 350-

tionable in terms of consumption tax theory. The objectionable effect arises from the fact that graduated rates may tax an individual's consumption at different rates in different years, *if* he consumes at different levels in different years. The other effect is that if Taxpayer B consistently consumes more than Taxpayer A, the progressive tax will tax B at higher rates than A. This second effect is unobjectionable in consumption tax theory, and will be attractive to many on vertical equity grounds.

What if one wants both to eliminate tax distortions in the timing of consumption decisions, and to tax higher consumers more heavily than lower consumers? How then to choose a rate schedule for a cash flow tax, balancing these competing objectives? At one extreme, suppose people save, and dissave, only for the purpose of smoothing out consumption between high and low income years. In that case, A's consumption and B's consumption are both level over time, and B's is always higher than A's. On these facts, the objectionable effect of graduated rates is not implicated. A will be taxed at the same rate in all years, B will be taxed at the same rate (but different from A's) in all years, and neither will be discouraged from saving by the tax system. The vertical equity goal of graduated rates can be achieved without distorting the timing of consumption decisions.

More generally, the choice should be graduated rates if individuals' consumption patterns are fairly level over time, and if the differences in lifetime consumption levels among individuals are large.[113] Conversely, if individuals commonly save to finance higher consumption levels in the future, and if differences in lifetime consumption levels among individuals are small, the concern about distortion dominates the desire for vertical equity, and the tax should have a flat rate.

What is the evidence? Don Fullerton and Diane Lim Rogers recently have demonstrated—to no surprise—that there is significant inequality in the lifetime labor endowments, or human capital, of Americans.[114] At the tenth percentile of the distribution, the value of the labor endowment is $387,534; at the fiftieth percentile the value is $714,292; and at the ninetieth percentile the value is $1,218,735.[115]

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53. The leading legislative proposal for a cash flow tax also has graduated rates. USA Tax Act of 1995, S. 722, 104th Cong. (1995).

113 This situation is implicit in William Andrews' preference for a progressive consumption tax. He explains that rate graduation is not inconsistent with tax neutrality between present and deferred consumption, "from an equal-consumer perspective." William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947, 954 (1975).

114 Although labor endowments are not perfect substitutes for lifetime consumption levels, they are closely correlated.

115 DON FULLERTON & DIANE LIM ROGERS, WHO BEARS THE LIFETIME TAX BURDEN? 70 tbl.3-2 (1993). The values are in 1984 dollars. There is also strong evidence that income

The life-cycle, or permanent income, hypothesis holds that individuals save and dissave in order to consume fairly evenly over the years of their lives.[116] Although it is not clear exactly how much consumption smoothing occurs, economists commonly assume that there is sufficient smoothing to make even one year's consumption a reasonable proxy for lifetime income.[117] All this suggests—although it does not prove—that interpersonal differences in consumption dominate intertemporal differences, so that the major fairness benefit from graduated rates justifies the minor distortion of the savings decisions of those unusual persons who prefer uneven lifetime consumption patterns.[118]

Moreover, the nature of the dominant effect of a progressive cash flow tax on consumption timing may not be objectionable to most consumption tax proponents. Perhaps the best summary of the evidence is that savings are used to smooth lifetime consumption—in particular, income from peak earning years is used to finance consumption in retirement—but that even with this smoothing, the typical lifetime age-consumption profile is hump-shaped. That is, consumption peaks in peak earning years, and declines significantly in retirement.[119] If that is correct, it has an interesting implication for the effect of a progressive consumption tax on consumption timing neutrality. If the most common sort of lifecycle savings defers consumption from a high-income, high-consumption year, to a low-income, low consumption retirement year, then a progressive cash flow tax actually creates a bias in *favor* of future consumption in the typical case.

Let us return to the previous example of the taxpayer saving $10,000 in period 1, when the marginal rate is 20%, in order to finance consumption in period 2. This time, however, let us suppose that even with the savings, consumption is lower in period 2 than in period 1, and the marginal tax rate in period 2 is only 10%. The $10,000 grows to $15,000 by period 2 and, after paying a 10%

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inequality in the United States has increased in recent years. *See* Lynn A. Karoly, *Trends in Income Inequality: The Impact of, and Implications for, Tax Policy*, *in* TAX PROGRESSIVITY AND INCOME INEQUALITY 95 (Joel Slemrod ed., 1994); SLEMROD & BAKIJA, *supra* note 7, at 55-58 (data on growing income inequality between 1977 and 1990).

116 *See* MILTON FRIEDMAN, A THEORY OF THE CONSUMPTION FUNCTION 20-31 (1957); Franco Modigliani & Richard Brumberg, *Utility Analysis and the Consumption Function: An Interpretation of Cross-section Data*, *in* POST-KEYNESIAN ECONOMICS 388 (Kenneth K. Kurihara ed., 1954).

117 *See* Michael J. Boskin, *A Framework for the Tax Reform Debate*, *in* FRONTIERS OF TAX REFORM, *supra* note 44, at 10, 19 ("consumption in any year may well be a better proxy for permanent income than is income in that year").

118 This assumes, of course, that one begins by accepting the vertical equity argument for graduated rates.

119 *See generally* Orazio P. Attanasio, *Personal Savings in the United States*, *in* INTERNATIONAL COMPARISONS OF HOUSEHOLD SAVINGS 57 (James M. Poterba ed., 1994) (providing a detailed and sophisticated analysis of lifetime income, savings, and consumption, based on Consumer Expenditure Survey data).

tax, the taxpayer can consume $13,500. Viewed from period 1, that future consumption has a present value of $9000, which is *greater* than the $8000 period 1 consumption alternative (after paying a 20% tax on $10,000).

It seems quite probable that the most common effect of a progressive cash flow tax on consumption timing will be a distortion in favor of deferred consumption. This distortion would, of course, still be a violation of consumption timing neutrality, but for those who support a consumption tax in order to encourage savings, it should not be objectionable.[120] It may even be an attraction.

There are four additional considerations pointing toward the acceptability of graduated rates in a cash flow tax, despite the impact on consumption timing decisions. First, the mere fact that an individual's consumption is not perfectly level over time does not mean that graduated rates will cause distortions. If tax brackets are fairly wide—encompassing several tens of thousands of dollars within a single bracket—they can accommodate substantial variations in annual consumption without subjecting an individual to different tax rates in different years.

Second, *Blueprints for Tax Reform* describes a cash flow tax system in which taxpayers are allowed to opt out of cash flow treatment for some savings; opting out would result in no deduction for savings, but also no tax on investment return.[121] Taxpayers could use this flexibility to average their consumption for tax purposes, thus avoiding the distortion that would result from different tax rates applying in different years.[122]

Third, for taxpayers with very unequal consumption levels within a period of a few years, tax base averaging rules, similar to the repealed income averaging rules,[123] could be provided.

Finally, there is a strong argument that the goal of applying the same tax rate to an individual over a period of many years is quixotic. One Congress cannot bind later Congresses;[124] tax rates will inevitably change over time as economic conditions, revenue

120 The House-passed "Tax Code Termination Act" calls for elimination of "the bias against savings and investment." H.R. 3097, 105th Cong. § 3(a)(4) (1998). It seems unlikely the House Republicans would object strenuously to a tax bias in favor of savings and investment.

121 BLUEPRINTS, *supra* note 105, at 110-11.

122 *See id.* at 112-13.

123 Former I.R.C. §§ 1301-1305, *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 141, 100 Stat. 2085, 2117 (1986).

124 Kyle D. Logue offers several suggestions—some of them quite creative—as to how the government might credibly commit itself to a particular tax policy, if it desired to do so. Kyle D. Logue, *Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment*, 94 MICH. L. REV. 1129, 1181-94 (1996). Logue does not, however, suggest that Congress use any of these devices to commit future Congresses to a particular rate structure.

needs, and congressional attitudes change.[125] This reality suggests that there is no point in enacting a flat tax to pursue the consumption tax goal of neutrality in the timing of consumption decisions, because neutrality requires the tax rate to remain unchanged over decades, and that cannot happen.[126] That impossibility leaves the greater interpersonal fairness of graduated rates as the only achievable goal; it wins by default.

3. Relating the Case to the Bifurcated Base of the Flat Tax

The flat tax can be understood as an unusual version of a cash flow tax, using a look-through model of individuals' investments in businesses. When an individual invests wages in a business he is not entitled to a wage tax deduction for making the investment. He can be viewed, however, as benefitting indirectly from the ability of the business to expense the assets it buys with his money.[127] Similarly, when those assets produce business income, the investor formally pays no tax, but the tax the business pays can be viewed as paid on behalf of the investor, like a withholding tax.[128]

The clearest case for viewing the flat tax as a kind of cash flow tax is the wage earner with a sole proprietorship business on the side. If he takes some of his wages and uses them to buy assets for his business, the net tax effect will be the same as under a cash flow tax, if the wage tax and the business tax share the same rate. The savings from the business tax deduction will offset the taxation of the wages under the wage tax,[129] just as a savings deduction would offset the tax on wages under a standard cash flow tax. If he consumes the income generated by the assets, rather than reinvesting it in the business, that income will be taxable to him under the business tax, with the same result as if he had been taxed on consumed income under a standard cash flow tax.

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125 *See* GRAETZ, supra note 47, at 203-04; C. EUGENE STEUERLE, THE TAX DECADE 135, fig.8.3 (1992) (showing changes in average and marginal income tax rates at several income levels from 1955 to 1990).

126 Strictly speaking, avoiding distortion between present and future consumption does not require that the tax rates *actually* be the same in both years. It requires only that at the time the taxpayer makes the decision to consume or save, he *believes* the rate will be the same in both years. The history of changes in United States income tax rates, however, would give taxpayers under a cash flow tax little reason to have that belief.

127 *See* Stein, *supra* note 45, at 107.

128 This is how Hall and Rabushka explain the business tax: "The business tax is a giant, comprehensive withholding tax on all types of income other than wages, salaries, and pensions. . . . As a result, all income that people receive from business activity has already been taxed. Because the tax has already been paid, the tax system does not need to worry about what happens to interest, dividends, or capital gains after these types of income leave the firm . . . ." FLAT TAX I, *supra* note 11, at 61.

129 This result assumes the taxpayer has enough other business income to make the deduction for the cost of the assets fully useable.

If the flat tax base is analogized to a cash flow tax, must the tax be flat in order to achieve tax neutrality toward the timing of consumption? Perhaps surprisingly, a variation on the flat tax, with a flat rate for the business tax but graduated rates for the wage tax, has consumption timing neutrality.[130] For example, David Bradford's "X tax,"[131] which has a flat business tax at the same rate as the top wage tax rate, features consumption timing neutrality. *Any* combination of a graduated wage tax and a flat business tax has consumption timing neutrality, regardless of the relation between the business tax rate and the top wage tax rate.[132] The X tax approach of setting the business tax rate equal to the top wage rate seems the most attractive option, however, on the assumption that most business income accrues to high-income persons.[133]

Suppose the wage tax has graduated rates, with the top wage tax rate equal to the business tax rate of 40%. Consider again the wage earner with a business on the side. He has $100 of wages, subject to the wage tax at the rate of 25%.[134] If he opts for current consumption, he will pay a tax of $25, and consume $75. If he chooses instead to invest those wages in the business, he will be able to spend $125 on business assets. Deducting $125 from the 40% business tax generates a tax savings of $50, so the after-tax cost of the investment is $75, which equals the wages he has available to invest after paying the $25 wage tax. Viewing the first year in isolation, the net effect of the two taxes is a 25% *negative* tax: the burden of the lower rate wage tax is more than offset by the benefit of the deduction against the higher rate business tax.

The assets generate income at the normal rate of return in the economy—say, 10% for one year. One year later, the business has the assets, still worth $125,[135] and the $12.50 income from the assets. The taxpayer then decides he wants to devote the entire $137.50 to consumption, which requires selling the assets. He will have to pay the 40% business tax on the entire $137.50,[136] so the

130 *See* Bradford III, *supra* note 93, at 385-86.

131 *Id.*

132 For that matter, the combination of a wage tax and a flat business tax has consumption timing neutrality no matter what rate structure is chosen for the wage tax. *See infra* text accompanying notes 137-38.

133 *See supra* text accompanying notes 93-94 (discussing surrogate taxation under the X tax).

134 This rate is the average or effective rate on the $100 wages. The analysis does not depend on what marginal rate structure produces that average rate.

135 For simplicity of illustration, the example assumes the assets suffer no economic depreciation.

136 The $12.50 income is obviously subject to tax, since it was not reinvested in business assets. The other $125 is subject to the business tax because the assets were sold, and proceeds from the sale of plant and equipment are subject to the business tax (unless reinvested). *See* FLAT TAX I, *supra* note 11, at 63. In income tax terms, an expensed asset has a zero basis, so the entire amount realized on its sale is taxable gain.

amount he will be able to consume is $82.50. Using a 10% discount rate, the present value in the first year of $82.50 in the next year is $75. The result is that the combination of the 25% wage tax and the 40% business tax does *not* distort the consumption timing decision. Whether he consumes in the first year or the second year, the present value of the consumption will be $75.

The result in the example generalizes. The present value of the after-tax consumption will always be simply the amount of the wages, reduced by the effective wage tax rate in the year the wages were earned.[137] Since the present value of the consumption depends only on the wage tax burden in the year the wages were earned, it is unaffected by consumption timing. As a result, consumption timing neutrality will exist in this bifurcated tax system no matter what rate structure is chosen for the wage tax. What is crucial to consumption timing neutrality in this system is that the rate of the business tax be flat and constant over time.[138] As long as the business tax rate is flat and constant, the present value of consumption depends on the effective wage tax rate in the initial year, *and on nothing else*—not the structure of wage tax marginal rates (whether flat, progressive or regressive), not on the relationship between wage tax and business tax rates, and not on wage tax rates in later years.

Whatever the merits of the consumption timing neutrality argument for a flat cash-flow tax of the usual sort, the argument places no limits on the rate graduation of the wage tax portion of the Hall-Rabushka bifurcated tax.

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137 Suppose a taxpayer earns wages W. The amount he can invest in his business, after taking into account both the wage tax rate (wt) and the business tax rate (bt) is:

$$W\left(\frac{1-wt}{1-bt}\right).$$

This amount will grow at the annual rate of r, for the n years that the taxpayer postpones consumption. Thus in year n the investment will have grown to:

$$W\left(\frac{1-wt}{1-bt}\right)(1+r)^n .$$

If it is converted to consumption in year n, the amount available for consumption after imposition of the business tax will be:

$$W\left(\frac{1-wt}{1-bt}\right)(1+r)^n(1-bt) .$$

From the perspective of the first year (in which the wages were earned), the present value of that future consumption is:

$$\left(\frac{1}{(1+r)^n}\right)W\left(\frac{1-wt}{1-bt}\right)(1+r)^n(1-bt) .$$

Simplifying the expression, $(1+r)^n$ and $(1-bt)$ drop out, and the present value is just $W(1-wt)$. Obviously, this value is independent of n (i.e., the year in which consumption occurs).

138 Only if bt is flat and constant over time does $(1-bt)$ drop out of the present value formula. *See supra* note 137.

B. A Wage Tax and Neutrality among Earnings Patterns

1. The Case for the Link

One argument in favor of a consumption tax is based on the similarity between a consumption tax and a one-time tax on endowment. *Blueprints*, for example, suggests that "endowment"—defined as a person's wealth at the beginning of his working years, including the value of his human capital—is a good measure of lifetime ability to pay tax, and thus a theoretically attractive tax base.[139] Problems of valuation and liquidity make an endowment tax impractical, but a consumption tax more nearly approximates the effects of an endowment tax than does an income tax.

For ease of illustration, consider a situation in which the only wealth is human capital.[140] Imagine two persons with equal value human capital. Each wants to consume an equal amount in each year. Under an income tax they will bear different lifetime tax burdens despite their equal endowments, if they have different patterns of lifetime earnings.[141] Under a wage tax, however, two persons with equal human capital endowments will bear equal lifetime tax burdens regardless of the timing of their earnings, *if* the same tax rate applies to all earnings of each. Therefore, one who favors a wage tax out of a desire to impose equal tax on equal human capital endowments will want the tax to have a single rate, constant over time.

A simplified example illustrates the point. Taxpayers C and D begin their working years with no wealth except the present value of their future earnings. There are only two earnings periods—present period 1 and future period 2. C will earn $100,000 in period 1 and nothing in period 2; D will earn nothing in period 1 and $150,000 in period 2. The time value of money is such that $100,000 now and $150,000 in period 2 have equal present values. Thus C and D have human capital endowments of equal value. Will they face equal tax burdens under a wage tax? Yes, *if* the same tax rate applies to each. At a 20% rate, for example, C will have $80,000 after tax in period 1 and D will have $120,000 after tax in period 2. The pre-tax equality of the present value of their endowments is thus maintained post-tax.[142] If C and D both want

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139 BLUEPRINTS, *supra* note 105, at 36.

140 In this situation the major difference between a consumption tax and a wage tax disappears; the fact that a consumption tax burdens existing nonhuman capital, while a wage tax does not (*see supra* text accompanying notes 30-33), is irrelevant when there is no wealth other than human capital.

141 A taxpayer whose earnings are front-loaded will have to save to smooth his consumption, and that will subject him to the income tax's double tax on savings. *See* BLUEPRINTS, *supra* note 105, at 37-38. A taxpayer who earns the same amount each year will not have to save to smooth consumption, and so will avoid the double tax.

142 As the example illustrates, a flat rate wage tax will impose equal tax burdens on taxpayers who begin their working years with future earnings of equal present value, even

to smooth their consumption over the two periods, C will have to save and D will have to borrow. The saving and borrowing have no tax consequences under a wage tax, and so do not disrupt the equality between the two taxpayers.[143]

But what if the tax has graduated rates, so that C pays tax at an average rate of 20% on $100,000, and D pays at an average rate of 30% on $150,000? Then C's after-tax endowment is still $80,000, but D's is only $70,000 (the present value of period 2 after-tax earnings of $105,000). The general point is that if two taxpayers have equal-value endowments, but one has greater bunching of wages, a graduated rate wage tax will impose a heavier burden on the taxpayer with the bunching.[144]

2. Relating the Case to the Bifurcated Base of the Flat Tax

The essence of the above analysis is not changed by moving to a world with old capital, other than human capital, in existence at the time a new tax system is introduced, and by imposing the bifurcated base of the flat tax rather than simply a wage tax. If the business tax is imposed at the same rate as the wage tax, and if the rate of each tax remains fixed over time, the combined effect of the business and wage taxes will be to tax equal endowments equally—regardless of how those endowments are divided between human and other capital, and regardless of the timing of earnings from either form of capital.

This conclusion can be illustrated by modifying the above example, so that D has no human capital endowment, but is en-

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if their earnings patterns are different. However, economists commonly define a person's labor endowment as the present value of *potential* future earnings, were one to work the maximum possible number of hours. *See* FULLERTON & ROGERS, *supra* note 115, at 22-23. This definition includes the value of all time available to a person—whether devoted to paid labor, to unpaid labor, or to leisure, and values all that time at the person's wage rate. Under this definition of endowment, even a flat rate wage tax will not impose equal burdens on two persons with equal endowments, if one decides to devote more time to paid labor than the other, or if one chooses to work at his highest available wage rate and the other does not.

There is another, closely related, difference between a wage tax and an actual one-time tax on endowment. An actual endowment tax, as defined by Fullerton and Rogers, would involve no efficiency cost. It would not distort behavior, because it would not be based on behavior. *See id.* at 39. The wage tax, by contrast, imposes an efficiency cost because it distorts the choice between paid labor and untaxed uses of time.

143 Each will be able to consume $48,000 in each period. C has $80,000 after-tax in period 1. If he consumes $48,000 and saves $32,000, the savings will grow to $48,000 by period 2. D borrows and consumes $48,000 in period 1. In period 2 he earns $150,000. After paying $30,000 tax and $72,000 loan principal and interest, he can consume $48,000 in period 2.

144 *See* McCaffery, *supra* note 112, at 351. A taxpayer may have greater bunching of wages than another taxpayer with an equal-value endowment either because his earnings occur later in life, as in the example in the text, or simply because his earnings vary more from year to year.

dowed with other capital that will earn $150,000 in period 2. The endowments of C and D now differ both in nature (human capital for C, other capital for D) and in timing, but are still equal in present value. A 20% bifurcated wage-business tax will leave C with $80,000 after the wage tax in period 1, and D with $120,000 after the business tax in period 2, thus maintaining post-tax the equality of the present value of their endowments. The fact that the wage tax and the business tax share the same flat rate thus could be explained by a desire to impose equal tax burdens on endowments of equal value.

3. Some Objections

Imposing equal tax burdens on equal endowments is the strongest argument for a logical link between the Hall-Rabushka consumption tax base and a flat rate, but even this argument is subject to important objections. Three objections can be briefly noted before considering others in more detail. At the outset, the link is only as strong as the case for equal-tax-on-equal-endowments as a tax policy goal. *Blueprints* simply assumes the appropriateness of the goal,[145] without defending it. One who thinks ability to pay is better determined based on shorter periods than a lifetime will not be impressed with the goal.[146] Second, any tax imposed on actual earnings is a poor proxy for an endowment tax, if equal-endowment taxpayers make different choices about the extent to which they convert their earnings *potential* to *actual* earnings. The flat tax will impose a much heavier burden on the taxpayer who realizes his full earnings potential, than on an equally able taxpayer who works short hours at a low-paying, but pleasant, job.[147] This problem is sufficiently serious to call into question the entire project of trying to mimic the results of an endowment tax. Finally, the point about the implausibility of constant tax rates over time made earlier, with respect to the cash flow tax, applies here as well.[148] A policy goal whose accomplishment depends on Congress holding the tax rate steady over decades may not be worth pursuing.

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145 "*If* endowment is regarded as a good measure of ability to pay over a lifetime, this implies that *a consumption base is superior to an income base as a measure of lifetime ability to pay*." BLUEPRINTS, *supra* note 105, at 36 (first emphasis added, second emphasis in original).

146 "Ultimately, a lifetime view is not likely to hold much sway with legislators." GRAETZ, *supra* note 47, at 204.

147 *See* the discussion, *supra* note 142.

148 *See supra* text accompanying notes 124-26.

a. The inconsistency of Hall-Rabushka with the endowment tax rationale

Despite the fact that the endowment tax analysis supplies the strongest link between their chosen tax base and a flat rate, Hall and Rabushka do not rely on, or even mention, that analysis. That omission may be because the endowment tax rationale calls for a *truly* flat wage tax—i.e., a tax with no zero rate bracket created by exemptions. Consider how taxpayers C and D would fare under a 20% "flat tax" with a $30,000 exemption. The present value of C's after-tax wages would be $86,000.[149] The present value D's after-tax wages would be only $84,000.[150] D's average tax rate is higher than C's because of the exemption, and that difference destroys the equality of the tax burdens. In addition, the exemption means that an endowment consisting entirely of human capital is taxed less heavily than an equal-value endowment consisting entirely of other capital. Perhaps Hall and Rabushka realized that the wage tax exemptions in their proposal are inconsistent with the logic of the endowment tax analysis, and so they decided not to rely on that analysis.

Of course, one might believe that equal tax on equal endowments is a worthy goal, but also believe that exempting subsistence wages from tax is even more important. Then the flat tax might be attractive as imposing at least similar tax burdens on equal endowments, while also avoiding the taxation of subsistence earnings.

b. Balancing horizontal and vertical equity concerns

Equal tax burdens on those with equal endowments is purely a goal of horizontal equity; it says nothing about vertical equity—the relative tax burdens on those with greater and lesser endowments. Suppose a one-time tax on endowments were practical. Regardless of rate structure, the system would necessarily impose the same tax on all persons with the same endowment value, thus automatically achieving horizontal equity. If one's version of vertical equity were that those with larger endowments should be taxed at higher rates, a graduated rate structure could achieve that goal without compromising horizontal equity. There is no logical inconsistency in favoring both equity goals—equal tax on equal endowments in the name of horizontal equity, and progressive rates in the name of vertical equity. If a true endowment tax were feasible, then there would also be no technical inconsistency.

149 $100,000 wages (receivable immediately), less $14,000 tax (20% of $70,000 taxable wages).

150 The tax would be $24,000 (20% of $120,000 taxable wages). The after-tax wages of $126,000 would have a present value of $84,000.

In moving from a true endowment tax to a consumption tax substitute, however, a technical inconsistency emerges. The task for one who favors both goals is to find the best compromise between them. The question is whether graduated rates for the wage tax would do more good in terms of vertical equity than harm in terms of horizontal equity.[151] To a large extent, the answer depends on empirical information about the distribution of wages, among persons and over time.[152]

If everyone at any given level of lifetime labor endowment had the same lifetime earnings curve, there would be no horizontal equity objection to graduated rates. Each member of the group would bear the same lifetime tax burden regardless of the rate schedule. It is not necessary that the lifetime earnings curve for each member of the group be *flat* in order to obviate the horizontal equity objection to graduated rates; it is only necessary that the curve be *the same* for each member of the group.

It is easy, then, to state the two extreme cases. If there are no variations in earnings patterns *within* endowment levels, but there are large differences *between* endowment levels, rates should be graduated. On those facts, graduation would not interfere with horizontal equity, and would contribute significantly to vertical equity.[153] At the other extreme, if everyone has the same level of endowment, but the timing of earnings differs greatly among individuals, there should be a flat rate. On these facts, vertical equity would be a nonissue, and horizontal equity would require a flat rate. Which of these extremes is closer to the real world? As mentioned earlier, Fullerton and Rogers have documented the existence of large differences in the human capital en-

151 Graduated rates for the business tax are not possible under the Hall-Rabushka system, because the system makes no attempt to assign business income to particular business owners. FLAT TAX I, *supra* note 11, at 60-61.

152 A complete analysis would also require information about the distribution of other forms of capital. However, human capital tends to dwarf other forms of capital, even toward the high end of the endowment distribution. For example, David Bradford has calculated that "if a male with the 90th-percentile position in the discounted-income [i.e., human capital endowment] ranking received at age 40 the 90th-percentile inheritance, the effect would be to increase his lifetime wealth by about 4.2%; at the 95th-percentile position (by interpolation), 3.6%." BRADFORD I, *supra* note 35, at 173.

153 There is a qualification. It is theoretically possible that graduated rates could backfire in terms of vertical equity. Suppose there are just two endowment groups—high and low—and that they have very different lifetime earnings curves. Members of the high group earn $100,000 in period 1 and nothing in period 2. Members of the low group earn nothing in period 1 and $120,000 in period 2, which has a present value of $80,000 in period 1. With graduated rates, the low group may face a higher lifetime tax burden than the high group, which would be perverse. The chances of this being a serious problem in the real world are remote. As the example illustrates, the backfiring is likely to occur only if there are tremendous differences in the timing of earnings at different endowment levels. Although Fullerton and Rogers found that the earnings of different endowment groups do peak at different ages, the shapes of the curves are not so different as to make backfiring a major concern. FULLERTON & ROGERS, *supra* note 115, at 28 fig.1-3.

dowments of Americans.[154] To my knowledge there are no studies of differences in the timing of labor income *within* endowment levels.[155] It seems plausible, however, that differences in the timing of earnings within endowment levels are minor compared to differences in endowment levels. If that is true, then one who favors flat rates for horizontal equity and graduated rates for vertical equity, might well decide the vertical equity concern dominates—at least enough to justify moderate rate graduation. That decision would be reinforced by the possibility of lessening the impact of graduated rates on horizontal equity by wage averaging provisions.[156]

VII. CONCLUSION

A flat rate imposed on a bifurcated wage-business tax base is a defensible compromise among simplicity, efficiency, and fairness objectives in tax system design. There is nothing magic, however, about that particular compromise. Other than political expediency, there is no good reason for considering the base and the rate of the flat tax as a take-it-or-leave-it package. A single-minded concern for efficiency cannot justify the linkage of base and rate, because the flat tax does not remotely resemble the tax an efficiency purist would propose. Nor can an overriding desire for simplicity explain the base-rate connection. A version of the Hall-Rabushka model with a graduated wage tax would be nearly as simple as the flat tax, as would a version of the Hall-Rabushka model converted into a flat rate income tax. The argument for linking a consumption base and a flat rate in order to achieve tax neutrality between present and future consumption is problematic even for a standard cash flow tax, and the argument has no application to the bifurcated wage-business tax.

The endowment tax analysis is unique in suggesting a logical connection between the Hall-Rabushka base and a flat rate, but the connection will not persuade those who do not believe equal tax on equal endowments is an important and achievable policy goal. The most serious problem is that the logical connection addresses only horizontal equity, whereas tax system design must consider vertical equity as well. Those who favor graduated rates on vertical equity grounds are likely to find the horizontal equity case for a flat tax overwhelmed by the vertical equity case for graduated rates.

The terms of the tax reform debate should be changed. The issue should not be the merits of the flat tax. Instead, there

154 *See supra* text accompanying note 115.

155 Fullerton and Rogers emphasize that their study does not consider differences within groups. FULLERTON & ROGERS, *supra* note 115, at 26-27.

156 *See supra* text accompanying note 123 (discussing consumption averaging and income averaging).

should be two debates—one on a consumption base versus an income base, and the other on a flat rate versus graduated rates. In the end, this separation of the issues is inevitable. The emphasis on flatness has worked well in attracting public attention to tax reform, but it would be naïve to suppose that the base issue can be kept hidden long enough for the flat tax to become law. If flat tax proponents are to succeed, they must eventually convince the public not only that flat is better than graduated, but also that a consumption base is better than an income base.

When public attention finally does focus on the base issue, the flat taxers may find that their political acumen in linking a consumption base to a flat rate is matched only by their folly in the choice of form for a consumption tax. With the high visibility of the wage portion of the tax, and the near invisibility of the business portion, the base can be easily portrayed by opponents as simply a wage tax. So portrayed, it is an easy target for populist complaints that a millionaire living off wealth (such as Steve Forbes himself) would pay no tax, while his chauffeur and his gardener would pay substantial tax.[157] In fact, owners of old capital would bear a substantial burden under the business tax, but it is probably impossible to convince the public of that reality.

For all their political savvy, the advocates of the flat tax may have made a crucial mistake in proposing a consumption tax in a form involving no personal tax on investment income. Although the USA Tax never caught on with the public because it lacked the attention-getting feature of a flat rate, the public is probably more open to an unlimited deduction for savings than to an exemption for investment income. Not taxing investment income sounds like an undeserved windfall for the idle rich, but an unlimited deduction for savings sounds like a just reward for the thrifty middle class.[158] The most saleable proposal for fundamental tax reform may be a flat version of the USA Tax, but it has yet to find a champion.

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157 *See* Ernest S. Christian, *How Much Simplification Is Enough? Is a Returnless Tax Realistic?* 73 TAX NOTES 1481, 1491 (1996) (citing example of a Rockefeller and his gardener); Bob Minzesheimer, *Key for Forbes Plan is Outsider Status*, USA TODAY, Feb. 5, 1996, at A6 ("Forbes' plan means a millionaire who lives off dividends and interest pays less tax than his chauffeur."); Patrick J. Buchanan, *A Flawed Flat Tax and the Way Out*, N.Y. TIMES, Jan. 17, 1996, at A19 (Bill Gates would pay no tax following an early retirement, but Microsoft employees would pay tax.). Slemrod and Bakija speculate that the flat tax will "fail a simple 'sniff test' of Americans accustomed to a personal tax on all income, who will find that a tax that *appears* to be on labor income only just doesn't smell right." SLEMROD & BAKIJA, *supra* note 7, at 250 (emphasis added).

158 "While the Armey Flat Tax gives providers of labor less power to choose [how much tax they pay] than the current system, the Nunn-Domenici Tax gives them more." Alice G. Abreu, *Untangling Tax Reform: Simple Taxes, Complex Choices*, 33 SAN DIEGO L. REV. 1355, 1416 (1996). If taxpayers prefer feeling empowered to feeling trapped, they will prefer a cash flow tax to a wage tax.

The Missing Links in Tax Reform

*Edward J. McCaffery**

A funny thing happened on the way to fundamental tax reform: Nothing. Just a few short years ago, it looked as if we might have another great American tax revolt, akin to the one that started this country over 200 years ago. Ronald Reagan had gotten the modern bandwagon started, first in California in the 1970s and later, from the White House, in the 1980s.[1] Politicians—like football coaches, investment advisors, and most of the rest of us—are apt to keep trying the same old thing until it has proven beyond a shadow of a doubt to work no longer. Thus the antitax talk continued full force into the 1990s.

George Bush's quivering lips probably cost him the 1992 presidential election, and only further proved how deadly serious antitax talk had become.[2] The *Contract with America*, which fueled the sweeping Republican electoral victories in the mid-term elections of 1994, was full of fire and brimstone talk of tax.[3] Steve Forbes nearly made the 1996 presidential election a referendum on the flat tax, even as Jack Kemp was more effective at personally cashing in on the idea.[4] The fire still burned bright after Bill

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1 *See, e.g.*, GARRY WILLS, REAGAN'S AMERICA (1987); Kenneth Cooper, *GOP Offers a "Contract" to Revive Reagan Years*, WASH. POST, Sept. 28, 1994, at A1. Of course, Reagan stood in a long line of American tax cutters, haters, and protesters. *See generally* CHARLES ADAMS, THOSE DIRTY ROTTEN TAXES (1998) (chronicling history of taxes and tax protests in America).

2 *See* Alan Murray & Jackie Calmes, *The Great Debate: How the Democrats, with Real Cunning, Won the Budget War*, WALL ST. J., Nov. 5, 1990, at A1; John E. Yang, *Budget Deal Appears at Hand*, WASH. POST, Oct. 25, 1990, at A1; Thomas Patterson, *Bad News, Bad Governance*, 546 ANNALS AM. ACAD. POL. & SOC. SCI. 97, 104 (1996).

3 *See* CONTRACT WITH AMERICA: THE BOLD PLAN BY REP. NEWT GINGRICH, REP. DICK ARMEY, AND THE HOUSE REPUBLICANS TO CHANGE THE NATION (Ed Gillepsie & Bob Schellas eds., 1994) [hereinafter CONTRACT]. *See also* CONTRACT WITH THE AMERICAN FAMILY: A BOLD PLAN BY CHRISTIAN COALITION TO STRENGTHEN THE FAMILY AND RESTORE COMMONSENSE VALUES (1995) [hereinafter CONTRACT II]. I discuss the two Contracts and their talk of tax in Edward J. McCaffery, *Tax's Empire*, 85 GEO. L.J. 71, 128-37 (1996). *See also* EDWARD J. MCCAFFERY, TAXING WOMEN 202-25 (1997).

4 *See* Jackie Calmes, *Forbes's Flat-Tax Plan Will Be a Tough Sell*, WALL ST. J., Feb. 5, 1996, at A1; Jack Kemp, *Lower Taxes, Higher Revenues*, N.Y. TIMES, Feb. 11, 1996, § 4,

Clinton had defeated Bob Dole—perhaps the only major Republican candidate *without* a radical tax overhaul plan.[5] By 1997, Representatives Dick Armey and Billy Tauzin were touring the country putting on a "Scrap the Tax Code Tour," a kind of Lincoln-Douglas debate for the 1990s, with taxes replacing slavery as the topic du jour.[6] Calls for a national sales or value-added tax to replace the income tax gained steam. Republicans took to calling the gift and estate tax the "death tax" and made popular, if not quite populist, calls for its repeal.[7] The "marriage tax" became a front page issue in major newspapers, and Congress was full of proposals to kill it.[8] In a kind of crowning glory to all this talk of tax, Republicans initiated the Tax Code Termination Act, calling for the utter abolition of the income tax as we have come to know it by the dawn of the next millennium.[9]

But, lo and behold, actual tax policy and legislation of the 1990s has looked suspiciously like its predecessors in, say, the 1960s or 1970s—lacking even the radicalness of Ronald Reagan's 1980s. The Omnibus Budget and Reconciliation Act of 1993,[10] the Taxpayer Relief Act of 1997,[11] and the IRS Restructuring and Reform Act of 1998,[12] to name three quick examples, all featured typically *ad hoc* and incremental changes: tinkering among the deck chairs of the Titanic. Among the key provisions of these laws were a nonrefundable $500 per child credit, an expansion of the earned-income tax credit, the creation of new individual retirement accounts (IRAs), reductions in the capital gains rates, and an increase in the unified credit under the estate and gift tax. These changes are hardly the stuff of revolution.

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at 15; Rob Norton, *The Wrong Way to Sell a New Idea: The Flat Tax Has Emerged as the Single Biggest Issue in the 1996 Presidential Race. Can It Succeed in Spite of its Supporters?*, FORTUNE, Feb. 19, 1996, at 41.

5 *See* Thomas Powers, *The Last Hurrah*, N.Y. REVIEW OF BOOKS, Feb. 15, 1996, at 3 (discussing Dole and his positions on tax reform); *Dole Calls for "Flat" Tax Rate*, N.Y. TIMES, Jul. 5, 1982, at A17; Lawrence Kudlow, *Cut Taxes, Starve the Beast*, WALL ST. J., Sept. 30, 1996, at A18; Marvin Chirelstein, *Taxes and Public Understanding*, 29 CONN. L. REV. 9, 14 (1996).

6 *See* Agnes Roletti, *Republicans Urging Radical Change in IRS Cheered Here*, SAN DIEGO UNION TRIB., Feb. 22, 1998, at B1.

7 *See* Greg Hitt, *GOP Targets Estate Taxes, Capital Gains*, WALL ST. J., June 10, 1997, at A3; *Estate Tax Elimination: A Family Relief Act* (Editorial), ARIZONA REP., Sept. 11, 1998, at B6. *See also* Joel Dobris, *A Brief for the Abolition of All Transfer Taxes*, 35 SYRACUSE L. REV. 1215, 1225 (1985).

8 *See, e.g.*, Janet Hook, *Appeal Grows for Bid to End "Marriage Tax,"* L.A. TIMES, Oct. 20, 1997, at A1. The so-called marriage tax was a major theme in MCCAFFERY, TAXING WOMEN, *supra* note 3.

9 *See Grandstanding on Taxes*, N.Y. TIMES, June 24, 1998, at A24 (editorial).

10 Omnibus Budget and Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (1993).

11 Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997).

12 IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (1998).

So much sound and fury thus signified so much nothing. Even as a large federal surplus made the kind of radical reform called for in the early part of the decade—and called irresponsible by liberals—possible, Democrats, led by President Clinton, continued to advocate a panoply of small *ad hoc* changes, while even Republicans seemed to be abandoning the radical tax reform ship.[13] What happened?

In this essay I want to answer that question by looking at three related missing links in tax reform: the people, principle, and policy. First, however, let us take a deeper look at the rhetoric and reality of tax today.

I. THE RHETORIC AND REALITY OF REFORM

This Part summarizes the dominant themes in the tax debates over the last quarter-century, and then looks at actual tax reform in the 1990s. It concludes by looking at some structural reasons why the reality of tax reform has not lived up to the fiery promise of its rhetoric.

A. Talk of Tax

The modern antitax movement can usefully, if a bit simplistically, be laid at the feet of Ronald Reagan. Reagan's America featured a vision of a downsized government off of the people's backs, taxing and doing less. Reagan participated in the great tax-limitation movements in California in the 1970s,[14] and he rode this antitax rhetoric into the White House.

Reagan delivered, partially. The two great tax acts of his presidency, the Economic Recovery Tax Act of 1981 (ERTA)[15] and the Tax Reform Act of 1986 (TRA 1986),[16] certainly changed the face of the Internal Revenue Code. The highest marginal tax rate when Reagan took office was 70%, as it had been ever since the Kennedy administration.[17] ERTA lowered this to 50%, and the TRA 1986 brought it down further, to 28% or 33%, depending on how one considers the notorious "bubble."[18] The 1986 Act also eliminated any preference for capital gains, and, notwithstanding

13 *See State of the Union: Clinton Outlines His Vision for Nation's Transition to the 21st Century*, N.Y. TIMES, Jan. 20, 1999, at A22; Eric Pianin and Ferge Hager, *With Black Ink, Clinton Draws a Line*, WASH. POST., Jan. 21, 1999, at 6; *Clinton, Republicans Each Pitch Own Tax, Budget Plans*, L.A. TIMES, Jan. 24, 1999, at A16.

14 *See* David Kyrig, *Refining or Resisting Modern Government? The Balanced Budget Amendment to the U.S. Constitution*, 28 AKRON L. REV. 97, 105 (1995). *See also* WILLS, *supra* note 1.

15 Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981).

16 Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

17 I.R.C. § 2001(c) (1976) (amended 1981).

18 *See* Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLA L. REV. 1861, 1989-99 (1994).

bickering among many practitioners and academics, fairly significantly simplified the Code.[19] Among other things, by raising the standard exemption levels and by indexing the marginal rate brackets for inflation, TRA 1986 got millions of lower and lower-middle income Americans off the tax rolls to stay.[20] By any measure, this was radical tax reform.

Of course, as we well know by now, these tax reductions only captured part of the story. Under Reagan there was in fact, a large shift to payroll and corporate taxes, while the total tax burden stayed more or less the same. Giving credit where credit is due, however, we can at least see the 1980s as a time of significant tax reform.

Tax reform rhetoric continued full force into the 1990s. Indeed, picking up on the success of Reagan, the rhetoric intensified. The *Contract with America* illustrates this trend well. This skilled political tract ingeniously mixed antigovernment, antitax, and pro-family talk. The *Contract* called for a reduction in the capital gains rate and a $500 per child credit, an idea that had originated with the Christian Coalition as an infra-marginal way to get tax relief to all families, without altering the disincentives facing working wives in two-earner ones.[21] These technical provisions were part of a bigger agenda. The *Contract* made clear throughout, with its calls for term limits, supra-majority voting requirements, and a line-item veto, that none other than the federal government, now seen as the arch-enemy to family values, was its prey.[22] Tax had become the government's life-blood; any blow against taxes was a blow against the beast itself. Tax reduction, government downsizing, and morality were all, in the end, one and the same thing.

Going beyond the *Contract*, which perhaps hinged too narrowly on its social conservative underpinnings, talk of tax reform continued to expand and become more specific while retaining its radical taint. In the late 1990s, we have witnessed attacks on the income tax, the "marriage tax," and the "death tax."[23] Advocates of fundamental reform have been recommending a flat tax, national sales tax, VAT tax, MAX tax, just about any tax but what we now have.[24] A defining moment in this antitax fever was the

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19 *See id.* at 1920-23, and sources cited therein.

20 *See* Marjorie Kornhauser, *The Morality of Money: American Attitudes Toward Wealth and the Income Tax*, 70 IND. L.J. 119, 159 (1993); McCaffery, *supra* note 18, at 1894.

21 *See* MCCAFFERY, TAXING WOMEN. *supra* note 3.

22 *See* CONTRACT, *supra* note 3.

23 *See* William Gale, *Tax Reform in the Real World,* 15 YALE J. ON REG. 387 (1998) (book review).

24 *See* Alan Schenk, *The Plethora of Consumption Tax Proposals: Putting the Value Added Tax, Retail Sales Tax and USA Tax Into Perspective*, 33 SAN DIEGO L. REV. 1281, 1283 (1996).

proposal of the Tax Code Termination Act to eliminate the Internal Revenue Code as we have come to know it as of the dawn of the millennium.[25]

B. The Facts of Tax in the 1990s

With so much talk of tax, one would think that something was in fact being done. Since the monumental TRA 1986, however, tax legislation has been characterized by *ad hoc* tinkering within the basic confines of an income-plus-estate tax. Consider, for example, the principal provisions of three major pieces of 1990s tax legislation.

The Omnibus Budget Reconciliation Act of 1993 raised marginal rates a bit, reopened the preference for capital gains that TRA 1986 had briefly shut down, expanded the earned-income tax credit, increased the income taxation of social security benefits, and limited the corporate tax deduction for executive pay.[26]

The Taxpayer Relief Act of 1997 primarily accepted the principal recommendations of the *Contract* by further lowering the tax rates on capital gains and adding a $500 per child credit. It went on to essentially eliminate the taxation of gain on the sale of personal residences, increase the unified credit under the gift and estate tax to $1,000,000 over time, add a bonus for qualified family-owned businesses under the estate tax, modify the treatment of IRAs, and continue a Clinton-era theme of creating special savings provisions for health and education.[27]

The IRS Restructuring and Reform Act of 1998 added scores of relatively minor substantive provisions to its principal themes, which were the administrative overhaul of the IRS and revisions to the procedures for the collection and enforcement of taxes. Among these changes were additional lowering of the capital gains rates and more tinkering with IRAs and savings accounts.[28]

All of these changes did not add up to very much. There was no major change to the structure of the income or "death" taxes, nor was a death blow dealt to the marriage tax. No steps were taken in the direction of simplification. Within days of its passage, for example, the Taxpayer Relief Act was being dubbed the *Tax Preparer's* Relief Act.[29] The 1998 law may only have been worse. As the millennium drew to a close, politicians showed every sign of continued tinkering to come. The more things failed to change, the more they stayed the same.

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25 *See supra* note 9.

26 *See supra* note 10.

27 *See supra* note 11.

28 *See supra* note 12.

29 *See, e.g.*, Jacqueline Albus, Comment: *The Deduction for Interest on Student Loans: Relief is on the Way*, 42 ST. LOUIS U. L.J. 591, 610 (1998).

C. Barriers to Reform: The Tyranny of the Practical

Why has so little been done? There are several deep-seated structural barriers to real reform, rooted in both our politics and in our habits of heart and mind. Fundamental change in a system as large, coercive, and important as tax requires the support of the people, which in turn requires the articulation of simple, consistent principles as guides to tax reform. President Reagan was able to use both simplification and an assault on the absurdly high marginal tax rates under the income tax as his principal tools for galvanizing public opinion. Since Reagan, the Great Communicator, we have lacked an articulate and popularly accessible sense of where to go with tax reform. Everybody hates the status quo, it seems, but it is hard to build a positive agenda on negative sentiment alone. Absent some general consensus on the ideal, actual tax reform has fallen prey to what I have called the "tyranny of the practical."[30] Consider three related aspects of this.

First, tax policy, as Michael Graetz among others has pointed out,[31] seems to have become enslaved to the lure of distributive tables. Policymakers in Washington prepare charts of "winners" and "losers" from any proposed tax reform. This characterization has a quite specific meaning. "Winners" are those whose taxes will go down under a proposed change, *ceteris paribus*, and "losers" are those whose taxes will go up. The distributive tables get picked up in the popular press and consciousness. They then stand as an obstacle to further dialogue or ultimate change. Once one has seen oneself stamped as a "loser," typically on the front page of the local newspaper, it is hard to get enthusiastically on board behind any particular tax reform. Nobody likes to lose—most especially not money.

There are some unfortunate things about this political and intellectual habit. Consequences matter, of course, and distribution is one of the most important elements of tax policy. There is, for example, very good reason to believe that the flat tax is unattractive on the grounds of traditional liberal theories of distributive justice *and* in the popular consciousness. Reformers should listen to both dimensions of the case against this idea. There is no reason that the upper class should be the systematic "winner," and the middle class the systematic "loser," under fundamental tax reform. The distributive tables, painted in big broad strokes, are often telling us something important.

The questions of the distributive tables, however, are not *all* that there is to the case for tax reform. There are also problems of

30 *See* McCaffery, *Tax's Empire*, *supra* note 3, at 90-91.

31 *See* Michael J. Graetz, *Paint-by-Numbers Tax Lawmaking*, 95 COLUM. L. REV. 609 (1995).

measurement, such as whether or not one uses "dynamic" or "static" "scoring,"[32] but this really is the least of it. Our current tax system is very badly flawed—it is in many ways immoral—and yet we seem stuck in it, forever, because we are blinded by a narrow vision of dollars and cents. The distributive tables and the attendant focus on winners and losers lead us away from focusing on the bigger picture of the ideal shape of our tax system.

An alternative way to proceed would be to put the numbers aside and get the principles down right first. After all, questions of a tax's base, the "what" of taxation, are logically distinct from questions of the tax's rate structure, or the "how much" question. We can and should decide on the broad structure of the tax system first, and then design a rate structure such that we can all live with the "winners" and "losers" produced by the ensuing distributive tables. In plain terms, the tail shouldn't be wagging the dog.

Second, there has been, at times, an excessive focus on the problems of transition.[33] Once an idea for fundamental reform is floated, however tentatively, think-tanks and academics produce detailed analyses of all the headaches involved in getting from here to there. This focus on the downside of reform buttresses our natural aversion to change of any sort, and seems to consign us, forever, to the status quo. Of course change is hard. Taxes are a big part of our lives, and so changing the tax system will, no doubt, pose many difficulties, both seen and unseen. This anxiety about change is part of the reason why old taxes are good taxes, by and large, all things being equal.[34]

But all things are not equal. Things are very bad indeed. I don't think our current, complex, hybrid tax system scores particularly well on any criteria of sensible tax policy: equity, efficiency, or administrability.[35] It is a fairly simple matter for the wealthy and well-advised property-owning class to avoid paying taxes al-

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32 *See, e.g., id.* at 668-72.

33 An excellent general discussion of various tax systems and the problems of transition in getting to them can be found in AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, CHANGING AMERICA'S TAX SYSTEM: A GUIDE TO THE DEBATE (1996) [hereinafter AICPA]. *See also* JOEL SLEMROD AND JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE GREAT DEBATE OVER TAX REFORM (1996). For a classic statement of problems in making the transition to a consumption tax, *see* Michael J. Graetz, *Implementing A Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979).

34 The saying that "old taxes are good taxes," or the variant that "the only good tax is an old tax," is generally attributed to Adam Smith. *See, e.g.*, J. Mark Ramseyer & Minoru Nakazato, *Tax Transitions and the Protection Racket: A Reply to Professors Graetz and Kaplow*, 75 VA. L. REV. 1155, 1157 n.7 (1989); ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 873 (E. Cannan ed. 1937) (new taxes meet opposition from the populace).

35 *See generally* Edward J. McCaffery, *Tax Policy under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145 (1992) [hereinafter *Hybrid*]. I return to and expand on this theme in my current book project, EDWARD J. MCCAFFERY, THE NEXT GREAT AMERICAN TAX REVOLT (forthcoming 2000—manuscript on file with *Chapman Law Review*).

together, on both first- and later-generation wealth.[36] Meanwhile, the middle and lower-middle classes are hit hard by what is increasingly a wage tax system, looking at both the "income" tax per se, and the large and important payroll tax system. Two-earner families, and especially the working mothers within them, are hard hit,[37] and other problems of justice and fairness abound. When we look at the current tax system from the standpoint of principle, almost anything seems better—no matter how hard and long the route from here to there might be.

We ought not to let practical details preclude better theoretical thinking. Without first focusing on some attractive light at the end of the tunnel, we may never start the journey toward tax reform. The tail is now wagging the dog to sleep.

Third, aside from the general habits of mind that have us looking to distributive tables and questions of transition as ways of cutting off the revolution at its roots, there are a host of more particular reasons—political, intellectual, psychological—that keep us wedded to the way things are. Consider, for one very large example, how our practical bipartisan politics have played out—a story that might be most simply described as "Gridlock Happens."

Republicans, starting with Ronald Reagan, got on the antitax bandwagon and found it to be wildly successful, but they also loaded up this wagon with a good deal of baggage. Tax reform in the hands of Republicans has been linked throughout to the logically independent case against government itself or has been used in the service of supporting a narrow, socially conservative, "family values" agenda.[38] Republicans married what I take to be, and what I shall argue below to be, a sensible policy answer to the question of the ideal tax base, or the "what" of taxes—the case for consumption taxes—to a position on the appropriate rate structure, or the "how much" question. As others at this Symposium have discussed, we now have a plethora of flat-tax consumption plans floating about,[39] but there is no reason sounding in logic, policy, or principle why consumption taxes need be "flat."

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36 *See* MCCAFFERY, THE NEXT GREAT AMERICAN TAX REVOLT, *supra* note 35.

37 *See* MCCAFFERY, TAXING WOMEN, *supra* note 3.

38 *See generally* CONTRACT, *supra* note 3; CONTRACT II, *supra* note 3; both discussed in McCaffery, *Tax's Empire*, *supra* note 3. *See also* Christine Klein, *A Requiem for the Rollover Rule: Capital Gains, Farmland Loss, and the Law of Unintended Consequences*, 55 WASH. & LEE L. REV. 403, 409 (1998).

39 Lawrence Zelenak, *The Selling of the Flat Tax: The Dubious Link Between Rate and Base*, 2 CHAP. L. REV. 197 (1999); Alan Schenk, *Radical Tax Reform in the 21st Century: The Role for a Consumption Tax*, 2 CHAP. L. REV. 133 (1999); Barbara H. Fried, *The Puzzling Case for Proportionate Taxation*, 2 CHAP. L. REV. 157 (1999). *See also* AICPA, *supra* note 33 and SLEMROD & BAKIJA, *supra* note 33.

Democrats, meanwhile, ever distrustful of Republicans, paid little or no attention to tax. They confused the preferred Republican endpoint of smaller, less redistributive taxes and spending programs with one of its institutional means, tax reform. President Clinton seems to have grown especially fond of small, targeted, nonrefundable tax credits.[40] Looked at closely, this predilection, like the fondness for substantive positions such as the one favoring school uniforms, consists more of rhetoric than reality. The nonrefundable nature of the credits means that they cannot possibly benefit the 40% or so of adult Americans too poor to pay positive income tax, while their various caps and ceilings ensure that they cannot benefit the wealthiest Americans who are most likely to act on tax law incentives.[41] We are left with small, technical provisions that cost little and sound nice—serving worthy goals such as helping adoptive families or the disabled—but that do next to nothing.

In this climate, no one is advocating what is an obvious, sensible compromise. We should concede the base issue to the Republicans and the rate issue to the Democrats. This compromise would leave us with a progressive consumption-without-estate tax, a system with attractive normative properties that seems to resonate well with contemporary democratic values.[42] Yet, except for the brief moment that the Nunn-Domenici USA Tax had in the sun, no one has worked very hard to advance this sensible idea.[43]

II. THE MISSING LINKS

Rhetoric has left us with the same old dreary reality. What is to be done? In this part, I cash in on the promise of this essay's title and discuss the missing links in tax reform.

A. The People

Missing link number one is the people. The American tax system is big, coercive, and important; nearly $3 trillion, roughly one-third of our gross domestic product, gets churned through the tax

40 *See, e.g.*, Heidi Glenn & Daniel Tyson, *Clinton Throws Out First Tax Cut Chip*, 82 TAX NOTES 159 (1999). *See generally* AMITY SHLAES, THE GREEDY HAND: HOW TAXES DRIVE AMERICANS CRAZY AND WHAT TO DO ABOUT IT (1999).

41 *See, e.g.*, Jane Bryant Quinn, *The Downside of a Tax Credit for Caregivers*, WASH. POST., Jan. 24, 1999, at H2. *See also* MCCAFFERY, TAXING WOMEN, *supra* note 3, at 148-49.

42 I develop these arguments further in Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283 (1994) [hereinafter *Uneasy Case*]; Edward J. McCaffery, *The Political Liberal Case against the Estate Tax*, 23 PHILOS. & PUB. AFF. 281 (1994); Edward J. McCaffery, *Being the Best We Can Be (A Reply to Critics)*, 51 TAX L. REV. 615 (1996); and McCaffery, *Tax's Empire*, *supra* note 3.

43 *See generally* LAURENCE S. SEIDMAN, THE USA TAX: A PROGRESSIVE CONSUMPTION TAX (1997).

system each year.[44] It is simply unthinkable that we could change such a massive and massively important system without popular support, input, and understanding. Tax stands at the center of our practical political lives. It often dominates our presidential politics. The people care, passionately, about tax, yet we have very little public understanding of the real facts and possibilities of tax, and very few attempts to get more.

The people themselves can hardly be blamed fully for this sorry state of affairs. Tax is complex and it hits close to the bone. Modern life is complicated enough without expecting people to educate themselves in the nuances of public finance and policy alternatives. The passions of tax make it even harder to think clearly about it.[45] A further problem is that the people are not getting any help in their obvious hunger to replace the current disaster of a tax system with something more sensible, efficient, and fair.

One set of culprits is the politicos, the "inside the beltway" crowd, who have proven time and time again to be out of step with the American people, most recently in the extended saga of President Clinton's impeachment.[46] Insiders talk of tax in terms of "dynamic scoring" and narrow pragmatics. Talk of tax, as we have seen above, gets wrapped up and lost in other agendas, such as the Republicans' for downsizing government or the Democrats' for preserving spending programs. There is even reason to be cynical about the ultimate political will to change tax. A certain sociological tendency of bureaucracy makes tax, an already complicated subject, more and more distant from the language and concerns of everyday people.[47] At the same time, the fact that the taxing power and the threat of its exercise provides a major impetus behind campaign contributions leads one to doubt how much Washington insiders genuinely desire any radical change.[48] A similar pattern of heated rhetoric followed by icy inaction has characterized one of the other great areas of modern inertia: campaign fi-

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44 *See* BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 1998, at 307 tbl.499, 456 tbl.721 (118th ed. 1998).

45 Consider for example Hume's observation: "As violent passion hinders men from seeing directly the interest they have in equitable behavior towards others; so it hinders them from seeing that equity itself, and gives them a remarkable partiality in their own favours." DAVID HUME, A TREATISE OF HUMAN NATURE 538 (Lewis A. Selby-Bigge & P.H. Nidditch eds., 2d ed. 1978) (1740).

46 *See* Howard Kurtz, *Americans Wait for the Punch Line on Impeachment as the Senate Trial Proceeds, Comedians Deliver the News*, WASH. POST, Jan. 26, 1999, at A1.

47 *See, e.g.*, Bayless Manning, *Hyperlexis and the Law of Conservation of Ambiguity: Thoughts on Section 385*, 36 TAX LAW. 9 (1982).

48 *See generally* Richard L. Doernberg and Fred S. McChesney, *Doing Good or Doing Well?: Congress and the Tax Reform Act of 1986*, 62 N.Y.U. L. REV. 891 (1987); Richard L. Doernberg and Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913 (1987) (both articles suggesting and amply demonstrating that campaign contributions drive tax lawmaking and reform).

nance reform.[49] Tax as usual is part of business as usual. Those who are in power have won under the rules, and seem hesitant to change them.

In this climate, the academy, including lawyers, accountants, and economists, has only proven to be a second culprit. Scholars who have the time and talent to understand this kind of thing could be helping to reach out to the people, to speak of tax and tax reform in plain terms. Trapped in narrow debates among themselves, however, and concerned about appearing too "popular" or "political," the academy has been turning inward, not reaching outward.[50] Although the situation has been changing of late, with symposia such as this one being an important example of a new promise, too much tax scholarship is still too devoted to the concerns of too few people.

All of this is unfortunate, for the people seem clearly ready and willing to change—if they can be helped to see a way. Looking at general attitudes, we see that the current tax system is widely disdained. If this anger against the status quo can be translated into a popular and understandable program, then the people can get behind tax reform. We need them.

B. Principle

Missing link number two is principle. I mean "principle" in a rather precise sense, picking up on the jurisprudential ideas of Ronald Dworkin.[51] Dworkin distinguishes between concerns of "policy," where matters can be left to a net balancing of social interests—he cites as an example the decision to pursue some project in national defense, or questions about which military bases to close—and concerns of "principle," where questions of right, fairness, and justice trump any narrowly framed calculus of indi-

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49 For the interesting idea that Congress often tries to delay in order to do nothing—to "strike while the iron is cold"—*see* Roger G. Noll & James E. Krier, *Some Implications of Cognitive Psychology for Risk Regulation*, 19 J. LEG. STUD. 747 (1990).

50 A somewhat contrary tendency has appeared in a new movement of tax scholarship, to which I have often been linked, loosely called "critical tax theory." To the extent that adherents of this self-identified movement take a critical questioning and normative stance in relation to tax law, doctrine, and policy, I think that the movement is salutary and long overdue. At times, however, perhaps inevitably, critical tax theorists have also turned inward and been as trapped within their own intellectual debates as the older generation of tax law scholars of whom they are often critical. Critical tax theory itself has also become bogged down in a debate over its meanings and possibilities. *See, e.g.*, Lawrence Zelenak, *Taking Critical Tax Theory Seriously*, 76 N.C. L. REV. 1521 (1998) and the several responses to it in the same issue. For the record, I tend to think that such academic pursuits are important and valuable, but that tax *also* needs for scholars to reach out and explain things better to the people affected by it all.

51 RONALD DWORKIN, LAW'S EMPIRE (1986); RONALD DWORKIN, A MATTER OF PRINCIPLE (1985). *See also* Edward J. McCaffery, *Ronald Dworkin, Inside-Out*, 85 CAL. L. REV. 1043 (1997); Larry Alexander & Ken Kress, *Against Legal Principles*, 82 IOWA L. REV. 739, 745 (1997).

vidual interests.[52] "Equality" is a principle, for example, and when it is seen to come into play, its dictates must be followed. Thus, in an example that I think should strike home for tax reformers today, the right to equal concern and respect, to equal opportunity, that propelled the Supreme Court to overrule the "separate but equal" rule of *Plessy v. Ferguson*[53] in *Brown v. Board of Education*,[54] was a matter of principle. The fact that the transition to desegregated schools was difficult and costly, as well as the fact that this change no doubt had its "losers," did not count as arguments against the principle. Rights "trump" interests, narrowly conceived.

Now clearly tax is quite often a matter of policy—of horse trades and dollars and cents. But it is more than that. The failure to articulate a domain of principle for tax underlies and informs the current gap between rhetoric and reality. Narrow questions of distribution and transition are indeed fair game, and can often be decisive, in a narrowly policy regime, but a huge and coercive system like tax cries out for something else, and more. Democratic legitimacy demands that the state's exercise of coercive power through its tax system be principled. Tax matters.

There are two connected reasons for this commitment to principle in tax. First, there is a principle behind the need for principle. Tax is large and coercive and it affects far-reaching aspects of our social lives: the kinds of people we are and might reasonably hope to become, to paraphrase John Rawls.[55] It is a fundamental part of a reasonable conception of democratic legitimacy that power be exercised with principle.

Second, just as there is a principle of requiring principle, the case for more principle in tax draws support from pragmatic politics. In short, principle sells. There is nothing bad or disingenuous about this truth. The people cannot understand intricate debates about tax, but they can understand the core principles and commitments of alternative tax regimes. We ought to have that out, to get a chance to arrive at principles that can serve as going-forward guides to debate and reform.

We can understand these abstractions with reference to contemporary practice. The current income-plus-estate tax system rests on a principle that tax burdens should be borne according to one's "ability to pay."[56] This principle suggests an income tax,

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52 *See* RONALD DWORKIN, TAKING RIGHTS SERIOUSLY, ch. 2 (1977).

53 Plessy v. Ferguson, 163 U.S. 537 (1896).

54 Brown v. Board of Educ., 347 U.S. 483 (1954).

55 See John Rawls, *Kantian Constructivism in Moral Theory*, 77 J. PHIL. 515 (1980); JOHN RAWLS, POLITICAL LIBERALISM 269-71 (1993 & 1996).

56 For a seminal statement of the "ability to pay" norm, see Richard Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 45-46 (1967).

which differs from a consumption tax only in its inclusion of savings within the base.[57] Since savings add to a taxpayer's ability to pay, traditional tax theorists insist on including them within the tax base.

As an *a priori* matter, "ability to pay" is a perfectly compelling principle. The problem—and it is a factual problem—is that nearly a century of experience has taught us that American society is not committed to taxing savings. Thus, we have the realization requirement, supplemented with the nontaxation of most retirement savings, insurance, home equity, and human capital.[58] The practical and political inability consistently to tax the yield to capital has left us with a hybrid income-consumption tax that is badly flawed in practice and altogether ungrounded in theory. As a practical matter, the current hybrid tax is no tax at all for the rich and well-advised, especially if they presently have capital and an inclination to spend it all on themselves. That situation is a disgrace, or it ought to be, and it leaves us with no compelling principle to take to the people in arguing for any particular tax reform.

C. Policy

Missing link number three is policy, in a specific, practical sense. The previous section argued that the people cannot get involved in practical tax reform politics without some coherent principle that they can understand and endorse. We need principle. At the same time, however, principle needs policy—in the concrete, particular sense of a specific plan or proposal to carry and illustrate it. Abstractions only go so far in America. "Equality," for example, has long been a widely accepted principle, but the case of *Brown v. Board of Education* was necessary to suggest that the principle required desegregation of public schools.

In the case of tax, this all might seem hopeless. There is so much talk of tax and so little agreement. Where are the common principles, other than that everyone wants to tax someone else? There seems to be neither principle nor policy to cling to in tax. Fortunately, however, it all comes together when we step back a bit and take a calm, dispassionate look at the current lay of the land.

Let's start with two simple facts of tax logic. One, as I have mentioned above, is the recognition that questions of a tax's base are logically separate from questions about its rates. We can talk

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57 *See generally Hybrid, supra* note 35.

58 I discuss these deviations from an income concept in *Hybrid, id.*, and I return to them in chapter 4 of MCCAFFERY, THE NEXT GREAT AMERICAN TAX REVOLT, *supra* note 35.

about them separately. Let's put the more contentious rate issue aside, and focus on the base.

Two, in understanding the tax base, we have the familiar Haig-Simons definition of income to guide us. In simplified terms, this definition states that:

Income = Consumption + Savings,[59]

which tells us no more and no less than that all money is either spent or not.

Nonetheless, we can rearrange the Haig-Simons definition to see the very important point that, since

Consumption = Income – Savings,

a consumption tax is any tax that does not tax savings.[60]

These simple insights allow us to see the practical missing link in talk of tax today. Briefly and simply put:

It's Consumption, Stupid.

It turns out, on closer inspection, that all popular reform proposals feature some variant of a consumption tax. This is true of the national sales tax, the VAT tax, all popular proposals for "flat" taxes, and the Nunn-Domenici USA Tax.[61] Even more striking, the theme of consumption taxation is present in almost all "*income*" tax reform in the 1990s. Movements to lower the tax rate on capital gains, exempt the gain from the sale of homes from tax, and expand IRAs or other savings account vehicles are all the stuff of *consumption* taxation, because they retreat from an income tax's theoretical commitment to taxing savings. Our so-called income tax is already well on its way towards being a "consumption" tax in fact, and it is getting closer and closer with each and every major act of tax legislation in the 1990s.[62]

The movement towards consumption taxation is not just of practical interest. A consumption tax is appealing to both independent, abstract, moral and political theory and commonsensi-

59 *See generally* HENRY SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY (1938) and HENRY SIMONS, FEDERAL TAX REFORM (1950). *See also* Robert M. Haig, *The Concept of Income—Economic and Legal Aspects, in* THE FEDERAL INCOME TAX 1, 7 (Robert M. Haig ed., 1921), *reprinted in* READINGS IN THE ECONOMICS OF TAXATION 54 (Richard A. Musgrave & Carl S. Shoup eds., 1959). *See also Hybrid, supra* note 35.

60 *See Hybrid, supra* note 35; William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); NICOLAS KALDOR, AN EXPENDITURE TAX (1955).

61 *See, e.g.*, Schenk, *supra* note 24; SLEMROD & BAKIJA, *supra* note 33; AICPA, *supra* note 33.

62 *See generally Hybrid, supra* note 35.

cal popular morality, because a consumption tax rests on a principle that we can indeed endorse and take to the people:

> We should consistently tax spending, not work or savings.

This simple principle goes a surprisingly long way in crafting practical tax reform proposals. It not only suggests a more systematic exemption for savings than our present hybrid income-consumption tax features, but it also has relevance for such contemporary debates as that over "death" taxes. Specifically, the principle of taxing spending, and spending alone, suggests that we should indeed abolish the estate and gift tax for one simple reason: Dead men don't spend.

An estate tax falls only on savings, or nonconsumed wealth.[63] As such, it encourages and rewards consumption; it encourages the wealthy elderly to spend down their wealth in one grand final binge, and discourages and penalizes savings, especially, and indeed only, long-term, inter-generational savings. It is an anticonsumption tax. Further, under the consistent principle of a consumption tax, no death tax is needed, even in the cause of fairness or justice. A consistent consumption tax can tax the *heirs*, when and as they spend the wealth, as current law systematically fails to do.

The careful reader will have noticed that I have not yet said anything of substance about the appropriate tax rates. This omission is by design, following the first fact of tax. The consistent principle we have thus far developed is about the "what" of taxes. Now, however, having agreed on a consumption tax base, there are compelling reasons to advocate maintaining the historic American commitment to progressive effective tax rates.

Once again looking at the practical proposals—since part of the idea, after all, is to pay respectful attention to the people[64]—all of these turn out not to be "flat" taxes at all, but rather to be two-rate plans, with some kind of rebate or zero bracket for the lower income or consumption levels.[65] Under a consistent consumption tax, and under a general tax system now committed to the principle of being principled, accommodation for the first dollars of a family's spending can be seen to rest on another compelling principle:

> Spending on life's necessities should bear a lower rate of tax than spending on life's ordinary matters.

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63 I elaborate on all these arguments at much greater length in *Uneasy Case*, *supra* note 42.

64 This is my central argument in McCaffery, *Being the Best We Can Be*, *supra* note 42.

65 *See* Zelenak, *supra* note 39.

This same principle can support reasonable exclusions under a consumption tax base, such as for medical or education expenses. What we would have, which we now lack, is a consistent principle against which to measure these "special" provisions.[66]

Having said that, there is no reason to pull up short and stop the argument for progression at the lower and middle classes. In point of fact, the experience of practical politics suggests that while the flat tax plans are initially attractive, the bloom soon fades from the rose.[67] Once the distributive tables are trotted out showing that all popular flat-rate tax plans, which tend to feature something like a 20% marginal rate, would in fact involve a tax *increase* on the middle classes to pay for a tax *decrease* for the rich, the appeal of this radical tax plan fades. And why shouldn't it? What's fair about making the middle classes, who have suffered enough under the current disaster of a tax system, pay a dollar price for its improvement, while the rich get richer?

Now, once again, we are committed to principle. Stating these attitudes in principled fashion leads to the following:

> Spending on life's luxuries should bear a higher rate of tax than spending on life's ordinaries, which should bear a higher rate of tax than spending on life's necessities.

And, voilà, we are done. We have made the case for a progressive consumption-without-estate tax. Note that, just as the consumption and anti-estate tax elements were grounded in both current popular democratic norms and some sense of ideal political theory, so too with the progressive element. Americans have consistently shown support for at least moderate progressivity in the tax system.[68] This arrangement strikes us as fair; liberal political theory supports it; and we can see it in the current political winds, most importantly in the ultimate disillusionment with the flat tax.

D. A Modest Proposal

We have developed important governing principles for tax, looking both to popular attitudes and moral theory. All that remains to be done is to wrap these principles into a coherent policy proposal, one that the people can understand and endorse. Then our missing links will have been supplied.

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66 *See generally* William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972); Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343 (1989).

67 *See* Zelenak, *supra* note 39.

68 *See* Marjorie Kornhauser, *supra* note 20; Peggy A. Hite and Michael L. Roberts, *An Experimental Investigation of Taxpayer Judgments on Rate Structure in the Individual Income Tax System*, 13 J. AM. TAX. ASS'N 47 (1991).

It is not all that difficult to implement our principles. Practical proposals exist, such as the Nunn-Domenici USA Tax Plan,[69] which get pretty close to doing just that. Starting with current law, we would have to take just three or four basic steps:

(1) allow unlimited IRAs or other savings accounts;

(2) repeal the gift and estate tax and allow IRAs or other tax-free savings accounts to be transferred with zero basis;[70]

(3) include debt in the tax base, to prevent arbitrage;[71] and,

(4) if we wanted to, we could even raise the progressive marginal rates at the high end, so that we would have, in essence, a general luxury tax in place.

What is most important about this modest proposal is that principle has been its guide. Officials must make reforms with core commonsensical beliefs in mind. This would help us to have a tax system open to public scrutiny and accountability—properties highly and independently attractive to ideal political theory.

To keep the conversation going, consider some simplifying moves. Imagine this. We put in place a national sales tax at, say, a 15% rate. There are technical reasons to prefer a value-added tax to a literal sales one, but this comes out to much the same place for our purposes.[72]

To create a "zero bracket," we give a rebate to consumers, say for spending of up to $5000 per person. There are several ways to do this, including by allowing an exemption from Social Security contributions. Although the typical American family of four would pay $3000 in sales taxes on its first $20,000 of consumer purchases, they would get this money back via the rebate, effectively netting out at a 0% tax rate over this initial range of spending.

To create a higher bracket for high-end consumption, we next set up an individual consumption tax, such as the one proposed by then-Senators Nunn and Domenici in the mid-1990s.[73] By allowing unlimited deductions for savings, such a tax isolates out

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69 *See* SEIDMAN, *supra* note 43; SLEMROD & BAKIJA, *supra* note 33; AICPA, *supra* note 33.

70 Note, importantly, that this proposal does not mean that heirs are getting off the hook. They would pay tax when and as they spent their inheritance, in withdrawing from the accounts. This situation is as it should be under a consistent consumption tax.

71 *See generally* Alan J. Auerbach, *Should Interest Deductions Be Limited, in* UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX (Henry J. Aaron et. al. eds., 1988). If this strikes us as too radical—even though a sales tax, the most commonly understood form of consumption tax, similarly reaches out to include spending out of debt—we might have an even more systematic interest deduction limitation than current law now has. I.R.C. § 163 (1994 & Supp. III 1997).

72 *See generally* AICPA, supra note 33, for a discussion of the value added tax versus sales tax.

73 *See generally* SEIDMAN, *supra* note 43.

consumption. Because everyone would already be paying tax under the 15% national sales tax, we could have a large exemption level from this so-called Supplemental Consumption Tax.

Imagine, for example, that we exempted the first $100,000 that a family of four spent. Only those Americans spending more than this high level need to be concerned with the supplemental tax. This step would remove tens of millions of Americans from the annual tax rolls. The supplemental tax could be levied at a flat rate, again say 15%. Then, spending over $100,000 would bear the regular 15% sales tax, plus the 15% supplemental tax, for a combined marginal tax rate of 30%.

Voilà. We are done. We now have a tax system economically equivalent to a progressive national sales tax, with a rate structure that looks as follows:

TABLE 1: TAX RATES UNDER A PROGRESSIVE NATIONAL SALES TAX

SPENDING	TAX RATE
$0 to $20,000	0%
$20,000 to $100,000	15%
over $100,000	30%

The progressive national sales tax would relieve most Americans from the burden of filling out annual tax forms. It would systematically exempt savings from tax, and thus in one stroke greatly simplify the law. Yet, it would also maintain our historic commitment to some progression in tax rates and avoid the absurdity of raising taxes on the middle classes to lower them on the upper classes. We could easily maintain the most popular and important features of the present tax system, such as home mortgage interest deductions, charitable contribution and extraordinary medical expense deductions, and additional exemptions for children and other personal dependents.[74]

The call for a progressive national sales tax actually isn't too crazy. It is similar to proposals independently put forth by former Representative Sam Gibbons, a Democrat from Florida,[75] and Professor Michael Graetz of Yale Law School.[76] Both Gibbons and Graetz would have a broad-based national sales or value-added tax, supplemented with a continuation of the current income tax

74 *See* I.R.C. §§ 163(h) (home mortgage interest deduction), 170 (charitable contribution deductions), 213 (extraordinary medical expense deduction), and 151 (personal dependency exemptions) (1994 & Supp. III 1997).

75 *See* H.R. 4050, 104th Cong. (1996).

76 *See* MICHAEL J. GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX (1997).

for high earners. Because I consider the actual income tax to be a failure, and the very idea of taxing savings to be misguided, my proposal instead keeps a consistent focus on consumption. Indeed, under a progressive national sales tax, we can even eliminate the gift and estate, or so-called "death," taxes, because a consistent consumption tax would fall on anyone who spends, parent, child, or heir, when and as she spends. Under the progressive national sales tax, there is no need for the costly, confusing, inefficient and unpopular death tax.

The important thing, however, is not the smallest of specifics. The devil may be in the details, but we ought, at least, to look for angels first. The modest proposal is a consistent and progressive consumption tax, and that's a practical policy proposal that the American people can understand and endorse. It's also a long way from where we are today.

III. Conclusion: Where There's a Way?

As we stand at the dawn of the millennium, the state of tax is a state of disgrace. Our major federal tax, the nominal income-plus-estate tax, is complicated, costly, inefficient, and unfair. The rich and clever can avoid paying taxes altogether, while the middle classes continue to toil under what has become, with the increasingly important social security system factored in, an onerous wage tax system. The people have noticed, and the income tax and its administrators are among the most loathed of our public institutions. Yet they are also among the most important. We cannot get around the central fact of modernity that tax is big, coercive, and wide-ranging in its effects. In short and in sum, tax stinks. And as long as it does, our great democracy is hindered from reaching its full potential.

The people's anger alone is not sufficient to effect change. This is the lesson that the last decade of radical antitax talk has taught us. The people need some sense of where to go. They need help in seeing some light—any light—at the end of what might seem to be more a bottomless pit than a tunnel. If the people are our first missing link in tax reform, principle is our second, for the people need some set of ideals to rally around.

Fortunately, with a little bit of intellectual work, it is indeed possible to discern principles in the cacophony of antitax talk. A principled reading of democratic values and norms gives us reason to hope that a progressive consumption tax may one day arrive. Using what we know and have learned about tax, it is possible to package these principles in an attractive policy proposal, for what is, in essence, a progressive national sales tax. Such a plan effects a Grand Compromise between Republicans calling for a consump-

tion tax base and Democrats wishing to maintain at least a moderate degree of progressivity in our laws. It is a good, fair, efficient, and sensible thing to do. With any luck at all, we just might do it.

Until that day, we can at least aspire to abide by the Hippocratic oath: do no harm. Rather than continue to tinker with our tax system, we ought to let principle be our guide in the small, as well as in the large. We should strive in each and every tax act to get a fairer, simpler, more sensible law, by taking even more systematic steps in the direction of a consumption tax and maintaining progressive rates on spending, even as we eliminate taxes on savings altogether. We should keep trying to get lower and middle-class Americans off the tax rolls, for filling out an annual tax form has become one of modern life's worst horrors. One day, just maybe, we will get to a better place in our most important system of social and economic control. Until that day, let's not make things worse.

CORRESPONDENCE

Some Comments on *Our Constitutionalized Adversary System* by Monroe H. Freedman

*Marvin E. Frankel**

It is probably fitting at the outset to acknowledge that this critical comment is "inspired," to choose a doubtful word, by discovering my name and some of my phrases scattered unflatteringly through the pages of Professor Freedman's article.[1] I will devote only slightly excessive space to personal rejoinders. Instead, I attempt to state the issues more soundly, and propose that suggested reforms (not abolition) of the adversary system are not necessarily sacrilegious.

For openers, and most fundamentally, it should be noted that the central problem about which I have written, steadily obscured by Professor Freedman, has to do with seeking *factual truth* in litigation. My initial venture into this field of debate began with a lecture prompted by some years of observing from the bench the daily practices of obfuscation and downright perjury that often disfigure our trial proceedings. Coining a word meant to reflect the American trial judge's odd role, somewhere between "umpire" and "referee," I gave my piece an arch title that I would probably improve on in my now more advanced old age: *The Search for Truth: An Umpireal View*.[2] Be that as it may, the gist of that article was complaints about distortions of *factual truth* in the court-

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1 Monroe H. Freedman, *Our Constitutionalized Adversary System*, 1 CHAP. L. REV. 57 (1998).

2 Marvin E. Frankel, *The Search for Truth: An Umpireal View*, 123 U. PA. L. REV. 1031 (1975).

room, and some incipient suggestions for *reform*—not, for heaven's sake, abolition—of the adversary system. The article became a substantial portion of the little book[3] in which Professor Freedman finds ominous threats to the Constitution and the liberties of Americans.[4]

On the other hand, the Professor has a chronological jump on me in the business of adversariness and the truth. In 1966, he published one of the most debated articles in the history of law review controversy. The article was entitled *Professional Responsibility of the Criminal Defense Lawyer: The Three Hardest Questions*.[5] Those "three hardest questions" were the following:

1. Is it proper to cross-examine for the purposes of discrediting the reliability or credibility of an adverse witness whom you know to be telling the truth?
2. Is it proper to put a witness on the stand when you know he will commit perjury?
3. Is it proper to give your client legal advice when you have reason to believe that the knowledge you give him will tempt him to commit perjury?[6]

Professor Freedman tendered affirmative answers to each of these questions. These responses presumably reflected the way he practiced as a criminal defense lawyer, and thought that everyone should. In the intervening years, the Code of Professional Responsibility, to which he now pays tribute, overruled him on the second question,[7] and he confessed error on the third.[8] I think he purports to live comfortably with his answer to the first question. The reader may judge whether it is fitting in a learned profession to pursue the trail of falsity in the manner Professor Freedman's answer proposes.

In any case, I think it makes professional sense to join issue on such specific questions, and that there is room for answers both ways. The fact of major interest for this reply, however, is that Professor Freedman has substantially abandoned the field on which his present article purports to be engaged with me and others, and has distorted the real issues about what, if anything, needs to be done to improve the adversary process as we have tended to administer it.

The most notable fact about Professor Freedman's article is that he chooses to mount a passionate defense where nobody has undertaken an attack. He cites a number of cases in which the

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3 MARVIN E. FRANKEL, PARTISAN JUSTICE (1980).

4 Freedman, *supra* note 1, at 64, 66, 73-75.

5 Monroe H. Freedman, *Professional Responsibility of the Criminal Defense Lawyer: The Three Hardest Questions*, 64 MICH. L. REV. 1469 (1966).

6 *Id.* at 1469.

7 MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 7-26, DR 7-102(A)(4) (1981).

8 MONROE H. FREEDMAN, LAWYERS' ETHICS IN AN ADVERSARY SYSTEM 71-76 (1975).

Supreme Court has written glorious chapters of *constitutional law* by ordering school desegregation, upholding the right to litigate in constitutional cases, sustaining the right of free speech, and otherwise elaborating treasured rights under the Constitution.[9] None of these cases remotely approaches the specific issues—related to *factual controversies*—between the Professor and me. The decisions he cites did not involve issues of fact or concerns about trying issues of fact. I believe it unnecessary to protest my attachment to the great constitutional rulings Professor Freedman defends against me. On the other hand, noting that he does not mention his "three hardest questions," I find it bemusing that he now chooses to create ersatz disputes, while defining out of existence the genuine subjects of legitimate disagreement.

I should note, by the way, that the furor generated by Professor Freedman's 1966 article included regrettable attacks upon him from places as high as the chambers of the then Chief Justice of the United States, whence proposals for his disbarment were heard to emanate.[10] The legitimacy of the Professor's expressions as subjects for honest discussion should never have been doubted, and I never doubted it. What I not only doubt, but thoroughly regret, is the tendentious and intellectually bankrupt form in which he recasts the problem and distorts the genuine concerns.

The major point I want to make in this short submission is that it little profits to mount arguments whether we should "replace or radically reform the adversary system."[11] Insofar as Professor Freedman poses a series of questions about whether we should preserve the right to counsel, the right to a jury trial, the right generally to be heard and to submit evidence in opposition, this is a parade of straw men that can lead to no place useful.

Finally, circling back to the provocations that led to this intervention, and before suggesting more concretely some of the real problems, let me say that Professor Freedman's quotations from and representations of my sundry positions are not a reliable source for learning about those things. I select a couple of examples. The Professor says that I have "proposed significant restrictions on confidentiality that would subordinate clients' interests to those of nonclients."[12] For that he cites my 1980 book, without page reference. This is a broadside that lacks rudimentary fairness. I think I do recall raising the question, without stopping now to find the exact place, whether a confidence disclosing that the client committed a crime for which someone else is languish-

9 Freedman, *supra* note 1, at 66-73.

10 For a brief discussion of the immediate reaction to Professor Freedman's 1966 article, see FREEDMAN, *supra* note 8, at viii.

11 Freedman, *supra* note 1, at 73.

12 *Id.* at 58.

ing in prison or facing execution could be breached in a civilized system of justice. If that is the kind of subordination that worries Professor Freedman, it may merit discussion in specific terms, but not in terms of the unmanageable generality he chooses to assert.

One more example will serve to sufficiently prolong this aggravation. The Professor says that "Frankel . . . recognizes . . . that his proposals for change run counter to constitutional interests in 'privacy, personal dignity, security, autonomy, and other cherished values'."[13] For this he cites page 12 of my book, and I reproduce in the margin the passage from which he quotes.[14] If anyone can find in that passage where I made proposals running "counter to constitutional interests in privacy, personal dignity, security, autonomy, and other cherished values," I will simply plead that the passage was not meant to say—and I do not now read it to say—anything of the sort.

These examples are enough, in any event, in the way of personal protests. Outside the teapot in which academic tempests rage, there are real and difficult questions about how we undertake to deal with the factual histories that lead to legal judgments. Our methods for handling this age-old problem are no more final or eternal than was trial by ordeal or compurgation. The notion that they are sacrosanct is silly. Efforts to improve them are necessary and should be welcomed. Invocations of the Constitution and other sacred texts against would-be reformers are ill-calculated to move us toward a better legal world.

There is no meaningful practical question, though Professor Freedman purports to discern one, about abolishing the adversary system and substituting an inquisitorial system. There is no need for anyone in 1998 to be taking over 30 pages and 200 footnotes to defend "Our Constitutionalized Adversary System" against the onslaughts of those who stand "for abandoning the adversary system in favor of the inquisitorial system."[15] There are no such on-

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13 *Id.* at 73.

14 "Like any sweeping proposition, the claim that our adversary process is best for truth seeking has qualifications and limits recognized by its staunchest proponents. While it would not be essential, we have again the high authority of the Supreme Court pronouncements noting that lawyers in the process are often expected, with all propriety, to help block or conceal rather than pursue the truth. These endeavors are commonly justified in the service of interests that outweigh truth finding—interests in privacy, personal dignity, security, autonomy, and other cherished values. The problem of how to weigh the competing values is, obviously, at the heart of the concerns to be addressed in these chapters. Nobody doubts that there are ends of diverse kinds, at diverse times and places, more worthy than the accurate discovery or statement of facts; that there are even occasions, not easily defined with unanimity, when a lie is to be preferred. One way to state the thesis of this book is to say, recognizing the complex relativities of life, that the American version of the adversary process places too low a value on truth telling; that we have allowed ourselves too often to sacrifice truth to other values that are inferior, or even illusory." FRANKEL, *supra* note 3, at 12.

15 Freedman, *supra* note 1, at 85.

slaughts requiring heavy defenses. The meaningful subject is not about wholesale "system" changes, but about concrete, specific, real-life issues—the kind familiar to common-law (and other) lawyers—as to whether we can find remedies for the specific defects in our adversary process that continue, after generations of debate, to create dissatisfaction, both within and outside the bar, with the way our litigation practices work. We know that there are palpable reasons for the lay impression—sometimes well founded, sometimes not—that lawyers are more prone than they should be to shade or block factual truth in the interest of winning their cases. That is the central subject for legitimate debate—not, forsooth, whether *Brown v. Board of Education*[16] should be overruled.

When Professor Freedman raised his three hardest questions, and gave his unsound answers, he was in the target area. He knew, and we all still know, that lawyers, in numbers, practice in accordance with his prescriptions. Comparable issues continue to plague us. Another well-known law professor proclaimed recently, from his seat near Boston, that in his frequent representations of criminal defendants, he never asks the client to say whether he did the deed. He correctly observes that his practice, in this respect, is widespread in the criminal defense bar. Think of that practice for a minute. A learned professional deliberately *avoiding* knowledge of the problem he or she is engaged to address. Picture the physician who refrains from asking where it hurts, or the engineer who chooses to be ignorant of the subsurface conditions in the place where the foundation is to be laid. Think of what these comparisons tell us about the concern for truth on the part of lawyers who say they do not want to know, and, indeed, about whether the lawyers claiming to work behind blindfolds are really being candid with themselves or you when they make that claim.

Let me suggest that the lawyers making this claim do not and cannot mean exactly what they say. Imagine the case of a defendant client who is actually innocent, as all are presumed to be. No conceivable lawyer—certainly none of the sophisticated types that we are talking about—would fail to learn everything that that client knows in order to avoid the horrible miscarriage of justice that a guilty verdict would accomplish. So what is really meant by the "don't ask, don't tell" variety of lawyers? They mean, as a practical matter, that they do not ask because they know, in fact, that the client is guilty, but want to remain in a state for which the ugly word "deniability" was coined not long ago.

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16 Brown v. Board of Educ., 347 U.S. 483 (1954).

The lawyers that follow this course represent only one instance, if a striking one, of the games lawyers in our forms of the adversary system feel entitled to play. They have no hesitation to announce this publicly. Interestingly, this practice flies in the face of the fact that the *Model Code of Professional Responsibility* forbids a lawyer "knowingly . . . [to] make a false statement of law or fact" or to "use perjured testimony or false evidence."[17] The *Model Rules of Professional Conduct*, followed now in more states than the *Model Code*, contains substantially identical prohibitions.[18] Despite such rules, our views about privileges and zealous lawyers are thought, tacitly and openly, to countenance ambiguities that make it comfortable for lawyers to wink at the notion of pursuing truth in the courthouse. Real questions arise as to whether we could revise this kind of deception and self-deception without impairing worthwhile values of the adversary system.[19]

Without pursuing in detail this or comparable questions in the brief space generously given for this Comment, I simply mention that our adversary system has opened the way for a variety of debatable tactics by our public and private "officers of the court," as we lawyers are proudly labeled. Are we pleased with prosecutors who, having heard of the presumption of innocence, announce indictments as if they were convictions? Or defense lawyers, who know the difference between witnesses and counsel, proclaiming on the courthouse steps the entire innocence of their clients? Think what we have wrought with the wonderful *Miranda* warnings, under which an ignorant suspect can waive his or her way into prison, while a knowledgeable hood pays no attention, knowing and confidently exercising the right to keep still.[20] Consider whether our vaunted system of ideal trial procedures might be related to the facts that (1) we have the most severe sentencing ranges of almost any country in the world, and (2) we alone in the West have, and are increasingly using, capital punishment. Is our trial system fine beyond needs for serious reform when one of our greatest judges, Learned Hand, found it appropriate to express his famous dread?[21] Or when, blessed with that perfect system, 90% of defendants choose plea bargains over the right to be tried?[22] Is it possible, with the sentencing guidelines and other causes of en-

17 MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 7-102(A)(4) & (5) (1981).

18 MODEL RULES OF PROFESSIONAL CONDUCT Rule 3.3(a)(1) & (4) (1997).

19 *Cf.* Marvin E. Frankel, *Clients' Perjury and Lawyers' Options*, 1 J. INST. FOR THE STUDY OF LEGAL ETHICS 25 (1996).

20 *See* FRANKEL, *supra* note 3, at 95-99.

21 "I must say that, as a litigant, I should dread a lawsuit beyond anything else short of sickness and death." *Quoted in* JEROME FRANK, COURTS ON TRIAL: MYTH AND REALITY IN AMERICAN JUSTICE 40 (1949).

22 *See* BUREAU OF JUSTICE STATISTICS, OFFICE OF JUSTICE PROGRAMS, U.S. DEP'T OF JUSTICE, COMPENDIUM OF FEDERAL JUSTICE STATISTICS, 1996, at 1 (1998) (noting that 91% of federal felony convictions in 1996 were through plea bargains).

hanced prosecutorial power, that the *ex parte* decision to indict has become the main event, and the classic trial largely a vestigial appendix?

I do not propose to answer these rhetorical questions here. I pose them merely to note that Professor Freedman's simplistic view of the adversary system, if it ever could have been significant, is at best an irrelevant anachronism.

The short of this subject is, I think, that orations about the system, and whether it should be replaced by another system, are beside the point. The system we have will remain in place for the long future, changing only at a glacial pace, the way that systems in a democracy generally change. Taken all in all, it is by no means a bad system. Nevertheless, a key office for scholars includes the perception and understanding of defects, followed by the formulation of remedies. The office is not well served by distorting the problems and conquering windmills.

COMMENT

Oversimplification: Value and Function: Wetland Mitigation Banking

S. Scott Burkhalter

I. INTRODUCTION

> One morning . . . I rose early to see the sun come up. I was rewarded by moonflowers heavy with dew. They are white and as large as morning-glories. They close by day and open by night. I walked to the shore line to see what had been abroad. There were raccoon tracks on the beach. Not far offshore a small spit of sand showed. A mangrove had taken root there, sending down long tentacles from its branches that formed roots and gave the appearance of a tree on stilts. These roots were beginning to catch the debris of Florida Bay. Eventually that debris would accumulate, additional sand and marl would deposit, and in time a new key would be formed . . . Man tampered dangerously with this delicate balance . . . Settlers moved in and towns grew . . . [D]rainage canals to the oceans were dug; and farmers started tilling the rich peat land that had lain for centuries under the fresh waters . . . Endless acres of saw grass became dry. The great flights of birds went south, looking for water holes, and found only brackish water. The rich peat land shrunk and oxidized under the intense sun . . . The Everglades were dying.[1]

Historically, the destruction of wetlands in the United States has steadily increased from one generation to the next. The Environmental Protection Agency (EPA) has estimated that more than one million acres of U.S. wetlands were destroyed between 1985 and 1995.[2]

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1 WILLIAM O. DOUGLAS, MY WILDERNESS: EAST TO KATAHDIN 127-28, 135 (1961).

2 *See* John H. Cushman, Jr., *Nation's Wetlands Continue to Vanish; 1 Million Acres Disappeared From 1985 to 1995, U.S. Reports,* BALTIMORE SUN, Mar. 8, 1998, at B15. *But*

In an effort to prevent further destruction of these valuable resources, the federal government and the states have implemented legislation to protect wetlands or to at least minimize the adverse effects that people have on them.[3] One such mechanism to preserve wetlands is mitigation banking.

Mitigation banking is "a system in which the restoration, creation, enhancement, or preservation of wetlands is recognized by a regulatory agency as generating credits that may be used to compensate for multiple wetland impacts occurring generally within the same watershed as the banked wetlands."[4] Mitigation banking is a useful tool to preserve vast acres of wetlands and their inherent values.[5] However, mitigation banking may also be a simple device used by developers to offset development costs and circumvent accountability to the environment.[6]

Various techniques are used in the mitigation banking context to assess wetland characteristics, ranging from simple, limited indices to broad, ecologically comprehensive assessments.[7] A serious question exists concerning the consequences of using one technique as opposed to another. Specifically, current data suggests that the majority of mitigation banks use simple indices, the result of which is the potential loss of valuable ecosystems with their attendant contribution to the overall integrity of the natural environment.[8]

This comment questions the techniques used to value mitigation banking credits in mitigating unavoidable wetland loss and concludes that successful mitigation banking requires the use of broad, ecologically comprehensive methods for valuing mitigation credits to assure adequate compensation for destroyed or impacted wetlands in development projects.

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see VIRGINIA S. ALBRECHT & BERNARD N. GOODE, P.E., WETLAND REGULATION IN THE REAL WORLD ix, Appendix A (1994) (the actual loss of wetlands is often overstated).

3 *See* 33 U.S.C.A. § 1344 (West 1986 & Supp. 1998) (Section 404 Dredged and Fill Material Discharge Permit Program). *See infra* Section III.

4 ENVIRONMENTAL LAW INSTITUTE, NATIONAL WETLAND MITIGATION BANKING STUDY, WETLAND MITIGATION BANKING v (Institute for Water Resources (IWR) Report 94-WMB-6 Feb. 1994) [hereinafter ELI, MITIGATION BANKING STUDY]. The Institute for Water Resources has, and continues to conduct, a series of studies on wetland mitigation banking. The objectives of the studies are to evaluate the feasibility and appropriateness of wetland mitigation banks. *See id.* at 2.

5 *See id.* at 127; for example, Minnesota Wetland Habitat Mitigation Bank (1750 acres), South Carolina Department of Transportation (Bank) (1000 acres), Louisiana Department of Transportation and Development (Bank) (2944 acres), Fina LaTerre (7014 acres). *See id.* at 142-44.

6 Telephone Interview with Elizabeth White, EPA Region Nine, Water Resources, Coordinator on Mitigation Banking, U.S. Environmental Protection Agency (Apr. 7, 1998) [hereinafter White, Interview].

7 Generally, simple indices, narrowly tailored, and broadly tailored. *See* ELI, MITIGATION BANKING STUDY, *supra* note 4, at 63-64. *See infra* notes 270-345 and accompanying text.

8 *See infra* notes 281-97 and accompanying text.

Following this introduction, Section II recognizes that the destruction of wetlands continues at an alarming rate, and examines California's response to that destruction. Section III presents the federal government's response to the destruction of wetlands under the section 404 permit process. Section IV discusses the component of the section 404 permit process that requires permit applicants to compensate for unavoidable adverse impacts to wetlands occurring in the applicants' development projects. Section V discusses the concept of wetland mitigation banking and highlights the techniques used to value mitigation credits in compensating for unavoidable wetland loss. Section VI questions the various techniques used in valuing mitigation credits and suggests that an ecologically comprehensive method is needed to prevent further loss. Section VII compares the ethical considerations of using simple indices versus using ecologically comprehensive methods for assessing wetland values and functions. Section VIII suggests some solutions to valuing wetland function and values. Finally, Section IX concludes that wetland mitigation banking is a useful form of mitigating adverse impacts on wetland loss as a result of development, but that the success of mitigation banking depends upon using ecologically comprehensive methods of valuing mitigation credits.

II. THE DECLINING WETLANDS

The EPA estimates that more than one million acres of wetlands were destroyed between 1985 and 1995 and that 70,000 to 90,000 acres of wetlands on nonfederal, rural lands are lost each year in the United States.[9] As of 1993, only 10% of the total wetlands located in California prior to European settlement remained.[10]

Wetlands serve important public interests, including: 1) natural biological functions;[11] 2) wildlife sanctuaries; 3) drainage; 4)

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9 *See* Environmental Protection Agency, *U.S. Map: Wetland Loss Index-1780s-1990s* (last revised Oct. 27, 1998) <http://www.epa.gov/surf2/iwi/1998oct/ii7_usmap.html#why> [hereinafter EPA, *Wetland Loss*]. *See also* Cushman, *supra* note 2.

10 *See* CALIFORNIA STATE COASTAL CONSERVANCY, OPTIONS FOR WETLAND CONSERVATION: A GUIDE FOR CALIFORNIA LANDOWNERS 7 (1994) [hereinafter GUIDE] ("The Central Valley once had . . . over some 4 million acres; these have diminished to a mere 300,000 acres."); California Resources Agency, *Major Gains Achieved in State Wetlands Management; 78,000 acres of Additional High-Quality Wetlands; Unique Internet Site Unveiled, Added to "CERES"* (Jan. 24, 1996) <http://www.ceres.ca.gov/CRA/PressReleases/wetlands-site_012496.html> (in 1996 "a total of over 529,000 acres of high-quality permanent wetlands" existed in California). The California Resources Agency tracks existing wetlands from various federal and state agencies. The data (consisting of 273 projects) shows a significant increase in wetland acreage as a result of acquisition, restoration, enhancement, or creation. The largest increase was a result of wetland enhancement and the smallest increase derived from wetland creation. *See also* California Resources Agency, *Statewide Wetland Tracking* (modified Aug. 26, 1997) <http://ceres.ca.gov/wetlands/tracking.html>.

11 For example, food chain production, animal habitat, and spawning ground.

flood control; 5) erosion and storm damage barriers; 6) groundwater maintenance; 7) filtering systems;[12] and 8) aesthetic and recreational value.[13] According to the EPA and the United States Fish & Wildlife Service (USFWS), wetlands provide critical habitat for over one-third of all federally listed threatened or endangered species.[14] Similarly, "[b]etween 60 and 90% of all fish caught commercially . . . use wetlands as a spawning ground and nursery."[15]

As these factors suggest, the loss of our nation's wetlands has had a very negative impact on the environment. In response to this problem, the federal government and the states have developed strategies to encourage landowners to protect these valuable resources. Additionally, federal and state laws are becoming increasingly stringent, requiring permits prior to interfering with wetland values and functions in order to compel landowners to take a prospective approach to preserving wetlands.

In California, for example, the California Resources Agency has identified several strategies for the effective protection of wetlands, including: 1) conservation easements; 2) remainder interests; 3) management agreements; 4) limited development strategies; 5) leases; 6) transfer of full title; and 7) the voluntary landowner incentive program.[16]

A conservation easement is established when landowners transfer their rights to use property containing wetlands to a nonprofit conservation organization or government agency.[17] The nonprofit organization or government agency then ensures that the property is maintained in a manner such that its natural, agricultural, scenic or historic value is protected.[18] In return, the landowner may be compensated for the easement, receive a tax deduction, or simply enjoy the personal satisfaction gained from contributing to the preservation of a natural resource.[19]

A remainder interest in property is created when landowners transfer full or partial title to a nonprofit organization or government entity upon their death.[20] Similar to the conservation easement, the effect is the protection of the valuable resource conveyed

12 For example, water purification, and water quality.

13 *See* EPA, *Wetland Loss*, *supra* note 9. *See also* GUIDE, *supra* note 10, at 6; 33 C.F.R. § 320.4(b) (1998) (general policies for evaluating permit applications).

14 The Wildlife Society, *Wetlands, Mitigation and Mitigation Banking* (visited Feb. 18, 1998) <http://www.wildlife.org/wet.html>. *See also* EPA, *Wetland Loss*, *supra* note 9.

15 *Id. See, e.g.*, Steve LaRue, *Wetlands Vital to Fishing Industry, Report Claims*, SAN DIEGO UNION & TRIB., Oct. 1, 1993, at B3.

16 *See generally* GUIDE, *supra* note 10.

17 *See id.* at 9.

18 *See id.*

19 *See id.* at 9-10.

20 *See id.* at 10.

to the government entity or nonprofit organization.[21] In return for the dedication of a remainder interest, the landowner is entitled to a tax deduction in "proportion to the anticipated length of time [before the nonprofit organization or government entity] takes over the interest."[22]

A management agreement is an agreement between a nonprofit organization or government agency and the landowner.[23] Typically, such an agreement provides that the landowner will preserve or restore the natural integrity of the property in exchange for financial compensation and technical expertise.[24]

For landowners who wish to derive income from the use of their property, a limited development strategy may be available.[25] This strategy provides for partial development on the property, while protecting its more environmentally significant and sensitive areas.[26] In effect, the strategy places the land in trust, and simplifies and expedites the necessary development approvals.[27]

Leases to a nonprofit organization or government agency provide the landowner with a steady source of income while protecting the valuable resource.[28] Generally, leases last for 15 to 25 years and are negotiated between the landowner and the respective entity.[29]

The transfer of full title ensures the permanent protection of the natural resource.[30] The landowner transfers ownership by either sale or donation,[31] and is relieved of all tax and other liabilities for the property.[32]

Voluntary landowner incentive programs are designed to encourage the landowner to enter into a management agreement with a nonprofit organization or government agency for a financial or personal return on the "use value" of the property.[33] Such pro-

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21 *See id.*

22 *Id.*

23 *See id.* at 10-11.

24 *See id.*

25 *See id.* at 11. Two groups with experience with this technique are The Trust for Public Land and The State Coastal Conservancy. *See id.* at 12.

26 *See id.* at 11.

27 *See id.*

28 *See id.* at 12.

29 *See id.*

30 *See id.*

31 Donation entitles the landowner to a larger tax deduction than donation of a conservation easement. *See id.*

32 *See id.*

33 *See id.* at 15-27. Examples are: Agricultural Conservation Program, Water Bank Program, Wetland Reserve Program, Partners for Wildlife, California Waterfowl Habitat Program, Permanent Wetland Easement Program, Inland Wetland Conservation Program, Forest Stewardship Program/Stewardship Incentive Program, California Forest Improvement Program, and State Coastal Conservancy Resource Enhancement and Agricultural Programs.

grams are also structured to provide for long-term or permanent protection of the property.[34]

III. Federal Regulation of Wetlands: Section 404 Permit

If the landowner's property contains wetlands, and the owner seeks to develop the property, then the owner must apply for a permit under the Clean Water Act (CWA).[35] Congress enacted the CWA in 1972 pursuant to the Commerce Clause.[36] The Act's objective is to "restore and maintain the chemical, physical, and biological integrity of the Nation's waters."[37]

Under section 301(a) of the CWA, it is illegal for any person to discharge any pollutant into waters of the United States unless the discharge is made in compliance with applicable CWA provi-

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34 *See id* at 27-42. Examples are: Conservation Reserve Program, Wetland Reserve Program, Acquisition Program of the U.S. Fish and Wildlife Service, Wildlife Conservation Board Program, Inland Wetland Conservation Program, Permanent Wetland Easement Program, Debt Restructuring Program, Williamson Act (Land Conservation Act of 1965), State Coastal Conservancy Resource Enhancement and Agricultural Programs, Tahoe Conservancy Programs, Santa Monica Mountains Conservancy Programs, San Joaquin River Conservancy Programs, Coachella Valley Mountains Conservancy Programs, Land Trusts, and Open Space Districts.

35 *See* 33 U.S.C. § 1344(a) (1994) (permit required for discharge of dredged or fill material); 33 U.S.C.A. § 1344 (West 1986 & Supp. 1998). For a discussion on advising clients of potential changes in CWA jurisprudence see Daniel K. Slone & F. Paul Calamita, *Wetlands Reform: Is the Tide Turning?*, 10 Prob. & Prop. 7 (1996). *See generally* Lynn M. Gallagher & Leonard A. Miller, Clean Water Handbook 151-90 (2d ed. 1996); William L. Want, Law of Wetlands Regulation (1998). *See also* Virginia C. Veltman, Comment, *Banking on the Future of Wetlands Using Federal Law*, 89 Nw. U. L. Rev. 654 (1995) (with appropriate federal regulation, mitigation banking can be "an important tool in wetlands resource management." *Id.* at 688. In general, federal regulatory authority over the states and private property is derived from the Commerce Clause of the United States Constitution. U.S. Const. art I, § 8, cl. 3 (Congress has the power "to regulate Commerce . . . among the several states. . . ."). Thus, like other federal environmental legislation, the provisions of the CWA stem from this authority. 33 U.S.C.A. §§ 1251-1387 (West 1986 & Supp. 1998). Historically, the Court held that the regulation of "navigable waters" is within the commerce power. Gibbons v. Ogden, 9 Wheat. 1 (1824). Today, the regulation of navigable waters is limited to the Court's interpretation of the commerce power. Elaine Bueschen, Comment, *Do Isolated Wetlands Substantially Affect Interstate Commerce?*, 46 Am. U. L. Rev. 931 (1997) (with the use of scientific data, courts could determine that isolated wetlands substantially affect interstate commerce). *Id.* at 935. The current interpretation of the commerce power is reflected in *United States v. Lopez*, 514 U.S. 549, 559 (1995), where the Court held that a regulated activity must have a substantial effect on interstate commerce to be upheld. For additional discussion on the power to regulate wetlands pursuant to the commerce power see Lori J. Warner, *The Potential Impact of* United States v. Lopez *on Environmental Regulation*, 7 Duke Envtl. L. & Pol'y F. 321 (1997) (endangered species and wetland regulation will survive *Lopez* analysis); J. Blanding Holman IV, Note, *After* United States v. Lopez*: Can the Clean Water Act and the Endangered Species Act Survive Commerce Clause Attack?*, 15 Va. Envtl. L.J. 139 (1995) (habitat modification and isolated wetland provisions of Endangered Species Act are susceptible to more stringent review under *Lopez*); Jonathan G. Hieneman, *The Shrinking Reach of the Commerce Power: Is Wetland Jurisdiction in Danger?*, 10 J. Nat. Resources & Envtl. L. 341 (1995) (debate between wetland jurisdiction and commerce power).

36 U.S. Const. art I, § 8, cl. 3.

37 33 U.S.C.A. § 1251(a) (West 1986 & Supp. 1998).

sions.[38] One such provision is 33 U.S.C. § 1344, commonly referred to as the section 404 Dredged and Fill Material Discharge Permit Program. The U.S. Army Corps of Engineers (Corps) has the primary authority to determine whether a particular activity requires a permit.[39] Consequently, the federal wetlands permit program is run primarily by the Corps.[40] Under section 404,[41] however, the EPA retains ultimate authority to regulate the discharge of pollutants,[42] including the power to veto permits.[43] The EPA may veto section 404 permits for disposal at specific sites if there would be an unacceptably adverse effect on environmental resources.[44] However, this power has been used sparingly by the EPA.[45] In 1989, the EPA and the Corps entered into a Memorandum of Agreement (MOA) which limited the EPA's authority.[46] In essence, the EPA makes only jurisdictional determinations when a permit involves important policy or technical issues; the Corps retains all other jurisdictional authority.[47]

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38 *See* 33 U.S.C. § 1311(a) (1994) (compliance with CWA provisions includes §§ 1312, 1316, 1317, 1328, 1342, 1344).

39 33 U.S.C. § 1344(a) (1994).

40 The Corps' role in issuing § 404 permits is not exclusive. Other federal agencies play a role in the federal regulation of wetlands; *e.g.*, United States Fish & Wildlife Service (USFWS) (comments on § 404 permits), National Marine Fisheries Service (MFS) (comments on § 404 permits), Natural Resources Conservation Service (NRCS) (Swampbuster program). *See* Mark A. Chertok, *Federal Regulation of Wetlands*, SB91 ALI-ABA 859, 866-67 (1997); Margaret N. Strand, *Wetlands: Avoiding the Swamp Monster*, *in* ENVIRONMENTAL ASPECTS OF REAL ESTATE TRANSACTIONS 603, 604-05 (James B. Witkin ed., 1995). Enforcement authority is vested in both the EPA and the Corps, 33 U.S.C.A. §§ 1319, 1344(s) (West 1986 & Supp. 1998).

41 33 U.S.C.A. § 1344 (West 1986 & Supp. 1998) (dredged and fill permit program). *See also* Lawrence R. Liebesman, *The Section 404 Dredged and Fill Material Discharge Permit Program*, *in* THE CLEAN WATER ACT HANDBOOK 136-82 (Parthenia B. Evans ed., 1994).

42 *See* 33 U.S.C.A. § 1342(a) (West 1986 & Supp. 1998).

43 *See* 33 U.S.C. § 1344(c) (1994).

44 *See id.*; Bersani v. EPA, 850 F.2d 36 (2d Cir. 1988), *cert. denied sub nom.* Robichaud v. EPA, 489 U.S. 1089 (1989) (upholding EPA's veto of § 404 permit issued by Corps for construction of a shopping mall). *See also* Chertok, *supra* note 40, at 865 (authority has been used sparingly); 33 U.S.C. § 1344(g) (1994) (EPA may approve delegation of § 404 permitting to states).

45 *See* Chertok, *supra* note 40, at 865. The author also argues that in recent years the EPA veto power has become controversial. *See id.* at 897. The appropriate standard of review under this veto power is "arbitrary and capricious." *See* James City County v. EPA, 12 F.3d 1330, 1338 n.4, 1339 (4th Cir. 1993) (EPA action under statute governing permits for dredged or fill material . . . is reviewable under "arbitrary and capricious" standard). By 1992, the EPA had exercised its veto authority 11 times. *See* Liebesman, *supra* note 41, at 153-56.

46 *See* Memorandum of Agreement Between the Department of the Army and the Environmental Protection Agency Concerning the Determination of the Geographic Jurisdiction of the Section 404 Program and the Application of the Exemptions Under Section 404(f) of the Clean Water Act, 58 Fed. Reg. 4995 (1993).

47 *See* Chertok, *supra* note 40, at 871.

A. Defining Wetlands

Under the federal wetlands program, a section 404 permit must be issued for the discharge of dredged or fill material into the navigable waters at specified disposal sites.[48] Jurisdiction under the section 404 program extends to all navigable waters of the United States.[49] "Navigable waters" are defined as "the waters of the United States, including the territorial seas."[50] The Corps and the EPA have broadly defined navigable waters to include wetlands adjacent to the waters of the United States,[51] artificially created wetlands,[52] and wetlands physically separated from other waters or isolated wetlands.[53] The regulations thus provide that the CWA applies to 1) all traditional navigable waters;[54] 2) all interstate waters, including interstate wetlands; 3) wetlands adjacent to other waters; and 4) all waters, including

48 *See* 33 U.S.C. § 1344(a) (1994); "Discharge of a pollutant" means, "any addition of any pollutant to navigable waters from a point source. . . ." 33 U.S.C. § 1362(12) (1994). Dredged or fill material "means material that is excavated or dredged from the waters of the United States." 33 C.F.R. § 323.2(c) (1998). The regulations broadly define fill material as "any material used for the primary purpose of replacing an aquatic area with dry land or of changing the bottom elevation of any waterbody." 33 C.F.R. § 323.2(e) (1998). Furthermore, Section 401(a) of the CWA requires that any applicant for a federal permit, who conducts "any activity . . . which may result in any discharge into the navigable waters, shall provide the licensing or permitting agency a certification from the state in which the discharge originates or will originate . . ." and no "permit shall be granted until the certification . . . has been obtained or has been waived . . ." 33 U.S.C. § 1341(a)(1) (1994). An example of discharging fill material occurred in United States v. Banks, 115 F.3d 916 (11th Cir. 1997). A landowner who bulldozed his property for farming was considered to be discharging fill material into a wetland. In contrast, the "placement of pilings in waters of the United States for piers, wharves, and an individual house on stilts generally does not have the effect of a discharge of fill material." 58 Fed. Reg. 45,008, 45,038 (1993) (to be codified at 33 C.F.R. pt 232.2). *But see* Fox Bay Partners v. United States Corps of Eng'rs, 831 F. Supp. 605 (D. Ill. 1993) (Corps denied application for permit for construction of marina on river because the project would contribute to the significant degradation of the aquatic system of the United States).

49 *See* Liebesman, *supra* note 41, at 136-37.

50 33 U.S.C. § 1362(7) (1994). *See* NRDC v. Callaway, 392 F. Supp. 685, 686 (D.D.C. 1975) ("Congress [intended] 'the waters of the United States, including the territorial seas' [to provide federal jurisdiction] to the maximum extent permissible under the Commerce Clause of the Constitution."); United States v. Phelps Dodge Corp., 391 F. Supp. 1181, 1187 (D. Ariz. 1975) ("[T]he scope of [CWA] control must extend to all pollutants which are discharged into any waterway [which] could reasonably end up in any body or water . . . in which there is some public interest.").

51 *See* 33 C.F.R § 328.3(a) (1998), 40 C.F.R. § 230.3(s) (1998). *See also* 33 C.F.R. § 328.2(c) (1998) (adjacent wetlands are defined by three parameters: soils, hydrology, vegetation); United States v. Riverside Bayview Homes, Inc., 474 U.S. 121 (1985) (adjacent wetlands play an important role in protecting and enhancing water quality). The EPA possesses the ultimate authority to define the existence and extent of wetlands. *See* Chertok, *supra* note 40, at 866.

52 *See, e.g.*, Leslie Salt Co. v. United States, 55 F.3d 1388 (9th Cir.), *cert. denied sub nom.* Cargill, Inc. v. United States, 516 U.S. 955 (1995) (artificially created pond); Chertok, *supra* note 40, at 874 ("All waters" may include artificial ponds, lakes or reservoirs.). *Id.*

53 *See* United States v. Riverside Bayview Homes, Inc., 474 U.S. 121 (1985).

54 This definition includes oceans, bays, and rivers.

wetlands, the use, degradation, or destruction of which could affect interstate commerce.[55]

B. Wetland Delineation

Generally, the Corps and the EPA define wetlands as "those areas that are inundated or saturated by surface or ground water at a frequency and duration sufficient to support . . . a prevalence of vegetation typically adapted for life in saturated soil conditions."[56] Although they use the same definition, "the Corps and EPA often do not agree upon whether a given area is a wetland."[57] In addition, a multidisciplinary approach has developed for assessing whether an area is a wetland; the various agencies have developed different methodologies for making the determination.[58] As a practical matter, the approach used by federal agencies and most states is set forth in the 1987 delineation manual developed by the Corps.[59]

In 1989, the Corps, EPA, USFWS and the Soil Conservation Service (SCS) adopted a "joint federal manual" to identify and delineate wetlands.[60] However, the 1989 manual is considered to constitute a supplement to the 1987 Corps Manual because the 1989 version did not undergo the requirements of Administrative Procedure Act (APA) rulemaking.[61]

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55 *See* Strand, *supra* note 40, at 606; 33 C.F.R. § 328.3 (1998). "All waters" would include isolated wetlands. However, the federal government's authority to regulate isolated wetlands is still unsettled. *See* United States v. Wilson, 133 F.3d 251 (4th Cir. 1997) (regulation's definition of wetland that could affect interstate commerce held invalid); Hoffman Homes, Inc. v. EPA, 999 F.2d 256 (7th Cir. 1993) (isolated wetland having no source of moisture other than rainfall outside jurisdiction of EPA under CWA). *Compare* Leslie Salt Co. v. United States, 55 F.3d 1388 (9th Cir.), *cert. denied sub nom.* Cargill, Inc. v. United States, 516 U.S. 955 (1995) (isolated wetlands used by migratory birds were within scope of CWA). *See also* Edward Alburo Morrissey, *The Jurisdiction of the Clean Water Act Over Isolated Wetlands: The Migratory Bird Rule*, 22 J. LEGIS. 137 (1996) (Congress should codify migratory bird rule); Michael Bablo, Note, Leslie Salt Co. v. United States: *Does the Recent Supreme Court Decision in* United States v. Lopez *Dictate the Abrogation of the "Migratory Bird Rule"?*, 14 TEMP. ENVTL. L. & TECH. J. 277 (1995) ("tenuous tie between migratory birds and interstate commerce does not satisfy the tests of Commerce Clause enunciated in *Lopez*"). *Id.* at 278. *See also* James H. Levine, Note, Leslie Salt Co. v. United States: *The Ninth Circuit Revisits Federal Jurisdiction Over Isolated Wetlands*, 9 TUL. ENVTL. L.J. 167 (1995) (Corps must find substantial evidence that migratory birds use isolated wetlands before asserting jurisdiction); John A. Leman, Comment, *The Birds: Regulation of Isolated Wetlands and the Limits of the Commerce Clause*, 28 U.C. DAVIS L. REV. 1237 (1995) (Congress cannot regulate isolated wetlands based on potential use by migratory birds). *Compare* Marni A. Gelb, Note, Leslie Salt Co. v. United States: *Have Migratory Birds Carried the Commerce Clause Across the Borders of Reason?*, 8 VILL. ENVTL. L.J. 291 (migratory bird rule was a reasonable interpretation of the CWA).

56 33 C.F.R. § 328.3(b) (1998); 40 C.F.R. § 230.3(t) (1998).

57 Liebesman, *supra* note 41, at 138.

58 *See id.* The agencies include the EPA, Corps, USFWS, and Soil Conservation Service (SCS).

59 *See id.*

60 *See id.*

61 *See id.* at 139. For a comparison between the 1987 and 1989 manual see *id.* at 140.

Wetlands are delineated according to the landowner's individual parcels or property.[62] Historically, federal agencies have used three factors to delineate wetlands: hydrology, hydrophytic vegetation, and hydric soils.[63] The 1989 manual requires that all three technical criteria be satisfied for a particular site to warrant the "wetland" label, "but describes methods for determining wetlands where one or more of the criteria are missing, especially for disturbed or difficult areas."[64] In reality, these factors or characteristics may be difficult to assess.[65] A trained professional may have to determine where these wetland characteristics begin and cease.[66] Often, the trained professional is hired by the developing landowner,[67] because the Corps and the EPA are not required to provide a wetland delineation to a property owner on demand.[68] This private consulting performed at the bequest of the landowner is encouraged by the Corps to save time,[69] to designate "safe" areas for immediate construction,[70] and to inform the landowner whether he or she qualifies for an exemption or general permit.[71] The professional's determination is, however, subject to Corps' approval.[72]

Generally, "sufficient hydrology exists when there is inundation of the subject area, either by surface flow or groundwater, for a specified percentage of the growing season."[73] This test may be

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62 *See* Strand, *supra* note 40, at 609.

63 *See* Liebesman, *supra* note 41, at 138. Factors are based on the 1989 Delineation Manual. *See id. See also* United States v. Riverside Bayview Homes, Inc., 474 U.S. 121 (1985).

64 Liebesman, *supra* note 41, at 139. An example of a disturbed area is prior converted cropland. "Prior converted cropland is not considered wetlands because the water regime has been substantially altered." *Id.*

65 *See id.* at 138.

66 *See* Strand, *supra* note 40, at 609.

67 *See id.*

68 *See id.*

69 Corps offices may be too understaffed to perform delineation upon demand. *See id.*

70 *See id.* The landowner should exercise caution in developing sites without Corps approval. The Corps retains the ultimate authority to determine whether the developed property requires a permit. *See generally id.*

71 *See id. See* MARK S. DENNISON, WETLAND MITIGATION: MITIGATION BANKING AND OTHER STRATEGIES FOR DEVELOPMENT AND COMPLIANCE 107-08 (1997) ("[A]pplicants for Section 404 permits are encouraged to arrange preapplication meetings with the Army Corps, other federal agencies, and state and local governmental authorities. Such meetings are crucial to applicants because they provide a background in specific application procedures which may vary from site to site, and often indicate to the applicant what specific mitigation procedures, monitoring requirements, etc. may be considered acceptable."). *Id.* at 107; Telephone Interview with Dr. Robert W. Brumbaugh, Policy Analyst, Institute for Water Resources, U.S. Army Corps of Engineers (Feb. 2, 1998) (beneficial for the applicant to consult early with the Corps) [hereinafter Brumbaugh, Interview].

72 *See* Strand, *supra* note 40, at 609. In some instances the Corps will accept a privately consulted delineation without a site review (office review). *See id.*

73 Chertok, *supra* note 40, at 868.

demonstrated by the presence of hydrophytic vegetation.[74] Likewise, hydric soils can be determined using a field comparison of soil color at certain depths matched with soil color reference charts.[75] The soil charts "reflect the anaerobic conditions typical of water-saturated soils."[76]

C. Wetland Exemptions

If the property in question meets the delineation criteria, it is considered a wetland.[77] Unless the wetland is statutorily exempt from the CWA, the landowner must apply for a permit to discharge dredged or fill material.[78]

The exemptions under the CWA are enumerated in 33 U.S.C. § 1344(f).[79] Some examples of exemptions under the CWA are: normal farming, silviculture, ranching, emergencies, maintenance, and temporary sediment basins.[80] The courts have tended to construe the exemptions narrowly;[81] therefore, a permit will typically be required. Two types of permits are available to the landowner: a general, nationwide permit (NWP) or an individual permit.[82]

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74 An area has hydrophytic vegetation when, "under normal circumstances, more than 50 percent of the dominant species are either obligate wetland plants, facultative wetland plants, or facultative plants." Chertok, *supra* note 40, at 869. *See* Liebesman, *supra* note 41, at 139.

75 *See* Liebesman, *supra* note 41, at 139.

76 Chertok, *supra* note 40, at 869.

77 *See supra* notes 56-76 and accompanying text.

78 *See* Strand, *supra* note 40, at 613.

79 33 U.S.C. § 1344(f) (1994).

80 *See id.*

81 *See* Strand, *supra* note 40, at 612. *See, e.g.*, United States v. Akers, 785 F.2d 814, 819 (9th Cir. 1986), *cert. denied*, 479 U.S. 828 (1986); United States v. Huebner, 752 F.2d 1235, 1240-41 (7th Cir.), *cert. denied*, 474 U.S. 817 (1985); Avoyelles Sportsmen's League, Inc. v. Marsh, 715 F.2d 897, 925 n.44 (5th Cir. 1983).

82 "[T]he Secretary may, after notice and opportunity for public hearing, issue general permits on a State, regional, or nationwide basis for any category of activities involving discharges of dredged or fill material if the Secretary determines that the activities in such category are similar in nature, will cause only minimal adverse environmental effects when performed separately, and will have only minimal cumulative adverse effects on the environment." 33 U.S.C. § 1344(e). "The term 'individual permit' means a Department of the Army authorization that is issued following a case-by-case evaluation of a specific project involving the proposed discharge(s) in accordance with the procedures of this part and 33 CFR Part 325 and a determination that the proposed discharge is in the public interest pursuant to 33 CFR Part 320." 33 C.F.R. § 323.2(g) (1998). "The term 'general permit' means a Department of the Army authorization that is issued on a nationwide or regional basis for a category or categories of activities when: (1) Those activities are substantially similar in nature and cause only minimal individual and cumulative environmental impacts; or (2) The general permit would result in avoiding unnecessary duplication of regulatory control exercised by another Federal, state, or local agency provided it has been determined that the environmental consequences of the action are individually and cumulatively minimal." 33 C.F.R. § 323.2(h) (1998).

D. Nationwide Permits

The Corps will issue an NWP for development projects that will have only minimal adverse effects on the impacted wetland.[83] This process saves the Corps considerable time in evaluating mitigation projects compared to issuing thousands of individual permits to developer applicants.[84]

Currently, there are 39 NWPs available with one reserved.[85] NWPs are prior-issued by rule;[86] after a project meets the requisite conditions of an NWP, the permit is considered to have already been issued.[87] NWPs are commonly used in California.[88] However, landowners who believe they meet the criteria of an NWP must carefully review the conditions.[89] Regulations authorize the Corps to modify, suspend, or revoke NWPs for specific activities, and a district (regional authority) may impose its own additional conditions.[90] In addition, "certain NWPs require predischarge notification (PDN) to the Corps of information regarding delineation of wetlands and compliance with other conditions."[91] If, after reviewing the PDN, the district engineer determines the impacts are more than minimal, the Corps may require mitigation to allow the project to continue.[92] Finally, an activity will not be eligible to operate under an NWP if the activity affects: 1) navigation, erosion, siltation, or aquatic life more than minimally; 2) species listed as endangered or designated critical habitat; 3) properties eligible for listing on or listed on the National Register of Historic Places; 4) tribal properties; or 5) designated wild and scenic rivers.[93] In these instances, an individual permit will be required.

E. Individual Permits

If a landowner's property does not meet a statutory exemption or an NWP, then an application must be filed for an individual

83 *See* William T. Gorton, *Replacing Nationwide Permit 26: The Next Battle Over Wetlands Development*, 18 CONSTRUCTION LAW. 43, 44 (1998).

84 *See id.*

85 *See* 33 C.F.R. § 330.4 (1998). It should also be noted that NWP 26—Headwaters and Isolated Waters Discharges—is the most controversial (allows unregulated development to small parcels of property); Strand, *supra* note 40, at 613-14. NWP 26 is the most commonly used NWP in California. *See* PAUL D. CYLINDER ET AL., WETLANDS REGULATION: A COMPLETE GUIDE TO FEDERAL AND CALIFORNIA PROGRAMS 71 (1995).

86 *See* CYLINDER, *supra* note 85, at 66.

87 *See id.*

88 *See id.* at 67.

89 *See id.*; Strand, *supra* note 40, at 613.

90 *See* 33 C.F.R. § 330.1(d) (1998).

91 CYLINDER, *supra* note 85, at 67.

92 *See* Liebesman, *supra* note 41, at 159.

93 *See* CYLINDER, *supra* note 85, at 69.

permit.[94] The permit process may be expensive and time-consuming.[95] For example, the process involves public notice, mitigation, and potential multi-agency involvement.[96]

1. Public Interest Review Process

The section 404 individual permit process "consists of steps of determinations and considerations."[97] The first step in the Corps' determination of whether or not to issue a permit is the Corps' public interest review process,[98] which requires public notice and comment.[99] The process subjects the Corps' decision to scrutiny; thus, the process is a delicate one.[100] The factors the Corps considers include: 1) the probable impacts, including cumulative impacts on the public interest and its intended use;[101] 2) the relative extent of public and private need for the proposed project; 3) the reasonable alternative locations and methods to accomplish the proposed project (mitigation); 4) a weighing of the detrimental and beneficial effects of the project; 5) the overall effect on the wetland; 6) the views of the USFWS and the National Marine and Fisheries Service (NMFS) concerning fish and wildlife impacts; 6) consideration of property ownership;[102] and 8) other federal, state, or local requirements.[103] No single factor controls the outcome of the public interest review process.[104]

2. EPA Guidelines

The second step in the permit process involves application of the EPA's section 404(b)(1) Guidelines.[105] Under the Guidelines,[106] the Corps must first determine if there is a practicable alternative to the discharge of dredged or fill material having an adverse impact on the environment.[107] The Corps considers the costs (economics), technology, and the project's logistics in making its

94 "The term 'individual permit' means a Department of the Army authorization that is issued following a case-by-case evaluation of a specific project involving the proposed discharge(s) in accordance with the procedures of this part and 33 CFR Part 325 and a determination that the proposed discharge is in the public interest pursuant to 33 CFR Part 320." 33 C.F.R. § 323.2(g) (1998); *see supra* note 82 and accompanying text.

95 *See* Strand, *supra* note 40, at 614.

96 *See id.*

97 Liebesman, *supra* note 41, at 146.

98 *See id.*

99 *See* 33 C.F.R. § 325.3 (1998).

100 *See* Liebesman, *supra* note 41, at 147.

101 *See id.* at 146. Other factors include economics, aesthetics, general environmental concerns, historic properties, and water supply. *See id.*

102 For example, the right to reasonable private use, property protection, access, and the right to exclude others.

103 *See* 33 C.F.R. § 320.4(j) (1998).

104 *See* Liebesman, *supra* note 41, at 146.

105 *See* 40 C.F.R §§ 230-230.80 (1998).

106 *See id.*

107 *See* 40 C.F.R. § 231.1(c) (1998). *See* Chertok, *supra* note 40, at 890-91.

determination.[108] The burden is on the applicant to demonstrate that an alternative is "not practicable."[109] Even if the applicant meets the burden of clearly demonstrating that no practicable alternative exists,[110] the application still may be denied if discharging of the dredged or fill material violates other federal or state laws or contributes "to the significant degradation of the waters of the United States."[111] "Significant degradation" includes significant adverse effects on human health or welfare, ecosystems, biodiversity, recreation, aesthetics, and economic values.[112] The Corps' findings of significant degradation are based on appropriate factual determinations, evaluations, and tests.[113] The Corps further requires that "no discharge of dredged or fill material shall be permitted unless appropriate and practicable steps have been taken which will minimize potential adverse impacts of the discharge on the aquatic ecosystem."[114]

3. Sequencing

In 1990, an MOA between the Corps and EPA standardized section 404(b)(1) into a three-step sequencing process for evaluating permit applications.[115] The stated purpose of the MOA was to "improve consistency in the implementation of the Guidelines and to eliminate misunderstanding and confusion on the part of agency personnel."[116] The process consists of: 1) avoidance, 2) minimization, and 3) compensation.[117] The first step, avoidance, requires that the applicant demonstrate that there are no practicable alternatives to the project and that the impacts cannot be avoided.[118] The second, minimization, requires that appropriate project modifications and permit conditions be met to minimize the adverse impacts.[119] The third, compensation, requires appro-

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108 *See* 40 C.F.R. § 230 (1998).

109 *See* 40 C.F.R. § 230.10(a)(3) (1998) ("[P]racticable alternatives that do not involve special aquatic sites are presumed to be available, unless clearly demonstrated otherwise.").

110 *See id.*

111 40 C.F.R. § 230.10(b)-(c) (1998). *See* Chertok, *supra* note 40, at 894.

112 *See* Chertok, supra note 40, at 894.

113 *See id.*

114 40 C.F.R. § 230.10(d) (1998).

115 *See* Memorandum of Agreement Between the Department of the Army and the Environmental Protection Agency Concerning the Clean Water Act Section 404(b)(1) Guidelines, 55 Fed. Reg. 9210 (1990) [hereinafter MOA].

116 *Id.* at 9210.

117 *See id.* at 9211.

118 *See id.* at 9212. In National Wildlife Federation v. Whistler, 27 F.3d 1341, 1342-43 (8th Cir. 1994), the Eighth Circuit upheld a section 404(b) permit for a planned housing development's boat access to a nearby river. In granting the permit, the Corps reasoned that no practicable alternative existed in the project's proposal and that the boat access could not be located elsewhere.

119 *See* Fund for Animals, Inc. v. Rice, 85 F.3d 535, 544, 548 (11th Cir. 1996), where the Eleventh Circuit granted a county's motion for summary judgment on a challenge to the

priate and practicable compensatory mitigation for unavoidable adverse impacts which remain after all minimization measures have been exercised.[120] Compensation may take the form of on-site mitigation, off-site mitigation, or mitigation banking.[121] Compensatory mitigation is discussed in Section IV.

4. Choosing Appropriate Mitigation

In practice, the choice of mitigating adverse impacts to wetlands requires an evaluation of individual wetland functions and values.[122] Some of the goals of mitigation include: enhancing, creating, or restoring wildlife and fisheries habitat; protecting water quality;[123] providing flood protection; stabilizing shorelines; facilitating groundwater recharge; and protecting socioeconomic values, such as recreation and aesthetics.[124]

In determining which goals are appropriate for a given project, all pertinent functions and values should be considered.[125] In addition, multiple objectives are often desired to afford the greatest protection to the affected wetland.[126] The objectives may not always be reconcilable with each other, such as habitat conservation versus aesthetic value.[127] In such a case, clearly identifying the objectives in a proposed mitigation plan is necessary to yield optimal results.[128]

"Successful mitigation" is determined by the ability of the mitigated wetland to provide the biological, hydrological, and biogeochemical functions of the original wetland or emulated wetland.[129] These functions can be evaluated based on observable characteristics within the compensated wetland. The characteristics of a successful mitigation project include: 1) basic structural

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proposed construction of a municipal landfill. In reaching its conclusion, the circuit court recognized that the county minimized the proposed landfill's adverse impact on an isolated wetland by scaling down its original design from 120 acres to 74 acres.

120 *See* MOA, *supra* note 115, at 9212. In Friends of the Earth v. Hintz, 800 F.2d 822, 837-39 (9th Cir. 1986), the Ninth Circuit upheld the Corps' decision to issue a section 404 permit authorizing a logging company to discharge fill material into a wetlands area. In granting the permit, the Corps secured a mitigation agreement whereby the developer would compensate for the unavoidable loss of wetlands in dispute by restoring other property owned by the developer back to wetlands.

121 *See* MOA, *supra* note 115, at 9212.

122 *See* CYLINDER, *supra* note 85, at 110.

123 For example, sediment trapping, chemical detoxification, nutrient removal, and nutrient cycling. *See id.*

124 *See id.*

125 *See id.*

126 *See id.*

127 *See id.*

128 *See id.*

129 *See* Watersheds, *Successful Mitigation*, (visited Feb. 18, 1998) <http://h2osparc.wq.ncsu.edu/info/wetlands/mitsucc.html> [hereinafter Watersheds]. *See also* Michael G. Le Desma, Note, *A Sound of Thunder: Problems and Prospects in Wetland Mitigation Banking*, 19 COLUM. J. ENVTL. L. 497, 513-14 (1994); 28 C.F.R. § 63.6 (1998).

considerations, such as landscape and contour design; 2) a self-perpetuating hydroperiod similar to that of the emulated wetland; 3) successful colonization of wetland vegetation; 4) chemical and physical soil properties similar to the emulated wetland; and 5) diversity, density, and biomass of animal species similar to the emulated wetland.[130] Successful mitigation thus requires that the wetland's ecological characteristics be as good as that which was impacted or as good as a model wetland possessing high values and functions. Furthermore, these characteristics or criteria are interdependent; a failure in one can lead to a failure in others over time.[131]

F. Impact of Other Federal Legislation on the Section 404 Permit Process

Other federal legislation works in connection with, or is mandated in the section 404 permit process. For example, under the National Environmental Policy Act (NEPA),[132] the Corps is required to prepare an Environmental Assessment (EA) to determine if the proposed project will have a significant effect on the quality of the human environment.[133] If such an effect is found, then an Environmental Impact Statement (EIS) is required.[134] If there will not be a significant effect, then the Corps prepares a Finding of No Significant Impact (FONSI).[135]

The Coastal Zone Management Act (CZMA) requires that each applicant receive approval from the appropriate coastal zone agency if the proposed discharge is within a coastal zone as defined under the Act.[136] The Act requires that each applicant demonstrate that the proposed discharge is consistent with the state's Coastal Management Program.[137]

Under section 7 of the Endangered Species Act (ESA), the Corps is required to ensure that the permitted activity "is not likely to jeopardize . . . any endangered or threatened species."[138]

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130 *See* Watersheds, *supra* note 129; DAVID SALVESEN, WETLANDS MITIGATING AND REGULATING DEVELOPMENT IMPACTS 136-37 (2d. ed. 1994) (process of successful mitigation requires consultation with the Corps, the use of experienced crews, and a detailed mitigation plan).

131 *See* Watersheds, *supra* note 129.

132 42 U.S.C.A. §§ 4321-4370d (West 1994 & Supp. 1998).

133 *See* 33 C.F.R. § 230 (1998) (procedures for implementing NEPA); 40 C.F.R. § 1508.9 (1998).

134 *See* 40 C.F.R. § 1508.11 (1998).

135 *See* 40 C.F.R. § 1503.13 (1998); 42 U.S.C.A. §§ 4321-4370d (West 1994 & Supp. 1998) (NEPA requirements).

136 *See* 16 U.S.C.A. §§ 1451-1464 (West 1985 & Supp. 1998).

137 *See* 33 C.F.R. § 325.2(b)(2) (1997).

138 16 U.S.C. § 1536 (1994 & Supp. III 1997).

Thus, an applicant's permit must be denied if "it is determined that such [a result is] likely."[139]

The National Historic Preservation Act (NHPA) requires the Corps to consult with the Advisory Counsel on Historic Preservation (Council) if the proposed project may affect properties listed on the National Register of Historic Places.[140] The Council may request the Secretary "to provide a report to the Council detailing the significance of the property, describing the effects of the undertaking on the property, and recommending measures to avoid, minimize, or mitigate adverse effects."[141]

The Fish and Wildlife Coordination Act (FWCA) requires the Corps to consult with the USFWS, the NMFS, and state wildlife agencies on the proposed effect of the project on wildlife and their habitat.[142] However, the Corps is not required to comply with the Agencies' recommendations.[143]

G. Enforcement

Once the Corps considers all the relevant factors discussed above, a final permit is issued, subject to the EPA's veto authority.[144] However, the Corps, the EPA, and private citizens still have the opportunity to ensure that the applicant is complying with the permit's requirements through various enforcement mechanisms.[145] Such mechanisms are also available in instances where the landowner has failed to properly acquire a section 404 permit and has improperly filled a wetland.[146]

There are four types of enforcement mechanisms available under the CWA: administrative, civil, criminal, and citizen suits.[147] They are designed to penalize landowners for the illegal filling of wetlands or improper compliance with section 404 permits.[148]

Section 309 of the CWA empowers the EPA to issue compliance orders for the illegal discharge of fill material into wetlands.[149] A compliance order may require the violator to stop the illegal filling of wetlands and order corrective action such as resto-

139 Liebesman, *supra* note 41, at 152. *See* Tennessee Valley Auth. v. Hill, 437 U.S. 153 (1978) (environmental groups brought action to prevent completion of Tellico Dam because the project had an adverse impact on the habitat of the endangered snail darter).

140 *See* 36 C.F.R. § 800.10 (1998).

141 36 C.F.R. § 800.10(b) (1998).

142 *See* 16 U.S.C.A. § 662 (West 1985 & Supp. 1998).

143 *See* 16 U.S.C. § 662 (1994).

144 *See* 33 U.S.C. § 1344(j) (1994).

145 *See* 33 U.S.C.A. §§ 1319, 1344, 1365 (West 1986 & Supp. 1998). *See also infra* notes 147-61 and accompanying text.

146 *See* 33 U.S.C. § 1362(5) (1994). *See also infra* notes 147-61 and accompanying text.

147 *See* 33 U.S.C.A. §§ 1319, 1344, 1365 (West 1986 & Supp. 1998).

148 *See* 33 U.S.C.A. § 1365 (West 1986 & Supp. 1998).

149 *See* 33 U.S.C.A. § 1344(s) (West 1986 & Supp. 1998); 33 U.S.C. § 1319(a) (1994).

ration or mitigation.[150] The CWA also authorizes the Corps and the EPA to assess administrative penalties for violations under state issued permits and permits authorized under the CWA.[151]

Similar to administrative penalties, the CWA authorizes civil penalties under section 309(c) for failing to comply with a section 404 permit.[152] Civil penalties can be severe and are designed to deter the violator from further illegal action.[153]

Criminal enforcement is allowed under the CWA for negligent and knowing violations.[154] A negligent violation carries a minimum $2500 fine and maximum $25,000 penalty per day for each violation.[155] The violator may also be imprisoned for up to one year.[156] A knowing violation carries a minimum fine of $5000 and maximum fine of $50,000 per day or for each violation.[157] Additionally, the violator may be imprisoned for not more than three years.[158] If the landowner knowingly commits a second violation, the maximum fine is $100,000 per day for each violation, or the violator may be imprisoned for not more than six years.[159]

Section 505 of the CWA authorizes citizen suits against "any person" for violating any provision of the CWA, including the illegal discharge of fill material.[160] The provision also authorizes a suit against the Administrator of the EPA for failure to perform any act or duty under the CWA which is not discretionary.[161]

H. Remedies

If the Corps denies a permit application, the applicant can 1) challenge the permit denial in a federal district court, or 2) prove that the denial of the permit constituted a "taking" under the Fifth Amendment to the United States Constitution.[162]

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150 *See id. See also* Liebesman, *supra* note 41, at 162.

151 *See* 33 U.S.C.A. § 1319(g) (West 1986 & Supp. 1998).

152 *See* 33 U.S.C. § 1319(b) (1994).

153 *See* 33 U.S.C.A. § 1319(d) (West 1986 & Supp. 1998) (penalties can be assessed at $25,000 per day for each violation).

154 *See* 33 U.S.C.A. § 1319(c) (West 1986 & Supp. 1998).

155 *See* 33 U.S.C.A. § 1319(c)(1)(B) (West 1986 & Supp. 1998).

156 *See id.*

157 *See* 33 U.S.C.A. § 1319(c)(2)(B) (West 1986 & Supp. 1998).

158 *See id.*

159 *See id.*

160 *See* 33 U.S.C. § 1365 (1994 & Supp. III 1997).

161 *See* 33 U.S.C. § 1365(a)(2) (1994 & Supp. III 1997).

162 For a thorough discussion on "takings" jurisprudence and the effect upon wetlands see Charles H. Ratner, Comment, *Should Preservation Be Used as Mitigation in Wetland Mitigation Banking Programs?: A Florida Perspective*, 48 U. MIAMI L. REV. 1133, 1165-73 (1994); Dawn S. Spratley, Note, *Constitutional Law—Regulatory Takings—The Meaning of a Taking Under the Fifth Amendment and the Definition of Just Compensation Entitle Property Owners Regulated by the Wetlands Protection Act to Judicially Defined Compensation for Both Temporary and Permanent Takings.* K & K Constr., Inc., et al. v. Dep't of Natural Resources, *551 N.W.2d 413 (Mich. Ct. App. 1996)* 75 U. DET. MERCY L. REV. 467 (1998); Peter L. Henderer, *The Impact of* Lucas v. South Carolina Coastal Council *and the*

To establish a Fifth Amendment violation,[163] the applicant must prove that his or her property was "taken for public use, without just compensation."[164] The first factor to be considered is whether the challenged regulation substantially advances a legitimate state interest.[165] If the regulation does advance a legitimate state interest, then it must be determined whether the regulation deprives the landowner of all economically viable use of his or her property.[166] In *Lucas v. South Carolina Coastal Council*,[167] the Supreme Court held that, where a landowner is denied all economically viable use of his or her property, the landowner has suffered a per se taking.[168] If some economically viable use of the property remains, the court still may determine that there is a taking.[169] The court's determination is based on an ad hoc factual inquiry (i.e., balancing test) for determining whether or not a taking has occurred.[170] Essentially, the government's interest in the regulation is balanced against the economic harm the regulation will have on the landowner.[171] Alternatively, if the granting of the permit is conditioned upon the landowner's dedication or granting of some property interest to the government (i.e., an exaction), the condition or granting of the property interest must have an essential nexus between the permit condition exacted and the legitimate agency interest being pursued.[172] Furthermore, the condition exacted must be roughly proportional to the harm caused by the landowner's use of his or her property.[173] Lastly, the landowner must meet the procedural requirement of ripeness by showing that he or she has obtained a final decision from the regulatory agency, including the agency's decision to grant permits and variances.[174]

Logically Antecedent Question: A Practitioner's Guide to the Fifth Amendment Takings of Wetlands, 3 ENVTL. LAW. 407 (1997); Royal C. Gardner, *Banking on Entrepreneurs: Wetlands, Mitigation Banking, and Takings*, 81 IOWA L. REV. 527 (1996).

163 U.S. CONST. amend. V.

164 *Id.*

165 *See* Nollan v. California Coastal Comm'n, 483 U.S. 825 (1987).

166 *See* Lucas v. South Carolina Coastal Council, 505 U.S. 1003 (1992).

167 *Id.*

168 *See id.* at 1019. *Cf.* United States v. Riverside Bayview Homes, Inc., 474 U.S. 121, 126 (1985) (holding "that the mere assertion of regulatory jurisdiction by a governmental body does not constitute a regulatory taking").

169 *See Lucas*, 505 U.S. at 1015-16 & nn.6-7.

170 *See* Penn Central Transp. Co. v. City of New York, 438 U.S. 104 (1978). *See also Lucas*, 505 U.S. at 1015-16 & nn.6-7.

171 *See* Ehrlich v. City of Culver City, 911 P.2d 429 (Cal. 1996).

172 *See* Nollan v. California Coastal Comm'n, 483 U.S. 825 (1987).

173 *See* Dolan v. City of Tigard, 515 U.S. 374 (1994).

174 *See* Williamson Co. Reg'l Planning Comm'n v. Hamilton Bank, 473 U.S. 172 (1985); *See also* First English Evangelical Lutheran Church of Glendale v. County of Los Angeles, 482 U.S. 304 (1987).

IV. COMPENSATORY MITIGATION

The goal of compensatory mitigation is to prevent any net loss of acreage, functions, or values.[175] As part of his political campaign in 1988, then-Vice President George Bush "pledged no-net-loss of wetlands as a national goal."[176] President Bill Clinton and the EPA continue to support the no-net-loss policy of preserving wetlands.[177] California also endorses this policy to "[e]nsure no overall net loss and achieve a long-term net gain in the quantity, quality, and permanence of wetland acreage and values in California in a manner that fosters creativity, stewardship and respect for private property."[178] Generally, four methods of compensatory wetland mitigation are recognized: preservation, enhancement, restoration, and creation.[179]

A. Preservation

Wetland "[p]reservation refers to the protection of ecologically important wetlands or other aquatic resources in perpetuity through the implementation of appropriate legal and physical mechanisms."[180] In theory, wetland preservation is the preferred method of compensatory mitigation because it is performed on-site.[181] However, in the context of mitigation banking, wetland preservation is generally discouraged because the typical result is a "net loss" of wetlands.[182] This result is likely to occur because awarding credits for preservation does not replace lost wetland values and functions.[183] Regardless of the policy considerations, preserving wetlands on-site may be an attractive form of compensatory mitigation for developers,[184] because it saves them considerable time, costs, and aggravation by building around wetlands rather than in them.[185] In addition, preserving wetlands may increase property values by keeping property in its unadulterated state.[186]

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175 *See* Alyson C. Flournoy, *Preserving Dynamic Systems: Wetlands, Ecology and Law*, 7 DUKE ENVTL. L. & POLY. F. 105, 126 (1996).

176 Liebesman, *supra* note 41, at 170.

177 *See* Cushman, *supra* note 2.

178 Governor Pete Wilson, *California Wetlands Conservation Policy* (Aug. 23, 1993) <http://ceres.ca.gov/wetlands/policies/governor.html> [hereinafter Gov. Wilson, *Conservation Policy*].

179 *See id. See also* DENNISON, *supra* note 71, at 118-20.

180 DENNISON, *supra* note 71, at 118.

181 *See* MOA, *supra* note 115, at 9212.

182 *See* DENNISON, *supra* note 71, at 118-19.

183 *See id.* at 119. *See also* MOA, *supra* note 115, at 9212 (preservation of existing wetland resources accepted as compensatory mitigation only in exceptional circumstances).

184 *See* SALVESEN, *supra* note 130, at 91.

185 *See id.*

186 *See id.* Preserving wetlands may increase property values simply as a result of aesthetic beauty. For case studies and examples supporting wetland preservation see *id.* at 91-99 ("cluster concept," educational value, aesthetic beauty). The Elliott Ranch project is

B. Enhancement

Wetland enhancement is achieved by increasing desirable attributes of an existing wetland at a mitigation site.[187] However, enhancing only the desired attributes logically results in a negative trade-off between aquatic resource structure, functions, and values of other, undesirable characteristics of the enhanced wetland;[188] that is, a positive result in one function or value may result in a negative effect to another.[189] The enhancement approach has been criticized because the net result may not be beneficial to the overall ecological value of the altered wetland.[190] Thus, developers should consult ecologists and others with expertise in the field to maintain the ecological integrity of the impacted wetland.[191]

C. Restoration

Wetland restoration involves "re-establishing wetlands where they once existed but were lost due to disturbance of one or more of the site's physical or biological components."[192] Wetland restoration is the preferred method of compensatory mitigation of all federal and most state mitigation policies.[193] This preference may be attributed to the fact that wetland restoration results in a "net gain" of wetlands,[194] and involves less risk than creating new wetlands.[195] Critics of this approach argue that the restoration of degraded wetlands as a compensation for filling perfectly good ones actually leads to a "net loss" of wetland acreage and values.[196] However, a "net loss" would not result if the restored wetland "is created out of upland, assuming that the created wetland exhibits

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an example of preserving a wetland to offset the adverse impacts of development. At Elliott Ranch, 67 acres of vernal pool and seasonal marsh wetlands were preserved to mitigate the placement of fill into 66.2 acres of wetlands in a mixed-use planned community development project. California Resources Agency, *Elliot Ranch* (last modified May 13, 1996) <http://ceres.ca.gov/wetlands/projects/elliot_ranch.html>.

187 CYLINDER, *supra* note 85, at 106.

188 DENNISON, *supra* note 71, at 119.

189 *See id.*

190 *See id.* at 119-20. In response to such criticism, proponents argue that "human interventions into nature can be creative and indeed can improve on nature, provided that they are based on ecological understanding of natural systems and of their potentialities for evolution as they are transformed into humanized landscapes." SALVESEN, *supra* note 130, at 114 (quoting René Dubos).

191 *See generally*, DENNISON, *supra* note 71, at 119-20.

192 CYLINDER, *supra* note 85, at 106. *See generally* Robert E. Beck, *The Movement in the United States to Restoration and Creation of Wetlands*, 34 NAT. RESOURCES J. 781 (1994).

193 *See* DENNISON, *supra* note 71, at 120; *See also* Gov. Wilson, *Conservation Policy*, *supra* note 178 (encouraging landowners to conserve and restore wetlands).

194 Compare with wetland preservation, which results in a "net loss" of wetlands. *See* DENNISON, *supra* note 71, at 119.

195 *See* SALVESEN, *supra* note 130, at 100.

196 *See id.*

the same values and functions as the one filled."[197] Regardless of which view is followed, restoration may be the better alternative in mitigating adverse impacts because of the existing wetland's ecological value.[198]

D. Creation

Wetland creation is "the development of new wetlands where they have not historically occurred."[199] This form of mitigation involves creating wetlands from scratch, such as by turning dry woods into swamps, or sandy shores into salt marshes.[200] The creation of wetlands is "strongly supported by the Corps, by developers, and especially by a cadre of environmental consultants who travel around the country creating wetlands where none existed."[201] However, creating wetlands is a complex process, requires technical expertise, and may be costly.[202] Variations among regions and wetland type cause the complexity.[203] Wetlands typically occur as a result of their natural setting: "the topography, soil conditions, hydrology, and climate" are crucial to their formation.[204] Wetland creation has been met with varying degrees of success.[205] Regardless, it continues to be a favored activity of the Corps because the creation of wetlands is a viable solution to the burgeoning of development in environmentally sensitive areas.[206] Developers cannot practically restore and enhance enough existing wetlands to achieve "no net loss" while at the same time realizing a high level of development.

V. Mitigation Banking

Under traditional methods of regulating wetlands, developers and governmental agencies with regular construction needs[207]

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197 *Id.*

198 *See* Cylinder, *supra* note 85, at 112.

199 *Id.* at 106. *See generally* Beck, *supra* note 192.

200 *See* Salvesen, *supra* note 130, at 120.

201 *Id.*

202 *See id.* at 120-31.

203 *See* Jon A. Kusler & Mary E. Kentula, *Executive Summary, in* Wetland Creation and Restoration (Jon A. Kusler & Mary E. Kentula eds., 1990).

204 Salvesen, *supra* note 130, at 121.

205 *See id.* at 120; Wetland Creation and Restoration (Jon A. Kusler & Mary E. Kentula eds., 1990) (series of articles and case studies of wetland creation and restoration successes and failures).

206 *See* Brumbaugh, Interview, *supra* note 71. However, Elizabeth White, EPA Region Nine, Water Resources, Coordinator on Mitigation Banking, disagrees. She states that it may be preferable to mitigate on-site because of the existing ecological value of the wetland marked for destruction. She attributes the Corps' position to pressure from developers to expedite the section 404 permit process. White, Interview, *supra* note 6; *See also* Shirley Jeanne Whitsitt, *Wetlands Mitigation Banking*, 3 Envtl. Law. 441, 459-62 (1997) (advantages of mitigation banking over on-site mitigation).

207 For example, the California Department of Transportation (Caltrans).

faced recurring and unpredictable time delays and costs in obtaining approval for projects which impact wetlands.[208] As a result, the need for means of advanced planning arose that would make the permitting process more reliable and less costly.[209] Responding to this need, the concept of mitigation banking emerged.[210]

A. Policy Development

Consistent with the policy goal of "no-net-loss" endorsed by the federal government and the states, wetland mitigation banks are considered a useful tool.[211] However, a brief discussion of wetland mitigation policy leading up to mitigation banking must first be considered.

1. Federal

On May 24, 1977, President Jimmy Carter issued Executive Order No. 11,990 for the protection of wetlands.[212] President Carter announced that "each agency shall provide leadership and shall take action to minimize the destruction, loss or degradation of wetlands, and to preserve and enhance natural and beneficial values of wetlands in carrying out the agencies' responsibilities."[213] Regarding the beneficial values of wetlands, the Executive Order specified factors such as 1) the public health, safety, and welfare;[214] 2) maintenance of natural systems and ecological value;[215] and 3) other uses such as public interest, which includes aesthetics and recreation.[216]

Consistent with those policy objectives and the "no-net-loss" policy announced by President Bush, in 1993 the Clinton administration endorsed the use of mitigation banks for mitigating unavoidable wetland loss in the section 404 permit process.[217] The Corps, USFWS, EPA, and other federal agencies responded by announcing a memorandum for federal guidance for the establish-

208 *See* Robert D. Sokolove & P. Robert Thompson, *The Future of Wetland Regulation Is Here*, 23 REAL EST. L.J. 78, 85 (1994).

209 *See id.*

210 *See id.*

211 *See* Michael Lenetsky, Comment, *President Clinton and Wetlands Regulation: Boon or Bane to the Environment?*, 13 TEMP. ENVTL. L. & TECH. J. 81, 95 n.146 (1994).

212 Executive Order No. 11,990, 42 Fed. Reg. 26,961 (1977), *reprinted in* 42 U.S.C. § 4321 (1994 & Supp. III 1997).

213 *Id.*

214 These factors include water supply, quality, pollution, and flood control. *See id.* at 26,963.

215 These factors include conservation and long-term productivity, habitat protection, and biodiversity. *See id.*

216 *See id.*

217 *See* Joyce Price, *Criticism Greets Environmental Plan*, WASH. TIMES, Aug. 25, 1993, at A3.

ment, use, and operation of mitigation banks in 1995.[218] The document provides guidance for the successful creation, management, and implementation of mitigation banks as a means of compensating for wetland loss.[219] The enumerated policy considerations are: key planning considerations, goal-setting, site selection, technical feasibility, and the role of preservation.[220] Underlying these considerations is attention to preserving wetland values, effectiveness, efficiency, cost, and the integrity of the ecosystem.[221] Thus, the memorandum attempts to balance the overall effectiveness of using mitigation banking between low development costs and prospective planning with the ecological value the banks represent.

2. The California Approach

In 1993, Governor Pete Wilson announced California's Wetlands Conservation Policy.[222] The stated goals of the policy are to:

- Ensure no overall net loss and achieve a long-term net gain in the quantity, quality, and permanence of wetlands acreage and values in California in a manner that fosters creativity, stewardship and respect for private property;
- Reduce procedural complexity in the administration of state and federal wetlands conservation programs; and

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218 *See* 60 Fed. Reg. 58,605 (1995).

219 *See id.*

220 *See id.*

221 *See id.*

222 *See* Gov. Wilson, *Conservation Policy, supra* note 178. Like a wetland mitigation bank, "[c]onservation banking enables developers and others to compensate for environmental impacts by purchasing credits that can be consolidated, thus making it possible to acquire ecologically important areas of greater value than otherwise might be obtainable." Douglas P. Wheeler, Letter to the Editor, *Conservation Banking Gains a Foothold in San Diego County,* SAN DIEGO UNION & TRIB., Dec. 27, 1995, at B9. There are 39 conservation banks in California which currently are in operation or in the process of being created. The majority of the banks are located in San Diego County, with 20, followed by Sacramento County, with five. California Resources Agency, *Restoration and Mitigation Projects* (last modified Jan. 21, 1998) <http://ceres.ca.gov/topic/banking/shasta.html> [hereinafter *Catalog*]; The Santa Ynez River Conservation Bank in Lompoc, California is being developed by McCollum Associates. The Bank is designed to preserve willow-riparian habitat and may be used as flood control for adjacent farmland. Ideally, the end result will be a "large wildlife corridor along the Santa Ynez River" in Santa Barbara County. Credits produced from the bank may be sold to other individuals, firms, or agencies that are required under law to compensate for the adverse environmental impacts of a development project. McCollum Associates developed the first conservation bank in April 1995. The bank, Carlsbad Highlands Conservation Bank, located in San Diego, is a 180-acre bank consisting of coastal sage scrub habitat. "Multispecies credits are sold to mitigate for most upland impacts throughout . . . San Diego County, including coastal areas." Other wetland mitigation banks developed by McCollum Associates are: Medford Island Conservation Bank (seasonal and riparian wetland habitat), Barry Jones Wetland Mitigation Bank (e.g., fairy shrimp), and Wilmont Ranch (ocean, riparian). McCollum Associates, *Conservation Banks* (visited Apr. 15, 1998) <http://www.mccollum.com/Mitbanks.htm>.

- Encourage partnerships to make landowner incentive programs and cooperative planning efforts the primary focus of wetlands conservation and restoration.[223]

To achieve these goals, the policy calls for 1) statewide policy initiatives;[224] 2) "geographically based regional strategies in which wetlands programs can be implemented, refined, and combined in unique ways;"[225] and 3) the "[c]reation of an interagency wetlands task force on wetlands to direct and coordinate administration and implementation of the policy."[226] The policy states that California must "develop and adopt guidelines for wetland mitigation banks which recognize [ ] regional concerns, contain flexible mitigation ratios, are consistent with Federal agency guidelines, and encourage decisions to locate banks in the context of local or regional plans."[227] For example, the California Coastal Commission has established procedural guidance for the establishment of wetland mitigation projects in California's coastal zone.[228] Generally, the procedures are: 1) making an ecological assessment;[229] 2) defining the project's goals, objectives and performance standards; 3) identifying the type of mitigation used; 4) selecting the location; 5) monitoring; and 6) evaluating wetland performance.[230] The document attempts to define the proper methods and procedures for the successful implementation of a mitigation plan that will achieve the best results in protecting the ecological integrity of the impacted wetland.

B. History and Concept

Mitigation banking is a relatively new concept, which has had limited success to date.[231] Generally, mitigation banking is defined as "off-site wetland restoration, creation, enhancement, and in exceptional circumstances, preservation undertaken expressly

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223 *See id. See generally* GUIDE, *supra* note 10 (wetland conservation options).

224 A statewide wetlands inventory, support for wetland planning, improved administration of existing regulatory programs, strengthened landowner incentives to protect wetlands, support for mitigation banking, development and expansion of other wetland programs, integration of wetlands policy and planning with other environmental and land use processes. *See* Gov. Wilson, *Conservation Policy, supra* note 178, at 2-7.

225 The Central Valley, San Francisco Bay Area, and Southern California. *See id.* at 1-2.

226 *Id.* at 2. Participating entities include the California Resources Agency, Cal/EPA, the State Water Resources Control Board and other agencies. *See id.* at 10.

227 *Id.* at 5.

228 *See* California Resources Agency, *Procedural Guidance for the Establishment of Wetland Mitigation Projects in California's Coastal Zone* (visited Feb. 21, 1998) <http://ceres.ca.gov/coastalcomm/weteval/wetc.html>.

229 For example, assessing wetland habitat, functions, and ecological contribution to the landscape. *See id.*

230 *See id.*

231 *See* Dr. Robert W. Brumbaugh, *Wetland Mitigation Banking: Entering a New Era?*, (visited Mar. 11, 1999) <http://www.wes.army.mil/EL/wrtc/bulletins/v5n3/brum.html> [hereinafter Brumbaugh, *New Era*].

for the purpose of mitigating unavoidable adverse wetland losses in advance of development actions."[232] The central goal of mitigation banking is to "provide for the replacement of the chemical, physical, and biological functions of wetlands and other aquatic resources which are lost as a result of authorized impacts."[233] Mitigation banking is different from the normal permitting process in two key aspects: 1) it attempts to construct mitigation areas in advance of anticipated projects that will have an adverse impact on existing wetlands;[234] and 2) banks are typically sufficiently large in area to allow multiple users use of the bank to offset the impacts of the wetland(s) affected by their specific projects.[235] Mitigation banking is premised on the theory that "in some circumstances there may be ecologically better ways of providing compensatory mitigation for wetland conversions than onsite replacement."[236]

The mitigation banking concept was first developed by the USFWS in the early 1980s "in an attempt to increase the effectiveness of wetlands mitigation while reducing the costs to the regulated community."[237] As of 1994, there were 46 existing wetland mitigation banks, with 64 proposals for creating new ones.[238] The majority of mitigation banks were located in California, with 11, followed by Florida, with 8.[239]

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232 DENNISON, *supra* note 71, at 129-30.

233 *Id.* at 130.

234 *See id.* (effectively this consolidates the compensation requirements of the § 404 permit). *See id.*

235 *See id.*

236 ELI, MITIGATION BANKING STUDY, *supra* note 4, at 127.

237 DENNISON, *supra* note 71, at 130.

238 *See* ELI, MITIGATION BANKING STUDY, *supra* note 4, at 131-34. *See also* William W. Sapp, *The Supply-Side and Demand-Side of Wetland Mitigation Banking*, 74 OR. L. REV. 951 (1995). A 1994 report by the Corps found that 8 out of 21 operational banks were of questionable success. Yancey Roy, *State Ponders Construction of Alternative Wetlands*, TIMES UNION, Oct. 20, 1995, at B1.

239 *See* ELI, MITIGATION BANKING STUDY, *supra* note 4, at 131-32. In 1997, there were approximately 100 banks; *See* E-mail from Dr. Robert Brumbaugh, Policy Analyst, Institute for Water Resources, U.S. Army Corps of Engineers (Apr. 20, 1998) (on file with *Chapman Law Review*) (report in E-mail to be called ENVIRONMENTAL LAW INSTITUTE, NATIONAL WETLAND MITIGATION BANKING STUDY, OPERATING WETLAND MITIGATION BANKS (not verified) (Institute for Water Resources (IWR), Feb. 1997)) [hereinafter ELI, OPERATING BANKS]. California had approximately 17 banks and more are expected as a result of the state's policy in protecting and preserving wetlands. *See id.*; John Grove, Vice President of American Wetlands and Natural Resource Exchange Corp., estimates that there are between 100 and 200 wetland mitigation banks in the country. Linda McCrerey, *Wetland Banks Preserve Land*, COLO. BUS., Nov. 1, 1997, at 18.

C. Types

There are three types of wetland mitigation banks: 1) single client, private and public; 2) publicly sponsored, commercial; and 3) privately sponsored, commercial.[240]

1. Single Client, Private and Public

Single client banks are typically developed by a landowner or local government.[241] The former may be called a single client-private bank and the latter a single client-public bank. Using a single client bank expedites the permit review process for a developer who may foresee a series of development activities involving compensatory mitigation.[242] A developer thus uses the bank to fulfill its own mitigation needs.[243] For example, several single client-public banks were used to mitigate impacts of highway construction projects.[244]

Funding for a single client bank may present some obstacles for the developer.[245] In the case of single client-public banks, the government entity[246] may "front" the money and recoup its costs from the development agencies as the project proceeds.[247] With a single client-private bank, the private developer is typically a "major player" who can afford to finance the bank and recoup the costs from the subsequent profits of the compensated project.[248]

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240 *See* Whitsitt, *supra* note 206, at 454. *See* ELI, MITIGATION BANKING STUDY, *supra* note 4, at 98-100. In 1994, the United States had 40 single client banks, 2 publicly sponsored banks, and 4 privately sponsored banks. *See id.* at 131-32, 141-47. At that same time, there were 34 proposed single client banks, 15 proposed publicly sponsored banks, and 16 privately sponsored banks. *See id.* at 132-34 (2 banks are public/private banks).

241 *See* DENNISON, *supra* note 71, at 134-35. As of 1994, in the United States there were 6 single client-private and 33 single client-public banks representing 87% of the existing wetland mitigation banks in the country. *See* ELI, MITIGATION BANKING STUDY, *supra* note 4, at 131-32, 141-47 (one additional bank was a hybrid public/private bank). The same year there were 29 proposed single client-public and 5 single client-private banks representing 53% of the total proposed wetland mitigation banks. *See id.* at 132-34. *Compare* with 1997. There were 43 single client-public and 14 single client-private banks. *See* ELI, OPERATING BANKS, *supra* note 239.

242 *See* Whitsitt, *supra* note 206, at 454.

243 *See* ELI, MITAGATION BANKING STUDY, *supra* note 4 at 134.

244 Huntington Beach Wetlands Restoration Project, Georgia Department of Transportation, Acequia, Louisiana Department of Transportation and Development, Minnesota Wetland Habitat Mitigation Bank, Dahorney National Wildlife Refuge, Malmaison Wildlife Management Area, State Line Bog & Dead Dog Bog, Interagency Wetland Mitigation Bank, Company Swamp, Pridgen Flats Mitigation Site, North Dakota State Highway Department Bank, Highway Mitigation Bank, South Carolina, Wetlands Accounting System, West Tennessee Wetland Mitigation Bank, Goose Creek/Bowers Hill Tidal Mitigation Bank, Cabin Creek, Fort Lee Wetland Mitigation Bank, Otterdam Swamp, Patrick Lake Wetland Mitigation Bank. *See* ELI, MITIGATION BANKING STUDY, *supra* note 4, at 135-45.

245 *See* Whitsitt, *supra* note 206, at 454.

246 For example, the Highway Department. *See id.*

247 *See* ELI, MITIGATION BANKING STUDY, *supra* note 4, at 100. Additional methods include issuing bonds, permitting fees, federal and state grants, and general revenue (taxes). *See id.*

248 *See* Whitsitt, *supra* note 206, at 454.

2. Publicly Sponsored, Commercial

Publicly sponsored commercial banks are "developed with public funds which the government seeks to recoup by selling mitigation credits to permit applicants."[249] A publicly sponsored bank may be advantageous because the government entity is "motivated . . . by a desire to protect and enhance wetland values, rather than out of a desire for profit" or to compensate for destruction of wetlands elsewhere.[250]

3. Privately Sponsored, Commercial

Like publicly sponsored banks, privately sponsored or entrepreneurial banks are developed by private entities to generate credits for subsequent sale to permit applicants.[251] A distinguishing characteristic of privately sponsored banks is that the bank, rather than the permittee, bears the legal and financial responsibility for mitigation failure.[252]

The Fina LaTerre Bank, located in Terrebonne Parish, Louisiana is perhaps the best known privately sponsored wetland mitigation bank in the country.[253] The bank is also one of the largest, comprised of 7,014 acres.[254] Fina LaTerre was established in 1984 by the Tenneco Company.[255] As part of an MOA between the Tenneco Company and various state and federal agencies,[256] the Tenneco Company "is required to spend $3 million per year over a 25-

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249 DENNISON, *supra* note 71, at 135; *See also* APOGEE RESEARCH INC., ALTERNATIVE MECHANISMS FOR COMPENSATORY MITIGATION: CASE STUDIES AND LESSONS ABOUT FEE-BASED COMPENSATORY WETLANDS MITIGATION (Institute for Water Resources (IWR) Working Paper, Mar. 1993). "Mitigation Credits" are discussed in the next section.

250 Jonathan Silverstein, Comment, *Taking Wetlands to the Bank: The Role of Wetland Mitigation Banking in a Comprehensive Approach to Wetlands Protection*, 22 B.C. ENVTL. AFF. L. REV. 129, 144 (1993-94). As of 1994, there were only two publicly sponsored wetland mitigation banks in the United States, representing 4% of the total existing banks. *See* ELI, MITIGATION BANKING STUDY, *supra* note 4 at 131-32 (Washoe Lake Mitigation Bank, Astoria Airport). However, 14 publicly sponsored banks were proposed, representing 22% of the total proposed banks; *See id.* at 132-34. Compare with 1997. There were 14 publicly sponsored banks. *See* ELI, OPERATING BANKS, *supra* note 239.

251 *See* DENNISON, *supra* note 71, at 134; PAUL SCODARI & ROBERT BRUMBAUGH, NATIONAL WETLAND MITIGATION BANKING STUDY, COMMERCIAL WETLAND MITIGATION CREDIT VENTURES: 1995 NATIONAL SURVEY (Institute for Water Resources (IWR) Report 96-WMB-9, Aug. 1996) (case studies of commercial ventures).

252 *See* Whitsitt, *supra* note 206, at 456. As of 1994, there were only four privately sponsored wetland mitigation banks in the United States, representing 6.5% of the total existing banks. *See* ELI, MITIGATION BANKING STUDY, *supra* note 4, at 131-32, 141-47. (Bracut Wetland Mitigation Marsh, Mission Viejo/ACWHEP, Morse Reservoir, Fina LaTerre). However, 15 privately sponsored banks were proposed, representing 23% of the total proposed banks; *See id.* at 132-34. Compare with 1997. There were 32 privately sponsored banks. *See* ELI, OPERATING BANKS, *supra* note 239.

253 *See* DENNISON, *supra* note 71, at 138.

254 *See* ELI, MITIGATION BANKING STUDY, *supra* note 4, at 143.

255 *See* DENNISON, *supra* note 71, at 138.

256 USFWS, SCS, NMFS, LA Department of Natural Resources, and LA Department of Wildlife & Fisheries. *See id.*

year period" to enhance fish and wildlife habitats within the Fina LaTerre Bank.[257] In return, the Tenneco Company generated mitigation credits to offset the company's own mitigation requirements in future development projects or for sale to other developers for profit.[258]

D. Mitigation Credits

Mitigation banking "involves the sale of mitigation credits to permit applicants who are seeking off-site mitigation" to compensate for an adverse impact to an on-site wetland involved in the development project.[259] Mitigation credits represent an increase in the function or value of the wetland bank derived from restored, created, enhanced or preserved wetlands at the mitigation bank.[260] Debits represent the unavoidable wetland loss of on-site development.[261] Credits and debits are the "currency" of the mitigation bank.[262] However, a mitigation bank does not function like a checking account; instead, "[c]redits placed in deposit by a sponsor can only be spent by a user (developer) if the regulator approves the action."[263]

Typically, a single credit represents a unit of acreage or habitat.[264] For example, mitigation banks typically assign a single credit to one acre of wetland value or function. Generally, the number of credits available at a mitigation bank will be based on "standards tailored to the specific restoration, creation, or enhancement activity at the bank site or through the use of an appropriate functional assessment methodology."[265]

E. Credit Valuation: Functional Value Assessment

The value of the credits is determined by various valuation techniques[266] that may be divided into three categories "which roughly correspond to greater scopes of ecological comprehensiveness."[267] These are: 1) simple indices; 2) narrowly tailored assessment methods; and 3) broadly tailored assessment methods.[268]

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257 DENNISON, *supra* note 71, at 138.

258 *See id.* at 139.

259 *Id.* at 131.

260 *See id;* Brumbaugh, *New Era*, *supra* note 231.

261 *See* Brumbaugh, *New Era*, *supra* note 231; DENNISON, *supra* note 71, at 131.

262 *See* DENNISON, *supra* note 71, at 131. The sale of credits is represented in dollars. *See id. See also* Charles P. Edmonds et al., *Wetland Mitigation*, 65 APPRAISAL J. 72 (1997); David M. Keating et al., *A Conceptual Framework for Appraising Wetland Mitigation Banks*, 65 APPRAISAL J. 165 (1997).

263 Brumbaugh, *New Era*, *supra* note 231.

264 *See* DENNISON, *supra* note 71, at 131.

265 *Id.* at 132.

266 *See id.*

267 ELI, MITIGATION BANKING STUDY, *supra* note 4, at 63.

268 *See id.* at 63-64.

Many banks use a combination of these various techniques in assessing wetland values and functions.[269]

1. Simple Indices

Simple indices "are derived from quickly and easily observed characteristics of a wetland" such as its size and the number of species.[270] The technique is preferred by developers and regulatory agencies because valuation can often be completed quickly, and the information gained can be readily understood.[271] With simple indices, the developer has the advantage of "being able to avoid the complexity of developing project-specific mitigation plans," and thus saves valuable time, cost, and resources.[272] The regulatory agency benefits because the technique is "not resource-intensive to apply," saving the agency time, effort, and resources.[273]

The obvious disadvantage to using simple indices is their relatively limited scope. The simple index technique merely assesses wetland values based on quantitative, rather than qualitative data.[274] For example, "[t]he most common simple index used in mitigation banking is acreage."[275] Based on acreage, a developer may simply purchase "x" number of credits represented by "x" number of acres contained in the mitigation bank to compensate for the unavoidable wetland loss in his or her project.[276] Thus, the correlation between the affected wetland and the banking credits is, at best, a replacement for lost characteristics of the impacted wetland. In reality, the sole use of acreage for replacing wetlands "ignore[s] the complexities of wetland ecosystems."[277]

To correct this problem, other indices may be used, in lieu of or in addition to acreage, to offset the inadequacies of using acreage as the sole component.[278] For example, diversity of species present within a given area could be used to form an index for conversion into mitigation credits.[279] However, determining which species are present in a given area and their corresponding value may be time-consuming.[280] The end result of using other indices

269 *See id.* at 72.
270 *Id.* at 63-64.
271 *See id.* at 64.
272 *Id.*
273 *Id.*
274 *See id.*
275 *Id.*
276 *See id.*
277 *Id.*
278 *See id.* at 65.
279 *See id.*
280 *See id.* In some instances, using diversity of species may be advantageous to a specific development project because the core aim is the replacement of a particular species in mitigating the impacts of the project. For example, at Hawes Ranch Mitigation Bank in

for determining the value of mitigation credits may undermine the advantages of using a simple index method.

In 1994, almost half of the banks in the United States and a majority of banks in California used this method. More specifically, 22 wetland mitigation banks (48% of the total) used simple indices for valuing mitigation credits in the United States,[281] and in California, 6 of the total 11 mitigation banks (55%) used this method.[282] One example, the Naval Amphibious Base Eelgrass Mitigation Bank, is a 10-acre bank operated by the U.S. Navy and created to transplant aquatic beds of eelgrass to mitigate development impacts of the San Diego Naval Base.[283] The compensation ratios used to mitigate and compensate for project impacts is 1-to-1.[284] The 1-to-1 ratio means that for every one acre of destroyed or impacted wetland, one acre of compensated wetland in the bank must be used. Thus, the Naval Amphibious Base Eelgrass Mitigation Bank represents a mere quantitative method for replacing a single wetland characteristic[285] and does not consider the complexities of the entire wetland ecology.

The use of a simple index for compensating unavoidable wetland loss may be inconsistent with the goals of the section 404 permit process and public policy. For example, under the Code of Federal Regulations, the decision whether or not to issue a section 404 permit "will be based on an evaluation of the probable impacts, including cumulative impacts, of the proposed activity and its intended use on the public interest."[286] Wetlands serve important public interest functions, including natural biological functions, wildlife habitat, flood control, groundwater maintenance, aesthetic value, and recreation.[287] Thus, there are several factors to be considered when evaluating the values that wetlands serve to the public interest, contrary to merely evaluating a single wetland characteristic like the Naval Amphibious Base Eelgrass Mitigation Bank in San Diego does.

In addition, the regulations indicate that "the specific weight of each factor is determined by its importance and relevance to the particular proposal."[288] The transplant of eelgrass at the San Di-

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California (also called Barry Jones Wetland Mitigation Bank, *see supra* note 222) the targeted species is vernal pool fairy shrimp, tadpole shrimp, and Orcutt's grass. California Resources Agency, *Hawes Ranch Mitigation Bank* (visited Mar. 11, 1999) <http://ceres.ca.gov/topic/banking/shasta.html>.

281 *See* ELI, MITIGATION BANKING STUDY, *supra* note 4, at 145-47.

282 *See id.*

283 *See id.* at 141, 145.

284 *See id.* at 145.

285 *See id.*

286 33 C.F.R. § 320.4(a)(1) (1998).

287 *See* EPA, *Wetland Loss, supra* note 9; 33 C.F.R. § 320.4(b) (1998) (general policies for evaluating permit applications).

288 33 C.F.R. § 320.4(a)(3) (1998).

ego bank may be the most important value of that particular wetland area. However, by simply requiring a 1-to-1 replacement ratio based solely on eelgrass vegetation, the mitigation bank, on its face, fails to consider all ecological impacts that the loss of that wetland will have upon the environment, and destroys the potential for future use.[289]

In addition to losing the ecological value of a wetland by using simple indices, mitigation credits are often undervalued.[290] For example, in 1996 the EPA rejected a MOA submitted through the Corps for the creation of a mitigation bank along the Santa Ana River in Riverside County, California.[291] The proposed bank[292] was to be located on a 174-acre site "to promote natural revegetation and restoration of native habitat for the endangered least Bell's vireo and other native riparian species through the removal of *Arundo donax, Ricinius communis and Tamarix spp.*"[293] In rejecting the proposal, the EPA listed its concerns: 1) the "long term viability of a native riparian ecosystem at the bank" was not considered;[294] 2) the bank actually would result in a "net loss" of wetlands because the proposal simply enhanced the value of the wetland in the bank and did not adequately mitigate the permanent loss of wetland acreage elsewhere;[295] 3) there was no acreage cap or maximum specified in the proposal, thus resulting in a gross undervaluation of the credits that would be used to mitigate other development projects;[296] and 4) the proposal did not consider other significant aspects of the bank, including biodiversity, hy-

289 *See supra* notes 283-85 and accompanying text.

290 *See* White, Interview, *supra* note 6.

291 *See* Letter from Daniel A. Meer, Chief, Clean Water Act Compliance Office, EPA, to Richard J. Schubel, Chief, Regulatory Branch, U.S. Army Corps of Engineers (Nov. 22, 1996) [hereinafter Letter from EPA] (on file with *Chapman Law Review*).

292 To be called the Santa Ana River Mitigation Bank. *See id.*

293 *Id. Arundo donax, Ricinius communis and Tamarix spp* is a giant cane-like weed. Erik Smith, *War Declared on Plant That Chokes Rivers: $6.4 Million Fight Readied Against the Baneful Weed*, THE PRESS-ENTER., Mar. 4, 1997, at B1. "It grows up to 10 inches a day, with 30-foot bamboo-like stalks so dense they squeeze out native plants and animals, not to mention people." *Id.* The plant (weed) has infested up to 5,000 acres and consumes "enough water each day to serve the city of Riverside, and Colton." *Id. See also*, Editorial, *Reclaiming the Santa Ana*, THE PRESS-ENTER., Mar. 5, 1997, at A10.

294 The proposed bank called for only a 20-year management period. The EPA considered this a significant problem because the bank would be part of the greater Santa Ana watershed which contains 5000 acres of *Arundo*. *See* Letter from EPA, *supra* note 291.

295 *See id.*

296 *See* Letter from Alexis Strauss, Acting Director, Water Division, EPA, to Lieutenant Colonel Robert L. Davis, District Engineer, U.S. Army Corps of Engineers (Feb. 24, 1997) (on file with *Chapman Law Review*). "The MOA allows the bank to be used as mitigation for impacts under the individual permit process. While the MOA states that it would only be used for minimal impacts, EPA is concerned that there is no acreage cap. Without a cap on the acreage, we believe that the bank could be used inappropriately as mitigation for the significant permanent loss of wetlands." *Id. See* Letter from EPA, *supra* note 291.

drology, and other wetland functions.[297] The EPA thus signified that it was primarily concerned with the long-term viability of the proposed bank and its value as an entire ecosystem with its attendant effects upon the environment.

2. Narrowly Tailored Assessment Methods[298]

In contrast to using simple indices, narrowly tailored systems attempt to directly measure and predict particular wetland functions.[299] For example, these methods assess the habitat of species, hydrology, or soil conditions.[300]

The most common narrowly tailored assessment method is the Habitat Evaluation Procedures (HEP) developed by the USFWS.[301] Under this technique, a standard computer model evaluates the "biological requirements and tolerances for certain indicator species to environmental variables as they occur on the subject property."[302]

Many mitigation banks have used the HEP assessment method in evaluating credits.[303] However, in most cases, the mitigation banks have altered the HEP methodology "to facilitate easier comparison of disparate wetlands."[304]

A method similar to the HEP is the Habitat Evaluation System (HES) developed by the Corps.[305] The HES method "examines an entire wetland for the structural indicators of habitat . . . rather than selecting species themselves as function indicators."[306] Thus, the HES method examines the dominant indicators of species habitat but fails, nonetheless, to assess the entire ecology of the property.[307]

Like simple indices, narrowly tailored assessment methods fail to evaluate *all* wetland functions.[308] However, from an ecologi-

297 *See* Letter from EPA, *supra* note 291.

298 There are various assessment methods developed by the states (e.g., SUPERBOG). *See* ELI, MITIGATION BANKING STUDY, *supra* note 4, at 67. Some are variations of the methods that are discussed here. Others are tailored to the specific projects involved. *See id.* at 67-68.

299 *See id.* at 63, 65.

300 *See id.* at 65-68.

301 *See* DENNISON, *supra* note 71, at 132.

302 *Id.* For example, water depth and quality, flooding periodicity, vegetation density and type, and soil type. *See id.*

303 *See* ELI, MITIGATION BANKING STUDY, *supra* note 4, at 67.

304 *Id.* The Astoria Airport Mitigation Bank in Clatsop County, Oregon has established the available credits to be the difference in totals of the species HUs before and after restoration. Thus, this variation considers the number of habitat units available after restoring the wetlands rather than the HEP's version of prior assessment. *See id.* at 143, 147.

305 *See id.* at 68.

306 *Id.*

307 *See id.*

308 *See id.* at 65 (emphasis added).

cal perspective, these approaches are superior to using simple indices because they require more information in assessing actual wetland functions, rather than a cursory evaluation of wetland characteristics.

As of 1994, 13 wetland mitigation banks (28% of the total) used narrowly tailored assessment methods for valuing mitigation credits in the United States.[309] In California, 4 of the total 11 mitigation banks (36%) used the same method.[310] One example is the San Joaquin Marsh in Orange County, California.[311] The bank, developed by the Irvine Company,[312] is 492 acres, the largest freshwater marsh in Southern California.[313] As part of the restoration, several species of plants were transplanted into the marsh and several non-native plants were removed.[314] These plants and other wetland functions and values were assessed using a Habitat Valuation Analysis (HVA), a narrowly tailored method similar to the HEP.[315]

3. Broadly Tailored Assessment Methods

In response to the disadvantages of simple indices and narrowly tailored assessment methods, "wetland scientists have developed assessment methods that attempt to evaluate a broader spectrum of wetland functions."[316] Ideally, these methods empirically measure each wetland function in the field and produce measurable, quantitative values.[317] However, the time and expense involved in using these methods may be impracticable for use in mitigation banking.[318]

The Wetland Evaluation Technique (WET) developed by the Corps and Federal Highway Association is an example of this technique.[319] WET has been used by many agencies and banks in

309 *See id.* at 145-47.

310 *See id.*

311 *See id.*

312 The Irvine Company is a privately held real estate investment firm based in Orange County, California. It owns roughly one-sixth of the land in Orange County, thereby controlling much of the development of the County. It has substantial holdings in the cities of Irvine, Newport Beach, and Tustin.

313 *See* California Resources Agency, *San Joaquin Marsh* (visited Mar. 30, 1998) <http://ceres.ca.gov/wetlands/geo_info/so_cal/san_joaquin.html>.

314 California bulrush or tules, Olney's bulrush, Alkali bulrush, Common rushes (transplanted), tamarisk, artichoke, black mustard (removed). *See* Tim Bradle & Marjorie Patrick, Department of Ecology & Evolutionary Biology, UC Irvine, *Restoration of a Marsh Pond in the San Joaquin Freshwater Marsh Reserve* (visited Apr. 20, 1998) <http://128.200.23.67/sjfmr/restore2.html>. *See also* Bill Bretz, Office of Natural Resources, U.C. Irvine, *San Joaquin Freshwater Marsh Reserve* (last modified Mar. 9, 1999) <http://nrs.ucop.edu/reserves/sjfm.html>.

315 *See* ELI, MITIGATION BANKING STUDY, *supra* note 4, at 145.

316 *Id.* at 68.

317 *See id.*

318 *See id.* at 68-69.

319 *See* DENNISON, *supra* note 71, at 132.

assessing wetland functions.[320] Under this technique, the analyst first gathers information from maps and other printed materials about "various wetland characteristics or 'indicators.'"[321] These indicators are then combined into "three ratings[322] for each of eleven wetland functions: groundwater recharge; groundwater discharge; flood-flow storage & desynchronization; shoreline anchoring & dissipation of erosive forces; sediment trapping; nutrient retention & removal; food chain support; fisheries habitat; wildlife habitat; active recreation, and passive recreation & heritage value."[323] The ratings represent, for each function, the wetland's projected "effectiveness,"[324] "opportunity,"[325] and "social significance."[326] The ratings are qualitative rather than quantitative.[327] Thus, the overall quality of the wetland is assessed to determine the probability that each of the indicators supply their corresponding wetland functions.[328]

Similar to WET, the Wetland Evaluation Methodology (WEM) values wetland functions by assessing wetland characteristics or indicators.[329] WEM, however, uses fewer indicators to value wetland functions.[330] The indicators are processed and the data is assessed into quantitative and numerical functional ratings.[331] These ratings are then converted to represent a quantitative value, and are assigned a rating based on their importance to wetland functions.[332]

The greatest disadvantage in using a broadly tailored assessment methodology is that the process is time-consuming, complex, and expensive.[333] The obvious advantage of using this method is that it provides a better representation of the entire ecological value of the mitigation bank or compensated wetland.[334]

As of 1994, only four mitigation banks (9%) used a broadly tailored method for assessing wetland functions and values.[335] Two of the four were supplemented by using the best professional

320 *See* ELI, MITIGATION BANKING STUDY, *supra* note 4, at 69.

321 *Id.* Including, gradient of the basin, soils, land cover, and habitat. *See id.*

322 Those ratings are low, moderate, and high. *Id.*

323 *Id.*

324 "[C]an the wetland perform the function?" *Id.*

325 "[D]oes the wetland have the opportunity to be effective?" *Id.*

326 *Id.* "[H]ow important is the function to society?" *Id.*

327 *See id.*

328 *See id.*

329 *See id.* at 70.

330 *See id.* (Flood-flow characteristics, water quality, wildlife, fish, shoreline anchoring, and visual values). *See id.*

331 *See id.*

332 *See id.*

333 *See id.* at 68.

334 *See id.*

335 *See id.* at 145-47.

judgment approach.[336] In California, no mitigation banks used this approach in assessing wetland values and functions.[337]

Wetland mitigation banks that use this method, such as the Hillsborough County Utilities Department in Florida,[338] assess wetland values based on several wetland indicators, such as groundwater recharge and discharge, flood control, sediment trapping, food chain support, and wildlife habitat.[339] Thus, rather than merely assessing a few of the dominant wetland characteristics like a narrowly tailored assessment method, the broadly tailored approach attempts to determine how several wetland functions contribute to the overall ecological value of the wetland bank being analyzed. Therefore, the broadly tailored approach provides a better representation of the overall value of the wetland and its attendant values and functions.

4. Best Professional Judgment

Although not listed within the three categories of valuation techniques, some banks use best professional judgment in assessing wetland values and functions.[340] Under this technique, individuals who are familiar with wetlands and their functions make the decisions regarding the best use of the wetland "based on their own knowledge."[341]

The advantage of this method is that it produces an educated and well-founded assessment of individual wetlands based on expertise and experience.[342] The disadvantage is that the individual making the assessment is granted limitless power and thus the "real issue then becomes holding the [assessor] to a standard of quality and loyalty to the ecological objectives of wetland mitigation."[343]

As of 1994, only three wetland mitigation banks (6%) used this method in the United States.[344] In California, one bank (9%) used best professional judgment for assessing wetland values and functions.[345] A summary of the number of banks using each technique both nationally and in California is listed in the following tables.

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336 Cheval Tournament Players Club, Hillsborough County Utilities Dep't Mitigation Bank. *See id.* at 141, 145; *See infra* notes 340-45 and accompanying text.

337 *See id.* at 145-47.

338 *See id.* at 141, 145.

339 *See id.* at 69.

340 *See id.* at 71-72.

341 *Id.* at 72.

342 *See id.*

343 *Id.*

344 *See id.* at 145-47.

345 *See id.* at 141, 145.

TABLE 1. WETLAND MITIGATION BANKS & CREDIT VALUATION METHODS—UNITED STATES (1994)[346]

Credit Valuation Method	Number of Banks Using Method	Percentage of Banks Using Method
Simple Indices	22	48%
Narrowly Tailored	13	28%
Broadly Tailored	4[347]	9%
Best Professional Judgment	3	6%
Other[348]	4	9%
Totals	46	100%

TABLE 2. WETLAND MITIGATION BANKS & CREDIT VALUATION METHODS—CALIFORNIA (1994)[349]

Credit Valuation Method	Number of Banks Using Method	Percentage of Banks Using Method
Simple Indices	6	55%
Narrowly Tailored	4	36%
Broadly Tailored	0	0
Best Professional Judgment	1	9%
Other	0	0
Totals	11	100%

Based on the 1994 data, the majority of wetland mitigation banks in the country use simple indices for determining wetland values and functions.[350] The second most common approach is a narrowly tailored method.[351] Thus, the data suggests that more mitigation banks are using a simpler, easier, less expensive approach to assessing wetland values and functions, rather than using more sophisticated, ecologically responsible approaches.

VI. CHALLENGE: CREDIT VALUATION

A continuing debate exists over whether or not wetland mitigation banking is a good mode of compensatory mitigation.[352] One author concludes that mitigation banking is a useful tool for protecting wetlands because mitigation banks can be more successful

346 *See id.* at 131-32, 145-47.

347 Two banks used a broadly tailored assessment method and best professional judgment. *See id.* at 145.

348 *See id.* at 145-47. (Other, not specified, case-by-case).

349 *See id.*

350 *See id.* at 145-47.

351 *See id.*

352 *See* Andrew Roe, *These Banks Are All Wet: Wetland Banks Are Growing as an Alternative to Fragmented Rebuilding of Damaged Sites, But Their Rules Are Changing*, ENG'G NEWS-RECORD, Feb. 16, 1998, at 32.

ecologically, as well as more convenient and less expensive to the applicant.[353] On the other hand, one opponent argues that mitigation banking decreases the national supply of wetlands because they often fail,[354] the sale of credits is not susceptible to public scrutiny through review and comment, and mitigation banking significantly alters the type and location of wetlands.[355] The opponent concludes: "[w]etlands mitigation may be a necessary evil, but mitigation banks may well be the devil incarnate."[356]

Generally, "as the understanding of wetland types and functions has increased, [mitigation banking] has been recognized as potentially detrimental within a watershed" because, by allowing "out-of-kind" mitigation such as restoration and creation, "regulatory agencies cause overall local gains of certain common, easily attained, earlier successional-stage [sic] wetland functions, while concurrent losses are of increasingly scarce, difficult to replace, more complex functions."[357] The detriment to the watershed and the supply of wetlands is caused primarily by "gaps in technical understanding of ecological functions [that] make it difficult for regulators to require applicants to quantify such functions in site assessments and mitigation designs."[358]

One way to correct this problem is to simply require on-site mitigation.[359] However, requiring on-site mitigation effectively dismantles the mitigation banking concept. To continue using mitigation banking as a form of compensatory mitigation, regulators must apply an ecologically comprehensive method of assessing wetland functions and values which are, in the mitigation banking framework, represented by credits.

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353 *See* William W. Sapp, *Mitigation Banking: Panacea or Poison For Wetland Protection*, 1 ENVTL. LAW. 99 (1994). Benefits include: an organization can remove the uncertainty of mitigation requirements by obtaining credits from a bank, thus expediting a project and more quickly realizing financial objectives; an organization will save time and money on site acquisition, environmental analysis, regulatory negotiations and the maintenance and monitoring of a wetlands mitigation site; a company can purchase mitigation credits for less than it would cost the company to perform its own mitigation or to contract out for the mitigation; and an organization will be freed of mitigation requirements and liability including long term monitoring. Michael G. Le Desma, Note, *A Sound of Thunder: Problems and Prospects in Wetland Mitigation Banking*, 19 COLUM. J. ENVTL. L. 497 (1994); *But see* White, Interview, *supra* note 6 (wetland mitigation banking may not be preferable to on-site mitigation because it is too "easy for a developer to simply cut a check" rather than take the ecological value of the impacted wetland into consideration).

354 *See* Arthur Feinstein, *Mitigation Banks Often Rob Us*, ENG'G NEWS-RECORD, Apr. 6, 1998, at 91 (citing recent Florida study showing that many mitigation projects subsequently failed).

355 *See id.* ("An entrepreneur will seek the cheapest land for a mitigation bank and it is cheaper to dig a shallow hole rather than design and create a complicated ecosystem.").

356 *Id.*

357 Watersheds, *supra* note 129.

358 *Id.*

359 *See* White, Interview, *supra* note 6.

VII. OVERSIMPLIFICATION: ECOLOGICAL ETHICS

The extensive use of simple indices for assessing wetland values and functions is problematic in essentially three ways: 1) it is ecologically irresponsible; 2) it is inconsistent with the goals and objectives of the section 404 permit process; and 3) it is contrary to public policy at both the federal and state level.

A. Ecologically Irresponsible

The primary argument against using simple indices for valuing wetland functions and values is based on ecological ethics.[360] Professor Joseph Sax has identified two conflicting views of property rights based on a private citizen's use of property versus the property's inherent worth.[361] The first view is referred to as land in a "transformative economy."[362] The second, ecological approach, is called the "economy of nature."[363]

In a transformative economy, which Professor Sax calls the "conventional perspective of private property," property is viewed "as a discrete entity that can be made one's own by working it and transforming it into a human artifact."[364] Land "is in a passive state, waiting to be put to use."[365] In the context of mitigation banking, the property is being put to use by a developer depositing dredged or fill material into a wetland for a particular development project for his or her own use. To compensate for the loss of that wetland, the developer uses mitigation credits to replace the functions and values of the destroyed wetlands.[366] It is irrelevant to the developer whether or not the credits used are of comparable value and function to the destroyed values and functions of the wetland, because the land is "subject [to the] owner's dominion" and control.[367] Therefore, this view supports the proposition that land has a single purpose—to be transformed into the desirable use of the property owner.

In contrast, the economy of nature "views land as consisting of systems defined by their function, not by man-made boundaries."[368] "Land is not a passive entity waiting to be transformed by its landowner. . . . Land is already at work, performing important

360 For another example of environmental ethics, see PAUL W. TAYLOR, RESPECT FOR NATURE: A THEORY OF ENVIRONMENTAL ETHICS (1986) (biocentric outlook on nature).

361 Joseph L. Sax, *Property Rights and the Economy of Nature: Understanding* Lucas v. South Carolina Coastal Council, 45 STAN. L. REV. 1433, 1442 (1993).

362 *Id.*

363 *Id.*

364 *Id.*

365 *Id. See also* Jonathan R, Macey, *Property Rights, Innovation, and Constitutional Structure, in* PROPERTY RIGHTS (Ellen Frankel Paul et al. eds., 1994).

366 *See* DENNISON, *supra* note 71, at 138.

367 Sax, *supra* note 361, at 1445.

368 *Id.* at 1442.

services in its unaltered state."[369] For example, wetlands are sanctuaries for wildlife, act as flood control, and are barriers to erosion and storm damage.[370] In the context of mitigation banking, the wetland being impacted by the developer is already at work performing valuable services to the ecological integrity of the natural environment. Thus, the mitigation credits used to compensate for a developer's adverse impact on that wetland should represent similar values and functions to maintain ecological equilibrium.

The issue becomes the interest of the developer in using the property "at will" versus an ecologically based ethic that land has inherent value. Viewing land as being under the dominion and control of the landowner suggests that any method of assessing wetland values and functions is proper in the mitigation banking context. Thus, whether or not the regulatory agency assesses wetland values and functions based on simple indices, narrowly tailored methods, or a broadly tailored approach is irrelevant. However, the use of simple indices is preferred by the landowner because this technique saves the developer considerable time and costs. This preference is criticized, because, as one environmental scientist has stated, "[w]hat you end up with is a lot of lousy mitigation sites because people do the minimum they can to get a permit."[371]

In contrast, viewing land as having inherent, ecological value, that is already providing valuable services to the natural environment, requires utilizing the best methods available for assessing wetland values and functions in determining the value of mitigation credits. The widespread use of valuing wetlands using simple indices is repugnant to maintaining the ecological balance of the natural environment because of their limited scope in actually considering all functions and values present in the wetland ecosystem. The "economy of nature" view requires a broadly tailored assessment method to ensure actual replacement of lost wetland values and functions because of the method's ecologically comprehensive approach.

In making a decision as to which view of private property rights is the correct one, morality and ethical considerations may differ from the law.[372] For example, some may view the filling of wetlands as morally irresponsible, although it may be legal via the section 404 permit process. Similarly, the use of simple indices in

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369 *Id.*

370 *See supra* notes 11-13 and accompanying text.

371 Patty Reinert, *Developers, Environmentalists Find Common Ground on Wetlands Bill*, DAILY RECORD, Mar. 29, 1993, at 5.

372 *See* TIMOTHY BEATLEY, ETHICAL LAND USE: PRINCIPLES OF POLICY AND PLANNING 16 (1994).

valuing wetland mitigation credits may not be the morally best method of assessing wetland values and functions. Thus, an examination of the goals and policy of the section 404 permitting scheme is required to determine which view of land is reflected—that land's single purpose is to be transformed into the desirable use by the landowner, or that land is already at work performing important services in its unaltered state—and which assessment method is consistent with that view.

B. Inconsistency with Goals and Objectives of Section 404 Permitting

Applying the EPA Guidelines,[373] the Corps is required to deny a section 404 permit if the discharge of dredged or fill material violates state or federal law or contributes to the significant degradation of waters of the United States.[374] In determining what constitutes "significant degradation," the Corps must consider the adverse effects on human health or welfare, ecosystems, biodiversity, and economic values.[375] Thus, a consideration of adverse impacts on ecosystems and biodiversity are components in the Corps' analysis of whether or not a permit should be granted.

By definition, the use of simple indices does not consider the overall ecological value of the wetland being assessed.[376] Instead, only a few characteristics of the wetland are identified, such as eelgrass in the Naval Amphibious Base Eelgrass Mitigation Bank in San Diego.[377] The result is therefore a one-for-one acreage replacement based on a few characteristics between the two wetlands in the form of a credit, rather than making a general assessment of the overall ecological value of the wetland in the mitigation bank and the compensated wetland.[378] One may conclude that by using simple indices the Corps fails to adequately identify the potential impact on the ecosystem and other factors, such as biodiversity, making it impossible to correctly determine if there is significant degradation to the waters of the United States.

Similarly, the 1990 MOA between the EPA and the Corps identifies the requirements necessary for compensating for wetland loss when there is an unavoidable adverse impact to a wetland in a proposed development project after all minimization measures have been exercised.[379] In that case, the applicant developer is required to compensate for the unavoidable loss by us-

373 *See* 40 C.F.R. §§ 230-230.80 (1998).
374 *See* 33 U.S.C.A. § 1344 (West 1986 & Supp. 1998).
375 *See* 40 C.F.R. §§ 230.10(b)-(c) (1998).
376 *See supra* notes 270-71 and accompanying text.
377 *See supra* notes 283-85 and accompanying text.
378 *See id.*
379 *See* MOA, *supra* note 115 at 9211-12.

ing on-site mitigation, off-site-mitigation, or mitigation banking.[380] The MOA expressly states that on-site mitigation is the best alternative.[381] This preference is attributed to the belief that on-site mitigation is a better representative of the overall ecological value of the impacted wetland.[382] In contrast, the use of mitigation banking as an alternative is least preferred because mitigation banks often fail to adequately represent the overall functions and values lost or destroyed in the wetland impacted by a development project.[383] The failure to replace lost values and functions of a wetland ecosystem may be attributed to the use of simple indices because only a select few of the wetland characteristics are identified and used in replacing lost values or functions.[384] In contrast, mitigation banks that use a broadly tailored assessment method should consider the overall ecological value of the wetland.[385] Banks using a broadly tailored assessment method are arguably similar to those using the preferred on-site mitigation because the actual lost values and functions are adequately replaced.

In conclusion, simple indices fail to adequately consider the overall ecological value of the wetland mitigation bank and compensated wetland. This failure is inconsistent with the goals and objectives of the section 404 permitting process, because the intent of the Corps and the EPA is to replace all functions and values of a destroyed or impacted wetland with similar values and functions represented in a mitigation bank. To accomplish this result, the use of broadly tailored assessment methods is necessary because these techniques do, in fact, assess wetlands based on multiple characteristics and values which are a better representation of the overall ecological value of the wetland being compensated with the ecological value in the mitigation bank.

C. The Better Approach: Comparable Ecological Value

Both federal and state policy considerations recognize that wetlands play a vital role in maintaining the ecological integrity of the nation's waters.[386] Thus, the federal government implemented the no-net-loss policy, which was endorsed by the states.[387] Arguably, the no-net-loss policy is a call for maintaining the existing number of wetlands in the United States. This interpretation merely requires that for each acre of wetland destroyed, one must be replaced. However, such an argument is contrary to broader

380 *See id.* at 9212.
381 *Id.*
382 *See* White, Interview, *supra* note 6.
383 *See id.*
384 *See supra* notes 270-71 and accompanying text.
385 *See supra* note 316 and accompanying text.
386 *See supra* notes 211-30 and accompanying text.
387 *See id.*

social goals and objectives involved in preserving wetlands because it fails to consider whether what is being replaced is ecologically comparable to what has been destroyed. Therefore, the correct interpretation of the no-net-loss policy is not simply a one-for-one replacement of wetlands restored, enhanced or created for ones destroyed, but a one-for-one replacement of wetlands of comparable ecological value to those destroyed. Since simple indices fail to assess the overall ecological values and functions present in a compensated wetland or mitigation bank, the results are uncertain about whether there is actually a net loss of wetland values and functions between the compensated wetland and mitigation bank.[388] To correct this uncertainty, a broadly tailored assessment method is necessary to determine if actual wetland functions and values are being compensated in the bank.

VIII. Remediating the Oversimplification Dilemma

The simplest means of correcting the problem of valuing wetland mitigation credits is to abandon mitigation banking altogether. This approach would require landowners and regulators to use traditional forms of compensatory mitigation, such as on-site preservation or off-site creation, restoration, or enhancement. Alternatively, the landowner could utilize one of many wetland protection strategies, such as a conservation easement, management agreement, limited development agreement, or voluntary landowner incentive program.[389] However, such a solution does not really correct the problem; it ignores it.

One way to correct the widespread use of simple indices in valuing mitigation credits would be to require landowners and regulators to use ecologically comprehensive methods of assessment, such as the Wetland Evaluation Technique or Wetland Evaluation Methodology. The use of these comprehensive or broadly tailored assessment methodologies results in a better representation of the entire ecological value of the compensated wetland versus the functions and values of the mitigation bank.[390] However, the use of broadly tailored assessment methods is time-consuming, complex, and expensive.[391] These characteristics are inconsistent with the mitigation banking concept because mitigation banking is designed to reduce costs to the regulated community and save time by creating banks in anticipation of development.

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388 *See supra* notes 270-77 and accompanying text.

389 *See supra* notes 16-34 and accompanying text.

390 *See supra* notes 316-17 and accompanying text.

391 *See supra* note 318 and accompanying text.

To remedy this inconsistency, the developer or regulatory agency can exercise various land-use planning techniques. For example, section 404(b)(1) of the CWA allows the Corps and the EPA to identify wetlands as suitable or unsuitable for disposal sites even before a permit application has been filed (Advanced Identification Program).[392] The developer-applicant can reasonably foresee whether or not his or her proposed project will require a section 404 permit. This prospective planning may save the developer-applicant considerable time in determining whether or not the property will have to be mitigated. A similar approach exists under applicable special area management plans and procedures, such as California's procedural guidance for the establishment of wetland mitigation projects in California's coastal zone.[393] These plans and procedures guide the developer in determining which mitigation measures are appropriate within a defined geographic region such as the coastal zone. Like the Advanced Identification Program,[394] the developer-applicant can reasonably determine what mitigation measures are appropriate for his or her project. Finally, state and local planning agencies may assist landowners in defining what mitigation will be appropriate for their potential projects under various planning techniques. For example, California's conservation policy and programs assist developer-applicants in determining suitable areas for mitigation, determining the actions required, and in creating incentives for the developer-applicant to comply with the program's requirements, such as tax deductions, technical advice, and limited liability.[395] Thus, the developer can save time and costs by consulting various planning techniques already instituted by various federal, state, and local authorities.

The disadvantages of using broadly tailored assessment methods, such as time, complexity and costs, can be offset by applying various federal, state, and local planning techniques. The end result would be a broader, more ecologically comprehensive approach to assessing wetland values and functions. The ecological integrity of the wetland would be preserved, the goals of the section 404 permit process met, and federal and state policy considerations satisfied.

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392 *See* 40 C.F.R. § 230.80 (1998).

393 *See* California Resources Agency, *Procedural Guidance for the Establishment of Wetland Mitigation Projects in California's Coastal Zone* (visited Feb. 21, 1998) <http://ceres.ca.gov/coastalcomm/weteval/wetc.html>. *See also* 60 Fed. Reg. 58,605-14 (1995).

394 *See* 40 C.F.R. § 230 (1998).

395 *See generally* Timothy Beatley, *Preserving Biodiversity Through the Use of Habitat Conservation Plans*, *in* COLLABORATIVE PLANNING FOR WETLANDS AND WILDLIFE: ISSUES AND EXAMPLES 35 (Douglas R. Porter & David A. Salvesen eds., 1995).

IX. CONCLUSION

The destruction of wetlands in the United States continues at an alarming rate.[396] To prevent further destruction of this natural resource, the states and the federal government have implemented legislation to protect wetlands or at least to minimize adverse effects upon them.[397] One such mechanism to prevent further destruction of wetlands is mitigation banking, a form of compensation in the section 404 permit process for unavoidable impacts on wetlands in development projects.[398] However, for mitigation banking to work successfully, ecologically comprehensive methods of valuing mitigation credits must be employed to assure that there are, at least, similar wetland values and functions in the mitigation bank to compensate for the destroyed or impacted wetland in the development project. The use of ecologically comprehensive methods is consistent with the goals and objectives of section 404 permitting, federal and state policy, and is simply a matter of ecological ethics: land is at work, performing valuable services to the ecological integrity of the natural environment.

396 *See supra* notes 1-2 and accompanying text.
397 *See supra* note 3 and accompanying text.
398 *See supra* notes 4-6 and accompanying text.