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# Ability to Pay

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# ABILITY TO PAY

STEPHEN UTZ\*

## I. INTRODUCTION

There is broad,<sup>1</sup> if not universal,<sup>2</sup> agreement that fair taxation should be in accordance with “ability to pay,” or the capacity of the

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1. “Taxation according to ability to pay for the last hundred years or more has been a universally accepted postulate, not only amongst political and economic writers, but amongst the public at large.” Nicholas Kaldor, *An Expenditure Tax* 26 (3d ed., George Allen & Unwin, Ltd. 1955); see Joseph A. Schumpeter, *The Crisis of the Tax State*, in *International Economic Papers* (Alan Peacock et al. eds. 1954).

2. Proponents of taxation according to benefit, sometimes called the “equivalence principle,” traditionally reject the ability to pay approach. See e.g. Knut Wicksell, *Ein neues Prinzip der gerechten Besteuerung*, in *Finanztheoretische Untersuchungen* iv-vi, 76-87, 101-59 (1896), translated as *A New Principle of Just Taxation*, in *Classics in the Theory of Public Finance* 72-118 (Richard A. Musgrave & Alan T. Peacock eds., J.M. Buchanan trans., St. Martin’s Press 1967) [hereinafter, Musgrave, *Classics*] (introducing indifference curve analysis of benefit taxation); see generally e.g. Erik Lindahl, *Die Gerechtigkeit der Besteuerung* 85-98 (1919), translated as *Just Taxation—A Positive Solution* in *Classics in the Theory of Public Finance*, 168-76 in Musgrave,

taxpayer to bear the tax burden.<sup>3</sup> It is not easy, however, to state the consensus view with any precision. Ability to pay or capacity to bear a

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*Classics* (further refinements on Wicksellian approach); Richard A. Musgrave, *The Theory of Public Finance, A Study in Public Economy* 61-89 (McGraw-Hill 1959) [hereinafter Musgrave, *Theory*] (illustrating a survey of benefit taxation); Edwin R.A. Seligman, *Progressive Taxation in Theory and Practice*, 78-126 (2d ed. Princeton U. Press 1908) [hereinafter Seligman, *Progressive Taxation*] (a survey of benefit taxation); Klaus Tipke, 1 *Die Steuerrechtsordnung* 473-78 (Verlag 1993) (discussing the survey of benefit taxation). Despite the general acceptance of the ability to pay approach, a minority tradition in tax policy still considers benefit taxation a theoretically significant alternative. See Richard A. Epstein, *Simple Rules For a Complex World* 137-38 (Harvard U. Press 1995) (discussing the centrality of matching taxes with governmental benefits). More importantly, perhaps, tax policy theorists sometimes regard the benefit and ability to pay approaches as compatible, at least if they are understood to apply to separate portions of the tax system; for example, the benefit approach seems appropriate to state and local taxation, and has long been influential on that area of tax policy, while the ability to pay approach may seem to dominate the design and implementation of broad-based direct taxation of income or consumption. Musgrave, *Theory*, at 62-63, 68. It should also be noted that the benefit and ability to pay approaches may overlap; we may, for example, consider rich people to be both more capable of bearing the burden of taxes and to be more greatly benefited by some governmentally provided public goods. David F. Bradford, *Untangling the Income Tax* 150 (Harvard U. Press 1986).

3. Richard A. Musgrave, *Horizontal Equity, Once More* 43 Natl. Tax J. 114 (1990) (stating Adam Smith is often credited with the first formulation of an ability to pay doctrine: his first "maxim" of taxation prescribed that "the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities . . .") (quoting Adam Smith, *The Wealth of Nations*, Bk. IV, Ch. II, Pt. II (1776); Seligman, *Progressive Taxation*, *supra* n. 2, at 205-06 (stating ability to pay has roots in medieval and modern versions of the view that tax justice requires that and only that subjects or citizens pay taxes according to "faculty"). Contemporary writers often invoke the doctrine as if it were universally accepted. See Richard Goode, *The Economic Definition of Income*, in *Comprehensive Income Taxation* 1-10 (Joseph Pechman ed., 1977) (stating "as I see it the income tax is superior in principle to the expenditure tax, first because income is generally a better index of ability to pay than is consumption"); Institute For Fiscal Studies, *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J.E. Meade* 34 (George Allen & Unwin 1978) (illustrating that between income and consumption as tax bases, ability to pay should determine which is the more equitable); but see David F. Bradford, *Untangling the Income Tax* 150-52 (Harvard U. Press 1986) (demonstrating "benefit" and "ability to pay" approaches to determining tax fairness are clear enough for use in tax design but administrative convenience is a better guide to practical tax problems). Principal works on the history of the ability to pay doctrine include Edwin R.A. Seligman, *The Income Tax* 15-18, 638 (Macmillan Co. 1911); Musgrave, *Theory*, *supra* n. 2, at 90-115; see also Henry C. Simons, *Personal Income Taxation* 5, 69-80 (U. of Chi. Press 1938). Simons also surveys the development of parallel and divergent concepts of ability in Germany in the nineteenth

tax<sup>4</sup> is of interest because, by general assumption, the fair treatment of taxpayers requires that burdens be equal.<sup>5</sup> The greater one's ability to pay, the higher the fair tax, and perhaps the higher the fair rate of tax.<sup>6</sup> This much is commonly accepted.<sup>7</sup> Opinions differ crucially as to the best measure of ability to pay. Individual wealth, income, endowment for consumption, and other proxies figure in a voluminous tax policy literature.<sup>8</sup> But even as broad a statement as this may not capture all that ability to pay has come to mean.<sup>9</sup>

Throughout much of the last two centuries, an ability to pay approach has been inextricably linked with arguments for direct taxation.<sup>10</sup> Thus, the vast majority of those who today either advocate a purified income tax or would prefer a shift to a general consumption tax nevertheless seem to agree that taxation in accordance with ability

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century. *Id.* at 69-102 (ostensibly a survey of "other definitions" of income, this chapter in fact provides a partial summary of German theorists' responses to the underlying concept of ability to pay as well).

4. Unless otherwise indicated, "ability to pay" and "taxable capacity" are used interchangeably throughout this article, as indeed they are in the literature on the subject. See Kaldor, *supra* n. 1, at 25.

5. Simons, *supra* n. 3, at 6.

6. See *id.* at 26-30. This formulation assumes some ambiguity concerning what it is that confers "ability" in the relevant sense. The early history of direct taxation in the major industrial democracies illustrates that even experts found it difficult not to equivocate concerning these alternatives, before they were made familiar through legislation and administrative practice.

7. *Id.*

8. Seligman, *Progressive Taxation*, *supra* n. 2, at 241-50.

9. *Id.* at 206. Ability to pay apparently descends from medieval notions of tax fairness, associated with the term "faculty," from which more recent tax theorists extracted the essence, or thought they were doing so. *Id.* at 205-06. "Faculty" had already taken on the meaning of something like revenue or income in the seventeenth century British colonies in America. *Id.* Five colonies' laws imposed "faculty taxes" which were expressly not applicable to "visible estates" or property but to "returns or gains." *Id.* at 206. (Plymouth, Massachusetts Bay, Connecticut, New Haven, and Rhode Island, as separate legislating authorities, imposed taxes on "faculty" in this sense. *Id.* at n. 4). *The French Declaration of the Rights of Man and of the Citizen* declared that "[l]a contribution commune doit être également répartie entre tous les citoyens en raison de leur facultés"—"general support of government must be equally divided among citizens according to ability." *Id.* at n. 5 (quoting *Déclaration des Droits de l'Homme et du Citoyen*, 26 Août-3 Novembre, 1789, §13). Nevertheless, nineteenth and early twentieth-century writers sometimes had the older concept of faculty in mind when they wrote of tax-paying ability.

10. Kaldor, *supra* n. 1, at 25-26.

to pay sums up the issue of tax justice.<sup>11</sup> Despite this, in my view, no useful formulation of ability to pay has escaped devastating criticism.

The thesis of this Article is that assumptions based on blurred and patently wrong conceptions of ability to pay undermine the discussion of tax equity and other matters of tax principle. Much past and current writing on tax policy relies on views that adherents of the ability to pay approach and critics alike have long since agreed are mistaken, irrelevant, or misleading.<sup>12</sup> We would reason more cogently about taxation if we carefully distinguished between two approaches that have been conflated. One postulates that utility schedules or welfare schedules of another sort are the ultimate touchstone of fairness in taxation.<sup>13</sup> The second, strongly associated with the rejection of the "welfarism" of the first approach, holds that monetary measures of wealth, income, or consumption are adequate and indeed authoritative in settling questions of equal treatment.<sup>14</sup> The two approaches are obviously not equivalent, but the tacit assumption that they are approximate twins haunts many discussions, especially those concerning income and consumption tax alternatives.

In modern form, the ability to pay approach took shape in nineteenth-century debates about the proper design of direct taxation, at roughly the same time as the widespread adoption of the first national income tax regimes.<sup>15</sup> These debates drew heavily on then current views about utility and welfare and generated complex and explicit hypotheses about the impact of taxes on individual and collective welfare, but subsequent criticism has devastated those hypotheses.<sup>16</sup> Nevertheless, many writers on tax policy continue to pay lip service to the primacy of ability to pay as a distinctive approach to tax fairness issues, often deriving no particular argumentative advantage from

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11. *Id.* at 26 (stating "[t]axation according to ability to pay for the last hundred years or more has been a universally accepted postulate, not only amongst political and economic writers, but amongst the public at large").

12. See generally Bradford, *supra* n. 3, at 151; Simons, *supra* n. 3, at 5-7; Kaldor, *supra* n. 1, at 25-28.

13. Jeffrey A. Schoenblum, *Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 Am. J. Tax Policy 221, 236-39 (1995).

14. Seligman, *Progressive Taxation*, *supra* n. 2, at 208-10.

15. Schoenblum, *supra* n. 13, at 232-33.

16. *Id.* at 223 (illustrating a recent negative assessment of the utilitarian version of ability to pay).

doing so, but nevertheless refusing to re-examine this asserted grounding of their views.<sup>17</sup> Perhaps encouraged by such nominal support for ability to pay, others unapologetically rely on the approach in its now largely discredited earlier forms, and they do so without pausing to answer the discrediting arguments.<sup>18</sup> In brief, ability to pay survives as an honored but empty relic or as an excuse for outmoded analysis.

The usual utility-based interpretation of ability to pay typically assumes that taxpayers have identical utility schedules for money-income, at least over the relevant range of income for a given tax regime.<sup>19</sup> The assumption is often not expressed in these or any other precise terms, it is tacitly assumed, perhaps without serious comprehension of its significance. Sometimes, the assumption is imported as a corollary of the proposition that a "comprehensive" definition of income for tax purposes is fairer than more limited definitions.<sup>20</sup> This occurs when tax policy experts who profess that they accept the Schanz-Haig-Simons definition of income actually mean that they consider income measured in monetary terms to be a fair proxy for increase or decrease in welfare or utility.<sup>21</sup>

Professed reliance on the ability to pay principle may also sometimes signify no more than that, the author believes a progressive income or consumption tax to be preferable to proportional and regressive versions of such taxes.<sup>22</sup> Of course, a preference for progressive tax rate structures may rest on the underlying premises that individual welfare can be adequately analyzed in terms of utility, that money has an identical decreasing marginal utility for everyone *and*

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17. See e.g. Joseph M. Dodge, *The Logic of Tax* 86-91 (West Publ. Co., 1989).

18. See e.g. Louis Kaplow, *A Note on Horizontal Equity*, 1 Fla. Tax Rev. 191 (1992).

19. Schoenblum, *supra* n. 13, at 239.

20. See Goode, *supra* n. 3, at 9.

21. See e.g. Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. Pa. L. Rev. 851 (1987); Daniel Halperin, *Valuing Personal Consumption: Cost Versus Value and the Impact of Insurance*, 1 Fla. Tax Rev. 1 (1992); Stanley A. Koppelman, *Personal Deductions Under an Ideal Income Tax*, 43 Tax L. Rev. 679 (1988).

22. See e.g. Daniel L. Simmons, *The Tax Reform Act of 1986: An Overview*, 1987 B.Y.U. L. Rev. 151 (1987); William J. Turner, *Personal Deductions and Tax Reform: The High Road and the Low Road*, 31 Vill. L. Rev. 1703 (1986); Deborah M. Weiss, *Can Capital Tax Policy Be Fair? Stimulating Savings Through Differentiated Tax Rates*, 78 Cornell L. Rev. 206 (1993).

that tax fairness requires an equal, minimal, or proportional sacrifice of welfare.<sup>23</sup> A believer in progressivity may on the other hand be noncommittal where welfare analysis is concerned, may not be sure what makes progressivity fair, but may simply believe that this is the right result, whatever the justification may ultimately be.<sup>24</sup>

To assume everyone to have the same utility schedule is at odds with widely shared views about how people actually value or benefit from their acts and experiences. No serious defender of utilitarianism would today maintain that the utility of most events for most people is approximately or on average the same. Indeed, serious utilitarians take pains to explain how the evident differences among people's utility schedules may be reconciled with welfare analysis of rules, measures, events, and so on, that have widely felt consequences.<sup>25</sup>

Even if we knew everyone's actual, idiosyncratic utility schedule, there would still be room to doubt the validity of an interpretation of individual welfare in utility terms, or at least only in terms of utility. One need only mention the work of John Rawls<sup>26</sup> to make the point that, among serious contenders in the forum of public policy thought, deontological theories ascribe importance to values that purport not to be reducible to utility and that imply a different view of individual and social well being; such views challenge the primacy of "welfarism"—the assumption that welfare, individual or collective, is to be understood ultimately by reference to individual utility schedules alone.<sup>27</sup>

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23. Simons, *supra* n. 3, at 6-7.

24. *Id.* at 1-2 (demonstrating this as Henry Simons's main point in his commonly misrepresented work); see John Witte, *The Politics and Development of the Federal Income Tax* 52 (U. of Wis. Press 1985) ("the merging of [Simons's standard and ability to pay] by many of Simons' subsequent disciples has created more confusion over the theory than Simons' extremely careful presentation deserves").

25. See *infra* nn. 350-85 and accompanying text.

26. John Rawls, *A Theory of Justice* (Harvard U. Press 1971) [hereinafter Rawls, *Theory*]; John Rawls, *Political Liberalism* (Columbia U. Press 1993) [hereinafter Rawls, *Liberalism*].

27. See generally James Griffin, *Well-Being: Its Meaning, Measurement, and Moral Importance* 21-55 (Clarendon Press 1986) (discussing the utility theory's subjectivist account of welfare and difficulties besetting objective accounts); Amartya Sen, *On Ethics and Economics* 38-39 (Basil Blackwell Ltd. 1987) [hereinafter Sen, *Ethics*] (critique of "welfarism," the utility-based analysis of welfare, as merely one of several possible analyses of welfare); Amartya Sen, *Interpersonal Comparisons of Welfare*, in *Economics and Human Welfare* (Michael Boskin, ed., Academic Press 1979)



Further, provisional acceptance of the simple utilitarian interpretation of ability to pay does not provide a useable backdrop for microeconomic analysis of specific features of an income or other tax, such as the deductibility of expenses of a particular sort, at least if the analysis is intended to provide a detailed application of the ability to pay principle and establish the fairness of the tax treatment of the expense or other item.<sup>28</sup> This is because microeconomic analysis routinely assumes that individual's utility schedules differ. Any conclusions that follow from actual or presumed differences in utility schedules cannot normally be integrated with the assumption that individuals' utility schedules are all alike. In particular, if microeconomic analysis could establish that some outlay reflected on an individual's welfare in an unusual way, it would not necessarily follow that this item should receive exceptional treatment under a comprehensive income tax; the differentiation among individuals that is routine in microeconomics is just as routinely ignored by the ability to pay approach (again in its crude form).<sup>29</sup> Therefore, to take welfare differences into account for different individuals, might worsen the discrepancy between the way in which a comprehensive income tax reflects utility-based welfare, rather than work towards a better correspondence of tax burdens with welfare losses due to taxation.<sup>30</sup>

Moreover, these reasons for doubting the value of the utilitarian version of the ability to pay approach have persuaded a number of the most influential proponents of ability to pay to regard that principle as at best representing a direction for future analysis, a sort of aspirational guide to our intuitions concerning tax fairness.<sup>31</sup> For example, Henry Simons deplored "the whole hedonistic calculus" as "a merely superfluous embellishment of the argument" for progressivity and offered his famous definition of income primarily as an antidote to the errors of the ability to pay tradition.<sup>32</sup> Richard Musgrave—who is perhaps the only remaining conscious defender of the utilitarian account of ability to pay—comprehensively set forth the shortcomings

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[hereinafter Sen, *Economics*]; L.W. Sumner, *The Subjectivity of Welfare*, 105 *Ethics* 764, 774-76 (1995) (distinguishing and categorizing numerous theories of welfare and arguing that "objective" as opposed to "subjective" theories are never adequate).

28. See Kaldor, *supra* n. 1, at 21-54.

29. See Graetz, *supra* n. 21; Halperin, *supra* n. 21; Koppelman, *supra* n. 21.

30. Simons, *supra* n. 3, at 1-20.

31. *Id.* at 12.

32. *Id.*

of that account and has striven ever since to shore it up, though with only tentative results.<sup>33</sup> Yet, the contemporary literature of tax policy typically invokes both Simons and Musgrave as authorities for the continuation of errors they decried.

How then should we regard professed, but casual reliance, on the principle of ability to pay? It might be thought that a doctrine so vacant of content and so infrequently used, to important effect might well be ignored. Certainly, many tax theorists have done important work without relying on or rejecting ability to pay.<sup>34</sup> Nevertheless, important contemporary tax debates show traces of insensitivity to its problematical status. For example, much of the debate about alternative tax bases is meaningless without a quaintly untenable view of human welfare that is linked to the ability to pay approach. Proponents of consumption taxation have assumed, as common ground with income tax proponents, that people can fairly be taxed in accordance with their ability to pay, disputing only the correlation between a person's ability to pay and that person's income measured over brief accounting periods.<sup>35</sup> Instead, they argue that ability to pay is of interest only because it measures a person's "endowment" for consumption.<sup>36</sup> What supports this identification of currently measured ability to pay with ability to consume is the idea that cash flow is a viable measure of a person's control over how well off the person will be for the period in question. This parallels, though it is of course not equivalent to, what income tax theorists have assumed about the connection between income and welfare, namely, that current *income* is the best measure of current welfare.<sup>37</sup> At first glance, neither assumption about short-term welfare is plausible. A person can have somewhat a greater ability to spend without being better off than without that ability. Units of income and units of endowment for consumption are equally bad proxies for increments of well being, and

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33. See Musgrave, *Theory*, *supra* n. 2, at 61-89.

34. Carl Shoup, *Public Finance* 302-10 (1969); Daniel Shaviro, *When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity* (2000); Jon Bakija & Joel Slemrod, *Taxing Ourselves: A Citizen's Guide to the Great Debate Over Tax Reform* 53-54 (1996).

35. See e.g. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax* 87 Harv. L. Rev. 1113, 1125, 1167-69 (1974).

36. Peter Diamond & James A. Mirrlees, *Optimal Taxation and Public Production II*, 6 Am. Econ. Rev. 261, 261 (1971); Kaldor, *supra* n. 1, at 1-25.

37. Diamond & Mirrlees, *supra* n. 36, at 264.

for essentially the same reason: One's well being has only a loose relationship with how much money one has.<sup>38</sup>

The great majority of technical commentators in this country who invoke the ability to pay approach do so in loose conjunction with an acceptance of the Schanz-Haig-Simons definition of income.<sup>39</sup> It is common to equate the definition of income, the sum of accumulation and consumption, with the ability to pay approach.<sup>40</sup> During the 1970s, for example, there was an outpouring of support for "comprehensive income taxation," where that goal was understood to be based on acceptance of the Schanz-Haig-Simons definition in order to implement an ability to pay approach.<sup>41</sup>

What the adherents of this movement evidently had in mind was that income, defined as the sum of accumulation and consumption, measured in units of money, provides a crude, but objective measure of whatever it is that should guide the allocation of tax burdens.<sup>42</sup> No segment of society disputes the relevance of this measure. It really does not matter whether income, so defined, is a good measure of welfare or of any other humanly relevant characteristic.<sup>43</sup> Given the extent of consensus in favor of broad income taxation, the only issue is whether any argument can be made for adjusting tax burdens in accordance with a modified definition of income. Conspicuously, the question whether money income or any function of money income is an adequate proxy for individual welfare simply did not come up. If this is equated with the ability to pay approach, it is a view that has no significant link with the similarly named theories of the past that led to the adoption of income tax regimes here and abroad. In fact, when one scratches the surface of the comprehensive income tax movement, one finds that many, if not all, of its followers actually do rely on a utilitarian analysis of welfare in defending and fine-tuning the comprehensive definition of income.<sup>44</sup> While this grounding of the

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38. *Id.* at 271.

39. *Id.* at 273.

40. See e.g. Graetz, *supra* n. 21; Simmons, *supra* n. 22; Turnier, *supra* n. 22; Weiss, *supra* n. 22.

41. Simons, *supra* n. 3, at 158; Musgrave, *Theory*, *supra* n. 2, at 164-65.

42. Simons, *supra* n. 3, at 49-50.

43. *Id.*

44. See generally Kaldor, *supra* n. 1; Musgrave, *Theory*, *supra* n. 2; Musgrave, *Classics*, *supra* n. 2; Simons, *supra* n. 3.

movement may not be foremost in all accounts, it turns out to be the real underpinning.

What does tax theory look like if the utilitarian version of ability to pay is dropped? It is fair to suppose that we know a lot about our own welfare and that of many people we do not know. Theories of welfare, however, are changing. This article, therefore, also takes up the task of discussing the relevance to tax policy of the sort of theory of welfare that is evolving from current debates. Unfortunately, constructive criticism of utilitarian theories of welfare does not point towards a simple replacement. This is in part because what was wrong with earlier views of welfare was their oversimplification of the interdependence of the welfare of different individuals as well as of the interdependence of different temporal states of a single individual's welfare.<sup>45</sup> On the contrary, one person's welfare quite often depends on another's, and a person's own welfare at different times in his or her life is very often influenced by the same events, e.g., when one plans for one's future. Not only are there problems about the measurement of welfare for the purpose of making public policy (including tax policy) decisions, but there are also problems about the exclusivity of passively conceived welfare as a factor to be considered.<sup>46</sup> Some contemporary thinkers on the topic have persuasively argued that freedom and personal achievement, which may be to some extent independent of benefits received, must be considered in this context as relevant factors in addition to welfare.<sup>47</sup> Others have argued that freedom and personal achievement ought to be factored into the measurement of welfare itself, again in addition to other measures of benefits available to the individual.<sup>48</sup> The relevance of these views to tax policy, and what it would look like to take them into account, is also discussed in this article.

Part II reviews the history of the ability to pay approach since its alliance with the theory and defense of income taxation. The history in question is necessarily intellectual history and therefore contains a large element of cross-reference: later commentators on ability to pay inevitably refer to earlier work in the field. That complicates my

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45. See *infra* nn. 404-12 and accompanying text.

46. Sen, *Ethics*, *supra* n. 27, at 29-57.

47. *Id.*

48. Griffin, *supra* n. 27, at 64-67; Daniel M. Hausman & Michael McPherson, *Economic Analysis and Moral Philosophy* 81-83 (Cambridge U. Press 1996).

argument in the following way. Certain radical criticisms of the ability to pay approach seem to me well taken.<sup>49</sup> While the question whether a revised ability to pay approach might escape these criticisms is taken up later in the article, it is necessary to assess the criticisms themselves as part of the historical account, because later writers within the tradition themselves made such assessments, and to understand their importance is to take a position concerning the merits of the criticisms they advanced. The article therefore examines arguments that challenge the connection between ability to pay and tax justice from two perspectives: As components of the ability to pay tradition and as freestanding proposals concerning tax justice. Some of these arguments are not new, and those acquainted with the meager explicit theory advanced by defenders of ability to pay will find them familiar. Other objections made here to the traditional theory of ability to pay reflect more recent developments in welfare economics.

Part III attempts to identify what is, or ought to be, left of the ability to pay approach, once its shortcomings are fully taken into account. This Part examines what the core insight about ability to pay may have to tell us concerning a range of current puzzles in income taxation; puzzles about which numerous experts have written, often in reliance on antique and defective views about ability to pay.<sup>50</sup> The analysis leads to the conclusion that ability to pay, when disconnected from the utilitarian analysis of welfare, provides a compelling guide to at least some income tax issues, although on the whole its results are indeterminate. It appears therefore that, considered as a principle of analysis, ability to pay can at best play a weaker role in contemporary tax policy than it is customarily given. It also appears that what ability to pay *should* represent is not entirely a function of welfare, even when welfare is more adequately analyzed than it was in traditional welfarism. Tax fairness, in accordance with widely shared political judgments, is not merely a matter of how taxes affect our welfare but also of how taxes affect our opportunities.<sup>51</sup> That is why Simons, Surrey, and others have been able to persuade us so readily to accept objective, market-based measures of tax fairness.<sup>52</sup>

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49. See *infra* nn. 401-12 and accompanying text.

50. See *infra* pt. III.

51. Griffin, *supra* n. 27, at 47-57.

52. Simons, *supra* n. 3; Stanley S. Surrey, *The Supreme Court and Federal Income Tax: Some Implications of Recent Decisions* 35 Ill. L. Rev. 779 (1941).

## II. HISTORICAL DEVELOPMENT OF THE ABILITY TO PAY APPROACH

Principles of justice are prominent among the criteria of acceptable tax design, as of course they are in all areas of public policy.<sup>53</sup> Taxation, however, makes issues of distributive justice more conspicuous than do some other forms of governmental intrusion on the private sphere. Tax levies, like takings by eminent domain, interfere immediately in one's private financial affairs. Because taxes cannot avoid singling people out for individual treatment, the demand for impartiality is perhaps more urgently felt.

The acknowledged need for tax fairness may account in part for the historical connection between conscious theories of public policy analysis and recent historical developments in tax design.<sup>54</sup> In the days when excises and customs were the main sources of government revenue, pamphleteers were already obsessed with taxation and early proposed the revolutionary notion that the state had gone awry if it collected taxes unfairly.<sup>55</sup> The type of unfairness most often condemned was embodied in tax design that paid no heed to the circumstances of those who had to pay the taxes. When governments began to find that only taxes apportioned in some way among individual taxpayers were desirable because they assured a more reliable flow of revenue, the public benefited at least from the more conspicuous role allotted to the matter of just apportionment of the tax burden.<sup>56</sup> So-called direct taxes, particularly income taxes, seem actually to have caught the fancy of legislators and the public in large part because they would make tax burdens more evident to everyone, allowing taxpayers to anticipate what they and their neighbors would owe.<sup>57</sup>

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53. Simons, *supra* n. 3, at 103.

54. Richard A. Musgrave, *Horizontal Equity: A Further Note*, Fla. Tax R. 354, 354-56 (1993).

55. See John Brewer, *The Sinews of Power* 95-114 (Unwin Hyman Ltd. 1989) (discussing portions of the pamphlet literature and the practice of the excise in late eighteenth century Britain); M.J. Daunton, *Progress and Poverty: An Economic and Social History of Britain 1700-1850* 513-14 (Oxford U. Press 1995) (pamphlet literature on "old corruption" at the beginning of the nineteenth century); F. Shehab, *Progressive Taxation: A Study in the Development of the Progressive Principle in the British Income Tax* 27-42 (Clarendon Press 1953).

56. Brewer, *supra* n. 55, at 101.

57. *Id.*

Elaborate public debates about the design of direct taxation took place in Britain and Germany in the nineteenth century.<sup>58</sup> Although French, Italian and Dutch theorists also contributed significantly, at about the same time, to the understanding of modern taxation of income and similar direct tax bases, only the British and German contributions left their mark on subsequent borrowings and remodelings by American tax theorists.<sup>59</sup> Historical accounts of the more influential debates are plentiful, largely because the participants themselves and their followers during the early part of the present century seem to have considered recapitulation of public controversies over taxation highly persuasive arguments in favor of the legislative measures that triumphed.<sup>60</sup> The Progressivism of the late nineteenth and early twentieth centuries was after all in significant part a tax reform movement.<sup>61</sup> A brief retelling of the nineteenth-century evolution of the British and German tax laws, together with a short account of how ability to pay and alternative approaches were discussed by participants and commentators of the time, is important for a grasp of twentieth-century adaptation of the ability to pay approach.

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58. Similar debates accompanied important phases of the French Revolution, which was in large part a tax revolt. D.A. Schremmer, *Taxation and Public Finance: Britain, France, and Germany*, in *VIII Cambridge Economic History of Europe* 315, 378-80 (Peter Mathias & Sidney Pollard eds., Walter Stern trans., Cambridge U. Press 1989) (characterizing the reliance of French post-revolutionary direct taxes on objective ability to pay). The revolutionary moment, however, did not perceptibly influence the development of thought about ability to pay or of modern direct taxes and is therefore not considered at length in this article. See Seligman, *supra* n. 2, at 273-24.

59. See e.g. Seligman, *Progressive Taxation*, *supra* n. 2 (comparison of British, German, French, Italian, Swiss and Dutch income tax developments through 1900); Paul H. Wueller, *Concepts of Taxable Income I: The German Contribution*, 53 Pol. Sci. Q. 83 (1938); Paul H. Wueller, *Concepts of Taxable Income II: The American Contribution*, 53 Pol. Sci. Q. 83-110, 557-83 (1938); Paul H. Wueller, *Concepts of Taxable Income III: The Italian Contribution*, 54 Pol. Sci. Q. 555 (1939) (inventory of German, American and Italian debates on the proper definition of income for tax purposes).

60. See generally Schremmer, *supra* n. 58, at 378-80.

61. John D. Buenker, *The Income Tax and the Progressive Era* 1-17 (Garland Publ., Inc. 1985).

A. *THE BRITISH DEBATE*1. *Legislative Evolution of the British Income Tax*

The British interest in direct taxation generally and in income taxation in particular was stimulated by one of the first really enormous national debts, accumulated during the American colonial war and wars, real and anticipated, with Napoleon and his successors.<sup>62</sup> Although until the end of the century the Liberal Party and a substantial part of the public opposed the permanent introduction of an income tax, the empire had grown used to orderly excise taxation that had some of the characteristics of income taxation, and during the course of the century endured a succession of temporary income tax measures introduced to finance military exploits.<sup>63</sup>

In 1798, several years into the French Wars, Sir William Pitt's government introduced what was known as the "triple assessment," setting in motion the series of legislative developments that made the income tax at first an impermanent but regular and eventually a permanent feature of British taxation.<sup>64</sup> The triple assessment was a graduated increase in the assessment on which various wealth-related taxes were based, such as the inhabited house tax, the window tax, and taxes on dogs, clocks, watches and so forth; the maximum of the increase was three times the previous assessment in the case of non-landowners or simply three times the previous tax liability for those keeping a taxable establishment.<sup>65</sup> The great increase in tax liabilities under the triple assessment brought to the fore the manifestly greater burden borne by less well-to-do households.<sup>66</sup> Six months after introducing it, Pitt acknowledged its shortcomings and moved to

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62. Martin Daunton, *Trusting Leviathan: The Politics of Taxation in Britain, 1799-1914* 77-108 (Cambridge U. Press 2001); Arthur Hope-Jones, *Income Tax in the Napoleonic Wars* 14 (U. Press 1939).

63. Daunton, *supra* n. 62, at 77-108.

64. Stephen Dowell, *A History of Taxation and Taxes in England* vol. 2, 201-15 (Frank Cass & Co. Ltd. 1884) (development of the triple assessment); A. Hope-Jones, *supra* n. 62, at 5-14; Shehab, *supra* n. 55, at 43.

65. Hope-Jones, *supra* n. 62, at 5-14; Shehab, *supra* n. 55, at 43 (illustrating the war finance background of Pitt's income tax).

66. Hope-Jones, *supra* n. 62, at 18-33.



introduce a directly assessed income tax.<sup>67</sup> This went into effect in 1799<sup>68</sup> and continued to be the principal war levy through 1816.<sup>69</sup>

When war abated, the income tax was repealed.<sup>70</sup> This made an enormous and popular difference to traders and manufacturers and led Vansittart, as Chancellor of the Exchequer, to effectuate the repeal of a wartime duty on malt that had been regarded as a tax on agriculture.<sup>71</sup> Tax relief was expensive, however, and the government borrowed more heavily to finance these political gestures.<sup>72</sup> By 1818, over half the public revenue went to service the national debt.<sup>73</sup> In 1819, Vansittart responded to the debt problem by instituting additional taxes on tea, coffee, cocoa, tobacco, spirits, and malt.<sup>74</sup> Parliamentary proposals for piecemeal revision of the country's multiplicity of duties abounded.<sup>75</sup> In the background, the vocal free trade movement began to capture the minds of an emerging generation of politicians.<sup>76</sup>

In 1823 and 1824, a new Chancellor of the Exchequer, Robinson, counting on increased tax revenues due to renewed national prosperity, repealed a further range of taxes on agricultural commodities, to relieve agricultural laborers and small farmers, and a range of cumbersome duties on trade, to relieve the emergent class of people in trade.<sup>77</sup> These measures responded to the now powerful intellectual ferment prompted by the Manchester Free Trade School, as best expressed in David Ricardo's pamphlets in support of a broadly pro-capitalist and anti-rentier fiscal policy.<sup>78</sup> When the prosperity receded, a pro-income-tax group emerged under the leadership of Henry Parnell.<sup>79</sup> These voices favored a new tax or taxes capable of assuring the fiscal durability of the government's increasingly important programs of

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67. *Id.* at 1-2.

68. Shehab, *supra* n. 55, at 46 (citing 38 Geo. III, ch. 13 (Eng.)).

69. *Id.*

70. *Id.* at 46 (citing 42 Geo. III, chs. 42, 60 (Eng.)).

71. *Id.* at 70.

72. *Id.*

73. *Id.* at 70-71.

74. *Id.* at 71 (citing Dowell, *supra* n. 64, at 256-57).

75. *See id.*

76. *See id.*

77. *Id.* at 72.

78. *Id.* at 71.

79. *Id.* at 72.

reform, as well as to pay the still sizable debt service.<sup>80</sup> Military and naval expenditures grew as relations with the government of Louis Philippe became strained.<sup>81</sup> Severe trade crises in 1837 and 1839, harvest failures, and the irregularity of budgetary policy, added to the deficits.<sup>82</sup> Despite longstanding opposition to income taxation, Sir Robert Peel in 1841 led his government to re-introduce an income tax very much like Pitt's, largely in a quest for national economic recovery.<sup>83</sup> This income tax lasted until 1851, having been renewed by a Tory government after Peel's defeat.<sup>84</sup> When the tax was about to expire, Joseph Hume, a member of Parliament, moved that it should be extended for one more year while a select committee studied and recommended whether, and if so how, it should be revised.<sup>85</sup> Under his chairmanship, Hume's Committee, as it came to be known, heard experts from the Inland Revenue, business groups, economists, statisticians and actuaries.<sup>86</sup>

While Hume's Committee sat, Disraeli, as Chancellor of the Exchequer in 1852, proposed a revised income tax that differentiated among incomes derived from different sources, generally conceding much lower tax rates to incomes from agriculture and professional endeavor and a heavier rate for landowners.<sup>87</sup> The opposition defeated this proposal and Gladstone, also a member of Hume's Committee, replaced Disraeli as Chancellor of the Exchequer.<sup>88</sup> In 1853, Gladstone proposed an income tax again (under Lord Aberdeen's administration), making it clear that he regarded income taxation as basically a bad idea to be resorted to only as a temporary measure.<sup>89</sup> He was unenthusiastic about discrimination among sources of income, which he regarded as essentially an issue of partisanship between trade and land, and he announced his own analysis of data showing that on

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80. *Id.* at 73 (citing Sir H. Parnell, *On Financial Reform* ch. xviii 269 (4th ed., London 1832)).

81. *Id.* at 82.

82. *Id.*

83. *See id.* at 82-85.

84. *Id.* at 99.

85. *Id.*

86. *Id.* at 100.

87. *Id.* at 112.

88. *Id.* at 112, 115.

89. *Id.* at 115.

the whole land, and houses paid higher taxes than trade.<sup>90</sup> Because inequities in the treatment of different kinds of income were inevitable, Gladstone argued, it would be best to abolish the income tax altogether; and he proposed to do so, once the expedient of deficit reduction had been accomplished.<sup>91</sup> Gladstone's proposals were carried by overwhelming popularity.<sup>92</sup>

Despite Gladstone's arguments for temporary enactment of the income tax, the Crimean War and the various expedients of shifting administrations led to its acceptance by 1859 as "the [permanent] elastic element in the budget."<sup>93</sup> Throughout the decade of Gladstone's income tax, Gladstone and Disraeli returned repeatedly to the merits of their respective views on income taxation as characteristic of the deepest differences between them on matters of political principle.<sup>94</sup> It was during this period that questions of tax equity finally emerged as an additional central theme in discussions for and against the permanent adoption of direct taxation.<sup>95</sup> The critics of Gladstone's income tax forced the government to accept a select committee charged with investigating again the proper method of assessing income tax liability.<sup>96</sup> J.G. Hubbard chaired the committee.<sup>97</sup>

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90. *Id.* at 116.

91. *Id.* (citing Hansard (3d ser.), cxxv. 1383).

92. Seligman, *The Income Tax*, *supra* n. 3, at 154 (citing 16 & 17 Vict., ch. 34 (Eng.)).

93. *Id.* at 155.

94. Shehab, *supra* n. 55, at 120-21 (stating J.G. Maitland, a Cambridge lawyer, wrote editorials for the *Morning Chronicle* backing Gladstone's skepticism about the possibility of fair discrimination among income sources. J.G. Hubbard, later Lord Addington, an independent politician, and a governor of the Bank of England, frequently defended differentiation in the *Times*. One of Hubbard's arguments was that arbitrary treatment of incomes from different sources would result in a non-neutral tax treatment of consumption, because different fractions of the incomes derived from different sources were saved and consumed. F. Shehab, *supra* n. 55, at 127 (citing J.G. Hubbard, *Reform or Reject the Income Tax: Objections to a Reform of the Income Tax considered in Two Letters to the Editor of the 'Times'; with Additional Notes* 9 (1853). In the third and later editions of John Stuart Mill's *Principles of Political Economy*, he supported Hubbard's contention in this regard and greatly elaborated the theme that income taxation should make proper allowance for the savings needs and proclivities of differently situated taxpayers. See *infra* nn. 134-42 and accompanying text.

95. Shehab, *supra* n. 55, at 128.

96. *Id.* at 139 (citations omitted).

97. *Id.*

By this time Gladstone's opposition to a permanent income tax appears to have been a rather empty banner, but he continued to wave it, and mounted a final effort to abolish the tax in 1874, when his government possessed a large surplus. He called general elections to test the popular support for the income tax and, when his Liberal Party was overwhelmingly defeated, accepted the defeat as a verdict on his fiscal views. The whole character of the central government had changed over the course of the century, however, and even income-tax opponents had no choice but to accept this direct tax or some near substitute as a routine feature of the fiscal system. Meanwhile, the technical aspects of income tax administration were gradually improved, so that by 1894 the British income tax had become a straightforward antecedent of its current descendant.<sup>98</sup>

## 2. *The Contribution of Theorists to the Evolution of the British Income Tax*

The free trade movement and the rise of classical economics fueled a wide-ranging British income tax debate.<sup>99</sup> As Parliament appointed one committee after another to consider the proper design of direct tax at the national level, those commissioned to participate included eminent free-traders, and among the experts who gave evidence were the heirs apparent of the legacy of Ricardian economics and Benthamite utilitarianism.<sup>100</sup> James Mill, John Ramsey McCulloch, Nassau Senior, and John Stuart Mill all made significant public contributions.<sup>101</sup> Though given audience for their technical expertise, they were openly committed public moralists.<sup>102</sup> Their field—"political economy"—was still a branch of moral philosophy.

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98. *Id.* at 173-209.

99. *Id.* at 214 (citations omitted).

100. This accounts for, among other things, the schedular design of the income tax that was regarded as more or less permanent by 1894. Shehab, *supra* n. 55, at 217-21. The Ricardians had believed that heavier taxes on rents were deserved because rents themselves were largely undeserved, and they believed that by discouraging rent-seeking they would encourage productive, i.e., profit-seeking investment. Carl Shoup, *Ricardo on Taxation* 80 (Columbia U. Press 1960); Stephen G. Utz, *Tax Policy: An Introduction and Survey of the Principal Debates* 3-15 (West 1993).

101. Stefan Collini, *Public Moralists: Political Thought and Intellectual Life in Britain*, at 13-90 (Clarendon Press 1991);

102. *Id.*; Emery Neff, *Carlyle & Mill* 12-16 (Columbia U. Press 1926).

Political economy was also undeniably a movement, adherents of a complex political platform that was partly vindicated and partly transformed out of existence during the last half of the nineteenth century.<sup>103</sup> The first half of the century had been more contentious, both for the economists and for other loosely organized schools of political opinion, including a vital and articulate working class movement.<sup>104</sup> There can be no doubt that the latter, whose views contemporary British politicians rarely acknowledged as relevant, helped shape the new fiscal constitution, of which the mid-century income tax was the centerpiece.<sup>105</sup> For all camps, "means" or income, at least in some rough and ready sense, was already of prime interest by the 1820s.<sup>106</sup> The political economists presented a comprehensive analysis of tax issues with a high degree of consistency.<sup>107</sup>

Free trade had made sense to David Ricardo and James Mill, the father of John Stuart Mill, both because it would foster the rising

103. Daunton, *supra* n. 62, at 162-79.

104. The working class movement that focused on the efforts of the handloom weavers and their advocates to win more equitable economic and political treatment for labor sometimes proclaimed income taxation one of its goals. R.M. Martin, a nongovernmental expert on British taxation, testified before the 1834 parliamentary Select Committee on Handloom Weavers, in favor of income taxation as well as in favor of the reduction of excise taxes on necessities. Although the committee was not representative of parliamentary sentiment, *see* Duncan Bythell, *The Handloom Weavers* 158-64 (Cambridge U. Press 1969), the theme of tax reform was a prominent feature of some radical working class political campaigns, *see* Karl Marx, *The Communist Manifesto* (1848).

105. *See e.g.* Robert Lowery, *Robert Lowery: Radical and Chartist* 102 (Brian Harrison & Patricia Hollis eds., Europa Publications Ltd. 1979) [Lowery's autobiography] ("The prominent topics of the new [Chartist] press was [*sic*] class legislation, the unequal pressure of taxation on the working classes [of increased excise duties on commodities]"); J.H. Clapham, *An Economic History of Modern Britain: The Early Railway Age 1920-1850*, 317, 319-30 (2d ed., Cambridge U. Press 1939) ("Continentalers agreed with the islanders [the British] that the islanders carried a fearful burden of debt and a tax-system radically bad."); G.W.F. Hegel, *The English Reform Bill*, in *Hegel's Political Writings* 301 (Z.A. Pelczynski, T.M. Knox trans., Oxford U. Press 1964) (asserting in 1831 that excessive taxation is notoriously the outstanding abuse to be removed by political reform in England); E.P. Thompson, *The Making of the English Working Class* 303-05 (Vintage Books 1966) (excessive commodity taxation a principal cause of the suffering of the handloom weavers during the 1830s), 603-04 (the "enormous amount of the taxes" routinely cited as a central reason for radicalism during the "heroic age of popular Radicalism," from 1815 to 1820).

106. *See e.g.* Shehab, *supra* n. 55, at 72-74.

107. *See e.g.* John Stuart Mill, *Principles of Political Economy* (J.M. Robson ed., U. of Toronto Press 1965).

mercantile class and because it promised to improve the lot of the working multitudes and of society in general.<sup>108</sup> Free trade necessarily meant a change in tax policy during the age of the classical economists, because protective duties strangled trade in some commodities, and Ricardo led the theoretical campaign to end the resultant rents taken by protected landowners because of their distorted consequences for the economy in general.<sup>109</sup> The political economists and representatives of commerce who addressed the income tax commissions stood for a comprehensive style of tax policy analysis that openly purported to maintain the unity of macroeconomic analysis and humanitarian concern, even if they were not, on the whole, enthusiastic about income taxation.<sup>110</sup> As the younger Mill deepened his comprehensive analysis, the role of utilitarian ethics as a source of overarching principle, as well as of analytical tools, became more pronounced.<sup>111</sup> Finally, at the end of the period, Mill's *Principles of Political Economy* laid the groundwork of a new orthodoxy.<sup>112</sup> At its core was the ability to pay approach, backed by an analysis of taxpayer welfare in terms of utility.<sup>113</sup> Although J.R. McCulloch had given a similar exposition of the role that ability to pay must have in assessing the fairness of an income tax, he had been unwilling to say that ability to pay (he did not

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108. See e.g. D.P. O'Brien, *The Classical Economists* (Oxford U. Press 1975).

109. Ricardo favored direct taxation, regarding customs and excise as demoralizing to the public at large because of their historical linkage with the "old corruption," but he believed that a tax on wage goods, rent and income from government securities would provide the best revenue base. O'Brien, *supra* n. 108, at 226.

110. *Id.* at 251; Utz, *supra* n. 100, at 2-6.

111. See e.g. John Stuart Mill, *Utilitarianism* (Indianapolis, Bobbs-Merrill 1957).

112. See Mill, *supra* n. 107.

113. It is worthwhile to mention that the most important early contributions to American income tax theory, those of E.R.A. Seligman and Irving Fisher, inherited this analysis of welfare in terms of utility, as have highly influential later American works on tax policy including: Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation* (U. of Chi. Press 1953); Simons, *Personal Income Taxation*, *supra* n. 3; Musgrave, *Theory of Public Finance*, *supra* n. 2. Each devotes lengthy discussion to a utilitarian approach to taxation, citing Mill and most of the others I have just mentioned. Each takes this approach to be the core of the received wisdom in this country concerning the foundations of horizontal equity in taxation. Only Simons disagrees with the ability to pay tradition and leaves it behind (although interestingly, few of Simons's admirers among later tax theorists seems to recognize that he abandoned ability to pay on fundamental grounds and offered his own definition of income as a foil to the earlier theory).

anticipate Mill's equal sacrifice analysis) was the touchstone of equality in all matters of taxation.<sup>114</sup>

The younger Mill, though not an income tax advocate, succinctly stated what appears to have become the guiding principle of tax fairness for all those who gave public testimony.<sup>115</sup> Tax burdens should be designed to impose an equal sacrifice on all individuals, and this sacrifice should be measured in terms of means.<sup>116</sup> It was not necessary for him to spell out how the sacrifice associated with tax payments should in general be measured.<sup>117</sup> Mill was by this time a principal spokesperson for the Utilitarian School of Ethics and the related Analytical School of Jurisprudence.<sup>118</sup> His comments were naturally understood to assume a utilitarian analysis of sacrifice: The sacrifice an individual makes by paying a given tax is the net cost in utility of paying the tax.<sup>119</sup>

The "equal sacrifice" gloss on ability to pay fused several themes in a new phase of thought about taxation.<sup>120</sup> First was the importance of fairness itself, about which little need be said here: It goes without saying that eighteenth and nineteenth century political thought enshrined fairness as a basic principle in an unusual and peculiarly

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114. See J.R. McCulloch, *A Treatise on the Principles and Practical Influence of Taxation and the Funding System* 109-11 (D.P. O'Brien ed., Scottish Academic Press 1975).

115. John Stuart Mill, *Principles of Political Economy with Some of Their Applications to Social Philosophy*, Bk. V, Ch. II, § 2, 806-07 (J.M. Robson ed., U. Toronto Press 1965).

116. Mill set the terms and tone of the discussion with the unargued assertion that tax equity, for income tax purposes, required that each taxpayer should suffer an equal sacrifice *and* that the preferred "mode [should be] that by which least sacrifice is occasioned on the whole." Mill, *supra* n. 115, at 806-07. It took thirty years for Mill's friendly critics to point out the non-coincidence of these goals. O'Brien, *supra* n. 108, at 252; see *supra* nn. 32-33 and accompanying text.

117. Mill, *supra* n. 115, at 806-07.

118. *Id.*

119. Mill did not have to spell this out. His readers understood what he had in mind. See e.g. Henry Sidgwick, *The Principles of Political Economy* 563 (3d ed., Macmillan and Co., Ltd. 1901) (discussing Mill's equal sacrifice principle, "we may assume generally that if poor and rich alike are deprived of a certain proportion of their resources available for luxurious expenditure, the loss thus incurred of purchasable satisfaction will be at least as great to the poorest class that will be taxed at all, as it will be to any other class").

120. See Sidgwick, *supra* n. 119, at 562.

"modern" way, at least from a late twentieth century perspective.<sup>121</sup> A second theme implicit in the role Mill attributed to minimum sacrifice was the commensurability of the sacrifice endured by different taxpayers.<sup>122</sup> A third was the ease and objectivity with which absolute differences in "sacrifice" or loss of utility, could be measured.<sup>123</sup>

A fundamental commitment in fairness, conceived as a principle of indifference among individuals in the allocation of utility, lay at the heart of utilitarianism.<sup>124</sup> The utilitarian could not explain otherwise how the greatest good of the greatest number of individuals would necessarily be better than the greatest good of select individuals. Admittedly, utilitarianism had some difficulty with the possibility that indifference as to the allocating of utility among individuals would lead to the victimization of a few for the enrichment of the many.<sup>125</sup> But in 1860, the critics of utilitarianism had not yet seized on this as a target for fundamental objection.<sup>126</sup>

The commensurability of the utility of the same or similar events for different individuals did not appear problematical at the time.<sup>127</sup> We cannot be entirely sure why. It appears from Bentham's and the Mills' writings that the primary things to which one should ascribe utility were publicly accessible objects or states of affairs,<sup>128</sup> but this only means that they saw no difficulty in determining what the utility of a thing or event might be for any individual. It may be that the

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121. *Id.*

122. *Id.*

123. *Id.*

124. See Mill, *supra* n. 111, ch. V ("On the connection between justice and utility") ("justice [is] only a particular kind or branch of general utility"). It must be borne in mind, however, that Mill does not himself introduce the term "utility" in his discussion of taxation, nor does he otherwise directly indicate that his measure of tax burdens is subjective rather than objective. See Samuel Hollander, *The Economics of John Stuart Mill* Vol. II, 647-56 (U. of Toronto Press 1985). Despite this conspicuous reticence, Mill's commentators, for reasons developed more fully in the text accompanying notes, assume he understood equal sacrifice to refer to equal burdens on utility. But see *id.* at 858-63 (discussing Mill's views on equal sacrifice *without* assuming Mill means equal losses of utility thereby).

125. See Mill, *supra* n. 115.

126. See O'Brien, *supra* n. 108.

127. *Id.* at 241-42 (discussing Mill's approach to the problem of the distribution of the tax load "in terms of attempting to achieve equal sacrifices (of utility) by different taxpayers"); Musgrave, *Theory*, *supra* n. 2, at 92 ("strictly subjective concept of equal sacrifice").

128. See John Broome, *Utility*, 7 *Econ. & Phil.* 1 (1991).



attribution of utility to things, rather than to the relation of individuals to things or events, manifested an objectivist approach to the concept of utility. If so, Mill's assumption that all taxpayers had identical "utility schedules" would appear natural after all.<sup>129</sup> However that may be, later utilitarians and economists who built on the utilitarian tradition refined the earlier conceptual framework of utilitarianism in ways that threw the difficulty of these assumptions into high relief. This is further discussed later.

In the course of the parliamentary committee hearings at which John Stuart Mill testified, no one seems ever to have questioned the inevitability of striving for fairness by attempting to equalize "burdens" on "means," as they repeatedly put it, and Mill himself understood equalizing such burdens to equivalent to equalizing taxpayers' sacrifices.<sup>130</sup> There was also general agreement on the importance of minimizing the burden of the tax on society.<sup>131</sup> Indeed, the happy coincidence that both concerns could be met by a single criterion for tax design—equal sacrifice—won the day seemingly without contest.<sup>132</sup> From that point, the debate shifted to refining the meaning of these two key terms.

Before chronicling the process of refinement through a few of its stages, it is worthwhile to notice that ability to pay can only serve as the touchstone for spreading tax responsibility if we abandon the goal of making people pay in accordance with the governmental benefits they receive. Ability to pay theories are inconsistent with benefit taxation and with every form of quid pro quo allocation of tax liability. That the political as well as theoretical debate shifted to a consideration of ability to pay, and has scarcely deviated from that orientation since,

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129. See Mill, *supra* n. 115.

130. *Id.*

131. Shehab, *supra* n. 55, at 73-74 (discussing Sir Henry Parnell's tax reform proposals of 1832 and contemporary pamphlet literature). Pigou was apparently the first to note that minimizing individual sacrifice and minimizing the dead weight loss imposed by taxation on an economy as a whole were not a single goal and might indeed be incompatible goals. A.C. Pigou, *A Study in Public Finance* 76 (3d ed., MacMillan & Co. Ltd. 1947).

132. Later writers who acknowledged the importance of Mill's postulate did nevertheless attempt to refine it. The course of their comments and criticisms is traced in the text accompanying *infra* notes 151-198. One of the principal refinements was the recognition that revenue minimization and equal sacrifice did not necessarily coincide.

is worth noting, because it signaled a victory for theorists who favored re-distributive taxation.<sup>133</sup>

Building on his characterization of ability to pay, Mill took a stand in favor of taxation in proportion to the utility of the taxpayer's income for the accounting period.<sup>134</sup> The principal reason Mill mentioned for the declining marginal utility of income is that the person whose *income* is greater need not save as much for future needs as the person with a smaller income.<sup>135</sup> He assumed, as of course virtually all commentators on taxable capacity have, that the utility of money decreases with the amount of one's income.<sup>136</sup> Mill's inference from the equal sacrifice premise was that "[n]o income tax is really just, from which savings are not exempted . . ."<sup>137</sup> Interestingly, from a twentieth century perspective, he argued that the different needs of different classes of people required such an exemption.<sup>138</sup> Laborers, whom he assumed to be penniless apart from their wages, had to set aside more for the future (emergencies, old age, and so forth) than did professionals, whose business income might be expected to flow more evenly and predictably.<sup>139</sup> Capitalists and rentiers, quite different groups according to the Ricardian conceptions still in vogue, had different savings needs.<sup>140</sup> Capitalists must protect their future positions in competitive enterprise and therefore must set aside contingency funds.<sup>141</sup> Landowners were by definition inactive reapers of rent and had no need qua rent gatherers to endeavor to manage or

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133. See Musgrave, *supra* n. 2, at 90; Gunnar Myrdal, *The Political Element in the Development of Economic Theory* 165 (Paul Streeten trans., 2d ed., Richard Swedbeg ed., Transaction Publishers 1990).

134. See Mill, *supra* n. 115.

135. Mill, *supra* n. 115, at 813-16.

136. *Id.*

137. *Id.* at 816.

138. Mill was agreeing with J.G. Hubbard in advocating such "differentiation," as it was called at the time. Dauntton, *supra* n. 62, at 93-95. Pitt's income tax had differentiated among income sources, and the twentieth century British income tax returned to this "schedular" approach. But Gladstone rejected it, on the grounds that it would symbolize and perhaps exacerbate class differences. "That is not the way in which the relations of classes brought into the nicest competition with one another under a scheme of direct competition are to be treated . . ." *Id.* at 99 (quoting Parliamentary Debates, 3d ser. 125 at 1383-84 (Apr. 18, 1853)).

139. Mill, *supra* n. 115, at 818.

140. *Id.*

141. *Id.*

conserve their income streams (any move towards competition would apparently have made them capitalists, again by definition).<sup>142</sup>

Mill's defense of consumption taxation on the grounds that the necessities of different economic classes affected their ability to pay was a bold departure. It appealed to an objective feature of the taxpayer's situation as a determinant of taxable capacity.<sup>143</sup> One's lot in life, as wage-earner or capitalist, for example, gave one inevitably objective burdens apart from taxation, which must be taken into account in assessing residual ability to pay.<sup>144</sup> On the other hand, that residual element appears to have been conceived in utilitarian terms, and the difficulties later critics raised concerning our ability to be objective about utility schedules did not surface in Mill's analysis.<sup>145</sup>

Under certain conditions, a proportionate tax rate structure may implement an equal *absolute* sacrifice of utility by all taxpayers; but under other conditions, it may exact only an equal *proportional* sacrifice.<sup>146</sup> A flat rate tax on income forces taxpayers to give up the same amount of utility or imposes on each the same reduction in welfare, if the marginal utility, of income declines at the same percentage rate as that at which income increases; or in simpler terms, if each taxpayer's last dollar of income does him or her less good than the last just in the proportion that it increases his or her total income.<sup>147</sup> On the other hand, a flat rate tax imposes an equal proportional sacrifice on all taxpayers if every dollar of income does each taxpayer, no matter how great his or her income, the same amount of good.<sup>148</sup> But Mill did not comment on all this.<sup>149</sup> It remained for later writers to clarify how the sacrifice of the taxpayer varies with the amount paid to the government.<sup>150</sup>

We may distinguish three ways in which the sacrifices required of different taxpayers can be considered "equal."<sup>151</sup> The sacrifices can be absolutely equal, that is, the value of what each taxpayer gives up may

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142. *Id.* at 819.

143. *Id.* at 807-08.

144. *Id.* at 818.

145. *Id.* at 811.

146. Musgrave, *Theory*, *supra* n. 2, at 99.

147. *Id.*

148. *Id.* at 100.

149. *Id.* at 98.

150. *Id.*

151. *Id.* at 96.

be equal in whatever terms are considered most relevant.<sup>152</sup> Thus, two taxpayers might be required to suffer equal utility deprivations measured in some basic units of utility.<sup>153</sup> If A gives up ten units of utility, B should also give up ten units, even though their utility income before and after tax are different, e.g., A has 1000 before and 990 after, and B has 100 before and 90 after.<sup>154</sup> Another sense of "equal sacrifice," however, involved only the sacrifice of equal *fractions* of the utility each taxpayer would otherwise have enjoyed from nongovernmental receipts.<sup>155</sup> Thus, taxpayer A who receives 1000 units of utility before tax should give up 100 units, if taxpayer B, who starts with 100 units, is required to give up ten.<sup>156</sup> Finally, equal sacrifice can be understood to require each taxpayer to give up that portion of his or her money income that will produce the least aggregate sacrifice.<sup>157</sup> Thus, regardless of how money translates into utility for different taxpayers, the government should assess tax liabilities so that the desired revenue maximizes the sum of post-tax utility enjoyed by all taxpayers. The results might coincide with the results of the equal absolute or equal proportional sacrifice principles or yield a different result entirely, all depending on the income-utility schedules, both marginal and total, of the taxpayers in question.<sup>158</sup>

It appears that Mill did not notice these alternative interpretations of equal sacrifice.<sup>159</sup> He did at least suppose that the more income one has the better off he or she is, other things being equal.<sup>160</sup> But the money units in which we normally measure income are not units of the benefit income confers. Defining such benefit units—units of utility—is perhaps impossible, at least not at all straightforward. Anyway, we count income in units of money.<sup>161</sup> We suppose, however, that the

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152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.* at 96-98.

159. *Id.* at 98.

160. Mill, *supra* n. 115, at 809. For the moment, it does not matter whether this proposition is a tautology, following from a definition of income in terms of utility added to a person's stock of utility, or an empirical truth, following from some correlation between increases in wealth measured in money and increases in utility.

161. Musgrave, *Theory*, *supra* n. 2, at 94.

different dollar levels of income enjoyed by different people often indicate differences in how well off they really are (and not merely differences in how well off they appear to be). If the goal is to impose equal sacrifices on all concerned, we must first decide what we would take from each individual if the utility of his or her total income could be reckoned in common units of some kind.<sup>162</sup> Would we take the same amount of utility from each (given that this might mean taking different amounts of money from different people because the value of money to them differed)? If so, then equal sacrifice would mean equal absolute sacrifice.<sup>163</sup> Note that equal absolute sacrifice does not mean equal tax liabilities all round.<sup>164</sup> If, on the other hand, we would take the same percentage of the utility each person's income gave them, then an equal proportional sacrifice would be imposed on each.<sup>165</sup> Finally, to require sacrifice only at the margin of the individual taxpayer's income utility is to levy the tax only on the highest income utility shares.<sup>166</sup> Equal marginal sacrifice is just confiscation of the amounts by which the highest incomes differ from the next highest, until the required yield is achieved.<sup>167</sup>

Equal absolute sacrifice, as some of Mill's contemporaries argued, may require different tax payments by people with equal money incomes.<sup>168</sup> It will depend on how much a money unit of income benefits the recipient.<sup>169</sup> If another money unit added to any person's income makes that person better off to the same extent as it would anyone else, then the marginal utility of money income is the same for everyone.<sup>170</sup> Under this condition, equal absolute sacrifice means equal tax liabilities.<sup>171</sup>

A further condition permits us to equate equal proportional sacrifice with flat rate taxes.<sup>172</sup> Tax rates are set in percentages and are

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162. *Id.* at 95.

163. *Id.* at 97.

164. *Id.* at 99.

165. *Id.* at 100.

166. *Id.* at 98.

167. *Id.* at 99.

168. *Id.*

169. *Id.*

170. *Id.*

171. *Id.*

172. *Id.* at 100.

meant to be applied to amounts of income measured in money.<sup>173</sup> If we assume the equal marginal utility of money income (as in the previous paragraph), different levels of income in money correspond to different levels of the utility derived from that income.<sup>174</sup> A flat rate tax is one that requires each taxpayer to surrender the same percentage of his or her money income.<sup>175</sup> This will correspond to the same percentage of the utility of that income to the individual taxpayer only if we know (in addition to the equal marginal utility of money income) that the marginal utility of money income is the same for everyone and is constant, i.e., each money unit of income confers the same amount of utility on whoever gets it, no matter how much he or she already has.<sup>176</sup> Obviously, removing the same percentage of each person's income-related utility does not exactly equal sacrifice in the same sense that removing the same amount of utility would. Therefore, equal proportional sacrifices differ from equal absolute sacrifices.<sup>177</sup>

Perhaps the most popular assumption concerning this matter of tax rates and the value of money to people is that the marginal utility of money income is not constant but diminishes.<sup>178</sup> Assuming this, a *progressive* schedule of marginal tax rates is required to exact an equal absolute sacrifice at different income levels.<sup>179</sup> Note that progressive rates, on this rather strong assumption, do not have the effect of reshuffling the comparative order of after-tax incomes.<sup>180</sup> The person with a greater pre-tax income will have a greater after-tax income.<sup>181</sup>

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173. *Id.* at 101.

174. *Id.*

175. *Id.* at 99.

176. Despite the marginalist revolution, early welfare economics deliberately put aside qualms concerning the postulate of identical utility or welfare schedules that is common to all discussions based on Mill's analysis of equal sacrifice. See Sandra Peart, *The Economics of W.S. Jevons* 155-69 (1996) (Jevons, who led the English branch of the marginalist revolution, opined that the assumption of identical utility schedules was appropriate in public policy analysis).

177. Musgrave, *Theory*, *supra* n. 2, at 98-99.

178. If the marginal utility of money income declines at the same percentage rate as that at which income increases, a proportional tax is required to achieve equal absolute sacrifice. See Musgrave, *Theory*, *supra* n. 2, at 99.

179. *Id.*

180. Without the assumption in question, progressive rates might either re-rank incomes or leave their rank unchanged. *Id.* at 100.

181. *Id.*

Tax liabilities measured in dollars will differ.<sup>182</sup> The person with the greater pre-tax income will pay a higher dollar tax than a person with less pre-tax income.<sup>183</sup> But tax burdens measured in utility will all be the same.<sup>184</sup> Thus, there is no redistribution of income.<sup>185</sup> Finally, it is noteworthy that both the flat or proportional tax (same rate for all money income levels) and a progressive schedule of marginal tax rates preserve the rank order of incomes measured in dollars.<sup>186</sup>

Late nineteenth-century tax theorists chose from among these positions mostly in reaction to Mill's powerful arguments for proportional tax rates.<sup>187</sup> Cohen-Stuart analyzed the implications of proportional and progressive tax rate structures, exposing some of the features of these approaches that are restated in the foregoing paragraphs.<sup>188</sup> On that basis, he preferred equal proportional sacrifice because this would leave the relative positions of different taxpayers, in terms of total utility, unchanged.<sup>189</sup> Sidgwick and Marshall considered equal absolute sacrifice the only truly equal treatment, while Carver and others held fast to equal marginal sacrifice, again for reasons of equality.<sup>190</sup> As we have seen, these views did not translate into easy practical solutions, because the task of imposing equal absolute sacrifice and equal marginal sacrifice could require detailed knowledge of the shared marginal utility curves of the population to be taxed.<sup>191</sup> Among those who proposed variations of these principal analyses of ability to pay, some were also concerned with the effect of income to the taxpayer's life circumstances—educational status, freedom to vary one's employment, mortgages, *et cetera*.<sup>192</sup>

182. *Id.* at 101.

183. *Id.* at 100.

184. *Id.* at 101.

185. *Id.* at 97-98.

186. *Id.* at 97.

187. *Id.* at 98.

188. *Id.*

189. Arnold Jacob Cohen Stuart, *Bijdrage tot de Theorie der progressieve Inkomstenbelasting* (1889), transl. in part as *On Progressive Taxation*, in Musgrave, *Classics*, *supra* n. 2, at 48.

190. *Id.* (citing Sidgwick, *supra* n. 119, at 562); Alfred Marshall, *Principles of Economics* 135 n.1 (8th ed. Macmillan and Co., Ltd. 1922); Thomas N. Carver, *The Minimum Sacrifice Theory of Taxation*, 19 Pol. Sci. Q. 66 (1904).

191. See *supra* nn. 168-77 and accompanying text.

192. See e.g. R. Meyer, *Die Prinzipien der gerechten Besteuerung* (Berlin 1884), cited in Knut Wicksell, *A New Principle of Just Taxation*, in Musgrave, *Classics*, *supra*

Different positions on the nature and implications of equal sacrifice evolved largely on the assumption that tax equity was the primary issue and that individual utility was the proper touchstone of equity.<sup>193</sup> The entire debate took a novel turn when some economists re-examined the distributive problem from the perspective of the overall effects of taxation on society.<sup>194</sup> Mill had claimed that equal absolute sacrifice achieved the least sacrifice of utility in the aggregate.<sup>195</sup> F. Y. Edgeworth, in his resoundingly titled "The Pure Theory of Taxation," was the first to contend that morality alone could not decide the issue whether equal absolute or equal proportional sacrifice was fairer, but that only equal marginal sacrifice met the general social goal of least *aggregate* sacrifice.<sup>196</sup> Looking at a society's economy only at an instant, or assuming away changes in the economy resulting from the adjustment of taxpayers' behavior to the effects of taxation as well as other possible structural changes in the economy, Edgeworth's argument amounted to a proof of the efficiency of socialism, because as we have seen equal marginal sacrifice requires the confiscation of the highest incomes and then the next highest incomes until the required yield is achieved.<sup>197</sup> Yet his contention was also that welfare objectives should control the outcome because it was impossible to resolve the fundamental issue of tax equity among taxpayers.<sup>198</sup>

## B. THE GERMAN DEBATE

### 1. *The Direct Taxation Movement in Germany*

Changes in the political atmosphere, brought about in part by the French Revolution and by Napoleon's incursions into Germany,<sup>199</sup> led

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n. 2, at 75, 97.

193. *Id.* at 75.

194. *Id.* at 97.

195. Musgrave, *Classics*, *supra* n. 2, at 96.

196. Frances Y. Edgeworth, *The Pure Theory of Taxation*, in *Papers Relating to Political Economy* 117 (Royal Econ. Socy. 1925); *cf.* Pigou, *supra* n. 132, at 61.

197. Edgeworth, *supra* n. 196, at 117; Musgrave, *Theory*, *supra* n. 2, at 99.

198. Musgrave, *Theory*, *supra* n. 2, at 98.

199. Schremmer, *supra* n. 58, at 417 *et seq.* (discussing a survey of Prussian and other German states' practical fiscal policy choices after 1815); William Carr, *A History of Germany 1815-1945*, 1-36 (St. Martin's Press, Inc. 1969) (discussing Metternich, who embodies the period of the restoration following Napoleon's



to general dissatisfaction with the fairness of late eighteenth century tax regimes in the German states.<sup>200</sup> From the beginning, the movement of the larger states—especially, Prussia, Saxony, and Bavaria—toward tax reform grew less out of a need for greater revenue than in reaction to a trenchantly expressed desire for tax equity among classes of citizens and among sources of revenue.<sup>201</sup> The gradual convergence of disparate political struggles within the individual states towards the apparent solution of national unification, formally achieved in 1871, resolved challenges to the political legitimacy of a host of monarchies and other traditional forms of government, but left the problem of fiscal equilibration to the states, now acting as members of a federal union.<sup>202</sup> The fact that in Germany taxes were not the same sort of problem as in England seems to have affected the content of the debates that accompanied the acceptance of direct taxation as the new norm.

In the first half of the nineteenth century, the German Länder relied primarily on taxes on yield or product (*Ertrag*).<sup>203</sup> These taxes, though levied on the individual, were considered property taxes, and

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conquests in Germany, strove for a balance of forces within society and among states); Bernhard Grossfeld, *Die Einkommensteuer* 10-14, 26-27 (1981) (discussing tax reform driven by inter-class political struggle); see Otto Pflanze, *Bismarck and the Development of Germany* vol. 1, 183-96 (Princeton U. Press 1990) (discussing political motivation of the liberal coalition during the early and middle years of the nineteenth century); Agatha Ramm, *Germany 1789-1919*, 143 (Methuen & Co., Ltd. 1967) (an "aspiration for a wider sharing of political power" pervaded the period of the German Confederation of 1815).

200. Ramm, *supra* n. 199, at 318; Frederick Blachly & Miriam Oatman, *The Government and Administration of Germany* 181-82 (John Hopkins Press 1928).

201. Schremmer, *supra* n. 58, at 421. "The long-term goal [after the Peace of Tilsit] was equal distribution of land tax, needing reform along principles of universality . . . and equality of tax incidence." *Id.*; Seligman, *The Income Tax*, *supra* n. 3, at 225.

202. That direct taxation was left to the *Bundesstaaten* is one of the notable oddities of German constitutional history. *Verfassung des Deutschen Reichs*, arts. 36, 40, 47 (ed. L. von Rönne 1871); see Schremmer, *supra* n. 58, at 466-68 (Bismarck ultimately chose to disentangle the Reich finances from the states' by relying on federal *indirect* taxes rather than direct taxes); Carr, *supra* n. 199, at 147 (citing Bismarck's comment that "[the Empire is] a troublesome sponger who had to go begging at the door of the separate states"); Ramm, *supra* n. 199, at 318-23 (describing the fiscal powers and problems of the Reichstag); Blachly & Oatman, *supra* n. 200, at 181-82 (noting that recently formed Reich had no separate financial administration until World War I). In this respect, the early Reich resembled the American Federation and suffered many of the same difficulties.

203. Blachly & Oatman, *supra* n. 200, at 181-82.

they approximated earlier personal taxes on wealth.<sup>204</sup> Unlike other property taxes, however, the basis of assessment was the yield or product of the property rather than its value.<sup>205</sup> Virtually all the German states imposed *Ertragssteuern* on land and buildings; some, on businesses as well; comparatively few considered wages or funded capital to be subject to yield or product-based assessment.<sup>206</sup> Some also imposed taxes on expenditures.<sup>207</sup> The most important exception to the general preference for yield taxation was Prussia, in which expenditure taxation was prominent through the teens and twenties of the century.<sup>208</sup>

Nevertheless, Prussia experienced a profound eruption of reformist activity in 1811 and 1812.<sup>209</sup> Before 1810, a land tax called the direct contribution had been levied only in rural districts, while a so-called "universal excise tax" was levied only in towns.<sup>210</sup> In 1810 the government introduced several taxes on consumption of specific types and extended their application to rural districts.<sup>211</sup> Farmers rebelled against one of these taxes (the *Mahlsteuer*).<sup>212</sup> In 1811, the old differentiation between town and country districts was reintroduced, but the rural districts were subjected to a new poll tax, called the "direct personal tax," which heralded subsequent steps towards universal direct personal taxation.<sup>213</sup>

In 1820 Prussia revised several of its tax schemes again. The chief innovation was a "class tax" (*Klassensteuer*), which applied only outside the larger towns.<sup>214</sup> It divided the population into twelve

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204. *Id.*

205. *Id.*

206. Seligman, *The Income Tax*, *supra* n. 3, at 223 (citing A. Kölle, *Zur Entstehung der Ertrags- und Katastersteuern in den deutschen Staaten*, 16 *Finanz Archiv* 477-96 (1899)).

207. Blachly & Oatman, *supra* n. 200, at 181-82.

208. Joseph A. Hill, *The Prussian Income Tax*, 6 *Quarterly J. Econ.* 207-08 (1892).

209. See generally Peter Greim-Kuczewski, *Die preussische Klassen- und Einkommensteuergesetzgebung im 19. Jahrhundert: Eine Untersuchung über die Entwicklungsgeschichte der formellen Veranlagungsvorschriften* 40-42 (1990); B. Fuisting, 4 *Die preussischen direkten Steuern* 40-44 (1902); Seligman, *supra* n. 3, at 264.

210. Schremmer, *supra* n. 58, at 421-23.

211. *Id.* at 423.

212. *Id.*

213. Seligman, *The Income Tax*, *supra* n. 3, at 226.

214. *Gesetz wegen Einführung einer Klassensteuer. vom 30sten Mai 1820*, in

categories of classes, according to criteria like social standing, occupation, general estimate of wealth and mode of life.<sup>215</sup> Each household in a given category was liable for the same annual sum, without regard to actual wealth, expenditures, or income.<sup>216</sup> The rates of tax were low, but class tax revenues were about two thirds of land tax revenues, the largest single category of tax revenues.<sup>217</sup> The lower classes paid the overwhelmingly greater part of the class tax yield, and the administration of the tax was designed not to permit an accurate reflection of the real wealth or income of taxpayers.<sup>218</sup> As Professor D.E. Schremmer has noted, the class tax, even after reform in 1850, did not accord with "principles of taxation according to ability to pay."<sup>219</sup>

In the 1830s, Saxony followed Prussia in adopting a business and personal tax (*Gewerbe und Personalsteuer*), based like the Prussian class tax on taxpayer characteristics other than income or expenditure for the given accounting period.<sup>220</sup> Although both the Prussian and the Saxon taxes approximated the results of an income tax in some ways, neither required the taxpayer to calculate income and expenses nor permitted tax officials to audit a taxpayer's representations concerning the characteristics on which enrollment in the classes was determined.<sup>221</sup> Several Prussian cities elected to be subject to the class tax instead of the grist tax.<sup>222</sup>

Tax theorists in Germany recognized that the class tax and other surrogates for the old yield taxes were gestures in the direction of a single, direct personal tax based on economic means, and the majority

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*Gesetzsammlung* 1820, Nr. 617, S. 140ff (cited in Peter Greim-Kuczewski, *supra* n. 209, at 85); see Greim-Kuczewski, *supra* n. 209, at 85-107.

215. Seligman, *The Income Tax*, *supra* n. 3, at 226.

216. *Id.*

217. The class tax proved highly efficient. From 1821 through 1838 actual revenue fell short of projected revenue of 123 million thalers by only 2.3 million thalers, and tax revenue from the regions subject to the class tax increased by 22% for the period. Greim-Kuczewski, *supra* n. 209, at 106-07; see Seligman, *The Income Tax*, *supra* n. 3, at 226-30.

218. Seligman, *supra* n. 3, at 230 (citing Adolf Held, *Die Einkommensteuer—Finanzwissenschaftliche Studien zur Reform der Directen Steuern in Deutschland* 284 (1872);

219. Schremmer, *supra* n. 58, at 440.

220. Seligman, *The Income Tax*, *supra* n. 3, at 233.

221. *Id.*

222. Schremmer, *supra* n. 58, at 229.

strenuously opposed the trend.<sup>223</sup> The 1840s, however, brought further popular demand for less regressive taxation when Sir Robert Peel, though long an opponent of income taxation, led his Whig majority in England's Parliament to adopt an income tax as a temporary measure.<sup>224</sup> His reasons for relenting on the question of income taxation included the argument that the long series of annual budget deficits threatened the viability of the party's opposition to the political reform movement and ability to continue other policies such as the Corn Laws.<sup>225</sup> The Whigs were strongly in favor of keeping the long list of excise taxes on "articles of consumption" as the basis for government revenues.<sup>226</sup> Peel convinced his party, however, that an increase in these taxes could not be employed to reduce the budget deficits because this strain even further the government's ability to withstand pressure for political reform.<sup>227</sup>

The link between tax reform and political reform was not lost on German observers of the English scene. Suddenly, a significant handful of Prussian political figures and civil servants became outspoken supporters of an income tax, primarily as a means of reducing the Prussian public debt, but also as a means of exacting a greater portion of the support of government from the wealthy.<sup>228</sup> At the core of their conversion was acceptance of, as a necessary evil, the intrusion by government officials into the private affairs of taxpayers.<sup>229</sup> It is significant that German opponents of income taxation, like their English counterparts, had long made much of the intrusiveness of income tax administration. The growing political storm

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223. Seligman, *The Income Tax*, *supra* n. 3, at 230-32.

224. Daunton, *supra* n. 62, at 80.

225. Sir Robert Peel, Speech, *New Scheme of Taxation* (House of Commons, Mar. 11, 1842), in 61 Hansard 431.

226. Daunton, *supra* n. 62, at 82.

227. *Id.* at 83.

228. Seligman, *The Income Tax*, *supra* n. 3, at 234-35 (citing D.A. Benda, *Robert Peel's Finanz-System oder Über die Vorzüge der Einkommensteuer im Gegensatz zu Staats-Anleihen und Zinsreductionen* (1842); Karl von Sparre, *Die Allgemeine Einkommensteuer als einzige gerechte Abgabe, aus Theorie und Erfahrung nachgewiesen* (1848); Freiherr von Gross, *Allgemeine Progressive Grund- und Einkommensteuer Gleiches Maas und Gewicht für Deutschland* (1848); von Graffenried, *Über die Einkommensteuer* (1855)).

229. *Id.*

of the 1840s apparently undermined the persuasiveness of this liberal sentiment.<sup>230</sup>

Bavaria adopted separate income and capital taxes in 1848, combining them into a single general income tax in 1850.<sup>231</sup> Hesse and the independent republic-city of Bremen also introduced income taxes in 1848.<sup>232</sup> Of these, only the Bremen tax worked well enough to survive for a reasonable period without revision.<sup>233</sup> Inadequate audit machinery is usually blamed for the failure of the Bavarian and Hessian income taxes.<sup>234</sup> Several Prussian governments tinkered with the class and consumption taxes, with a view to making them resemble an income tax more closely.<sup>235</sup> But these experiments fought shy of adopting a workable administrative structure. More theorists joined the income tax movement, however.<sup>236</sup>

Meanwhile, the political upheaval and re-drawing of borders that followed the Napoleonic wars in Germany had played themselves out in one sense. In 1871, the King of Prussia accepted the title of sovereign of the united German states.<sup>237</sup> This was Bismark's crowning achievement, at least as a practitioner of *Realpolitik* but also of course as a national architect.<sup>238</sup> It marked the readiness of the larger German states for a new approach to internal political stability as well.

In 1874 Saxony completed the last of a series of revisions of its "personal tax," which was actually a thinly disguised amalgam of taxes on property yields.<sup>239</sup> Baden followed the Saxon example in 1884.<sup>240</sup>

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230. Greim-Kuczewski, *supra* n. 209, at 110-14.

231. Seligman, *The Income Tax*, *supra* n. 3, at 237.

232. *Id.*

233. *Id.*

234. *Id.*

235. *Id.* at 237-38.

236. Seligman, *The Income Tax*, *supra* n. 3, at 242 (citing and translating Held, *supra* n. 218) (comparing the threat of "concealed socialism" in income taxation with the "really dangerous socialism, that of the Paris Commune"); R. Birnbaum, *Über die Anwendbarkeit der Einkommensteuer und Steuerreformen überhaupt* (Leipzig 1873); S. Glattstern, *Die Steuer vom Einkommen—Eine finanzwissenschaftliche Studie* (Leipzig 1874); Fr. J. Neumann, *Die Progressive Einkommensteuer in Staats- und Gemeinde-Haushalt* (Leipzig 1874).

237. Michael John, *Politics and the Law in Late Nineteenth-Century Germany* 42-45 (Clarendon Press 1989).

238. *Id.*

239. Seligman, *The Income Tax*, *supra* n. 3, at 245 (citing *Königliche Sächsische*

Both income taxes applied initially to associations and corporations as well as to individuals.<sup>241</sup> Two smaller states, Saxe-Weimar and Anhalt, adopted income tax laws similar to those of Saxony in 1883 and 1886.<sup>242</sup>

In 1891 Prussia adopted its own rather different income tax law.<sup>243</sup> At last it replaced the class tax, but kept its administrative structure.<sup>244</sup> It applied to corporations and certain categories of association as well as to individuals.<sup>245</sup> The tax base consisted of annual net receipts from capital, real estate, trade and industry, and lucrative occupations—a division of the sources of income that resembled that of the then well-established British schedular income tax.<sup>246</sup> Extraordinary receipts from inheritance, gifts, life insurance policies, the sale of non-business real estate, and similar receipts (income that was not fixed (*feststehende*) or determinable (*bestimmte*) [periodic] income) were treated as accessions to capital and exempted from taxation.<sup>247</sup> The tax law prescribed which expenses and expenditures were to be deducted from gross receipts in computing net receipts or taxable income.<sup>248</sup> The taxable unit was the family, including the income of children unless a child's income was not at the disposal of the father.<sup>249</sup> The rates of tax ranged from .57% to about four percent in seventy-five brackets.<sup>250</sup> Prussia, however, had

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*Steuergesetze* 1880).

240. Seligman, *The Income Tax*, *supra* n. 3, at 248-49.

241. Corporations and associations were exempt from the Baden tax in 1892. *Id.* at 249 n. 1.

242. *Id.*

243. *Einkommensteuergesetz vom 24 Juni, 1891*, in *Gesetzsammlung* 1891, Nr. 9463, at 175 ff.; see generally Greim-Kuczewski, *supra* n. 209, at 180-250; Hill, *supra* n. 208 at 211.

244. Schremmer, *supra* n. 58, at 444.

245. *Id.*

246. *Id.*

247. This exclusion was repealed in 1906, apparently in response to criticism by Bernard Fuisting, of the Royal Administrative Supreme Court of Prussia, whose enormous book on the administration of the Prussian income tax is the principal contemporary source concerning its successes and failures. Seligman, *The Income Tax*, *supra* n. 3, at 253 (citing Von B. Fuisting, *Die Einkommenbesteuerung der Zukunft in Anknüpfung an das Preussische Einkommensteuer-Gesetz* (Berlin 1903)).

248. Schremmer, *supra* n. 58, at 444-45.

249. Seligman, *supra* n. 3, at 252.

250. *Id.* at 251-52.

simultaneously reformed its old business tax, and this continued in effect alongside the new income tax until 1893.<sup>251</sup> The Prussian income tax law introduced compulsory declaration of income by the taxpayer.<sup>252</sup> This had been the most controversial feature of the tax reform.<sup>253</sup>

Other German states, impressed by the success, both in administration and in revenue yield, of the Prussian income tax, adopted similar income tax laws or revised existing income tax laws to make them resemble the Prussian tax more closely.<sup>254</sup>

## 2. *German Theories of Income*

As the progress of nineteenth century German tax legislation suggests, German tax experts advocated a great variety of approaches to direct taxation during the period.<sup>255</sup> Theorists there helped popularize or pillory the British example and were still battling over basic premises long after most German states had opted for recognizably modern forms of income taxation.<sup>256</sup> This efflorescence of theory was, as one might expect, grounded in wide differences of partisan political views.

Peel's income tax of 1799, fairly regarded as the first of the "temporary" British income tax laws, quickly caught the attention of Prussian political economists, who in turn advertised the amazing invention to Prussian political decision makers.<sup>257</sup> It has been

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251. *Id.* at 257.

252. Schremmer, *supra* n. 58, at 444.

253. One opponent assailed the new tax as a "lie and cheat system" (*ein Lug- und Trug-system*). Seligman, *The Income Tax*, *supra* n. 3, at 253 (citing Von L. Heinrich, *Die Reform der Directen steuern, insbesondere die Einführung der Selbsteinschätzung in Preussen—Ein Mahnwort an die Preussischen Landtagswähler* 59 (Berlin 2d ed. 1889)).

254. Hesse modified its existing income tax in 1899 to resemble the Prussian model. Saxony did so in 1900, Baden in 1906. Würtemberg adopted an income tax law in 1903. By 1911, a general income tax existed in all twenty-five states of Germany, except Bavaria, the two Mecklenburgs, and Alsace-Lorraine. Seligman, *The Income Tax*, *supra* n. 2, at 48.

255. See Simons, *supra* n. 3, at 69-80.

256. *Id.*

257. Grossfeld, *supra* n. 199, at 26-27 (attributing priority to Gentz and Kraus, among German academics, who self-consciously imported British tax innovations into the German intellectual environment); see Rolf Grabower, *Preussens Steuern vor und nach den Befreiungskriegen* 131 et seq. (1932).

suggested that the novelty of Adam Smith's economic writings, with their emphasis on issues of public finance, caught the attention of Prussian political economists because they saw themselves as intermediaries between the British Isles and a wider German audience.<sup>258</sup> The idea that national welfare might be shaped through self-conscious employment of the tax laws, among other forms of governmental intervention, appealed strongly to the Prussian court of the period following the peace with Napoleon in 1807.<sup>259</sup>

One consequence of the British influence, however, was that German theorists became entranced with an aspect of their own fiscal problems that was no problem at all for the British.<sup>260</sup> The British income tax laws had, from Peel's time on, relied on the device of requiring taxpayers to report income in accordance with scheduled activities or from scheduled sources, which apparently made sense to the British, because British classical economists had so successfully sold their public on the inevitability of a macro-economic model that distinguished land, capital and labor as ultimately distinct sources of new wealth.<sup>261</sup> In Britain, this differentiation corresponded to the more or less straightforward partisan debate between landed interests and the new capitalist class, whose ideologues the classical economists more or less consciously became. In Germany, capital may also have been on its way to political significance (Marx had difficulty making this credible to himself or his German readers), but in the first decades of the nineteenth century, the inevitability of the British list of income sources was not so obvious to the German intelligentsia or general public.<sup>262</sup>

Theorists therefore had to work hard to justify a source-based view of income. By the middle of the century, with several approximations to income taxation figuring already in the laws of

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258. Grossfeld, *supra* n. 199, at 26-27.

259. *Id.* at 27; Seligman, *The Income Tax*, *supra* n. 3, at 224 (citing Karl Mamroth, *Geschichte der Preussischen Staats-Besteuerung 1806-1816* (Leipzig 1890). Under the Treaty of Tilsit, Frederick the Great of Prussia lost almost half the territory and population of his kingdom, and subsequent agreements forced on the Prussian monarchy reduced Prussia to a secondary German state until the restoration in 1813, after the Battle of Leipzig, at which Austria and Russia backed the Prussian cause against the French. *Id.*

260. Schremmer, *supra* n. 58, at 477.

261. Carl Shoup, *supra* n. 100, at 25-39; Utz, *supra* n. 100, at 1-15.

262. Schremmer, *supra* n. 58, at 443-44.



important German states, the *Quellentheorie* (the "source theory") had numerous proponents, each with a slightly different view of why and how sources mattered and should play a structural role in German tax laws.<sup>263</sup> Practical politics gave the puzzles of income taxation great urgency. The German states had begun, soon after Napoleon's intrusion on their lands, to replace sales taxes on a wide range of consumable items with taxes on the yield, or product (*Ertrag*), of certain categories of property.<sup>264</sup> Some of the categories were more closely associated with agricultural industry, others with urban production and service industry, and the merit of the yield taxes was to harmonize the taxation of these increasingly different productive activities. Lower income groups identified the general dominance of the landed aristocracy and urban capitalists with the tax favoritism these groups apparently enjoyed.

Accordingly, the principal focus of German tax reform efforts was not, as in England, the stability of broad-based direct taxes as a means of dealing with governmental debt but the greater fairness of broad-based direct taxes as a response to what might well be called the "class struggle."<sup>265</sup> If the familiar Marxist diagnosis of the significant tension of the times has sometimes been called in question, it echoes language that was vital to a half-century of Prussian direct tax reform efforts, for as we have seen, the Prussian government introduced a so-called class tax (*Klassensteuer*) to approximate the results of British income taxation without the need for inquisitorial methods of enforcement.<sup>266</sup>

In any event, German theorists of the period extended the range of theoretical discussion by searching for their own rationale for the

263. Simons, *supra* n. 3, at 69-80.

264. Schremmer, *supra* n. 58, at 411-12.

265. Edwin R.A. Seligman, *Essays in Taxation* 13 (2d ed. 1913). Seligman's characterization of the sources of the instability of the medieval property taxes seems particularly applicable to Germany in the early nineteenth century.

Now begins the contest between the landed and the moneyed interest, between rent and profit. The landowners in medieval times, like the farmers in our own time, vainly attempt to expand the original property tax so as to include all these new forms of property [productive capital]. The capitalist and moneyed class either seek to shift the burden by devising the indirect tax . . . or they attempt to escape the burden entirely through evasion or through lax administration of the property tax.

*Id.*

266. See *supra* nn. 214-30 and accompanying text.

British schedular approach to income taxation. By the time they took an interest in the British innovation, the Ricardian model had lost much of its interest for the British themselves and, perhaps for that reason, did not interest the German theorists either. Instead, some found a different significance in the classification of land, capital, labor, and professional expertise as factors of production, proceeding as if the analysis of national income had special authority as a source of principles of tax fairness.<sup>267</sup> It is beyond the scope of this article to reconstruct the political needs and commitments that fostered this approach; it is sufficient to say that one broad tributary to the debate poured energy into the task of understanding income at the individual level as a special case of national income, with particular emphasis on ensuring that national income should be seen to be the sum of individual incomes.<sup>268</sup>

Others defended the aversion of the wealthy to an invasive income tax regime by developing theoretical defenses of "objective," *i.e.*, non-intrusive, measures of tax liability.<sup>269</sup> For these theorists, the class tax was itself so intrusive as to threaten the very fabric of the social order. Based as it was on an individualized assessment of taxpayers' wealth, mode of life, and average income situation, the class tax drew into relief precisely those differences within the citizenry that were best left out of the political realm, even so mild a form of the political realm as a tax audit.

Some, and most notably, Adolf Wagner, a leading advocate of tax reform, followed the lead of John Stuart Mill and what may have appeared to the German audience the consensus among British authorities concerning the proper measure of income.<sup>270</sup> These espoused Mill's minimum-sacrifice principle, although they proposed other approaches to it.<sup>271</sup> All of them agreed with some of Mill's critics in believing that minimum-sacrifice and ability to pay required

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267. Simons, *supra* n. 3, at 62-66.

268. See Alvin C. Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 Yale L.J. 1081, 1085 (1980) (recapitulation of some of the puzzles associated with the equation of national income and the sum of individual incomes).

269. Simons, *supra* n. 3, at 63-65.

270. *Id.* at 65.

271. Musgrave, *Theory*, *supra* n. 2, at 112.

progressive income taxation.<sup>272</sup> These camps developed slowly during the last half of the nineteenth century.

What is important here is that while in Germany tax justice figured more prominently in analytical thought about fiscal matters, it was not widely taken for granted that the measurement of tax burdens must focus on the utility of a person's wherewithal. Instead, many writers set out from a recognition that a person's vulnerability to tax injustice might be associated with various aspects of his or her situation in life, and that the intrusiveness of the government in determining one's susceptibility to taxation should influence the choice of a tax base.<sup>273</sup>

Three German writers of the late nineteenth century deserve closer examination here. Adolf Wagner followed Mill in accepting his analysis of equal sacrifice, though with an important qualification.<sup>274</sup> Wagner considered the principle of equal sacrifice to follow from the theory of production or what would now be called allocative efficiency.<sup>275</sup> He also accepted Mill's argument from the equal sacrifice principle that proportional taxation was to be preferred—but again, only from the standpoint of the “purely fiscal” or allocative efficiency.<sup>276</sup> He recognized as well, however, that considerations of “social welfare” (*das sozialpolitische Prinzip*) might require a redistributive deviation from the dictates of the equal sacrifice principle.<sup>277</sup> In brief, Wagner seized upon the distinction between allocation and distribution that Mill had himself made central to his

272. Adolph Wagner, *Three Extracts on Public Finance*, in *Classics in the Theory of Public Finance* 1-15 (Richard Musgrave and Alan T. Peacock eds., Nancy Cook trans., St. Martin's Press 1967).

273. Simons, *supra* n. 2, at 70-74.

274. Musgrave, *Theory*, *supra* n. 2, at 112.

275. Wagner, *supra* n. 272, at 13 (stating, “The justice of the conclusions as to the universality and equality of taxation [in accordance with equal sacrifice] are unassailable, if the premises are granted . . .”).

276. Wagner's views resemble those of F.Y. Edgeworth and Alexandre Pigou, who both held that “there was no logical or intuitive choice between the equity principles of equal absolute and equal proportional sacrifice.” Musgrave, *Theory*, *supra* n. 2, at 98. “Arguing on welfare grounds, they considered equal marginal sacrifice the only proper rule, not as a matter of equity, but because it met the welfare objective of least aggregate sacrifice.” See Edgeworth, *supra* n. 198, at 100-02; Pigou, *supra* n. 132, at 61.

277. Wagner, *supra* n. 272, at 14-15.

political economy,<sup>278</sup> and found therein a justification for progressive taxation: What social welfare required depended on the historical setting of the taxing state. He associated *both* the allocative and distributive aspects of just taxation with ability to pay.<sup>279</sup>

Friedrich Kleinwächter subjected the income tax base to an exhaustive critique, based largely on the shortcomings of identifying income with welfare, understood in a comparatively modern utilitarian fashion.<sup>280</sup> He is best known in this country, perhaps, for what Henry Simons called "Kleinwächter's conundrums"—puzzles hurled against the project of analyzing individual income as a special case or increment of national income.<sup>281</sup> To regard society as "a kind of giant partnership," as Simons put it,

raises the unanswerable question as to where or how a line may be drawn between what is and what is not economic activity. If a man raises vegetables in his garden, it seems clearly appropriate to include the value of the product in measuring his income. If he raises flowers and shrubs, the case is less clear. If he shaves himself, it is difficult to argue that the value of the shaves must also be accounted for. Most economists recognize housewives' services as an important item of income. So they are, perhaps; but what becomes of this view as one proceeds to extreme cases? Do families have larger incomes because parents give competent instruction to children instead of paying for institutional training? Does a doctor or an apothecary have relatively large income in years when his family requires and receives an extraordinary amount of his own professional services?<sup>282</sup>

Kleinwächter raised these difficulties and others related to differences among individuals' preferences, which relate not only to the difficulty of determining which benefits enjoyed by individuals should be swept into the tax base, but also in order to emphasize the wide discrepancies in "psychic" income received by different individuals in similar circumstances.<sup>283</sup> The most famous example is

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278. Mill, *supra* n. 115, at 806-07.

279. See Musgrave, *Theory*, *supra* n. 2, at 112.

280. Friedrich Kleinwächter, *Das Einkommen und Seine Verteilung* (1896); Simons, *supra* n. 3, at 42-43.

281. Simons, *supra* n. 3, at 51-52.

282. *Id.* (citing Kleinwächter, *supra* n. 281).

283. Simons, *supra* n. 3, at 54-58.

his *Flügeladjutant* (regimental aide-de-camp) attached to the sovereign, who receives the same nominal pay as an ordinary officer but accompanies the prince to the theater and the opera, and hates it.<sup>284</sup> Does the *Flügeladjutant* have income as a result of the royal life style he is in a position to enjoy, although he does not in fact do so?<sup>285</sup> These objections to the income tax base are actually drawn only from the introduction to Kleinwächter's magnum opus; the more important chapters of which bedevil the traditional divisions of national income, alleged by national income/individual income theorists. Nevertheless, he established a benchmark of skepticism concerning the intellectual respectability of the more comforting teachings of the era's technical economic writings on taxation.<sup>286</sup>

Given the later ascendancy of the Schanz-Haig-Simons definition of income, the alternative Georg Schanz defended deserves separate mention, as well as a synthesis of the "objectivists" described above, by believers in progressive taxation. Schanz came late to the debate, but as the influential editor of the most distinguished German tax policy journal, he succeeded in changing its tenor and direction. His own view could be understood as a variant of minimum-sacrifice or ability to pay theory, but it was distinctly contrary to the subjectivism that had begun to characterize the work of political economists whose work descended from Mill's. He insisted on economic power (*wirtschaftliche Kraft*) as the ultimate measure of "pure" taxable capacity (*rein wirtschaftliche Vermögen*), and argued that these concepts should be understood without reference to the idiosyncratic preference satisfaction of the individual who enjoyed or wielded the economic power at issue.<sup>287</sup>

Interestingly, some of the key terms Schanz used pose a problem for the continuity of the equal sacrifice debate. While he thought income taxation should be concerned with the economic power

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284. *Id.* at 53.

285. *Id.*

286. *See id.* at 51-56.

287. Georg Schanz, *Der Einkommenbegriff und die Einkommensteuergesetze*, 13 *Finanz Archiv* 23 (1896); *see* Simons, *supra* n. 3, at 60-61 (discussion of Schanz's response to ability to pay); Max Lion, *Der Einkommensbegriff nach dem bilanzsteuerrecht und die Schanzsche Einkommenstheorie*, in 2 *Beiträge zur Finanzwissenschaft* [Festgabe Für Georg von Schanz zum 75 Geburtstag] 273 (ed. Hans Teschemacher 1928).

(*wirtschaftliche Kraft*) of a person during a given temporal period,<sup>288</sup> his preferred term for the analytical touchstone was not economic power but something more like "wherewithal" (*Reinvermögenszuwachs* or *-zugang*).<sup>289</sup> The crucial root term *Vermögen* can, depending on the context, be translated as "means" (in the economic sense), wealth, or . . . ability to pay.<sup>290</sup> Nevertheless, it is clear from Schanz's various lists of items of income that he considers all receipts that have economic value (*geldwerte Leistungen*) to be items of income in his sense.<sup>291</sup>

### C. THE AMERICAN PROGRESSIVE MOVEMENT AND BORROWINGS FROM ABROAD

#### 1. *The Sixteenth Amendment and the First Revenue Acts*

The United States adopted an income tax in a mood of euphoric confidence that the European precedent for such a tax was overwhelmingly positive and that no analytical puzzles remained to be solved.<sup>292</sup> The idea of a federal income tax had for some time generated great warmth in national electoral campaigns. The Progressive political movement had championed it, and President Theodore Roosevelt had defended the income tax against the Supreme Court's decision in *Pollock v. Farmers' Loan & Trust Co.*,<sup>293</sup> which had invalidated the income tax of 1894.<sup>294</sup> In the 1908 presidential campaign, both the Republican and the Democratic Parties supported the introduction of an income tax, in the Republicans' case only if customs taxes did not meet revenue requirements.<sup>295</sup> When newly elected President Taft balked at the prospect of introducing an income tax, public sentiment ran so strongly against the proposed Payne-Aldrich Tariff, introduced by the Republicans in Congress as an

288. Schanz, *supra* n. 287, at 5; Simons, *supra* n. 3, at 61.

289. Simons, *supra* n. 3, at 62.

290. *Id.* To avoid confusion, it should be mentioned here that "ability to pay" would more usually be *Leistungsfähigkeit*.

291. Schanz, *supra* n. 287, at 5, 24.

292. Max West, *The Income Tax and the National Revenues*, 8 J. Pol. Econ. 433, 447-48 (1900).

293. 158 U.S. 601 (1895).

294. *Id.* at 920-21.

295. Seligman, *The Income Tax*, *supra* n. 3, at 591-92.

alternative to income taxation, that Taft and the Republican members of Congress agreed to the immediate introduction of a corporate income tax and the submission of an income tax amendment for ratification by the States.<sup>296</sup>

## 2. *Intellectual History of the U.S. Income Tax*

The public debate that led to federal income taxation, however, had only a slender intellectual component. In order to finance the country's 1917 war effort, Congress appeared in part simply to draw on the past in devising an income tax.<sup>297</sup> During the Civil War Congress had adopted a temporary corporate profits tax, and the 1917 War Revenue Act was similarly referred to as an "emergency" measure.<sup>298</sup> Presumably, everyone knew that there was substantial organized support for making the income tax features of the new revenue measures permanent, but the circumstances permitted lawmakers and the public alike to avert their gaze from the momentous implications of the federal experiment.

Among the handful of American theorists who explained and defended the new income tax,<sup>299</sup> E.R.A. Seligman was easily the most prominent. From his post at Columbia, he wrote constantly, elaborately, and in suitably statesmanlike tones, of history's inexorable drive towards income taxation as the bedrock of politically fair public finance.<sup>300</sup> He led or took part in many privately or publicly sponsored "commissions," organized to survey European developments on the taxing and social spending front.<sup>301</sup> He kept up with innumerable developments in state and local tax reform.<sup>302</sup> In all these endeavors,

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296. 44 Cong. Rec. 1351 (1909) (Sen. Cummins of Iowa introduces bill for an amendment authorizing a progressive individual income tax); Seligman, *The Income Tax*, *supra* n. 3, at 592-93 (giving text of President Taft's "special message" endorsing the income tax amendment proposal).

297. Joseph J. Thorndike, *Reforming the Internal Revenue Service: A Comparative History*, 53 Admin. L. Rev. 717, 741-42 (2001); Witte, *supra* n. 24, at 67-70.

298. Witte, *supra* n. 24, at 83-87.

299. See e.g. West, *supra* n. 292; Wayne MacVeagh, *The Graduated Taxation of Incomes and Inheritances*, 182 N. Am. Rev. 823 (1906).

300. See generally Seligman, *The Income Tax*, *supra* n. 3, at 631-42.

301. Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 Duke L.J. 1021, 1074-75 nn. 215-17 (1997).

302. Seligman, *supra* n. 3 (collection of early historical essays on indirect taxation in Europe and America, reports on American tax reform movements, and surveys of

he pressed the theme of ability to pay as the touchstone of enlightened tax policy.

Seligman's understanding of ability to pay was thoroughly grounded in his historical scholarship concerning the doctrine. Nevertheless, he was content to use the term as if it signified a Hegelian idea working its way out in history. He commented with overwhelming approval on Mill's innovation in linking ability to pay with the utilitarian analysis of welfare.<sup>303</sup> Elsewhere, however, he simply championed ability to pay without recognizing objections.<sup>304</sup> His historical surveys of European tax reform movements took for granted that income taxation was the wave of the future and that it was ideal from a practical and moral standpoint.<sup>305</sup>

As it appears in Seligman's several approaches to the history of ability to pay, a phrase he popularized, the inexorable march of history towards acceptance of individual income taxation was a response only to the broad demand for tax justice as between the apex and base of the economic pyramid.<sup>306</sup> Although he reported historical events in other countries that actually provided rather different motivation for the move towards income taxation, his accounts of these historical antecedents airbrushed away the peculiarities of contrasting cultures, leaving only a generalized concern for equity between economically different groups. In this, of course, Seligman epitomized the Progressives, whose willingness to rely on European examples invariably divorced those examples from the circumstances that brought them about.<sup>307</sup>

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theoretical literature on taxation).

303. E.R.A. Seligman, *A Quarter Century's Progress in Taxation*, in *Essays in Taxation* 330, 339-40 (9th ed., The MacMillan Company 1921) ("[T]he subjective measure of the obligation was found to consist in sacrifice . . . . The doctrine of ability or faculty, as thus reinvigorated, is not only free from objection; it is, because more inclusive, superior to any of the rival conceptions that now divide the camp of fiscal thinkers.").

304. Graetz & O'Hear, *supra* n. 301, at 1075.

305. *Id.* at 1076.

306. Seligman, *Progressive Taxation*, *supra* n. 2, at 33.

307. See James T. Kloppenberg, *Uncertain Victory: Social Democracy and Progressivism in European and American Thought, 1870-1920*, at 277-297 (Oxford U. Press 1986) (discussing how Progressives in Europe and America, and especially British and U.S. exponents of the movement, reformulated the objectives of earlier socialist and social democratic thought in pragmatic and deliberately chose not to seek to institutionalize any one concept of distributive justice).



Seligman's most explicit analytical defense of income taxation begins with his unargued assertion that income is a more sensitive measure of the *impact* of a tax on individuals than any other property or transaction tax base.<sup>308</sup> He acknowledges that equal amounts of money revenue or the equivalent may not necessarily reflect equal ability to pay, because of differences in "social demands," philanthropic impulse, family needs, and so forth.<sup>309</sup> He concludes that an income tax alone is "not a thoroughly adequate test" of ability to pay and should be supplemented by property and other taxes.<sup>310</sup> He further favors differentiating between earned and unearned income, on the grounds that unearned income is a reliable symptom of greater freedom to choose how the income will be used.<sup>311</sup> Finally, however, he repeats his approval of the equal sacrifice analysis of tax fairness and relies on it without elaborate discussion to support a progressive income tax rate structure.<sup>312</sup> It is interesting that in the course of the discussion, Seligman emphasizes that income is a desirable tax base because it can easily be measured and then later laments the impossibility of relying on differences in money income to determine an exact comparison of individual sacrifice in paying taxes.<sup>313</sup>

Seligman had one intellectual adversary before the American audience who did take aim at the weaknesses he saw in the vague conception of income. Irving Fisher at Yale offered a radical critique of received notions of income and argued that properly understood income does not include normal returns on capital, a conclusion that sometimes leads commentators to describe Fisher as a consumption tax proponent.<sup>314</sup> His assumptions, however, did not differ from Seligman's or other contemporary tax theorists where the relevance and intellectual authority of the ability to pay criterion was concerned. Fisher, like Seligman and other contemporaries, considered utility to be

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308. Seligman, *The Income Tax*, *supra* n. 3, at 1-38.

309. *Id.* at 16-17.

310. *Id.*

311. *Id.* at 25-27.

312. *Id.* at 29-34.

313. *Id.* at 20, 32-33 (including any but the most notorious sorts of psychic income would be impractical and noting the psychological differences among individuals make it impossible to determine any "definite scale of progression" but political expedience permits the adoption of *some* progressive tax rate structure).

314. Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 Tex. L. Rev. 1145, 1168 (1992).

the ultimate measure of economic gain or loss and wholeheartedly accepted the implication that like amounts of money may represent different amounts of income to different individuals.<sup>315</sup> The difference in "psychic" income deserved to be taken into account only as a correction to values as determined by the market.<sup>316</sup>

#### D. HENRY SIMONS'S REJECTION OF ABILITY TO PAY

Henry Simons is well remembered for his definition of individual income as the sum of a person's accumulation and consumption over a given period of time.<sup>317</sup> Definitions of income had once been a central feature of some accounts of the basics of tax policy, but by the time Simons published *Personal Income Taxation* in 1938,<sup>318</sup> however, income taxation had also been accepted in all the major industrial democracies.<sup>319</sup> Politicians and those close to contemporary political debate had nothing more to say about the general legitimacy of taxing income, from a political point of view, or about the fine tuning of the tax base for purposes of tax justice or effective fiscal planning.<sup>320</sup>

315. Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S. Cal. L. Rev. 397, 415 (1987).

316. Irving Fisher, *The Nature of Capital and Income* 113 (Macmillan & Co., Ltd. 1906).

317. Simons, *supra* n. 3, at 60-61. The frequency with which contemporary writers invoke Simons's name and definition is staggering. It is worthwhile to note the only occasional reservations that are expressed. See e.g. Louis Kaplow, *Human Capital Under an Ideal Income Tax*, 80 Va. L. Rev. 1477, 1477 n. 1 (1994) (observing that Simons was less than assertive concerning the extension of "income" to non-market transactions); Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes under the Federal Income Tax*, 82 Va. L. Rev. 413, 430-41 (1996) (relying on the traditional equation of ability to pay with identical utility schedule assumptions and analysis); Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 Harv. L. Rev. 961, 979-99 (2001) (defending utility analysis, apparently on similar streamlined assumptions, for all public policy analysis).

318. Various commentators attest that Simons had in fact written *Personal Income Taxation* during the twenties and that its belated publication might somewhat mislead the reader concerning the intellectual setting in which it was conceived. Robert Haig, for example, had just published the article with which Simons professed himself in agreement. Robert Haig, *The Concept of Income*, in *The Federal Income Tax* 1 (Robert Haig ed. Columbia U. Press 1921).

319. Seligman, *The Income Tax*, *supra* n. 3, at 329 n 1.

320. Fiscal planning through manipulation of the tax laws of course remained a lively topic, as the influence of Keynes's writings illustrates. J.M. Keynes, *The General Theory of Employment Interest and Money* (Macmillan & Co. Ltd., 1957); A. Asimakopulos, *Keynes's General Theory and Accumulation* (Cambridge U. Press

Simons's contribution to tax policy was, in effect, an attempt again to turn the debate in the direction of definitional subtlety. For our purposes, the most important feature of Simons's argument is that it begins with his rejection of the ability to pay tradition.<sup>321</sup>

The greater part of what has been written about justice in taxation has been couched in terms of sacrifice. This concept, along with "ability" and "faculty," is a more or less legitimate progeny of "utility"; and it has contributed about as much confusion, with respect to the ethics of public policy, as has "utility" with reference to the explanation of human behavior.<sup>322</sup>

Within very few pages, Simons recapitulates what by Simons's day was a long litany of criticisms of Mill's original suggestion, that taxation should exact equal sacrifices from all taxpayers.<sup>323</sup> He gives particular attention to the objections put forward by Edgeworth and Pigou—all of which relate to the artificiality, indeed the evident falsehood, of the assumption that different individuals have the same utility functions or schedules, an assumption that is apparently fundamental to Mill's original application of the equal sacrifice principle.<sup>324</sup> These criticisms touch on the fact that a straightforward defense of fixed progressive taxation (or any other unchanging tax structure) assumes the independence of the individual taxpayer's long-run income-utility function to the prevailing (and changing) distribution of income, a distribution partly affected by taxation. For example, Simons argues:

The fact that consumption, especially in the upper-income classes, is so largely competitive and invidious constitutes by itself a powerful argument for steep progression. For the minimum-sacrifice program, it implies that the rates of tax should be much

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1991) (discussing Keynes's influence). Significantly, Simons mentions Keynes's views only for their broad fiscal implications, not at all for their implications concerning the definition of income. Simons, *supra* n. 3, at 23 n. 14.

321. Simons rejects the ideal of taxation according to benefit as well, although he does so with considerably less discussion. Benefit taxation was certainly not a thing of the past when he wrote, but its intellectual defenders were few at the time; see *id.* at 3-4. For the lack of vitality then evident in benefit taxation circles, see Musgrave, *supra* n. 2, at 61-63; Klaus Tipke, 2 *Die Steuerrechtsordnung*, *supra* n. 2, at 473-75.

322. Simons, *supra* n. 3, at 5. Haig had been just as forthright in rejecting the ability to pay approach as Mill had left it. Haig, *supra* n. 318, at 6.

323. Simons, *supra* n. 3, at 54-58.

324. *Id.* at 6-9; see Utz, *supra* n. 100, at 41-52.

more progressive at the outset, and should be more rapidly increased afterward, than would otherwise be appropriate.<sup>325</sup>

But Simons goes Edgeworth and Pigou one better. Whereas they point out the likely differences among individuals' initial utility functions and the interdependence of different individuals' utility functions, both were content to make the unjustified and undefended assumption that "all individuals are, or must be treated as, equally efficient as pleasure machines."<sup>326</sup> Simons suggests that what really lies behind these otherwise careful theorist's willingness to ignore awkward differences among individual's utility functions is that no other approach "is either politically practicable or morally tolerable."<sup>327</sup> Our zeal, in other words, for the technically attractive explanation of tax impacts by reference to utility simply runs out when we have discussed its puzzles:

[This] last argument would evidence frankness and candor; but it invites suspicion of logical legerdemain. Certainly it would reduce the whole hedonistic calculus to a merely superfluous embellishment of the argument. The other premises, to many persons, will therefore seem more inviting. For votaries of hedonistic welfare economics, however, they all have the disadvantage of revealing the crucial importance of this step in the argument.<sup>328</sup>

Simons proceeds thereafter as having dispatched the utility-based analysis of equal or minimum sacrifice, which he equates with the ability to pay tradition.<sup>329</sup>

Simons's positive theory is a defense of the famous definition of income. He begins with the premise that income taxation is a good thing and that it is politically acceptable for governments to use income taxation to re-distribute wealth.<sup>330</sup> He notes too that despite the wide

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325. Simons, *supra* n. 3, at 9.

326. *Id.* at 11. Compare that assumption with John Harsanyi, *Essays on Ethics, Social Behavior, and Scientific Explanation* vol. 12, 6-23 (Gerald Eberlein & Werner Leinfellner eds., D. Reidel Publishing Co. 1976) (assuming that differences between individuals' utility functions can be causally explained by environmental and otherwise irrelevant differences in their backgrounds).

327. Simons, *supra* n. 3, at 12.

328. *Id.*

329. *Id.* at 14-18.

330. *Id.* at 41-42.

variety of definitions of income proposed by technical writers, the term is "widely used without serious misunderstanding in certain ranges of discourse . . . ." <sup>331</sup> His purpose is only to sort out a number of puzzles to which the ordinary, vague, but consistent usage of the term gives rise. He does not defend the rationality of taxing income rather than some other base, and he does not try to justify the proposition that it is fair to be satisfied with similar treatment of similar incomes. "Since it is widely agreed that income is a good tax base, its meaning may be sought by inquiring what definition would provide the basis for most nearly equitable levies." <sup>332</sup> Simons admits at the outset that some arbitrary limits on the concept of income are inevitable, but that arbitrary distinctions should be kept to a minimum. <sup>333</sup> In this connection, he refers to Friedrich Kleinwächter's barrage of puzzles designed to discredit income as a tax base. <sup>334</sup> Simons treats these puzzles as merely illustrating that no concept can be precisely delimited in all respects. <sup>335</sup>

It is interesting that Simons's defense of the Schanz-Haig-Simons definition of income should be so universally hailed, although its theoretical underpinnings have virtually nothing to do with topics of contemporary debate concerning either the foundations of welfarism or the measurement of national and individual income.

#### E. RECENT LANDMARKS IN THE ABILITY TO PAY TRADITION

Since the appearance of Simons's *Personal Income Taxation*, few English-speaking writers have returned to the problem of refining the concept of income with a view to defending the resultant concept of tax fairness, and those few have done so without overhauling the assumptions of their predecessors. It is as if the community of tax theorists breathed a collective sigh of relief in accepting Simons's grand summary of the area and proceeded thereafter to repair the boat of theory without recourse to a dry dock. Yet a few writers have revisited the problems that prompted and plagued the concept of ability to pay.

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331. *Id.* at 42.

332. *Id.*

333. *Id.* at 42-43.

334. *Id.* at 43 n. 3.

335. *Id.* at 43.

1. *Harry Kalven and Walter Blum*

*The Uneasy Case For Progressive Taxation*,<sup>336</sup> must be regarded as among the most influential American law review articles of all time. It appeared at a propitious moment, the eve of the adoption of the 1954 Internal Revenue Code, and sounded a minatory note of skepticism concerning the basics on which most tax policy writers, including fiscal conservatives like Henry Simons, had previously agreed.<sup>337</sup> In a sense, their challenge to the ideal of a progressive income tax marked the end of the honeymoon that had begun with Mill's compromise in favor of the progressive, because schedular, British income tax of the 1840s.<sup>338</sup>

Crucially, Kalven and Blum assumed that there would be an income tax and further assumed that taxation in proportion to income was to be preferred if a stronger case could not be made for any alternative.<sup>339</sup> Their article reviewed the course of the debate among Mill's disciples and critics concerning the principle of equal sacrifice and concluded that the proportionalists had the better of it.<sup>340</sup>

For our purposes, the importance of Kalven and Blum's work lies in its acceptance of the utilitarian understanding of ability to pay.

2. *Nicholas Kaldor*

The most articulate of consumption tax advocates of his generation, Nicholas Kaldor, devoted an elaborate analysis to the reconciliation of consumption taxation with the ability to pay tradition.<sup>341</sup> It is worth stressing that he based his defense of consumption taxation on two different lines of argument. The first concerned the equity of consumption taxation as compared with income taxation.<sup>342</sup> The second concerned differences in tax neutrality of the two tax bases.<sup>343</sup> According to Kaldor's own characterization of

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336. Blum & Kalven, *supra* n. 113.

337. *Id.* at 1-2.

338. Mill, *supra* n. 115, at 816.

339. Blum & Kalven, *supra* n. 113, at 64-68.

340. *Id.* at 49-51.

341. Kaldor, *supra* n. 1, at 1-101. In this he anticipated the more succinct analysis of the Meade Committee. Meade, *supra* n. 3, at 30-36 (comparing income and consumption tax bases in terms of ability to pay).

342. Kaldor, *supra* n. 1, at 1-101.

343. *Id.*

his argument, however, his revision of the equity argument was more original and, as he thought, basic.<sup>344</sup>

Kaldor expressed the core of his equity analysis quite succinctly:

[N]either Mill nor any of the other advocates did full justice to the case for an expenditure tax on grounds of equity—they did not even suspect it. This case does not really rest on the element of “double taxation” of savings involved in an income tax, but arises from more fundamental shortcomings of the concept of “income” as a measuring-rod of taxable capacity. The real inequities of the system arise not so much from the failure to exempt savings out of “income,” but the failure to tax as “income” the spending power that is exercised through “dis-savings” (or spending out of capital) or through capital profits or other receipts of various kinds.<sup>345</sup>

This idea was not just quietly in the background of the current British debate concerning consumption and income taxation. The Chancellor of the Exchequer, in response to a request from the Butler Commission on which Kaldor sat, had opined that “the expenditure of those whose expenditure is not confined to necessities includes a large element of payment of tax . . . .”<sup>346</sup> Kaldor essentially saw the role of overall dis-savers as crucially undermining the support for income taxation provided by the ability to pay approach.<sup>347</sup> To ignore the ability to pay of those possessing large fortunes, because their fortunes did not fit the flow of income model on which earlier theorists had relied, was to misconceive the general character of the British economy of the time.

For our purposes, Kaldor’s discussion has a second significance. He, like Simons before him, very eloquently summarized the tradition of thought that had won primacy for the ability to pay tradition. He placed Mill at the center of that tradition, as was inevitable, and he

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344. *Id.* Kaldor’s *An Expenditure Tax* grew out of memoranda he submitted to the Royal Commission on the Taxation of Profits and Income, appointed in 1950, sometimes called the “Butler Commission.” Apparently, about half of the Commission refused to consider the global preferability of consumption as a tax base, although they did endorse it on limited grounds, because in their view this aspect of the grounding of the tax was beyond their commission. *Id.* at 7.

345. *Id.* at 13-14.

346. *Id.* at 7 (citing First Report of the Royal Commission of Taxation, Cmd. 8761, 1953, ¶ 5; see also Parliamentary Debates, House of Commons, cols. 1433-55, April 2, 1953).

347. *Id.* at 13.

gave Mill large credit for having emphasized the importance of differences in different economic classes' need to save for future wants or emergencies.<sup>348</sup> Kaldor thought this insight went to the heart of "the meaning of taxable capacity."<sup>349</sup> He assumed that taxable capacity or ability to pay was the bedrock on which "the justification for a system of progressive income taxation rests . . ."<sup>350</sup> He reviewed the developments that led Mill's followers and friendly revisionists to suggest minimum sacrifice and equal marginal sacrifice as substitutes for the original equal sacrifice of Mill's landmark discussion, only to point out that none of these revisionists had for a moment considered seriously the possibility of a return to Mill's preference for consumption taxation.<sup>351</sup> They all simply judged consumption taxation to be impractical, as Mill apparently had himself.<sup>352</sup>

Kaldor opposed those who found support for income taxation in the notion of equal sacrifice by noting:

For the man in the street, spending power is simply "money"—in that vague everyday sense of the word which does not mean *just* cash or money in the bank or the total of disposable wealth looked at a point of time, or a regular flow of receipts in the form of a wage and salary, or interest and dividend payments, or casual receipts, like gifts, bequests and gambling winnings, but all these things together in a mysterious and seemingly illogical combination.<sup>353</sup>

Like Simons and Surrey,<sup>354</sup> Kaldor had little time for difficulties concerning utility schedules. His discussion, however, firmly assumes that spending power, in the sense recognized by the common citizen, is an adequate proxy for individual well being or welfare.<sup>355</sup> The intuitions of the nontechnical person, he believed, got at the heart of the

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348. *Id.* at 13.

349. *Id.* at 25.

350. *Id.* (stating that "[t]axation according to ability to pay for the last hundred years or more has been a universally accepted postulate, not only amongst political and economic writers, but amongst the public at large").

351. *Id.* at 13-14.

352. *Id.* at 11-13, 26-30.

353. *Id.* at 30.

354. See *supra* nn. 318-37 and accompanying text; see *infra* nn. 379-88 and accompanying text.

355. Kaldor, *supra* n. 1, at 30-31.



matter.<sup>356</sup> Nevertheless, he emphatically concluded that subjective enjoyment of an endowment to consume more nearly approximated the felt sense of ability to pay than did traditional income accounting, even when refined to take into account some subjective discrepancies between income and overall welfare.<sup>357</sup>

### 3. *Richard Musgrave's Theory of Public Finance*

In his *Theory of Public Finance*, Richard Musgrave managed what is perhaps the most influential recent revival of the utilitarian version of ability to pay. In a brief but thorough review of the doctrine's merits, Musgrave admirably set forth the many good reasons for rejecting it and yet concluded that since there was nothing better to put in its place, it must serve.<sup>358</sup> Briefly, he accepted Mill's equation of ability to pay with the principle of equal sacrifice,<sup>359</sup> and showed that the attempts of Mill and others to define equal sacrifice functionally ran aground in the shallows of the utilitarian analysis of welfare (welfarism). Since Musgrave's influence on contemporary tax policy has successfully imprinted this new-old welfarism on discussions of ability to pay and of horizontal equity,<sup>360</sup> it is vital to recognize with what thoroughgoing reservations Musgrave himself regards the utilitarian version of ability to pay. Before reviewing these results, Musgrave's reasons for sympathy with ability to pay deserve some attention.

In several places, Musgrave has pointed out that for classical writers, the attraction of ability to pay may have been the succinct explanation the doctrine provided for divorcing fairness in taxation

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356. Compare *id.* at 25 with Simons, *supra* n. 3, at 31 (noting that compromise between objective inequality and the requirement that taxes find approval by the public "leads directly back into the utter darkness of 'ability' and 'faculty' or, as it were, into a rambling, uncharted course pointed only by fickle sentiments").

357. Kaldor, *supra* n. 1, at 53.

358. Musgrave, *Theory*, *supra* n. 2, at 92.

359. *Id.*

360. See e.g. Richard Musgrave, *ET, OT and SBT*, 6 J. Pub. Econ. 3, 3-4 (1976); Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 Natl. Tax J. 139 (1989); Richard A. Musgrave, *Horizontal Equity, Once More*, 43 Natl. Tax J. 113 (1990); Louis Kaplow, *A Note on Horizontal Equity*, 1 Fla. Tax Rev. 191 (1992); Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 Fla. Tax Rev. 607 (1993); Richard A. Musgrave, *Horizontal Equity: A Further Note* 1 Fla. Tax Rev. 354 (1993).

from any requirement that taxes correspond to benefits received.<sup>361</sup> Benefit theorists insisted that each individual's taxes should essentially pay for the benefits flowing from government to that taxpayer.<sup>362</sup> Benefits, of course, exist only if governmental intervention satisfies an individual's preferences. Hence, government intervention to provide a public good, for which a particular taxpayer is indifferent, confers no benefit on that taxpayer and should not be reflected in his or her tax liability. Benefit theorists, therefore, had to defend the limits they sought to place on the public expenditure function by what amounted to a priori judgments regarding the relative usefulness of public and private wants.<sup>363</sup> The ability to pay approach simply declares that the spending side of governmental taxing and spending is simply irrelevant to tax fairness.<sup>364</sup>

Musgrave's quite impartial review of the responses to Mill leads inexorably to the conclusion that ability to pay is, as Simons had argued, mere window dressing for some basic political judgments.<sup>365</sup>

Assuming that all taxpayers have the same marginal and total money-utility schedules, Cohen-Stuart and Edgeworth demonstrated: (1) that equal proportional sacrifice requires a proportional rate of tax if the marginal utility decreases at the same percentage rate as the average utility; (2) that progressive taxation is required if marginal utility declines more rapidly than average utility; and (3) regressive taxation is required if marginal utility declines less rapidly than average utility. The upshot is that a great deal must be known about the shape of the shared money-utility schedules in order to choose among these approaches to taxation, even if taxpayers are assumed to be ideally similar in every relevant way.<sup>366</sup>

Matters are even less clear if the possibility of differences among taxpayer's utility schedules is admitted. The tradeoff between labor and leisure further complicates the picture, because leisure arguably should be viewed as a commodity that competes in the utility rankings of individual taxpayers with the commodities they might buy with their

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361. Musgrave, *Theory*, *supra* n. 2, at 93-94.

362. *Id.* at 69-70.

363. *Id.* at 70-71.

364. *Id.* at 93.

365. See *supra* nn. 178-80 and accompanying text.

366. Musgrave, *Theory*, *supra* n. 2, at 100-01.

wages if they worked.<sup>367</sup> The long run introduces further difficulties for the possibly attractive idea of progressive taxation, because the cumulative effect of income taxation renders the distribution of the total tax burden a matter of indifference under equal marginal sacrifice, regressive under equal absolute sacrifice, and proportional under equal proportional sacrifice. As a consequence, we must make the tax rate structure, applicable to short accounting periods, ever more progressive in order to prevent the distribution of tax burdens from being more favorable to large incomes.<sup>368</sup>

Musgrave points out that the comparisons among different conceptions of equal sacrifice, just set forth, do not yield a specific schedule of tax rates, even on the relatively strong assumptions under discussion.<sup>369</sup> The slope of the marginal money-utility schedule must be known for the entire scale of incomes for equal proportional sacrifice tax tables to be formulated, and the slope must be known over the relevant range for equal absolute sacrifice tax tables to be formulated. Equal marginal sacrifice is easier to exact: maximum progression is indicated if marginal money utility declines over the relevant range, regardless of the rate of that decline.<sup>370</sup> All these conclusions hold good if differences between individuals' money utility schedules are admitted, as long as these schedules are similar for the relevant range. If both total and marginal schedules differ, "strict adherence" to the same tax tables for all individuals is simply improper.<sup>371</sup>

Rather, each individual must now be assessed according to his own utility schedule. While the slope of any one schedule may call for progression if applied to all individuals, some wealthy people whose utility curve lies at a low level will pay a lower rate of tax than some poor people whose schedule lies at a high level. At the same time, the average rate of tax payable by people in various income brackets may still show a positive relation between income and tax assessment.<sup>372</sup>

Finally, Musgrave takes into account the objections to welfarism that motivated the "new welfare economics" of the 1930s and after:

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367. *Id.* at 102.

368. *Id.* at 103.

369. *Id.* at 105.

370. *Id.*

371. *Id.*

372. *Id.* at 105-06.

Moreover, this entire discussion rests on the assumption that interpersonal utility comparisons can be made in a meaningful fashion. This assumption is basic to a subjective view of the ability to pay doctrine. Yet it is an assumption generally rejected by the "new" welfare economics. If such rejection is valid, the entire concept of equal sacrifice becomes so much nonsense and must be discarded—lock, stock, and barrel.<sup>373</sup>

The criticism of the old welfare economics by the new is a complex chapter in the history of economics. Although Musgrave took at face value the arguments of Lionel Robbins,<sup>374</sup> whose arguments continue to be cited more frequently than anyone else in this connection, he essentially admitted their cogency regarding the problem of how we get to know the utility of any event or condition for other people.<sup>375</sup> Interestingly, Musgrave threw the considerable weight of his treatise behind the search for a rehabilitation of utility,<sup>376</sup> by which in this context he must be understood to mean something like "welfare" in a more open-ended sense. He has accepted criticisms of the concept of utility that will not permit it to serve as the touchstone of equal sacrifice:

It remains to be seen whether a workable and reasonably meaningful measure of utility can be developed in time and whether thereby the subjective concept of ability to pay can be given an operational meaning. At this stage, we do not possess a universally accepted measure of utility by which to apply one or the other sacrifice formula.<sup>377</sup>

#### 4. *Stanley Surrey and Paul McDaniel*

The concept of a "tax expenditure" crucially requires a concomitant standard of what is essential to an ideal income tax. In his *Pathways to Tax Reform: The Concept of Tax Expenditures*, Stanley

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373. *Id.* at 108.

374. Lionel Robbins, *Interpersonal Comparisons of Utility: A Comment*, 48 Econ. J. 635 (1938). At almost the same time, Simons had expressed similar thoroughgoing doubts about the use of the concept of utility for the purpose of welfare analysis. Simons, *supra* n. 3, at 5, 13.

375. See generally Robbins, *supra* n. 374, at 636-40.

376. *Id.*

377. Musgrave, *Theory*, *supra* n. 2, at 109.

Surrey defended an approach to income tax reform that invokes the seemingly neutral goal of eliminating legislative deviations from such an ideal.<sup>378</sup> From the outset, Surrey's idea was that special tax preferences should be ruthlessly pruned from the tax law, not so much out of deference to a normative income tax structure as for the purpose of eliminating political favoritism to particular groups.<sup>379</sup> As has been suggested, this powerful conception—like other fundamental conceptions advanced during the decades after Simons's contribution—assumed the existence of a consensus in favor of income taxation of some sort and further assumed that the ideal form that an income tax should take was a matter of wide, if not complete, or universal agreement.<sup>380</sup>

Essentially, the tax expenditure concept, as applied to an income tax, regards such a tax as composed of two distinct elements. The first element contains the structural provisions necessary for implementation of a normal income tax. These structural provisions include the definition of net income; the specification of accounting periods; the determination of the entities subject to tax; and the specification of the rate schedule and exemptions levels. These provisions compose the revenue raising aspects of the tax. The second element consists of the special preferences found in every income tax system. These special preferences, often called tax incentives or tax subsidies, are departures from the normal tax structure.<sup>381</sup>

Interestingly, Surrey and Paul McDaniel, with whom Surrey pioneered the tax expenditure doctrine, had no time for precision in the definition of income.<sup>382</sup> When Richard Goode criticized the concept of

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378. Stanley S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* vii (Harvard U. Press 1973).

379. Stanley S. Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 Harv. L. Rev. 352, 361-63 (1970).

380. Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C. L. Rev. 225, 227-28 (1979); compare Stanley S. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 Ill. L. Rev. 779 (1941) (survey of assignment of income cases and others emphasizing that consensus exists as to the elements of a sound tax system and that Congress and the courts should implement this consensus in a common sense fashion).

381. Surrey & McDaniel, *supra* n. 380, at 227-28.

382. *Id.* at 236.

tax expenditures as resting on a "shaky conceptual foundation,"<sup>383</sup> Surrey and McDaniel responded that when Congress and the public do not perceive the exclusion or inclusion of an accounting item as a tax incentive, there is no "point" in pressing for an economically satisfying treatment of it.<sup>384</sup> In short, the tax expenditure doctrine was conceived, and probably widely understood, as a rough-and-ready guide to tax reform, essentially without underpinnings apart from that of political acceptance.

The reception of the tax expenditure doctrine has been accompanied by the widely shared assumption that Surrey and McDaniel accepted—in the interest of tax fairness—the goals of Simons and of the later advocates of comprehensive income taxation.<sup>385</sup> For example, Douglas Kahn, among other recent commentators on tax expenditures, argues that one reason for combating tax expenditures is to tax the possessors of equal amounts of economic power equally.<sup>386</sup> While Kahn does not expressly reintroduce ability to pay as the ultimate point of reference for such equilibration of tax burdens, it is difficult to understand his criticism of the tax expenditure concept in any other way. But that is also entirely natural. If comprehensive income taxation is a norm, its normative character may at least be expected to be consistent with other widely recognized goals of tax system design, if not to include them outright.<sup>387</sup> Thus, while sensitivity to tax expenditures may provide a neutral enough working posture for the policy maker who, like Surrey

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383. Goode, *supra* n. 3, at 27.

384. Surrey & McDaniel, *supra* n. 381, at 236 n. 26.

385. See Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 *Hastings L.J.* 343, 364-66 (1989) (disputing Surrey's, Andrews's, and Kelman's conclusions on the grounds that none relates the concept of income consistently with a broad concept of human welfare or considers alternative versions of the principle of fairness in distributional decision making).

386. Douglas A. Kahn, *The Two Faces of Tax Neutrality: Do They Interact or Are They Mutually Exclusive?*, 18 *N. Ky. L. Rev.* 1 (1990) (exaggerating the "evaluative" attributes of the Haig-Simons definition of income is to mistake the purpose of the definition); Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical View*, 54 *Tax Notes* 1661, 1662 (March 30, 1992) (stating that a less clear consensus concerning "normal" tax structure exists than Surrey and McDaniel hypothesized); Herman P. Ayayo, *Tax Expenditures: Useful Economic Concept or Budgetary Dinosaur?*, 93 *Tax Notes* 1152 (Nov. 26, 2001).

387. Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 *Harv. L. Rev.* 925, 980-85 (1967).

and McDaniel, worked close to the furnace of changing tax legislation, its contextualism becomes less satisfactory as one steps back from particular legislative struggles to consider the overall shape of the income tax. Much criticism of the tax expenditure doctrine amounts to just this.

For our purposes, however, it is important to emphasize the instability of tax expenditure analysis when it is projected onto the plane of generality in tax policy at which the ability to pay approach has reigned supreme. A “normal” tax structure, against which tax expenditures are to be judged, must simply be an “ideal” tax structure based on ability to pay or some other concept. By and large, even the sophisticated participant in tax expenditure debates has assumed ability to pay as a fundamental principle.

### 5. *Optimal Tax Theory*

Although it draws vigor from abstract successes in model building, the “theory of optimal taxation” once again applies to fundamental issues of tax policy—an unrepentant utility analysis that characterized the old welfare economics. The enterprise is largely an outgrowth of one particularly brilliant response to a general puzzle about the design of tax systems. In 1927, Alexandre Pigou of the Cambridge Economics Faculty set an undergraduate philosopher and mathematician, Frank Plumpton Ramsey, a puzzle concerning the correlation between minimum sacrifice and least aggregate sacrifice.<sup>388</sup> Ramsey’s solution had a great influence on Pigou’s later writing about equal sacrifice.<sup>389</sup>

Pigou’s own later writing on public finance depended heavily on the precedent Ramsey had established,<sup>390</sup> but several decades passed before James Mirrlees and Stephen Diamond constructed an optimal

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388. Agnar Sandmo, *Optimal Taxation: An Introduction to the Literature*, 6 J. Pub. Econ. 37, 38 (1976).

389. Pigou, *supra* n. 132, at 105-09.

390. Most of this work was closer to Ramsey’s in that it concentrated on optimal commodity taxation. Boiteux, *Sur La Gestion des Monopoles Publics Asteints a l’équilibre Budgetaire*, 24 *Econometrica* 22 (1956); Green, *The Social Optimum in the Presence of Monopoly and Taxation*, 29 *Rev. Econ. Stud.* 66 (1961). Other theoretical studies, however, also dealt with balancing losses due to efficiency against more equitable distribution of income, as does Mirrlees model. Ray C. Fair, *The Optimal Distribution of Income*, 85 *Q.J. Econ.* 551 (1971).

income tax model that now virtually defines the field.<sup>391</sup> The goal of their original model was to determine the optimal income tax rate structure for a society in which all income is derived from labor. The nature of the tax—a tax on income—is thus taken for granted; lump sum and commodity sales taxes alone are not considered as alternatives (in one extension of the model Mirrlees does consider combining commodity taxes with an income tax).<sup>392</sup>

Although the model relied on drastically simplifying assumptions, so that it cannot be thought, as some admirers have supposed, to “groun[d] . . . progressive taxation . . . in a theory of distributive justice,”<sup>393</sup> it quite successfully illustrated how social welfare and tax burdens might interact in ways unimagined by previous public finance experts, including those in the ability to pay tradition.<sup>394</sup>

The model posits an individual utility function that increases with the sum of consumption and leisure, and further assumes that consumption equals income (i.e., that all income is spent on consumption).<sup>395</sup> It also assumes that all individuals have identical utility schedules, and that the values of this utility schedule can unproblematically be stated in terms of the same units (they are in effect units of labor).<sup>396</sup> The curve of the utility function is assumed to be concave: Although utility increases with the sum of consumption and utility, it increases more slowly than that sum does. Ramsey’s proof had relied on similar assumptions in deriving the counter-intuitive conclusion that to optimize social welfare, viewed as a simple utilitarian sum of individual utilities, the highest rates of commodity tax should apply to necessities and the lowest to luxuries.<sup>397</sup> Plainly, the adequacy of these assumptions as premises for policy analysis cannot be lightly conceded.

Nevertheless, the prototypical optimal tax model did permit, in a novel and apparently illuminating manner, different assumptions about

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391. Sandmo, *supra* n. 388, at 39; Peter A. Diamond & James A. Mirrlees, *Optimal Taxation and Public Production I: Production Efficiency*, 61 Am. Econ. Rev. 8 (1971).

392. James A. Mirrlees, *Optimal Tax Theory: A Synthesis*, 6 J. Pub. Econ. 327, 336-37 (1976).

393. Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 Cal. L. Rev. 1905, 1966 (1987).

394. See Mirrlees, *supra* n. 392, at 329-36.

395. *Id.*

396. *Id.*

397. Utz, *supra* n. 100, at 232-34.



the choice of a social welfare function to be compared with respect to their tax policy implications. Classical utilitarians and proponents of ability to pay had assumed, for example, that social welfare is a simple sum of individual utilities. Current defenders of a utilitarianism in ethics commonly abandon simple summation for an approach that discounts differences among individuals by "weighting" the values of their utility functions differently before computing a resultant value. If individual utility functions were capable of taking on different values for different sums of leisure and consumption—which is not possible on the assumptions built into the model—weighting might be used to correct for distortions considered not in the interest of the individual, injurious to others, or otherwise morally or politically unacceptable. No such need arises here because individuals have identical utility functions. But they may choose to work different numbers of hours and hence have different levels of consumption. The weighted social welfare function examined under the model is, therefore, only of the sort that differentiates between amounts of consumption and leisure, giving less weight to greater total amounts and more weight to lower total amounts. (It should be noted that this is an odd thing to consider doing, because utility is presumably of value in itself; we are not discounting to reflect the declining value of greater amounts of utility, but more of this later.)

Mirrlees considered yet a third choice of social welfare function, one suggested by John Rawls's second principle of justice; that any reduction in the welfare of an individual member of society is justifiable only if it improves the welfare of the person whose welfare happens to rank last.<sup>398</sup> Although Rawls did not intend this "difference" principle to be translated into traditional utilitarian terms,<sup>399</sup> the only expression it can be given on this model is that of assuming that the social welfare function varies with the *product* of the utilities of individual members of society, and does so to improve the welfare of the person whose welfare is lowest.

The model yields a schedule of tax rates that maximize social welfare under these three social welfare principles. More precisely, given the amounts of pre-tax income of all the individuals who make up a society, the model permits us to calculate which tax will maximize social welfare, given that the tax will induce the individuals to change

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398. Rawls, *Theory*, *supra* n. 26, at 150-61.

399. *Id.* at 22-33, 167-75, 183-92.

their working hours by reducing the utility they derive from their labor. Thus, it highlights the peculiar type of distortion that income taxes cause in giving people a reason to substitute untaxed leisure for taxed consumption.

In fact, a model of human conduct based on the ascription of identical utility schedules to all the modeled individuals does not easily square with a long standing problem of the interpersonal comparison of utility functions. First, there is the often discussed problem of the comparability of different persons' utility schedules. In a landmark article, Lionel Robbins attacked the foundations of welfare economics, which at the time assumed such modeling, by pointing out that we have no interpersonal standard of comparison, no yardstick, against which to measure utilities on the basis of the information individuals are able to give us about their desires and preferences.<sup>400</sup> Despite the widespread acceptance of Robbins's argument, it is not clear that he correctly grasped (or that others correctly grasped his analysis of) the nature of the difficulty about getting from utility for different individual people to shared or interpersonal utility.<sup>401</sup> However that may be, comparing utility for people is not the only problem for welfare economics or for tax policy; at least five other difficulties, taken for granted by early utilitarians, have been noticed by more recent writers.<sup>402</sup> When these are taken into account, the utilitarian account of human welfare, even with the most sympathetic revisions and adjustments, simply is no longer an account of human welfare but is instead at best an arbitrary pronouncement on that topic.

Mirrlees, not surprisingly, fully comprehended the counterfactual nature of the assumptions necessary for optimal tax models.<sup>403</sup> Given that "[w]hat a person plans to do can be described as the totality of what he plans to do at particular times, and under particular circumstances," he notes that in order to assign numerical utilities to the individual's actions and experiences at particular times and under particular circumstances, "it is necessary that his preferences regarding

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400. Lionel Robbins, *Interpersonal Comparisons of Utility*, 48 Econ. J. 635, 637-40 (1938).

401. See Musgrave, *supra* n. 2, at 108-09; Sen, *Ethics*, *supra* n. 27, at 30 n.1.

402. See generally Utz, *supra* n. 100, at 45-52.

403. It is perhaps worth mentioning that Mirrlees' own caution concerning the utilitarian footings of optimal tax models is sometimes overlooked by those who rely on optimal tax theory's results. See Bankman & Griffith, *supra* n. 394, at 1958-59.

what he will be doing at one particular time in one particular set of circumstances be *independent* of [or according to some economists' usage, *separable from*] what he may be planning for all other times and circumstances."<sup>404</sup> Yet the separability assumption is boldly at variance with our knowledge of and assumptions about our nature as planning and self-reflective beings.<sup>405</sup> As Mirrlees puts it, "[e]verything that has to do with life as a connected whole—such as habit, memory, preparation for future action, anticipation, achievement and failure—seems to have been ignored" by modeling human rational decision making in this way.<sup>406</sup> He suggests that a more complex model in which we consider choice under uncertainty might avoid this defect.<sup>407</sup> The model would then portray the individual, not as having utilities for actions and experiences at each given time that are independent of the utilities of actions and experiences at other times.<sup>408</sup> Instead, it would be posited that the utility of any given event depends on antecedent or consequent circumstances that are known with certainty to occur, that have a known probability, or are simply known to be possible without known probability.<sup>409</sup> The mathematical complexity of such a model is daunting and indeed can be shown incapable of yielding optimal tax (or other public policy) outcomes unless drastic restrictions are imposed on the size of the population, the variety among their utility schedules, and the number of their options.<sup>410</sup> More importantly, choice under uncertainty is still not quite the counterpart of what we do when we plan *without* considering alternative future scenarios in detail, or even in general, or when we attach value to our own role, or other process features that lead to a given outcome.<sup>411</sup>

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404. J.A. Mirrlees, *The Economic Uses of Utilitarianism*, in *Utilitarianism and Beyond* 66 (Amartya Sen & Bernard Williams eds., Cambridge U. Press 1982) (emphasis added).

405. *Id.*

406. *Id.*

407. *Id.* at 67.

408. *Id.*

409. *Id.*

410. Mirrlees, *supra* n. 392, at 333; N.H. Stern, *On the Specification of Models of Optimum Income Taxation*, 6 J. Pub. Econ. 123, 123-25 (1976).

411. Others have commented on the significance for welfare analysis of the capacities of individuals, and the sources of their capacities, in evaluating welfare. Whether one has done something for oneself is obviously important in many instances in determining how the outcome of the action ranks. When something is done for or to

## 6. *Ability to Pay and the Argument for a Consumption Tax*

The resurgence of interest in consumption taxation owes a peculiar debt to the ability to pay tradition.<sup>412</sup> Despite the historical association of income taxation advocacy with the ability to pay approach, income tax partisans have since 1900 often attacked the welfare analysis of tax burdens that defined ability to pay for most of the previous century.<sup>413</sup> It is therefore ironic that consumption tax advocates have made ability to pay one of the two main supports of their case for consumption taxation. Taking up themes Kaldor had canvassed, William D. Andrews, in a landmark essay for the American tax audience, placed even greater emphasis on the Millian argument that a consumption tax is to be preferred on grounds of equity.<sup>414</sup> Other champions of consumption taxation sometimes slight these welfarist premises.<sup>415</sup> On the whole, however, the ability to pay approach may now be said to serve as a mainstay of consumption tax advocacy.<sup>416</sup>

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us, not only the resultant pleasure or pain but also the process that brought it about can influence its value for us. It is not unreasonable to think due process is better than no process, even if the result is the same. See Amartya Sen et al., *The Standard of Living* (Geoffrey Hawthorn ed., Cambridge U. Press 1985) (various approaches to the importance of the reason and manner of the individual's choices on the individual's well-being); Martha Nussbaum & Amartya Sen, *The Quality of Life* 77, 264 (Clarendon Press 1993).

412. A very distinguished band of tax theorists—Thomas Hobbes, John Stuart Mill, Alfred Marshall, Alexandre Pigou, Irving Fisher, Nicholas Kaldor, and the United States Treasury among other distinguished authorities—have advocated a general consumption tax as a replacement of the general income tax. Nicholas Kaldor's exquisite re-introduction of the consumption tax ideal, however, reframed the issues with respect to which the debate has since been concerned. Kaldor, *supra* n. 1, at 11.

413. *Id.*

414. Andrews, *supra* n. 35, at 1165-73.

415. David Bradford, for example, based an elaborate defense of consumption taxation on the comparison of an ideal income tax, along the lines made familiar by Simons and Surrey, with several alternative forms of consumption tax, corresponding to recent proposals of other consumption tax advocates. For Professor Bradford, administrative convenience and the reduction of economic distortions appear to top the list of reasons for favoring a consumption tax. Nevertheless, when he does come to discuss broad principles, he highlights the compatibility of consumption taxation with ability to pay principles, so that on balance a consumption tax appears, on his account, to beat income taxation at its own game. See Bradford, *supra* n. 3, at 312-16.

416. Of course, the arguments for consumption taxation are susceptible of analysis without significant reference to the ability to pay approach. See Barbara H. Fried, *Fairness and the Consumption Tax*, 44 Stanford L. Rev. 961 (1992); but see *id.* at 979,

Kaldor's re-working of the concept of ability to pay has received relatively little notice. As we have seen, he preferred consumption to income as a general tax base primarily because he believed in a reinterpretation of the long standing traditional view, traceable to John Stuart Mill, that taxation should be just in relation to the taxpayer's "means."<sup>417</sup> Both economic and political writers and the public at large, Kaldor conceded, had previously regarded "means" in the relevant sense as equivalent to "income."<sup>418</sup> He argued, however, that "income" missed the mark for this purpose, because it:

[C]arries a sense not just of "money", [sic] but of money in relation to certain objective needs, obligations, commitments—a sense which can best be described as taking into account, and making allowance for, variations between individuals in the opportunity, in terms of living standards, which any given amount of money commands.<sup>419</sup>

Kaldor asserted that the original reasons for preferring income to expenditure as a measure of the power to effect relevant outcomes in the taxpayer's life were: First, that during the time of proportional taxation, a tax on consumption rather than income would have been highly regressive; and second, that just taxation should rely on criteria that are as much as possible independent of the taxpayer's volition or disposition.<sup>420</sup> During the twentieth century, the first of these reasons had ceased to be important. Only the second remained plausible, but it could not withstand close scrutiny.<sup>421</sup>

There are patent differences in real spending power of a person who regularly receives sums of a certain amount and that of a person who receives the same amount once in a lifetime or at irregular intervals. The two, of course, face quite different spending alternatives. When we take into account other factors that may also affect the individual's reasoning concerning spending alternatives, the picture gets worse. The illiquidity of investments, peculiarities of personal taste, age and family status, and a host of other elements bear on the value of money as a means of commanding consumption

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997, 998, 998 n. 101, 1006, 1010.

417. Kaldor, *supra* n. 1, at 27.

418. *Id.*

419. *Id.* at 28.

420. *Id.* at 29-30.

421. *Id.* at 30.

alternatives.<sup>422</sup> Income falls short as a measure of ability to pay because it does not discriminate among these differences in the individual's perspectives.<sup>423</sup> Consumption stands out as a better candidate for an ability to pay tax base because, the individual who has the prerogative of making his or her own spending decisions may be trusted to do so in a manner that properly reflects ability to pay.

Accruals from the various sources cannot be reduced to a common unit of spending power on any objective criteria. But each individual performs this operation for himself when, in the light of all his present circumstances and future prospects, he decides on the scale of his personal living expenses. Thus, tax based on actual spending, rates each individual's spending capacity according to the yardstick that he applies to himself.<sup>424</sup>

Thus, Kaldor's case for consumption taxation essentially accepts the ability to pay approach and revises it. *Ex ante* reckoning of the individual's options or capacity to bear the tax is impossible because the value of money depends on so many aspects of the individual's circumstances, including previous endowment, investment commitments, and perhaps class or other considerations.<sup>425</sup> A better measure, Kaldor concludes, is actual expenditure, the *ex post* measure of ability, because it leaves the individual free to assess capacity.<sup>426</sup>

This view, though not emphatically taken up in the recent literature advocating consumption taxation, is reflected in the recent formulations of the argument that taxing income is unfair to investment in a way that consumption taxation is not.<sup>427</sup> The argument goes like this: Consider the effect of an income tax on an investment;<sup>428</sup> absent income or other taxes, an investment of 100 dollars at four percent compounded annually is worth 211 dollars after twenty years.<sup>429</sup> If the

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422. See Fisher, *supra* n. 320, at 101-18; Kaldor, *supra* n. 1, at 25-53.

423. *Id.*

424. *Id.* at 47.

425. Compare Bradford, *supra* n. 3, at 167-69.

426. Kaldor, *supra* n. 1, at 47.

427. Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax A Debate About Risk? Does it Matter?*, 47 Tax L. Rev. 377, 380-82 (1992)

428. Andrews, *supra* n. 35, at 1125, 1167-69 (resembling the example in text); see Irving Fisher & Herbert Fisher, *Constructive Income Taxation* 56-57 (Harper & Bros. Publishers 1942) (similar example).

429. Andrews, *supra* n. 35, at 1169.

dollar's value holds constant, the total yield is more than twice the invested principal. The total yield must be adjusted to take inflation or deflation into account, but that will not affect the argument. Interest rates, like the four percent assumed here, may be affected by inflation as well as by tax rates, or the absence of all tax, and this fact *may* affect the validity of the argument.

Now consider what happens to the investment if an income tax of thirty percent is imposed throughout the period: The 100 dollars that was to be invested is reduced to seventy dollars at the outset. Part of the annual yield at four percent, assuming that this was not affected by the general imposition of the tax, must also go to pay taxes. After twenty years, the investment turns out to be worth only 122 dollars, and the ratio of total yield to initial investment is accordingly just 1.22 to 1, again assuming no change in the dollar's value. Yet to consume something worth 122 dollars after twenty years, one would only have had to earn 173 dollars and 72 cents in that year, and not 211 dollars.

Suppose that in year one, when the 100 dollars was first invested, the investor had bought a consumer durable that would hold its value for nineteen years and be consumed only in the twentieth year, and suppose that this durable item appreciated at four percent compounded annually.<sup>430</sup> Suppose further that the appreciation of property is taxable only when realized. Then the purchase of the consumer durable allows the investor to enjoy consumption that would in year twenty be worth 2.21 times the purchase price in year one—the 2.21 to 1 ratio of yield to investment that prevailed in the no-tax world could still be achieved.

It is supposed to follow that an income tax not only discourages saving, but is also *unfair* to that category of activity.<sup>431</sup> Certainly, given the assumptions mentioned, you get less for your money if you save for future consumption than if you consume right away.<sup>432</sup> Does this indicate not only that saving is discouraged but treated unfairly? In the attempt to show that there is *no* unfairness, it has been argued that under an income tax, investors demand a higher pre-tax rate of return

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430. *Id.* at 1150, 1157 (describing a consumer durable is a purchase, such as a house or automobile, wherein consumption is determined more by current use value than by purchase price).

431. Alvin C. Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 Harv. L. Rev. 931, 941 (1975).

432. *Id.* at 941.

to make up for the tax on investment yields, so that something closer to the 2.21 to 1 ratio of the pre-tax example may be maintained.<sup>433</sup> It has also been maintained that deferred consumption should not be analogized to a consumer durable that bestows a delayed benefit without subjecting its owner to renewed taxation; and conversely, that it is not appropriate to discount the value of future consumption for comparison with present values.<sup>434</sup> Further, the fairness of taxing saving plus consumption has been defended on the grounds that the benefit of possessing wealth would be preferentially treated if consumption alone were taxed.<sup>435</sup>

What is interesting about these arguments is their common assumption that prices reflect the welfare of the individuals who pay them. This is, in a sense, everyday microeconomics. That, however, is little comfort in the context of an argument intended to shed light on the fundamental fairness of taxes. The objection based on the supposed compensatory effect of interest rates under an income tax regime works only if it is taken to imply that interest rates generally, or almost always, counteract the effect of an income tax on deferred consumption, and there is no general reason to think this is the case. If interest rates only sometimes undo the effect of taxes on deferred consumption, or do so only in part, it would follow that an income tax does not necessarily disturb the pre-tax difference between immediate and postponed consumption in present value terms. What is not clear is why the time value of money, and ultimately the pricing of consumption at different times, is relevant.

The contention that under an income tax we cannot preserve our consumption opportunities by deferring them takes on several forms. In one version the issue is whether interest is the standard psychological "price" to be paid to a person who agrees to put off his or her consumption in order to save.<sup>436</sup> If interest is instead a function of other forces within the economy, such as the demand for capital, then "the interest rate will be positive even if no significant

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433. *Id.* at 937-38.

434. Mark Kelman, *Time Preference and Tax Equity*, 35 *Stan. L. Rev.* 649, 655-57 (1983); *see generally* Bankman & Griffith, *supra* n. 427.

435. Kaldor, *supra* n. 1, at 8; Nicholas Kaldor, *Comments on William D. Andrews, A Supplemental Personal Expenditure Tax*, in *What Should be Taxed: Income or Expenditure?* 151 (Joseph Pechman ed., Brookings Instn. 1980).

436. Kelman, *supra* n. 434, at 658.



psychological time preference exists.”<sup>437</sup> The trouble with this argument is that it confuses descriptive and normative issues. It may well be that interest rates are in fact set by market forces other than lender’s time preferences. It does not follow that lenders should not receive compensation if they agree to resist a bias in favor of current consumption.

In another version, the argument simply asserts that the satisfaction given by a particular type of consumption, say, eating a good meal, does not (or should not) depend on timing. The enjoyment of a good meal today is equal to the enjoyment of the same meal tomorrow, and no allowance need or should be made, in comparing these enjoyments, for how soon or late they occur. Hence, the argument goes, it is nonsense to expect *a priori* that I must be offered something to compensate me for postponing eating a good meal—more than the assurance that I can indeed enjoy it tomorrow—something more, in other words, than the maintenance of the economic power to command the meal tomorrow.

There can obviously be two views of the merits of this claim. The law has traditionally ignored the time value of consumption deferred in calculating tort damages,<sup>438</sup> and there is no doubt something to be said for the traditional approach. On the other hand, commentators regularly deride the traditional approach,<sup>439</sup> with little more than a nod towards the widespread view that all value is time-sensitive: A dollar taken away today and returned tomorrow without interest, is a diminished asset, even if there has been no inflation.

Does it matter what people actually feel or think about the postponement of consumption? Some discussions of the matter are framed as if this is the only real issue.<sup>440</sup> Thus, for example, it is

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437. *Id.* at 672.

438. See *Beaulieu v. Elliott*, 434 P.2d 665 (1967).

439. See e.g. Frank Falero, *Wage Loss in Wrongful Death—A Historical Analysis*, 1996 J. Leg. Econ. 53; Rolando F. Pelaez, *Calculating Awards for Lost Earnings: An Empirical Assessment of Beaulieu*, 1995 J. Leg. Econ. 49.

440. Andrews, *supra* n. 35, at 1188 n.119. This is not clearly true of Professor Andrews’s formulation of the argument, although he does speak in terms of the satisfaction afforded the consumer under no-tax and income tax regimes. *Id.* He also appears to equate a downward effect on the consumer’s satisfaction level with the “burden” of the tax. *Id.* at 1168-69. Elsewhere, Professor Andrews more forthrightly speaks in welfarist or utilitarian terms concerning the problem of a just allocation of tax burdens. William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 Harv. L. Rev. 309, 325-37 (1972). In all fairness, it should be noted that Professor Andrews

argued that rational people value deferred consumption less than immediate consumption of the same kind and intensity, because deferral makes the outcome less certain, and so forth.<sup>441</sup> These observations, if true, are relevant only if the welfare of the individual taxpayer and the influence of the timing of consumption on it have a direct bearing on tax fairness.<sup>442</sup> More particularly, they only matter if the subjectively felt gratification one derives from consumption is always an unqualified addition to one's well being, and *that* is crucial in determining tax equity.<sup>443</sup> On a moment's reflection, the first of the two premises seems absurd. Instant gratification of some, even most, varieties has at best a weak correlation with how well off one is, even from a subjective perspective. What must lie behind references to people's actual preferences for current or delayed consumption is either a mistaken assumption that such preferences directly determine the individual's welfare or a more complicated assumption about what does determine the individual's welfare.

These implications of the equity argument for consumption taxation are of interest because they show the argument to be directly in line with the ability to pay approach. It is from ability to pay (and notably not from, e.g., the Schanz-Haig-Simons rationale for comprehensive income taxation) that subjective variations in the individual taxpayer's welfare draw their potency for tax policy analysis.<sup>444</sup> Nineteenth-century income tax advocacy obviously plays directly into the hands of the consumption tax theorist in this regard.<sup>445</sup>

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takes the terms of the discussion from Richard A. Musgrave, who assumes a traditional utilitarian version of the ability to pay approach. See Andrews, *supra* n. 35, at 1167 n. 119, 1168 n. 122 (citing Musgrave, *supra* n. 2, at 160-71). Others interpret his argument as assuming the utilitarian interpretation of ability to pay. See e.g. Bankman & Griffith, *supra* n. 427, at 380 (referring to the consumption-tax equity issue as one of "welfare loss"); Joseph Isenbergh, *The End of Income Taxation*, 45 Tax L. Rev. 283, 291 (1990) (characterizing the "second tax" on saving as a burden on satisfaction deferred); Halperin, *supra* n. 21, at 11; Mark Kelman, *supra* n. 434, at 656-57 (characterizing the explanations of interest assumed by both Professors Andrews and Warren as "psychological"); Warren, *supra* n. 432, at 935 (arguing that the two taxpayers in Professor Andrews's example are not similarly situated, presumably because *ex hypothesi* their subjective choices concerning investment and consumption differ).

441. See generally Kelman, *supra* n. 434, at 656, 659-60.

442. Utz, *supra* n. 100, at 50.

443. *Id.*

444. *Id.* at 98.

445. Fried, *supra* n. 416, at 970 n. 26, 971 n. 28.

That is not surprising, given John Stuart Mill's role in formulating the ability to pay approach. He was after all a consumption tax advocate himself, though willing to countenance income taxation as an administrative compromise.<sup>446</sup>

In brief, the ability to pay approach haunts the debate over the merits of income and consumption taxation. Not all arguments for either tax base depend significantly on the ability to pay approach, but key arguments for consumption taxation, both in Kaldor's and in Andrews's basic works on the subject, revive the utilitarian analysis of tax fairness in order to ground a least-of-evils argument for a consumption tax in comparison with an income tax.<sup>447</sup> Anyone aware of the weaknesses of the utilitarian ability to pay approach must find this line of argument irrelevant.

### III. A CONTEMPORARY PERSPECTIVE

#### A. *THE STATE OF THE ABILITY TO PAY APPROACH*

Our survey of the ability to pay approach over the last two centuries shows, among other things, that many people, at least for some purposes, accept one or more of the following propositions: That the fairness of tax burdens is independent of whatever governmental benefits taxpayers (and others) receive; that the fairness of tax burdens depends entirely on the reduction or increase of taxpayers' welfare that is directly caused by the imposition of the tax in question;<sup>448</sup> and that the fairness or unfairness of a tax depends ultimately on how the tax affects people's welfare.<sup>449</sup> Our survey has also traced the evolution of a sophisticated, but ultimately unworkable, interpretation of ability to pay in terms of utility schedules,<sup>450</sup> which promised to provide a neutral analytical tool for assessing whether a tax measure is in accordance with ability to pay.<sup>451</sup> Sadly, the criticisms of the welfarist interpretation of ability to pay have gone unanswered.<sup>452</sup>

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446. See *supra* nn. 141-43 and accompanying text.

447. See *supra* nn. 347-48, 441 and accompanying text.

448. Utz, *supra* n. 100, at 50.

449. *Id.*

450. *Id.* at 49.

451. *Id.* at 49-54.

452. See Musgrave, *Theory*, *supra* n. 2, at 108; Simons, *supra* n. 3, 11-12; Utz, *supra* n. 100, at 59.

The virtue of the ability to pay approach, therefore, cannot be said to lie in its neutrality as an analytical tool for dissecting rival tax regimes. In order to provide a neutral analytical stance, something like the welfarist interpretation of ability to pay would be needed. Welfarism can, at best, provide a means of modeling ability to pay for the limited purpose of establishing negative propositions, like Mirrlees' theorem that a steeply progressive income tax would not be optimal apart from accumulated wealth.<sup>453</sup> There is so far no alternative to utility, although some theorists have proposed that there should be.<sup>454</sup>

It remains to be considered whether ability to pay can be made sufficiently definite apart from the welfarist interpretation that has foundered to be of any use in thinking about issues of tax fairness. One way to approach this question is to ask what ability to pay, broadly conceived, can tell us about any of several conceptual puzzles raised by income or consumption taxation.

### 1. *Outlays for Health*

Consider, for example, what fairness, conceived in terms of the allocation of burdens according to ability to pay, implies concerning the taxation of taxpayer's health care expenditures. In order to apply the ability to pay approach, minus its utilitarian interpretation, to health care expenditures, we must decide how illness, disability, and health problems generally affect a taxpayer's capacity to bear tax burdens. If having the economic means to pay to restore one's health is evidence of taxable capacity, health outlays should not be excluded from an income or consumption tax base. Reasonable minds have differed notoriously on this point. Professor Andrews has argued that health care expenditures should be excluded for income tax purposes to the extent that they merely pay to restore the taxpayer to the starting position from which healthy taxpayers proceed.<sup>455</sup> Others have disagreed.<sup>456</sup> The difference of opinion, however, is not about whether the effect of health care expenditures on a taxpayer's ability to bear a tax burden is relevant, but about what that effect is.<sup>457</sup> To this extent, agreement that we should adopt an ability to pay approach is merely

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453. See *supra* n. 393 and accompanying text.

454. See Sen, *Ethics*, *supra* n. 27, at 29-57.

455. See Andrews, *supra* n. 35, at 334.

456. Warren, *supra* n. 268.

457. *Id.* at 1092-93.

agreement that tax fairness requires a fair distribution of tax burdens. Without some more operational definition of tax burdens—such as the now-abandoned utilitarian analysis—we can advance no farther.

Perhaps this is already quite a lot, however, especially in view of the fact that we consider good health a *minimum* ingredient in a person's welfare, without which other ingredients are pro tanto worth nothing or are worth a good deal less. Good health thus appears to be an element in the scale of tax burdens that does not pose peculiar problems about subjective preference. If that is the case, we may regard health as a part of a person's welfare that does not raise the usual problems of comparing different people's welfare, a sort of "primary good" in Rawls's sense, with respect to which principles of fairness can be discussed without the risk of undervaluing or overvaluing any individual's actual preferences.<sup>458</sup> The significance for this discussion of such a point of reference is not that it permits a Rawlsian, as opposed to a utilitarian, approach to tax fairness to be established, but that only that it shows our sense of tax burdens to have some objective purchase, regardless of individual preferences.

## 2. *Zarin* and "Psychic Income"

The puzzle concerning "psychic income" presented in *Zarin v. Commissioner*<sup>459</sup> offers another opportunity for testing a nonutilitarian understanding of the ability to pay approach. The taxpayer was a compulsive gambler whose gambling debts a casino forgave.<sup>460</sup> Since the debts were real obligations, the gambler was arguably enriched by their cancellation, on a theory made familiar by *United States v. Kirby Lumber Co.*<sup>461</sup> and section 108 of the Internal Revenue Code.<sup>462</sup> The Tax Court divided over the question whether in this instance forgiveness of indebtedness conferred a taxable benefit, and the court of appeals sidestepped deciding precisely that issue by resting its decision instead on the contested liability doctrine.<sup>463</sup>

*Zarin* poses a puzzle about consumption and the fairness of tax burdens: Why should the amount of a person's consumption be taken

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458. Rawls, *Theory*, *supra* n. 26, at 90-95.

459. 92 T.C. 1084, 1098 (1989), *rev'd*, 916 F.2d 110 (3d Cir. 1990).

460. *Id.* at 1085-86.

461. 284 U.S. 1, 3 (1931).

462. 26 U.S.C.A. § 108 (e)(5) (West 2002).

463. *Zarin*, 916 F.2d at 115.

into account in determining what tax he or she can fairly be required to pay?<sup>464</sup> Perhaps because we are already so steeped in the ability to pay tradition, this question readily suggests a solution. The ability to pay approach teaches that fair taxation depends exclusively on the taxpayer's ability to bear the burden of the tax; ability to pay is simply the reverse image of one's vulnerability to the economic sacrifice in question.<sup>465</sup> If one taxpayer suffers less from a given dollar increment of taxation than another, the former has the greater ability to pay, and his or her tax burden should be greater because he or she would be subjected to a smaller sacrifice if the same dollar increment of taxation were exacted from both. It seems to follow that consumption is relevant because the extent of a person's consumption is evidence of how comfortably or painfully he or she can pay various levels of tax. If one person *consumes* more than another, he or she *could* have paid a greater tax without as great a loss.

Thus far, the ability to pay approach only gives a general reason for thinking a person's level of consumption relevant to that person's fair tax burden.<sup>466</sup> The core of the explanation, however, is that consumption is evidence of his or her comfort or pain in making a payment of a certain size.<sup>467</sup> But how freely one gives up a given increment of wealth to pay for a given episode of consumption has a bearing on the interpretation of that evidence. Perhaps it should be said to have a bearing on whether the episode is indeed one of consumption at all. When we speak of consumption in this connection, we seem to assume that different acts or instances of consumption can easily be compared against some standard of measurement.

On the interpretation of ability to pay that equates a person's well being with the utility of his or her economic resources, it is possible to compare the ability to pay of different individuals only if we know the

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464. Daniel Shaviro, *The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption*, 45 Tax L. Rev. 215, 223 (1990) (stating, "as an element of income, consumption is relatively nonobvious").

465. By definition, an individual's ability to pay is greater, the less vulnerable he or she is to a given level of taxation, where the level is specified in some medium of exchange. See Pigou, *supra* n. 131, at 58 (noting "it is impossible in practice to take account of variations between people's capacities for enjoyment"); Simons, *supra* n. 3, at 11-12 (characterizing the individual's differences in sensitivity to changes in money income as differences in their "efficiencies as pleasure machines").

466. See *supra* nn. 465-66 and accompanying text.

467. Shaviro, *supra* n. 464, at 223.

relevant portions of the utility schedules of money for each. When theorists of the past assumed that all individuals had identical utility schedules for money, it became trivial to argue that a person who had more money than another could afford to pay more, in the sense that he or she would sacrifice less. We have seen that serious ability to pay theorists soon abandoned this easy assumption of identical utility schedules. It is an untestable assumption that in any case seems to contradict our beliefs about how individuals' preferences vary.

Without this assumption, our question about consumption can nevertheless, also be understood as a question to which ability to pay is relevant. For that relevance to be obvious, however, it is necessary to decide whether subjective or "psychic" consequences of a person's outward situation translate into cognizable tax burden. Some adherents of the ability to pay approach have essentially answered this question in the negative, arguing that it is inconvenient to take into account differences in individuals' preferences, and consequent differences in subjective enjoyment of income.<sup>468</sup> Some critics of ability to pay have cited the counter-intuitive consequences of taking subjective preferences into account as a sufficient reason to reject income as a tax base.<sup>469</sup> Is there anything to be said for the contrary view?

Certainly, no one will seriously argue that tax fairness, in general, requires us to take into account the idiosyncratic enjoyment an individual derives from receiving an item of value or an increment of money. Kleinwächter's headquarters officer despises the opera but gets massive doses of it on the job.<sup>470</sup> This in-kind "benefit," though of no value to the officer, may be intended as compensation, and may be understood by others as such.<sup>471</sup> It would invite lies were the tax system to make the officer's introspection the ultimate test of taxability, and other taxpayers would perhaps be demoralized by the exclusion of such a benefit, even if we had good evidence of the officer's true feelings.<sup>472</sup> Unless the employment context provides a reason to exclude the fringe benefit, the operatic windfall should be

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468. Simons, *supra* n. 3, at 12. Simons accuses Pigou of doing this, and he could have extended the accusation to Edgeworth, Sidgwick, and others, at least in some of their statements on the matter.

469. See e.g. Kleinwächter, *supra* n. 280, 1-20.

470. Simons, *supra* n. 3, at 53.

471. *Id.*

472. *Id.*

reckoned part of the officer's income for income tax purposes.<sup>473</sup> That was the point of Kleinwächter's example.

Similar considerations apparently persuade most people that charitable contributions should not be regarded as conferring a benefit on the donor, despite the overwhelming likelihood that most donors find it rewarding to give. Likely, it would demoralize not only donors but also their admirers, were we to treat the laudable motivation of the former as a form of taxable self-indulgence; and the measurement of the value of the self-indulgence would require introspection or a draconian presumption (e.g., the value of the consumption equals the market value of the donation).

To deal with these problems we might attempt to modify the ability to pay approach as follows: We might posit that although individual preference or satisfaction may vary, any taxpayer's ability to pay should be regarded as increasing to the same extent with respect to an accession of some market value—except for special circumstances that: (1) prevent the particular taxpayer's subjective sense of ability to pay from increasing by reason of this accession; (2) can be determined in an administratively convenient manner; and (3) would be regarded by other taxpayers as justifying different treatment. Applying this principle to the *Zarin* facts,<sup>474</sup> we might conclude that the first two conditions are met, but that the third condition is not; this would be so if we concluded that, if taxed, the compulsive gambler would suffer more than others who are forgiven the same amount, because he was not really better off by that sum. This is administratively easy to determine, but other taxpayers would not regard the special circumstances—the gambler's compulsion—as excusing special treatment. Or if we concluded that gambling should be regarded as, at least sometimes, an ailment for which the gambler is not to blame, we might conclude that all three conditions are met.<sup>475</sup>

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473. *Id.*

474. Shaviro, *supra* n. 464, at 215-17.

475. Another path to a similar result would distinguish the consumption in which each gambler engages by reference to the extent of the particular gambler's ability to gauge cost of the gambling experience in advance. Shaviro, *supra* n. 464, at 230-33. Rather than distinguish only the compulsive gambler for special treatment, this approach would allow us to differentiate the value of the consumption of a range of gambler-types, from mild recreational gamblers through heavier recreational gamblers up to the unfortunate compulsive gambler, while distinguishing the professional gambler who engages in the activity not for consumption but for profit. *Id.*



What good is it, though, for the ability to pay approach to be repaired in this way? What is distinctive about this approach is that it offers to generalize our intuitive or common sense view that tax burdens should be distributed fairly. If that fundamental thought seems too obvious to be considered instructive, it is because the very idea of tax fairness immediately connotes fair tax *burdens*.<sup>476</sup> If there is no more to the ability to pay approach than a concern for how tax burdens are distributed, with no special guidance for determining how they should be distributed, we might as well speak of the fairness of tax burdens directly and acknowledge that we are in need of a theory of tax justice that tells us more than that we should be concerned with them.

This experimental approach to the *Zarin* problem can be repeated in connection with other conundrums about putatively taxable items, such as expenses for the taxpayer's health or education, interest paid to borrow for consumption, and so forth. In each instance, if we are not allowed to rely on the utilitarian interpretation of equal sacrifice, the question whether some receipt or reduction of wealth should be regarded as affecting a taxpayer's capacity to bear a given tax burden simply turns into another question about the relevance of the taxpayer's special circumstances to perceptions of fairness, and about the administrative convenience of making special allowances if those circumstances are deemed relevant.

### 3. *Expenses for Education*

Education presents a slightly different puzzle for the nonutilitarian ability to pay approach. No one will disagree that education enhances the individual's earning capacity in many, perhaps most cases. Nor will anyone disagree that education can be pursued for pleasure alone or at least without the remotest productive purpose or likelihood. In addition, it is evident that some enjoy getting an education more than others, and no doubt, some enjoy the fruits of education more or less than others. Given these variations in the effect on different individuals of the same educational goods, the ability to pay approach should favor some differentiation in tax treatment. Administrative convenience looms large in this connection for several

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476. See Musgrave, *Theory*, *supra* n. 2, at 62-63. As we have seen, the distinctive content of the ability to pay approach may not be that it calls attention to the importance of tax burdens in determining tax fairness, but that it implicitly denies the relevance of the benefits taxpayers derive from governmental expenditures. *Id.* at 63.

oft-recited reasons: The uncertainty of the individual's expectations on obtaining an education, the broad range of choices individuals may entertain in deciding how to exploit an education, and the interaction between an individual's other endowments and advantages and the opportunities education provides.<sup>477</sup> Since these factors multiply the ways in which individuals may be able to foresee and control the consumption component of education, tax administration has a proportionately greater difficulty in measuring the subjective values of ostensibly similar educational experiences,<sup>478</sup> and hence in determining how the corresponding educational expenses should be thought to affect the student's (or the student's family's) ability to pay.<sup>479</sup> For a different reason, then, the ability to pay approach does little to sort out the proper tax treatment of education expenses.

#### 4. *Interest Paid to Finance Consumption*

One of the more intriguing recent topics of analysis to which ability to pay notions have been applied is the deductibility of interest paid on borrowing for consumption. Not only theorists, but also practical politicians, have rather explicitly differed over the theory of the interest deduction.<sup>480</sup> In one prominent view, interest incurred to finance consumption should not be deductible because it is part of the cost of consumption, a key component of the income tax base, and a prime indicium of ability to pay.<sup>481</sup> On another view of the matter, two episodes of consumption occurring at different times, each of the same value from the perspective of the moment, must be regarded as equally valuable absolutely.<sup>482</sup> Although a person may prefer to consume now rather than later and may have to pay for the privilege, the value of the consumption to that person cannot depend on timing. If this is so, then interest incurred to finance early consumption should be deductible, because it does not represent an increment of welfare or ability to pay.<sup>483</sup>

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477. Utz, *supra* n. 100, at 94.

478. *Id.* at 94-95.

479. *Id.*

480. See generally Kelman, *supra* n. 434, 35 Stan. L. Rev. 649, 658-59.

481. *Id.*

482. *Id.* at 658.

483. *Id.* at 655-57.

Opponents of interest deductibility often point to the consumer's evident benefit from earlier—as opposed to later—enjoyment.<sup>484</sup> The argument is that immediate gratification has a value in itself, and that this is evident from the eagerness with which the early consumer seizes, and pays for seizing, the opportunity of earlier consumption.<sup>485</sup> The premises of the argument, however, beg the question whether subjective preferences are relevant at all to tax fairness. The utilitarian interpretation of ability to pay affirmed that subjective preferences were of vital significance in this connection, because ability to pay was conceived of as a function of welfare, which was in turn understood simply as a matter of individual preference satisfaction.<sup>486</sup> Moreover, the premise that immediate gratification has a value in itself also implies that the saver who postpones consumption foregoes that valuable something and gains nothing of comparable value by saving to consume later.<sup>487</sup> Again, it is sometimes suggested that the interest that borrowers pay to lenders corresponds precisely to the value to the lender of surrendering his or her opportunity for current consumption.<sup>488</sup> Unfortunately, no proponent of consumption taxation has spelled out what that more complicated assumption would be.

Could a non-utilitarian view of ability to pay help in sorting out the merits of consumption interest deductibility? If consumption belongs to the tax base because it is evidence of ability to pay (it betokens greater invulnerability to sacrifice at the hands of the tax collector), consumption plus interest incurred solely for consumption is arguably evidence of even greater ability to pay. On the other hand, if one borrows to consume in one accounting period and repays the loan in another accounting period, the latter period is impoverished without offsetting benefit. Hence, unless the gratification of earlier consumption is greater than that of later consumption, *and* the difference in gratification signifies a difference in one's susceptibility to tax burdens, the payment of interest is beside the point. In brief, it would appear that ability to pay, broadly conceived, merely reminds us that we are ultimately concerned with how tax burdens are distributed, but does not assist us in measuring those burdens.

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484. *Id.*

485. *Id.*

486. Hausman & McPherson, *supra* n. 48, at 72-74.

487. Kelman, *supra* n. 434, at 660.

488. *See supra* nn. 437-44 and accompanying text.

B. *IS ABILITY TO PAY EVEN OF LIMITED USE?*

The vague advice that we should consider how burdens are borne by different taxpayers not only does not take us far in responding to puzzles about the taxation of particular items, but it may also divert our attention from affirmatively important features of the environment in which we must assess the fairness of tax measures. Ability to pay, despite appearances, may not be comprehensive enough even as a broad guide in discussions of tax fairness.

The respects in which traditionally conceived utility functions miss the point, or may miss the point, provide a focus for extensive contemporary debate among economists, political theorists and philosophers.<sup>489</sup> Although the mainstream of writing by tax economists and tax lawyers has yet to take that debate into account, the outline of a different approach and style is already discernible.

One ingredient in the alternative assessment of human welfare is the recognition that economic behavior, which can be and usually is viewed as a concatenation of discrete decisions, provides a weak reflection, or no reflection at all, of what matters most to people's lives from a less piecemeal perspective. "Quality of life" has come to connote background rather than foreground aspects of how we live, and usually such shared aspects as the general social climate or environmental health or sheer variety of experiences available.<sup>490</sup> The quality of an individual's life, however, is easily capable of triumphing over the limitations of the society in which he or she lives, just as a life can easily go wrong or sour despite the most favorable circumstances. Our understanding of human welfare, to say the least, cannot leave out these obvious facts. The principal flaw of traditional utilitarian analysis, and even of more modern welfare analysis based on the assumption of homogeneous, continuous, separable utility functions, is that they cannot accommodate the larger perspective that matters most.

Thus, for example, it is argued that welfare economics has traditionally short-changed, and should take account of, the basic measure of individual welfare provided by comparing the situation of the individual with an acceptable standard of living that happens to be

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489. See *supra* nn. 337-412 and accompanying text.

490. Tibor Scitovsky, *The Joyless Economy: The Psychology of Human Satisfaction* 140-45 (rev. ed., Oxford U. Press 1992).

shared by that individual with others in the same society.<sup>491</sup> This is advisedly a measure of welfare that varies from society to society.<sup>492</sup> But to look for such a measure amounts to more than simply admitting the effects of sympathy and envy (charitable impulse or keeping up with the Joneses) on how well off people feel themselves to be. (Introducing sympathy and envy effects on welfare is already difficult enough, from a computational point of view, for mathematical welfare economics: interdependent utility functions, as they are called, greatly complicate and may defeat the definition of aggregate welfare functions.) What else is included in the relevant measure of deviation from an acceptable standard of living? An acceptable standard of living necessarily must make some ordinary human life plans possible: Feeding and clothing oneself, living in security from physical violence, raising a family, and so forth.

So far, tax experts have not rushed to adopt standard-of-living welfare notions. It is easy to imagine the difficulties facing any empirical investigation of welfare in this untraditional and less myopic sense. One must have much more information about people than tax returns typically provide. On the other hand, the elusiveness of information does not make it irrelevant. Much of the information old-fashioned welfare analysis assumes to be available, in principle is practically beyond our reach. One need consider only the most heavily investigated of factors, such as cross elasticities of labor and leisure.<sup>493</sup>

The criterion of ability to pay occupies a central place in income tax policy. If, at the theoretical level, this is primarily a matter of lip service and muddled tradition, the popular reception of the income tax still stands or falls with the belief that apportioning taxes to income can in principle achieve a fair burdening of differently situated taxpayers, a belief that can only be rationalized by some sort of appeal to ability to pay. Our survey of the history and of recent theoretical development of ability to pay offers no hope of intellectual reform from within mainstream welfare economics and tax policy. Tax theorists, therefore, must look elsewhere for constructive interpretation of this fundamental notion.

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491. Amartya Sen et al., *The Standard of Living* (ed. Geoffrey Hawthorn, Cambridge U. Press 1987).

492. *Id.* at 34.

493. Mirrlees, *supra* n. 404, at 64.

## IV. CONCLUSION

One may describe what is burdensome about individual tax burdens in a variety of ways: "Ability to pay" vividly suggests, though without any precision whatsoever, the core concern that tax liabilities should be adjusted to the circumstances of the individual taxpayer. An important, but now derelict, interpretation of that phrase would take us further. It would assure us that there is an objective substrate to which questions of tax fairness can ultimately be referred. Some otherwise sophisticated tax policy analyses take this proposition for granted and pursue its implications in quite detailed ways.

The upshot of this survey is that every serious examination of the objective substrate interpretation of ability to pay has rejected that interpretation of the doctrine,<sup>494</sup> and that without this interpretation the ability to pay approach is only a mild bromide. Yet the tradition that stresses ability to pay has proven to be a sort of quicksand for its critics. Henry Simons's rejection of ability to pay, for example, has been routinely ignored and his advocacy of a definition of income in terms of economic power has been read as a mere re-formulation of the views he opposed.

More importantly, the debate concerning the merits of the consumption and income tax bases rests largely on the assumption that utility schedules are the bedrock of tax fairness, so that the allocation of tax burdens according to income or according to consumption alone may be straightforwardly compared, by reference, to the effects of such burdens on the taxpayer's welfare measured in terms of utility. Some such comparisons might well be made on the basis of assumed utility schedules and reasonable modeling of a diversity of taxpayer welfare profiles. Even this, however, is open to dispute on the grounds Sen, Scitovsky, and others have urged for rejecting the utility-based analysis of welfare. The customary approach, however, is to assume, even more egregiously, identical or highly similar money-utility schedules and to ignore all evidence that this is misleading, including the entire marginalist revolution in micro-economics.

In sum, the ability to pay tradition lives on as a piece of traditional disinformation, a license not to confront foundational issues, and distraction from the genuine difficulty of analyzing our shared assumptions about tax fairness.

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494. See *supra* nn. 342-448 and accompanying text.