SYMPOSIUM: CLASS IN AMERICA

PAYROLL TAXES, MYTHOLOGY, AND FAIRNESS

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As the 2012 fiscal cliff approached, Congress and President Obama bickered over the top marginal income tax rate that would apply to a tiny sliver of the population, while allowing payroll taxes to quietly rise for all working Americans. Though most Americans pay more payroll tax than income tax, academic and public debates rarely mention it. The combined effect of the payroll tax and the income tax produce dramatically heavier tax liabilities on labor compared to capital, producing substantial horizontal and vertical inequity in the tax system.

This article argues that a fair tax system demands just overall burdens, and that the current combination of income taxes and payroll taxes imposes too heavy a relative burden on wage earners. It scrutinizes the payroll tax to debunk myths that artificially link payroll taxes to retirement security, and argues that these myths have lulled workers into accepting substantial and regressive tax burdens. Freed from the analytical limitations of an insurance label and a private-savings paradigm, policymakers can be better guided by fundamental principles of fairness. By refuting justifications for taxing capital income more lightly than labor income, and offering fairness arguments for taxing work less than investment, the article makes a case for equalizing the tax burdens on labor and capital income. Social Security's outlays constitute one-fifth of total federal spending, and this article maintains that it should be financed by a fair tax.

I. INTRODUCTION

People who work bear a disproportionate share of the federal tax burden, while those lucky enough to live off their investments contribute a much smaller share to the federal treasury. Mitt Romney's assurance that he paid at least 14% of his income in taxes,[1] and Warren Buffett's assertion that his secretary paid a higher average rate of tax than he did,[2] taught many Americans that the super-rich can pay very low rates of tax. Romney and Buffett are primarily taxed under the federal income tax, which has preferential rates for people who earn their money from investments. Most Americans are not so lucky because they are primarily taxed under the payroll tax.[3] The payroll tax does not apply to investment income, only to wage earnings,

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[1] Annie Lowrey, *Romney's Taxes Compared With Everyone Else's*, N.Y. Times THE CAUCUS BLOG (Sept. 21, 2012, 4:17 PM), http://thecaucus.blogs.nytimes.com/2012/09/21/romneys-taxes-compared-with-everyone-elses, *archived at* http://perma.cc/0LLBVjTxviN.

[2] Seniboye Tienabeso, *Warren Buffett and His Secretary Talk Taxes*, ABC NEWS (Jan. 25, 2012 5:14 PM), http://abcnews.go.com/blogs/business/2012/01/warren-buffett-and-his-secretary-talk-taxes/, *archived at* http://perma.cc/0pV85XJdsPp.

[3] Historical Payroll Tax vs. Income Tax, TAX POL'Y CTR., http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=230, *archived at* http://perma.cc/0JGHbo1Ln5U.

and it has no preferential rates or loopholes.[4] It is a flat tax imposed on every dollar of wages that most individuals earn.[5] A single, childless worker earning $20,000 will pay $1,530 in payroll tax in 2013, and his employer will pay the same on his behalf. Although Romney made 47% of Americans famous for paying no federal income tax, a worker in the 47% nonetheless pays a substantial share of earnings in federal tax.[6] Of the 53% who do pay income taxes, wage earners are taxed twice on their earnings, under both the payroll and income taxes.

The Romney and Buffett examples illustrate why the lighter burden on investment income should be understood as an issue of progressivity. The super-rich earn a greater percentage of their total income from investments than other taxpayers.[7] Because investment income has preferential tax treatment, the federal tax system imposes lower effective rates on some people with more income than it does on others with less.[8] That's not how the rate structure was supposed to operate: the federal income tax has graduated marginal rates that rise as total income rises, designed so that higher income households pay a higher average rate of tax than lower income households. When preferential rates on investment income allow high-income taxpayers to reduce their average effective tax rate, those rates undermine the progressivity of a graduated rate structure.

Undermining progressivity is not the only problem with the tax system's disparate treatment of income from different sources, and the trouble

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[4] I.R.C. §§ 3101, 3111 (2006) impose tax on wages, defined in I.R.C. § 3121(a) (2006). There is an exception to this: a 3.8% Medicare tax on net investment income of high-income taxpayers. Healthcare and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1411, 124 Stat. 1029 (2010) (codified at I.R.C. § 1411(a)(1) (Supp. V 2011)). It is not a tax on payroll, but on investments and is paid on the income tax return. *See Questions and Answers on the Net Investment Income Tax*, Internal Revenue Serv., http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs (last updated Aug. 8, 2013), *archived at* http://perma.cc/0KZQoCm3MKB.

[5] More than 90% of families are taxed on every dollar. *See* Thomas Hungerford, Cong. Research Serv., RL33943, Increasing the Social Security Payroll Tax Base: Options and Effects on Tax Burdens summary (2013), *available at* http://www.aging.senate.gov/crs/ss28.pdf, *archived at* http://perma.cc/0dgTcpyaJ81.

[6] Mitt Romney made the 47% number famous in a speech surreptitiously taped and released to Mother Jones magazine. *Watch: Full Secret Video of Private Romney Fundraiser*, Mother Jones (Sept. 18, 2012, 11:30 AM), http://www.motherjones.com/politics/2012/09/watch-full-secret-video-private-romney-fundraiser, *archived at* http://perma.cc/0wSFT5QiU1u. 7The number has declined to 43%. *Who Doesn't Pay Federal Taxes?*, Tax Pol'y Ctr., http://www.taxpolicycenter.org/taxtopics/federal-taxes-households.cfm (Last visited Oct. 22, 2013), *archived at* http://perma.cc/0Pj5L4GdVRq.

[7] *See* Justin Bryan, Individual Income Tax Returns, 2010, IRS Statistics of Income Bulletin 10 fig.F (2012), http://www.irs.gov/PUP/taxstats/productsandpubs/12infallbulincome.pdf, *archived at* http://perma.cc/0eDkzjyJCSK (showing that capital gains and dividends taxed at preferential rates in 2010 constituted about half of total income of taxpayers with adjusted gross income in excess of $10 million, but less than 1% for all taxpayers with adjusted gross income under $50,000).

[8] *See id.* (showing that the highest category of taxpayers paid an average income tax rate of 20.7% in 2010, while the moderately rich with $1–1.5 million paid an average tax of 24.9%). A regressive income tax system is one in which the average rate of tax declines as income rises. In a progressive system, rates rise as income rises.

extends beyond the super-rich. The discrepancy in the taxation of investment income and labor income is a fairness issue for all taxpayers. Taxpayers who earn the same amount—at all income levels—may pay vastly different amounts of tax depending on how they earned the money. The payroll tax produces substantial inequity between wage earners and investors with the same total income, and the income tax exacerbates that inequity by taxing wage earners more heavily in addition to the payroll tax.

The goal of this article is to draw attention to the payroll tax's role in the overall design of federal taxation, and to analyze the difference in the tax burden imposed on income from work and income from investment in the system as a whole. While academics and politicians perpetually debate the fairness of the income tax, the payroll tax is virtually ignored—it is taken for granted. A mythology surrounding the payroll tax has protected it from meaningful critique. The connection between payroll taxes and Social Security retirement benefits has lulled working Americans into accepting heavy burdens on labor income as a fair price for retirement benefits. The mythology of the payroll tax as insurance and private savings has minimized criticism of a regressive tax that burdens people who work. It is ironic that a conceptualization originally created to benefit workers—by making retirement security a right for people who have worked—has transformed into a justification for an outsize burden on them.

The payroll tax affects too many people and raises too much revenue to remain outside the core debate about tax fairness. The disproportionate burden that the tax system imposes on workers compared to investors under current law lacks valid justification on fairness grounds. It is time to start treating the payroll tax as a tax and subjecting it to rigorous examination to determine whether it contributes to a just distribution of the tax burden.[9] Because Social Security retirement is a worthy federal program, we should be willing to pay for it with taxes that distribute the burden fairly. As Congress and the President undertake tax reform, they should lighten the federal tax burden from the backs of workers and make individuals earning income from capital pay their fair share.

A. Income from Labor Is More Heavily Taxed than Income from Capital

Although the federal income tax and the federal payroll tax are different taxes, governed by different chapters of the United States Code,[10] they are both federal taxes imposed on many of the same individuals. In fact, they

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[9] If the tax system's treatment of retirement savings is analyzed along with the Social Security system, the combined system reveals "a far less redistributive, and thus less justice-enhancing, national retirement security program than emerges from looking at Social Security benefits alone." Michael Graetz, *The Troubled Marriage Of Retirement Security And Tax Policies*, 135 U. PA. L. REV. 851, 873 (1987).

[10] The individual income tax is covered by Chapters 1–5 of the Internal Revenue Code, while the payroll tax is covered by Chapters 21–28.

both impose tax on the same dollars because wages are taxed under the payroll tax, and again under the income tax. Since fairness in taxation depends on the distribution of total tax burdens, it is necessary to aggregate the burdens under both taxes before deciding whether the federal tax system is justly designed. Taken together, the combination of the income tax and the payroll tax doubly burdens people who work for a living, compared to people who live off their wealth.

By its terms, only labor income is taxed under the payroll tax—it is a tax on "payroll." In addition, labor income is disproportionately taxed under the income tax. Although section 61 of the Code purports to treat all sources of income the same—it includes "all income from whatever source derived"—the tax law does not tax all income equally. The marginal rate structure, including the new 39.6% rate on high-income individuals, applies mostly to income from labor because investment income is largely carved out of the "ordinary" income subject to tax at graduated rates. Long-term capital gains and dividends are privileged by a preferential rate that is currently a maximum of 20%.[11] The only investment income taxed at ordinary rates is interest. While a preference for capital gain is a longstanding feature of the income tax, dividends were taxed as ordinary income until 2003. Consequently, the starkness of the contrast between capital income and labor income taxation is relatively new; only in the last decade has the divide between capital and labor income taxation been so striking within the income tax itself.

The combined effect of the payroll tax and the income tax produce dramatically heavier tax liabilities on labor income compared to capital income, which means that workers are taxed more heavily than investors. As Mitt Romney and Warren Buffett show, this combination can be a boon for higher earners. The rich have more investments than the poor.[12] On account of this distribution of wealth, *income* that derives from wealth is heavily skewed toward the rich, and the discrepancy in tax imposed on labor and capital income benefits high-income taxpayers. Income from wealth enjoys advantageous treatment under both the income tax and the payroll tax—

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[11] As a result of the recent fiscal cliff legislation, Section 1(h) of the Internal Revenue Code imposes a 20% maximum rate for "adjusted net capital gain." I.R.C. § 1(h)(1)(D) (West 2013). That amount includes gains from sales of investment property held longer than a year. I.R.C. §§ 1222, 1223 (2006). There are a few exceptions from the most preferential rate: collectibles and unrecaptured depreciation on real estate are taxed at higher rates, I.R.C. § 1(h)(1)(E)–(F) (West 2013), as well as gains on investments held for a short period. With a minimum of planning, taxpayers can make sure that all their gains are taxed at the most preferential rates.

[12] The top 10% of the income distribution holds over $400,000 in asset wealth for every $35,264.42 in wealth held by the bottom 20%. *See* Fed. Reserve Bank, Changes in U.S. Family Finances from 2007 to 2010 30 tbl.6 (2012), *available at* http://www.federalreserve.gov/pubs/bulletin/2012/pdf/scf12.pdf, *archived at* http://perma.cc/0godfiGbvaW. Ninety percent of families in the top income decile hold stocks, compared to 12% for households in the bottom quintile. *See id.* at 41 tbl.7.

investment income is exempt from the payroll tax[13] and is subject to preferential rates in the income tax.[14] While low-income taxpayers can enjoy a zero rate on capital gains,[15] they have precious little investment income taxed that way.[16]

In addition to changes in the law that have made the preference for capital gains and dividends more generous,[17] inequity in the taxation of capital and labor income has grown over time because the economic returns to capital and labor have diverged. Capital income has enjoyed an increasing share of corporate returns while labor has reaped less. "[T]he shift away from labor incomes towards capital incomes plays a significant role in driving the rise in *overall* income inequality . . . . [T]his labor-to-capital shift explains about a third of the overall rise in the share of total income claimed by the top 1 percent."[18] Given that the top 1% has captured 62% of total income growth over the last generation,[19] the labor-to-capital shift is an important phenomenon. The tax law reinforces the effects of this economic polarization by taxing the type of income earned by lower-income individuals more heavily than the type of income earned by higher-income individuals.

While generally understood as a problem of vertical equity, the payroll tax/income tax preference in favor of investment income also creates horizontal inequity—two taxpayers with the same total income can pay very different amounts of tax depending on whether their income was earned through work or through investment. The horizontal inequity of the current scheme applies throughout the income spectrum; lower income investors are taxed less than equal-earning workers and high-income investors are taxed less than equal-earning salaried employees.

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[13] Under the Affordable Care Act, there is an unearned income Medicare tax of 3.8% on investment income for single taxpayers with income exceeding $200,000. Health Care and Education Reconciliation Act of 2010 § 1402(a)(1) (Pub. L. 111–152, 124 Stat. 1029). Healthcare and Education Reconciliation Act of 2010, Pub. L. No. 111–152, § 1402(a)(1), 124 Stat. 1029 (2010) (codified at I.R.C. § 1411 (Supp. V 2011)).

[14] I.R.C. § 1(h) (West 2013). Depending on a taxpayer's marginal rate, adjusted net capital gains and dividends are taxed at either 0%, 15%, or 20%.

[15] I.R.C. § 1(h)(1)(B) (West 2013).

[16] *See* Bryan, *supra* note 7, at 10 fig.F.

[17] Under the Tax Reform Act of 1986, there was a brief time when capital gains were not subject to a preference at all. JOINT COMM. TAXATION STAFF, 99th CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 178 (Comm. Print 1987), *available at* http://www.jct.gov/jcs-10-87.pdf, *archived at* http://perma.cc/0pV85XJdsPp. From 1993 until this year, an unusually low 15% rate was in effect for capital gains and dividends. *Federal Capital Gains Tax Rates, 1988-2013*, TAX FOUND. (June 13, 2013), http://taxfoundation.org/article/federal-capital-gains-tax-rates-1988-2013, *archived at* http://perma.cc/0rdbp9t1Tav.

[18] Josh Bivens, *More Fiscal Implications of a Rising Capital-Share of Income*, ECON. POLICY INST. BLOG (Jan. 2, 2013, 2:36 PM), http://www.epi.org/blog/fiscal-implications-rising-capital-share-income/ (considering the years 1979–2007), *archived at* http://perma.cc/0XiDgaehaUE.

[19] EMMANUEL SAEZ, DEPT. OF ECON., U. OF CAL., STRIKING IT RICHER: THE EVOLUTION OF TOP INCOME IN THE UNITED STATES 4, *available at* http://elsa.berkeley.edu/~saez/saez-UStopincomes-2011.pdf, *archived at* http://perma.cc/0CYLVa6iBKs.

B. Payroll Taxes are Underexamined

The payroll tax is the stepchild in tax policy.[20] It has a much lower public profile than the income tax, and has been the subject of much less scholarly debate. I have called it the "furtive tax"[21] because people may fail to notice their payroll tax payments. Individuals do not file annual payroll tax returns, and never write a check for their payroll taxes. Instead, payroll taxes are withheld by employers and remitted directly to the government, without any participation by the employees who pay them. Even when payroll taxes change, some taxpayers do not seem to notice the adjustment in their withholding.[22]

This is unfortunate because the payroll tax is economically crucial to both government and taxpayers. Payroll taxes produce 40% of total federal tax revenue, about the same as income taxes.[23] Its share has gradually grown over time—in 1970, the payroll tax's revenue share was 23% and in 1950, its share was only 11% of total revenue.[24] By contrast, the corporate income tax produces less than 9% of total revenue, so even though it is hotly debated in Washington and academia, from the perspective of revenue, the corporate

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[20] Academic interest in the income tax is overwhelming by comparison. There was a flurry of interest in the payroll tax when a conversion to private accounts was being considered as part of Social Security reform. *See, e.g.*, R. Douglas Arnold, Michael J. Graetz & Alicia H. Munnell, Nat'l Acad. of Soc. Ins., Framing the Social Security Debate: Values, Politics, and Economics (1998). Privatization was an important campaign issue for President George W. Bush in 2000 and 2004. *See, e.g.*, President's Comm'n to Strengthen Soc. Sec., Strengthening Social Security and Creating Personal Wealth for All Americans (2001), *available at* http://www.ssa.gov/history/reports/pcsss/Final_report.pdf, *archived at* http://perma.cc/0cnRxxPQswB; Greg Hitt, *Social Security Plan Stalls —- Stock Market's Slide Undermines Support for Privatization*, Wall St. J., July 23, 2002, at A4; Jackie Calmes, *Bush Pushes Action on Social Security — Bennett, DeMint Are Asked to Move Forward With Their Conflicting Proposals*, Wall St. J., June 22, 2005, at A4, *available at* http://online.wsj.com/article/0,,SB111938082139765503,00.html, *archived at* http://perma.cc/0BSZLsTNkUw; Mark Silva, *Bush: Vote is Mandate*, Chi. Trib., Nov. 5, 2004, at C1, *available at* http://articles.chicagotribune.com/2004-11-05/news/0411050276_1_second-term-agenda-president-bush-clear-mandate, *archived at* http://perma.cc/0FnexBkrSBy; John D. McKinnon, *Plans to Mend Social Security Win Some Praise*, Wall St. J., July 22, 2004, at A2; Jacob M. Schlesinger, *Bush Plan To Privatize Social Security Will Face Host of Hurdles*, Wall St. J., Dec. 18, 2000, at A24.

[21] Linda Sugin, *The Furtive Tax*, N.Y. Times, Apr. 14, 2013, at SR7, *available at* http://www.nytimes.com/2013/04/14/opinion/sunday/payroll-tax-returns-anyone.html, *archived at* http://perma.cc/0atpgf2UDjG.

[22] The temporary payroll tax holiday in 2011 and 2012 increased take-home pay for workers. In a survey about uses of funds, some respondents did not realize that their withholding had changed. *See* Grant Graziani, Wilbert van der Klaauw & Basit Zafar, Fed. Reserve Bank of N.Y., Staff Rep. No. 592, A Boost in the Paycheck: Survey Evidence on Workers' Response to the 2011 Payroll Tax Cuts 9 (2013), *available at* http://ssrn.com/abstract=2197793, *archived at* http://perma.cc/0uMDoukK6pC.

[23] This is the number for 2010, the last year without a tax holiday. Office of Mgmt. & Budget, Budget of the U.S. Government, Fiscal Year 2013 Historical Tables 33 tbl.2.2 (2013), *available at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/hist.pdf, *archived at* http://perma.cc/0DMjK8c6hKV.

[24] *Id.* (providing historical data).

tax is substantially less important than the payroll tax.[25] The tax rates applied to payroll have also risen over time. When the tax was first adopted in 1937, the rate was 1% on both employers and employees. In 1950, it was still only 1.5%, and in 1970, 4.8%. Today, the rate for both employers and employees is 7.65%.[26] These climbing rates, along with increased labor productivity, explain why the payroll tax's share of federal revenue has increased so substantially over time.

From the perspective of individual taxpayers, the payroll tax is the single most important tax. Virtually every taxpayer in the bottom two quintiles of the income distribution—and about 70% of taxpayers in the middle quintile—pays more payroll tax than income tax.[27] Overall, about 60% of taxpayers pay more payroll tax than income tax.[28] The income tax exceeds the payroll tax only for the top quintile of taxpayers[29]; the income tax is really a high-income issue, while the payroll tax is important to taxpayers at all income levels.

It would be hard to argue that the payroll tax is fair.[30] Unlike the income tax, it allows no adjustments for ability to pay. While income tax liability depends on whether a taxpayer supports children or gives to charity, for example, the payroll tax does not.[31] It is a flat-rate levy on the wage base. Workers pay their 7.65% on the very first dollar earned—there is no standard deduction, personal exemption, or zero-bracket amount. Their employers pay an additional 7.65% on the same comprehensive base.[32] These combined levies impose a substantial burden on taxpayer-workers because employers shift their part of the tax to workers by adjusting wages downward.[33] That means that low-and moderate-income workers bear a higher average rate of tax—at least 15.3%—than Mitt Romney.[34] In contrast, an

[25] Self-employed individuals pay at twice that rate, 15.3%, essentially paying both the employer and the employee portions of the tax. *Id.*

[26] *Social Security and Medicare Tax Rates*, SOC. SEC. ADMIN., http://www.ssa.gov/oact/progdata/taxRates.html (last updated Mar. 8, 2012), *archived at* http://perma.cc/0h1xyV37daD.

[27] *Historical Payroll Tax vs. Income Tax*, *supra* note 2.

[28] *Id.*

[29] Over 90% of top quintile taxpayers pay more income tax than payroll tax. *Id.*

[30] Twenty-five years ago, Michael Graetz stated, "the real fairness problems with social security are the regressivity of its tax structure and its modest capacity to maintain the standard of living of low and moderate wage earners." Graetz, *supra* note 9, at 851.

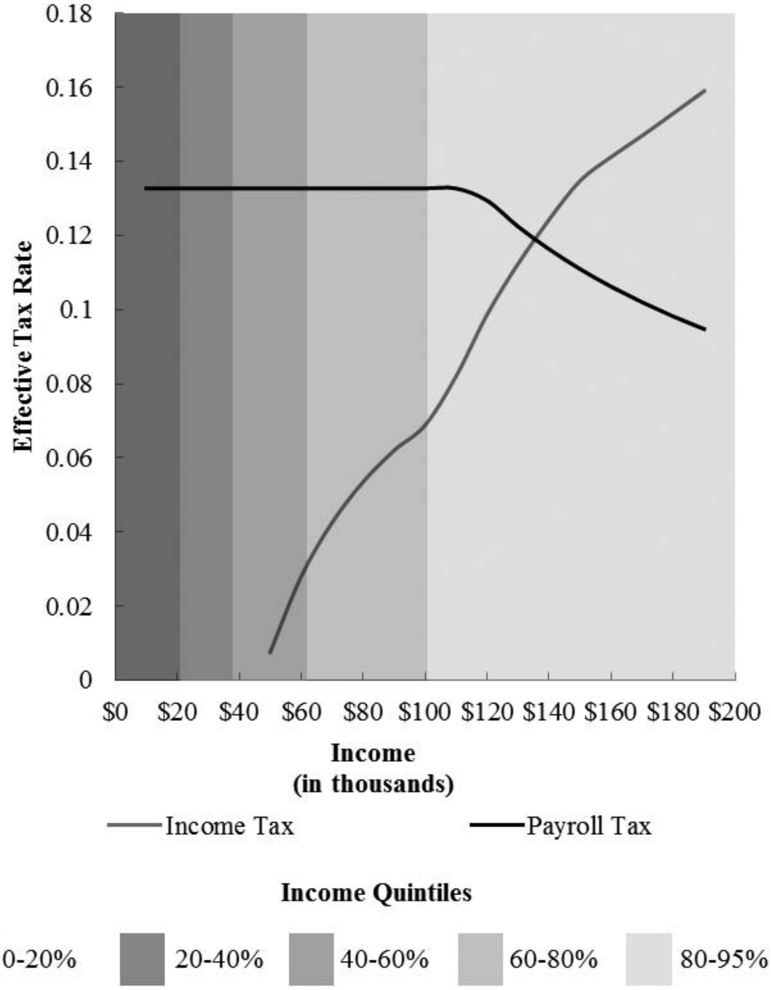
[31] The income tax has myriad adjustments for the differing circumstances of individuals. The complexity of the individual income tax is the product of attempting to make fine distinctions between individuals' financial circumstances.

[32] Since its original adoption, payroll tax rates have risen twenty-one times, from 2% (from 1937–1949) to 15.3% today. *See Social Security and Medicare Tax Rates*, *supra* note 26.

[33] *See* HUNGERFORD, *supra* note 5, at 1 n.4 ("Most economists agree that workers ultimately bear the full burden of the payroll tax. Employers typically pass on their share of the payroll tax to employees through paying lower wages.").

[34] For example, a hypothetical single, childless taxpayer in 2013 with wages in excess of $14,340 will owe payroll tax (including the employer and employee portion) of 15.3% on those wages. *See* INTERNAL REVENUE SERV., INTERNAL REVENUE BULLETIN, REV. PROC. 2013-15 (2013), *available at* http://www.irs.gov/irb/2013-05_IRB/ar06.html (containing inflation

Chart 1: Payroll and Income Tax Rates by Quintile



individual is unlikely to have a 15% average rate of *income* tax until earnings exceed $70,000.[35]

Even without a comparison to the income tax, the design of the payroll tax itself is inequitable because it is regressive—the average rate of tax goes down as income goes up. The payroll tax is capped at $113,700 in earn-

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adjustments for 2013), *archived at* http://perma.cc/06vjx4chEBv. The earned income tax credit, I.R.C. § 32 (West 2013), reduces the effective rate of tax for individuals with less wage income than that threshold because it operates to subsidize earnings below the statute's phaseout amount. *See id.*

[35] A hypothetical single taxpayer in 2013 with AGI of $70,000, taking the standard deduction pays $10,929 in income tax, an average rate of 14.5%. *Tax Calculator*, Tax Pol'y Ctr., http://calculator.taxpolicycenter.org (last visited Oct. 22, 2013).

ings.[36] Employees with wages exceeding that amount pay no tax on their excess earnings. An individual with income equal to twice the cap pays an average rate of tax equal to only half the statutory rate. An individual's average tax rate indicates how much that individual is burdened by a tax because average rates compare total tax paid to an individual's total income.[37] Average rates of tax are the most important element in judging the fairness of a tax. They are important for evaluating whether the government takes too much of a person's overall available resources. While marginal rates (i.e. the rate paid on a person's last dollar) may be more salient in public discourse, from a fairness perspective, they are less important than average rates because marginal rates give no indication about the burden of taxation on individuals.[38] Most people favor proportional or progressive taxes over regressive ones because they believe that people with more resources should pay a greater share of total tax.[39] Nevertheless, as the story of the "fiscal cliff" shows, there was barely a peep when the payroll tax rose at the beginning of 2013.

C. *The Fiscal Cliff Legislation Allowed Payroll Taxes to Rise*

Not only is the payroll tax underappreciated by taxpayers, it is also underappreciated by lawmakers. For 2011 and 2012, the payroll tax took a partial "holiday" during which it was reduced by 2% to 4.2% for employees.[40] The fiscal stimulus legislation in which the payroll tax holiday was included was adopted to alleviate the effects of the recession, and the purpose of the payroll tax holiday was to get more money into the hands of

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[36] This is the 2013 cap, applicable to the retirement portion (OASDI), which rises over time. The HI (Medicare) portion is not subject to the cap. *Social Security and Medicare tax rates; maximum taxable earnings*, Soc. Sec. Admin., http://ssa-custhelp.ssa.gov/app/answers/detail/a_id/240/~/social-security-and-medicare-tax-rates%3B-maximum-taxable-earnings (last updated Sept. 12, 2013), *archived at* http://perma.cc/0iD3QhVo3V1. Beginning in 2013, an additional HI tax of 0.9% is assessed on earned income exceeding $200,000 for individuals and $250,000 for married couples filing jointly. *Social Security and Medicare Tax Rates*, *supra* note 26.

[37] Average rates are also called "effective" rates. Since the payroll tax is at a single rate, individuals with earnings below the cap pay tax at the same average rate and marginal rate.

[38] The graduated marginal rate structure in the federal income tax imposes tax at inframarginal rates in addition to marginal rates. A person with a marginal rate of 39.6% pays that rate on last dollars, but pays at all the statutory lower rates on dollars below the top rate break. Thus, a person with a marginal rate of 39.6% is likely to pay an average rate significantly lower. For example, in 2007, taxpayers in the top quintile paid an average income tax rate of only 14.5%, much below the top statutory rate of 35%. *See* Jeff Rohaly, *The Distribution of Federal Taxes*, 115 Tax Notes 1293 (2007).

[39] *See generally*, Jennifer Hochschild, What's Fair? American Beliefs About Distributive Justice 280 (1981).

[40] The tax was reduced to 4.2% for employees and 10.4% for the self-employed. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No.111-312, 124 Stat. 3296. For an explanation of the payroll tax holiday, see Joint Committee on Taxation, JCS–2–13, General Explanation of Tax Legislation Enacted in the 112th Congress 81–83 (2013), *available at* https://www.jct.gov/publications.html?func=download&id=4509&chk=4509&no_html=1, *archived at* http://perma.cc/044Z5uoM2Fd.

individuals likely to spend it.[41] The payroll tax holiday increased the take-home pay of every worker in proportion to wage income. It was originally adopted for only one year, but was extended through 2012 as the economy lagged.[42] The payroll tax reduction replaced a more progressive provision that had been included in the prior round of fiscal stimulus, the "Making Work Pay" credit.[43] That provision, adopted in 2009, provided a refundable tax credit to the lowest income earners, but did not benefit higher income taxpayers as much as the payroll tax holiday.[44]

At the end of 2012, Congress and the President had to decide what to do with expiring legislation, including stimulus provisions and other tax reductions. Starting in 2001, numerous tax provisions were adopted with explicit sunset dates, at which time the law was scheduled to revert to its prior form.[45] The "fiscal cliff" at the end of 2012 was the reckoning for many of those temporary provisions; if Congress had failed to act, taxes would have risen for most individuals.[46] The expiring provisions included lower marginal rates, a reduced estate tax, a larger exemption for the alternative minimum tax, a more generous earned income tax credit, and a payroll tax rate reduction. In the nick of time, the "American Taxpayer Relief Act of 2012" permanently extended many of the provisions that were most advantageous to high-income taxpayers.[47] While it allowed the top marginal rate to rise for the very highest income taxpayers, it made lower marginal rates permanent

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[41] *See* Dawn Nuschler, Cong. Research Serv., R41648, Social Security: Temporary Payroll Tax Reduction summary (2012), *available at* http://assets.opencrs.com/rpts/R41648_20120109.pdf, *archived at* http://perma.cc/03pRVVY8RW1.

[42] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296.

[43] American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115. The Make Work Pay credit expired at the end of 2010. It provided a 6.2% credit to wage-earning taxpayers, with a maximum $400 credit. Taxpayers earning less than $20,000 benefitted more from the Make Work Pay credit than from the payroll tax holiday. *See* Nuschler, *supra* note 41 at 5.

[44] Because the credit was 6.2% of wages, for the lowest income taxpayers, the Making Work Pay credit was more valuable than a 2% reduction in the payroll tax rate. *See* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115.

[45] The original "sunset" date for the 2001 legislation was December 31, 2010. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38. Most of the expiring provisions in the 2001 legislation were extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Pub. L. No. 111-312 (2010), 124 Stat. 3296.

[46] *See* Roberton Williams, Eric Toder, Donald Marron & Hang Nguyen, Tax Pol'y Ctr., Toppling Off the Fiscal Cliff: Whose Taxes Rise and How Much? 1 (2012), *available at* http://www.taxpolicycenter.org/UploadedPDF/412666-toppling-off-the-fiscal-cliff.pdf, *archived at* http://perma.cc/0iV6VTSNFiM ("Almost 90 percent of Americans would see their taxes rise if we topple off the cliff.").

[47] For a description of major provisions in the American Taxpayer Relief Act of 2012, *see generally* James Nunns & Jeffrey Rohaly, Tax Pol'y Ctr., Tax Provisions In The American Taxpayer Relief Act Of 2012 (ATRA) (2013), *available at* http://www.taxpolicycenter.org/UploadedPDF/412730-Tax-Provisions-in-ATRA.pdf, *archived at* http://perma.cc/0FQ-szy2Ywv7. For revenue estimates, *see* Joint Comm. on Taxation, Estimated Revenue Effects Of The Revenue Provisions Contained In An Amendment In The Nature Of A Substitute To H.R.8, The "American Taxpayer Relief Act Of 2012," As Passed By The

for most income,[48] permanently patched the alternative minimum tax, and permanently reduced the scope of the estate tax. It also provided for a permanent 20% maximum rate for capital gains and dividends.[49] Expiring provisions benefitting lower income taxpayers fared less well, with the expiring enhancements to the earned income credit[50] and the higher education credit[51] extended only through 2017.[52]

The big loser in the fiscal cliff legislation was the payroll tax holiday. The tax holiday was allowed to expire completely at the end of 2012 amid widespread political indifference to extending it.[53] According to the Congressional Budget Office, the expiration raises $108 billion revenue in 2013 alone[54]—a significant sum even by federal budget standards. There was considerable debate in government and the popular media about the income level at which marginal rates would be allowed to rise to pre-2001 levels,[55] but the payroll tax expired with virtually no discussion. Although Demo-

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SENATE ON JANUARY 1, 2013 (2013), *available at* https://www.jct.gov/publications.html?func=startdown&id=4497, *archived at* http://perma.cc/0gS7vupoMUm.

[48] Even the highest income taxpayers benefit from the lower marginal rates in the graduated schedule. *See* Rohaly, *supra* note 38, at 1293.

[49] In the fiscal cliff negotiations, there was conflict over whether to maintain the 15% rate adopted as part of the Bush tax cuts, or allow the rate to rise to 20%, as it had been previously. *See* Lori Montgomery & Paul Kane, *As 'Cliff' Nears, McConnell and Biden in Talks*, WASH. POST, Dec. 31, 2012, at A1, *available at* http://articles.washingtonpost.com/2012-12-31/business/36070958_1_income-taxes-rise-fiscal-cliff-estate-tax, *archived at* http://perma.cc/0Lhgk WiSiC7; Lori Montgomery & Zachary A. Goldfarb, *Obama, Boehner Again Prepare to Tackle Debt*, WASH. POST, Nov. 9, 2012, at A8, *available at* http://articles.washingtonpost.com/2012-11-08/business/35506134_1_obama-and-boehner-tax-code-rates-for-investment-income, *archived at* http://perma.cc/0cqMSBaSHMq; James B. Stewart, *Tax Plan Is Popular, But Not Quite Fair*, N.Y. TIMES, Dec. 15, 2012, at B1, *available at* http://www.nytimes.com/2012/12/15/business/plan-to-cap-deductions-is-setback-for-charities.html, *archived at* http://perma.cc/06ymt2gUp4H.

[50] I.R.C. § 32 (West 2013).

[51] American Opportunity Tax Credit, I.R.C § 25A (West 2013).

[52] American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 103, 126 Stat. 2319 (codified at 26 U.S.C. §§ 25A, 32 (West 2013)).

[53] Ross Douthat, *Our Enemy, The Payroll Tax*, N.Y. TIMES, Nov. 24, 2012, *available at* http://www.nytimes.com/2012/11/25/opinion/sunday/douthat-our-enemy-the-payroll-tax.html?ref=opinion&_r=0, *archived at* http://perma.cc/0MRgXJbXK6A.

[54] CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2013 TO 2023 at 14 (2013), *available at* http://www.cbo.gov/sites/default/files/cbofiles/attachments/43907-BudgetOutlook.pdf, *archived at* http://perma.cc/0SkYEdp72YX.

[55] *See, e.g.*, *Talks Ongoing for Fiscal Cliff* (CNN television broadcast Dec. 30, 2012); Lori Montgomery & Paul Kane, *Obama, GOP Reach Fiscal Deal*, WASH. POST, Jan. 1, 2013, at A7, *available at* http://articles.washingtonpost.com/2012-12-31/business/36070958_1_income-taxes-rise-fiscal-cliff-estate-tax, *archived at* http://perma.cc/0JpCMBuRhJY; Paul Kane, As 'cliff' nears, will McConnell be a dealmaker?, WASH. POST, Dec. 23, 2012, at A1, *available at* http://articles.washingtonpost.com/2012-12-22/politics/36016655_1_fiscal-cliff-tax-cuts-vice-president-biden, *archived at* http://perma.cc/03CScZ2tw8S; Lori Montgomery & Paul Kane, Offer Revives Talks on 'Cliff', WASH. POST, Dec. 17, 2012, at A17, *available at* http://articles.washingtonpost.com/2012-12-16/business/35863991_1_debt-limit-boehner-and-obama-national-debt, *archived at* http://perma.cc/0AfwjS4ZjtP. Congress decided to reinstate the 39.6% marginal rate at $400,000 taxable income for singles and $450,000 for joint filers. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 101, 126 Stat. 2319 (codified at 26 U.S.C. § 1 (West 2013)).

cratic Representative Chris Van Hollen argued that the payroll tax holiday should be extended, he seemed more concerned about its economic benefits than its unfairness.[56] Larry Summers also advocated for its extension, solely because it provided economic stimulus.[57] Aside from them, and a few others,[58] Congress and the media were largely silent about the expiring payroll tax cut.[59] The last, real challenge to the payroll tax on equity grounds was a brief one from Senator John McCain, in a statement he made in 2009.[60] He proposed a temporary 3.1% payroll tax cut for employees on the grounds that the tax imposed too heavy a burden on working people.[61]

Given the economy's continuing sluggishness, allowing payroll taxes to rise, while preserving other cuts, was counterproductive. Before the fiscal cliff negotiations, the Congressional Budget Office had estimated that the payroll tax cut was the most cost-effective tax-based economic stimulant in the package under review—more effective than extending the Bush tax cuts or the alternative minimum tax patch. Only direct spending targeted to the poor was considered more stimulative.[62] After its expiration, the Office of Management and Budget credited the payroll tax holiday with sustaining economic demand and fostering economic growth, calling it the "culmination" of the government's economic recovery efforts.[63] As shown above, when legislators, journalists and pundits should have been talking about the

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[56] *See* Suzy Khimm, *Chris Van Hollen Wants to Consider Another Payroll Tax Holiday*, Wash. Post, Oct. 22, 2012, *available at* http://www.washingtonpost.com/blogs/wonkblog/wp/2012/10/22/chris-van-hollen-wants-to-consider-another-payroll-tax-holiday/, *archived at* http://perma.cc/0gQiLwUoEix.

[57] Lori Montgomery, *Larry Summers: Keep the Payroll Tax Cut*, Wash. Post, Oct. 11, 2012, *available at* http://articles.washingtonpost.com/2012-10-11/business/35500653_1_payroll-tax-budget-deficits-sluggish-growth, *archived at* http://perma.cc/06djrXM23nS.

[58] Senator Robert Casey was the sole sponsor of a bill to extend the payroll tax holiday; it died in committee. Middle Class & Small Business Tax Cut Act 2012, S. 3660, 112 Cong. (2012); *S. 3660 (112th): Middle Class & Small Business Tax Cut Act of 2012*, GovTrack.us, https://www.govtrack.us/congress/bills/112/s3660 (last visited Nov. 10, 2013), *archived at* http://perma.cc/0WhZVG1DqAA; *see generally* 158 Cong. Rec. S7419 (daily ed. Dec. 5, 2012).

[59] *See* Douthat, *supra* note 53.

[60] Statement by Senator John McCain on the Floor of the United States Senate, U.S. Senator John McCain (Oct. 15 2009), http://www.mccain.senate.gov/public/index.cfm?FuseAction=PressOffice.FloorStatements&ContentRecord_id=58B50118-BB3A-1744-4379-CD7BAB997F3F, *archived at* http://perma.cc/0qyWvVSia9P.

[61] Ironically, several congressmen raised the concern of regressivity and burden on workers in opposition to Speaker Pelosi's payroll tax proposal to finance the Affordable Care Act. 155, pt. 15 Cong. Rec. 20,564 (2009).

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> The estimated economic impact of those policies per dollar of budgetary cost is larger than that of extending other expiring tax provisions and indexing the AMT for inflation because a larger share of the additional unemployment benefits and extended payroll tax cut would be spent by the recipients in 2013. As a result, the short-run increase in aggregate demand and output would be greater.

Cong. Budget Office, Economic Effects of Policies Contributing to Fiscal Tightening in 2013 11 (2012). Only direct spending targeted to the poor was considered more stimulative. *See id.*

[63] Office of Mgmt. & Budget, Mid-Session Review Budget of the U.S. Government. Fiscal Year 2014 5 (2013).

expiration of the payroll tax cut, nobody seemed interested. Only after it expired and when workers noticed the hit to their paychecks did anyone start to express concern.[64] On April 5, 2013, Floyd Norris of the New York Times wrote: "Raising taxes on the least well-off working people—through the payroll tax increase that took effect at the beginning of the year—might have been a poor idea."[65] Why did Congress and the President accept expiration of the payroll tax reduction as inevitable, but fight so hard over raising the top marginal rate in the income tax? Why did people accept it as inevitable that the payroll tax holiday would expire,[66] when they did not accept as inevitable that other 2001 tax cuts would expire? This article argues that the New Deal rhetoric surrounding Social Security, and the mythology that payroll taxes are premium payments for social insurance, largely explain why the payroll tax holiday fell off the fiscal cliff at the end of 2012. It contends that what started as a scheme to ensure that government would commit long-term to reducing poverty among the elderly has been perverted to justify disproportionate tax burdens on workers.

II. Fairness and Taxation of Wages

A. Wages Bear the Heaviest Total Tax Burden

The payroll tax burden on labor income must be evaluated against the backdrop of more preferential income tax treatment for capital income. Given the favored treatment of capital income under the income tax, the regressivity of the payroll tax is particularly troubling because it means that individuals with wealth (and the capital income it produces) reap benefits under both regimes. The payroll tax imposes a heavier relative levy on taxpayers with total wage income under the maximum income payroll cap, compared to both workers with wages exceeding the cap and investors whose income is exempt from the payroll tax. Such a levy is vertically inequitable since high-income individuals are treated more favorably under the law than are low-income individuals. As Professor Michael Graetz wrote, "The income tax benefits that are skewed in the direction of high-income

[64] *See* Nelson Schwartz, *Restored Payroll Tax Pinches Those Who Earn the Least*, N.Y. Times, Feb. 7, 2013, at A1, *available at* http://www.nytimes.com/2013/02/08/business/restored-payroll-tax-pinches-those-with-the-smallest-checks.html, *archived at* http://perma.cc/0AVS2rbU5Za.

[65] Floyd Norris, *The Shrinking Ranks of the Working*, N.Y. Times Economix Blog (Apr. 5, 2013, 10:25 AM), http://economix.blogs.nytimes.com/2013/04/05/the-shrinking-ranks-of-the-working, *archived at* http://perma.cc/0p6aGWvX25g.

[66] *See* Tony Nitti, *Dear America: Your Higher Payroll Taxes Are Not The Result Of A Tax Increase*, Forbes (Jan. 14, 2013, 10:37 PM), http://www.forbes.com/sites/anthonynitti/2013/01/14/dear-america-your-higher-payroll-taxes-are-not-the-result-of-a-tax-increase/, *archived at* http://perma.cc/0PyzDipMFco.

individuals render inexcusable the dramatic regressivity of the payroll tax . . . ."[67]

While vertical equity is important, the most striking (and less well-known) effect from combining the two taxes occurs in horizontal comparisons of people with the same income. Under 2013 law, a single individual with $20,000 in wage earnings pays $3,700 in federal taxes, mostly payroll taxes, but also including about $860 in income taxes.[68] If that income had been from long-term capital gains instead of earnings, the taxpayer would have paid no federal tax at all because the payroll tax does not apply to non-wage income, and the rate for long-term capital gains is zero for low-income taxpayers.[69] So the low-income wage earner pays more payroll tax and more income tax than the low-income investor. The inequity occurs at every income level. An individual with $45,000 wage earnings pays $10,700 in total federal tax, $4300 of which is income tax, while an individual with $45,000 in long-term capital gains still pays no federal tax, even though $45,000 is not poor for a single American.[70] At $70,000, the worker pays $19,600 in federal taxes, about half in payroll tax and half in income tax. The investor pays $3560, only 18% of what the worker pays; the worker with $70,000 pays 5.5 times more tax than the investor earning the same amount.

The pattern continues at higher incomes also, but the payroll tax becomes less important and the discrepant treatment within the income tax becomes more important. Payroll tax rates never rise,[71] and capital gains rates are capped at 20%.[72] But income tax rates rise as total income rises, so highly-paid wage earners pay the highest rates of tax under the law. At $145,000, the worker is over the maximum taxable amount for the payroll tax, so the effective rate of the payroll tax declines compared to taxpayers below the cap.[73] But the income tax rates rise, so that the high-wage worker pays more income tax. The worker with $145,000 wages pays total federal tax of $46,600, $18,000 of which is payroll tax.[74] The investor with $145,000 in capital gains pays $14,800 in income tax and no payroll tax. So even where payroll taxes are a less significant portion of total tax liability for

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[67] Graetz, *supra* note 9, at 906.

[68] All numbers here were generated with the Tax Policy Center's tax calculator. The calculator includes the employer's share of the payroll tax as cash income and attributes both the employer and employee portions of the payroll tax to the employee. *See Tax Calculator*, *supra* note 35.

[69] I.R.C. §§ 1, 1401, 3101, 3111 (Supp. V 2011).

[70] In 2011, the United States household median income was $50,054. Carmen DeNavas-Walt et al., U.S. Census Bureau, Income, Poverty, and Health Insurance Coverage in the United States: 2011 5 (2012), *available at* http://www.census.gov/prod/2012pubs/p60-243.pdf, *archived at* http://perma.cc/0HWL8LSDtkd.

[71] I.R.C. §§ 1401, 3101, 3111 (Supp. V 2011).

[72] I.R.C. § 1 (West 2013).

[73] The taxpayer with $145,000 earnings and the taxpayer with $113,700 both pay the same OASDI tax, $14,099, which is 12.4% of the lower earner's wages, but only 9.7% of the higher earner's wages. *Tax Calculator*, *supra* note 35.

[74] *Id.* The health insurance portion of the payroll tax has no cap, so it is 2.9% of all earnings. I.R.C. §§ 1401, 3101, 3111 (Supp. V 2011).

the worker, the investor pays less than a third of the worker's tax. At $500,000, the worker pays $178,000 in tax, which includes the maximum payroll tax plus an additional high-income Medicare tax on payroll adopted as part of the Affordable Care Act.[75] Her marginal income tax rate is the highest—39.6%—under current law and her income tax liability is $147,400. The investor with $500,000 in capital gains pays just under $86,000 in income tax, less than half of the tax burden of the worker. The following chart illustrates these comparisons:[76]

Chart 2: Total Tax Liability

Exacerbating the inequity in the taxation of labor income and capital income is that, due to the realization rule, the real rate of tax applied to much investment income is zero. The realization rule imposes tax on investment gains only at the time an asset is sold,[77] allowing accessions to wealth to escape taxation. Accurate income measurement would tax gains as they accrue, on a so-called "mark-to-market" basis, regardless of when the investment is sold. The classic definition of income underlying the federal income tax includes the "net accretion to economic power" during the relevant time

[75] Patient Protection and Affordable Care Act, Pub. L. 111-148, § 9015, 124 Stat. 119 (2010) (imposing additional hospital insurance tax on wages exceeding $200,000); *Tax Calculator*, *supra* note 35.

[76] These numbers assume that the taxpayer is single and claims the standard deduction. *Id.*

[77] I.R.C. §§ 61(a)(4), 1001 (2006).

period,[78] and the "change in the value of the store of property rights."[79] This understanding of income requires only valuation, not liquidation. Nevertheless, the federal income tax has always allowed unrealized gains to remain untaxed.[80] As long as an investment continues unliquidated, any built-in appreciation remains tax-free.

This is a significant tax benefit for investors accumulating wealth because tax can be deferred indefinitely. Deferring the tax on gain has the effect of reducing the effective rate of tax applied to that gain—the longer the deferral, the lower the effective rate of tax becomes.[81] Deferral becomes forgiveness under current law if taxpayers hold investments until death because section 1014 of the Code steps up basis for heirs to fair market value at death, erasing any gain that accrued on property during a decedent's life. Neither the decedent nor the heirs will ever pay income tax on that gain. The realization rule allows taxpayers to choose when to include their gains, and if they have sufficient assets to hold until death, whether to ever subject those gains to income taxation at all.

The exclusion of unrealized gains from tax is an enormous benefit for investing taxpayers, but it is largely ignored. The government treats it as though it does not exist by failing to measure the realization rule's annual cost in lost revenue. The realization rule is not included in the tax expenditure budget as an item of tax preference.[82] While the exact amount may be impossible to determine given current data, the magnitude is certainly huge.[83]

The discrepancy between the taxation of labor and the taxation of investments could be substantially reduced if unrealized gains were subject to taxation. Mark-to-market taxation of gains would require immediate inclusion of all accretions to wealth, just as current law includes all financial returns to labor as they occur. Mark-to-market taxation might even pave the way for further uniformity in the taxation of labor and investment income because the preference for capital gains might no longer be necessary. If the

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[78] Robert Murray Haig et al., The Concept of Income in the Federal Income Tax 7 (1921).

[79] Henry Simons, Personal Income Taxation 50 (1938).

[80] Jeffrey L. Kwall, *When Should Asset Appreciation Be Taxed?: The Case for a Disposition Standard of Realization*, 86 Ind. L.J., 77, 79 (2011).

[81] A $10 gain subject to a 20% tax produces $2 tax currently. If that $2 tax is deferred for 10 years, the $2 tax to be paid then can be funded by only $1.50 today if it will grow at 3%. The necessary current outlay goes down as the rate of return rises. If the $2 tax is deferred for 20 years, it can be funded with just over a dollar.

[82] The realization rule was accepted in the normal baseline adopted by the original designers of the tax expenditure concept. *See* Stanley Surrey & Paul McDaniel, Tax Expenditures 3–4 (1985).

[83] Looking at the five year moving average, from 2000 to 2006, the gap between the asset appreciation and realized capital gains generally fluctuated between approximately two and three trillion dollars a year. Arthur B. Laffer & Stephen Moore, Return to Prosperity: How America Can Regain Its Economic Superpower Status 183 (2011). Thus, the exclusion of unrealized capital gains from the tax base excludes two to three trillion dollars a year from the potential tax base.

law's lower rate for capital gains is necessary to encourage people to realize their gains and pay the tax,[84] then mark-to-market taxation would make it unnecessary to provide that incentive. Since people would be taxed on their gains regardless of sale, it would no longer matter—from a tax perspective—whether investors sold their positions or continued to hold.

Dispensing with the realization rule may not be as dramatic as people might initially believe. At one time, the Supreme Court gave the impression that the realization rule was constitutionally required.[85] But its later interpretation made it clear that realization is a matter of convenience and administrability that Congress can choose to abrogate where appropriate.[86] Congress has retained it for most investments, but has adopted mark-to-market taxation in limited circumstances where necessary to prevent abuse.[87] Congressman Dave Camp has recently proposed a mark-to-market system for derivatives[88] that could create a toe-hold for a broader application of mark-to-market rules. There have been many reasonable proposals to abrogate the realization requirement.[89] To extend the partial reach of mark-to-market under current law, some proposals suggest limiting the investments covered or the people subject to the regime.[90] Short of taxing mark-to-market, Congress can achieve the economic equivalent of a more accurate income tax by taxing gain retrospectively with interest so that returns to capital are effec-

[84] The higher the rate of tax on capital gains, the more the tax represents a toll charge on changing investments. The higher the toll charge, the more attractive an alternative investment must be to make the toll worthwhile because the amount that can be invested in the new investment will be smaller (by the amount of the tax) than the amount currently invested in the old investment.

[85] *See* Eisner v. Macomber, 252 U.S. 189, 219 (1920) (holding that stock dividends were not taxable because they were not separated from the invested capital, and citing the Sixteenth Amendment).

[86] *See, e.g.*, Helvering v. Bruun, 309 U.S. 461, 468–69 (1940). Congress has, in fact, done so. *See, e.g.*, I.R.C. § 475 (2006) (requiring mark to market for dealers in securities); I.R.C. § 1256 (2006) (requiring mark to market for certain straddles).

[87] *See, e.g.*, I.R.C. § 1256 (2006).

[88] Tax Reform Act of 2013, H.R. _, 113th Cong., § 401 (draft as discussed by H. Comm. on Ways and Means, Jan. 23, 2013), *available at* http://waysandmeans.house.gov/uploadedfiles/leg_text_fin.pdf, *archived at* http://perma.cc/0wodoANqPkA. For a description of the proposal, *see generally* H. COMM. ON WAYS AND MEANS, SUMMARY DESCRIPTION OF WAYS AND MEANS DISCUSSION DRAFT: FINANCIAL PRODUCTS (2013), *available at* http://waysandmeans.house.gov/uploadedfiles/summary_description_of_wm_discussion_draft_financial_products.pdf, *archived at* http://perma.cc/071L9nfkXid.

[89] *See generally* David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986); Alvin C. Warren, *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460 (1993). For an analysis of the theoretical and administrative issues in taxing unrealized gains, see David M. Schizer, *Realization as Subsidy*, 73 N.Y.U. L. REV. 1549 (1998).

[90] *See generally* David S. Miller, *A Progressive System of Mark to-Market Taxation*, 121 Tax Notes 213 (2008) (proposing mark-to-market taxation to a small slice of very wealthy taxpayers while maintaining realization for most taxpayers).

tively taxed.[91] The realization rule is a source of substantial inequity and should not be immune to reform.

In addition to the pervasive inequity of the realization rule, the income tax is full of explicit preferences for all sorts of investment returns. There are provisions in the law that exempt income on investments if the proceeds are used for retirement,[92] education,[93] and health care.[94] If you invest in your house, the gain is tax-free when you sell,[95] no matter what you use the proceeds for. They all contribute to the unequal taxation of labor and capital income. Given these opportunities for sheltering, only a small portion of all the income from investment gets taxed at all.

There is some nuance to this story. Many people do not fit neatly into the labor-income or capital-income category; many have income from both sources and are taxed under both legal regimes. In addition, the lowest income workers are entitled to refundable tax credits that are not available to low-income investors. While low-income workers must pay payroll tax on their first dollars of earnings, they receive transfers under the income tax that may exceed the payroll tax they pay.[96] The size of the transfer depends on earned income and children supported.[97] Consequently, a very low-income worker pays less under the federal tax system than the very low-income investor.[98] The low-income investor is not eligible for the earned income tax credit because it only applies to wages earned.[99] Nevertheless, the general situation is quite clear: current law causes both horizontal inequity and vertical inequity. Those with more investment income are taxed less than those with more labor income, and the inequity between workers and investors applies across income cohorts, as well as within them. The fairness argu-

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[91] *See* Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167, 167 (1991); Noël Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 TAX L. REV. 725, 733 (1992).

[92] *See* I.R.C. §§ 401, 403, 408, 408A (2006).

[93] *See* I.R.C. §§ 529–30 (2006).

[94] *See* I.R.C. § 220, 223 (2006).

[95] *See* I.R.C. § 121 (2006) (stating that the maximum excludible amount is $250,000 for single filers and $500,000 for joint filers, and that excess gains are taxed as capital gains).

[96] For example, a single worker with two children who earns $10,000 in 2013 receives a refundable child tax credit and earned income tax credit under I.R.C. § 32 (West 2013) of $4660—a negative income tax—and pays less than a third of that ($1420) in payroll taxes. *See* INTERNAL REVENUE SERV., FORM 1040 INSTRUCTIONS 59 (2012), *available at* http://www.irs.gov/pub/irs-pdf/i1040.pdf, *archived at* http://perma.cc/0CNSK5QLNnD. She receives a net transfer from the government, for a negative effective tax rate.

[97] *See* I.R.C. § 32 (West 2013).

[98] Of course, the low-income investor has wealth, which the low-income wage earner eligible for the credits does not, so the very low-income investor is likely to be substantially better off financially than the very low-income worker.

[99] *See* I.R.C. § 32(b) (West 2013). The earned income tax credit was originally adopted to alleviate the burden of payroll taxes, and the amount allowed for childless taxpayers is precisely the rate of tax (7.65%) imposed statutorily on employees. So, for childless workers, the earned income credit effectively refunds the payroll tax on the first dollars earned. Martin Rein, *Equality and Social Policy*, 51 SOC. SERV. REV. 565, 575 (1977).

ments for taxing different sources and uses of income differently demand explication, and the next section turns to that task.

B. Fairness in Taxation Depends on Overall Burdens

What, precisely, is wrong with taxing income from wages more heavily than income from capital? Fairness in taxation demands that *individuals* be taxed equitably, but it may not require that all *income* be taxed the same. Just because income from capital and income from labor are both income does not automatically mean that a just system of taxation would treat them the same. Nonetheless, income is a widespread tax base because it is a mechanism for distributing the burdens of taxation equitably. Tax fairness demands a metric for comparison, and the metric underlying an income tax is ability to pay. The ability-to-pay norm has a long-established provenance.[100] Adam Smith wrote: "The subjects of every state ought to contribute to the support of the government, as nearly as possible in proportion to their respective abilities."[101] John Stuart Mill expanded on Smith's principle by explaining that allocating the tax burden based on respective abilities depends on the burden that a tax places on a taxpayer: "whatever sacrifices [a government] requires from [citizens] should be made to bear as nearly as possible with the same pressure upon all."[102]

How should we interpret the norms of "equal sacrifice" and "ability to pay" in the context of taxes on income from labor and from capital? First, it is important to aggregate all the taxes that a government imposes on an individual; neither the payroll tax nor the income tax can be evaluated in isolation. Total sacrifice depends on the sum total of taxes on people. That is why it is important to compare the total federal tax burden—including both payroll taxes and income taxes—on workers and investors.[103] In addition to taxes, the measure of net sacrifice relevant for justice must account for the total benefits from government as well. If benefits are evenly distributed throughout the population, then individual taxpayers' sacrifices can be isolated, and consequently, determined more easily. But if benefits are highly progressive or regressive, taxes should be adjusted to maintain a fair distribution of benefits and burdens overall. If government programs primarily

[100] The ability-to-pay criterion enjoys broad acceptance as a fundamental tenet of tax justice, although the details of its implementation are controversial. Graetz, *supra* note 9, at 861.

[101] ADAM SMITH, An Inquiry into the Nature and Causes of the Wealth of Nations V.2.25 (Edwin Cannan ed., Methuen & Co., 5th ed. 1904) (1776), *available at* http://www.econlib.org/library/Smith/smWN.html, *archived at* http://perma.cc/0W3LKjQBisM. There is substantial debate about what that principle requires in practice, but the abilities-based norm is clear.

[102] JOHN STUART MILL, Principles of Political Economy, V.2.6 (William J. Ashley, ed., Longmans, Green and Co., 7th ed. 1909) (1848), *available at* http://www.econlib.org/library/Mill/mlP.html, *archived at* http://perma.cc/0W3LKjQBisM.

[103] *See supra* text accompanying notes 67–76.

benefit low-income individuals, a more regressive tax can be justified than if government programs primarily benefit high-income individuals.[104]

There are many tax systems that can be just, and only a few that are categorically unjust.[105] Taxes on many bases can be justified as long as they leave individuals with the means to exercise individual agency—a confiscatory tax, on any base, is unjust.[106] Labor income represents a combination of returns to personal effort and returns to social institutions. Therefore, in a just society, taxes on labor income are acceptable because, to the extent that labor includes returns to social institutions, individuals lack an absolute right to the fruits of their labor. A fair tax on labor would recognize the personal contribution of workers in producing labor income, while also acknowledging that individuals cannot produce labor income without the social apparatus in which they labor. Too onerous a tax on labor income may devalue the contribution of those who work by leaving them without the means to exercise their autonomy. Thus, the outer limit on taxation of labor income comes from the magnitude of the tax, not its tax base.[107] Similarly, taxation of capital income is acceptable in a just system because holders of capital do not have absolute rights to everything their money produces in the market. In fact, the productivity of capital depends on the contributions of labor as well as the social institutions that make capital productive. Capital income taxation can account for these substantial collective inputs.

The justness of a particular scheme of taxation depends largely on the background institutions in place, against which the tax is imposed.[108] The challenge in designing a tax system is choosing which tax or combination of taxes are the *most* just, given the non-tax institutions in place. From this perspective, there is a compelling argument labor income should be taxed less than capital income because labor income commands a person's unique, irreplaceable investment of the self. Capital income is not exclusive in the same way, and does not require investment of an individual's autonomy. The rest of this section constructs this argument by refuting fairness claims for taxing labor more heavily than capital, and explaining why the tax system should not overburden labor.

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[104] *See* Liam Murphy & Thomas Nagel, The Myth of Ownership: Taxes and Justice 14–15 (2002).

[105] I have previously discussed this issue at length, and so far, I have taken the position that only endowment taxation and a confiscatory tax that leaves an individual without sufficient resources to exercise personal agency are per se unjust. *See* Linda Sugin, *Theories of Distributive Justice and Limitations on Taxation: What Rawls Demands From Tax Systems*, 72 Fordham L. Rev. 1991, 1998 (2004) [hereinafter Sugin, *Limitations*] ("Numerous tax systems could conceivably satisfy Rawls's principles of justice"); *see generally* Linda Sugin, *A Philosophical Objection to the Optimal Tax Model*, 64 Tax L. Rev. 229 (2011) [hereinafter Sugin, *Philosophical Objection*] (arguing that endowment taxation is uniquely unjust).

[106] *See* Sugin, *Philosophical Objection, supra* note 105, at 260 ("It is important whether government interference prevents a person from pursuing her conception of a meaningful life.").

[107] *See id.* ("[A] 100% income tax would leave a person at the mercy of the state").

[108] *See* Sugin, *Limitations*, *supra* note 105, at 2000, 2009.

C. Arguments to Tax Wage Income More Heavily than Capital Income are Deficient

1. Payroll Taxes Are Benefits Taxes

The only way to refute the unfairness of the payroll tax is to either deny that it is a tax at all, or to rationalize it in the context of a broader analysis of taxes and spending that offsets its regressivity. If it is not really a tax, then it cannot be judged as unfairly regressive because regressivity is a critique of taxes. Alternatively, regressive taxes can be justified on fairness grounds if they finance progressive spending; the entire package of taxes and spending can be distributed equitably to individuals in different economic positions.[109] Even regressive taxes can be redistributive.[110] Thus, to evaluate any defense of the payroll tax, it is important to place it in the larger scheme of social security retirement.

The payroll tax was adopted in 1935 as part of the Social Security Act, which guaranteed retirement benefits for workers.[111] The Act was a response to the rise in poverty caused by the Great Depression, and it was important to President Franklin Roosevelt that the program create an entitlement to retirement security, rather than need-based assistance.[112] An entitlement would be harder to repeal than need-based assistance, particularly if individuals had already earned the entitlement when Congress considered repealing it.[113] At that time, the income tax was not yet the "mass tax" that it is today, so it was not considered a viable source for the funds that would be re-

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> If the proceeds of taxes collected are redistributed to provide the greatest benefit to the least well-off—through whatever mechanism, whether direct transfers, schools, health care, or other programs that open opportunity and improve the prospects of the poorest—then it matters little what the tax itself looks like because the spending side of the budget corrects or adjusts the distributional consequences overall.

See Sugin, *Limitations*, *supra* note 105, at 1997.

[110] To illustrate, consider a society with two people, Rich and Poor. If Rich has $10,000 in income and Poor has $1000, a $1000 tax on Rich (10%) and a $200 tax on Poor (20%) would be regressive. But the government would have $1200 that it could spend entirely on Poor, which would redistribute Rich's $1000 to Poor and spend Poor's $200 on him also. The spending side is a key part of the overall distributional fairness of the system. *See* Murphy & Nagel, *supra* note 104, at 164.

[111] Franklin D. Roosevelt Statement on Signing the Social Security Act, American Presidency Project (Aug. 14, 1935), *available at* http://www.presidency.ucsb.edu/ws/index.php?pid=14916, *archived at* http://perma.cc/02RnxVUUCg6; Social Security Act, Pub. L. No. 74-271, 49 Stat. 620 (1935).

[112] Patricia E. Dilley, *Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization*, 41 B.C. L. Rev. 975, 981 (2000) ("The program's guaranteed income redistributive benefit formula promotes prevention rather than alleviation of poverty in old age and extends the expectation of retirement to all income levels.").

[113] *See* Karen C. Burke & Grayson M.P. McCouch, *Women, Fairness, and Social Security*, 82 Iowa L. Rev. 1209, 1213 (1997) ("The formal linkage between wages, contributions, and benefits distinguishes social security from pure social welfare programs and reinforces the widely-held perception of social security benefits as an 'earned right.'").

quired.[114] A new revenue supply needed to be tapped to finance the outlays, and so the tax on payroll, at 1%, was created. The statutory authorization was known as FICA, the shorthand for payroll tax payments widely understood today, which stands for the "Federal Insurance Contributions Act."[115] At its birth, the payroll tax was portrayed as "insurance." Calling the tax payments "contributions to the social insurance system"[116] gives them a substantially different connotation than simply calling them a tax, and that cognitive frame has endured; it is *the* essential element in the mythology of the payroll tax. Contributions to social *insurance* are connected to the benefits of social insurance, and that connection is important in evaluating the fairness of the system as a whole.

Payroll taxes and Social Security benefits are linked in two ways. The first connection is a revenue link—payroll taxes fund Social Security benefits.[117] Every tax dollar collected from payroll taxes must be used—at some time—to fund Social Security benefit payments. The tax revenue has mostly been disbursed immediately because the system is pay-as-you-go, in which current taxpayers finance the payments to current retirees. The first generation to receive benefits did not pay taxes into the system; the first lump sum benefits were paid out in the same month in which Social Security taxes were first collected.[118]

The second connection is an eligibility link—retirement benefits are available only to people who have earned eligible wages for a sufficient length of time. The law makes no explicit connection between taxes paid and benefits received; the connection is implied by the earnings requirement in the benefits formula. The earnings that entitle individuals to benefits are the same earnings that are taxed under the payroll tax. Thus, a schematic overview of the relationship between payroll taxes and retirement benefits looks like this: workers pay a flat rate of tax on their wage earnings up to a maximum, which has risen with average earnings over time; in 2013, that amount

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[114] *See* Carolyn Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax during World War II*, 37 Buff. L. Rev. 685 (1988–89).

[115] As the Social Security Administration explains on its website, "FICA is nothing more than the tax provisions of the Social Security Act, as they appear in the Internal Revenue Code." *What is the Meaning of FICA*, Soc. Sec. Admin., http://ssa-custhelp.ssa.gov/app/answers/detail/a_id/392/~/what-is-the-meaning-of-fica (last modified Jan. 28, 2013), *archived at* http://www.perma.cc/0T7MdEWKDdM.

[116] *See id.*

[117] *OASDI and SSI Snapshot and SSI Monthly Statistics*, 72 Soc. Sec. Bull. 63, 67 (2012) (showing payroll tax collections and benefits disbursements). Of the 15.3% collected in tax on every dollar earned, the Social Security portion is 12.4%. This includes retirement security and disability payments. The other 2.9% is for health. *Social Security and Medicare tax rates; maximum taxable earnings*, Soc. Sec. Admin. (Sept. 12, 2012), http://ssa-custhelp.ssa.gov/app/answers/detail/a_id/240/~/social-security-and-medicare-tax-rates%3B-maximum-taxable-earnings, *archived at* http://perma.cc/0osUHY8Uctn.

[118] January 1937. *Frequently Asked Questions*, Soc. Sec. Admin., http://www.ssa.gov/history/hfaq.html (last visited Oct. 23, 2013), *archived at* http://www.perma.cc/0xukTDbSbwD.

is $113,700.[119] When a worker retires, a calculation is performed to determine retirement benefits.[120] If a worker begins collecting benefits at full retirement age (currently 66 years),[121] the monthly benefit amount is determined by averaging indexed monthly earnings over 35 years (AIME)[122] and applying a stepped formula to that amount. The formula provides a higher replacement rate for lower wages than for higher wages so that benefits constitute a greater percentage of pre-retirement income for low-income workers than for high-income workers.[123] This formula is progressive because lower earners receive benefits equal to a higher percentage of the tax base than higher income earners. But it is not as redistributive as it might be—both high and low earners receive a 90% match on their first dollars, and high earners receive substantially more total benefits than low earners. Low earners receive a higher percentage of their earnings in benefits, but high earners receive more dollars.[124]

The crux of the payroll tax mythology is that taxes on wages pay for benefits connected to wages. Benefits taxes are like fees for government services—individuals purchase the government services they personally enjoy. A benefits tax mimics a market transaction. The widely held, but mistaken, notion that Social Security is like private savings invites a benefits taxation framework: If the entitlement to retirement security comes from having paid explicitly for it with payroll taxes over a lifetime, then retirees are simply receiving what they bought, in a market sense. The problem with this justification is that payroll taxes do not fit so well into a fee-for-services

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[119] *Social Security and Medicare tax rates; maximum taxable earnings*, Soc. Sec. Admin., http://ssa-custhelp.ssa.gov/app/answers/detail/a_id/240/kw/113%2C700 (last modified Sept. 12, 2012), *archived at* http://perma.cc/0hjhWGtMtmT.

[120] *See* Soc. Sec. Admin, Your retirement Benefit: How it Is Figured (2013), *available at* http://www.ssa.gov/pubs/EN-05-10070.pdf, *archived at* http://perma.cc/0uayzRyCvER. .

[121] Full retirement age is currently 66, but it is scheduled to rise to 67 for individuals born after 1960. *Retirement Planner: Full Retirement Age*, Soc. Sec. Admin., http://www.ssa.gov/retire2/retirechart.htm (last visited Oct. 23, 2013), *archived at* http://perma.cc/0PaGCzscuTY.

[122] This stands for "average indexed monthly earnings." The amount is computed by indexing a worker's earnings to reflect changes in wage levels. *See Social Security Benefit Amounts*, Soc. Sec. Admin. http://www.socialsecurity.gov/OACT/COLA/Benefits.html#aime (last visited Oct. 23, 2013), *archived at* http://www.perma.cc/0QLvA3uMiPW.

[123] For new beneficiaries in 2013, benefits are 90% for the first $791 in AIME. Benefits rise by 32 cents per dollar for AIME between $791 and $4768, and rise further by 15 cents for AIME over that amount. *See Primary Insurance Amount*, Soc. Sec. Admin., http://www.socialsecurity.gov/OACT/COLA/piaformula.html (last visited Oct. 5, 2013), *archived at* http://www.perma.cc/0DYLkjpa7U.

[124] For example, an individual with AIME of $600 receives $540 in monthly benefits, while a person with an AIME of $5000 receives $2019 in benefits under the formula. (90% x $791) + (32% x $3977) + (15% x $232) = $711.90 + $1272.64 + $34.80 = $2019.34. *See id.* There is a minimum benefit, so low-earning retirees might receive more in benefits than this formula provides, but very few people qualify for the special minimum benefit. Cong. Budget Office, Social Security Policy Options 28 (2010), *available at* http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/115xx/doc11580/07-01-ssoptions_forweb.pdf, [hereinafter Social Security Policy Options], *archived at* http://perma.cc/0uN9viYTFhM.

model, and even if they did, benefits taxes are generally an undesirable tax scheme from the perspective of fairness.

The payroll tax does not operate like a benefits tax because the benefits received are not well correlated to the taxes paid. If payroll taxes "buy" retirement security, the price is arbitrary, depending on numerous factors including lifespan, income, and marital status. Early participants in the program received significantly more in retirement benefits than they had paid in taxes. In contrast, Social Security is a bad "investment" for numerous workers today because many individuals retiring now paid more in Social Security taxes than they will receive in retirement benefits.[125] For them, their contributions were in the nature of a pure tax. There are also substantial differences in the relationship between taxes and benefits among different demographic groups. Some groups, like non-working spouses of high-income taxpayers who receive widow benefits have disproportionally benefitted under the scheme.[126] Others, black men in particular, do not live long enough to collect a fair share of benefits compared to taxes paid.[127] Although workers earn credits for their earnings, and those credits entitle them to benefits, the amount of tax that pays for credits is not uniform. It differs for high and low-income taxpayers, and has changed over time. The payroll tax rate has risen, as has the maximum taxable earning base, so there is no uniform benefit for taxes paid into the system.[128] Benefits are not guaranteed or transferrable. One of the key features of the system, the redistributive nature of the benefits formula, undermines the market model—high-income workers and two-earner couples subsidize lower-income workers and single-earner families.[129] These facts illustrate the capricious price of the Social Security "market."

The theory of benefits taxation requires taxation of individuals according to benefits received. While the current tax system links costs and benefits for groups like families and income cohorts, benefits taxation dictates that benefits and costs must correspond for individuals as well. Generalization across groups undermines the purpose of benefits taxation, which is a

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[125] *See generally* C. Eugene Steuerle & Caleb Quakenbush, Urban Inst., Social Security and Medicare Taxes and Benefits Over a Lifetime (2012), *available at* http://www.urban.org/UploadedPDF/412660-Social-Security-and-Medicare-Taxes-and-Benefits-Over-a-Lifetime.pdf, *archived at* http://perma.cc/0SftNL76KMP.

[126] Karen Smith et al., *Lifetime Distributional Effects of Social Security Retirement Benefits*, 65 Soc. Sec. Bull. 33, 34 (2003–04).

[127] *See id.* at 59 tbl.9 (showing largest negative net benefits).

[128] *See Social Security & Medicare Tax Rates*, *supra* note 26.

[129] *See* Smith et al., *supra* note 126. The Social Security system has a variety of redistributive features involving high to low earners, younger to older generations, larger to smaller families, short-lived to longer-lived individuals, unmarried to married individuals, and people with longer careers to those with shorter careers. *See Reforming Social Security Benefits: Hearing on the President's and Other Bipartisan Entitlement Reform Proposals Before the H. Comm. On Ways and Means,* 113th Cong. 7 (2013) [hereinafter *Steuerle Statement*] (Statement of C. Eugene Steuerle, Inst. Fellow, Urban Inst., *available at* http://waysandmeans.house.gov/uploadedfiles/steuerle_testimony_52313.pdf (last visited October 5, 2013), *archived at* http://perma.cc/0HXU8DUMLP6.

rejection of redistribution. Consequently, each individual's benefits must be determinable and must correspond to taxes paid. This makes some sense when the benefit is garbage collection, but not when the benefit is retirement security. Retirement security is too abstract and indeterminate a benefit to be reduced on these terms; there is no individual connection between tax payments and benefits received. This is precisely why Social Security is an entitlement—individuals have the right to receive benefits, which is distinct from the right to receive a particular benefit. Individuals who have paid the same in payroll taxes can receive different amounts in benefits,[130] while others who receive the same in benefits could have paid different amounts in taxes.[131] All of these aspects of the system distinguish it from a real market transaction.

Even if the system better resembled a market, the benefits tax model would still present problems because government benefits are not easily quantified. Valuation difficulties make benefits taxation an indeterminate base because the measurement of government benefits is difficult since they are shared, in-kind, and variable. Without clear allocation of benefits to individuals, the proper distribution of the tax burden is impossible to specify. People who have considered benefits taxes generally have argued for very different applications in practice. Some have suggested that a benefits tax would be the same as a head tax,[132] or that it might look very much like a progressive income tax.[133] In the case of Social Security retirement, the "price" for benefits must be paid many years prior to the receipt of benefits. Is the benefit the actual amount of Social Security received over a lifetime, or is the benefit the security of a steady income until death, regardless of the actual amount paid out? These valuation problems arise in determining the right levy for payroll taxes under a benefits tax scheme, and using the tax's flat rate as a percentage of wages up to a cap is problematic at best.

Benefits taxation has enjoyed some popularity among libertarians. Richard Epstein has argued that taxation can only be justified when it creates a market-like Pareto improvement so that every taxpayer is better off with the goods and services provided by taxation than with the money paid in

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[130] Differing lifespans is the most common reason for this. Smith et al., *supra* note 126, at 39 ("The main reason OASI hurts retirees in the bottom income quintile is that their life expectancies are relatively short.").

[131] The benefits formula only considers a subset of all the years that most individuals pay into the system. *See* Temporary Regulations on Procedure and Administration under the Tax Reform Act of 1976, 26 C.F.R. § 404 (2012). Benefits are determined based on 35 years of a worker's highest earnings, so workers with more than 35 years of earnings receive no extra benefits. DAWN NUSCHLER, CONG. RESEARCH SERV., R42035, SOCIAL SECURITY PRIMER 7 (2013), *available at* http://www.fas.org/sgp/crs/misc/R42035.pdf., *archived at* http://perma.cc/08yNX19UjLY.

[132] *See* Walter J. Blum and & Harry Kalven Jr., The Uneasy Case for Progressive Taxation, 19 U. CHI. L. REV. 417, 452–53 (1952).

[133] *See* Marjorie Kornhauser, *The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction*, 86 MICH. L. REV. 465, 491–97 (1987).

tax.[134] However, benefits taxation has more often been rejected as a just basis for taxation in the literature.[135] John Stuart Mill scorned it as "the reverse of the true idea of distributive justice."[136] Thus, the payroll tax is not a good example of a benefits tax, and even if it were, benefits taxation is not a noble aspiration.

2. *Investors Are Virtuous*

Another argument for a wage base that excludes capital income is that savers are virtuous, and should be treated better under the tax law than non-savers. This argument is generally made in the context of the consumption tax-income tax debate. Proponents of consumption taxation have described taxes on capital income as double taxation,[137] and discrimination against savers.[138] Edward McCaffery has called taxes on wealth "virtue taxes."[139] The implication of these value-laden descriptions is that it is a moral imperative to tax capital income less than labor income. The double taxation and discrimination arguments depend on one's perspective.[140] While many tax policy experts debate the merits of a consumption tax compared to an income tax, the debate turns on many contingent factors.[141] Apart from this small interjection, this article will stay out of that morass.

The virtue argument is more recent and more puzzling. It may have been lurking in the literature all along, but McCaffery has made it explicit.[142] It is puzzling because a tax described in terms of "virtue" suggests a moral distinction on which taxation is based. We do not generally think of taxation that way, and it is a dangerous development if we start. As Justice Holmes once said, "taxes are the price we pay for civilized society."[143] Treating taxa-

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[134] A good system should "insure that every public expenditure is worth more to every party taxed than the revenues that are lost." Richard A. Epstein, *Taxation in a Lockean World*, 4 Soc. Phil & Pol'y, no. 1, 49, 56 (1986). Although Epstein was explicitly arguing for proportional taxation, his argument goes more to tax base than tax rate.

[135] *See* Kornhauser, *supra* note 133, at 491 n.96.

[136] Mill, *supra* note 102, at V.2.7.

[137] *Id.* at V 2.7–2.8.

[138] *See* David Bradford, Taxation, Wealth and Savings 30 (2000); David Bradford, Untangling the Income Tax 315 (1986); William Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 Harv. L. Rev. 1113, 1167 (1974).

[139] Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 Yale L. J. 283, 344 (1994) ("The estate tax is quite possibly an anti-sin tax, or, equivalently, a virtue tax. The estate tax is a tax on work and savings, on thrift, and on altruism.").

[140] *See* Mark Kelman, *Time Preference and Tax Equity*, 35 Stan. L. Rev. 649, 656 (1983) ("[D]ifferent accounts of the origin of interest may influence our position on whether ex post or ex ante treatment of income is 'appropriate.'").

[141] *See*, *e.g.*, Barbara Fried, *Fairness and the Consumption Tax*, 44 Stan. L. Rev. 961 (1992) (debating the merits of different conceptual frameworks for taxes); Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 Yale L.J. 1081 (1980) [hereinafter *Would a Consumption Tax Be Fairer*] (same).

[142] McCaffery, *supra* note 139, at 343.

[143] Compania Gen. de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927).

tion as a morality judgment is inconsistent with that approach. Almost everything that we tax is necessary to keep the economy going. As this article has described, labor is taxed more heavily than any other factor of production, and yet, work is the classic element in Protestant virtue.[144] Consumption is taxed also, and while some people believe consumption to be less virtuous than savings (if not downright evil), both investment and consumption are necessary for economic prosperity. A moralistic approach to tax policy that equates taxation with moral censure is a mistake that threatens to undermine the civic commitment to tax for the common good. There are good efficiency reasons to tax costly behaviors, and to subsidize beneficial ones, but it is important that the arguments are presented solely in terms of efficiency, rather than fairness.

Tax policy should primarily be about how the government raises the revenue that it needs to operate. Taxation is too important to survival of the modern state to be *solely* the tool of social engineering. It is not a coincidence that advocates of small government are also proponents of taxes on bad side effects—so-called Pigouvian taxes.[145] Pigouvian taxes are designed to account for negative externalities imposed by taxed activities, such as pollution and smoking. For people who value efficiency as a social objective, Pigouvian taxes are normatively desirable because they correct imperfect markets to make them more efficient. In that way, they are unlike most other taxes, which have net efficiency costs, not benefits.[146] Nonetheless, there are very few Pigouvian taxes actually in effect[147]—even carbon taxes have little political traction, despite their clear economic benefits. While humorists have suggested taxing all manner of annoyances,[148] the universe of Pigouvian taxes—focusing on the externalities suffered by non-taxpayers—is limited, and it would be impossible to raise sufficient revenue to fund government policy if we narrowed the tax base to Pigouvian taxes alone. Pigouvian taxes are an attractive mechanism for regulation, but cannot substitute for broad taxation designed according to principles of justice.

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[144] *See generally* MAX WEBER, THE PROTESTANT ETHIC AND THE SPIRIT OF CAPITALISM (1905).

[145] *See* N. Gregory Mankiw, *Smart Taxes: An Open Invitation to Join the Pigou Club*, 35 E. ECON. J. 14 (2009).

[146] *See* RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 277–95 (5th ed. 1989) (explaining the problem of deadweight loss from taxation).

[147] Taxes on cigarettes that account for the harm of second-hand smoke on non-smokers are an example of a Pigouvian tax, but cigarette taxes that account for damages to smokers are less clearly Pigouvian. Taxes that increase costs to correct for psychological biases of the taxpayer are less clearly Pigouvian. *See* Jeff Strand, *Conceptualizing the "Fat Tax": The Role of Food Taxes in Developed Economies*, 78 S. CAL. L. REV. 1221, 1255–59 (2005).

[148] Jasper Reitman, *Should We Tax People for Being Annoying?*, N.Y. TIMES SUNDAY MAGAZINE, Jan. 8, 2013, at MM15, *available at* http://www.nytimes.com/2013/01/13/magazine/should-we-tax-people-for-being-annoying.html, *archived at* http://perma.cc/0zuBm2ZD5Zr (a cartoon showing the taxation of people singing in the shower, playing video games, keeping a pet, etc.).

3. *Taxes Should Improve Efficiency*

Since most taxes have efficiency costs, not efficiency benefits, an argument to tax for efficiency maximization is really an argument for less taxation—the most efficient tax is generally none at all. Consequently, the evaluation of taxes for efficiency is more fruitfully a comparison of relative costs. Most arguments supporting tax preferences for capital income are efficiency arguments: they concern incentives to save and invest. Taxes on capital income reduce the after-tax rate of return on capital. In response to the tax, some people might save less and earn less, while others might save more to earn more.[149] Scholars have argued that the costs of taxing capital income are too high, and believe that a tax on labor income should raise all the needed revenue.[150] But their argument depends on a value judgment that eliminating market distortions is more important than other goals—a dubious proposition for defining just government.

Some ostensible fairness arguments are really efficiency arguments in disguise—when efficiency is embraced as a normative goal, more efficient means more just.[151] For example, the claim that an income tax discriminates against savers compared to spenders is really an argument about interest rates, not distributive justice, because it compares rates of return in a world with taxes to one in a world without taxes.[152] The rate of return in a world without taxes has no moral significance in the real world, and creates no pre-social property entitlement to investors.

The "common pool"[153] argument that supports taxing only on withdrawal from investment gives an impression of being about individual fairness for people who benefit others, but it is really about economic growth. That argument says that amounts invested in the economy benefit everyone, not just the owner, and that only amounts withdrawn from investment are really private. Consequently, capital should not be taxed as long as it is en-

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[149] These are the income and substitution effects, which counteract one another. *See* LAURIE MALMAN ET AL., THE INDIVIDUAL TAX BASE: CASES, PROBLEMS AND POLICIES IN FEDERAL TAXATION 10 (2d ed. 2010).

[150] *See* Joseph Bankman & David Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006) (arguing that a tax on labor income alone is more efficient and fairer than a tax on both labor and capital income).

[151] To some, fairness means promoting growth. *See Tax Reform to Encourage Growth, Reduce the Deficit, and Promote Fairness: Hearing Before the S. Comm on the Budget*, 112th Cong. (2012) (statement of Daniel J. Mitchell, Senior Fellow, Cato Inst.), *available at* http://www.cato.org/publications/congressional-testimony/tax-reform-encourage-growth-reduce-deficit-promote-fairness, *archived at* http://perma.cc/0UscSQP2kgJ. Normative arguments for efficiency require justification in terms of political morality. *See* MURPHY & NAGEL, *supra* note 104, at 12.

[152] *See* Warren, *Would a Consumption Tax Be Fairer*, *supra* note 139.

[153] John Stuart Mill described it as follows: "they abdicate the personal use of their riches; in proportion as they divert their income from the supply of their own wants, to a productive investment, through which, instead of being consumed by themselves, it is distributed in wages among the poor." MILL, *supra* note 102, at V.2.22.

gaged in production.[154] The contemporary notion of private property makes it difficult to see this communal aspect of investments, particularly given that investments can foster productivity (or not) anywhere in the world. More important to rejecting the fairness claims of the common pool is the fact that a larger total economic pie does not necessarily make everyone's slice bigger.[155] The rising tide has definitively not lifted all boats. In addition, consumers—as well as investors—are necessary for economic prosperity. In fact, too much saving can slow down the economy.[156] The recent recession has proved the importance of demand to economic recovery, so a healthy supply of capital is not sufficient.[157] Spenders and savers are economically interdependent and essential to one another, and privileging savings has economic and distributional costs.

Despite some commentators' enthusiasm for taxing only labor income—and the tax law's undeniable shift in that direction—the jury is still out on the efficiency advantages of taxing only labor income, compared to taxes on both investment income and labor income.[158] Economists have generally concluded that taxes have little effect on savings behavior.[159] A Congressional Research Service report even noted that "[r]elationships between tax rates and savings appear positively correlated (that is, lower savings are consistent with lower, not higher, tax rates), although this relationship may not be causal."[160] In addition, there are some well-known inefficiencies that weigh against privileging capital income. Current law's preference for capital income over labor income encourages taxpayers to convert labor income

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[154] It is well known that tax deferral is equivalent to yield exemption. *See* E. Cary Brown, *Business-Income Taxation and Investment Incentives*, *in* INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300, 302–14 (1948). For further explanation, *see generally* Christopher Hanna, *Demystifying Tax Deferral*, 52 SMU L. REV. 383 (1999).

[155] Productivity gains in the last decades have gone only to those at the very top. *See* CONG. BUDGET OFFICE, TRENDS IN THE DISTRIBUTION OF HOUSEHOLD INCOME BETWEEN 1979 AND 2007 10 (2011), *available at* http://www.cbo.gov/sites/default/files/cbofiles/attachments/10-25-HouseholdIncome.pdf, *archived at* http://perma.cc/023berB8skm. *See generally* EMMANUEL SAEZ, STRIKING IT RICHER: THE EVOLUTION OF TOP INCOMES IN THE UNITED STATES (UPDATED WITH 2011 ESTIMATES) (2013), *available at* http://elsa.berkeley.edu/~saez/saez-UStopincomes-2011.pdf, *archived at* http://perma.cc/0tBG6KZDoBf.

[156] *See* TSUYOSHI OYAMA & KOTARO YOSHIDA, BANK OF JAPAN, DOES JAPAN SAVE TOO MUCH? OR DO OTHER MAJOR COUNTRIES SAVE TOO LITTLE? INTERNATIONAL COMPARISON OF SAVINGS RATES FROM THE MODIFIED GOLDEN RULE APPROACH 4 (1999); International Monetary Fund, *Saving Behavior and the Asset Price "Bubble"*, *in* JAPAN: ANALYTICAL STUDIES 5–8 (Ulrich Baumgartner, Guy Meredith & Juha Kähkönen eds., 1995).

[157] There is currently a glut of capital, as U.S. companies hoard cash and borrow at historically low rates. Apple recently borrowed $17 billion, even though it has $145 billion in cash. *See, e.g.*, Peter Lattman & Peter Eavis, *To Satisfy Its Investors, Cash-Rich Apple Borrows Money*, NY TIMES, May 1, 2013, at B1, *available at* http://dealbook.nytimes.com/2013/04/30/apple-raises-17-billion-in-record-debt-sale, *archived at* http://perma.cc/0aWf8k6MgPz.

[158] *Compare* Joseph Bankman & David Weisbach, *supra* note 150, *with* Chris Sanchirico, *A Critical Look at the Economic Argument for Taxing Only Labor Income*, 63 TAX L. REV. 867 (2010).

[159] JANE GRAVELLE & DONALD J. MARPLES, CONG. RESEARCH SERV., R42111, TAX RATES AND ECONOMIC GROWTH, 7 (2011) (reviewing literature on the topic).

[160] *Id.* at summary.

into capital income.[161] It discourages investment in people, compared to investment in equipment. The higher individual rate of tax on individual compensation encourages what Professor Edward Kleinbard has called "labor stuffing," which disguises labor earnings as capital income.[162]

Instead of engaging in a debate about economics, which has largely defined the terms of discussion about taxing labor and capital (even when argued by lawyers), lawyers should consider the proper context for efficiency in analyzing tax policy. Particularly where economists have concluded that efficiency differences among alternatives are small,[163] important tax policy questions should be judged for fairness rather than efficiency. The tax law is a very powerful tool for distributive justice, and almost always a source of inefficiency in the market, so in evaluating tax policies where efficiency differences among alternatives are small, we should be more concerned about fairness than efficiency.[164]

4. *It Is Hard To Tax Capital Income And Easy To Tax Labor Income*

Ease of collection may be the most compelling reason for taxing wages heavily, but it is a bad reason nonetheless. Capital income is hard to tax and labor income is easy to tax. The payroll tax is a paragon of administrative simplicity. Government has a collection agent in employers: they are required to collect the tax and remit it on behalf of employees. Withholding means that employees never get the opportunity to hide their earnings, so they cannot evade the payroll tax.[165] The people actually paying the tax are

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[161] This is a problem that proponents of consumption taxation have faced. The exemption of returns to capital encourages taxpayers to disguise labor income as capital income. *See* DAVID BRADFORD, BLUEPRINTS FOR BASIC TAX REFORM 117 (2d ed. 1984) (requiring that owners of small businesses include amounts on cash-flow basis in a consumption tax to ensure that labor not be subsumed within capital and free of tax). The same problem arises whenever labor income is more heavily taxed than capital income.

[162] Where labor income is taxed more heavily than capital income, business owners have an incentive to transform their labor income into capital income by characterizing returns to work in the business as returns to capital invested in that business. The strategy reduces the tax collected on the income. This is particularly problematic when tax rates on individual labor income are substantially higher than tax rates on corporations. *See generally* Edward D. Kleinbard, *Corporate Capital and Labor Stuffing in the New Tax Rate Environment* (Univ. S. Cal. Ctr. L. & Soc. Sci. Research Paper No. C13-5, 2013), *available at* http://ssrn.com/abstract=2239360.

[163] *See* GRAVELLE & MARPLES, *supra* note 159, at summary ("A review of statistical evidence suggests that both labor supply and savings and investment are relatively insensitive to tax rates.").

[164] I have critiqued the centrality of efficiency in tax policy. *See generally* Linda Sugin, *Tax Expenditures, Reform and Distributive Justice*, 3 COL. J. TAX L. 1, 35–39 (2012); Linda Sugin, *The Great and Mighty Tax Law: How the Roberts Court Has Reduced Constitutional Scrutiny for Taxes and Tax Expenditures*, 78 BROOK. L. REV. 777 (2013).

[165] Employees need the cooperation of their employers to evade payroll taxes, who must be willing to pay them "off the books" and incur the risks that accompany it. Employers who fail to collect payroll taxes and remit them to the government are liable for substantial penalties, sometimes including criminal liability. *Examples of Employment Tax Fraud Investigations*

not directly involved in the transaction at all. Unlike the income tax, there is no pretense that payroll taxes are part of a self-reporting system. All this means that it may be *too* easy to tax wages, and consequently, revenue pressures may have made taxes on labor income irresistible.

From a collection perspective, income taxes on wages are only slightly more cumbersome than payroll taxes. Employers also withhold income taxes on wages, and there is rarely a difficult calculation about how much an employee's wages are. Employees can deduct and credit various things from their income for income tax calculation, but every dollar of wage is included in taxable income, and taxpayers do not need to figure how much that is because employers report it on their form W-2s. There is virtually no gap between tax collections and tax liability for employee wages. However, the tax gap is large for individuals who work for themselves and consequently self-report their labor income.[166] While self-employment income is theoretically taxed in the same way as wage income of employees, in practice, it is often taxed less. People who work for themselves can understate their labor income by failing to report a portion of earnings, and can also mischaracterize labor income as income from capital in order to pay lower rates of tax on it.[167] In addition, there are questionable legal strategies used by high-income people to minimize their self-employment tax liability, which is the counterpart to employee payroll taxes.[168]

Compared to employee wages and even self-employment labor income, income from capital is infinitely harder to determine and considerably easier for taxpayers to minimize or hide. Capital income taxation relies on taxpayers to keep records, and self-report accurately and honestly. William Andrews' preference for a consumption tax over an income tax was based largely on his view that an accurate income tax would be too difficult to design and administer. He argued that the accretion component of income is

- *Fiscal Year 2012*, INTERNAL REV. SERV., http://www.irs.gov/uac/Examples-of-Employment-Tax-Fraud-Investigations-Fiscal-Year-2012 (last updated Sept. 17, 2013), *archived at* http://perma.cc/0oyNuwcSRAf.

[166] A recent IRS study estimates the annual tax gap to be roughly 15% of the total taxes owed (between $257 and $298 billion dollars. The bulk of the tax gap comes from individuals failing to report business activity income, and not wages. Wage earners, as a subset of taxpayers, have an estimated tax gap of only 1.5%. *New IRS Study Provides Preliminary Tax Gap Estimate*, INTERNAL REV. SERV., http://www.irs.gov/uac/New-IRS-Study-Provides-Preliminary-Tax-Gap-Estimate (last updated March 29, 2005), *archived at* http://perma.cc/0RaZTWnKTNm. *See generally* INTERNAL REV. SERV., TAX GAP FACTS AND FIGURES (2012), *available at* http://www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf, *archived at* http://perma.cc/0S7T9UUip7b.

[167] The self-employment tax covers a slightly different base than the payroll tax, so that it taxes some income from capital, but not all income from labor. *See* CONG. BUDGET OFFICE, THE TAXATION OF CAPITAL AND LABOR THROUGH THE SELF-EMPLOYMENT TAX v (2012), *available at* http://www.cbo.gov/sites/default/files/cbofiles/attachments/09-27-SECA.pdf, *archived at* http://perma.cc/0tos28VEYmU.

[168] Presidential candidates John Edwards and Newt Gingrich both used S corporations to evade SECA tax on their labor earnings. *See* Cherie J. Hennig, Blaise M. Sonnier, William A. Raabe, & John O. Everett, *S Corp Taxation: Level the Playing Field*, 139 TAX NOTES 435, 436 (2013).

too challenging for practical taxation, particularly if we try to accommodate inflation, interest rate changes, and human capital.[169]

In the current income tax system, where capital income is theoretically included in the tax base, its actual inclusion often depends on taxpayer acquiescence. As discussed above, the realization rule makes a current tax on gains voluntary—taxpayers can decide not to sell assets if they want to defer tax. They can even get cash without paying tax: it is perfectly legal to borrow against one's assets without current tax, even if that borrowing allows current consumption to be financed with untaxed funds.[170] Another simple and legal strategy for taxpayers with capital is offshore investment. Taxpayers with assets and income overseas can leave their earnings offshore and defer the tax on them.[171] Better advised taxpayers can engage in more complex tax planning, but there are plenty of simple strategies available to avoid current tax on investments because current law is generous to capital holders.

Sometimes avoiding tax on investments is not legal, but easy to accomplish for taxpayers with investment income. Taxpayers have historically self-reported their basis in assets inaccurately.[172] An overstatement of basis produces an understatement of income, and until financial institutions start reporting investment basis to the government, taxpayers can inflate their bases for determining gain on investment with little recourse for the government.[173] Jurisdictions with bank secrecy rules have historically made it easy for taxpayers to hide their earnings from the authorities.[174] New legal rules

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[169] William Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 Harv. L. Rev. 1113, 1143–46 (1974).

[170] *See* Edward McCaffery, *A New Understanding of Tax*, 103 Mich. L. Rev. 807, 892–93 (2005) ("buy, borrow, die").

[171] For an overview of how United States taxes income earned abroad, *see* Joint Comm. Taxation Staff, 112th Cong., Background And Selected Issues Related To The U.S. International Tax System And Systems That Exempt Foreign Business Income 2–7 (2011), *available at* https://www.jct.gov/publications.html?func=startdown&id=3793 ("Foreign business income earned by a domestic parent corporation indirectly through a foreign corporate subsidiary generally is not subject to U.S. tax until the income is distributed as a dividend to the domestic corporation.").

[172] *See* U.S. Gov't Accountability Office, GAO-06-603, Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed, 1 (2006), *available at* http://www.gao.gov/assets/260/250426.pdf, *archived at* http://perma.cc/0wjkdArNq9K.

[173] New requirements under I.R.C. § 6045(g) (Supp. III, 2009), adopted in the Energy Improvement and Extension Act of 2008 §403, Pub. L. No. 110-343, 122 Stat. 3765, requires basis reporting, but the effective date has been postponed to 2014. *See* I.R.S. Notice 2012-34, 2012-21 I.R.B. 937. Regulations implementing the requirements were recently adopted. *See* Basis Reporting by Securities Brokers and Basis Determination for Debt Instruments and Options; Reporting for Premium, 78 Fed. Reg. 23, 116 (Apr. 18, 2013) (to be codified at 26 C.F.R. pt. 1, 602). *See generally* James M. Bickley, Cong. Research Serv., RL34216, Tax Gap: Proposals in the 110th Congress Require Brokers to Report Basis on Traded Securities (2008), *available at* http://assets.opencrs.com/rpts/RL34216_20081008.pdf, *archived at* http://perma.cc/0pVvp5MMLoG.

[174] Some progress has recently been made to relax these rules for tax administration. *See* Andrew Higgins, *Europe Pushes to Shed Stigma of a Tax Haven*, N.Y. Times, May 23, 2013,

crack down on overseas investments,[175] but tax havens are still in the business of helping taxpayers shelter their income from the IRS.[176]

One goal of good tax policymaking is administrative effectiveness. Ease of administration and costs of collection are part of the efficiency analysis of taxation, though not its central concern in the tax policy literature. Efficiency analysis is primarily about the behavioral distortions produced by taxation—how taxes on savings discourage investment, for example. These issues are extensively analyzed and debated in the scholarly literature, but administrative convenience is mostly taken for granted in a way that elevates it in practical application.[177] If we had to justify taxing wages on the ground that they are easy to tax, we might see what a bad argument convenience really is. But the administrative ease of taxing workers—for the government and the ultimate taxpayers—may best explain why taxes on wages collected by employers are so universal.[178]

D. *Taxing Capital Income As Much As Labor Income Promotes Justice*

In the last section, I analyzed some of the arguments in favor of the current system. While the arguments are plausible explanations for a separate payroll tax, and for taxing labor income more than capital income, they ultimately fail to justify the distribution of tax burdens in current law's combination of payroll taxation and income taxation. This section focuses more specifically on fairness arguments. It considers the distinguishing characteristics of labor income and capital income in order to evaluate whether one should be more heavily taxed than the other on fairness grounds. I start by noting that income is a tax base replete with equity concerns.[179] One fairness argument regarding income taxation is that every dollar of income should be taxed once, and only once, so an income tax is inconsistent with taxing some sources of income multiple times and other sources of income less than once. In addition, there are timing differences in earnings and consumption, and capital income requires that a taxpayer wait to consume. Tax scholars

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at A1, *available at* http://www.nytimes.com/2013/05/23/world/europe/europe-pushes-to-shed-stigma-of-tax-haven-with-end-to-bank-secrecy.html?_r=0, *archived at* http://perma.cc/0Xq8KAQ65s1.

[175] *See* Foreign Account Tax Compliance Act (FATCA), I.R.C. §§ 1471–1474 (Supp. V 2011) adopted as part of The Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147, 124 Stat. 71.

[176] *See* Melissa Costa & Jennifer Gravelle, *Taxing Multinational Corporations: Average Tax Rates*, 65 TAX L. REV. 391, 399 (2012) (average tax rates of U.S. controlled foreign corporations in tax havens vary from 1.9% to 9.2%).

[177] Tax literature for a more public audience considers these issues in depth. *See* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES 157–188 (3rd ed. 2004).

[178] All OECD countries have wage taxes. *See Taxing Wages 2013*, OECD, http://www.oecd.org/ctp/tax-policy/taxing-wages.htm (last visited Oct. 25, 2013), *archived at* http://perma.cc/06SdsqSWkny.

[179] A full defense of an income tax base is beyond the scope of this article.

reflexively treat present values as equivalent for all purposes, but I argue that present value is not a normative concept, so that fairness for individual taxpayers does not demand that equal present values be taxed the same. Finally, labor income and capital income involve individuals differently. Because labor income requires work, it exemplifies individual autonomous choice and demands unique non-substitutable investment of the person. This ultimate reason may be the most important for my conclusion that fairness demands that capital income be taxed (at least) as heavily as labor income.

1. Income Is a Normatively Attractive Tax Base

The federal income tax was enacted in 1913, after the Constitution was amended to specifically authorize it.[180] Even prior to the adoption of the sixteenth amendment, Congress' power to tax was substantial,[181] and the government had ample capability to raise revenue. Nevertheless, the federal power to tax *income* was considered sufficiently important to national policy to warrant constitutional amendment. The income tax was originally adopted because it was considered "the most 'equitable' form of taxation."[182] In the Congressional debates that led to the adoption of the ill-fated 1894 income tax, legislators "recognized the injustice of imposing the full cost of government on those of limited means—farmers and workers—through the regressive system of protective tariffs and excises while largely exempting capital from taxation."[183] Today's statute follows that approach, by prohibiting source distinctions for income,[184] and thereby making the difference between labor income and capital income irrelevant. The section lists examples of what is included in the definition of "gross income," and it specifically mentions both income from labor[185] and income from capital.[186]

The normative reasons for adopting an income tax remain compelling today: income is a desirable tax base because it allocates tax burdens based on ability to pay and demands equal sacrifice from everyone.[187] Proponents of income taxation today, including this author, generally believe that an income tax is the most realistic way to tax the rich more than the poor, something a fair tax system must do.[188] In an income tax, those with greater abilities to pay tax are called on to contribute more to the collective welfare

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[180] U.S. Const. amend. XVI.

[181] U.S. Const. art. 1, § 8.

[182] Sheldon Pollack, *Origins of the Modern Income Tax, 1894–1913*, 66 Tax Law. 295, 295 (2013) ("Not only did many Republicans approve these new tax policies, the arguments they advanced in support of the income tax were commonly framed in terms of 'equity,' 'justice,' and 'fairness.' ").

[183] *Id.* at 304.

[184] Income includes "all income from whatever source derived" according to I.R.C. § 61(a)(1) (2006).

[185] *Id.*

[186] IRC §§ 61(a) (2006).

[187] *See* Allen Gunn, *The Case for An Income Tax*, 46 U. Chi. L. Rev. 370, 385 (1978–79).

[188] *See* Calvin Johnson, *We Don't Need No Stinkin' VAT*, 139 Tax Notes 527, 529 (2013).

than those with lesser abilities to pay tax. Because the marginal value of money declines as an individual's resources grow, the burden of taxation is equitably distributed when the rich pay more dollars; everyone feels an equal degree of pain from taxation.[189] The income base reflects the notion that "it is the taxpayer's claim to resources . . . that best measures his ability to bear tax."[190] It reflects the principle that people should contribute to the common good according to how much they have, and considers accumulation in investments part of a taxpayer's ability to contribute to the common good.[191] "Levying the tax on income is . . . simply a logical concomitant of the proposition that society in general has a claim on its annual product that is prior to the claims of its individual citizens."[192] An income tax also maximizes the opportunity for self-realization and democratic participation, compared to alternative tax bases.[193] Resources include all sources of income; a tax on labor income alone would allow those with greater resources from non-labor sources to bear a lesser overall burden.

Income might not be the only measure of ability to pay tax. Some have argued that endowments are the best measure of ability to pay tax,[194] and others have suggested that wealth is a superior measure.[195] While wealth, rather than income, might be a better measure of ability to pay,[196] the drafters of the income tax and the adopters of the sixteenth amendment were not crazy in thinking that an income tax better reflected Adam Smith and John Stuart Mill's maxims of fair taxation than what they replaced, a system primarily composed of excises and tariffs.[197] Income is a reasonable measure of ability to pay because it reflects economic resources that benefits a person

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[189] John Stuart Mill explained: "As a government ought to make no distinction of persons or classes in the strength of their claims on it, whatever sacrifices it requires from them should be made to bear as nearly as possible with the same pressure upon all, which, it must be observed, is the mode by which least sacrifice is occasioned on the whole." MILL, *supra* note 102, at V. 2.6.

[190] Calvin Johnson, *Measure Tax Expenditures by Internal Rate of Return*, 139 TAX NOTES 273, 286 (2013).

[191] *See* Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 TAX L. REV. 423, 463 (2000).

[192] *See* Warren, *Would a Consumption Tax Be Fairer*, *supra* note 141, at 1090. A review of the justifications for an income tax are beyond the scope of this article, but there is a rich literature on it.

[193] James Repetti, *Democracy and Opportunity: A New Paradigm in Tax Equity*, 61 VAND. L. REV. 1129, 1132, 1154 (2008).

[194] *See* Daniel Shaviro, *Endowment and Inequality*, *in* TAX JUSTICE: THE ONGOING DEBATE 123 (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002). I am critical of the endowment tax ideal. *See* Sugin, *Philosophical Objection*, *supra* note 106.

[195] An income tax does tax wealth. *See* Noel Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 Tax L. Rev. 17, 19–20 (1996).

[196] *See* Warren, *Would a Consumption Tax Be Fairer, supra* note 141, at 1122; Schenk, *supra* note 191, at 463–66.

[197] *See generally* CARL DAVIS ET AL., THE INSTITUTE ON TAXATION & ECONOMIC POLICY, WHO PAYS? A DISTRIBUTIONAL ANALYSIS OF THE TAX SYSTEMS IN ALL 50 STATES (4th ed. 2013) *available at* http://www.itep.org/pdf/whopaysreport.pdf, *archived at* http://perma.cc/0gZx3LX1cg6.

and over which he has control.[198] The architects of the income tax system treated command over acquired resources—from any source—as the appropriate measure of taxation. They were not mistaken to do so.[199]

2. *Labor Income is Doubly Taxed*

Our federal tax system does not just tax labor income, it taxes it twice, once under the payroll tax and again under the income tax. Although incomes exceeding the statutory cap are not taxed under the payroll tax, every dollar taxed under the payroll tax is also included in gross income for purposes of calculating income tax. The double-tax argument is an intuitive feature of tax policy discussions, along with the assumption that a double tax is unjust. Nevertheless, there is not anything intrinsically meaningful in whether a dollar is taxed once or twice—the same dollar is often taxed multiple times by different governments or to different taxpayers. What is important is the overall burden that the government imposes on individuals, and a double tax by a single tax collector is important if it indicates that a person is being taxed too heavily overall. Identifying the double tax on labor income is important because people treat the payroll tax as an insurance contribution, and consequently fail to include it as part of the total tax burden.

The double tax allegation has proved powerful. In debating possible repeal of the estate tax, people argued that the estate tax is unfair because it is a double tax on income previously taxed under the income tax.[200] The double tax argument is peculiar with respect to the estate tax since much of the estate tax base consists of untaxed appreciation under the income tax;[201] built-in gains at the time of death are permanently exempt from income taxation because the decedent's heirs receive the asset with a date of death basis for income tax purposes. Those gains are never taxed to anyone under the income tax. Consequently, the estate tax is an *alternative* to the income tax for a substantial amount of income—whenever an asset is taxed under the estate tax, but stepped up in basis under the income tax, the gain reflected in the step-up is taxed only in the estate tax.

[198] This is also the Supreme Court's definition of income. Commissioner v. Glenshaw Glass, 348 U.S. 426, 477 (1955) ("Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.").

[199] Debates about other bases are beyond the scope of this article because this article focuses on the narrower question of whether different sources of income should be taxed differently in a just system. Whether different uses of income should be subject to differential taxation is an independent question.

[200] *See* 160 Cong. Rec. H4084 (daily ed. June 8, 2000) (statement of Rep. Dreier).

[201] In 2000, 36% of taxable estates were unrealized capital gains. The ratio of unrealized capital gains increased as the size of the estate increased. For estates exceeding $10 million an average of 56% of the estate was unrealized capital gains. James M. Poterba & Scott Weisbenner, *The Distributional Burden Of Taxing Estates And Unrealized Capital Gains At The Time Of Death* 18–19 (Nat'l Bureau of Econ. Research, Working Paper No. 7811, 2000).

Similarly, some claim that a tax on investment returns is a double tax on the invested capital,[202] even though there are different dollars—the invested amount and the return—to which the tax applies. The argument is that the after-tax rate of return on an investment is reduced by tax imposed on that return, and gives the taxpayer the arithmetic equivalence of a greater tax on the corpus (and no tax on the return). While the arithmetic works, the unstated assumption is that present value is important for fairness. But that case has not been made.

Finally, some argue that investment returns should be taxed less or untaxed to individual investors because those dollars have already been taxed to the investors under the corporate tax. The data simply do not support this argument. First, corporate tax collections are low, and while the statutory rate is 35% for large corporations, the effective rate of tax that corporations pay is substantially lower than the 39.6% top rate on labor income, so even if all corporate income were taxed, it would be subject to a lesser burden than labor income. Second, economists disagree about whether capital holders even bear the burden of the corporate tax.[203] Some claim that labor really bears the tax,[204] which, if true, makes it even more troubling that our system explicitly taxes workers so heavily. If workers implicitly pay the corporate tax, then the fairness claim for increasing taxes on individual holders of capital becomes even stronger.

3. *Present Value Is Not a Normative Concept*

The financial concept of present value is crucial in tax policy. Present value allows us to compare dollars from different moments in time. I can

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[202] *See* MILL, *supra* note 102, at V. 2.22 ("[A]s the savings pay at any rate the full tax as soon as they are invested, their exemption from payment in the earlier stage is necessary to prevent them from paying twice, while money spent in unproductive consumption pays only once . . . .").

[203] *See generally* Kimberly Clausing, *Who Pays The Corporate Tax In A Global Economy*, 66 Nat'l Tax J. 151 (2013). That volume includes other articles discussing this issue. *See also Mirrlees Review*, INST. FOR FISCAL STUD., *available at* http://www.ifs.org.uk/mirrleesReview (last visited Oct. 25, 2013), *archived at* http://perma.cc/0oE1mp4dgwx.

[204] The argument stems from the relative mobility of capital and labor, and there is no consensus among economists. It is possible that capital competes worldwide, making it impossible for the U.S. to prevent companies from shifting the costs of a tax from its owners to its workers, who are less able to relocate to minimize tax. *See generally* Mihir Desai, *A Better Way to Tax U.S. Businesses,* HARV. BUS. REV. (July-Aug 2012) (advocating the labor-burden view), *available at* http://hbr.org/2012/07/a-better-way-to-tax-us-businesses/ar/1, *archived at* perma.cc/0CPnXBF5oG9. For a full explanation of the issue and how it might affect the progressivity of the tax, see generally BENJAMIN HARRIS, TAX POL'Y CTR., CORPORATE TAX INCIDENCE AND ITS IMPLICATIONS FOR PROGRESSIVITY (2009), *available at* http://www.taxpolicycenter.org/UploadedPDF/1001349_corporate_tax_incidence.pdf, *archived at* http://perma.cc/0Mekb6jJeVH. In its distribution tables, the Tax Policy Center assumes that the corporate tax is borne 60% by shareholders, 20% by all capital holders and 20% by labor. Prior to September 2012, it assumed that the entire incidence was on capital holders. *See* Urban Inst. & Brookings Inst., *TPC's Microsimulation Model FAQ*, TAX POL'Y CTR., http://www.taxpolicycenter.org/taxtopics/Model-FAQ-2013.cfm#q9 (last visited Oct. 23, 2013), *archived at* http://perma.cc/0wzxUWaQNk2.

pay tax today or tomorrow, and if the government charges me interest for paying later, the timing of the liability should not matter. If prevailing interest rates are 10% (and there is no inflation), a dollar today becomes $1.10 a year from now. One dollar today is the present value of $1.10 next year. What, if anything, does that imply about fair taxation?

Scholars generally assume that equivalent present values are the same, but equivalent is not the same. The present value of a dollar is not really the same thing as the dollar itself, even though we conventionally treat them as economically equivalent. It is reasonable to use the concept of present value to compare prices, but the concept of present value is financial, not normative. Present value is about accounting, not justice. Accepting a normative imperative from present value concepts demands that normal returns to investment be exempt from tax. That means that a dollar after-tax today should be $1.10 after-tax a year from now. But why imbue a financial concept with normative force? Utilitarians have argued that the return is not a real accretion to wealth because it is offset by the loss of welfare involved in waiting.[205] By exempting the return to capital, the tax system compensates the taxpayer for his pain from waiting—exclusion operates like a deduction that offsets the money income. This is not an uncontested fact. Mark Kelman's analysis of the utility of individuals who consume at different times suggests that the implied deduction might not be appropriate from a utilitarian perspective.[206]

Even if there is pain in waiting that the tax system should acknowledge, it cannot explain why labor income is taxed more heavily than capital income. If the tax system accounts for the pain in waiting inherent in capital income, it should also account for the pain in producing labor income. There is real pain in working, and a tax system that accurately measures various sources of disutility in income production might well treat the pain of working as deserving a bigger tax discount than the pain in waiting.

4. *Labor Income Reflects Personal Agency*

Equality demands that government "design[ ] institutions that guarantee equal concern and respect for everyone."[207] Part of guaranteeing equal concern and respect is allowing each person "to develop her own conception of a meaningful life."[208] Work is an integral aspect of an individual's self-conception, and an important component in creating a meaningful life. People are emotionally connected to their work and their chosen occupation is important in defining who they are. This is why work is so important to fairness and why a particular respect for work should inform the design of

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[205] *See* Mark Kelman, *supra* note 140, at 653.
[206] *Id.*
[207] Sugin, *Philosophical Objection*, *supra* note 106, at 239.
[208] *Id.* This conception of the role of government is a liberal-egalitarian one.

the tax base. A just government taxes in a way that allows individual development and personal expression through work. The tax system must acknowledge the special role of labor in contributing to personal autonomy, and must guarantee that individuals receive the fruits of their labor to the extent necessary to make their work (and life more generally) meaningful.

There is substantial room for taxing wages within this framework. Justice creates outer limits for taxation, but allows a broad variety of tax bases and rates,[209] and I would not argue that our current system is beyond the limits of justice.[210] Nevertheless, the creation of human capital—and the investment of the self that such creation requires—is one of the most fundamental means to personal development and fulfillment. Justice demands that policymakers acknowledge the importance of work to individual agency, and take care not to levy too heavy a relative burden on it. Ronald Dworkin explicitly advocated an income tax in his central treatment of economic justice because he believed that an income tax is able to "neutralize the effects of differential talents, yet preserve the consequences of one person choosing an occupation, in response to his sense of what he wants to do with his life . . . ."[211]

While human capital is crucial for individual autonomy, financial capital is not. Human capital is inherently limited, while financial capital is potentially unlimited. Consequently, individuals choosing to engage their human capital in a particular way foreclose other options for it. Financial capital, on the other hand, can be amassed and diversified, allowing individuals to invest in an infinite number of projects. The just limits on capital taxation do not come from protecting autonomy, but from maximizing the capacity of capital to increase social welfare; too heavy a burden on capital could potentially contract the economy to the detriment of individual welfare. Furthermore, a person with financial capital can produce returns despite being ill, disabled, weak or frail, while human capital income is more fragile, requiring continuing attention and effort. Investment of human capital is active, while financial capital can be invested passively. Human capital may be engaged in autonomously important ways that do not produce financial returns at all; an individual's pursuit of a meaningful life might not produce any money income. The distinction between human capital and financial capital is the difference between time and money. Because people have only a single life to make meaningful, time is crucial. The concept of desert is important in creating a hierarchy of just taxes, and individuals deserve more of the fruits of their labor than the fruits of their capital because they have invested more of themselves in it; taxing a person's financial capital is a lesser imposition on him as a person compared to taxing his human capital.

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[209] *See generally* Sugin, *Limitations*, *supra* note 105.

[210] Justice in the tax system depends substantially on factors outside the tax system, such as government spending and institutions for equality. *Id.* at 2005.

[211] Ronald Dworkin, *What is Equality? Part 2: Equality of Resources*, 10 Phil. & Pub. Aff. 283, 313 (1981).

If taxation is used as a mechanism to divide joint returns between individuals and society, the investment that individuals make in their labor income is more personal and costly to them than the investment they make in their capital income. The personal effort required for working is unique, so the returns to work are more closely related to personhood than the returns to capital.

The classic libertarian claim that taxes are akin to slavery[212] is consistent with the more autonomy-focused approach in articulating an objection that particularly applies to the taxation of labor income. Robert Nozick wrote: "Taxation of earnings from labor is on a par with forced labor . . . . taking the earnings of n hours labor is like taking n hours from the person."[213] Although libertarians generally oppose taxes on any income, including capital income, arguments based on personal freedom have significantly more resonance as applied to labor income than capital income. Nozick's own opposition to taxation on income from capital is derivative of his view about labor earnings.[214] So, whether one values institutional respect—as liberal egalitarians do, or freedom—as libertarians do, labor income has a uniquely important role.

III. The Most Unfair Tax

This article has argued that the current system—with its combination of payroll taxes on wages and higher income taxes on labor income compared to capital income—creates both horizontal and vertical inequity. The overall effect is unfair to people who work. Nevertheless, expiration of the payroll tax holiday at the end of 2012 produced mostly a yawn. Why? This section argues that a mythology surrounding payroll taxation—based loosely on its connection to Social Security retirement—has made wage earners complacent about the outsize tax burdens imposed on them. Given the design and the rhetoric of the payroll tax/retirement benefit scheme, it is not surprising that people fail to see the inequity in the system. We call the system insurance, so it is reasonable if people think it is like other kinds of insurance. Our payroll taxes go into a dedicated fund to pay out retirement benefits, so it is reasonable if people think it is like private retirement savings. There is a "trust fund," so it is reasonable for people to believe payroll taxes are held in trust. The payroll tax/retirement benefit system fits poorly into these paradigms, but they are the best explanation for why payroll taxes have remained largely below the radar of tax fairness debate. This section deconstructs the payroll tax mythology. The next section challenges that mythology by arguing that retirement security should be funded the same way as defense, homeland security and education—by fair taxes.

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[212] Robert Nozick, Anarchy, State and Utopia 169 (1974).
[213] *Id.*
[214] *Id.* at 171–72.

A. The "Trust Fund" Is Not a "Fund"

While most payroll tax collections are paid out immediately to eligible recipients, some are not. For many years, more payroll tax was collected from workers than was needed to fund benefits for current retirees, creating an excess amount. The system's creators had to devise a mechanism to accommodate these timing mismatches. The "trust fund" is that mechanism, and it was designed to accommodate temporary surplus, while ensuring "that social security would remain largely immune from political and fiscal pressures."[215] When Al Gore was running for President in 2000, he promised to put the Social Security trust funds into a "lockbox" to prevent them from being diverted to other uses.[216] This comment perpetuated the notion that the trust funds contain a pile of cash that could be locked up.[217] But it is an imprecise interpretation of the law, which requires that trust funds be invested in U.S. government securities.[218]

The trust fund is not a pot of gold; it is an accounting measure.[219] It contains no cash. It has "no economic meaning."[220] Instead, the trust fund consists of government obligations. The trust fund invests in Treasury securities, which means that the Social Security system loans the money it does not currently need to the rest of the federal government.[221] The government uses that money for other purposes—like wars and infrastructure—and promises that it will pay Social Security recipients for it later (with interest). So, the trust fund is just the federal government borrowing from itself.[222] As such, it is an unfunded obligation to pay in the future, an accounting entry that will have to be covered with cash to be raised at another time. The federal government owing money to itself means that it will collect the funds to pay for some current outlays later. It is possible—though unlikely—that

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[215] Burke & McCouch, *supra* note 113, at 1213.

[216] In an interview with Tim Russert, he said, "I want to put Social Security and Medicare in an iron-clad lockbox with a sign that says, 'politicians, hands off.'" *Text: Tim Russert's Interview with Vice President Gore*, WASH. POST (July 16, 2000), http://www.washingtonpost.com/wp-srv/onpolitics/elections/goretext071600.htm, *archived at* http://perma.cc/0yrGte9MKjw.

[217] It also provided a gold mine for comedians. *See First Presidential Debate*, SATURDAY NIGHT LIVE TRANSCRIPTS, http://snltranscripts.jt.org/00/00adebate.phtml (last visited Oct. 25, 2013), *archived at* http://perma.cc/0fPyXzXBSTS.

[218] 42 U.S.C. § 401 (2006).

[219] *See* NUSCHLER, *supra* note 131, at 3.

[220] Martin Feldstein, *The Case for Privatization*, 76 FOREIGN AFF. 24, 27 (1997).

[221] *See* Neil Buchanan, *Social Security And Government Deficits: When Should We Worry?*, 92 CORNELL L. REV. 257, 273 (2007) ("To say that the Trust Funds are invested in Treasury securities means simply that the Social Security system's surpluses have allowed the federal government to borrow less money from private parties than it otherwise would have in the absence of the Trust Funds.").

[222] It is a big borrower. The federal government itself holds more than 40% of total federal debt, and the trust funds are the government's biggest creditors. *See Federal Debt* Basics, U.S. GOV'T ACCOUNTABILITY OFFICE, http://www.gao.gov/special.pubs/longterm/debt/debtbasics.html (last visited Oct. 25, 2013), *archived at* http://perma.cc/0XmsNAL74Fy.

the federal government will default on its obligations to the trust fund.[223] If it does not default, the money to pay back the funds borrowed from the trust fund will have to come from someplace, and the most likely place is general revenues. So, as the trust fund is drawn down, general revenues will finance Social Security payments; income tax payments will then fund Social Security.

B. Payroll Taxes Are Not Insurance Premiums

The payroll tax is technically called the Federal Insurance Contributions Act—FICA. Despite the label, the payroll tax is fundamentally unlike an insurance premium or contribution. There is a connection between payroll taxes and Social Security benefits, but that connection does not resemble the premium/payout model of insurance. Insurance is about spreading risk. It is a communal instrument in which subscribers pay a small amount to protect against the risk of a large loss. I insure against the possibility that my house will burn down—even though the probability of my house actually burning down is small—because if my house did burn down, it would be catastrophic for me. Insurance requires many homeowners willing to pay modest premiums to cover the large loss that a few of them ultimately suffer. Insurance is designed so that everyone who buys insurance has a risk of loss, but only a few policyholders actually suffer the loss. Insurance companies make profits because homeowners are willing to pay higher premiums than the expected value of their losses.[224] If everyone's house burned down, the system would collapse. Similarly, people buy life insurance because they are afraid that their children would be without support in case of their death. Young, healthy people pay lower premiums than older, sicker people because their risk of death in any year is small. But like the house fire, a young parent's untimely death would be catastrophic for his family. People buy life insurance to pool the risk that they might die and be unable to provide for their families. If everyone died young and collected on their life insurance, the system would go bankrupt; it is because most policyholders don't die that the insurance works.

The payroll tax is unlike an insurance premium because it is not paid for pooling catastrophic—but unlikely—risk. Against the paradigms of homeowners insurance and life insurance, what are the risks that payroll taxpayers are insuring against? The two (somewhat connected) possibilities

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[223] The federal government's creditors include a wide variety of individuals and institutions. Until recently, it was inconceivable that the United States would default, but Congressional brinkmanship over the federal debt ceiling raised the possibility that the government would be unable to pay some of its debts as they came due.

[224] Insurance companies have two sources of profits—the float on premiums in addition to the premium income itself. *See* Tim Worstall, *What Warren Buffett's Results Tell Us About Obamacare*, FORBES (Feb. 26, 2012), http://www.forbes.com/sites/timworstall/2012/02/26/what-warren-buffetts-results-tell-us-about-obamacare/, *archived at* http://perma.cc/0SuN3qLwhwj.

are the risk of poverty in old age, and the risk of living too long. By characterizing the benefit in these terms, the tax is a payment to reduce risk and provide peace of mind, just like real insurance. For many individuals, payroll taxes are a cost with a negative expected value, just like real insurance, because premiums paid can be actuarially determined to exceed the expected benefits to be received.[225] Social security provides comfort to people who worry they may be unable to support themselves by working in their old age.

But the resemblance to real insurance ends there because *most* people anticipate being unable to work in their old age. Compared to real insurance contracts, the most obvious flaw in treating payroll taxes as insurance is that too many people collect. Insurance markets work only because the probability of a payout is small for each insured individual. But the probability of payout under Social Security is very high. Most people can expect to collect Social Security, while (fortunately) most cannot expect to collect on their fire insurance or their life insurance.[226] Lifetime payroll taxes need to be high because the Social Security system pays out huge sums. In 2012, 57 million people received Social Security benefits of $786 billion.[227] There were more Social Security recipients than the entire U.S. population of people over 65 years old.[228] The prospect of collecting on the "insurance" is likely, not remote. In fact, since individuals are entitled to collect Social Security even if they continue to work, only an early death (without survivor beneficiaries) prevents ultimate receipt of payments. Thus, the insurance analogy is upside down—those who win (by living until old age) collect the most in Social Security benefits, whereas real insurance compensates the policyholders with the biggest real-life losses.

Social Security does not operate like real insurance because it is not concerned with compensating for losses at all.[229] If it were actually insuring against the risk of poverty in old age, it would matter whether a person would be poor without the benefits. In contrast, Social Security is an entitlement earned by all premium payers; there is no risk pooling. Social Security's most essential feature is its entitlement character, and means testing benefits would fundamentally change its nature. The architects of Social Se-

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[225] *See* STEUERLE & QUAKENBUSH, *supra* note 125.

[226] The insured individual does not collect life insurance proceeds—the policy's beneficiaries do after the policyholder's death. Holders of term life insurance rationally cease coverage when they no longer have financially dependent family members to be beneficiaries.

[227] *See* BD. OF TR. FED. OLD-AGE AND SURVIVORS INS. & FED. DISABILITY INS. TRUST FUNDS, 2013 ANNUAL REPORT 2 (2013), *available at* http://www.ssa.gov/OACT/tr/2013/tr2013.pdf, *archived at* http://perma.cc/0Bcwc7fcEeK [hereinafter 2013 FEDERAL OLD-AGE ANNUAL REPORT].

[228] *See* CARRIE WERNER, U.S. CENSUS BUREAU, C2010BR-09, THE OLDER POPULATION: 2010, *available at* http://www.census.gov/prod/cen2010/briefs/c2010br-09.pdf, *archived at* http://perma.cc/0choFRB55Mi. Some Social Security recipient are under 65, including children, widows, and individuals who began collecting before age 65.

[229] *But see* MICHAEL GRAETZ & JERRY MASHAW, TRUE SECURITY 94–99 (1999) (stating that there are uncertainties about retirement security, so retirement should be an insurable event).

curity deliberately chose not to means test, and the demise of traditional welfare[230] proves that their concerns were prescient. Nonetheless, because it is not means tested, it does not directly respond to the risk of poverty in old age, and consequently fails to resemble insurance. While it does prevent many older individuals from falling into poverty, its non-targeted design is at odds with an insurance-against-loss model.

C. Payroll Taxes Are Not Like Private Savings

Another paradigm that people use for understanding the payroll tax and its relationship to retirement benefits is the private savings model, also called the "bank account" understanding.[231] This analogy is flawed also. In a private retirement trust, individuals contribute funds that are invested or safeguarded by a trustee until the beneficiaries are eligible to withdraw the funds. The amount withdrawn during retirement depends on the amounts contributed and the rate of return earned while saved. Because Social Security payments are made on a pay as you go basis, an individual's contribution to the system is not invested to be returned later; it is immediately paid out to current beneficiaries. Even the trust fund amounts are unlike a real savings plan because there is no connection between investment returns in the trust fund and the payments received by retirees. Instead, benefits to retirees are determined based on a statutory formula. Some individuals will receive more—and others less—than their contributions in payroll taxes. Early participants in the program received significantly more in retirement benefits than they had paid in taxes,[232] and many individuals retiring today paid more in taxes than they will receive in benefits.[233] Beneficiaries cannot be deprived of their formulary benefits because of poor investment returns on payroll taxes contributed.

President George W. Bush made privatization of Social Security one of his major initiatives,[234] and it was controversial precisely because it would have radically transformed Social Security into something that it was not. The changes that would have been required to convert the current system into one of private accounts illustrate just how different the current system is from actual private accounts.[235] Thus, it is clear that the system does not

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[230] Aid to Families with Dependent Children, what had been traditional welfare, was abolished as part of the Personal Responsibility And Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193, 110 Stat. 2105.

[231] *See* Graetz & Mashaw, *supra* note 229, at 259.

[232] *See generally* Smith et al., *supra* note 126.

[233] *See* Steuerle & Quakenbush, *supra* note 125.

[234] *See* Elisabeth Bumiller, *Bush Renews Push to Partly Privatize Social Security*, N.Y. Times, Mar. 1, 2002, at A17, *available at* http://www.nytimes.com/2002/03/01/us/bush-renews-push-to-partly-privatize-social-security.html, *archived at* http://perma.cc/0EhVxGaRyGs.

[235] *See* President's Comm'n to Strengthen Soc. Sec., *supra* note 20; Laurence Seidman, *Social Security: What Now?*, 106 Tax Notes 463, 468 (2005).

resemble a private savings strategy. While every taxed dollar of earnings produces a return benefit in the form of retirement payments, the redistributive benefit formula fails to resemble a market-based return.[236] The system overall is a poor imitation of real private savings.

D. General Revenues Already Fund Entitlements

A final mistake that people make about Social Security is connected to the other three. People believe that the money for retirement benefits is completely separate from the rest of the federal budget. This belief is not surprising, given that the law restricts paying Social Security benefits from sources other than dedicated tax collections and trust fund accumulations, and payroll taxes must be dedicated to this purpose.[237] Nevertheless, investing the trust funds in government securities co-mingles the trust funds with other government money.[238] When the trust fund buys Treasury securities, it lends payroll tax revenue within the government, making payroll taxes collected available for other government uses.

The investment requirement means that general revenues already finance entitlements, and the system was designed so that they would. Repayments to the trust fund on redemption of the Treasury securities that it holds must come from somewhere other than payroll taxes. Those funds must come from wherever the government ordinarily gets funds to repay debt—either taxes or more borrowing. If income taxes fund debt repayment, then they will finance Social Security through repayments to the trust fund. So, the Social Security trust fund is inextricably intermingled with general revenues that the government collects under the income tax.

As Social Security payments rise with the retirement of the baby boomers, general revenues will increasingly finance benefit payments because the trust fund will be drawing down on its investment in government bonds. The Social Security system will be taking cash from general revenues. So, the long-term prospect for Social Security is that substantial general revenues will be used to finance benefits to recipients, even though, under current law, the funds travel through a convoluted system to get there. When the trust funds run out, the elaborate rationale for paying benefits from general revenue disappears, and we will need to directly decide whether to finance retirement security with general revenue.

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[236] Low earners die younger than high earners, but the formula does not attempt to neutralize that fact. *See* Joyce Manchester & Julie Topoleski, Cong. Budget Office, Growing Disparities in Life Expectancy (2008), *available at* http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/91xx/doc9104/04-17-lifeexpectancy_brief.pdf, *archived at* http://perma.cc/0PgPe6PfRuT.

[237] *See* Bd. Of Tr. Fed. Old-Age And Survivors Ins. & Fed. Disability Ins. Trust Funds, 2012 Annual Report 2 (2012), *available at* http://www.ssa.gov/oact/tr/2012/tr2012.pdf, *archived at* http://perma.cc/0QDVnFnCrBP.

[238] *See supra* Part III.A.

The commingling of dedicated taxes and general revenues already exists for Medicare, our other major entitlement program. We are already further along in facing the problems of financing Medicare, since payroll taxes have already failed to keep up with the costs of the system. Nevertheless, Medicare has been more opaque because the connection between payments into the system and benefits out is not as explicit as it is for Social Security. Despite alarmists worried about Social Security, the cost of Medicare—and health care more generally—is the number one financial challenge we face as a nation. In 2012, 23% of federal spending was for health care, dwarfing other priorities like education at 3% and exceeding defense only slightly, at 25%.[239]

What have we done about Medicare in light of the inadequacy of dedicated payroll tax revenues? We have taken the money from elsewhere in the budget. In its latest report, the Medicare trustees said: "This year's report projects the difference between outlays and dedicated financing revenues to exceed 45 percent of total Medicare outlays during fiscal year 2012, prompting a determination of 'excess general revenue Medicare funding' for the seventh consecutive report, triggering another 'Medicare funding warning.'"[240] General revenues covered the Medicare shortfalls identified by the trustees, and entitlements were spared the automatic cuts of this year's automatic sequester.[241] We are not covering the costs of Medicare with payroll taxes, even though those taxes—unlike the Social Security portion—are not subject to an earnings cap, and even though the Affordable Care Act instituted additional taxes on high-income earners with both labor income and investment income dedicated to healthcare costs.[242]

General revenues pay for the majority of federal health-care expenditures, which means that income taxes are financing the health care that all older Americans receive. President Obama recently lamented that older Americans have the mistaken view that they pay in full for their Medicare benefits.[243] People think their contributions cover their expenses because the

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[239] *See Federal Budget*, USGOVERNMENTSPENDING.COM, http://www.usgovernmentspending.com/health_care_budget_2012_1.html (last visited Oct. 25, 2013), *archived at* http://perma.cc/0hq8X2PymGr.

[240] Soc. Sec. & Medicare Bds. Trs., *A Summary of the 2013 Annual Reports*, SOC. SEC. ADMIN., http://www.ssa.gov/oact/trsum/ (last visited Oct. 25, 2013), *archived at* http://perma.cc/0M5q7cQzYdy.

[241] BD. OF TRS., FED. HOSP. INS. & FED. SUPPLEMENTARY MED. INS. TRUST FUNDS, THE 2012 ANNUAL REPORT (2012), *available at* http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/downloads/tr2012.pdf, *archived at* http://perma.cc/0mUwJ1fku8k (showing general revenues covered shortfalls); *see generally* KAREN SPAR, CONG. RESEARCH SERV., R42050, BUDGET SEQUESTRATION AND SELECTED PROGRAM EXEMPTIONS AND SPECIAL RULES (2013), *available at* http://www.fas.org/sgp/crs/misc/R42050.pdf (detailing programs exempt from sequestration, including Medicare and Social Security), *archived at* http://perma.cc/03pRVVY8RW1.

[242] *See* I.R.C. § 1411 (Supp. V 2011) (3.8% Net Investment Income Tax); I.R.C. § 3101(b)(2) (Supp. V 2011) (0.9% additional Medicare tax on high earners).

[243] *See* Jackie Calmes, *Public Misperceptions of Government Benefits Makes Trimming Them Harder*, N.Y. TIMES Apr. 3, 2013, at A0, *available at* http://www.nytimes.com/2013/04/

payroll tax and Medicare premium system lead them to believe that.[244] The general public is woefully misinformed about the economics of government-financed health care and who benefits most from it.[245] They are wrong, but their mistake is precisely what the policy seems to have intended. While Social Security is not there yet, Medicare is an example of what funding entitlements in the future may demand from general tax revenues. The Social Security trustees have called on Congress to address the projected shortfalls over the long term,[246] but it has yet to do so. Because the insolvency of the Social Security trust fund is still a long way in the future, it is impossible to know how the government will ultimately address it. While raising payroll taxes and cutting benefits are possible solutions,[247] the Medicare model of using non-dedicated revenues is an important forerunner that sheds light on how lawmakers can finesse the challenges.

E. Mythology Hasn't Protected Social Security Benefits From Reform

The myths that payroll taxes are insurance premiums, private savings, and confined in a lockbox have protected the most regressive tax from challenge. If payroll taxes really were insurance premiums, then they could be a fair price for reducing individual risks; if they really were private savings then we would each be creating personal property interests with our payments; if they were in a lockbox then we might be confident that taxpayers would get the value of what they contributed. Each of these myths contributes to acceptance of heavy tax burdens by workers because they create the impression that the system's design is integral to an entitlement to retirement security—something everyone wants.[248] The rhetoric is powerful in connecting payroll taxes and desirable public spending. But these myths are analytical constructs that narrowly frame conventional analysis about retirement security. All the options being considered by policymakers for reforming

04/us/politics/misperception-of-government-benefits-makes-trimming-them-harder.html?_r=1&, *archived at* http://perma.cc/0v1ehZ5nsP4.

[244] *Id.* ("[T]he president was referring to the widespread and incorrect view, especially among older Americans, that Medicare recipients get only what they have paid for through taxes, premiums and medical co-payments.").

[245] Children constitute 49% of Medicaid beneficiaries, and the blind and disabled comprise 14%, but account for 43% of the total budget. *See* U.S. Census Bureau, Statistical Abstract of the United States 2012 109 (2012), *available at* http://www.census.gov/compendia/statab/2012/tables/12s0151.pdf (showing numbers of beneficiaries; percentages of total calculated), *archived at* http://perma.cc/08kZ6MEXKCk.

[246] 2013 Federal Old-Age Annual Report, *supra* note 227, at 5.

[247] *See generally* Social Security Policy Options, *supra* note 124 (considering multiple options for raising taxes and modifying benefits).

[248] Even the Tea Party likes Social Security and Medicare. *See* Theda Skocpol & Vanessa Williamson, *Whose Tea Party Is It?*. N.Y Times Campaign Stops (Dec. 26, 2011, 9:00 PM), http://campaignstops.blogs.nytimes.com/2011/12/26/whose-tea-party-is-it/, *archived at* http://perma.cc/0qPcd9WxC28/.

Social Security and its financing are limited by these heuristics.[249] It is very difficult to think outside the payroll tax/retirement benefits box with these dominant references.

Despite the mythology, Social Security benefits have not in fact been immune to reform and diminution over time. Taxes on Social Security benefits have risen over time,[250] as have payroll tax rates. In 1983, Congress altered essential elements of the program to extend its long-term solvency. For example, current workers must delay retirement, even though many of them paid taxes prior to the adoption of the rules increasing the retirement age. People born in 1960 or later will not reach full retirement age until 67, compared to 65 for their parents.[251] The major deficit reduction proposals on the table today include substantial entitlement reform as a central feature,[252] despite the fact that the Social Security system is not in imminent financial distress.[253] The trustees project that the Social Security trust fund will be solvent through 2035[254] and that payroll tax revenues will fund 75% of benefits through 2087.[255] Nevertheless, the President's latest budget includes a subtle diminution in Social Security benefits. It proposes changing the cost-of-living formula applicable to increases that retirees will receive in their benefits over time to the "chained consumer price index."[256] The most elderly—who are also the neediest recipients of Social Security—would lose the most under the proposed change.[257] Given that the greatest fiscal pressure

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[249] *See generally* Social Security Policy Options, *supra* note 124 (the CBO's comprehensive analysis of Social Security policy options).

[250] Social Security recipients are taxed, under the income tax system, to the extent that the combination of their modified adjusted gross income and one-half of their benefits exceed the statutory base, $25,000 for individuals and $32,000 for married individuals filing jointly. Once the combined total of the modified adjusted gross income and one-half Social Security benefits exceeds $34,000 for individuals, or $44,000 for married individuals filing jointly, eighty-five percent of the benefits are included in gross income. *See* I.R.C. § 86 (2006).

[251] Social Security Policy Options, *supra* note 124, at 9.

[252] *See generally* Nat'l Comm'n On Fiscal Responsibility And Reform, The Moment of Truth (2010), *available at* http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf, *archived at* http://perma.cc/0Qh8XUJiy6N; Bipartisan Pol'y Ctr., Restoring America's Future (2010), *available at* http://bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf, *archived at* http://perma.cc/0NRNkBq17Hg.

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> In isolation, the Social Security system's future looks surprisingly robust, with much of the current concern about its future based on unnecessarily pessimistic economic assumptions and a widespread failure to understand that future changes in the proportion of retirees to workers will be more than offset by future increases in worker productivity.

Buchanan, *supra* note 221, at 261.

[254] 2013 Federal Old-Age Annual Report, *supra* note 227, at 3.

[255] *See* Soc. Sec. & Medicare Bds. Trs., *supra* note 240.

[256] Social Security Policy Options, *supra* note 124, at 5 ("Scheduled benefits are indexed to growth in earnings and (after initial benefits are received) to inflation"). The chained CPI would produce smaller increases over time than does the formula currently used, reducing the total benefits that retirees receive over a lifetime.

[257] *See* Tara Siegel Bernard, *Budget Negotiating Chip Has Big Downside for Old and Poor*, N.Y. Times, April 20, 2013, at B1, *available at* http://www.nytimes.com/2013/04/20/your-money/the-potential-effect-of-obamas-social-security-proposal.html, *archived at* http://

comes from rising medical costs, not retirement expenditures, some believe that reducing retirement security now may be unnecessarily painful.[258]

Thus, the payroll tax-Social Security link, and the mythology that has developed around it, has not prevented entitlement modifications. There are no private accounts, lockboxes or insurance contracts. Social Security is a government program subject to the political process, and vulnerable to fiscal pressures. Entitlements are sensitive to economic times and public priorities, and there is nothing intrinsically wrong with that. But just as the terms of Social Security retirement benefits may need to change, financing retirement security also must adjust to maintain fair burdens in every generation.

IV. Fund Retirement Security With General Revenues

A. *Raising the Earnings Cap Is Not a Good Solution*

The long-term Social Security projections[259] are a legitimate concern, but they are not an emergency; in twenty-two years, payments will be twenty-two cents short on the dollar if Congress does nothing between now and then to address the issue.[260] When the trust fund expires, the system does not suddenly go belly up. Rather, the pool of money available to pay retirees will be limited to the payroll taxes currently collected (plus the small amount of income tax imposed on Social Security retiree benefits). Although it is not clear how benefits would be cut, current law requires that they will have to be reduced at that time.[261]

The government is aware of this problem, and has been considering a broad array of options to prevent a plunge in benefits.[262] Rebalancing Social Security with payroll tax collections can be achieved by tweaking either the taxing or spending side, or both. Some of the proposals being considered have been on the spending side—reducing benefits paid out or starting them later. Others have been on the taxing side—increasing payroll taxes to replenish the trust fund. In 2010, the Congressional Budget Office did a com-

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perma.cc/09wSAEgvDTC. The proposal is particularly controversial because some argue that the chained CPI is a less accurate measure of the cost of living for older people than it is for younger people.

[258] Robert Reich, *What's the 'Chained CPI,' Why It's Bad for Social Security and Why the White House Shouldn't Be Touting It*, Huffington Post (Apr. 4, 2013 2:39 PM), http://www.huffingtonpost.com/robert-reich/chained-cpi_b_3016471.html (citing MoveOn.org, *Robert Reich on Chained CPI (the proposal to cut Social Security benefits),* YouTube (Apr. 3, 2013), http://www.youtube.com/watch?v=fvXuANd2l80#t=98), *archived at* http://perma.cc/0gjntEDYd4v.

[259] 2013 Federal Old-Age Annual Report, *supra* note 227, at 3.

[260] *Id.*

[261] Social Security Act § 201(h), Pub. L. No. 74-271, 49 Stat. 620 (1935) (codified as amended at 42 U.S.C. § 401(h) (2006)); Section 201(h) of the Social Security Act, 42 U.S.C. § 401(h) (2006).

[262] *See generally* Social Security Policy Options, *supra* note 124 (comprehensive study of proposals made by different analysts and policymakers).

prehensive study that included thirty options for reform of Social Security and its financing.[263] It considered changing the taxation of earnings in nine different ways, and altering the benefits formulas or timing in twenty-one ways. The thirty options have vastly different budgetary effects and distributional consequences, and only some of them would solve the long-term fiscal imbalance in the system.[264] There are many possible changes on the tax side, the simplest of which is raising the rates, as has been done twenty-one times since the payroll tax was first adopted in 1937.[265]

The possibility of raising or eliminating the earnings cap has been the most widely discussed solution for the long-term imbalance.[266] Under current law, wage earnings up to $113,700 are taxed for OASDI, but amounts above that are exempt. The cap works like a cliff; workers pay the full rate until they hit the limit, and then nothing.[267] The CBO considered a variety of methods for increasing the cap.[268] Removing the cap altogether would raise the most total revenue, compared to the other options for changing the taxation of earnings.[269]

Although removing the cap and taxing all wages would ameliorate the regressivity problem, it would exacerbate the other problem that this article has highlighted. It would increase the tax on labor income, further skewing the unequal treatment of labor income and capital income. High-income wage earners would pay more tax than they do under current law, and at an even higher marginal rate than they do now. Top wage earners would continue to pay income tax at a marginal rate of 39.6%, but they would pay additional payroll taxes at 15.3%,[270] which they do not pay on their last dollars under current law. Along with the extra 0.9% "additional Medicare tax" on high earners,[271] top wage-earners would have a total federal marginal rate

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[263] The Senate Finance Committee recently collected proposals. *See generally* S. Fin. Comm. Staff, 113th Cong., Non-Income Tax Issues and Related Reforms (2013), *available at* http://www.finance.senate.gov/imo/media/doc/06202013%20Non-Income%20Tax%20Reform%20Options%20Paper1.pdf, *archived at* http://perma.cc/0ywGMsjY6CK.

[264] *See generally* Social Security Policy Options, *supra* note 124, at xi fig.1.

[265] *See Social Security and Medicare Tax Rates*, *supra* note 26.

[266] *See* Thomas Edsall, *The War on Entitlements*, N.Y. Times Opinionator (Mar. 6, 2013, 11:40 PM), http://www.opinionator.blogs.nytimes.com/2013/03/06/the-war-on-entitlements/?_r=0, *archived at* http://perma.cc/0n59t5Pu4X6; Social Security Policy Options, *supra* note 124, at 18–19.

[267] *See generally supra* note 36 and accompanying text.

[268] Proposals suggested raising the cap some, removing it altogether, taxing above the cap at a reduced rate or at steps, and allowing the cap to move as a percentage of total earnings in the economy Social Security Policy Options, *supra* note 124, at xi, 16–19.

[269] *Id.* at xi summary fig.1.

[270] Employees technically pay only half the payroll tax, while their employers pay the other half, but economists agree that the entire economic burden of the tax—both parts—falls on employees. *See* Hungerford, *supra* note 5, at 1 n.4 ("Most economists agree that workers ultimately bear the full burden of the payroll tax. Employers typically pass on their share of the payroll tax to employees through paying lower wages.")

[271] I.R.C § 3101(b)(2) (Supp. V 2011), added by the Patient Protection and Affordable Care Act, Pub. L. 111-148, § 9015, 124 Stat. 119 (2010). *See* Notice of Proposed Rulemaking and Notice of Public Hearing Rules Relating to Additional Medicare Tax, 77 Fed. Reg. 72268

of 55.8%. Their investment-earning counterparts would pay at a maximum rate of 23.8%, including the 20% preferential rate on capital gains[272] and the net investment income tax under the Affordable Care Act.[273]

Many proponents of progressivity favor lifting or removing the payroll tax cap. But improving progressivity in that way has its equity costs: increasing vertical equity by increasing taxes on high-income wage earners must be balanced against creating more horizontal inequity between equal earning wage earners and holders of capital.[274] It is not obvious how proponents of a progressive tax system should balance those competing interests, but I am reticent to impose greater taxes on wage earners in the name of fairness before increasing taxes on holders of wealth.

B. Social Security Should Be Funded by Fair Taxes

Even though the CBO's thirty options appear to offer a broad range of choices, they are actually quite limited in imagination. Each of the considered options conceptualizes the Social Security/payroll tax scheme as a closed universe in which all the moving parts are contained.[275] But, in fact, there is no compelling reason to look for solutions to the problem of long-term Social Security insolvency only in the payroll tax system and schedule of retirement benefits. Social Security's outlays constitute one-fifth of total federal spending,[276] more than any other single budget function, including defense.[277] That makes retirement security one of the principal functions of the federal government. Yet, it is not funded by the broad-based income tax that was adopted for the purpose of financing federal purposes in the most equitable way. If Congress opened up the possibility of using general revenues, in addition to the payroll tax, the financial options for saving Social Security would expand.[278]

(proposed Dec. 5, 2012). *See* Notice of Proposed Rulemaking and Notice of Public Hearing Rules Relating to Additional Medicare Tax, 77 Fed. Reg. 72268 (proposed Dec. 5, 2012).

[272] I.R.C. § 1(h) (West 2013).

[273] I.R.C. § 1411 (Supp. V 2011). The 3.8% Net Investment Income Tax is imposed on investment income of high-income taxpayers. It was adopted in § 1402(a)(1) of the Health Care and Education Reconciliation Act of 2010, Pub. L. 111–152, 124 Stat. 1029, and goes into effect for 2013.

[274] "Taxes on labor income alone—even if, unlike FICA taxes, they were progressively structured—do not produce taxation based upon ability to pay, for those with the greatest ability to pay often have channeled their monies into capital." Graetz, *supra* note 9, at 864.

[275] Social Security Policy Options, *supra* note 124, at x ("Other than an increase in the Social Security payroll tax, changes to federal tax policy are not considered.").

[276] Cong. Budget Office, The 2012 Long-Term Projections for Social Security: Additional Information 1 (2012), *available at* http://www.cbo.gov/sites/default/files/cbofiles/attachments/43648-SocialSecurity.pdf, *archived at* http://perma.cc/0oH2mNYHKVd.

[277] Social security accounts for 22% of federal outlays and defense for 19%. OMB, 2012 numbers at 348–49, *available at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/hist.pdf.

[278] It could also open a Pandora's Box.

> [O]nce Social Security's fiscal elements are viewed simply as part of the aggregate fiscal mix, questions arise as to whether we should replace payroll taxes with wealth

While President Roosevelt may have been right in thinking that a dedicated "contribution" based on payroll was crucial for funding retirement security at the program's inception,[279] today there is no compelling reason to eschew funding retirement security with income taxes or wealth taxes.[280] A major reason why the Social Security system is underfunded today is because income has shifted to capital from labor; if workers were receiving a higher share of corporate productivity, their wages—and their payroll taxes—would be higher.[281] Today's payroll tax includes only 84% of total wages in the economy, compared to 90% in 1983.[282] That decline is the result of diverging earnings of the top earners, compared to everyone else.[283] The changing distribution of income from labor to capital, and from rank-and-file to highly paid workers, must be considered in determining whether a once-reasonable system of financing particular benefits has become increasingly unfair over time. The government's responsibilities in taxing and spending depend, in part, on the pre-tax distribution of income, wealth, and power. The more unequal background institutions are, the more work a just government must do to guarantee equality.[284]

There may be a mistake of cognitive connection in this story. Because retirement security is financed by taxing work, it appears that there is a natural connection between the two parts of the program. But just because retirement payments make it possible for people to stop working does not mean that those payments must be financed by work. We do not tax privately owned weapons to pay for national defense, even though national defense

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> or inheritance taxes, or vice versa. The benefit of the current arrangement is that it takes some choices off the table and constrains other choices in ways that might make policymaking more understandable.

See Buchanan, *supra* note 221, at 276.

[279] In a 1934 address to Congress, FDR insisted that Social Security "must be financed by contributions, not taxes." Address to Advisory Council of the Committee on Economic Security on the Problems of Economic and Social Security, 3 Pub. Papers 452–55 (November 14th 1934), *available at* http://www.ssa.gov/history/fdrstmts.html.

[280] *See* Jonathan Barry Forman, *Making Social Security Work*, 65 Ohio St. L.J. 145, 160 (2004) ("it would make more sense to use the income tax or, perhaps, a wealth tax, to pay for any redistribution through Social Security benefits").

[281] Josh Bivens, *More Fiscal Implications of a Rising Capital Share of Income*, Econ. Pol'y Inst. Blog (Jan. 2, 2013, 2:36 PM) http://www.epi.org/blog/fiscal-implications-rising-capital-share-income/ (estimating that the shift has cost the Social Security trust fund $365 billion by 2011), *archived at* http://perma.cc/0zn8gUEbJJs.

> [282] At the time of the 1983 reforms, the "cap" on annual earnings that were taxed was set to capture 90 percent of all economy-wide earnings, and to rise with the rate of average wage growth. But since wage-growth *above* the cap was so much faster than the average in subsequent decades, more and more of overall earnings are spilling over the cap.

Id.

[283] *See* Saez, *supra* note 19, at tbl.1.

[284] Rawls was not particular about taxation because he considered various taxes to be consistent with justice. He suggested that a wealth tax or an income tax could be adopted for the purpose of preventing "accumulations of wealth that are judged to be inimical to background justice, for example, to the fair value of the political liberties and to fair equality of opportunity." John Rawls, Justice as Fairness: A Restatement 161 (Erin Kelly ed., 2001).

makes it possible for people to forego defending themselves. We do not tax cars to pay for public transportation, even though buses and trains make it possible for people to stop driving cars. The connection between wages and retirement payments is invented by the current design of the system, with no inherent compelling logic underlying it.

Many public goods that bestow private benefits are financed with general revenues, and retirement security should be funded the same way. Compare retirement security and K-12 education. Education is a public good—it benefits the society as a whole by improving the productivity of the population, while inculcating civic responsibility and engagement. But it is also a private good because it increases lifetime incomes for educated individuals, and contributes to personal development.[285] Similarly, retirement security prevents the elderly population from becoming dependent on others, protects small communities from burdens of support, and allows an orderly exit from the labor market to the benefit of both young and old, while also providing individual benefits to retirees themselves.[286] We pay for public education with a variety of taxes, and people who pay higher taxes in whatever form finance more education than those who pay lower taxes. Like retirement security, nobody pays for their own K-12 education with their own taxes—one generation supports another. Redistribution occurs across incomes, geographic areas, and ethnic groups. While the method for financing education is often politically controversial, the national commitment to free public education is not threatened. We can disagree about who pays the taxes even while remaining committed to what they finance.

That commitment is an important prototype for retirement security. Retirement security flips the generations, but otherwise looks much like spending on public education. Like education, the system is redistributive in multiple directions.[287] It is also similarly entrenched—we have a social commitment to retirement security benefits. Social Security is popular, and for good reason.[288] It is a great program—an undeniable triumph of govern-

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[285] More education produces higher earnings. *See Employment by Summary Education and Training Assignment, 2010 and projected 2020*, Bureau of Lab. Stat., http://www.bls.gov/emp/ep_table_education_summary.htm (last updated Feb. 1, 2012), *archived at* http://perma.cc/06LztyAuW9D.

[286] *See generally* Patricia E. Dilley, *Remarks: Reinventing Retirement: Reforming Social Security, Medicare and Private Pension Plans: Proceedings of the 2006 Annual Meeting, Association of American Law Schools, Section on Employee Benefits*, 10 Emp. Rts. & Emp. Pol'y J. 695 (2006).

[287] More Americans are transitioning from net winners to net losers in the system overall. *See* Steuerle & Quakenbush, *supra* note 125.

[288] The reasons for this popularity are not entirely determinable. Burke and McCouch argued that "[t]he presence of large positive transfers to virtually all income groups helps to explain why social security has traditionally enjoyed such widespread political support." Burke & McCouch, *supra* note 113, at 1217. Martin Feldstein has argued that the system's popularity will decline as its costs and inefficiencies become clearer. *See* Feldstein, *supra* note 220, at 27–28.

ment.[289] It has been crucial in supporting quality of life for millions of elderly Americans, and has eased the social transformation of the family over the last century.[290] The working generation, collectively, supports its parents, as a replacement for individual workers supporting their own aging parents.

We do not need the social insurance fiction or a dedicated payroll tax to justify income support for the elderly.[291] While the social insurance fiction may have helped to entrench Social Security in its early years, retirement security is too popular and too successful to be vulnerable to extinction today.[292] Public support for those no longer able to work is a reasonable way to resolve one of the central questions facing contemporary societies: how to allocate the benefits and burdens of social productivity over time.[293] National priorities do not automatically become vulnerable without a dedicated revenue stream connected to them. People are concerned about the date of the trust fund's insolvency because they do not want the system to cease. And it should not. But the significance of the trust fund's insolvency is a problem that politics—not economics—has created. Retirement security is a reasonable government entitlement; a rich society can guarantee an old age without poverty to people who have fulfilled their obligations of citizenship.[294] It is time to accept the permanence of Social Security so we can have a more productive debate about it.

C. Separating Payroll Taxes from Retirement Benefits Might Allow Desirable Modification to Both

Just because people like Social Security does not mean that the program is perfect in every way. The fiction that has justified taxing wage earners so heavily has also largely frozen the program's design. If we move away from

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[289] "Social security's success in bolstering the economic position of the elderly, particularly the elderly poor, makes relative political security its just desert." THEODORE MARMOR, JERRY MASHAW & PHILIP HARVEY, AMERICA'S MISUNDERSTOOD WELFARE STATE xv (1992).

[290] "Starting right after World War II, the extended family household fell out of favor with the American public. In 1940, about a quarter of the population lived in one; by 1980, just 12% did." But it has been on the rise in recent years, and in 2008, 16.1% of the population lived in extended family households. *See The Return of the Multi-Generational Family Household*, PEW RESEARCH CTR. (Mar. 18, 2010), http://www.pewsocialtrends.org/2010/03/18/the-return-of-the-multi-generational-family-household/, *archived at* http://perma.cc/09FtPTa38pK.

[291] One commentator has predicted that "[t]he political power of the elderly and elderly lobbies like the AARP make it unlikely that future Social Security retirement benefits will actually ever be cut by much." Forman, *supra* note 280, at 173.

[292] "[P]olitical untouchability has led pundits to label Social Security 'the third rail of American politics' and critics to lament the inability of politicians to make tough choices and dramatically revise the program's benefits and financing." Dilley, *supra* note 112, at 1052.

[293] *See* Sugin, *Philosophical Objection*, *supra* note 105, at 243 (discussing John Rawls, *Social Unity and Primary Goods*, *in* Collected Papers 359, 365 (Samuel Freeman ed., 1999)).

[294] Patricia Dilley has argued that Social Security creates economic rights on account of effort, rather than investment. Dilley, *supra* note 112, at 984 ("Social Security, far from being a quaint, retrograde souvenir of the New Deal, in fact was ahead of its time in creating economic rights based on effort rather than equity in support of the public institution of broad-based retirement.")

the notion that people have paid for something precisely along the lines of what we have, there would be more freedom to modify the program and improve its equity and efficiency, while maintaining its essential feature as an entitlement. Shifting public focus away from the contrived crisis arising from the depletion of the trust fund would allow more energy to be invested in better achieving the goals of protecting the elderly from poverty and making retirement a civic right.

For example, retirement security could be transformed from a right to a social minimum. Public guarantee of a basic minimum has played an important role in contemporary political theory[295] because it allows individuals to exercise their political rights and civic obligations. Unknown to most people, Social Security has included "minimum" retirement payments for individuals who worked at very low wages during their lifetime.[296] Very few people are currently eligible for the minimum payment because they would be entitled to more under the regular benefits formula.[297] But the minimum payment is an important paradigm for what publicly funded retirement security might be if it were freed from the mythologies that lead people to believe a closer connection between payroll taxes and retirement benefits than actually exists. The minimum benefit in the current system provides subsistence to individuals who earned very little while they worked, but worked for many years.[298] Social Security as a guaranteed basic minimum reflects a commitment to public financing of retirement dignity, in exchange for an individual's satisfaction of a civic obligation to work for an extended period.[299]

The obligation to work differs from the obligation to pay taxes. Under this approach, Social Security is better understood as an entitlement for productivity during a lifetime, rather than a benefit purchased with prior

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[295] *See* Murphy & Nagel, *supra* note 104 at 45 ("[A] social minimum as a positive right . . . identifies a basic core of purely personal property rights that are essential for individual liberty . . . .").

[296] *See* Kelly A. Olsen & Don Hoffmeyer, *Social Security's Special Minimum Benefit*, 64 Soc. Sec. Bull. 1, 5 (2001–02) ("Since the special minimum benefit was intended to provide regular long-term workers with an income that would free them from dependency on welfare, one might conclude that it was designed to reduce poverty. That rationale also might explain why the maximum special minimum benefit payable . . . at the program's inception nearly equaled the poverty threshold (96 percent) for aged individuals.")

[297] This is because of the design for eligibility for the special minimum benefit. *Id.* at 1. That benefit could be made more generous. Eugene Steuerle has proposed adopting a more substantial minimum benefit. *See Steuerle Statement*, *supra* note 129, at 8.

[298] Individuals must work for at least ten years to be eligible for the special minimum benefit, but low wages will not reduce it. *See* Social Security Policy Options, *supra* note 124, at 9.

[299]

> The goal of providing a basic income level to poor workers after their retirement is simply no justification for mandatory social security provisions that require poor workers to shift consumption from the present to the future. At a minimum, poor workers should be exempted from paying social security taxes after they have participated in the payroll tax system for a sufficient number of quarters to qualify for payment of minimum benefits.

Graetz, *supra* note 9, at 868. *See also* Dilley, *supra* note 112.

taxes.[300] This conceptualization acknowledges the collective payment of one generation to the one that preceded it, as a debt for past service, instead of pretending that Social Security is something we each pay for in advance. The principle of entitlement earned for productivity also allows more imagination in the definition of who becomes entitled. If retirement security is understood as an entitlement for working, the amount of benefits might vary along multiple axes—by years worked, types of jobs worked, or other factors related to the grounds for entitlement or need for security. For example, while productive—but unpaid—work fails to earn credit for Social Security under current law, a civic obligation framework could include services in the home.[301] The prior generation's productivity contributed to our own, and today's earners should be willing to pay for those contributions in the same way that they pay for the rest of the public infrastructure that allows them to prosper.

Retirement policy should account for changes in the lives of workers and the structure of the work force and income base over the last century: the expected income and demographics of today's retirees differ substantially from those in the early years of the program. Many more women work, so there are fewer single-earner couples, but more families headed by a single adult.[302] Never-married retirees are more likely to be poor than those who have been married.[303] Median family income and income inequality have both risen.[304] Many people can work at older ages, at jobs that require less physical exertion. The Social Security Administration projects that future retirees will have more income (i.e. less poverty) than earlier generations, but that their retirement income will decline as a percentage of their working income.[305] Most importantly, projections show that the retirement income prospects are dimmest for identifiable groups "including unmarried retirees, non-Hispanic blacks, high school dropouts, those with weak labor force attachments, and those with the lowest lifetime earnings."[306] A more effective Social Security system might legitimately address these challenges.

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[300] "Notwithstanding the centrality of the right to private property in American democracy, a tradition of rights based on labor and earning also has deep cultural roots and provides an alternative democratic tradition that can serve as the basis for an earnings-based entitlement that encompasses redistribution without contradiction." *See also* Dilley, *supra* note 112, at 1044.

[301] *See generally* Nancy Staudt, *Taxing Housework*, 84 Geo. L. Rev. 1571 (1996) (proposing taxing housework so that homemakers could earn credits towards Social Security); Sugin, *Philosophical Objection*, *supra* note 105 (distinguishing productivity from market work and leisure); Mary E. Becker, *Obscuring the Struggle: Sex Discrimination, Social Security, and Stone, Seidman, Sunstein & Tushnet's* Constitutional Law, 89 Colum. L. Rev. 264 (1989).

[302] Barbara A. Butrica, Karen E. Smith & Howard M. Iams, *This Is Not Your Parents' Retirement: Comparing Retirement Income Across Generations*, 72 Soc. Sec. Bull. 37, 37 (2012).

[303] *See id.* at 40.

[304] *See id.* at 37, 41, 44.

[305] *See id.* at 38.

[306] *Id.* at 55.

V. Conclusion

"Entitlements" has become a dirty word, as the costs of health care threaten our country's long-term fiscal well-being.[307] Substantial cutbacks in benefits were precisely what President Roosevelt intended to foreclose when he draped Social Security in the insurance cloak,[308] but the fortress he had hoped to create is developing cracks. The main theme of this article is that the mythology of social insurance and personal savings has given entitlement programs a veneer of protection, and has made people complacent about paying payroll taxes to fund them.[309] But it has not *actually* protected the programs from reform or prevented general revenues from supplementing dedicated taxes.[310] Instead, it has contributed to a tax system in which labor is substantially overtaxed compared to capital. The system does not work as an earmark of taxes for spending,[311] but it is convenient for collecting large sums cheaply. We pretend that our dedicated taxes neatly finance particular purposes, and then we can avoid analyzing both the fairness of the tax and whether the costs could produce greater benefits. On closer analysis, the arguments for taxing labor income as heavily as we do are wanting. We should reduce the tax burden on labor compared to capital to promote equality, autonomy, and individual respect.

Delinking payroll taxes from retirement security—while maintaining a commitment to retirement security on grounds of justice—only starts the discussion. This article takes no view on the specific design of retirement security benefits.[312] Instead, it argues that retirement security and its financing should be determined on grounds of justice, rather than on a contrived notion of insurance or personal savings. Designing taxes and government benefits requires an analysis of what individuals owe, and what they deserve

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[307] *See* Editorial, *The New Republican Landscape: From Congress to Statehouses, A Sweeping Attempt To Dismantle The Social Compact*, N.Y. Times, Apr. 18, 2011, at A22, *available at* http://www.nytimes.com/2011/04/18/opinion/18mon1.html?_r=0, *archived at* http://perma.cc/09zMKsB2Upe; Taegan Goddard, Is 'Entitlement' A Dirty Word?, The Week (Apr. 15, 2013, 2:20 PM), http://theweek.com/article/index/242757/is-entitlement-a-dirty-word, *archived at* http://perma.cc/0tJeBBLnUzi; Edward Schumacher-Matos, *Is 'Entitlements' A Dirty Word?*, NPR (Aug. 11, 2011, 5:02 PM), http://www.npr.org/blogs/ombudsman/2011/08/11/139557647/is-entitlements-a-dirty-word, *archived at* http://perma.cc/0MaknohYPPf. Complaints about entitlements have, in fact, ebbed and flowed for decades. *See* Marmor, Mashaw & Harvey, *supra* note 289, at 2.

[308] Roosevelt's universe of entitlements did not include Medicare and Medicaid, so the dynamic of entitlement financing and spending is significantly more complex than he may have imagined. Social Security Amendments of 1965, Pub. L. 89–97, 79 Stat. 286 created Medicaid and Medicare in 1965, 30 years after Social Security became law.

[309] *See* Deborah Schenk, *Exploiting the Salience Bias in Designing Taxes*, 28 Yale J. Reg. 253 (2011).

[310] *See supra* Part III.E.

[311] *See supra* Part III.C–D.

[312] There is a literature on that topic. *See*, *e.g.*, Graetz & Mashaw, *supra* note 229, at 255–78; *Steuerle Statement*, *supra* note 129. *See* Social Security Policy Options, *supra* note 124; Bipartisan Pol'y Ctr., *supra* note 252, at 72–85; Nat'l Comm'n On Fiscal Responsibility And Reform, *supra* note 252.

to receive from—the collective efforts of the community. While it may be possible to argue for the approximate distribution and amount of benefits under current law as a combination of desert and need, those rationales should be explicit in the public conversation.[313] Delinking taxes from benefits is both a blessing and a curse. It requires that we articulate a rationale for whatever schedule of benefits we choose, but it also frees us from the limitations of the analytical frame in which we have been stuck. We need to be willing to pay for whatever retirement benefits we promise, the same way that we need to be willing to pay for everything in the federal budget. Retirement security is important enough, successful enough, and venerable enough that it should be worth paying for with a fair tax.

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[313] *See* Buchanan, *supra* note 221, at 269 ("A PAYGO system does not directly equate market returns with 'just deserts,' whereas a prefunded system implicitly bases the right to consume in retirement on abstention from consumption while working.").