The Reification of Metaphor: Income Taxes, Consumption Taxes and Human Capital

LAWRENCE ZELENAK*

I. Introduction

For more than two decades, legal academics have debated whether a consumption tax should replace the income tax.¹ Unlike an income tax, a consumption tax exempts saved income from tax until it is converted to consumption.² The debate is no longer of only academic interest. Many members of Congress—largely, but not exclusively, Republicans—have expressed a desire to replace the income tax with some form of consumption tax,³ and several bills have been introduced.⁴ The House Ways and Means Committee held widely publi-

---

¹ Reef C. Ivey Research Professor of Law, University of North Carolina. Thanks to Anne Alstott, Lisa Broome, Louis Kaplow and Michael Selmi for comments on earlier versions of this Article.


³ See David F. Bradford and the U.S. Treasury Tax Policy Staff, Blueprints for Basic Tax Reform 3-11 (2d ed. rev. 1984) [hereinafter Blueprints] (describing income tax and consumption tax models). The current income tax is actually a hybrid of income and consumption tax features. See Edward J. McCaffery, Tax Policy Under a Hybrid Income-Consumption Tax, 70 Tex. L. Rev. 1145 (1992) [hereinafter Tax Policy]. To the extent the current tax does not tax accretions to wealth as they occur, it functions as a consumption tax. Important consumption tax features include the deferral of tax on qualified retirement savings, IRC §§ 219, 401-417, and the deferral of tax on unrealized appreciation, IRC § 1001(a) (indicating taxable gains and losses with respect to property occur only upon “sale or other disposition of property”).

cized hearings in 1995 on eliminating the income tax in favor of a consumption tax; Chairman Bill Archer stated his goal was to “pull the current income tax code out by its roots and throw it away so it can never grow back.” Steve Forbes, a political neophyte, rode his advocacy of a flat rate consumption tax to a strong showing in several of the 1996 Republican presidential primaries. The public debate has begun, and radical changes in the tax system are possible.

Proponents of each approach argue that their preferred tax base is fairer. In addition, adherents of a consumption tax claim it will increase capital formation. A very different kind of argument in favor of a consumption tax is advanced by Professor Louis Kaplow in his article, *Human Capital Under an Ideal Income Tax*. Professor Kaplow’s analysis begins by considering how an ideal income tax would treat human capital. Despite the apparent normative implication of the adjective, Professor Kaplow explains that calling the tax ideal does not constitute an endorsement. Rather, the label de-

---

5 Rosenbaum, note 4, at A22. In addition, Speaker of the House Newt Gingrich and Senate Majority Leader Robert Dole created a panel, chaired by Jack Kemp, to consider fundamental changes in the tax system, including possible replacement of the income tax with a form of consumption tax. See Michael Wines, Gingrich Promises to Tie Tax Relief to Cuts in Deficit, N.Y. Times, Apr. 4, 1995, at A1. Not surprisingly, the Commission recommended replacing the income tax with some sort of flat rate consumption tax. See National Comm’r on Economic Growth and Tax Reform, Unleashing America’s Potential: A Pro-Growth, Pro-Family Tax System for the 21st Century, reprinted in 70 Tax Notes 413 (Jan. 22, 1996).


7 See, e.g., Andrews, note 1; Warren, Fairness, note 1.

8 See, e.g., USA Tax Act of 1995, note 4, § 101(a)(1) (stating purpose of Act is to “achieve higher levels of saving and investment, which will in turn increase productivity, economic growth, and living standards”); McCaffery, Tax Policy, note 2, at 1166-67. But see Staff of Joint Comm. on Tax’n, 104th Cong., 1st Sess., Discussion of Issues Relating to “Flat” Tax Rate Proposals 23 (Comm. Print 1995) [hereinafter Flat Tax Proposals] (reviewing literature and concluding, “[e]conomists disagree whether, in fact, an income tax does discourage saving”).


10 See id. at 1479.

11 See id. Given the inevitable normative implications of “ideal,” better terms might be a “pure” or “radical” income tax. In this Article, however, I follow Professor Kaplow’s terminology; my use of the “ideal” label is descriptive, not normative.

Imaged with the Permission of N.Y.U. Tax Law Review
scribes a tax whose base would include all accretions to wealth during the tax accounting period, whether saved or consumed, and whether realized or unrealized.\textsuperscript{12} By contrast, a consumption tax would not take into account increases in wealth until converted to consumption.\textsuperscript{13} The current income tax (referred to by Professor Kaplow as a “conventional” income tax\textsuperscript{14}) generally treats realized income from physical and financial capital on the income tax model. It treats unrealized appreciation, however, on the consumption tax model.\textsuperscript{15}

Professor Kaplow’s claim is that the conventional income tax treatment of human capital follows the consumption tax model. Each person is endowed at birth with an asset called human capital—the ability to generate income in future years by working. Its present value can be determined by applying an appropriate discount rate to the expected income stream, and that present value constitutes ideal income.\textsuperscript{16} A rigorous application of an ideal income tax to human capital would require taxing each person at birth on the value of this human capital endowment.\textsuperscript{17} The actual tax system, however, “ig-

\textsuperscript{12} See id. at 1479-80.
\textsuperscript{13} See Blueprints, note 2, at 8-11.
\textsuperscript{14} Kaplow, Human Capital, note 9, at 1480.
\textsuperscript{15} Unrealized appreciation is not taken into account by the conventional income tax. IRC § 1001(a). This is contrary to ideal income taxation, but consistent with consumption taxation (because unrealized appreciation has not been consumed).
\textsuperscript{16} See Kaplow, Human Capital, note 9, at 1482-90. In fact, it is debatable whether accrued human capital is an element of the ideal income base. “It is true that by discounting a stream of future earnings, [human capital’s] value can be ‘capitalized,’ but if there is no way in which that capitalized value can be used currently to command economic resources, why should it be counted [as ideal income]?” See Alvin C. Warren, Jr., Comments, in What Should be Taxed: Income or Expenditure? 120, 124 (Joseph A. Pechman ed., 1980) [hereinafter What Should be Taxed]. Rather than debating definitions, however, I would prefer to consider whether there is a policy justification for the different treatments the conventional income tax applies to human and other capital. Professor Kaplow expresses a similar distaste for argument by definition. See Kaplow, Human Capital, note 9, at 1500.
\textsuperscript{17} In each later year, ideal income would include the labor earnings in that year, less amortization of the human capital asset. Kaplow, Human Capital, note 9, at 1483-84. Alternatively, the ideal income (with respect to human capital) for any given year can be understood as “the increase in the value of human capital as a result of future earnings being one period closer.” Id. at 1484. Professor Kaplow discusses the cases of uncertain earnings streams and investments in human capital, and explains how they complicate the analysis somewhat, but do not affect his basic point. See id. at 1484-87.

Some commentators contend that the fairest of all taxes would be a one-time tax imposed on each person’s initial endowment, defined as his wealth—in both human capital and other assets—at the beginning of his working years. See Blueprints, note 2, at 36-38. Such a tax obviously is not practical, but, under certain conditions, a cash flow consumption tax (which does not tax saved income until it is consumed) has equivalent effects. See id. at 37. Thus, the endowment tax ideal becomes an argument for a consumption tax, as the closest practical approach to the ideal.

The endowment tax ideal is not identical to Professor Kaplow’s ideal income taxation of human capital. The endowment tax resembles accrual income taxation of human capital, in that both would value and tax each person’s initial endowment of human capital. Under
nores the ‘capital’ in ‘human capital,’” by simply taxing wages as they are earned. Since the substantial majority of all income is labor income, this constitutes an enormous departure from the ideal income tax.

Professor Kaplow notes the obvious objections to taxing human capital at birth (or even at some later event, such as graduation from college), due to valuation, liquidity and libertarian concerns, but he describes (without endorsing or rejecting) an ingenious system of proxy taxation of human capital, which would approximate the effect of ideal taxation while avoiding these problems. The proxy tax would tax wages only when earned, but would “gross them up by a factor that reflects the extent to which ideal income would otherwise be undertaxed.” This would require applying a multiplier, $m$, to each period’s earnings.

The increased tax burden on wages that would result from application of the multiplier would act as a deferral charge, offsetting the tax benefit of not taking human capital into in-

---

an endowment tax, however, the initial tax would be the only tax ever imposed, whereas under accrual income taxation, the initial tax would be followed by later annual taxes on accrued income. This difference results in different proxy taxes. The proxy tax for the endowment tax ideal is simply a cash flow tax on wages as earned, while the proxy for the income tax accrual ideal also includes a deferral charge.

18 Kaplow, Human Capital, note 9, at 1490.

19 One recent study estimates labor’s share of total income at 77%. See Don Fullerton & Diane L. Rogers, Who Bears the Lifetime Tax Burden? ’161 (1993).

20 See Kaplow, Human Capital, note 9, at 1506-07. The libertarian concern is that taxation of human capital “might force individuals to work in order to realize the value of their human capital so that they could pay their taxes.” Id. at 1506.

21 See id. at 1507-12. This is the most innovative aspect of Professor Kaplow’s analysis. The inconsistency of the cash flow taxation of wages with the income ideal has been discussed before, most thoroughly in William A. Klein, Timing in Personal Taxation, 6 J. Legal Stud. 461 (1977).

22 Kaplow, Human Capital, note 9, at 1507-08.

23 The formula for the multiplier is:

$$m = \frac{1}{t} - \frac{1 - t}{t} \left( \frac{1 + r_s}{1 + r} \right)^i$$

In the expression, $r$ is the tax rate, $i$ is the time period in which the earnings are received, $r$ is the interest (discount) rate, and $r_s$ is the after-tax interest (discount) rate. See id. at 1508. An important feature of the proxy tax is that the multiplier would increase with the taxpayer’s age $i$. Thus, $10,000$ earned near retirement would be taxed more heavily than $10,000$ earned in one’s twenties. See id. at 1508-09. This result may seem odd, but it follows from Professor Kaplow’s analysis. The taxpayer has benefitted from a longer deferral of tax with respect to near-retirement wages, and so must be subject to a greater offsetting deferral charge.
come when it accrued.24 One effect of the proxy tax would be to increase labor’s share of the total tax burden.25

Professor Kaplow’s apparent interest is not to promote the proxy tax. Rather, in his conclusion, he uses his analysis of the taxation of human capital (and his suggested proxy tax) to argue for applying a pure consumption tax model to physical and financial capital.26 Professor Kaplow claims that if income tax proponents really believed in the income tax ideal, they would favor ideal taxation of human capital endowments—but, in fact, they do not. He implies that income tax proponents cannot rely on the standard objections to ideal taxation of human capital, because his proxy tax overcomes those objections. He suggests that if they object even to the proxy tax, intellectual consistency demands that they abandon their advocacy of income taxation of physical and financial capital. Professor Kaplow concludes with these sentences: “If . . . ideal treatment of human capital is rejected, it may be difficult to defend present and proposed treatments of physical and financial capital. In that case, the objective of taxing income may have to be abandoned.”27

These concluding sentences seem to be the political point of Professor Kaplow’s article—a new and important argument for replacing the current income tax with a consumption tax. Given the use of “if” and “may” in the quoted passage, Professor Kaplow has not announced absolutely his consumption tax allegiance, but the rhetorical thrust of his conclusion is unmistakable. In a shorter, more recent article on the same topic, Professor Kaplow issues a challenge to income tax purists who reject the proxy tax: “[T]hey would have to explain why it made sense to insist upon a comprehensive income-tax norm with respect to a minority of capital while favoring something close to a consumption-tax norm with respect to the majority of capital—human capital.”28 In addition, in both articles, Professor Kaplow expresses a preference for designing tax systems not based on definitions (such as

24 For a somewhat similar proposal for a deferral charge to offset the benefit of the realization requirement with respect to other forms of capital, see Mary L. Fellows, A Comprehensive Attack on Tax Deferral, 88 Mich. L. Rev. 722 (1990). Professor Fellows reluctantly exempts human capital from her proposal because of practicality concerns. See id. at 780-83.

25 See Kaplow, Human Capital, note 9, at 1514.

26 See id. at 1512-14.

27 Id. at 1514. Despite Professor Kaplow’s earlier disclaimer of any normative implications of the ideal label, see id. at 1479, this passage makes rhetorical use of the label to suggest that intellectual consistency requires an income tax proponent to favor ideal taxation of all income.

income or consumption), but according to "fundamental moral principles or views of distributive justice."  

In this Article, I take up Professor Kaplow's challenge to defend the current income tax from the implications of his analysis. I do so not as an income tax purist, but as a defender of the broad outlines of the actual income tax—which, of course, applies consumption tax treatment not only to human capital, but to much physical and financial capital as well.

The basic problem with the argument against the income tax, founded on Professor Kaplow's human capital analysis, is that it is based on reification of the human capital metaphor. Economists have found it useful, for some purposes, to think of a person's income producing capacity as a kind of asset, and have applied the term human capital to the concept. If human capital is like other assets in certain ways, it is radically different in others. The argument utilizes the "capital" label to suggest that any tax system that does not treat human capital as it treats other capital is internally inconsistent. But there may be fundamental differences between human capital and other assets that justify the approach of the conventional income tax. In addition to disregarding the possibility of such differences, the argument depends on comparing the current system's treatment of human capital with the ideal—rather than the actual—tax treatment of other assets. The actual taxation of physical and financial capital is a hybrid of the income and consumption models, and the current system is not internally inconsistent if other capital is taxed under the consumption model in the situations most analogous to human capital.

In this response to Professor Kaplow, I make three major points. Section II explains that there are plausible policy reasons for applying

---

29 Kaplow, Human Capital, note 9, at 1513; see also Kaplow, Divergence, note 28, at 351.
31 In discussing the political ramifications of the concept of human capital, Lester Thurow remarks: "No one can dismiss lightly... the political importance of words and intellectual concepts. They form blinders that lead to specific decisions even when there is no logical necessity for them to lead to such decisions." Thurow, note 30, at 8.
32 See id. at 135 ("Analysis cannot be so overwhelmed by the similarities [between physical capital and human capital] that it forgets the very real differences.").
33 See note 2.
34 My arguments in response to Professor Kaplow are grounded much more in equity than in efficiency. This is because, as Professor Kaplow notes, efficiency does not require ideal taxation of the value of human capital: "Even though investments in human capital typically have a positive present value, at the margin they tend to have a zero present value. Thus, applying conventional treatment of physical capital to human capital would result in no marginal distortion." Kaplow, Human Capital, note 9, at 1496 (footnote omitted).
the consumption tax (or cash flow) model to human capital, even while applying the income tax model to some income from other capital. First, accrued human capital does not represent current ability to pay tax. Second, given a tax system that taxes different savings under different models according to their purposes—in particular, that generally taxes life cycle savings under a consumption tax model—human capital savings fall on the consumption tax side of the line. My purpose in invoking these norms—of ability to pay and consumption tax treatment of life cycle savings—is the narrow one of defending the conventional income tax against Professor Kaplow's suggestion that it is internally inconsistent. I do not attempt here the much broader task of proving the current system is the best of all possible taxes. Section III argues that the proxy tax fails, even on Professor Kaplow's own terms. It falls so far short of being an adequate approximation for ideal taxation of human capital that it is not worth pursuing, even assuming accrual taxation were the ideal. The failures of the proxy tax include its disregard of human capital never converted to market earnings and its inability to serve the income tax goal of reaching the intangible returns to the possession of wealth. Section IV explores some implications, not considered by Professor Kaplow, of taking the human capital metaphor seriously. If the law is to tax people on the premise that they are best viewed as income-producing machines, lawmakers need to consider treating as business expenses many costs currently treated as nondeductible personal consumption. The result of doing so would be a more progressive tax on earned income, but not necessarily an increase in labor's share of the total tax burden.

II. HUMAN CAPITAL AND THE REASONS FOR CHOOSING AN INCOME TAX

A. Ability to Pay

The classic argument for favoring an income tax over a consumption tax is that tax burdens should be distributed in accordance with ability to pay, and that saved income creates ability to pay to the same extent as consumed income.\(^{35}\) Does human capital, not converted to

---

\(^{35}\) See, e.g., Joseph M. Dodge, Taxing Human Capital Acquisition Costs—Or Why Costs of Higher Education Should Not Be Deducted or Amortized, 54 Ohio St. L.J. 927, 948 (1993) ("[T]he ethical obligation of citizens to contribute to the reallocative and redistributive functions of government is a function of the material resources (money and property) they respectively control during a given budget period."); Richard Gose, The Superiority of the Income Tax, in What Should be Taxed, note 16, at 49, 52 ("In my view, the total increase in a person's power to consume marketable output has greater intuitive appeal as an indicator of ability to pay than the exercise of the power to consume has. ... A person's decision to save a portion of his income is an individual choice and does not lessen his capacity to satisfy his private wants or to contribute to the public budget."); Alan Gunn,
market earnings, generate ability to pay, so that it should be taxable under an income tax? Answering this question requires distinguishing between unused current earning capacity, and the capacity to generate earnings in the future.

Unexercised current earning capacity does create ability to pay—if required to pay a tax on earning capacity, a beachcombing neurosurgeon could go back to work. A tax on that capacity might be objectionable on libertarian or administrative grounds, but it would not violate the principle of ability to pay. In alimony and child support cases—where the libertarian concern is less compelling because the potential earner voluntarily has assumed an obligation—courts routinely consider unused earning capacity as generating ability to pay. But the taxation of this form of human capital is not involved in Professor Kaplow's proxy tax, which would continue the practice of ignoring unused current earning capacity.

The proxy tax is aimed at increasing the tax burden on the capacity to generate market earnings in the future, by increasing the tax on income when it is earned as a substitute for taxing future earning capacity when it accrues. The crucial question is whether the potential to earn money in future years creates the ability to pay tax in the current year. The proxy tax does not avoid the need to ask this question simply because it waits until money actually is earned to impose the tax. Professor Kaplow assumes that an earlier accretion tax is the

---

The Case for an Income Tax, 46 U. Chi. L. Rev. 370, 386-88 (1979) (defending idea of ability to pay against charge of consumption tax advocates that it is not a useful concept); Alvin C. Warren, Jr., Would a Consumption Tax Be Fairer Than an Income Tax? 89 Yale L.J. 1081, 1094 (1980) [hereinafter, Consumption Tax] (“[Savers] have not only current consumption, but also an option for additional consumption that can be exercised at will. Why, from the point of view of distributional fairness, should the existence of such options be ignored?”).

36 This example is suggested by Mark G. Kelman, Personal Deductions Revisited: Why They Fit Poorly in an “Ideal” Income Tax and Why They Fit Worse in a Far From Ideal World, 31 Stan. L. Rev. 831, 838-42 (1979). See id. at 841; see also Fullerton & Rogers, note 19, at 23 (“When the individual is free to choose the number of hours to work, ‘ability to pay’ is best reflected by the total value of the individual’s labor endowment[,] regardless of how much of his time he chooses to devote to producing market income”); Gunn, note 35, at 381-82.

37 See Kelman, note 36, at 841-42. But see the critique of Professor Kelman’s analysis in Paul B. Stephan III, Federal Income Taxation and Human Capital, 70 Va. L. Rev. 1357, 1365 n.12 (1984) (“Either he . . . is treating as taxable volunteers those members of the underclass who are driven into the labor market to survive, or he proposes an exclusion available only to persons with relatively high earning potentials.”).

38 See, e.g., Pencovic v. Pencovic, 287 P.2d 501, 504 (Cal. 1955) (“Defendant is an able-bodied man, and the trial court could reasonably conclude that he had the earning capacity to discharge the obligation of the [child] support award.”); Pierce v. Pierce, 243 S.E.2d 46, 49 (Ga. 1978) (stating father’s desire to be full-time student did not relieve him of his child support obligation); Hawkins v. Hawkins, 47 S.E.2d 436, 439 (Va. 1948) (alimony based on husband’s ability to earn, not his actual earnings).
theoretical ideal, and suggests the deferral charge as an administratively feasible approximation of that ideal. But, if the theoretical foundation of the income tax is ability to pay, and if future earning capacity creates no current ability to pay, an accrual tax on that capacity would not be justified theoretically. If the accrual tax is not desirable in principle, even if it were practical, there is no reason to look for a practical way of approximating it.

Ability to pay is a fuzzy enough concept that it provides only limited guidance in designing a tax system. At a minimum, however, it means that things that are neither cash nor currently convertible to cash ordinarily should be exempt from tax.\footnote{There are a few exceptions to this principle. Tax may be imposed on kind benefits, not convertible to cash, if they relieve a taxpayer of the need to spend cash. An example is employer-provided housing that does not satisfy the requirements of § 119. In addition, tax may be imposed to correct what now appears—with the benefit of hindsight—to have been unduly favorable tax treatment in the past. See Hillsboro Nat'l Bank Co. v. Commissioner, 460 U.S. 370 (1983) (tax benefit rule); Commissioner v. Tufts, 461 U.S. 303 (1983) (requiring unpaid balance of nonrecourse mortgage to be included in amount realized, even if in excess of fair market value of property). None of the exceptions is relevant to the taxation of future earning potential.} If future earning capacity cannot be converted to current cash—by sale or by borrowing—it does not generate current ability to pay tax. Most people have little or no ability to turn that future capacity into cash.\footnote{See, e.g., David F. Bradford, Untangling the Income Tax 23 (1986) ("[I]f wealth is understood as the current purchasing power an individual can obtain by committing the future inflows from an asset (as by selling a share of stock or by pledging the profits of a business as collateral for a loan), the omission [of human capital from wealth] is sensible for most people. Anyone who has tried to borrow against future earning power will know that its current market value is quite limited."); Gunn, note 35, at 380 ("One with a bank account or stock portfolio can pay by withdrawing money or selling stocks, but one with only human capital would be hard pressed to convert that capital into the cash with which taxes must be paid.").} Because employers cannot insist on specific performance, they generally are unwilling to pay now for the promise to perform services in future years;\footnote{Professor Warren remarks that this may not apply to those—such as outstanding professional athletes—whose unique skills put them in an especially strong bargaining position, but it certainly is true for most of us. See Warren, Consumption Tax, note 35, at 1116.} and except for two special situations (educational loans and home mortgages), no substantial borrowing against future earnings is possible. Most of the time, all one can do is rent out one’s capacity to work in the present, and it is only that present capacity that gives rise to an ability to pay.

Professor Kaplow is not much concerned with whether human capital creates ability to pay, but he does note in passing that some borrowing occurs—law and medical students may be eligible for unusually large educational loans, and qualification for a home mort-
gage loan depends in part on likely future earnings. But these two situations are far too narrow to justify general tax accrual of human capital. These types of loans are irrelevant for anyone who would like to borrow against his human capital for any other purpose. Even when the borrowing is for an accepted purpose, the amount that can be borrowed is a small fraction of the total present value of one's human capital. Home mortgage loans, for example, usually are limited to about three times annual earnings. Moreover, the limitation on the use of the loan proceeds—education or home purchase—means that even the borrowed funds create no ability to pay tax. (Imagine the reaction of the mortgage lender if one wanted to borrow $200,000, using $150,000 to buy a $150,000 house and using $50,000 to pay taxes.) For this reason, the limited ability to borrow against future earnings provides no ability-to-pay justification for taxing even the borrowed amounts, let alone a justification for a general system of accrual taxation for human capital.

It is enough to defend the current income tax from the implications of Professor Kaplow’s analysis by comparing the taxation of human capital with the taxation of other (physical and financial) capital under the actual income tax. Professor Kaplow suggests that logic compels one who supports income tax treatment of other capital also to support income tax treatment of human capital. But the proxy tax would subject human capital to an extreme version of income taxation—the rough economic equivalent of taxation without realization—that is not imposed on the vast majority of other capital. It is sufficient refutation of the charge of inconsistency if the current tax treatment of human capital parallels the current less-than-ideal taxation of other capital. And so it does—the realization requirement departs from the accrual ideal in exactly the same way for both human and other capital. (Conversely, when income is realized in cash, the current income tax provides consistent treatment for the return on human capital and the return on other capital—by taxing both.) It is actually much easier to justify, on grounds of ability to pay, the deferral of tax on unrealized human capital, than it is to justify the deferral of tax on unrealized appreciation in many other forms of capital, where the appreciation easily could be borrowed against or sold.

---

42 See Kaplow, Human Capital, note 9, at 1505 n.65.
43 See Judy Rose, Affordable Housing; Should You Be Conservative or “Max Out”? Chi. Trib., May 27, 1994, at C18.
44 Under current law, unrealized appreciation remains untaxed even if it actually is borrowed against. See Woodsam Assocs. v. Commissioner, 198 F.2d 357 (2d Cir. 1952).
45 In some situations—where selling or borrowing would be difficult or impossible—the application of the realization requirement to other capital can be defended forcefully on ability-to-pay grounds. See, e.g., Dodge, note 35, at 948-49; Gunn, note 35, at 385-86.
B. Human Capital as a Form of Savings

The debate between an income tax and a consumption tax is about the tax treatment of savings. In their pure forms, an income tax would tax all saved income, and a consumption tax would not tax savings until consumed. As Professor Edward McCaffery has pointed out, people save for different purposes, and there may be a policy justification for a hybrid income-consumption tax, which treats different savings differently depending upon their purposes.46 This suggests a way of evaluating the tax treatment of human capital: Determine what form of savings accrued human capital represents, and then consider whether consumption tax treatment is justified for that kind of savings.

The standard taxonomy of savings identifies three categories. Life cycle savings are intended to defer consumption to a later period—most commonly, to smooth out consumption over a lifetime by transferring income from earlier years of higher income to later years of little or no income.47 Precautionary savings serve a function similar to insurance. Saved income becomes a safeguard against extraordinary circumstances, such as serious illness or disability.48 Bequest savings, by contrast, are intended not for future consumption by the saver, but for transfer to younger generations.49 Precautionary saving is arguably a less fundamental category than the other two, since such savings ultimately become either life cycle savings (if the savings turn out to be needed), or bequest savings (if they do not).

Depending on the chosen perspective, accrued human capital can be viewed as either life cycle or bequest savings. I discuss the tax policy consequences of each perspective below.

1. Human Capital as Life Cycle Savings

If asked how they expect to finance their consumption needs and wants in future years, most people would respond that until retirement they will pay for each year's consumption with that year's earnings, and that after retirement they will rely on their retirement savings. Just as tax-deferred retirement savings are the dominant form of life cycle savings for post-retirement consumption, accrued human capital is the dominant form of preretirement life cycle savings.

46 See McCaffery, Tax Policy, note 2, at 1179-216.
47 See id. at 1176-77.
48 See id. at 1177-78.
49 See id. at 1178.
Viewing human capital as life cycle savings, the question is whether, in a hybrid tax system, life cycle savings merit consumption tax treatment. Professor McCaffery identifies as "perhaps the easiest and strongest argument for favoring life cycle savings" the fact that income tax treatment imposes a heavier burden on deferred consumption than on current consumption, thus discouraging life cycle savings.\footnote{Id. at 1185. Consider a simple example. (This example is similar to one in Marvin A. Chirelstein, Federal Income Taxation 305-06 (7th ed. 1994).) In a tax-free world, both Consumer (C) and Saver (S) earn $100 this year. C chooses to consume the $100 this year. S plans to invest the $100 at 10%, and consume only the $10 annual investment income. Suppose a 50% income tax is imposed. C will be left with $50 after tax, reducing his current consumption by one-half. S will be left with $50 to invest, after tax. Assuming the pretax return on investment remains 10%, the $50 will yield $5 per year before tax, and only $2.50 after tax. S's future consumption is reduced by three-quarters. The heavier tax burden on future consumption will discourage people from saving, thus distorting choices in favor of current consumption. The substitution effect in favor of current consumption could be partially or fully offset by an income effect. The increased burden on saving might cause S to save more, if S is determined to have a $10 after-tax annual investment return, no matter how great the cost. Cf. Andrews, note 1, at 1173 & n.134. The majority opinion among economists, however, is that there would be greater savings under a consumption tax than under an income tax. As Professor McCaffery notes, "Economists so rarely agree about anything that we might well regard their consensus on this point as decisive ..." McCaffery, Tax Policy, note 2, at 1166-67. But see Flat Tax Proposals, note 8, at 23 (disputing existence of such a consensus).}

This effect is not unique to life cycle savings—an income tax will burden savings for any purpose more heavily than will a consumption tax. It certainly would be a rational policy decision, however, that it is not acceptable for the tax system to discourage people from saving for their future consumption needs, but that it is acceptable for the tax system to favor current consumption over saving for bequests—especially if most bequest dollars go as windfalls to affluent adults. The standard policy argument in favor of tax-deferred retirement savings is based on the premise that the tax system should not discourage life cycle savings, although it usually is expressed in more positive terms.\footnote{In the words of the Staff of the Joint Committee on Taxation, "The policy rationale for this tax expenditure is that the tax benefits for qualified plans encourage employers to provide retirement benefits for their employees." Staff of Joint Comm. on Tax'n, 102d Cong., 1st Sess., Simplification of Present-Law Tax Rules Relating to Qualified Pension Plans S (Comm. Print 1991). The Staff goes on to note, "This reduces the need for public assistance and reduces pressure on the social security system." Id.}.

In addition to the concern about distortion, the heavier burden an income tax imposes on deferred consumption also can be used to support a fairness argument for deferral of tax on life cycle savings. Even if there is no distortion—that is, even if taxpayers do not change their choices between current and future consumption in response to tax considerations—it is arguably unfair for an income tax to impose a
greater burden on savers than on current consumers, just because they have different tastes in the timing of consumption.\textsuperscript{52}

For the purpose of responding to Professor Kaplow, it is not necessary to accept or reject the arguments for applying consumption tax treatment to life cycle savings. Professor Kaplow's analysis is premised on the alleged inconsistency of the income tax's treatment of human capital and other capital. But I am interested in the real income tax, not an academic ideal. His analysis disregards the considerable extent to which the real income tax applies a consumption tax model to physical and financial capital. In particular, it ignores the consumption tax treatment of retirement life cycle savings under the rules for qualified pension plans and individual retirement accounts.\textsuperscript{53} If human capital is life cycle savings, and if its cash flow taxation is consistent with the taxation of other life cycle savings under current law, the supposed inconsistency vanishes.

Two—and only two—possible responses come to mind. The first response is that the concern about distortion of choices between consumption and saving does not apply to human capital, to the extent that human capital is innate (or endowed), rather than acquired through investment of time or money. Since human capital is a windfall, taxation cannot discourage its acquisition. If future earning capacity cannot be converted into current cash, as it usually cannot,\textsuperscript{54} there is no danger that it will be consumed currently instead of saved. Efficiency concerns are important, however, to the considerable extent human capital is acquired by investment rather than received as endowment. Even with respect to endowment human capital, there is a powerful equity argument derived from efficiency concerns: Once efficiency considerations have dictated that life cycle retirement savings of financial capital be taxed on the cash flow model, fairness requires equivalent treatment of human capital life cycle savings, even if efficiency does not.

The second possible response is that the cash flow treatment of qualified-plan retirement savings is subject to statutory ceilings, whereas the cash flow treatment of human capital savings is not. In

\textsuperscript{52} See, e.g., Andrews, note 1, at 1167-68; McCaffery, Tax Policy, note 2, at 1186. This argument is controversial. If one believes it is inappropriate to discount future consumption to present value, a saver will have more total consumption than a consumer, and the greater burden an income tax imposes on a saver is appropriate. For an extended argument to this effect, see Mark Kelman, Time Preference and Tax Equity, 35 Stan. L. Rev. 649 (1983). Professor Kelman concludes, "If savers are rentiers, earning a rate of return independent of time preference, the capacity to save gives rise to an ability to command equal resources with less work that is not counterbalanced by any reasonably universal psychic detriment." Id. at 680.

\textsuperscript{53} IRC §§ 401-417 (qualified plans); IRC § 219 (IRAs).

\textsuperscript{54} See Section II.A.
the case of a defined benefit plan, annual benefits are limited to the lesser of $120,000 or 100% of average compensation for the top three years.\footnote{IRC § 415(b)(1); see Notice 95-4, 1995-1 C.B. 291 (providing inflation adjustment). An employer's annual contribution to a defined contribution plan is limited to the lesser of $30,000 or 25% of compensation. IRC § 415(c)(1); Notice 95-4, supra (providing no adjustment).} In addition, the Code imposes a 15% excise tax on aggregate annual distributions from tax-favored retirement savings, to the extent they exceed $150,000.\footnote{IRC § 4980A. The 15% excise tax does not apply to distributions made during 1997, 1998 and 1999. IRC § 4980A(g), added by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1452(b), 110 Stat. 1755, 1816.} These limits are quite high. They obviously are intended to allow the vast majority of taxpayers cash flow taxation of all their retirement savings, even if those savings enable the taxpayers to maintain a very comfortable post-retirement standard of living.\footnote{The $120,000 and $150,000 annual limits are especially generous considering that most retirees will have neither home mortgage payments nor child-related expenses.} Cash flow treatment is denied only for savings that either support a luxurious standard of living or are more likely to be disguised bequest savings.\footnote{The § 415(b) and (c) limits originated in the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2004, 88 Stat. 829, 979-85. The legislative history explains: "These limitations . . . have been designed to avoid abuse of the favored tax treatment to finance extremely large pensions. However, the limitations are generous enough to permit substantial retirement benefits which are adequate judged from any reasonable standard." H.R. Rep. No. 93-779, at 25 (1974), reprinted in 1974-3 C.B. 276. The § 4980A excise tax was part of the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1133, 100 Stat. 2085, 2481-83. The Joint Committee Staff explained that "Congress believed that there was no need to permit a participant to accumulate excessive retirement savings, regardless of whether such excess was attributable to the receipt of multiple maximum benefits from several employers, very large appreciation in defined contribution plans, or the use of IRAs by individuals receiving significant employer-provided benefits." Staff of Joint Comm. on Tax'n, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 755 (Comm. Print 1987) [hereinafter 1986 Bluebook].} 

If these limits are viewed as distinguishing bequest savings from lifecycle savings, that is a concern that does not apply to human capital. Human capital disappears at death, so it cannot be bequeathed.\footnote{After human capital is converted to cash, it can be bequeathed, but, at that point, it is no longer human capital.} But even if the limits are viewed as denying cash flow taxation for excessive lifecycle savings, their existence would justify only a very limited application of Professor Kaplow's deferral charge. Consistent with the tax on excess retirement distributions, the deferral charge should be imposed only on annual earnings in excess of $150,000.\footnote{Under current law, many mixed business-personal expenses, incurred by workers but not by the retired, cannot be deducted. Examples include commuting, work-related clothing and child care. See Lawrence Zelenak, Marriage and the Income Tax, 67 S. Cal. L. Rev. 339, 372-73 (1994). If the law is not changed to make direct allowance for these expenses (a possibility discussed in text accompanying note 112), a worker would need more than $150,000 to live as well as a retiree could live on $150,000. Arguably, then, the}
son of the taxation of human capital with the actual taxation of other forms of life cycle savings, rather than with an ideal income tax, does not support a radical change in the relative taxation of human and other capital; it merely suggests a higher tax rate on a rather small number of highly compensated earners.

2. **Human Capital as Bequest Savings**

As the preceding discussion has shown, human capital appears to be a form of life cycle savings when the focus is on the purpose for which a taxpayer holds it. If, however, the focus changes from the purpose for holding to the manner of acquisition, a person's innate human capital looks more like a parental gift or bequest. To put the point another way: Viewed in relation to *succeeding* generations, human capital appears to be life cycle savings, because it will be used to support one's own lifetime consumption, rather than to create a bequest to the next generation.\(^{61}\) But viewed in relation to *preceding* generations, human capital endowment is a genetic parental bequest.\(^{62}\) If innate human capital is thought of as bequest savings, should it be subject to income taxation upon its creation?\(^{63}\)

Professor McCaffery makes a strong efficiency-based case against subjecting traditional bequest savings to the income tax model. If substantial savings are motivated by the desire to leave bequests, and if the choice between bequest savings and current consumption is tax-sensitive, then "to the extent that we are concerned with the macroeconomic and efficiency gains promised by the consumption model, we should be reluctant to impose too high a toll on bequests."\(^{64}\) His argument is not merely about efficiency, however. It is plausible that the capital formation encouraged by favorable tax treatment of bequests, across generations, would redound to the benefit of

---

\(^{61}\) It also will be used to support one’s children during their dependency. The tax treatment of earnings used for that purpose is discussed in text accompanying notes 122-25.

\(^{62}\) There are suggestions of this view in the tax literature. Professor Kaplow notes that future wages are determined partly by inheritance, broadly construed “to include genetic endowment and learning in the home.” Kaplow, Human Capital, note 9, at 1500 n.53. Similarly, Professor Klein observes that innate human capital can be analogized to physical assets acquired by gift or bequest—although he prefers to equate it with assets acquired by luck or windfall. See Klein, note 21, at 468 n.27.

\(^{63}\) Professor Klein argues that the theoretically correct taxpayers in that case would be the parents of the talented child; the child would receive the human capital from the parents as a nontaxable gift. See Klein, note 21, at 468 n.27.

\(^{64}\) McCaffery, Tax Policy, note 2, at 1210.
even the least advantaged members of society.\textsuperscript{65} Whether or not one agrees with Professor McCaffery’s argument with respect to bequest savings of physical and financial capital, it has no application to human capital endowments. The argument depends on potential bequest savers having a choice between self-indulgent consumption and saving for future generations. They do not have that choice with respect to the human capital of their children. The very creation of new innate human capital in a new human being alienates the human capital asset from the creators; the parents do not have the option of spending their children’s human capital inheritance, as they do with other inheritance.\textsuperscript{66}

More relevant here than Professor McCaffery’s transferor-focused analysis is a long tradition of recipient-focused, equity-based arguments in favor of taxing bequest savings. These generally are presented as arguments for transfer taxes (gift, estate or inheritance), rather than for accrual income taxation.\textsuperscript{67} When the rate of tax is the same, however, accrual income taxation of innate human capital imposes the same burden on genetic endowment that an estate tax imposes on traditional bequests.\textsuperscript{68}

\textsuperscript{65} See id. at 1211. In a later article, McCaffery develops at considerable length the case for his favored tax system, a progressive consumption-without-estate tax. McCaffery, Uneasy Case, note 1.

\textsuperscript{66} This does not mean no efficiency concerns are implicated by the taxation of innate human capital as a form of bequest savings. Although parents cannot consume their children’s human capital, an accrual tax imposed on the parents at birth, see note 63, certainly could serve to discourage fertility, thereby depressing societal human capital formation (to push the metaphor). Professor Kaplow’s proxy tax alternative, imposed much later on the child rather than on the parents, should not have an appreciable effect on fertility.

\textsuperscript{67} The textual discussion refers to fairness arguments for taxing bequests. Bequest taxation also has been defended, however, as a way of raising revenue without causing inefficiency. Taking the recipient’s perspective, John Stuart Mill viewed inheritance as pure windfall, which could be taxed without adverse effect on savings incentives. See John Stuart Mill, Principles of Political Economy, bk. V, ch. II, § 7, at 822 (W. J. Ashley ed., Longmans, Green and Co. 1923) (1848) (noting that if inheritance is taxed, recipient “feels no more inducement than at any other time . . . to economize in his expenditure”). Professor McCaffery rightly criticizes Mill’s position as ignoring the savings disincentive bequest taxation creates for the potential transferor, with respect to traditional bequests. See McCaffery, Tax Policy, note 2, at 1188. Mill’s point might have been better taken, however, with respect to accrual taxation of innate human capital. If the tax somehow could be imposed on the child rather than the parents (so it did not discourage fertility, note 66), it would not cause distortion. Fullerton and Rogers use such a tax as a benchmark for measuring the excess burden of other tax systems, precisely because it “does not distort any labor-leisure or consumption choices.” Fullerton & Rogers, note 19, at 155. Professor Kaplow’s proxy tax, however, loses this advantage. Since it looks only to earned income, it distorts the labor-leisure choice in the same way as any tax system that taxes earned income but not unused earning capacity.

\textsuperscript{68} If, however, traditional bequest savings were subject to both accrual income taxation and estate taxation (which sometimes happens under current law), the result would be a triple tax burden—on the initial accrual, on investment return and on transfer. An
John Rawls, for example, supports using inheritance and gift taxes "gradually and continually to correct the distribution of wealth and to prevent concentrations of power detrimental to the fair value of political liberty and fair equality of opportunity."\(^{69}\) When other forms of capital are at issue, taxation of bequest savings can promote fair equality of opportunity by redistribution of capital—taking from those with more and giving to those with less.\(^{70}\) Innate human capital, however, is fundamentally different; it cannot be redistributed. Equality of opportunity with respect to human capital endowment can be achieved only by the destruction of the human capital of those with more—for example, by lobotomies of the unusually intelligent.\(^{71}\) That would require an appalling violation of the personhood of those "taxed." The idea is so offensive that it appears never to have occurred to Rawls, even as a possibility,\(^{72}\) despite his view of the distribution of abilities by the "natural lottery" as "arbitrary from a moral perspective."\(^{73}\) In sharp contrast with the intolerable attack on personal integrity involved in the destruction of human capital, redistribution of other capital plausibly can be defended as for the good even of the person whose assets are taken.\(^{74}\)

---

\(^{69}\) John Rawls, A Theory of Justice 277 (1971). Rawls defines fair equality of opportunity:

[...]ssuming that there is a distribution of natural assets, those who are at the same level of talent and ability, and have the same willingness to use them, should have the same prospects of success regardless of their initial place in the social system, that is, irrespective of the income class into which they are born.

Id. at 73.

\(^{70}\) For an unusual, contrary view of the meaning of wealth redistribution, see Gunn, note 35, at 397 n.80 ("By "redistribution" I mean taking wealth from the rich as an end in itself, not necessarily giving that wealth to the poor.").

\(^{71}\) Kurt Vonnegut's short story, Harrison Bergeron, describes a dystopia in which the United States Handicapper General ensures that nobody is better looking, more athletic or smarter than anyone else. The beautiful must wear masks, the athletic bags of birdshot and the intelligent earphones that emit sharp noises every 20 seconds. Kurt Vonnegut, Jr., Harrison Bergeron, in Welcome to the Monkey House 7, 7-8 (1968).

\(^{72}\) Rawls' failure to consider equalization of opportunity by the destruction of human capital is not surprising, in light of his statement at the beginning of his book: "Each person possesses an inviolability founded on justice that even the welfare of society as a whole cannot override." Rawls, note 69, at 3.

\(^{73}\) Id. at 74. Michael Graetz has expressed nicely the moral arbitrariness of the distribution of both human and other capital: "Many outcomes are determined simply by accidents of birth—being born in this country rather than in the Third World; being born smart or good-looking, rather than stupid or ugly; being born into a family of wealth and education, rather than one of poverty and ignorance." Michael J. Graetz, To Praise the Estate Tax, Not To Bury It, 93 Yale L.J. 259, 276 (1983).

\(^{74}\) The most famous proponent of this position is Andrew Carnegie: "[L]ooking at the usual result of enormous sums conferred upon legatees, the thoughtful man must shortly
In addition to the violation of those whose human capital is destroyed, such levelling likely would work to the detriment of those less able, whose human capital is untouched. Rawls' difference principle allows that "the higher expectations of those better situated are just if and only if they work as part of a scheme which improves the expectations of the least advantaged members of society." Differences in natural ability seem to pass this test easily. The world would be a poorer place if deprived of the special talents of a Michael Jordan or a Bill Gates, in the name of equality of opportunity.

There is a possible response to this. Perhaps the real goal should be reduction of the inequality of total endowments, of human and other capital. Those with large human capital endowments would pay their tax not by partial destruction of their human capital, but with their endowments of other capital. The result would be that those with large human capital would be left with little or no other capital, and those with little human capital would be compensated by large redistributions of other capital. This response has problems of its own. First, it assumes that those with large human capital endowments will have enough other capital to pay the tax; this assumption will not necessarily be true. Second, it is far from clear why one would want such a system, even if it were feasible. Human and other capital are far from fungible. Does it really equalize opportunity if one person has $1 million dollars of human capital and no other capital, and another person has the reverse? In addition, the tendency of the system to separate stores of human and other capital would be inefficient, given that neither brains without money nor money without brains is very productive.

Given all these problems with any attempt to tax human capital as a form of bequest savings, it would be far better—as a matter of basic policy and not merely as a concession to administrative convenience—to wait until human capital is converted to cash earnings and then to redistribute the earnings to the extent deemed appropriate. That is

say, 'I would as soon leave to my son a curse as the almighty dollar'...” Andrew Carnegie, Wealth, 148 N. Am. Rev. 653, 658 (1889).

75 See Rawls, note 69, at 75.

76 Professor McCaffery argues that differences in fortune due to traditional bequests also satisfy the difference principle, because the capital formation from bequest savings benefits society as a whole. Thus, consumption tax treatment of bequest savings is justified. See McCaffery, Tax Policy, note 2, at 1193, 1208-14. (Rawls acknowledges the theoretical appeal of this line of reasoning, but he is agnostic as to the existence of the state of facts it assumes. See Rawls, note 69, at 78.) The argument that inequality of human capital satisfies the difference principle is, however, more intuitively appealing than the argument concerning inequality of traditional bequests. Unlike the bequest argument, the human capital argument requires no speculation about the elasticity of bequest savings with respect to tax rules, in order to conclude that the world would be a poorer place without the special skills of Jordan or Gates.
precisely what the current tax system does. To the considerable extent differences in natural abilities are reflected in differences in earnings, this accomplishes redistribution with respect to differences in human capital endowment, without the destruction of human capital. This is what John Rawls has in mind. His response to the moral arbitrariness of the unequal inheritance of abilities is not a direct tax on abilities (which would be the analogue of his favoring an inheritance tax for traditional bequests), but simply a cash flow tax on income as it is earned.

Of course, the proxy tax also waits until human capital is converted to cash to begin redistribution. The gross up feature of the tax, however, is intended to approximate the effect of taxation of human capital at birth. If one rejects the theoretical case for taxing human capital at birth as a means of promoting fair equality of opportunity, one should have no interest in adopting the proxy tax. The proxy tax becomes nothing more than a way of approximating results one would not want to achieve if one could.

III. THE FAILURE OF THE PROXY TAX TO APPROXIMATE ACCRUAL TAXATION

There are significant differences between the economic effect of the proxy tax and the effect of accrual taxation of human capital. These differences raise the question of whether, even assuming approximation of accrual taxation is the goal, the proxy tax comes close enough to the ideal to be worthy of adoption. A serious proposal for a proxy tax would consider these shortcomings in detail, and explain why the proxy tax should be adopted despite its less-than-perfect implementation of the accrual ideal. Professor Kaplow, who describes but does

---

77 A cash flow tax on earned income as a means of redistributing human capital endowments is considered explicitly in William R. Johnson, Income Redistribution as Human Capital Insurance, 22 J. Hum. Resources 269 (1987). Johnson recognizes redistribution of human capital endowments as a legitimate policy objective. See id. at 269-70. Parents might favor institutionalizing a redistributive tax structure as a way of insuring that their children against the possibility of low human capital endowment. See id. at 273-74. Johnson views traditional cash flow taxation of earned income as fully capable of achieving this goal. See id. at 274.

78 The difference between redistribution of human capital by a cash flow tax on earned income and by destruction of “excessive” human capital, is roughly the difference between the golf handicap system and breaking the legs of the better golfers.

79 See Rawls, note 69, at 278-80 (comparing proportional and progressive tax systems). His preference is for a proportional tax on total consumption, but he notes that “even steeply progressive income taxes” may be defensible “given the injustice of existing institutions.” Id. at 279.
A. The Pleasantly Surprised and the Disappointed

1. The Nature of the Problem

The proxy tax requires a person who has unanticipated earnings to pay a deferral charge on those earnings, just as if they had been expected all along. If the earnings were a complete surprise, however, an ideal tax would have accrued nothing in previous years, making a deferral charge inconsistent with the accrual ideal. The effect of the proxy tax would be the overtaxation of windfall earnings, compared to the ideal. The mirror image of this problem is the taxpayer who fully anticipates earning money in a particular year, but whose expectations are dashed. An ideal tax would have accrued income on account of the expected earnings, and then would have allowed a loss deduction when the expectations were dashed. Because of the time value of money, the earlier accrual would be a greater burden than the later deduction would be a benefit, so the disappointed taxpayer would be left with a net tax burden under the ideal income tax. The proxy tax ignores the fact that dollars not earned had been expected, resulting in the undertaxation of this taxpayer compared with the accrual ideal.

A proponent of the proxy tax might defend it by arguing that the real choice is between the proxy tax, which assumes all earnings are anticipated, and the current system, which assumes all earnings come as a complete surprise. If the only choices were these two extremes, treating all wages as expected probably would come closer to reality than treating all wages as unexpected. Those are not, however, the only choices. As discussed below, the proxy tax could be refined to treat some earnings as expected since birth, some earnings as expected for some shorter period and some as a surprise.

The issue of surprises and disappointments suggests a deeper problem with the accrual ideal itself. The human capital accrual ideal implies that the person who fully expects to earn $X, and is disappointed at the last minute, is undertaxed if taxed on nothing. One who is unwilling to accept that conclusion has rejected the logic of accrual taxa-

---

80 See Kaplow, Human Capital, note 9, at 1508 n.76 (concerning problem of surprised and disappointed wage earners), 1507 n.73 (concerning problem of imputed income). Professor Kaplow also notes that the proxy tax “ensures only that the present value of the tax base is correct, which is sufficient with proportional rates but not with progressive rates.” Id. at 1508 n.76.

81 Professor Kaplow notes the surprise aspect of the current system: “The conventional income tax implicitly treats wages as if they come as a complete surprise—a surprise repeated annually throughout the working life of a typical taxpayer.” Id. at 1490 n.20.
tion, and should have no interest in either accrual taxation or in a proxy tax.\footnote{The reasoning behind the intuition that accrual taxation would be wrong in this situation is based on the concept of ability to pay, discussed in detail in text accompanying notes 35-45. The basic idea is that anticipated earnings create no ability to pay tax until they actually are earned. If they are not earned, there is never any ability to pay, and there should never be any tax. See note 40 and accompanying text.}

2. **Finetuning the Deferral Charge to Distinguish Expected From Unexpected Earnings**

Although the median annual earnings for all full-time workers is approximately $24,500,\footnote{Bureau of Labor Statistics, Usual Weekly Earnings of Wage and Salary Workers: Fourth Quarter 1994, tbl. 1 (USDL 95-43) (Feb. 9, 1995). The median weekly earnings for all full-time workers age 16 and older totalled $472. Multiplying by 52 weeks yields $24,544 median annual earnings.} when workers are categorized by sex and race or ethnicity, the medians vary widely. The median for white men is over $29,000, while the median income for both white women and black men is over $21,000. The median figures for black women and Hispanic men are over $18,000, and the median for Hispanic women is less than $16,000.\footnote{Conversely, if a white man earned only $16,000, he would be a disappointed earner, and he should bear a net tax burden with respect to the $13,000 he was expected to earn but did not. See preceding note 81.} This suggests the accuracy of the proxy tax would be increased if it operated differently on members of different groups. For example, if a white man earned $29,000, it all might be treated as expected since birth, so the deferral charge should apply to the entire earnings. But if a Hispanic woman earned the same amount, $13,000 of it might be treated as not having been expected since birth. The deferral charge on the $13,000 should run only from the later time—for example, graduation from college—at which the higher income became predictable.\footnote{Not too long ago, income and transfer tax regulations used sex-based actuarial tables to value annuities, life estates, remainders and reversions, but these were replaced with}

<table>
<thead>
<tr>
<th>Category</th>
<th>Annualized Median Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>White men</td>
<td>$29,068</td>
</tr>
<tr>
<td>White women</td>
<td>21,372</td>
</tr>
<tr>
<td>Black men</td>
<td>21,112</td>
</tr>
<tr>
<td>Black women</td>
<td>18,824</td>
</tr>
<tr>
<td>Hispanic men</td>
<td>18,148</td>
</tr>
<tr>
<td>Hispanic women</td>
<td>15,756</td>
</tr>
</tbody>
</table>

See id.
especially if based on race. Nevertheless, without making such distinctions, the proxy tax is a very crude substitute for accrual taxation.

Actually, a serious attempt to impose accurate deferral charges would require more sophisticated techniques than incorporating a few categories based on sex and race. For example, the lifetime wage profile for most workers shows relatively low earnings in their twenties and thirties, rising to a peak somewhere in middle age, and declining somewhat towards retirement. In the interests of accuracy, the proxy tax also should take this phenomenon into account. If a person earns $50,000 at age 25 and at age 50, the entire age 50 earnings might have been predictable at birth (and so subject to the full force of the proxy tax), but much of the age 25 earnings might not have been predictable (and so should not be subject to the proxy tax).

Better information about expected versus unexpected earnings could be obtained from individualized examination of each person’s earnings prospects at birth, as indicated by parental socioeconomic status. A leading study found that the most “successful” quintile of families could expect their sons to earn 45% to 80% more than the national average. For example, if a child of a doctor and a lawyer earns $100,000 at age 40, those earnings might be entirely expected


87 In a two-to-one decision, the Second Circuit upheld against constitutional challenge the sex-based valuation tables. See Manufacturers Hanover Trust Co. v. United States, 775 F.2d 459 (2d Cir. 1985), cert. denied, 475 U.S. 1095 (1986). The majority opinion stated that more stringent standard of review would have been required if the tables had made distinctions based on race. See id. at 464.

88 See Fullerton & Rogers, note 19, at 105 (presenting summary statistics for ages 20, 49 and 70 indicating that “the wage profile rises, then falls with age”). The location of the peak earning years differs for workers at different lifetime income levels. See id. at 115-17.

89 For example, predicted lifetime wages, per normal lifetime wage profile, might have included $30,000 at age 25 and $50,000 at age 50. Thus, when he actually earns $50,000 at both ages, all earnings at age 50 were expected but $20,000 at age 25 was not.

90 Christopher Jencks, Who Gets Ahead? The Determinants of Economic Success in America 217 (1979). The study was limited to sons. A more recent study found that men from the highest earning families had annual earnings about $5,800 higher than those of men with middle income parents, and about $7,000 higher than those of men with low income parents. The same study found smaller, but still significant, effects of family background on women’s earnings: a difference of about $2,100 in annual earnings between women from the highest and lowest income families. W. Norton Grubb, The Varied Economic Returns to Postsecondary Education: New Evidence from the Class of 1972, 28 J. Hum. Resources 365, 377 (1993). The primary mechanism by which family background influences earnings is indirect: Family background affects the level of achieved schooling, which affects earnings. See Zvi Griliches, Sibling Models and Data in Economics: Beginnings of a Survey, 87 J. Pol. Econ. S37, S59 (1979). For purposes of the proxy tax, the precise mechanisms by which family background affects earnings are unimportant. Whatever the mechanisms, family background is a valuable predictor of what a child will earn as an adult.
and the deferral charge should run from birth. But if a coal miner's daughter finds herself earning the same amount at the same age, the deferral charge should run only from whatever later time her unusual earning capacity became apparent.91

I find the idea of adjusting the proxy tax to distinguish between expected and unexpected earnings daunting and distasteful. But a proponent of using a deferral charge to approximate the effect of accrual taxation would have to come to grips with this issue. Professor Kaplow should not judge income tax purists too harshly if they reject his proxy tax, considering that his proxy tax does not address this crucial issue.

B. Human Capital Never Converted to Market Earnings

Taxpayers may not fully exploit their ability to convert their human capital into taxable compensation. This may happen because they do not devote as many hours as they could to market labor, or because they do not devote their hours in the market to the highest paying work they could perform.92 The ideal accrual tax would be imposed on all available human capital, regardless of how the taxpayer eventually chooses to use it, but the proxy tax badly misses the ideal by treating unconverted human capital as nonexistent.

1. Few Hours Worked

If one really wanted to bring the proxy tax as close to the ideal as practicable, one would consider imposing the tax on those who work few or no hours in the market.93 This would not be easy. It would

---

91 Another variable in the proxy tax equation is the taxpayer's dependent children. I argue later in this Article that at least some of the costs of supporting children are properly deductible in determining a worker's net income from human capital. See text accompanying notes 122-25. Imagine, then, two 40-year old taxpayers with equal (and equally expected) wages of $50,000 each. Neither has any children. At first, it seems that the proxy tax should apply in exactly the same way to each. But suppose that one always has known she did not want children, while the other lost a child last year in a tragic accident. She would have spent $10,000 on the child this year. Although the two taxpayers have equal net earnings this year, the second taxpayer has $10,000 less anticipated net earnings, and should be subject to a lesser deferral charge.

92 This second category subdivides into those who made the lower-paying choice in the past, choosing a less lucrative profession than they might have chosen, and those who continue to make a current lower-paying choice, by not taking the highest wage job available to them.

93 Professor Kaplow persuasively critiques as overestimated the common libertarian argument against a tax on unused earning capacity. In addition to noting that many taxes force the poor to work more than they would in the absence of taxation, he also remarks that "an ability tax with an upper limit of 90% of wages or income actually earned would almost completely achieve the ability tax result without literally violating the forced-labor constraint." Kaplow, Human Capital, note 9, at 1506-07 & n.71. Strangely, however, he
require a difficult decision about how many annual marketable hours people should be assumed to have, and at what age they should retire. It also would involve difficult practical problems of auditing claimed hours worked (especially for nonhourly employees), and of distinguishing voluntary from involuntary underutilization of hours (assuming the tax should not be imposed on hours involuntarily spent unemployed). A proxy tax proposal would need to consider to what extent the tax could be imposed on time not devoted to market labor. It also would need to consider, to the extent the tax could not be imposed on this time, the implications of this departure from the ideal. Professor Kaplow does not consider these issues.

2. Work at Less Than Highest Available Wages

It is not clear how far the proxy tax strays from the ideal with respect to taxpayers who do not earn the highest wages they could, because it is not clear how the ideal accrual tax would treat such taxpayers. Consider three taxpayers. A has the credentials to earn a high income as a partner in a corporate law firm, and she would find the work tolerable. She loves the life of a law professor, however, and is happy to sacrifice the high salary for work she prefers. There is a strong argument that the proper treatment of A, under accrual taxation of human capital, would value her human capital according to what she could earn in a law firm. That she prefers the psychic income of academia to the cash of practice is irrelevant to the determination of the amount of her human capital. The proxy tax, which would ignore what she could have earned in another job, would seriously undertax her. Unlike the problem of the taxpayer who works few hours, there does not seem to be any possibility of finetuning the proxy tax to address this problem.

Next consider B, another law professor, who enjoys the work just as much as A, but would not be able to find a higher-paying job with a law firm. If human capital were measured by potential market earnings, then even at the level of high theory, B's love of her work would be irrelevant to the determination of her human capital. Since B was earning her full market potential, the proxy tax would reach the correct result as to her. In the ideal world with all practical problems

ignores his own insight in designing the proxy tax, which makes no attempt to measure earning capacity (as distinguished from actual earnings).

Fullerton and Rogers construct a hypothetical one-time proportional tax on lifetime labor endowments, not as a viable policy option, but as a benchmark against which to evaluate various tax systems. See Fullerton & Rogers, note 19, at 155. (Endowment taxes are described and discussed in note 16.) They assume that each person could work 4,000 hours per year (77 hours per week). See id. at 204. That seems high, but they note that another study chose 5,000 hours per year for purposes of a similar analysis. See id.
removed, should A be taxed more heavily than B because of A’s greater cash earning potential, when both have the same actual earnings and the same psychic income from their work? If not, one might want to reconsider the conclusion that the ideal accrual tax should take into account what A could earn in a law firm. If it should not, the proxy tax would not undertax A after all.\textsuperscript{95}

Finally, consider C, a third law professor. Like A, C could find high income work with a law firm; unlike A, C would find the work utterly intolerable. C therefore works as a law professor—a job she does not particularly enjoy, but at least can stand. Even if the potential higher income is relevant to A’s human capital, it is arguably not relevant to C’s. Perhaps lacking the stomach for a job for which one has the credentials should be viewed as one way of not having the human capital to do the job. If so, the proxy tax would not deviate from the ideal by ignoring the fact that a law firm would welcome C.

The point of these musings is not that the proxy tax is necessarily wrong to ignore a taxpayer’s potential of finding more lucrative employment—in fact, the analysis suggests there may be a theoretical defense for ignoring that potential in some or all cases. Rather, the point is that a thorough discussion of accrual taxation of human capital, and of a proxy, would have to come to grips with questions of this sort, and then evaluate the proxy according to how closely it approximated the ideal. Professor Kaplow does not do this. Without a theoretical ideal, he cannot evaluate the proxy tax relative to that ideal.

\section{The Intangible Return to Wealth}

Under the “foundational” argument for the consumption tax, commonly associated with Thomas Hobbes, saved income should not be taxed because it has not yet been appropriated for private use; rather it remains in the “common pool” of national wealth.\textsuperscript{96} Only when it is consumed has it been devoted to private use, and only then should it be taxed. Proponents of the income tax respond that saved income confers a current private benefit on the saver, in the form of the

\textsuperscript{95} On the other hand, one might argue that the intangible benefits A and B enjoy as law professors are themselves a return on human capital, and should be taxed if feasible. The possibility of using the proxy tax to reach intangible returns to human capital is discussed in the text accompanying notes 96-104.

\textsuperscript{96} “[T]he Equality of Imposition, consisteth rather in the Equality of that which is consumed, than of the riches of the persons that consume the same. For what reason is there, that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged, than he that living idlyly, getteth little, and spendeth all he gets; seeing the one hath no more protection from the Common-wealth, than the other?” Thomas Hobbes, Leviathan 267 (1952) (reprint of 1651 ed.). The argument is stated, in modern form, in Fried, note 1, at 962-63 (setting forth the argument, but not advocating it).
power, prestige and security associated with wealth. In the words of Henry Simons, "[T]here is something sadly inadequate about the idea of saving as postponed consumption." 97

Professor Jeff Strnad has developed an elegant defense of the taxation of saved income, based on the premise that the intangible benefits of wealth—power, prestige and security—are a proper concern of the tax system. 98 He starts from the familiar fact that not taxing saved income is the economic equivalent of taxing the income when saved but exempting from tax the investment return on the savings (if tax rates are not progressive and do not change over time). 99 For this reason, advocates of the consumption tax ideal may favor implementation of the ideal through either a cash flow system (no tax on saved income, but investment return taxed when consumed), or through a yield exemption system (saved income is taxed, but investment return is not). 100

Professor Strnad's insight is that the intangible benefits of wealth can be viewed as a kind of return on investment, which he labels w. 101 In theory, it would be possible for the tax system to reach w directly, not by taxing saved income, but by measuring and taxing w each year. That is not practicable, of course, but it is possible to reach w indirectly through the economic equivalent of taxing the income when

97 Henry C. Simons, Personal Income Taxation 97 (1938). For other expressions of the argument, see, e.g., Warren, Consumption Tax, note 35, at 1122-23 ("[W]ealth not only embodies capacity for future consumption, but also yields current benefits such as security and independence, which are no more subject to a controlling moral claim by the wealthholder than are income or consumption. Indeed, such benefits can be conceived of as imputed and consumed income."); Fried, note 1, at 962 ("[T]he argument [for the consumption tax] is open to attack for ignoring the psychic benefits in the form of power, influence, security, and the like that come from the mere possession of wealth."); Richard Goode, The Individual Income Tax 22 (rev. ed. 1976) ("Investment, no less than consumption, is a withdrawal from the common pool in the sense that it is an exercise of a claim on the use of resources."); McCaffery, Tax Policy, note 2, at 1173 (noting that income tax proponents might "reject the premise of the consumption tax that it is only the private use of wealth that matters; rather, they might argue that possession alone can have pernicious effects").

98 See Jeff Strnad, Periodicity and Accretion Taxation: Norms and Implementation, 99 Yale L.J. 1817, 1833-46 (1990). Professor Strnad presents his analysis as a technical matter, without expressing an opinion as to whether the intangible benefits from wealth should be taxed.

99 See id. at 1833 and n.35. Suppose, for example, that the tax rate is 20% at all times, and that a taxpayer earns $100 this year, which he intends to invest at a 10% rate of return and annually consume the investment return. If the $100 is not taxed, but the annual $10 return is taxed, he will have $8 each year, after tax. If the $100 is taxed, but the investment return is not, he will invest the $80 left after tax, and will receive a tax-free 10% annual return of $8.

100 See Blueprints, note 2, at 110 (referring to yield exemption method as the "tax prepayment" approach).

101 See Strnad, note 98, at 1834-35.
saved, and then not taxing $w$. The tax on the saved income serves as a proxy for a tax on $w$ itself.\footnote{Professor Strnad notes that one attraction of this approach is that it “works independent of the value of $w$,” so it avoids the insuperable valuation problems of a tax directly on $w$. See id. at 1837.}

In evaluating Professor Kaplow’s proxy tax, the crucial question is whether “savings” in the form of accrued human capital produce the same sort of $w$—power, prestige and security—as other savings. If they do, accrual taxation could be justified under Professor Strnad’s analysis. Professor Kaplow briefly suggests the concern with $w$ does apply to human capital: “Even individuals who spend all their substantial earnings and thus have no wealth presumably have significant prestige if it is understood that their future earning power is great.”\footnote{Kaplow, Human Capital, note 9, at 1504.}

I agree with Professor Kaplow that human capital produces significant intangible benefits. It does not follow, however, that a proxy tax would do a reasonable job of identifying and taxing those benefits. This justification makes Professor Kaplow’s tax a proxy for a proxy—an accrual tax on human capital would be a proxy for a tax on human capital’s $w$, and the proxy tax would be a proxy for the accrual tax. There are reasons to doubt that the double proxy tax can do what is intended. To work, there must be a significant positive correlation between the cash one actually earns each year (the practical subject of the proxy tax) and the power, prestige and security one derives from one’s human capital (the theoretical subject of the tax).

Does such a correlation exist? Earnings are a hopelessly bad proxy for $w$ as to those who have substantial human capital but choose not to sell it in the market—not only the beachcombing surgeon, but, more significantly, the full-time homemaker with highly marketable skills. More disturbingly, the correlation is dubious even for those who do sell their labor. For many workers, $w$ is an alternative to cash as a return on human capital, rather than an additional return proportionate to cash compensation. Imagine three lawyers with equally marketable skills but different tastes. Lawyer $A$ chooses to become a plaintiff’s personal injury lawyer. He has high income, but low job security and prestige; $B$ chooses to become a government attorney, sacrificing money for security and power. $C$ chooses to become a law professor, sacrificing money for security and prestige (or so he hopes). By hypothesis, all three have equal human capital, but $A$ has chosen to convert it to cash as much as possible, while $B$ and $C$ have chosen less cash and more $w$. The irony is that the proxy tax would assume that $A$ has more $w$ than his counterparts, when, in fact, he may have less. Horizontal equity calls for equal tax on those with equal stores.
of human capital. But to the extent that taxpayers with equal human capital make tradeoffs between cash and \( w \), taxing cash as a proxy for \( w \) is perverse.

The proxy tax fares somewhat better if analyzed in terms of its effect on groups of taxpayers with differing levels of human capital. It is probable that, as a group, those with high levels of human capital have both more cash income and more \( w \), than do persons with low levels of human capital. Thus, the assumption of the proxy tax, that more cash income means more \( w \), is probably reasonable from a group perspective. The problem is that normally the system does not settle for tax rules that treat groups fairly; it insists on rules that are fair among individuals.\(^{104}\)

Consider four taxpayers. \( D \) and \( E \) have equally large stores of human capital; \( F \) and \( G \) have equally small stores. \( D \) and \( E \) have the same job options. \( D \) chooses a job that pays $100,000 a year and has moderate \( w \); \( E \) chooses a job that pays $60,000 and has high \( w \). \( F \) and \( G \) must choose between less attractive jobs. \( F \) chooses $60,000 a year and low \( w \); \( G \) chooses $40,000 a year and moderate \( w \). Professor Kaplow’s proxy tax does group justice, in the sense that it correctly assumes that the high human capital taxpayers have more \( w \) between them than do the low human capital taxpayers, but it does a miserable job of achieving fairness among individuals. \( E \) and \( F \) have very different levels of \( w \), but the proxy tax treats them as if they have the same; \( D \) and \( G \) have the same levels of \( w \), but the proxy tax treats them as if they have very different amounts.

As a means of indirectly taxing the power, prestige and security associated with human capital, the proxy tax is such a poor fit that it would be better not to try at all.

IV. Taking the Metaphor Seriously

Since Professor Kaplow uses the human capital metaphor for rhetorical purposes—as an argument for a consumption tax—he does not explore the broader implications for a tax system of taking the human capital metaphor seriously. This Section considers one important ramification not considered by Professor Kaplow: The allowances a

\(^{104}\) An exception is the tax treatment of term life insurance. Those insureds who lose their bets (that is, do not die) get no deduction for their premiums, and those who win (that is, die) are not taxed on their mortality gain. See Reg. § 1.262-1(b)(1) (nondeductibility of premiums); IRC § 101(a) (exclusion of policy proceeds from income). The absence of tax consequences is correct from a group perspective, because the losses and winnings cancel each other out. It is far from clear, however, that these rules do justice to individuals, since their effect is to allow the winners to treat their winnings as a recovery of the losers’ costs. This sort of aggregate fairness, as opposed to individual fairness, is rare in the current income tax.
tax system premised on the view of human beings as income producing machines should make for the cost of maintaining those machines. If human capital is to be taxed just as any other income producing asset is, it is only fair that human capital-related expenses be deductible.

A. Costs of Living as Business Expenses

Like most income producing machines, people require regular maintenance to remain productive. Maintenance costs of other assets are deductible business expenses,\textsuperscript{105} and taking the human capital metaphor seriously requires equivalent treatment for people. Professor Kaplow offers no discussion of this issue.\textsuperscript{106} It is not possible to decide whether human capital is undertaxed relative to other assets, by looking (as he does) solely at issues of timing; it is also necessary to look at the tax allowances for the expenses of producing income from each type of asset. Taxing human capital like other assets requires an examination of the adequacy of the tax allowances for the costs of subsistence—the standard deduction and the personal exemption—because the subsistence costs of workers should be thought of as human capital business expenses.\textsuperscript{107}

The current standard deduction and personal exemption are based not on a business expense rationale, but on the idea of clear income—that ability to pay tax comes only from income above subsistence, and that the standard deduction and personal exemption together shelter subsistence income from taxation.\textsuperscript{108} Even under the clear income analysis, the present allowances are too low. The standard deduction for 1996 is $4,000 for a single person, $5,900 for a head of household.

\textsuperscript{105} Reg. § 1.162-4 (allowing deduction for cost of repairs that do not materially increase the value or the life expectancy of assets but that keep assets "in an ordinarily efficient operating condition").

\textsuperscript{106} Professor Kaplow does note the common observation that ideal income taxation of human capital would require a cost recovery allowance for investments in human capital. See Kaplow, Human Capital, note 9, at 1491. Current law generally makes no allowance for such costs. For example, the costs of professional education for a new trade or business are neither currently deductible nor amortizable. Reg. § 1.162-5(b)(3) (denying deduction); Sharon v. Commissioner, 65 T.C. 515 (1976) (denying amortization), aff'd, 591 F.2d 1273 (9th Cir. 1978), cert. denied, 442 U.S. 941 (1979). Professor Kaplow says nothing, however, about the need for a tax allowance for human capital maintenance costs.

\textsuperscript{107} See Blueprints, note 2, at 36 (noting that the value of human capital is "the present value of future labor earnings . . . less the cost of earning income"); Thurow, note 30, at 125 ("Human capital assets require maintenance expenditures to keep them functioning. Man must eat and sleep to produce goods and services . . . . Technically, human capital maintenance costs should be subtracted from earnings . . . .").

\textsuperscript{108} See Lawrence Zelenak, Children and the Income Tax, 49 Tax L. Rev. 349, 361-62 (1994). The standard deduction and personal exemption are not limited to working taxpayers.
and $6,700 for a married couple filing a joint return. The personal exemption is $2,550 for each taxpayer and dependent. Congress would have to raise these amounts by at least 50 percent to reflect accurately the cost of minimally decent living in 1996. But their inadequacy would become even more glaring under the proxy tax, given its implication that the subsistence expenses of a wage earner are ordinary and necessary business expenses. A tax designed to increase the tax burden on net income from human capital must distinguish net income from gross receipts.

Under the human capital analysis, the cost of subsistence is only a floor on human capital maintenance expenses. In some cases, properly deductible expenses may be much higher than subsistence. A physically demanding job may require greater expenditures for food than the subsistence allowance. A stressful job may necessitate an annual 10-day cruise and a health club membership as the cost of avoiding breakdown of the human machine. If people are to be considered machines for tax purposes, it also would be appropriate to reconsider the nondeductibility of various expenses at the business-personal borderline, including work clothes and commuting.

Suppose that, after reexamination of the level of tax-free allowances, the allowances were increased by two-thirds. What effect

---

110 IRC § 151(d)(1); Rev. Proc. 95-53, note 109, at 448 (inflation adjustment).
111 Congress has relied on the official U.S. poverty thresholds in setting the levels of the standard deduction and the personal and dependency exemptions. See 1986 Bluebook, note 58, at 15-16. The official thresholds were established in the 1960's, and have not been updated to reflect changing patterns of consumption and changing opinions about what goods are necessary (although they have been adjusted for inflation). See Patricia Ruggles, Drawing the Line: Alternative Poverty Measures and Their Implications for Public Policy 47 (1990) (noting that "our current standards, based on 1955 consumption data, implicitly exclude many goods that have become common among lower-income households only within the last 35 years"); Zelenak, note 108, at 380-81. Ruggles concludes that "poverty standards today, to be comparable in terms of their consumption implications to the original . . . thresholds, would have to be at least 50 percent higher than the official thresholds." Ruggles, supra, at 167. A 1995 National Research Council study recommends increasing the poverty threshold for a family of four by 14% to 33% over the current level. See Measuring Poverty: A New Approach 55-56 (Constance F. Citro & Robert T. Michael eds., 1995).
112 See Pevsner v. Commissioner, 628 F.2d 467 (5th Cir. 1980) (holding work clothes not deductible if objectively suitable for general wear); Reg. § 1.162-2(e) (providing commuting expenses not deductible).
113 An increase of approximately 67% is suggested by Ruggles, note 111, at 50, as an appropriate way of adjusting poverty thresholds developed in the 1960's for changes in consumption patterns over the last several decades.

Interestingly, the resulting allowances actually would be lower than those featured in recent prominent flat tax proposals. Representative Armey's bill would allow a standard deduction of $24,700 for a joint return, $16,200 for a head of household and $12,250 for a single taxpayer, and a deduction of $5,000 for each dependent (but not for the taxpayer). H.R. 2060, note 3, § 1(b). Senator Specter's bill provides a standard deduction of $16,200.
would this have on the taxation of the income of low and moderate income wage earners? Although the Bureau of Labor Statistics (BLS) provides detailed information on the earnings of wage and salary workers, there is no simple way to map the revised exemption levels onto the BLS data in order to determine how many wage earners would be removed from the tax rolls by the change. The problem is that the level of exempt income would depend on one's family situation—marital status, the amount of spousal income (if any) and the number of dependents—and the BLS data does not indicate workers' family situations. Nevertheless, the data is suggestive.

For the fourth quarter of 1994, the median annualized earnings for full-time workers, 16 years and older, were $24,544. With a two-thirds increase in the standard deduction and personal exemption, a worker earning at the median would owe no tax as the sole earner of a married couple with two or more children. For the same period, the upper limit of the bottom quartile of the annualized earnings distribution was $16,120. With the increased allowances, no single parent in the bottom quartile of the earnings distribution would owe any tax.

The overall effect of taking the human capital metaphor seriously—taking into account both the Kaplow deferral charge and the increase in tax-free allowance levels—would be lower tax on lower income earners than under current law, and higher tax on higher income earners. It is not clear, as Professor Kaplow claims, that the net effect would be "an increase in labor's share of the tax base." It is clear,

for a joint return, $14,000 for a head of household and $9,500 for a single taxpayer, and a $4,500 deduction for each dependent. S. 488, note 3, § 1(a).

See note 83.

The appropriateness, under human capital analysis, of allowing parents to deduct the costs of supporting their children, is discussed at text accompanying notes 122-25.

See note 83.

Under actual 1996 allowances, the standard deduction ($6,700) and four exemptions ($2,550 each) would shelter wages of $16,900. Multiplying that figure by five-thirds gives a revised exemption level of $38,167.

Bureau of Labor Statistics, note 83, tbl. 4 (the figure is derived by multiplying $310 weekly earnings by 52 weeks).

Under 1996 law, a single parent with one child would be entitled to a $5,900 standard deduction (as head of household) and two $2,550 exemptions, for a total of $11,000. Multiplying that amount by five-thirds yields $18,333.

The result would be somewhat reminiscent of the early days of the U.S. income tax, as described by William Andrews: "Early income taxes with very high exemptions may have been conceived, to a degree, as indirectly measured taxes on the capital accumulation producing the income, earned income being assumed to be largely covered by personal exemptions." Andrews, note 1, at 1170 n.125.

Kaplow, Human Capital, note 9, at 1514. Professor Kaplow notes that this increase might be partially or wholly counteracted if taxation of other capital were moved simultaneously closer to the income ideal. See id. My point, however, is that labor's share of the
however, that the progressivity of the tax on earned income would increase.

It remains to extend the human capital metaphor to its reductio ad absurdum. To this point, the discussion has been limited to expenses without which the person could not do the job. But what about expenses without which he would not do the job? Suppose many jobs that pay well are unpleasant, and are made bearable only by the above-subsistence consumption the pay makes possible. Then the entire compensation is necessary motivation to generate the income, and arguably all of it should be deductible as a business expense. This is a picture of a tax system swallowing its own tail, but it is a picture worth contemplating before deciding how far the tax law should push the human capital metaphor.

B. Costs of Living at Either End of Life

1. Children

Once the human capital metaphor is accepted, the argument for treating basic consumption expenses as deductible during the working years is compelling. It is not so readily apparent, however, how the metaphor should influence the view of consumption expenses before and after the working years.\textsuperscript{122}

Much (probably most) of the cost of raising children reasonably can be viewed as an investment in their human capital. The parental expenditures on children are necessary to turn the children into income producing adults. This is most obviously true of education, but it is also true of food, clothing and shelter. In contrast with the admittedly strained case for the deductibility of consumption luxuries by adults,\textsuperscript{123} it is easy to make the case for the income producing function of many expenditures on children at levels far above subsistence. Even expenditures above $10,000 for private primary or secondary education may have a clear investment purpose. Under human capital analysis, subsistence definitely should not be the limit on child expenditures worthy of tax recognition.

There is the question, however, of whether the tax recognition should be granted to the parents or to the child. These expenditures could be viewed as nondeductible gifts from parent to child, followed

\textsuperscript{122} Of course, the clear income case for tax allowances for children and retired persons does not depend on human capital analysis. See text accompanying note 108. It is possible, however, that human capital analysis would support larger allowances than would clear income analysis.

\textsuperscript{121} See text following note 121.
by outlays by the child. It seems more reasonable, however, to give
the allowance to the parents, given the covenant that each generation
will finance the human capital investments of the next. This has the
virtue of simplicity—compare a current allowance for the parents with
the complications involved in allowing the child to recover parental
expenditures years later when the child is finally producing income.

How should the amount allowed to the parents reflect that these are
investments in the child's human capital, rather than costs of produc-
cing current income? If simplicity calls for a current deduction, should
the deduction be only for the present value of the theoretically correct
amortization deductions, rather than for the full amount of the ex-
penditures?124 Current deduction of the entire expenditure would be
proper, in the context of the deferral charge of Professor Kaplow’s
proxy tax. The deferral charge would compensate for not taxing
human capital endowment in the year it accrued, by grossing up the
amount subject to tax in the year payment was received. In the same
manner, the deferral charge would compensate for not taxing the in-
come sheltered by the expensing of a human capital investment.
When the child was not allowed amortization deductions in later years
(because the cost was recovered by the parents long ago), the income
not offset by amortization deductions would be grossed up by a multi-
plier, and the gross up would offset the benefit of the previous
expensing.125

---

124 The clear income analysis is sufficient to support a current deduction for the costs of
the child's subsistence. See text accompanying note 108. The question in the text arises
with respect to amounts in excess of subsistence, invested to develop the child's human
capital.

125 Consider a simple two period model. Assume the parents make a human capital
investment of $100 at Time 0, which will return $110 to the child at Time 1. The tax rate is
30%; the discount rate is 10%. (Thus, this is not a positive present value investment.
As Professor Kaplow notes, investments in human capital “have positive present value . . .
only when viewed narrowly”; the real value is in the chance to make the investment.
Kaplow, Human Capital, note 9, at 1495-96.) Under accrual taxation, there would be no
income or deduction at Time 0, and $10 of income at Time 1 ($110 cash flow minus $100
cost recovery). After tax of $3, the child would be left with $107.

Suppose instead a deduction was allowed for $100 at Time 0, and Professor Kaplow’s
deferral charge was imposed at Time 1. The deduction would result in a tax savings of $30,
which would grow at an after-tax rate of 7% to $32.10 at Time 1. The Time 1 income
would be $110, with no allowance for the $100 already deducted. The multiplier would be
1.06^3=1.0636366, which would gross up $110 to $117.00. The 30% tax on $117.00 would be
$35.10. Subtracting the tax from the $110 the child actually receives would leave the child
with $74.90. Adding the $32.10 from Time 0 tax savings would give a total of $107—the
same amount the child would be left with under the accrual taxation alternative.
2. *Retirees*

The deductibility during working years of retirement savings does not depend on human capital analysis; rather it reflects a longstanding congressional decision to put life cycle savings on the consumption tax model.\textsuperscript{126} Deduction of subsistence costs during retirement also does not depend on human capital analysis; it is fully justified by the clear income rationale. The only question left for human capital analysis is whether more extravagant consumption during retirement should be deductible for the same reason the wagon driver may deduct the carrots he dangles before his horse. Perhaps only the prospect of unlimited golf and cruises in sunny climes kept many retirees working all those years. This is the retirement version of the propensity of human capital analysis to cause a tax system to swallow its own tail.

V. **Conclusion**

If it has not already become apparent, I now admit to a preference for the conventional income tax over any consumption tax alternative.\textsuperscript{127} I readily concede that there are plausible arguments to be made in favor of consumption taxes. The argument based on Professor Kaplow's human capital analysis is not, however, one of them. Human capital is an interesting and (for some purposes) useful metaphor, but it is only a metaphor. One's ability to earn income is not an asset just like any other asset. The differences justify the differences in tax treatment—especially when the comparison is between the taxation of human capital and the *actual* tax treatment of other assets, rather than the "ideal" tax treatment. There is no logical inconsistency in applying the cash flow consumption tax model to human capital while sometimes applying the income tax model to other capital. Consumption tax advocates will have to rely on other arguments in making their case for elimination of the income tax.

\textsuperscript{126} See text accompanying note 51.

\textsuperscript{127} I generally agree with the fairness arguments presented in Warren, *Fairness*, note 1, and Warren, *Consumption Tax*, note 35. At the moment, however, I am simply disclosing my preference, not attempting to defend it.