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2. The "Definition" of Income

Throughout the history of income taxation in the United States, people have sought to capture the meaning of the concept of income in a sentence or two. One should not be surprised that these efforts have been frustrating and ultimately not only futile but mischievous. As has been suggested, *income* is only a word used to refer to a subtle, complex concept. It is a manageable surrogate for a less concrete, more amorphous concept, ability to pay. It is true that *income* has a meaning independent of the tax system; that is the basis for its appeal to objectivity. We do not want to adopt the attitude that for tax purposes income means whatever we want it to mean or that it means nothing other than ability. But even outside the tax system the word refers to a complex set of ideas that can be summarized briefly for some purposes but not for others. For example, income might be thought of as receipts less expenses. But that definition requires that we define expenses and, in doing so, resolve complex problems such as how to account for wear and tear on investments in plant and equipment, how to account for inventories, etc. For tax purposes, to the degree to which we think we have the freedom to do so, we will want to define *income* in ways that promote the objectives of income taxation, which objectives in turn reflect our underlying system of values. "At bottom, . . . every tax structure, whether on the books or projected, is an assemblage of value judgments on scores of issues that plausibly could have been decided differently," and it is silly to suppose that "value judgments can be plucked out of a definition."[30] The value judgments underlying the income tax are reflected in the goals that are next discussed, and it is only by reference to those goals that we can soundly and sensibly generate and appraise the myriad rules that provide the meaning of "income."

3. The Goals for a Good Income Tax

Before people can effectively analyze whether particular provisions of the tax law are good or bad they must establish a list of criteria. Over the years, tax scholars have proposed many such lists. They have differed in detail but reflect common themes. At this point in our study of the income tax law it is well to keep things simple; we can introduce more subtle ideas as we reach concrete problems. For now, it is enough to identify three basic goals: (a) fairness, (b) administrative feasibility, and (c) soundness of economic effects, or economic rationality. Each of

30. Bittker, The Tax Expenditure Budget: A Reply to Professors Surrey and Hellmuth, 22 Nat'l Tax J. 538, 542 (1969).

these will be considered in turn, but first we must dispose of an often-cited but spurious criterion — revenue-raising potential. It is true, of course, that a key objective of an income tax is to raise revenue, but that observation tells us nothing about whether an income tax is better than some other revenue-raising alternative or whether particular provisions are good or bad. If we were interested only in revenue we might, for example, allow no deductions from gross receipts; we might tax gross income rather than net. But the consensus among tax experts is that that would be unfair and would produce unsound economic results. Or we could entirely abandon the notion of taxing income and meet our revenue needs simply by printing money (as we have done to some significant degree in recent years).[31] The fact that we could rely exclusively on the printing press to meet our revenue needs tells us nothing about whether that is a sensible approach.

It is frequently claimed that one vital goal of a good tax system is *fairness*. Fairness is sometimes divided into two categories, *horizontal equity* and *vertical equity*. The principle of horizontal equity is sometimes said to be that people who are "similarly situated" should be taxed alike. This statement seems to have little, if any, content; it leaves open the essential question of what is meant by "similarly situated." The possibly more meaningful ethical proposition underlying the concept of horizontal equity is that people in the same economic circumstances should bear the same tax burden. Though this statement itself is obviously laden with ambiguity and uncertainty, it may point us in the right direction. It does lend support to the further principle that people with the same income should, all else equal, pay the same tax. Again, we are left with essential questions: what do we mean by "income" and by "all else equal." But again we may be moving in the right direction. We may have laid an ethical foundation for the conclusion, for example, that if one person earns $18,000 per year and receives from her employer, without cost, an automobile worth $2,000 per year, for her personal use, while another earns $20,000 and must pay for her automobile out of her own pocket, the two should pay the same tax — all else equal. We might conclude that the tax burdens should not be the same, however, if, for example, one person had incurred substantial, unavoidable medical expenses and the other had not.

Vertical equity refers to the relative amounts of taxes paid by people with different incomes. The rate structure of our income tax reflects adoption of a principle of vertical equity called *progressivity*, which means that as one's income rises the *proportion* of income that one pays as a tax rises. (The mechanics of progressivity and some of its implica-

31. This method of raising revenue has one great virtue. It minimizes costs of administration and enforcement by the government and of compliance by taxpayers (keeping records and preparing returns).

tions are described infra page 34.) The philosophic underpinning of progressivity is the notion that our free-market, private-property system of economic organization has many virtues (mainly, that it maximizes productivity and partly that it promotes individual freedom) but that justice requires a more equal distribution of rewards than what we get with this system. In other words, progressivity is designed to reduce the inequalities of income associated with our largely free-market system. Why do we want to do this? This book is not the place for anything even approaching a thorough examination of that question, but a very brief heuristic response may be helpful. That response begins with a woman described in Studs Terkel's fascinating and valuable book, Working (1974). Terkel begins his depiction with this introduction (at 289):

> She is a sparrow of a woman in her mid-forties. She has eighteen grandchildren. "I got my family the easy way. I married my family." She has worked in factories for the past twenty-five years: "A punch press operator, oven unloader, sander, did riveting, stapling, light assembly. . . ." She has been with one company for twenty-one years, ARMCO Corporation.
>
> During the last four years she has worked in the luggage division of one of the corporation's subsidiaries.

Terkel then presents the woman's own account of her job and her life (at 289-293):

> The tank I work at is six-foot deep, eight-foot square. In it is pulp, made of ground wood, ground glass, fiberglass, a mixture of chemicals and water. . . .
>
> In forty seconds you have to take the wet felt out of the felter, put the blanket on — a rubber sheeting — to draw out the excess moisture, wait two, three seconds, take the blanket off, pick the wet felt up, balance it on your shoulder — there is no way of holding it without it tearing all to pieces, it is wet and will collapse — reach over, get the hose, spray the inside of this copper screen to keep it from plugging, turn around, walk to the hot dry die behind you, take the hot piece off with your opposite hand, set it on the floor — this wet thing is still balanced on my shoulder — put the wet piece on the dry die, push this button that lets the dry press down, inspect the piece we just took off, the hot piece, stack it, and count it — when you get a stack of ten, you push it over and start another stack of ten — then go back and put your blanket on the wet piece coming up from the tank . . . and start all over. Forty seconds. We also have to weigh every third piece in that time. It has to be within so many grams. We are constantly standing and moving. If you talk during working, you get a reprimand, because it is easy to make a reject if you're talking.
>
> A thirty-inch luggage weighs up to fifteen pounds wet. The hot piece weighs between three to four pounds. The big luggage you'll maybe

> process only four hundred. On the smaller luggage, you'll run maybe 800, sometimes 850 a day. All day long is the same thing over and over. That's about ten steps every forty seconds about 800 times a day.
>
> We work eight straight hours, with two ten-minute breaks and one twenty-minute break for lunch. If you want to use the washroom, you have to do that in that time. By the time you leave your tank, you go to the washroom, freshen up a bit, go into the recreation room, it makes it very difficult to finish a small lunch and be back in the tank in twenty minutes. . . .
>
> The job I'm doing is easier than the punch presses I used to run. . . .
>
> I guess my scars are pretty well healed by now, because I've been off on medical leave for two, three months. Ordinarily I usually have two, three burn spots. It's real hot, and if it touches you for a second, it'll burn your arm. Most of the girls carry scars all the time.
>
> We had two or three serious accidents in the last year and a half. . . .
>
> I have arthritis in the joints of some of my fingers. Your hands handling hot pieces perspire and you end up with rheumatism or arthritis in your fingers. Naturally in your shoulder, balancing that wet piece. You've got the heat, you've got the moisture because there's steam coming out. You have the possibility of being burnt with steam when the hot die hits that wet felt. You're just engulfed in a cloud of steam every forty seconds. . . .
>
> It's very noisy. . . . I've lost a certain percentage of my hearing already. I can't hear the phone in the yard. The family can.
>
> In the summertime, the temperature ranges anywhere from 100 to 150 degrees at our work station. . . .
>
> I attended a conference of the Governor's Commission on the Status of Women. Another lady went with me. We were both union officers. Most of the women there were either teachers or nurses or in a professional field. When they found out we were from labor, their attitude was cold. You felt like a little piece of scum. . . .
>
> I hope I don't work many more years. I'm tired. I'd like to stay home and keep house. We're in hopes my husband would get himself a small hamburger place and a place near the lake where I can have a little garden and raise my flowers that I love to raise.

Terkel does not tell us how much the woman earned from her job, but one can imagine that the pay was low. With the image of Terkel's factory worker in mind, think of the corporate executives, the singers, the movie stars, and the athletes who earn millions of dollars a year. Then ask yourself, where is the justice in that? The point of the story about the factory worker is not that people like her necessarily work harder or at more onerous jobs than people who are highly paid. Nor can we assume that low-income people generally are kinder, more considerate, more loving, or in other ways more deserving than high-income people. The point is simply that, based on our common experience, it is not reasonable to assume that observable disparities in income can be adequately explained by differences in effort, in the psychic costs of the job, or in other measures of deservedness. It may be, of course, that the factory worker in the excerpt had a chance to go to school and ultimately earn big money and that she turned down the chance because she lacked ambition or determination or a willingness to defer gratification. People who lack ambition or determination or an ability to defer gratification may deserve the low incomes they wind up with. But if you think that generally it is not such factors that lead to differences in income, if you think the differences are more likely to result from genetic make-up or lack of education or opportunity, or other such factors, then you may share the sentiments of those who are uneasy with disparity in the distribution of income. You may sense that there is an argument for redistribution of income, and that may lead you to favor benefits for the poor and the near-poor and a progressive tax on income.

A second general goal of a good system of income taxation is *administrative feasibility*. One important part of this goal is that the government's cost of enforcement and the taxpayer's cost of compliance should be as low as possible. Another important part of the goal of administrative feasibility is objectivity. Objectivity implies, for example, that we should not tax imputed income from services performed for oneself since it seems virtually impossible to impose a tax on such economic benefits without requiring government officials to be subjective and intrusive. To some degree objectivity conflicts with fairness (since it means that we may need arbitrary rules and that we must ignore certain sources of income) and with minimization of enforcement and compliance costs (since objectivity may require detailed rules that will require long forms, expert advice, etc.).

The third major goal of income tax policy is *sound economic effects,* or *economic rationality.* This criterion embodies a number of related ideas. At the most modest, and perhaps the most sensible, level, this criterion requires simply that in appraising a tax provision we should consider carefully its economic effects. This means, for one thing, that we should try to be sure that we have not produced unintended perverse incentives. For example, the value of parking supplied to an employee by an employer generally is not included in income. The result may be that more people drive to work than would do so if that benefit were taxable. The increased driving may create congestion, air pollution, urban sprawl, etc. Maybe not; and maybe parking is part of the cost of earning a living and cannot properly be treated as a taxable benefit. But we should at least give the matter some serious thought. Another aspect of the goal of soundness of economic effects has to do with the increasing reliance on the income tax to provide incentives for various kinds of special activities and investments. Many observers have questioned the soundness of this use of the tax system and have argued that generally a direct subsidy program would be better than the more indirect (and more hidden) benefit granted by an exclusion, a deferral, a deduction, or a credit. (This idea is pursued in connection with the discussion of the tax expenditure budget, infra page 24.)

At one time tax experts often relied (and some still do) on an economic criterion of neutrality, or compatibility with the free-market system. This form of economic criterion rests on the assumptions, first, that a free-market, perfectly competitive, entirely unregulated economic system produces an ideal allocation of resources and, second, that the economy of the United States has those characteristics. Given the assumptions, it can be demonstrated that any tax rule that alters choices that would be made without a tax system wastes resources — creates a "deadweight loss" — since it induces people to use resources in less valuable ways than they otherwise would. In recent years, economists have increasingly recognized that the second assumption is unrealistic and that as a result the principle of economic neutrality has little to offer as a general guide to income tax policy[32] (though perhaps it is still a useful tool for economists for other purposes and the notion of "deadweight loss," in a limited application, can be helpful (see infra pages 27-28)).

A final criterion is worth mentioning even though it is probably redundant with the three that have already been discussed. This criterion is reflected in the phrase "*old taxes are good taxes,*" which reminds us that it is one thing to say that we never should have adopted a provision in the first place and quite another to say that it should be repealed, especially without transition rules designed to protect any legitimate reliance interests that may have arisen. For example, the deduction for interest paid on home mortgages may be a bad idea. It may be unfair to renters, it may encourage overinvestment in housing and reduce investment in productive capacity, etc. But people may have bought their houses in reliance on the deduction. It seems unrealistic to suggest that they should have planned on the possibility that the deduction might be repealed; most individual home buyers probably don't think that way. (By the same token, many business taxpayers probably do take account of the possibility of repeal of tax provisions favorable to them.) A repeal of the deduction could be drafted to apply prospectively, with interest on loans incurred before the change in the law continuing to be deductible. But even that would not entirely protect reliance interests since nondeductibility of the interest on new loans would adversely affect the price at which a person could sell a house and that might seem unfair for a person who had recently bought

32. This conclusion is associated with the problem of second best. See Lipsey and Lancaster, The General Theory of Second Best, 24 Rev. Econ. Studies 11 (1956), which is generally credited as originating the idea that once the economy deviates from the ideal of unregulated perfect competition, it is not clear whether a move in the direction of that ideal will improve the allocation of resources.

and was forced by changing circumstances to sell. The problem suggested by this example is one of general importance in the tax system.

A final aspect of tax policy deserves very brief mention. Economists have argued that an income tax can be used to promote economic stability by adjusting revenue to the need for economic stimulation or dampening. In recent years there has been a general decline in confidence in our ability to use any part of the tax system (and other economic tools) successfully for this purpose. In any event, this goal is relevant to aggregate or "macro" phenomena and not to the kinds of policy issues that are presented in this book.