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A Moral Perspective on 'Big Business' Fair Share of America's Tax Burden

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ARTICLE

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INTRODUCTION

When Dean Neil Hamilton called me in June 2003 extending me an invitation to participate in the University of St. Thomas Law Journal Symposium "Understanding the Intersection of Business and Legal Ethics," I was honored to be included among the fine group of—scholars—including Michael Novak—they had already lined up. My relationship with the St. Thomas faculty runs deep. Professor Thomas Berg was one of my early mentors when I first started thinking about my areas of the law from a moral perspective, and I presented my first article that morally evaluates a legal area, *An Argument for Tax Reform Based on Judeo-Christian Ethics*, to the St. Thomas faculty in September of 2002.[1] So I accepted without hesitation even though I had no idea what I might contribute to the sympo-

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1. My article first became public on August 11, 2002 when Sam Hodges published a newspaper article in the *Mobile Register* (Mobile, AL) entitled, *Tax Critic: Professor Blasts 'Immoral' Structure; Hamill's 77 Page Paper Says State Hammers The Poor.* Within days of that newspaper article I posted the unpublished manuscript on the internet. I presented the article, still in unpublished manuscript form, to the University of St. Thomas law school faculty on September 12, 2002. *An Argument for Tax Reform Based on Judeo-Christian Ethics* first appeared in published form in the *Alabama Law Review* in Fall 2002. 54 Ala. L. Rev. 1 (2002). The article was subsequently re-printed in Susan Pace Hamill, *The Least of These: Fair Taxes and the Moral Duty of Christians* 1 (Cliff Road Books 2003).

sium other than I was sure my contribution would fit in the category of "arrangements and ideologies of entire systems."

Some background will help explain why I have contributed a tax policy piece to this symposium. Instead of completing another book or law review article I spent my sabbatical earning a masters degree in theological studies from the Beeson Divinity School of Samford University. A search for ethics in my principal areas of tax and business law numbered among the complex reasons I went to Beeson. Initially my focus centered around business law, in particular the extremely wide level of discretion courts accord to business executives under the business judgment rule. Even before the Enron and related scandals shook the business world there were high profile examples of highly unethical business decisions resulting in substantial harm.[2]

While at Beeson I changed my thesis to an attack on the injustice inflicted on poor and low income Alabamians by Alabama's state and local tax laws. Using the divine command ethical model, my thesis develops two moral principles relevant to evaluating tax policy. These two moral principles deem a tax structure unjust if either of these conditions are present—the burden for paying taxes oppressively falls on poor and low income taxpayers or if the tax structure fails to raise adequate revenues in order to provide everyone in the community, especially poor and low income people, minimum safety nets and a minimum opportunity to better their lives. My thesis empirically proves that Alabama's state and local tax structure violates both these moral principles and makes an iron clad case that Alabamians practicing Christianity have a moral obligation to use their political rights to change the unjust tax laws.[3] Shortly after I publicly released my thesis in August of 2002, a firestorm erupted first inside and then outside of Alabama. By June of 2003, when Dean Hamilton called, I was embroiled in a political campaign in my home state of Alabama attempting to convince the voters to support the governor's tax reform plan, which was proposed within a year of my article becoming public.

Although the governor's attempt to bring tax reform to Alabama failed for a variety of complex political and cultural reasons, the interest in examining tax justice from a Judeo-Christian perspective spread rapidly to other states. Moreover as numerous journalists, tax policy analysts, academics, and ordinary citizens continued to ask me how Judeo-Christian ethics would evaluate federal tax policy, the topic of my next major research pro-

2. *See e.g.* Michelle Faul, *Improper Formula Feeding Spreads Malnutrition, Death in Third World*, L.A. Times A3 (May 19, 1991) (UNICEF estimated that 1.5 million babies die every year in third-world countries due to the aggressive promotion of infant formulas by companies, such as Nestle®, to persuade mothers to bottle feed rather than breast feed); Lisa Newton, *How Can We Trust Our Cars Are Safe?*, Newsday B4 (Sept. 3, 2000) (discussing Ford Motor Company failing to respond to the dangers of rollover accidents linked to Firestone tires).

3. Hamill, *supra* n. 1, at 3.

ject became clear. As I pondered the complexity of evaluating federal tax policy from a moral perspective, I decided that my contribution to this symposium must serve as a first step toward developing a thorough ethical evaluation of both how the burden for federal taxes should be spread out and how the adequacy of federal revenues should be measured given the prevailing "starve the beast" fiscal policies that permeate the political arena.

A symposium focusing on the intersection of business and legal ethics turned out to be the perfect forum to start the next phase of my research on the ethics of fair taxes. The tax laws clearly qualify as an important system where the arrangement and ideology greatly affects everyone, including business. Business, especially the largest vertically integrated business corporations that earn enormous profits, wield unprecedented power in the political arena,[4] and pay substantial corporate income taxes.[5] Under the current federal income tax regime these corporations also raise significant tax policy issues by creating and benefiting from elaborate and detailed tax avoidance techniques.[6]

The two most fundamental issues of tax policy are determining the level of revenues that must be raised to meet government needs and how the tax burden necessary to raise these revenues should be spread among tax-

4. Big businesses have vast federal lobbying power. By way of example General Electric spent $9.7 million in the first half of 2003 to lobby for business building equipment for the war in Iraq and for the bill authorizing defense spending. *GE, Citigroup, Sprint Spend Big at Lobbying*, Hartford Courant E2 (Jan. 7, 2004). Also in 2003, Citigroup spent $4.6 million (which was the most of any bank) on lobbying. "Citigroup hired lobbyists to boost a bill allowing financial institutions to save time and money by processing checks electronically. President Bush signed the measure into law in October [of 2003]." *Id.* The political action committee for Wal-Mart "was the biggest corporate donor to federal parties and candidates in 2003, with more than $1 million in contributions." Jeanne Cummings, *Joining the PAC: Wal-Mart Opens for Business in a Tough Market: Washington*, Wall St. J. (Mar. 24, 2004).

5. *See infra* app. A.

6. *See* Joel Slemrod & Jon Bakija, *Taxing Ourselves: A Citizens Guide to the Debate Over Taxes* 279-83 (3d ed., MIT Press 2004); Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* vol. 1 § 5.10, 5-91 (7th ed., Valhalla 2000) (discussing the recent wave of corporate tax shelters). Unlike the limited partnership tax shelters marketed to high-income individuals before the Tax Reform Act of 1986, corporate tax shelters, taking a variety of forms including contingent installment note sale transactions, liquidating REIT transactions, section 357(c) basis-shift transactions, step-down preferred transactions, lease-in lease-out transactions, and the leveraged purchase of corporate-owned life insurance, are marketed largely to Fortune 500 companies. *See* Dept. of the Treas., *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals*, http://www.ustreas.gov/offices/tax-policy/library/ ctswhite.pdf (accessed Nov. 10, 2004) (July 1999); Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 Tax Notes 1775 (June 21, 1999). Although the first wave of corporate tax shelters has largely been stopped, *The Problem of Corporate Tax Shelters*, *supra* at 134-45, many new forms are being developed all the time. *See* Robert S. McIntyre & T.D. Nguyen, *ITEP Report on Corporate Tax Avoidance*, 2000 Tax Notes Today 204-25 (Oct. 19, 2000); Janet Novack & Laura Saunders, *The Hustling of X-Rated Shelters*, 162 Forbes 198 (Dec. 14, 1998). From a societal perspective these complex schemes waste valuable resources and threaten to severely damage the integrity of the voluntary tax system by breeding a disrespect among the people who see large corporations unfairly reducing their tax burden. *See* Slemrod & Bakija, *supra* at 280; *The Problem with Corporate Tax Shelters*, *supra* at iv; McIntyre & Nguyen, *supra* at 225.

payers at different levels of income and wealth. Over the last decade, politicians, academics, and tax policy pundits have been debating the wisdom of the current moderately progressive income tax, which requires individuals and corporations at higher income levels to bear a proportionally greater tax burden than those at lower income levels and whether it should be replaced by a flatter tax structure, which lightens the tax burden of the wealthiest individuals and most profitable corporations while increasing the tax burden of all others, especially the middle classes. The flat tax proposals would accomplish this shift in burden primarily by removing income from savings and investment from the tax base and applying a single rate to a tax base measured largely by consumption. Although both the progressive and flat tax camps invoke economic theories to support their respective positions, a closer examination reveals that these economic theories offer no solid information supporting either tax structure. Moreover, even if these economic theories offered useful information favoring one regime over the other, the ultimate determination as to whether moderately progressive or flatter tax structures represent the best tax policy is an ethical issue that can only be decided on moral grounds.[7]

This Article explores the moral angle of the important policy debate between proponents of progressive versus flatter tax structures from the perspective of the tax burden[8] borne by America's largest and most profitable corporations.[9] Part I of this Article highlights the moderately progressive income tax system currently in existence and the relative share of those taxes borne by the largest corporations and wealthiest individuals. Part I also paints a profile of America's largest corporations, documenting that they represent well under half a percent of all corporations yet command the lion's share of assets, receipts, and profits and pay most of the corporate income taxes. Part I then critiques the theory of marginal utility—the most important of the economic theories used to claim that greater proportional tax burdens, as income climbs to higher levels, offer the best economic results. Although most economists agree that the theory of marginal utility establishes that a dollar is less valuable to taxpayers at higher rather than

7. *See* Slemrod & Bakija, *supra* n. 6, at 58 ("Fairness in taxation, like fairness in just about anything, is an ethical issue that involves value judgments"); *id.* at 59 ("[A]ny panel of economists offering their opinions on the best tax system should be followed by a panel of philosophers or ethicists who offer their views on tax equity.").

8. Although technically the debate between flat and moderately progressive tax structures focuses on burden, some argue that flat tax proponents have a hidden agenda to also cut revenues or "starve the beast." *See* Paul Krugman, *The Tax-Cut Con*, N.Y. Times Mag. 54 (Sept. 14, 2003). A moral evaluation on the important tax policy of defining the level of revenues morally required to adequately meet the needs of the community and the "starve the beast" strategy pursued by many political and intellectual figures is beyond the scope of this article and will be explored in a follow-up article.

9. The complicated issues of the incidence of the corporate tax (who really pays the corporate tax?) and corporate integration issue (is it appropriate to double tax corporate profits at the corporate level and again at the shareholder level?) are beyond the scope of this article.

lower income levels, nevertheless, because no solid proof accurately pinpoints the degree to which the dollar becomes less valuable as income levels climb, this theory fails to provide convincing support that moderately progressive tax structures offer the best tax policy.

Using the flat/consumption tax proposal sponsored by Congressman Armey and Senator Shelby as a model, Part II shows how flatter tax structures shift a substantial portion of the tax burden from America's largest corporations and wealthiest individuals to taxpayers in both the middle and lower income classes. Part II then critiques the economic incentive theory, also known as supply side economics, which flat tax proponents use to claim that lighter tax burdens on higher income taxpayers foster greater economic efficiency and growth. Although most economists recognize that any reasonable level of taxation decreases economic growth by diminishing incentives and distorting resource allocation, nevertheless, because no solid proof exists that reducing taxes on the wealthy, while shifting the burden to the middle class, will enhance economic growth, this theory fails to provide convincing support that flatter tax structures offer the best tax policy.

After first explaining why all questions of tax policy ultimately must be decided on moral grounds, Part III applies the secular based moral frameworks of utilitarianism, ethical egoism, and the virtue of justice to the debate between the progressive and flat tax camps in order to explore the important ethical issue of how America's tax burden should be spread among the wealthiest individuals, most profitable corporations, and other taxpayers within the vast range of the middle and lower classes.[10] Because utilitarianism, which finds the morally correct answer in the greatest good for the greatest number, favors the tax policy model that provides the best economic results through greater marginal utility or performance of the economy, this model offers no helpful guidance as to whether moderately progressive or flatter tax structures produce the most ethical results. Ethical egoism, which finds the morally correct answer in each person's long term best interests, can clearly be invoked to support flatter tax structures despite the shift in the burden from the wealthiest individuals and corporations to the middle classes. Finally, because of the shift of the tax burden to those with a lesser ability to pay, the ethical model based on the virtue of justice solidly opposes flatter tax proposals and provides strong moral arguments supporting a moderately progressive tax structure.

10. A moral evaluation using Judeo-Christian ethics of shifting the tax burden from the wealthiest taxpayers to the middle classes, as well as a moral evaluation under utilitarianism, egoism, virtue ethics, and Judeo-Christian ethics of the level of adequate revenues necessary to meet minimum community needs and "starve the beast" political strategies, is beyond the scope of this article and will be explored in a follow-up article.

I. A Profile of Big Business in America Today Under America's Moderately Progressive Income Tax Structure and the Economic Theory of Marginal Utility

A. *The Moderately Progressive Tax Structure Currently in Existence and the Burden Borne by Big Business and Wealthy Individuals*

Although the degree of progressivity has varied substantially over the years, the federal income tax law both with respect to individuals[11] and corporations[12] has always maintained a progressive rate structure. A progressive tax system increases both the tax rate on a percentage basis and the

11. Since 1913, when the Sixteenth Amendment was ratified, the income tax has had a progressive rate structure. From 1913 to 1945, the income tax could be viewed as a class tax, only imposing a tax on the very wealthy, with the number of returns filed never topping 7% of total population of the United States. In 1945, the number of returns filed increased to 34% of the population. From 1945 to 1986, the federal income tax system was marked by steeply progressive rates, peaking at 94% in 1945, and remaining over 70% until the 1980s. Michael J. Graetz, *The U.S. Income Tax: What It Is, How It Got That Way, and Where We Go from Here* 16 (W.W. Norton & Co. 1999); Slemrod & Bakija, *supra* n. 6, at 19-21. However, this steep progressivity was offset due to the narrow base provided by the numerous exclusions and deductions granted by the code, including deductions for state and local sales taxes, medical expenses, business meals and entertainment, certain business losses, and highly preferential treatment of long term capital gain. *Id.* at 19; Graetz, *supra* at 140; *General Explanation of the Tax Reform Act of 1986*, 100th Cong. 178 (May 4, 1987). In 1986, Congress passed the Tax Reform Act of 1986, which lowered the top rate to 28%, while drastically broadening the base by eliminating or limiting many deductions and the capital gains preference. *Id.* at 178; Slemrod & Bakija, *supra* n. 6, at 25. In 1990, under President Bush, Congress increased the top individual rate to 31%, and three years later, under President Clinton, increased the top individual rate to 39.6%, while leaving the capital gains rate capped at 28%. Graetz, *supra* at 94. The Taxpayer Relief Act of 1997 further enhanced the special treatment for an individual's capital gain by decreasing the top rate to 20% and the bottom rate to 10%. Slemrod & Bakija, *supra* n. 6, at 31; Joel Slemrod & Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate Over Tax Reform* 31 (2d ed., MIT Press 2000). The Economic Growth and Taxpayer Relief Reconcilation Act of 2001 decreased individual tax rates, with the top and bottom rate at 35% and 10% respectively, while the Jobs and Growth Tax Relief and Reconciliation Act of 2003 narrowed the tax base by reducing the rate on capital gains to 5% and 15%. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 101, 115 Stat. 138, 41-42 (2001) [hereinafter *2001 Bush Tax Cut*]; *The Jobs Growth Tax Relief Reconciliation Act of 2003*, Pub. L. No. 108-27, § 301, 117 Stat. 752, 758 (2003) [hereinafter *2003 Bush Tax Cut*].

12. Unlike the individual income tax rates, the corporate income tax rates followed a flatter pattern and until 1986 corporations enjoyed a lower effective tax burden than individuals due to favorable depreciation deductions – which became pronounced in the 1970s and further enhanced in 1981with the adoption of the Accelerated Cost Recovery System – as well as substantial capital gains preferences and other benefits. Jane G. Gravelle, *The Economic Effects of Taxing Capital Income* 260-70 (MIT Press 1994); Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 Ohio St. L.J. 1459, 1509-12 (1998). In addition to substantially cutting back on the tax benefits enjoyed from accelerated depreciation and eliminating the capital gains preference, the Tax Reform Act of 1986 imposed a noticeably progressive rate structure on corporations with top and bottom rates of 15% and 40% respectively and with a notch rate of 51% on income between $1 million and $1,405,000. *General Explanation of the Tax Reform Act of 1986*, *supra* n. 11, at 272; Gravelle, *supra* at 262. By 1993, the top rate had fallen to 35% with a notch rate of 38% on income between $15,000,000 and $18,333,333 caused by the 3% surtax of § 11(b). *Id.* Although the Bush tax cuts did not lower the tax rates for corporations, it allowed a "bonus" first year depreciation deduction and extended the carryback period for net operating losses in the tax

total tax liability as the taxpayer's income rises.[13] Although the tax structure currently in effect can be defined as moderately progressive, the most recently enacted tax legislation[14] sponsored by the Bush Administration cut taxes overall while reducing the level of progressivity of the federal income tax.[15]

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years ending in 2001 and 2002. The Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-47, §§ 101-102, 116 Stat. 21, 22-26 (2002) [hereinafter *2002 Bush Tax Cut*]; *infra* n. 16.

13. *See* Slemrod & Bakija, *supra* n. 6, at 58.

14. In addition to cutting income taxes, especially for the wealthiest individuals and most profitable corporations, the 2001 Bush tax cuts substantially reduced the estate, generation skipping, and gift taxes and plans to eventually eliminate both the estate and generation skipping taxes. *2001 Bush Tax Cut*, *supra* n. 11, at §§ 501, 511, 521. Although the gift tax is levied annually on transfers to donees over $11,000, I.R.C. § 2503(b) (2003), because individual donors that exceed the $11,000 exclusion can give away up to $1 million over the course of their lives without incurring gift tax, as a practical matter the gift tax only affects the very wealthy. Richard B. Stephens et al., *Federal Estate and Gift Taxation* ¶ 9.06 (8th ed., Warren, Gorham, & Lamont 2002); I.R.C. § 2505 (2003). The generation-skipping transfer tax, a separate tax levied in addition to any estate or gift taxes owed by the donor, is levied on transfers of income or principal to beneficiaries at least two generations younger than the transferor. Jay D. Waxenberg, *Overview of the Generation-Skipping Transfer Tax,* in *Understanding Estate, Gift, & Generation-Skipping Transfer Taxes* 297, 297 (Joshua S. Rubenstein ed., P.L.I. 2002); I.R.C. § 2601 (2003). In 2001, the estate and generation skipping tax transfer exemption was $675,000, and the top rate on estate and gift taxes was 60%. Brookings Inst. Tax Policy Center, *Tax Facts, Changes in Transfer Tax Exemptions and Rates Due to EGTRRA*, http://www.taxpolicycenter.org/TaxFacts/TFDB/TFTemplate.cfm?docid=48&topic2id=60 (accessed Nov. 10, 2004) (2003) [hereinafter *Changes in Transfer Tax Exemptions*]. The 2001 Bush tax cut increases the estate and generation-skipping tax transfer exemption to $1 million in 2002, $1.5 million in 2004, $2 million in 2006, and $3.5 million in 2009. *2001 Bush Tax Cut*, *supra* n. 11, at § 521; *Changes in Transfer Tax Exemptions*, *supra*. Further, the 2001 Bush tax cut decreases the top rate on estate and gift taxes to 50% in 2002, 49% in 2003, 48% in 2004, 47% in 2005, 46% in 2006, and 45% in 2007. *2001 Bush Tax Cut*, *supra* n. 11, at § 511; *Changes in Transfer Tax Exemptions*, *supra.* In 2010, the 2001 Bush tax cut repeals the estate and generation-skipping taxes and transfer exemptions, and sets the gift tax at a flat rate of 35%. *2001 Bush Tax Cut*, *supra* n. 11, at §§ 511, 2210; *Changes in Transfer Tax Exemptions*, *supra.* However, the 2001 Bush tax cut is subject to a sunset provision, which reverts the estate, gift, and generation skipping tax to the 2000 law in 2011. *2001 Bush Tax Cut*, *supra* n. 11, at § 901. There has been a great deal of debate whether the repeal of the estate tax represents good tax policy. *Defending the Estate Tax*, N.Y. Times A18 (Feb. 16, 2001) (arguing that repealing the estate tax cannot be justified by economic conditions, social benefits or the need for basic fairness in the tax code); Hilary Kramer, *Charity Doesn't Depend on the Tax Code*, Wall St. J. 26 (Feb. 21, 2001) (arguing that repealing the estate tax most affects the vast majority in the middle who will benefit the most from its elimination).

15. Congress has passed three major tax cuts since George W. Bush was elected President of the United States: The Economic Growth and Tax Relief Reconciliation Act of 2001, *2001 Bush Tax Cut*, *supra* n. 11; the Job Creation and Worker Assistance Act of 2002, *2002 Bush Tax Cut*, *supra* n. 12; and the Jobs and Growth Tax Relief Reconciliation Act of 2003, *2003 Bush Tax Cut*, *supra* n. 11. The major provisions of the 2001 Bush tax cut carve out a 10% tax rate bracket and reduce tax rates to be phased in over 5 years. *2001 Bush Tax Cut*, *supra* n. 11, at §§ 101, 501, 511. The major provisions of the 2002 Bush tax cut focused on business taxpayers by creating a "bonus" first year depreciation deduction and extended the carryback period for net operating losses in the tax years ending in 2001 and 2002. *2002 Bush Tax Cut*, *supra* n. 12, at §§ 101-02. The major provisions of the 2003 Bush tax cut expand the 10% tax bracket, accelerate the 2001 Bush tax cut reductions in the tax rates, reduce capital gains rates, provide capital gains treatment to qualified dividend income, and increase and extend the "bonus" depreciation deduction created by the 2002 Bush tax cut. *2003 Bush Tax Cut*, *supra* n. 11, at §§ 104-05, 301-02; *see also* Slemrod &

Although the Bush tax cuts lowered the rates on all individuals and households, the wealthiest enjoy the greatest tax savings, with the middle classes receiving only modest benefits, while providing those at the lowest income levels at best *de minimis* tax savings.[16] The current law contains six income tax rates for individuals and households, which start at ten percent and gradually rise to a top rate of thirty-five percent,[17] and four income tax

Bakija, *supra* n. 6, at 26-28 (summarizing the tax legislation passed since Bush took office in 2000).

16. Focusing on the 2001 Bush tax cuts, the Center for Tax Justice divided taxpayers into five groups based on levels of income (four levels of income earners separated by increments of 20% with the fifth and highest 20% of income earners further divided into three groups: the first 15%, the next 4%, and finally the top 1%), and projected the average tax savings. The lowest 20% of income earners would enjoy an average tax cut of $56 in 2001, which would fall to an average of $10 after 2001. On the next level, the second 20% group would enjoy an average tax cut of $269 in 2001, which would fall to an average of $107 after 2001. The middle 20% group would enjoy an average tax cut of $405 in 2001, which would fall to an average of $194 after 2001. The fourth 20% group would enjoy a $575 average tax cut in 2001, which would fall to an average of $449 after 2001. Within the top 20% group of income earners in America, the first 15% would enjoy an average tax cut of $739 in 2001, which would rise to an average of $1,416 after 2001. This trend of the largest tax cuts being enjoyed by the highest income groups continues with the next 4% expected to enjoy an average tax cut of $1,008 in 2001, which would rise to an average of $2,316 after 2001. Taxpayers in the top 1% of all income earners in America were expected to enjoy an average tax cut of $3,120 for 2001, which would rise to an average of $50,003 after 2001. Citizens for Tax Justice, *Center for Tax Justice Analysis Finds Little Post-2001 Tax Cut Relief for Most Americans*, 2001 Tax Notes Today 118-16 (June 18, 2001). Focusing on the 2003 Bush tax cuts, the Brookings Institution concluded that most of those benefits would be enjoyed by the top 1% of income earners. For example, 53% of all U.S. households could expect to see a tax cut of $100 or less from the 2003 tax cuts, with 36% of all U.S. households receiving no tax cut. The middle fifth of households could expect to see an average tax cut of $217 from the 2003 tax cuts. However, individuals earning $1 million or more could expect an average tax cut of $93,500. Center on Budget and Policy Priorities, *Center on Budget and Policy Priorities Fact Sheet on "True Cost" of Tax Cut Law*, 2003 Tax Notes Today 103-28 (May 28, 2003). The Center on Budget and Policy Priorities focused on the combined effects of both the 2001 and 2003 Bush tax cuts and concluded that households with after tax income of $1 million would save nearly $113,000 in 2003, allowing them to enjoy an average increase of 5.4% of after-tax income. Households in the middle fifth of income earners are expected to save $680, representing a 2.6% increase of after-tax income. Households in the bottom fifth of income earners enjoy only *de minimis* tax savings of $3, representing an average increase of 0.2% of after-tax income. Robert Greenstein & Isaac Shapiro, *Center on Budget and Policy Priorities Says Income Gap Widening*, 2003 Tax Notes Today 185-61 (Sept. 23, 2003). There has been a great deal of debate in tax policy circles whether the Bush tax cuts, especially the features granting the largest savings to the wealthiest taxpayers, represents good tax policy. *See e.g.* Paul Krugman, *A Touch of Class*, N.Y. Times A23 (Jan. 21, 2003) (arguing that the 2003 Bush tax cut will benefit "the very, very well off" while contributing to growing budget deficits); *Tax Cut for Granny*, Wall St. J. A12 (Mar. 13, 2003) (arguing that the 2003 Bush tax cut strengthens economic growth, builds an investor class, and benefits seniors). Like all issues of tax policy, whether or not the Bush tax cuts represent sound tax policy ultimately comes down to an ethical issue, which can only be decided on moral grounds.

17. A household of a married couple with two children had to realize at least $21,700 before paying any income tax at all. *VITA/TCE Instructor Guide*, I.R.S. Pub. No. 1155 (2003); *see* I.R.C. §§ 63, 151 ($9,500 standard deduction for married filing joint returns; $3,050 personal/dependent exemption for each family member). Such households incur income tax of 10% on the excess between $21,700 and $35,700, 15% on the excess up to $78,500, 25% on the excess up to $136,350, 28% on the excess up to $196,400, 33% on the excess up to $333,650, and 35% on the

rates for corporations, which start at fifteen percent and gradually rise to a top rate of thirty-five percent.[18] Current law also taxes capital gains at much lower rates,[19] and as a result of the Bush tax cuts, allows taxpayers

excess over $333,650. *Your Federal Income Tax for Individuals*, I.R.S. Pub. No. 17 (2003); *see* I.R.C. § 1. Before the 2001 Bush tax cuts, the typical household comprised of a married couple and two children had to realize at least $18,550 before paying any income tax at all. *Exemptions, Standard Deduction, and Filing Information*, I.R.S. Pub. No. 501 (2000); *see* I.R.C. §§ 63, 151 ($7,350 standard deduction married filing joint returns; $2,800 personal/dependent exemption for each family member). Such households incurred income tax of 15% on the excess between $18,550 and $62,400, 28% on the excess up to $124,500, 31% on the excess up to $180,000, 36% on the excess up to $306,900, and 39.6% on the excess over $306,900. *Your Federal Income Tax for Individuals*, I.R.S. Pub. No. 17 (2000). Many households, especially those in the upper income levels, further reduce their taxable income by itemizing deductions. *See* I.R.C. § 63(e).

18. Corporations are not allowed exemptions or a standard deduction. I.R.C. § 11 (2003). Corporations pay a corporate level tax of 15% of its first $50,000 of taxable income, 25% of the excess up to $75,000, 34% of the excess up to $10,000,000, and 35% of taxable income exceeding $10,000,000. I.R.C. § 11(b) (2003). The advantages of the 15% and 25% lower rates are phased out by a 5% surtax on taxable income between $100,000 and $350,000, which cannot exceed $11,750, and the advantages of the 34% rate are phased out by a 3% surtax on taxable income between $15,000,000 and $18,333,333 which cannot exceed $100,000. *Id.*; *see generally* Bittker & Eustice, *supra* n. 6, at 5-4 (describes in detail both the 5% and 3% surtaxes on corporate income). As a result of these surtaxes, the corporate tax rate structure is actually regressive. Gravelle, *supra* n. 12, at 262 (corporations earning income over $100,000 but less than $350,000 have a marginal rate of 39%, and corporations earning over $15 million but less than $18,333,333 have a marginal rate of 38%, while more profitable corporations–those earning more than $18,333,333 – have a marginal rate of 34%). Although the Bush tax cuts did nothing to alter the rate structure of the corporate tax, those changes did narrow the tax base for a limited period of time, which could increase the degree of regressiveness of the corporate tax burden. *See 2002 Bush Tax Cut*, *supra* n. 12, at § 101 (adding § 168(k) which allows, in addition to deductions already granted the first year depreciation, a deduction to include 30% of the adjusted basis of qualified property acquired after September 10, 2001 and before September 11, 2004); *id.* at § 102 (extends the net operating loss carryback period for tax years ending in 2001 and 2002 from two years to five years); *2003 Bush Tax Cut*, *supra* n. 11, at § 201 (adding § 168(k)(4) which increases to 50% and extends – to property acquired after May 5, 2003 and before January 1, 2005 – the first year "bonus" depreciation deduction.); *see also* John D. McKinnon & Rob Wells, *Some Top Companies Avoided Federal Income Tax under Bush*, Wall St. J. A2 (Sept. 23, 2004) (describing study sponsored by the Citizens for Tax Justice examining 275 Fortune 500 Companies indicating that one-third paid no federal income taxes for at least one year between 2001-2003, with many receiving refunds of federal taxes paid in prior years).

19. Gain realized from a sale or exchange of a capital asset held for one year or more qualifies for capital gain treatment, but if the capital asset has been held less than one year the gain is taxed at ordinary income rates. I.R.C. §§ 1, 1221 (2003). All property is generally classified as capital assets with some important exceptions designed to impose ordinary income treatment on gains from certain property such as inventory, the recapture element of depreciable property, property created by the taxpayer (e.g., literary, musical, or artistic works), and accounts receivable. *Id.* at § 1221. All net capital gains are taxed at 15% if the taxpayer's (assuming married filing jointly) level of ordinary income reaches or exceeds $56,800. *Id.* at § 1(h). Taxpayers (assuming married filing jointly) with ordinary income less than $56,800 enjoy a 5% tax rate on a portion of net capital gains. *Id.* The portion of the taxpayer's net capital gains taxed at 5% (as opposed to the higher 15% rate) will grow as the taxpayer's ordinary income and amount of net capital gain falls. *Id.*; Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts*, vol. 2, ¶ 46.2.2, 46-10 (3d ed., Warren, Gorman & Lamont 1999) (describing in detail how to precisely calculate the portion of net capital gain taxed at 5% and 15% for taxpayers at various ordinary income levels below $56,800); *see* I.R.C. § 1(h)(1)(D), 1(h)(1)(E) (2003) (taxing capital gains from certain property such as unrecaptured § 1250 gains at 25%, and collectibles such as antiques

receiving dividends from domestic corporations to enjoy the capital gains rates.[20] Although the federal income tax structure is probably less progressive as a result of the Bush tax cuts, individuals and corporations at the highest income levels still bear a greater proportional income tax burden than those at lower levels.[21]

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at 28%). Capital gains offset all losses from the sale or exchange of capital assets, and if a taxpayer's capital losses exceed capital gains, up to $3,000 of that loss can be deducted against ordinary income, with the excess carried forward indefinitely. *Id.* at § 1211(b). Capital gains realized by corporations are taxed at ordinary income rates. *Id.* at § 11; *see also id.* at § 1201(a) (limiting the top rate on capital gains to 35% even if the corporate income tax rate on ordinary income exceeds 35%). Capital losses realized by corporations can only be deducted against capital gains. *Id.* at § 1211(a). A corporation's net capital losses (exceeding capital gains) can be carried back for three years and forward for five years. *Id.* at § 1212(a). The 2003 Bush tax cut lowered the top rate on capital gains from 20% to 15% and the lower rate from 10% to 5%. *2003 Bush Tax Cut*, *supra* n. 11, at § 301.

20. The 2003 Bush tax cut provided capital gains treatment to dividend income received by individuals from domestic corporations and qualified foreign corporations. *2003 Bush Tax Cut*, *supra* n. 11, at § 302; I.R.C. § 1(h)(11)(B). Qualified foreign corporations are either incorporated in a U.S. possession (such as Puerto Rico) or have entered into a comprehensive income tax treaty with the U.S. *Id.* at § 1(h)(11)(C). Before the 2003 Bush tax cut, dividends were taxed as ordinary income at the regular tax rates provided by § 1. Although the Bush tax cuts did not extend capital gains rates for dividends received by corporations, current law allows all corporations to deduct 70% of dividends received from domestic corporations; that deduction rises to 80% if the corporation owns at least 20% of the stock of the distributing corporation and that deduction rises to 100% if the corporation owns at least 80% of the stock of the distributing corporation or if the distributing corporation is a small business investment company operating under the Small Business Investment Act of 1958. *Id.* at §§ 243(a), (c).

21. Although complete data is not yet available that fully measures the impact of the Bush tax cuts on the degree of progressivity, the evidence that does exist suggests that the Bush tax cuts have decreased the degree of progressivity. In 2000, before the Bush tax cuts were enacted, individuals paid over $1 trillion (the exact amount was $1,004,461,000,000) in federal income taxes, accounting for 42% of government revenues. House Policy Committee, *Annual Report on the United States Government 2000*, http://policy.house.gov/assets/ann_rep2000.pdf (July 2000). Families earning up to $17,988, $34,844, $59,079, $107,767, and over $107,767 accounted for 0.7%, 3.9%, 10.2%, 19.9%, and 65.1% respectively, of total federal income taxes paid. Julie-Anne Cronin, *U.S. Treasury Distributional Methodology* 24 (Office of Tax Analysis Papers No. 85, Sept. 1999). In 2001, when the Bush tax cuts had only started, individuals paid just under $1 trillion (the exact amount was $994,339,000,000) in federal income taxes, accounting for 41% of government revenues. House Policy Committee, *Annual Report on the United States Government 2002*, http://policy.house.gov/assets/ann_rep2002.pdf (Jan. 2002). It has been estimated that the percentage of federal taxes paid by at least the lower income groups has risen; families earning up to $15,000, $27,000, $44,000, $72,000, and over $72,000 in taxable income accounted for 1.1%, 4.1%, 9.2%, 17.9%, and 67.7% of total federal taxes paid. William G. Gale & Samara R. Potter, *An Economic Evaluation of the Economic and Growth and Tax Relief Reconciliation Act of 2001*, http://www.brookings.edu/dybdocroot/views/articles/gale/ 200203.pdf (accessed Oct 18, 2004). Although no data is available beyond the year 2000 breaking down the corporate federal tax burden among corporations at different income or asset levels, the corporate tax burden overall has declined as a result of the Bush tax cuts. House Policy Committee, *Annual Report on the United States Government 2002*, *supra* (in 2000 corporations paid nearly $210 billion (the exact amount was $207,288,000,000) in income taxes, accounting for 9% of government revenues; in 2001 and 2002, corporations paid just over $151 billion (the exact amount was $151,075,000,000) and just under $150 billion (the exact amount was $148,042,000,000) respectively, accounting for 6% of government revenues each of those years).

In order to ethically evaluate the appropriate tax burden that should be borne by the largest corporations, lines must be drawn attempting to separate those corporations from the others. Recognizing the enormous difficulties in drawing such lines, this Article arbitrarily deems corporations with $250 million worth of assets or more as among those defined as "big business."[22] For the 2000 taxable year, of the more than five million corporations filing income tax returns, just over 10,000 corporations—well under half a percent—had assets of $250 million or more.[23] Despite being few in number, these corporate giants collectively owned almost 90 percent of all corporate assets, produced almost 60 percent of all corporate gross receipts, generated almost 90 percent of all corporate net income, and paid just over 80 percent of all corporate income taxes.[24] Clearly, America's largest cor-

22. The Statistics of Income Division of the Treasury Department collects and processes data from income tax returns filed by all taxpayers in order to inform government agencies and the general public as to how the tax system works. *See* Statistics of Income Division, *Tax Statistics*, http://www.irs.gov/taxstats (accessed Oct. 5, 2004). Although asset size reveals far less than revenues and profits about the corporation's true economic state, Statistics of Income groups corporations according to size by the amount of the corporation's gross assets, with the largest group being corporations with $250 million or more of gross assets. *Statistics of Income Report*, SOI, 2000, tbl. 4 (IRS 2000) (available at http://www.irs.gov.pub/irs-soi/00co04nr.xls). The 2000 taxable year is the most recent for which complete Statistics of Income compilations are available. *See Statistics of Income Report*, SOI, 2000, (IRS 2000), http://www.irs.gov/pub/irs-soi/00cosec3.pdf [hereinafter *2000 SOI Report*]. Because gross asset size includes liabilities, highly leveraged corporations will appear to be larger than they are in actuality and corporations with relatively little debt will appear smaller than they are in actuality. Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 Mich. L. Rev. 393, 446 n. 131 (Nov. 1996).

23. The total number of tax returns filed by active corporations came to 5,045,274 with corporations having $250 million or more of assets numbering 10,883 of the total. *2000 SOI Report*, *supra* n. 22, at 83-86 tbl. 2. Although more than half of the corporations filing income tax returns elected Subchapter S (a pass-through tax regime broadly resembling the taxation of partnerships in that corporate net income is taxed at the shareholder level once and not at the corporate level), very few S corporations have assets at or exceeding $250 million and in fact the largest cluster have assets less than $50,000. *See 2000 SOI Report*, *supra* n. 22 (of the 3,008,022 S corporations filing income tax returns in 2000, 1,180,440 of these S corporations had assets under $50,000, while only 618 of these S corporations had assets of $250 million or more).

24. The just over five million active corporations collectively owned just over $47 trillion of total assets. *2000 SOI Report*, *supra* n. 22, at 83-86 tbl. 2 (exact assets totaled $47,026,871,874,000). Corporations in the $250 million or more total asset group (just 10,000 corporations) owned 89.5% of the total reported corporate assets. *Id.* (exact assets totaled $42,103,103,783,000, just over $42 trillion). Similarly, the just over five million active corporations collectively produced almost $21 trillion of gross receipts (exact gross receipts totaled $20,605,808,071,000), while active corporations in the $250 million or more group produced 60.7% of the gross receipts. *Id.* (exact gross receipts totaled $12,515,714,230,000, almost $13 trillion). The just over 5 million active corporations earned almost $928 billion of net income. *Id.* (exact net income totaled $927,525,517,000). However active corporations in the $250 million group earned 87.8% of this net income, just over $815 billion. *Id.* (exact net income earned totaled $815,281,844,000). All active corporations paid a total of just over $204 billion of corporate income tax. *Id.* (exact corporate income tax paid totaled $204,043,788,000). However, active corporations in the $250 million or more total asset group paid 82.1% of this corporate tax, almost $168 billion. *Id.* (exact corporate income tax paid totaled $167,599,740,000).

porations command a substantial presence in the economy and account for the lion's share of corporate tax revenues.

Of the 10,000 of America's largest corporations, a few command an extraordinary share of the assets owned, the gross receipts and the net income earned by all corporations. Within the group of corporations comprising big business (those owning $250 million or more of assets), who already as a group pay most of America's corporate taxes, these corporate mega giants pay a very large percentage of the corporate tax. These top companies are annually ranked among the "Fortune 500" by *Forbes Magazine* based on profits, assets, and sales metrics.[25]

For example, viewing ten (Bank of America, Citigroup, Exxon Mobil, General Electric, General Motors, Intel, Microsoft, Philip Morris, Verizon, and Wal-Mart) of some of the most well known of these corporate giants as a group,[26] together they each average almost $285 billion in assets,[27] generate just over $10 billion of net income[28] from almost $107 billion of average gross receipts[29] and pay almost $6 billion of corporate income taxes.[30] Finally, these ten corporations that numerically represent a negligible percentage of the total corporations owning $250 million or more of assets, and

25. *Forbes Magazine* is a very well respected business publication that annually ranks the top 500 companies in the U.S. based on the past year's sales, profits, assets, and market values. *Forbes 500s*, 167 Forbes 209 (Scott DeCarlo & Ann C. Anderson eds., April 16, 2001). These four lists are then combined to make an overall "superrank" based on a composite rating from the four lists. *See id.* at 256-80. The magazine then recognizes the top 100 from this "superrank." *See id.* at 230. In 2000, this top 100 was based on 817 companies that composed the four top 500 lists. *See id.* at 256. Pending an extreme circumstance (i.e., collapse of Enron, WorldCom), the companies in the top 100 remain fairly static.

26. *See infra* app. A. These ten corporations were randomly selected based on size and name recognition. Others that could be included in the list include Johnson & Johnson, AT&T, or PepsiCo. On Forbes' top 100 list for 2000, the ten companies chosen for this Article to put a face on "big business" were ranked as follows: #1 Citigroup; #2 General Electric Co.; #3 Exxon Mobil; #4 Verizon; #6 Bank of America; #10 Wal-Mart Stores, Inc; #12 Philip Morris; #15 General Motors; #18 Intel; #22 Microsoft. *See Forbes 500s, supra* n. 25, at 231.

27. The gross assets of each of the ten companies is $642,191,000,000; $902,210,000,000; $149,000,000,000; $437,006,000,000; $303,100,000,000; $47,945,000,000; $52,150,000,000; $79,067,000,000; $164,735,000,000; and $70,349,000,000 respectively, for a total of $2,847,753,000,000, when divided by ten averaging $284,775,300,000. *See infra* app. A.

28. The net income of each of the ten companies is $7,863,000,000; $13,519,000,000; $17,720,000,000; $12,735,000,000; $4,452,000,000; $10,535,000,000; $9,421,000,000; $8,510,000,000; $11,787,000,000; and $5,377,000,000 respectively, for a total of $101,919,000,000, when divided by ten averaging $10,191,900,000. *See infra* app. A.

29. The gross receipts of each of the ten companies is $43,258,000,000; $111,826,000,000; $232,748,000,000; $129,853,000,000; $184,632,000,000; $33,726,000,000; $22,956,000,000; $80,356,000,000; $64,707,000,000; and $165,013,000,000 respectively, for a total of $1,069,075,000,000, when divided by ten averaging $106,907,500,000. *See infra* app. A.

30. The corporate income taxes of each of the ten companies is $4,271,000,000; $7,525,000,000; $11,091,000,000; $5,711,000,000;, $2,393,000,000;, $4,606,000,000; $4,854,000,000; $5,450,000,000;, $7,009,000,000; and $3,338,000,000 respectively for a total of $56,248,000,000, when divided by ten averaging to $5,624,800,000. *See infra* app. A.

are a mere handful of the more than five million total corporations,[31] approached thirty-five percent of the corporate income tax liability within the $250 million asset group and nearly thirty percent of the corporate income tax liability of all corporations.[32] If Congress adopts a flatter income tax structure, America's largest corporations, like the wealthiest individuals, will enjoy a substantial reduction in tax burdens.[33] Clearly the outcome of the tax policy debate between proponents of moderately progressive tax structures and those favoring flatter structures greatly impacts America's largest corporations.

B. *Economic Theory of Marginal Utility Offers No Solid Information Supporting Moderately Progressive Tax Structures*

All reasonable tax policy experts conclude that tax structures should not be regressive and there should be no tax burden imposed at very low income levels at or approaching poverty.[34] The question whether the federal income tax structure should be progressive or flat is one of the most

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31. The ten companies make up just under a tenth of a percent (ten divided by 10,883 equals .092%) of the total active corporations (even when removing the 618 S corporations from $250 million asset group) (ten divided by 10,265 equals .097%) with assets of $250 million or more filing tax returns in 2000. *2000 SOI Report*, *supra* n. 22, at 83-86 tbl. 2.

32. In 2000, the total corporate tax of all active corporations equaled $204,043,788,000, *supra* n. 24, and the total corporate tax of the ten corporations, discussed *supra* n. 26, equaled $56,248,000,000, *supra* n. 30. Active corporations in the $250 million or more in total assets group paid $167,599,740,000, or 82.1% of the total corporate tax for 2000. *Supra* n. 24. The ten corporations discussed *supra* n. 26 incurred 33.56% of the total tax of corporations in the $250 million asset group ($56,248,000,000 divided by $167,599,740,000 equals .3356). The ten corporations incurred 27.6% of the total tax of all active corporations ($56,248,000,000 divided by $204,043,788,000 equals .2757). *Supra* n. 23 (of the 5,045,274 active corporations filing tax returns in 2000, 1,180,440 of these were S corporations).

33. *See infra* nn. 52-58 and accompanying text.

34. Regressive tax structures impose taxes as a percentage of income inversely proportional to income, which means that the taxpayer's percentage of income needed to pay tax shrinks to smaller percentages as their income climbs to higher levels and grows to greater percentages as their income falls. *See* Slemrod & Bakija, *supra* n. 6, at 58 (defining a regressive tax structure as one where the tax "takes a smaller percentage of income from those with higher incomes"); Adam Smith, *The Wealth of Nations* 777 (Edwin Cannan ed., Random House, Inc. 1937) (arguing that the maxim of equality, focusing on paying taxes in proportion to one's abilities, presumably would deem a regressive tax structure inequitable); Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. Chi. L. Rev. 417, 420, 506-07 (1952) (conceding the need for minimum exemptions to ensure people are not taxed below the subsistence level); Michael J. Graetz, *To Praise the Estate Tax, Not Bury It*, 93 Yale L.J. 259, 274 (1983) (noting that "the case for regressive taxation is surely wrong"); Nancy C. Staudt, *The Hidden Costs of Progressivity Debate*, 50 Vand. L. Rev. 919, 921, n. 10 (1997) (citing numerous sources finding that theorists on both sides of the debate over progressive taxes have come to a consensus agreeing that poor individuals, those living at or below subsistence levels of income, should not have to incur tax costs); Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 Cal. L. Rev. 1905, 1911 (1987) (the theoretical case for a regressive tax is so weak it is never discussed).

controversial issues debated in tax policy circles.[35] The theory of marginal utility, which assumes taxpayers derive a lesser amount of satisfaction from each additional dollar as their income level increases, is the most important, but not the only,[36] economically based argument advanced in favor of progressive taxes.[37] Emphasizing that a poor person values a dollar more than a middle class person, who in turn values a dollar more than a wealthy person, proponents of progressive tax structures claim that the economic theory of marginal utility—and the argument that all taxpayers should bear

35. This Article will morally evaluate tax burdens under a moderately progressive versus a flatter structure. A discussion of income tax burdens that reach steep levels of progressivity, especially very high effective rates over 50%, is beyond the scope of this Article.

36. Some progressive tax proponents invoke another economic theory, known as benefit theory, to support their arguments. Benefit theory starts with the anchor assumption that the free market sets a fair price for all goods and services purchased within it and assumes that the tax burden of each taxpayer should reflect the value of services received from the government. Slemrod & Bakija, *supra* n. 6, at 59-64. In apportioning the tax burden among taxpayers at different income levels, proponents of benefit theory justify progressive rate structures on the grounds that taxpayers at higher income and wealth levels have a greater amount to lose if government services, for example national defense, police protection, and the justice system, ceased to exist. *See* Leo P. Martinez, *To Lay and Collect Taxes: The Constitutional Case for Progressive Taxation*, 18 Yale L. & Policy Rev. 111, 147 (1999) (noting that several strong arguments exist in favor of the benefit theory). However, as critics of benefit theory point out, government benefits cannot be measured accurately. *See* William H. Anderson, *Taxation and the American Economy: An Economic, Legal, and Administrative Analysis* 55 (E. A.J. Johnson, ed., Prentice–Hall, Inc. 1951); Jeffrey A. Schoenblum, *Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 Am. J. Tax Policy 221, 229 (1995). Moreover, even if it were actually possible to measure governmental benefits, benefit theory would require the poorest citizens, who under the current system receive direct government services while bearing little or no taxes, to pay taxes. *See id.* at 230; Anderson, *supra* at 55-56; Slemrod & Bakija, *supra* n. 6, at 61. Because the same problems make it difficult to prove that big business in fact derives more benefit from the government services than individuals and smaller businesses at lower income levels, benefit theory offers little toward supporting progressive tax structures on big business.

37. *See* Slemrod & Bakija, *supra* n. 6, at 59-64 (discussing marginal utility as setting a lower degree of sacrifice for taxes imposed on wealthier as opposed to less wealthy taxpayers); Donna M. Byrne, *Progressive Taxation Revisited*, 37 Ariz. L. Rev. 739, 767 (1995) (defining diminishing marginal utility as the principle that one derives smaller and smaller satisfaction from each additional dollar as one's total income increases); Blum & Kalven, Jr., *supra* n. 34, at 456 (basing the definition of marginal utility on the assumptions that "the only significant variable in men's taste for money is the amount of money they have" and as one's amount of money rises, one's "appetite for money" correspondingly falls); Schoenblum, *supra* n. 36, at 237 (marginal utility assumes that a dollar is worth more to the low income taxpayer than to the high income taxpayer which allows the higher income taxpayers to sacrifice and pay greater amounts of taxes, more than the lower income taxpayers); Anderson, *supra* n. 36, at 57 (stating that diminishing marginal utility is based on the theory that a "marginal dollar of a higher income is believed to have less utility to the owner than the marginal dollar of a lower income"); Charles O. Galvin & Boris I. Bittker, *The Income Tax: How Progressive Should it Be?* 14-15 (American Enter. Inst. for Pub. Policy Research 1969) (describing the marginal utility argument by the example of the "marginal utility of the 10,000th dollar for one with a $10,000 annual income is greater than the marginal utility of the 100,000th dollar for one with $100,000 annual income" because of the assumption that the units of marginal utility are larger in terms of value for the poor and lesser for the rich).

equal sacrifice[38]—support the argument that the appropriate level of taxes a taxpayer can afford to pay rises proportionally with the taxpayer's level of wealth. In other words, in order to ensure that all taxpayers are asked to bear equal sacrifice given their different levels of income and wealth, a few progressive tax proponents support moderately progressive tax structures using the general theory of marginal utility and equal sacrifice.[39]

Although most economists agree that the marginal utility of money does decline at higher income levels and increases at lower income levels, no logical method exists that can determine the appropriate level or amount of the increase or decrease in the value of the dollar as income increases or decreases. Consequently, the relationship between a taxpayer's income level and what the corresponding tax burden ought to be cannot be accurately measured. Because of the complexities inherent in measuring the rate at which the marginal utility declines, comparisons of the sacrifice created by having less money across income classes cannot be made.[40] Many support progressive tax structures while fully recognizing the difficulty of measuring the declining marginal utility of money.[41] Opponents of pro-

38. The idea that taxpayers should bear an equal sacrifice when defining tax burdens is sometimes simplistically interpreted to mean that each taxpayer should pay the same dollar amount (i.e., head or poll taxes, the most regressive form of taxation) or that the same tax rate should apply to incomes above a reasonable amount (credible flat tax structures). The theory of declining marginal utility suggests that equal sacrifice, sometimes called ability to pay, requires those at greater income levels to pay higher taxes and is sometimes used to argue in favor of progressive taxes. However, because the decline of the marginal utility of money cannot be measured, the general concepts of equal sacrifice and ability to pay do not by themselves support progressive tax structures. Slemrod & Bakija, *supra* n. 6, at 63 (noting that although ability to pay focuses on tolerating sacrifice, that general concept fails to support progressive taxes because the marginal utility of money cannot be measured); Anderson, *supra* n. 36, at 56; Henry Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* 5-10 (U. of Chi. Press 1938) (recognizing that equal sacrifice does factor in declining marginal utility while recognizing "definite interpretations of these doctrines is exceedingly difficult").

39. *See* Bankman & Griffith, *supra* n. 34, at 1947 (arguing for progressive tax structures while assuming a declining marginal utility with regards to consumption and leisure, and that individuals have identical utility functions); Mark S. Stein, *Diminishing Marginal Utility of Income and Progressive Taxation: A Critique of 'The Uneasy Case'*, 12 N. Ill. U. L. Rev. 373 (arguing that Blum and Kalven's criticisms of diminishing marginal utility are incorrect, and arguing that diminishing marginal utility is a correct and useful premise when it comes to defending progressive taxation); Vada Waters Lindsey, *The Widening Gap under the Internal Revenue Code: The Need for Renewed Progressivity*, 5 Fla. Tax Rev. 1, 8 (2001) (noting that the progressive tax system is fair because it implements the traditional ability-to-pay principle); Martinez, *supra* n. 36, at 147 (strongly supporting progressive tax structures and noting that the inability to quantify equal sacrifice also means that no one can discount the idea).

40. *See* Slemrod & Bakija, *supra* n. 6, at 63 (stating that diminishing marginal utility might seem reasonable and convincing; however, there is no way to prove it, and noting that there is no way to compare sacrifice among individuals); Anderson, *supra* n. 36, at 58 (discussing how problematic it is to measure the marginal utility of income, due partially to the fact the concept was originally designed as an explanation of demand for consumption goods, not income).

41. *See* Boris Bittker, *The Income Tax: How Progressive Should it Be?*, in *Collected Legal Essays* 229, 234 (Fred B. Rothman & Co. 1989) (stating that one cannot put an exact value on declining marginal utility while supporting progressive taxes); Galvin & Bittker, *supra* n. 37, at 36-38 (noting that proportionate taxation should not be presumed to be fair simply because one

gressive tax structures vigorously claim that the marginal utility theory is useless because of the inability to accurately measure both the amount of sacrifice associated with the loss of one dollar from a person earning a specific income level and how that level of sacrifice relates to the appropriate tax burden.[42]

II. The Reduction of Tax Burdens Under the Armey/Shelby Flat Tax Proposal and the Economic Studies Used in Support

A. *The Armey/Shelby Flat/Consumption Tax Proposal and the Decreased Tax Burden of Big Business and Wealthy Individuals*

Over the last decade, politicians, academics, and other tax policy pundits have argued that progressive tax structures penalize the entrepreneurial success vital to a thriving economy based on capitalism. They would take the tax cuts recently passed under the Bush Administration substantially further by substituting the progressive income tax structure with a flat/consumption based tax regime that exempts income generated from savings and investment income from the tax base.[43] This Article uses the proposal sponsored by Congressman Armey and Senator Shelby as a model of comparison with the current progressive tax structure.[44]

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cannot determine with specificity the marginal utility curve); Marjorie E. Kornhauser, *Equality, Liberty, and a Fair Income Tax*, 23 Fordham Urb. L.J. 607, 617 (1996) (stating interpersonal comparisons of utilities are difficult at best, and more likely impossible, since one does not know the rate at which the utility of money declines while supporting progressive taxes); Liam Murphy & Thomas Nagel, *The Myth of Ownership: Taxes and Justice* 17-18 (Oxford U. Press 2002) (observing how no one knows how steeply the marginal utility curve declines while supporting progressive taxes).

42. *See* Blum & Kalven, *supra* n. 34, at 465 (in making their case for proportional rather than progressive structures, they assert that the shape of the marginal utility cannot be found and the most one can do is go on intuition so as to give the curve's common shape); Schoenblum, *supra* n. 36, at 236, 240-42 (in his vigorous criticism of progressive taxes he notes that the marginal utility curve is not the same for even those in the same income group and therefore, cannot be measured); Byrne, *supra* n. 37, at 767-69 (maintaining that there is no way to tell who gets more satisfaction from a marginal dollar, that interpersonal comparisons of utility are impossible, the slope of the utility curve cannot be measured, and arguments based on utility do not provide a compelling case for progressive taxation).

43. The flat tax concept was created by Robert Hall and Alvin Rabushka, two senior fellows at Stanford University's Hoover Institute. The flat tax concept represents a sea change in the way that taxes would be collected in the United States by replacing the current system with a flat tax rate structure for individuals and businesses. *See* Robert E. Hall & Alvin Rabushka, *The Flat Tax: A Simple, Progressive Consumption Tax*, in *Frontiers of Tax Reform* ch. 3, 29 (Michael J. Boskin ed., Hoover Instn. Press 1996). The estate and gift taxes and taxes on dividends and interest income would also be repealed. Proponents for a flat tax cite fairness, efficiency, and ease of administration as positive attributes when compared to the current tax structure. There have been many important tax reform proposals introduced by Congressmen since the early 1990s and they can be classified as either a consumption tax or a modified or simplified income tax. *See generally* James M. Bickley, *Flat Tax Proposals and Fundamental Tax Reform*, http://Hutchison.senate.gov/Taxes1.pdf (updated Mar. 19, 2002).

44. H.R. 1040, 107th Cong. (Mar. 15, 2001). The Freedom and Fairness Restoration Act, more commonly known as the Armey/Shelby flat tax proposal, was first introduced by Represen-

The Armey/Shelby proposal would impose a single flat rate on wages earned by individuals, allowing standard personal and dependent exemptions in order to avoid taxing individuals and families at the lowest income levels.[45] At the individual level, "wages" include salaries, retirement benefits, and unemployment compensation.[46] Although the proposal does not permit any other exemptions, deductions, or exclusions, it exempts from taxation all income realized from interest, dividends, and capital gains.[47]

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tative Dick Armey of Texas on June 16, 1994. Senator Richard Shelby of Alabama joined forces with Congressman Armey on July 19, 1995 by presenting this bill concurrently in the Senate. Armey and Shelby have proposed a variation of the famous flat tax model created in 1981 by Professors Robert Hall and Alvin Rabushka, but called for a lower 17% tax rate and larger exemptions. *See* James M. Bickley, *Flat Tax Proposals and Fundamental Tax Reform: An Overview*, http://Shelby.senate.gov/ legislation/leg_pdf/tax5.pdf (updated July 10, 2002); Robert E. Hall & Alvin Rabushka, *The Flat Tax* (2d ed., Hoover Instn. Press 1995); Robert E. Hall & Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax* (McGraw-Hill Book Co. 1983). This Article utilizes the Armey/Shelby flat tax proposal as the exemplary model of comparison with the current progressive tax system because it has received the most national attention of all of the proposed tax reform plans based on a flat/consumption model, and at least some view it as the most well-established, comprehensive and extensive proposal for fundamental tax reform that Congress is currently considering. Robert L. Sommers, *The Call for Radical Tax Reform*, "The Proposals," http://www.taxprophet.com/pubs/txrefm_01.html (accessed Oct. 18, 2004); Bruce Bartlett, *The A[rmey] Flat Tax*, http://www.ncpa.org/ba/ba136.html (accessed Oct. 18, 2004).

45. The Armey/Shelby plan's original flat tax rate of 17% was harshly criticized because substantial revenue shortfalls estimated at $139 billion were predicted. Eric Toder, *Treasury Analysis of Republican Tax Cuts, Flat Tax*, 95 Tax Notes Today 237-39 "A Preliminary Analysis of a Flat Rate Consumption Tax," (Dec. 5, 1995). To counter this shortfall, the rate would have to be raised to 20.8% or, in the alternative, personal and standard deductions would have to be substantially cut back (e.g., to break even at a 17% tax rate, exemptions would have to be reduced to $5,100 per taxpayer and $2,400 per child). *Id.* This revenue shortfall would likely be aggravated by successful lobbying by special interests groups and the need to provide transitional exemptions and deductions. Sommers, *supra* n. 44.

46. The Armey/Shelby proposal taxes individuals based on how much they make in respect to their employment with generous standard deductions and personal and dependent exemptions, allowing a high level of income to escape taxation. Bond Market Association, *Summary of Major Tax Reconstructing Proposals*, http://www.bondmarket.com/legislative/taxrefm.shtml (accessed Aug. 30, 2004). However, unlike the current system, which does not tax fringe benefits such as healthcare to the wage earner, the Armey/Shelby plan would tax all fringe benefits, FICA, and unemployment wages at the individual level. Citizens for Tax Justice, *Description of Various "Flat Tax" Proposals*, http://www.ctj.org/html/flatsum.htm (Nov. 1, 1998). Further, unlike the current system, which allows a certain threshold of retirement and pension benefits to be paid by both the employer and employee with pre-tax dollars, the Armey/Shelby plan would decrease benefits by requiring healthcare, FICA and Social Security taxes paid on the employee's behalf to be with after tax dollars. *Id.*

47. The exemptions allowed under this proposal include $24,600 for a married couple filing jointly, $15,700 for a single head of household, $12,300 for an individual, and an additional $5,300 for each dependent. H.R. 1040, 107th Cong. at § 63(b) (Mar. 15, 2001); *see also* James M. Bickley, *Flat Tax Proposals and Fundamental Tax Reform: An Overview*, Congressional Research Service Issue Brief for Congress IB95060 (updated July 10, 2002) (available at http://hutchison.senate.gov/Taxes1.pdf). However, the proposal eliminates several of the most popular exemptions, deductions and other benefits including the Earned Income Tax Credit, the home mortgage interest deduction, educational expenses, alimony, and charitable donations. H.R. 1040, 107th Cong. at § 105-6. The proposal also repeals the alternative minimum tax. *Id.* at §104.

The Armey/Shelby proposal taxes the cash flow of all businesses at the entity level, thus abolishing all distinctions between the corporate and unincorporated business forms.[48] The proposal measures cash flow by taking the business's gross revenue and subtracting purchases of goods and services, investments in capital assets, and wages and salaries paid.[49] Like individuals, business organizations exclude from their tax base all income realized from savings and investment income.[50]

Although the distributional effect on the tax burden of enacting a flat/consumption tax generally depends on the nature of the tax implemented, the rate structure imposed, and on which taxes the new tax would replace,[51] the founders of the flat tax concept themselves recognize that wealthier taxpayers will enjoy tremendous tax cuts, with the burden being shifted to the middle classes.[52] Economists also agree that a flat/consumption tax generally imposes a heavier tax burden on lower-income and middle-income individuals—opposed to the income tax—because these income groups typically consume a larger fraction of their income than do upper income groups.[53] Although some argue that the generous exemptions will prevent

48. All corporations (including Subchapter S corporations), partnerships (which would presumably include limited liability companies), and sole proprietorships would be taxed as Subchapter C corporations with partnerships, limited liability companies, and S corporations paying taxes on their net income before deducting the distributive shares to the partners, members, or shareholders). Martin A. Sullivan, *Flat Tax and Consumption Taxes: A Guide to the Debate*, 107 American Inst. of Certified Public Accountants, Tax Division 1995.

49. The business component of the Armey/Shelby flat tax under H.R. 1040 contains some dramatic departures from the way entities are taxed under the progressive tax system. All businesses from the smallest weekend fruit and vegetable stand to huge publicly traded corporations, such as Wal-Mart, would file the same tax return and pay the same tax rate. *See generally* H.R. 1040, 107th Cong. at § 11. The proposal, essentially a modified value added tax, would tax all business income minus wages, pension contributions, and capital expenditures with no deduction for benefits paid on behalf of the employee for health insurance, life insurance, and annuities with a full deduction allowed to expense capital expenditures, eliminating the delay of the current depreciation schedules. *Id.* Unlike the current system employees will not be able to contribute pre-tax dollars to their retirement accounts. *Id.* at § 103.

50. H.R. 1040 also eliminates all capital gains for businesses. Businesses would not have to recognize interest income because it does not fall into "active income." Also, appreciation in capital investments would go unrecognized because under the proposal, only money received over the fair market value needs to be reported. *Id.* at § 11(c)(2)(B).

51. Eric Toder, *Comments on Proposals for Fundamental Tax Reform*, 66 Tax Notes 2003, 2005 (Mar. 27, 1995) (Although there is general information regarding the distributional effects of replacing an income tax with a flat/consumption tax, the actual results will vary according to what proposal is enacted due to differences in the form of the tax and what tax structures are replaced by the flat/consumption tax.).

52. This burden shift was expressly admitted by the founders of the flat tax, Hall and Rabushka, themselves, in their 1983 book, *Low Tax, Simple Tax, Flat Tax*, where they pointed out that their flat tax "will be a tremendous boon to the economic elite." Hall & Rabushka, *supra* n. 44, at 67. They honestly divulged what they confess to be "some bad news," stating that "it is an obvious mathematical law that lower taxes on the successful will have to be made up by higher taxes on average people." *Id.* at 58.

53. Jane Gravelle, *The Flat Tax and Other Proposals: Who Will Bear the Tax Burden*, 69 Tax Notes 1517, 1524 (Dec. 18, 1995) (arguing that a consumption tax increases the burden on the middle and lower classes, all other things being equal, due to these groups' increased inclination

the tax burden from being shifted to income groups below the solid middle class,[54] substantial evidence suggests that the poor and lower middle classes will also bear a substantially higher tax burden under flat/consumption proposals, such as Armey/Shelby, than they do under the current moderately progressive income tax.[55]

B. *Economic Incentive Theory Offers No Solid Information Supporting Flatter Tax Structures*

Proponents of the Armey/Shelby and similar flat/consumption based proposals, while fully recognizing that a significant portion of the tax burden will shift from the wealthiest to the middle classes, justify this redistribution through the use of supply-side economics. Supply-side economics, more popularly known as "trickle-down" economics, postulates that reducing tax rates, especially for wealthy individuals and businesses, results in economic prosperity and growth by stimulating greater savings and investment, which in the long-term benefits everyone, including those whose tax burdens would increase from the shift.[56] Supply-side economics is based

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to spend as compared to upper class individuals); Slemrod & Bakija, *supra* n. 6, at 175 (discussing how flat tax proposals would "radically shift tax burdens toward low and middle income families"); Toder, *supra* n. 51, at 2005 (flat/consumption regime will shift the tax burden away from the wealthy, who would largely benefit from the exemption of savings and capital, to the middle and lower income classes, who consume a much larger portion of their income).

54. *See* Richard J. Joseph, *The "Consumption" and "Flat" Taxes Revisited*, 69 Tax Notes 211, 213-14 (Oct. 9, 1995) (exemptions shield low-income individuals causing a redistribution of the tax burden to the middle class only).

55. Slemrod & Bakija, *supra* n. 6, at 258-61 (discussing distributional impact of a change to a flat tax). The authors noted that the middle and lower income levels would see their after-tax incomes decline—with the two lowest quintiles (having income ranges of $35,000 or less)—showing the steepest declines (approaching 10% in some estimates under proposals that eliminate the earned income credit). *Id.* Under the same proposals, the top 1%—earning more than $409,000 a year—would see their after-tax income climb by over 10%. *Id. See* Lawrence H. Summers, *An Evaluation of the Flat Tax*, 70 Tax Notes 1555, 1558 (Mar. 11, 1996) (arguing that low income and poor families will actually receive the heaviest redistribution of the tax burden regardless of the generous standard deductions because the denial of payroll tax and health insurance deductions at the business level will result in lower wages and less fringe benefits; plus, the repeal of the earned income tax credit in the Armey/Shelby proposal would cause about 15 million families, who earn income below the current tax thresholds, to lose an average of $1,360 per taxpayer in benefits). Moreover, a study by the Treasury Department predicts that if enacted at a rate of 20.8% (necessary to avoid a massive loss of revenues), the Armey/Shelby proposal would substantially decrease the tax burden of wealthy individuals and corporations with taxable income over $200,000 while increasing, sometimes substantially, the tax burden for all taxpayers below this income range. Treasury Department Office of Tax Analysis, *New Armey-Shelby Flat Tax Would Still Lose Money, Treasury Finds*, 70 Tax Notes 451, 541 (Jan. 22, 1996) (estimates that the proposal at a 17% rate would result in a loss of approximately $138.3 billion of revenues annually at 1996 income levels); Eric Toder, *A Preliminary Analysis of a Flat Rate Consumption Tax*, 9 Tax Notes Today, 237 (Dec. 6, 1995) (wealthy individuals and corporations with taxable income over $200,000 would enjoy an average tax decrease of 28.1%, while those with income below $200,000 would see an average tax decrease ranging from 5% to 70.7%).

56. *Infra* app. B (discussing the development and the consequences of supply-side economics and the Economic Incentive Theory); *infra* nn. 115-16.

on economic incentive theory. Economic incentive theory purports that the promised growth in the economy would come from increased work effort, capital formation, and entrepreneurship, which would be stimulated by tax structures imposing lower burdens on taxpayers at higher levels of income and wealth such as the Armey/Shelby proposal.[57]

Economic incentive theory claims that the lower tax rates on income earned at higher levels offered by the flat tax proposals would increase the motivation to work, the labor supply, as well as the amount of actual wages.[58] This theory also asserts that the elimination of the preferential treatment of debt over equity[59] and the tax exemption of investment income (e.g., capital gains, interest and dividends) will increase capital formation by producing an environment more conducive to savings and investment.[60] Finally, economic incentive theory assumes that higher tax rates punish success and, when tax rates are decreased, a taxpayer's level of motivation to pursue entrepreneurial activities increases.[61] In its most basic form, proponents of flat taxes utilize the incentives argument as follows: "the net economic effect of the reforms proposed . . . include improved incentives for work, increased entrepreneur activity, and greater formation of capital, leading to a substantially higher level of national output and standard of living."[62]

Proponents of flat/consumption tax structures, at least implicitly, rely on economic studies to back up their belief that greater economic prosperity and growth will result. Through simulation models, which are the forecasting tools used by economists in all economic studies addressing tax reform, economic studies attempt to demonstrate the overall consequences of isolated variables, and the effect that they would have on the economy. In order to evaluate whether economic incentive theory actually provides legitimate scientific information that a flat/consumption tax structure will likely foster economic growth, the economic simulation models—the forecasting tools used by economists in all economic studies addressing tax reform—must be examined.[63]

The most common type of simulation model used by economists to predict economic consequences of fundamental tax reform is the general equilibrium model, which assumes that the prices of goods, capital, and

57. *Infra* app. B; *infra* nn. 115-20.

58. *Infra* app. B; *infra* nn. 121-28.

59. *Infra* app. B; *infra* nn. 132-33.

60. *Infra* app. B; *infra* nn. 129-31.

61. *Infra* app. B; *infra* nn. 134-36.

62. Joel Emes et al., *Critical Issues Bulletin: Flat Tax Principles and Issues*, "Economic Considerations," http://oldfraser.lexi.net/publications/critical_issues/2001/flat_tax/section_06.html (accessed Oct. 5, 2004).

63. *Infra* app. C (discussing the economic models supporting the Economic Incentive Theory and the fundamental flaws in economic studies); *infra* nn. 138-42.

labor will adjust until all markets are in equilibrium.[64] Each simulation model accounts for three economic sectors: a household sector, a production sector, and a government sector. In addition to these three sectors, simulation models make many other broad economic assumptions regarding human behavioral responses as well as assuming the nonexistence of other fluctuating economic variables at a constant rate. It is these broad economic assumptions in human behavior, and the assumptions regarding the way the economy is predicted to respond to numerous variables when altered, that are inherent to all economic simulation models.[65]

Due to fundamental flaws inherent in the models themselves, economic incentive theory fails to provide any solid information backing up the supply-side claim that a flat/consumption tax structure along the lines of the Armey/Shelby proposal would provide the economic growth predicted and promised by some proponents. Although economists generally agree that any reasonable level of tax will decrease economic growth by reducing the incentives to work, save, and invest,[66] economists also recognize that, because of these fundamental flaws, it is impossible to predict whether a particular kind of tax structure, such as those along the lines of the Armey/Shelby proposal versus the current moderately progressive income tax, will produce either positive or negative results on these economic incentives. Consequently, the study of economics offers no assistance toward making this important tax policy decision.[67]

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64. *Infra* app. C; *infra* nn. 143-49.

65. *Infra* app. C; *infra* nn. 150-62.

66. Slemrod & Bakija, *supra* n. 6, at 98 (stating that all taxes, no matter what the form, reduce the incentive to engage in all the activities people undertake to better themselves – for example, working harder, acquiring education and training, thinking of new products and ways to do business); *see generally* Joseph J. Minarik, *Making Tax Choices* 8-9 (The Urban Inst. 1985) (stating that regardless of whether a tax is regressive, progressive, or flat, it reduces the incentive to work, implement capital formation, and participate in entrepreneurial activities).

67. Joe Barnes, *Politics and Ideology of Tax Reform*, in *United States Tax Reform in the 21st Century* 307 (George R. Zodrow & Peter Miezskowski eds., Cambridge U. Press 2002) (stating that even with all the incommensurate theoretical assumptions, alternative models with different results, paucity of data, and different estimating techniques, we do not have unambiguous answers to how tax reform will affect the real growth of the economy or how resources will be allocated among households and enterprises within the economy); Robert D. Reischauer in Joint Comm. on Taxation, *Tax Modeling Project and 1997 Tax Symposium Papers*, JCS-21-97, 105th Cong. 306 (Nov. 20, 1997) [hereinafter *Tax Modeling Project*] (concluding that no model is at the "stage where it can be used in any of the formal estimating or score keeping procedures that the Congress relies on to maintain some semblance of fiscal discipline"); Slemrod & Bakija, *supra* n. 6, at 266 (models should not be given any more weight than what they deserve as a more sophisticated type of educated guess); Joel Slemrod, in *Tax Modeling Project*, *supra* at 300 (analogizing economic models to the allegory of the blind men and the elephant: each blind man touches one part of the elephant with one blind man believing the trunk to be a snake, and another believing the leg to be a tree; each economic model resembles a blind man accounting for one part of the elephant more carefully than others, while ignoring or treating inadequately other parts of the elephant); Lester Thurow, *Dangerous Currents: The State of Economics* (Random House 1983) ("I am convinced that accepting the conventional supply-demand model of the economy is rather like believing that the world is flat, or that the sun revolves around the earth – you can make a rigorous case, on

The major fundamental flaws inherent in the models themselves which explain why supply-side economics and economic incentive theory fail to provide any meaningful and reliable information as to how the economy would react to a flat/consumption tax regime can be grouped into three major areas. First, economic simulation models are not capable of accounting for the enormous variety of household and business sectors that exist in the American economy. Typically the majority of simulation models have the ability to take into account either a large representative sample of households or a large representative sample of industries, but not both. The models that allow for labor supply and consumption decisions to be made by a large sample of households only account for production decisions that are made by one aggregate producer. Conversely, those who allow for production decisions made by multiple producers limit their household representative sector decisions to one aggregate household. While there are some models that account for large representative samples in both sectors, economists recognize that these models lose both accuracy and sophistication in all other areas of their simulation.[68]

Second, even if economists had the ability to quantify and represent all household and business sectors affected by the proposed tax changes in their simulation models, it is impossible to accurately predict the human behavioral responses to these changes. In the labor market, the models cannot account for the personal factors[69] that all human beings weigh into all labor-related decisions beyond the desire to work more hours to achieve a greater after-tax return.[70] Moreover, the models assume that people make consumption decisions based on the maximum utility of their income—meaning they make the best and most rational consumption decisions[71]—which maximizes income available to save and invest. The models do not account for the various personal decisions that drive the incentive to save and invest; rather, they assume that all individuals in a representative sector save for similar reasons and in similar amounts.[72] Even if economic simulation models contained no flaws in all other areas of simulation, the failure

paper, for both propositions, but hard evidence is more than a bit scarce. Moreover, if you chose to act on either belief, you can get into a lot of trouble."); *infra* app. C Part II; *see* Jane G. Gravelle, *Behavorial Responses to a Consumption Tax*, in *United States Tax Reform in the 21st Century supra* at 25 (stating that no model can begin to incorporate all of the relevant features of a tax system and economic behavior); Gary R. Evans, *Chapter 1, Economic Models*, 12, http://www2.hmc.edu/~evans/CHAPI.pdf (1997) (observing the real economy is complex and cannot be faithfully duplicated in an abstract model of human design). Even some authors of the models themselves recognize these limitations. Alan J. Auerbach et al., *Fundamental Tax Reform and Macroeconomic Performance*, 20, http://www.cbo.gov/ftpdocs/2xx/doc266/twotax.pdf (1997) (urging a "cautious interpretation" of the results of their model).

68. *Infra* app. C; *infra* nn. 169-74.

69. *Infra* app. C; *infra* nn. 175-86.

70. *Id.*

71. *Id.*

72. *Id.*

to accurately simulate this area alone is enough to render the models unreliable in predicting the effects that tax policy changes would have on the economy.

Third, there is not any one economic simulation model that has the ability or the sophistication to account for all of the interrelated economic variables that are present in the economy that affect economic growth and efficiency. Within the economy there are certain extremely significant economic factors that greatly influence whether the economy thrives or stagnates. Some examples include international cash flows,[73] monetary policy,[74] governmental influence and actions, and market conditions.[75] Simulation models assume that these economic factors remain at constant levels or, even worse, fail to account for these factors at all. Because these economic variables constitute some of the most significant contributors to economic prosperity and success, the fact the simulation models do not account for their complexity by itself makes it unreasonable to rely on supply-side economics, as proven through the use of economic studies, as a justification for fundamental tax reform along a flat/consumption model.[76]

III. A Moral Analysis of Flat and Moderately Progressive Tax Structures

Whether acknowledged or not, tax policy ultimately is a value judgment based on moral standards. Economic theory and studies, at best, can provide useful information to be factored in the moral analysis, but can never, standing alone, be a substitute for the moral analysis. Even if the declining marginal utility of money at higher income levels could be measured, that alone would not conclusively justify a moderately progressive income tax structure. Even if supply-side economics and economic incentive theory could predict positive economic growth and prosperity, that alone would not conclusively justify a flat/consumption tax structure. The information provided by economic analysis, if it were available, would have to be factored in and be weighed under the principles of the moral framework being used to evaluate the tax policy question.

However, economic theories and studies offer neither the moderately progressive nor the flat tax proponents any credible information helpful to the moral analysis of their respective positions. Consequently, the moral analysis determining whether a moderately progressive or a flatter tax structure offers the most fair tax policy for spreading out the tax burden among taxpayers at different levels of income and wealth must be made without economic information. Even without credible information pinpointing the

73. *Infra* app. C; *infra* nn. 187-92.
74. *Infra* app. C; *infra* nn. 193-95.
75. *Infra* app. C; *infra* nn. 196-98.
76. *See generally* infra app. C.

economic consequences of the two alternatives, many different moral frameworks can be drawn upon to evaluate this difficult question of tax policy. This part morally evaluates whether moderately progressive or flat tax burdens are the most fair under three well known and common secular-based moral frameworks: utilitarianism, egoism, and virtue ethics. It also discusses how more reliable information from both the economic theories of marginal utility and supply-side economics based on economic incentive theory, if it were available, would affect both the moral analysis and the conclusions under each of the three models.

A. *Utilitarianism Morally Supports Neither Moderately Progressive Nor Flatter Tax Structures*

Under the utilitarian model the moral answer looks for the greatest amount of good for the greatest number.[77] At first blush that may appear to support a moderately progressive model because a greater number of actual taxpayers would have a lesser burden.[78] However, such a simplistic application has been discredited by all reputable scholars of utilitarian thinking.[79] In evaluating the greater good for the greatest number, the utilitarian must take into account the consequences of his or her actions.[80] Thus, a

77. Michael S. Russo, *Utilitarianism in a Nutshell* ¶ 5, http://www.malloy.edu/academic/philosophy/sophia/ethics/utilitarianism.htm (accessed Aug. 20, 2004). "In all of our actions we must always strive to produce the greatest possible balance of good over evil." *Id.* at ¶ 3. Utilitarianism developed in the mid-eighteenth to early nineteenth century from the teachings of John Stuart Mill and Jeremy Bentham. Utilitarians evaluate moral decisions in terms of determining whether their decision will result in more good than evil. If the decision will cause more good to occur, then the decision is a moral decision. John Stuart Mill, *Utilitarianism, Liberty and Representative Government* 6 (J.M. Dent & Sons LTD 1910). One of the tenets of utilitarianism is the hedonistic principle which states that good is defined by pleasure and bad is defined by pain. In applying the hedonistic principle, utilitarians must subscribe to Mill's axiom that "happiness is the sole end of human action." *Id.* at 36.

78. It must first be noted that highly progressive or confiscatory tax structures are outside the scope of this Article. A common criticism of utilitarianism is that it is, in fact, too egalitarian for the majority of persons. I.M.D. Little, *Ethics, Economics & Politics* 54 (Oxford U. Press 2002). "In accordance with the doctrine of diminishing marginal utility of income it required that wealth should be taken from the rich and given to the poor until marginal utilities were equalized. . . . This seemed to be embarrassingly egalitarian." *Id.* "However this equalizing tendency of utilitarianism depends on people being equally good converters of money or other resources into utility. . . . If someone is born with expensive tastes he needs more money than other people to achieve the same level of utility, and his marginal utility of income may remain high even at a high income level." *Id.*

79. Anthony Quinton, *Utilitarian Ethics* 1 (W.D. Hudson ed., St. Martin's Press 1973). Act utilitarianism subscribed to by the early creators of the philosophy, Mill and Bentham, is not practical for an individual trying to make an ethical decision. *Id.* at 4. Decisions must be made in a short period of time, and determining what effect any particular action might have on society would take a considerable amount of time. *Id.* Further, it is often impossible to determine what one particular action's effect will be on society as a whole. *Id.* at 8. An individual could think that he is doing something for the good of society, when in actuality his action has quite a detrimental effect on society.

80. Generally, two types of utilitarianism are discussed: (1) rule utilitarianism, and (2) act utilitarianism. Russo, *supra* n. 77, at ¶¶ 6-8; Little, *supra* n. 78, at 40. Act utilitarianism is reliant

simple bean counting approach—by myopically focusing solely on the actual dollar of tax burden by each taxpayer—fails to take into account or consider the collective consequence of how the tax burden is spread as a whole.[81]

In order to factor in the consequences of how the tax burden should be spread out among all taxpayers, which is required to make a moral judgment under utilitarian thinking, solid, reliable information must be available that addresses how the common good would be affected by the tax burden as a whole.[82] The common good of tax policy requires the tax system to raise adequate revenues[83] by spreading out the burden fairly, while mini-

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on the principle that "whether an action is right or wrong depends solely on the goodness of its consequences." *Id.* at 39. Rule utilitarianism, on the other hand, presupposes that certain moral rules are good for society as a whole and should be obeyed. *Id.* This model of utilitarianism was developed in response to criticism that act utilitarianism ignored important moral absolutes that were crucial to societies' well being. *Id.* The rules used in rule utilitarianism are generally rules that would be adopted by non-utilitarians in society, such as a prohibition on adultery. *Id.* However, rule utilitarianism allows for the application of moral absolutes, simply because they have been judged to be absolute, and not because a solid defense has been made about whether such actions are good in an objective sense. *See* Russo, *supra* n. 77, at ¶ 8. This form of utilitarianism can be used to justify any activity by simply declaring that one action or result is "good." Thus, rule utilitarianism "begs the question," and as such, will not be used in this Article.

81. An illustration of the short-sightedness of act utilitarianism can be seen in the context of lying. *See generally* Russo, *supra* n. 77, at ¶ 5. Lying is assumed to be wrong, but in some contexts an actor may believe that lying creates the greatest amount of good for the greatest number. *Id.* If a known murderer asks an individual the location of his next victim, and the individual is an act utilitarian, then he will probably lie to prevent the murderer from killing his next victim. *Id.* From the act utilitarian's perspective, he has created the greatest amount of good, because although he created a wrong by lying, he prevented the murderer's worse wrong. The rule utilitarians, such as Quinton, reject this stance, and look at lying from a Universalist perspective. Quinton, *supra* n. 79, at 7-8. There are certain absolutes that must be followed, because an individual can not actively determine what is best for society in any given context. Russo, *supra* n. 77, at ¶¶ 6-7. Assuming that not lying is a moral absolute, then the rule utilitarian would tell the murderer the location of his potential victim. The rule utilitarian's action would cause a temporary wrong to occur, but to a rule utilitarian the greater good was served by adhering to the maxims that all society should follow, since society is bettered by individuals abiding by these maxims rather than making their own determinations on which actions better society. *Id.*

82. It is well accepted doctrine that utilitarian ethics can be either good or bad, depending on the outcome of the action. John Stuart Mill, *Utilitarianism, Liberty & Representative Government* 6 (H.B. Acton ed., J.M. Dent & Sons Ltd. 1972) ("The creed . . . holds that actions are right in proportion as they tend to promote happiness, wrong as they tend to produce . . . unhappiness."). It is also well accepted that most decisions must be made in a short amount of time which does not allow for adequate consideration of potential adverse effects of the decision. Russo, *supra* n. 77, at ¶ 6. Even further, it is almost impossible for any person to accurately determine the long term effects of any action, and in this sense, act utilitarianism cannot make a value judgment where complete information does not exist. *See* Quinton, *supra* n. 79, at 3 (acknowledging that Mill and Bentham knew of these problems, but found them either impossible to resolve or inconsequential. Quinton notes a further weakness: "[I]t is possible that all the available alternatives would detract from the general happiness to some extent.").

83. A moral evaluation of tax policy addressing adequate revenues and "starve the beast" hidden motives is beyond the scope of this Article.

mizing the distortion of investment and business decisions and the chilling of economic growth.[84]

Under utilitarian thinking, the morally correct tax policy between moderately progressive and flatter tax structures is determined by the best economic results for the greatest number of people. If the economic theory of marginal utility were capable of accurately measuring the marginal utility of money at different levels of income and wealth, proving that a moderately progressive structure in fact offers the greatest good for the greatest number, then utilitarianism would deem the moderately progressive structure to be morally superior. Persons deriving their moral compass from this ethical framework, even those who personally would bear a greater tax burden under a moderately progressive structure, would nevertheless urge their political leaders to support and maintain tax laws that apportion a greater proportional burden as income and wealth levels rise.

Similarly, if supply-side economics and economic incentive theory were capable of accurately measuring changes in the economy, proving that a flat/consumption based tax structure would result in positive economic growth and enhanced economic prosperity for a greater number of people, then utilitarianism would deem flatter tax structures to be morally superior. Instead of supporting moderately progressive income taxes, under this scenario utilitarian thinkers, even those part of the vast range within the middle and upper middle classes whose individual tax burdens would rise, would urge their political leaders to replace the current moderate progressive income tax structure with a model like the Armey/Shelby plan, or at least support changes in the law, such as the Bush tax cuts, that decrease the degree of progressivity.

However, both the economic theory of marginal utility and supply-side economics based on economic incentive theory provide no solid information supporting either moderately progressive or flatter tax structures.[85] Consequently, the utilitarian model provides no guidance in making a moral judgment between the highly controversial issue of apportioning the tax

84. As discussed in nn. 81-83, utilitarianism demands that information regarding the long term effects of any decision be available before it can make a value judgment. Quinton, *supra* n. 79, at 3. This requirement can be annulled by adopting a form of rule utilitarianism which would allow certain norms or rules to be defined as good no matter what the effect of the rule may be. Russo, *supra* n. 77. However, this begs the question, as qualifying a certain behavior as good without proving the goodness of it resolves nothing. Therefore, in order for utilitarian ethics to make an ethical judgment regarding tax policy, reliable information must be available as to how any given policy will affect the general public. If the information does not exist, then utilitarian ethics offers no moral evaluation. Jeremy Bentham, *An Introduction to the Principles of Morals and Legislation* 11-12 (J.H. Burns & H.L.A. Hart eds., The Athlone Press 1970) ("By the principle of utility it is meant that principle which approves or disapproves of every action whatsoever, according to the tendency which it appears to augment or to diminish the happiness of the party whose interest is in question.").

85. *Supra* Parts I B and II B (discussing the lack of solid information found in the theory of marginal utility and economic incentive theory.

burden under moderately progressive or flatter tax structures. Many in both the moderately progressive and flat tax camps heavily rely on one of these economic theories to justify their arguments that more people will be better off, which amounts to another way of asserting the greatest good for the greatest number will be achieved. By implicitly assuming that economics either solidly supports or at least would probably support their position if the imperfections in the models were ironed out, they are inappropriately applying utilitarian ethics to a question where utilitarianism provides no moral guidance. For at least some of them, false reliance on economics and a stated desire to provide greater benefits to the greatest number is camouflaging a moral compass based on a different set of values.

B. Ethical Egoism Morally Supports Lower Taxes on Big Business and Wealthy Individuals Under Flatter Tax Structures Despite the Increased Burden on the Middle Classes

The egoism model, also known as objectivism, starts at the personal level and deems each person acting in his or her own long term best interest to be behaving morally.[86] Ethical egoists highly value the autonomy of each person to be able to freely work in the marketplace and benefit as much as possible from their labor, especially as they become more successful.[87] The moral framework of ethical egoism also evaluates complex

86. The basic tenet of egoism lies in the assertion that individuals should act in their own best interest. Ayn Rand, the founder of egoism, defines this drive for an individual to be "concern[ed] with one's interest" as selfishness. Ayn Rand, *The Virtue of Selfishness* vii (Signet 1961). Rand and other egoists attempt to dispel the negativity with the term selfishness, and believe that society would be bettered if all individuals are steadfast in their pursuit of their own interests.

> The meaning ascribed in popular usage to the word "selfishness" is not merely wrong; it represents a devastating intellectual "package-deal," which is responsible, more than any other single factor, for the arrested moral development of mankind. In popular usage, the word "selfishness" is a synonym of evil; the image it conjures is a murderous brute who tramples over piles of corpses to achieve his own end, who cares for no living being and pursues nothing but the gratification of the mindless whims of any immediate moment. Yet the exact meaning and dictionary definition of the word "selfishness" is: *concern with one's own interests*. This concept does *not* include a moral evaluation; it does not tell us whether concern with one's own interests is good or evil; nor does it tell us what constitutes man's actual interests. It is the task of ethics to answer such questions.

Id. Another central concept for egoist thought is that human beings are always rational. *Id.* at xi. This rational thinking lays the framework for the moral basis of egoism. *Id.* at x. Human beings will act in a rational matter, and therefore an egoist must follow the norms of society, because not doing so would be against his self interest. *See id.* at viii-xi. In essence, an egoist might make a decision that might seem to counter his self interest if it conforms with a norm of society, because otherwise if individuals are free to violate the norms of society then others would be prevented from acting in their own self interest. *Id.*

87. *See id.* at x (noting that "[t]he Objectivist ethics holds that the actor must always be the beneficiary of his action and that man must act for his own *rational* self interest"); *see also* George Reisman, *Capitalism* 27 (Jameson Books 1998) ("Being secure in their possession of property from violent appropriation by others, and rational enough to act on the basis of long run considerations, individuals save and accumulate capital, which increases their ability to produce and consume in the future.").

structures such as the relative tax burdens among individuals and corporations at different income levels of moderately progressive versus flatter tax structures.[88]

Applying the principles of egoism to evaluate difficult structural issues such as the question whether progressive versus flatter tax regimes produce the morally correct result involves a more complex process. Even though flat tax structures would impose a greater tax burden on far more individuals, those in the lower and middle income ranges, scholars of egoism have widely endorsed flatter tax structures despite the fact that our democratic process allows one vote per person and most people desire to pay as little tax as possible.[89] They reason that taxes that require greater proportional burdens at higher income levels violate individual autonomy, even if the particular taxpayer would in fact pay less tax under a progressive system.[90]

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88. It does this largely by evaluating society through the lens of the rational individual. In short, society is made up of

> *the harmony of the rational self-interest of all men*, in which the success of each promotes the well-being of all. The basis of capitalism's harmony of interests is the combination of freedom and rational self interest operating in the context of the division of labor, which is in itself their institutional creation.

Reisman, *supra* n. 87, at 28. According to objectivists, the current tax structure would violate the above principle, in that "the imposition of taxes does represent an initiation of force." Rand, *supra* n. 86, at 135. (Rand goes on to elucidate that, in a free society, the payment of taxes would be completely voluntarily).

89. The following articles directly support a flat tax, and are published in prominent objectivist sources: Daniel J. Mitchell, *Blame Congress for America's Tax System*, Capitalism Magazine, http://www.capmag.com/ article.asp?id=1786 (accessed Aug. 20, 2004) (Aug. 7, 2002); Daniel J. Mitchell, *If a Flat Tax is Good for Iraq, How about America?*, Capitalism Magazine, http://www.capmag.com/article.asp?id=3309 (accessed Aug. 20, 2004) (Nov. 16, 2003); Edwin Feulner, *Simplify the Tax Code with a Flat Tax*, Capitalism Magazine, http://www.capmag.com/article.asp?id=2163 (accessed Aug. 20, 2004) (Dec. 4, 2002); Bruce Bartlett, *The Flat Tax Makes a Comeback*, Capitalism Magazine, http://www.capmag.com/ article.asp?id=3297 (accessed Aug. 20, 2004) (Nov. 7, 2003); Daniel J. Mitchell, *Russia's Flat-Tax Miracle*, Capitalism Magazine, http://www.capmag.com/ article.asp?id=2612 (accessed Aug. 20, 2004) (April 20, 2003); Arthur Mode, *Graduated Tax for Medicare is Immoral*, The Ayn Rand Institute, http://www.aynrand.org/site/News2?page=newsArticle&id=5385 (accessed Oct. 26, 2004) (July 1, 1997); Robert W. Tracinski, *Reclaiming the "Right"*, The Ayn Rand Institute, http://www.aynrand.org/site/News2?news_iv_ctrl=-1&page=NewsArticle&id=5366&security=1 (accessed Oct. 26, 2004) (Dec. 27, 1999). The following articles criticize a progressive tax structure: Stefan Steph, *"Federal Budget Surplus" Equals a Sign to Cut Taxes*, Capitalism Magazine, http://www.capmag.com/article.asp?id=714 (accessed Aug. 20, 2004) (Oct. 21, 2000); Larry Elder, *"Reporting" on Taxes*, Capitalism Magazine, http://www.capmag.com/ article.asp?id=1589 (accessed Aug. 20, 2004) (May 16, 2002); Bruce Bartlett, *A Tax Plan Worse Than Nothing*, Capitalism Magazine, http://www.capmag.com/ article.asp?id=2744 (accessed Aug. 20, 2004) (May 2, 2003); Richard Salsman, *America's Real Robber Barons: The Congress of the United States*, Capitalism Magazine, http://www.capmag.com/article.asp?id=1860 (accessed Aug. 20, 2004) (Sept. 15, 2002,); Don Luskin, *Can We Afford Tax Cuts?*, Capitalism Magazine, http://www.capmag.com/article.asp?id=2992 (accessed Aug. 20, 2004) (July 4, 2003).

90. There are several principles of egoism that underlie this motivation. First among them is the principle that "[m]an's need for wealth is limitless because he possesses the faculty of reason." Reisman, *supra* n. 87, at 43 (stating further that, "[m]an needs wealth without limit if he is to fulfill his limitless potential as a rational being in physical reality"). It is also necessary to note that objectivism views any mandatory tax as an injustice, which translates into a disdain for taxa-

Relying on the iron clad value that all legal structures should impose little or no restraints discouraging personal autonomy, the principles of egoism assume that a progressive tax structure always thwarts the long term best interests of all taxpayers. Egoism principles assume that all taxpayers, even those at the lowest income levels, strive to maximize success and that drive to succeed will be discouraged by a progressive tax structure.[91] Egoists would especially favor lower burdens on big business because big business represents the collective success of autonomous persons acting in his or her long term bests interests.[92]

Due to the overarching emphasis of personal autonomy and the rewarding of success at the individual level, the moral evaluation of moderately progressive versus flatter tax burdens would not change under the egoism model even if economics offered reliable information supporting the moderately progressive structure. For example, even if the economic theory of marginal utility were capable of accurately measuring the degree the marginal utility of money declines at higher levels of income and, at the same time, supply-side economics and economic incentive theory still offered no solid proof that economic prosperity will be enhanced under a proposal like the Armey/Shelby plan, egoism would still deem flatter tax structures to be morally superior. Persons who are pure egoists, even those who personally would bear a greater tax burden under flatter tax structures, would still urge their political leaders to adopt a flat tax or at least support

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tion of all kinds, especially progressive taxation. Rand, *supra* n. 86, at 157 (As noted above, Rand views the use of force to convince to be illegitimate, and the imposition of taxes as a manifestation of force. Indeed, for Rand, the only proper tax would be a voluntary tax.). Thus, for an objectivist, higher tax rates are inherently objectionable. *Id.*

91. This assumption is well documented in objectivist literature. Rand, *supra* n. 86, at 20-23 (stating that man's central purpose in life is productive work, meaning a satisfying career. However, Rand goes further than this allusion to the primacy of self sufficiency and states that "every living human being is an end in himself, not the means to the ends or welfare of others—and therefore, that man must live for his own sake, neither sacrificing himself to others, nor sacrificing others to himself."). A flatter tax structure may go towards satisfying these self sufficiency requirements, as the taxpayer would pay proportionately no more or no less than anyone else. However, this would be seen as a compromise necessary in the present society. *Id.* at 157-63 ("The choice of implementation [of a voluntary tax] is more than premature today—since the principle will only be practicable in a fully *free* society."). The principles of egoism ethics apply to tax policy questions well beyond the debate between moderately progressive and flatter tax burdens and can potentially be invoked to support tax policy that reaches regressive ranges and provides only enough revenues to ensure personal safety and that contracts will be enforced. A complete examination of the moral framework of ethical egoism and how it applies to broader issues of tax policy is beyond the scope of this Article and will be explored in a follow-up article.

92. *See generally* Ayn Rand, *America's Persecuted Minority: Big Business*, in *Capitalism: The Unknown Ideal* 37 (The New American Library, Inc. 1966). Rand argues that taxing businesses with progressively higher tax structures based on income is persecution. *Id.* "If this group were penalized, not for its faults, but for its virtues, not for its incompetence, but for its ability, not for its failures, but for its achievements, and the greater the achievement, the greater the penalty—-would you call *that* persecution?" *Id.* The success of a corporation is a sign of its virtue, ability, and achievement, and to Rand and other egoists, taxing successful corporations at a high tax rate is penalizing them, and thus persecuting them. *Id.*

changes in the law, such as the Bush tax cuts, that decrease the degree of progressivity.

C. *Virtue Ethics Morally Supports Greater Tax Burdens For Big Business and Wealthy Individuals Under Moderately Progressive Tax Structures*

Virtue ethics looks to the moral character of acts.[93] Acts are considered virtuous if they abide by the classical virtues of justice, courage, temperance, and wisdom.[94] Virtuous acts contemplate both acts by individuals and public policies adopted by the state.[95] Clearly the virtue of justice speaks to the moral character of how a tax structure should spread out the burden among taxpayers at different income and wealth levels.[96]

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93. Virtue ethics originated from Plato's belief that nothing in the physical world is perfect and that there are certain attributes or forms of temperance, courage, wisdom, and justice that all individuals should strive to achieve. Steve Wilkes, *Beyond Bumper Sticker Ethics: An Introduction to Theories of Right & Wrong* 118 (InterVarsity Press 1995). Aristotle participated in the continued development of virtue ethics theory, but his view of the philosophy differed slightly from Plato's. *Id.* Plato believed that the virtues of temperance, courage, wisdom, and justice were metaphysical and beyond the senses of an individual. *Id.* Aristotle differed from this approach as he believed that ideals could be seen by witnessing actual events. *Id.* Additionally, Plato believed that the presence of any virtue was ideal, and without one of the virtues there must be a vice. *Id.* at 119. For example, if an act called for courage, and an individual did not display this courage, then the vice of cowardice would be evident in their action. *Id.* Aristotle differed from this assessment in his belief that the ideal should be not to just look at the virtues and vices, but to aim for a balance between the virtue and the vice. *Id.* For example, if an action calls for courage, an individual could display too much courage to the point that it reaches foolhardiness. *Id.* Aristotle's theory of virtue ethics centered around the belief that, in the previous example, individuals should aim for the midpoint, courage, between the extremes of foolhardiness and cowardice. *Id.*

94. Classical virtue ethics was first introduced by Plato in *The Allegory of the Cave*, which focused on a very abstract definition of the virtues. *See generally* Phillipa Foot, *Virtues and Vices*, in *Virtues and Vices and Other Essays in Moral Philosophy* 1 (U. of Cal. Press 1978). The virtues of justice, courage, temperance and wisdom differ from the Judeo-Christian virtues. Wilkes, *supra* n. 93, at 131. Plato's virtues lay in the metaphysical beyond the feelings of any individual. *Id.* at 118. Aristotle shed new light on the virtues by attempting to examine the virtues in the physical world rather than Plato's abstract world. *Id.* St. Thomas Aquinas developed the Judeo-Christian theories of the virtues, adding the "theological virtues" of faith, charity, and hope, diverging from Aristotle to synchronize virtue ethics with Christianity. St. Thomas Aquinas, *Summa Theologica* question 62 (Thomas Gilby ed., Blackfriars English trans., Image Books 1969) (available at http://home.austarnet.com.au/summa/FS/FS062.html).

95. *See* Justin Oakley & Dean Cocking, *Virtue Ethics and Professional Roles* 22-23 (Cambridge U. Press 2001) (stating that some virtues are agent intrinsic, such as friendship, and some are agent neutral, such as justice). Agent neutral virtues are generally considered to be ones that apply to society as a whole. *Id.*; *see also* Alasaidar MacIntyre, *After Virtue: A Study in Moral Theory* 187 (2d ed., U. of Notre Dame Press 1984) (noting that in societies where virtue ethics were considered the norm, "the exercise of a virtue exhibits qualities which are required for sustaining a social role and for exhibiting excellence in some well marked area of social practice").

96. Indeed, justice is often cited as a prerequisite for society in any fashion. *See* MacIntyre, *supra* n. 95, at 244 ("When Aristotle praised justice as the first virtue of political life, he did so in such a way as to suggest that a community which lacks practical agreement on a conception of justice must also lack the necessary basis for political community."). Thus, any effort at redistribution, being a function of government, must be "just." *See id.* at 246 (noting that, theoretically, justice regarding redistribution is often in the eye of the beholder).

The most relevant virtue in any discussion of tax policy is the virtue of justice.[97] Aristotle—the father of virtue ethics—noted that, in order for a man to be virtuous with his money, he must act generously with it.[98] Justice, in its modern secular form, calls for equality between humans to the greatest extent possible.[99] This equality requires that each person be given, at a minimum, an equal opportunity to succeed and thrive in society.[100] As such, virtue ethics, in mandating that the government act justly, requires that the government provide some redistribution of assets in which those who are unfairly advantaged by wealth contribute to the poorer classes.[101] Thus, virtue ethics would clearly support a moderately progressive tax scheme, and disapprove vehemently of a flatter tax structure.[102]

Due to the overarching emphasis of justice and equal opportunity at the community level, the moral evaluation of moderately progressive versus flatter tax burdens would not change under the virtue of justice model even if economics offered reliable information supporting flatter tax structures. For example, even if supply-side economics and economic incentive theory offered solid proof that economic prosperity would be enhanced under a

97. Justice has been recognized as a social virtue since the origins of virtue ethics, and as such, is highly relevant to social policy. *See generally* Plato, *The Republic* (G.R.F. Ferrari ed., Tom Griffith trans., Cambridge U. Press 2000) (agreeing that an integral part of the necessary social contract was the need for the state to be just, but tending to view justice as a personal virtue that would only be achieved by the state when the ruling class itself acted in a just fashion). Justice continues to be recognized as a necessary virtue by modern ethicists. *See* MacIntyre, *supra* n. 95, at 247.

98. Aristotle, *Nicomachean Ethics*, book 3 § 1, 57 (Hippocrates G. Apostle trans., Peripatetic Press 1975).

99. All virtues are, in theory, changeable depending on the context of the culture and society in which they are placed. *See generally* Daniel Statman, *Introduction to Virtue Ethics,* in *Daniel Statman, Virtue Ethics: A Critical Reader* 6 (Georgetown U. Press 1997) (discussing the lack of formal definitions for the virtues). However, the generally accepted modern view of justice is "each person . . . hav[ing] an equal right to the most extensive total system of equal basic liberties compatible with a similar system of liberty for all." MacIntyre, *supra* n. 95, at 247. There are competing views of justice which assert that it is "just" that a person keep possession of property that he has gained, most notably those voiced by Robert Nozick. *Id.*

100. John Rawls, *A Theory of Justice* 60 (Belknap Press of Harvard U. Press 1971) (providing the following steps for achieving equality: "[S]ocial and economic inequalities are to be arranged so that they are both (a) reasonably expected to be to everyone's advantage, and (b) attached to positions and offices open to all under conditions of fair equality of opportunity."). This could be construed as favoring confiscatory or purely socialist tax policies. However, such interpretations are outside the scope of this Article.

101. This may be somewhat of an understatement. Rawls would require that "[a]ll social values – liberty and opportunity, income and wealth, and the bases of self-respect – are to be distributed equally unless an unequal distribution of any, or all, of these values is to everyone's advantage." *Id.* at 62. The principles of virtue ethics apply to tax policy questions well beyond the debate between moderately progressive and flatter tax burdens and can potentially be invoked to support tax policy that reaches steeply progressive ranges, even approaching confiscatory, while providing generous revenues that reach levels of a welfare state. A complete examination of the moral framework of virtue ethics and how it applies to broader issues of tax policy is beyond the scope of this Article and will be explored in a follow-up article.

102. *Id.*

proposal like the Armey/Shelby plan and, at the same time, the economic theory of marginal utility still failed to accurately measure the degree the marginal utility of money declines at higher levels of income of wealth, the moral framework of virtue ethics would still deem moderately progressive tax structures to be morally superior. Persons who have adopted virtue ethics in its pure form as their moral compass, even those who personally would bear a greater tax burden under moderately progressive tax structures, would still urge their political leaders to resist all attempts to flatten out the tax burden, even changes in the law such as the Bush tax cuts, that decrease the degree of progressivity while still maintaining the basic moderately progressive structure.

Conclusion and Future Questions

Morally evaluating the complexity of federal tax policy is a long way from Alabama. Using the perspective of our largest and most profitable corporations as a starting point, this Article provides a significant first step toward the daunting task of interjecting moral principles into the critically important debates of federal tax policy. By comparing the current moderately progressive tax structure with the Armey/Shelby flat tax proposal, and exploring the effects of the Bush tax cuts, this Article identifies an important tax policy issue to be that of how the burden should be shared between the wealthiest individuals and corporations and those in the middle classes. This Article also documents that economic theories and studies in fact offer no help in resolving this debate and shows that even if reliable economic information were available supporting one structure or the other, the correct moral answer still depends on the ethical values of the community. Unlike Alabama, where over ninety percent of the population adheres to Christianity in some form, especially conservative evangelical Christians who look to divine command ethics as revealed in the Bible for their moral compass, the population of the United States as a whole has a much more pluralistic and diverse set of moral values.

This Article starts the difficult task of identifying a broad common moral framework that, at least partially, reaches the moral compass of most Americans by examining the two extremes of the most conservative and liberal ways of ethically thinking—ethical egoism and virtue ethics—and also shows how utilitarian ethics, the greatest good for the greatest number, provides no moral guidance. The egoist framework—which places great moral value on individual autonomy—will always favor a lesser burden for those at higher levels of income of wealth, while the virtue of justice framework—which places great moral value on community needs and equal opportunity—will always favor a greater burden on those at higher levels of income and wealth. Because solid, reliable economic information must prove which approach, moderately progressive or flat, offers the greatest

good for the greatest number, utilitarian ethics provides no guidance as to which offers the morally superior tax structure.[103]

This Article leaves many open questions that will be explored in follow-up articles. Future work will attempt to capture a broad ethical framework encompassing Judeo-Christian values relevant to evaluating federal tax policy, considering many theological points of view beyond divine command ethics, including that of mainstream Protestant, Catholic, and Jewish thought. Since the moral evaluation of how the tax burden should be spread out among taxpayers at different levels of income and wealth represents only half of the issue, future work will ethically evaluate the, at least equally important, issue of defining the level of revenues required to support the needs of the community and ensuring that the revenues raised are, in fact, applied to meet those needs.[104]

103. An interesting issue would arise under utilitarian ethics if the economic theory of declining marginal utility provided solid information supporting moderately progressive tax structures and at the same time if supply-side economics based on economic incentive theory provided solid information supporting flat tax proposals. In that it is highly unlikely that either theory will ever provide solid information, the problem of how to determine the greatest good for the greatest number, given the competing information, will probably remain as an academic issue only.

104. For too long, most tax policy debates have focused on economic theories and studies, and at best make only cursory references to the monumental moral issues at stake. Too often the tax policy issue addressing how the tax burden should be spread among taxpayers at different levels of income and wealth takes advantage of the natural desire of all taxpayers to enjoy a tax cut and obscures the important issue of minimum adequate revenues. Any time tax burdens are being adjusted in a fashion that could be revenue negative, the tax policy issue of adequate revenues must be separately evaluated at a moral level.

APPENDIX A: DETAILED INFORMATION ABOUT TEN SELECTED FORTUNE 500 COMPANIES

Bank of America Corporation is a bank holding company and financial holding company who, through banking and non-banking subsidiaries, "provides a diversified range of banking and non-banking . . . services and products" to individuals and businesses. Its business segments consist of Consumer and Commercial Banking, Asset Management, Global Corporate and Investment Banking, and Equity Investments. In 2000, they held $642,191,000,000 in total assets, gained $7,863,000,000 in net income from gross receipts of $43,258,000,000 and incurred corporate income tax liability of $4,271,000,000.[105]

Citigroup, Inc. "is a diversified global financial services holding company whose businesses provide a broad range of financial services to consumer and corporate customers with some 200 million customer accounts doing business in more than 100 countries," and employs approximately 134,000 full-time employees and 6,000 part-time employees in the U.S. alone. In 2000, it held $902,210,000,000 in total assets, had $13,519,000,000 in net income from gross receipts of $111,826,000,000 and incurred $7,525,000,000 in corporate income tax liability.[106]

Exxon Mobil Corporation is an energy corporation which operates and markets products in the U.S. and about 200 other countries and territories. Its business activities include: exploration and production of crude oil and natural gas; the manufacture of petroleum products; the transportation and sale of crude oil, natural gas, and petroleum products; and the manufacture and marketing of basic petrochemicals and a wide variety of specialty products. In 2000, this corporation held $149,000,000,000 in total assets, had $17,720,000,000 in net income from gross receipts of $232,748,000,000 and incurred $11,091,000,000 in corporate income tax liability.[107]

General Electric Company is "one of the largest and most diversified industrial corporations in the world [and has] engaged in developing, manufacturing and marketing a wide variety of products for the generation, transmission, distribution, control and utilization of electricity since our incorporation in 1892." GE not only produces a number of products ranging from locomotives to jet engines to chemicals for water treatment, but also offers a number of services including product services, broadcasting and television services through its affiliate National Broadcasting Company, Inc., and financial services through its affiliate General Electric Capital Services, Inc. In 2000, GE held assets worth $437,006,000,000, had net in-

105. Bank of America Corporation, *10-K Annual Report* 4, 62-63 (Mar. 1, 2004).

106. Citigroup, Inc., *10-K Annual Report* 2, 78-79 (Mar. 14, 2001).

107. Exxon Mobil Corporation, *10-K Annual Report* 1, 28-29 (Mar. 28, 2001).

come of $12,735,000,000 from gross receipts of $129,853,000,000, and incurred corporate income tax liability of $5,711,000,000.[108]

General Motors Company participates in a number of wide ranging industries, including automotive manufacturing, the production of locomotives, and financial services (which include consumer and dealership automotive financing, residential and commercial mortgage services, and insurance coverage). In 2000, GM held $303,100,000,000 in total assets, had $4,452,000,000 in net income from gross receipts of $184,632,000,000 and incurred corporate income tax liability of $2,393,000,000.[109]

Intel is "the world's largest semiconductor chip maker, supplying advanced technology solutions for the computing and communications industries" employing "79,700 people worldwide, with approximately 60% of these employees located in the U.S." Intel's major products include "microprocessors; chipsets; boards; wired Ethernet and wireless connectivity products; communications infrastructure components such as network and embedded processors and optical components; microcontrollers; flash memory; application and cellular processors used in cellular handsets and handheld computing devices; and cellular based chipsets." In 2000, Intel held $47,945,000,000 in total assets, had net income of $10,535,000,000 from total gross receipts of $33,726,000,000 and incurred corporate income tax liability of $4,606,000,000.[110]

Microsoft Corporation develops, manufactures, licenses, and supports a wide range of software products for a multitude of computing devices, including "scalable operating systems for servers, personal computers, and intelligent devices; server applications for client/server environments; information worker productivity applications; business solution applications; and software development tools." Microsoft also provides consulting and product support services, produces and sells video games and equipment, and operates online businesses, which include MSN subscription and the MSN network of Internet products and services. In 2000, Microsoft had assets of $52,150,000,000, net income of $9,421,000,000 from gross receipts of $22,956,000,000 and incurred corporate income tax liability of $4,854,000,000.[111]

Altria Group, Inc. (formerly Philip Morris Companies, Inc.) is a holding company that wholly owns Philip Morris USA, Inc., Philip Morris International, Inc., and is majority owner (84.6%) of Kraft Foods, Inc., and

108. General Electric Company, *10-K Annual Report* 3 (Mar. 1, 2004); General Electric Company, *10-K Annual Report* 3 (Mar. 23, 2004).

109. General Motors Company, *10-K Annual Report*, "Item 1: Business" (Mar. 11, 2004); General Motors Company, *10-K Annual Report*, "Item 8: Consolidated Statements of Income" (Mar. 7, 2001).

110. Intel Corporation, *10-K Annual Report* 1, 10 (Aug. 30, 2004); Intel Corporation, *10-K Annual Report* 19-20 (Mar. 13, 2001).

111. Microsoft Corporation, *10-K Annual Report* 16, 26 (Sept. 5, 2003); Microsoft Corporation, *10-K Annual Report*, "Item 1 Business" (Sept. 18, 2001).

these subsidiaries engage in the manufacture and sale of various consumer products, mainly food and tobacco products, for distribution worldwide. Philip Morris USA, Inc. is the largest cigarette producer in the U.S. Another wholly owned subsidiary, Philip Morris Capital Corporation, engages primarily in leasing activities. In 2000, Philip Morris Companies, Inc. had $79,067,000,000 in total assets, had net income of $8,510,000,000 from $80,356,000,000 in gross receipts and incurred corporate income tax liability of $5,450,000,000.[112]

Verizon Communications, Inc. is "one of the world's leading providers of communications services." Also, "Verizon companies are the largest providers of wireline and wireless communications in the United States" and Verizon is "the largest directory publisher in the world." In 2000, Verizon held $164,735,000,000 in assets, had net income of $11,787,000,000 from gross receipts of $64,707,000,000 and incurred corporate income tax liability of $7,009,000,000.[113]

Wal-Mart Stores, Inc. is the "world's largest retailer as measured by total revenues" with over 3,000 stores in the U.S. alone, and nearly 1,500 other stores around the world. Its retail outlets consist of Wal-Mart Discount Stores and Supercenters, Sam's Clubs, and Neighborhood Market Discount Stores. In 2000, Wal-Mart Stores, Inc. held $70,349,000,000 in assets, had net income of $5,377,000,000 from $165,013,000,000 in gross receipts and incurred corporate income tax liability of $3,338,000,000.[114]

112. Altria, Group Inc., *10-K Annual Report,* "Item 1: Business" (Mar. 12, 2004); Philip Morris Companies, *10-K405 Annual Report* (Mar. 29, 2001).

113. Verizon Communications, Inc., *10-K Annual Report* 1 (Mar. 12, 2004); Verizon Communications, Inc., *10-K Annual Report,* "Consolidated Statements of Income," "Consolidated Balance Sheets" (Mar. 23, 2001).

114. Wal-Mart Stores, Inc., *10-K Annual Report,* "Item I: The Business" (Apr. 15, 2003); Wal-Mart Stores, Inc., *10-K Amended Annual Report,* "11-Year Financial Summary" (Apr. 17, 2001).

APPENDIX B: SUPPLY-SIDE ECONOMICS AND ECONOMIC INCENTIVE THEORY

During the decade of the 1980s, supply-side economics was an important underlying determinate that provided the political and theoretical foundation for a significant amount of tax reductions in the United States and other countries.[115] In their support of flat/consumption tax proposals, such as Armey/Shelby which first appeared in the middle 1990s,[116] supply-side proponents rely on the expected positive economic growth and the corresponding increase of tax revenues to justify lowering the higher marginal rates on the most wealthy taxpayers while raising the burden on the majority of taxpayers within the middle and lower middle classes.[117]

Supply-side economics is a theory which postulates that cutting taxes will improve private sector incentives and cause economic growth through the increased ability of entrepreneurs to invest their tax savings, inevitably leading to the creation of higher productivity, jobs, and profits. Supply-side economics favors taxing higher income taxpayers at lower rates because the theory assumes greater savings will result in greater levels of investment.[118] Proponents of supply-side economics reason that a taxpayer's ability to retain a greater portion of his or her earned income creates an incentive to use these excess funds for investments. They also believe that high marginal income taxes are destined to discourage new businesses at high risks resulting from the scarcity in opportunities for offsetting losses under the present tax system, and assert that lowering the tax burden on businesses and individuals currently bearing the greatest burden within the highest marginal rates will increase productivity in the economy, which will in turn produce greater tax revenues due to a larger economic base available for taxation.[119]

Economic incentive theory is the working hypothesis that proponents of supply-side economics rely on in their assertions that the promised economic growth and increased revenues will in fact occur. Economic incentive theory claims that a lower tax burden for taxpayers at higher levels of income and wealth will result in substantial growth in the economy through

115. James D. Gwartney, *Supply-Side Economics* ¶ 15, http://www.econlib.org/library/Enc/SupplySideEconomics.html#biography (accessed Oct. 18, 2004).

116. *Supra* nn. 43-55 and accompanying text.

117. William G. Gale, Scott Houser & John Karl Scholz, *Distributional Effects of Fundamental Tax Reform,* in *Economic Effects Of Fundamental Tax Reform* 316-18 (Henry J. Aaron & William G. Gale eds., Brookings Instn. Press 1996) (explaining that consumption taxes generally are very regressive and the most wealthy taxpayers would gain the most, while lower and middle classes would gain the least); *see also* Hall & Rabushka, *The Flat Tax, supra* n. 44, at 93.

118. Slemrod & Bakija, *supra* n. 6, at 127-28.

119. *See* Hall & Rabushka, *The Flat Tax, supra* n. 44, at 83-88; Dale W. Jorgenson, *The Economic Impact of Fundamental Tax Reform,* in *Frontiers of Tax Reform, supra* n. 43, at 193, 194; Slemrod & Bakija, *supra* n. 6, at 135-36; *see generally* Barry P. Bosworth, *Tax Incentives and Economic Growth* 1 (The Brookings Instn. 1984); Gravelle, *supra* n. 67, at 94-97, 104-108; R. Glenn Hubbard, *Comment on Tax Reform, Capital Allocation, Efficiency, and Growth* in *Economic Effects of Fundamental Tax Reform,* supra n. 117 at 73.

greater national output. The theory assumes this greater national output will increase the level of revenues available for taxation and improve the standard of living for all Americans, even those at lower levels of income and wealth who will face greater tax burdens. The promised economic growth central to economic incentive theory purportedly results from greater work effort, capital formation, and entrepreneurial activity stimulated by lower tax burdens on taxpayers at higher levels of income and wealth.[120]

The economic incentive theory assumes that the burden of paying taxes makes working less attractive at the individual level because the person enjoys less after-tax dollars for consumption. Also known as the substitution effect, this assumes that taxpayers will work more when taxes are decreased because the reward for an additional hour of work is increased proportionately.[121] This is because the theory treats the decision whether to work more hours as primarily affected by the marginal tax rate, which is the highest tax rate applied to the last dollar of income. Consequently, by lowering the tax rates, the marginal rate on labor is decreased, which in turn increases the amount of consumption goods that can be bought per hour of work.[122]

Economic incentive theory also identifies the cost of leisure, in other words not working, as further supporting the idea that low tax rates encourage work. The return from work also considers how much current and future consumption a person will be able to obtain by substituting an hour of work instead of enjoying an hour of leisure.[123] If the marginal rate on income is lower, then the relative price of leisure, or giving up an hour of work, will increase thus acting as a positive incentive to work more hours.[124]

The economic incentive theory claims that lower tax rates will increase the labor supply when viewing the economy as a whole. The proponents assert that the substitution effect will become a dominant trend in the econ-

120. Minarik, *supra* n. 66, at 8-9 (stating that the imposition of taxes reduces the incentives to work, implement capital formation, and participate in entrepreneurial activities); *see also* Slemrod & Bakija, supra n. 6, at 98 (analogizing the behavior of the individuals at the highest marginal rates after the imposition of a flat/consumption tax regime as creating a "larger pie" of an economy from which all individuals, even those who must pay higher proportions of their income to taxes after the imposition of a flat tax, will gain benefit).

121. While proponents of flat/consumption taxes hope that the substitution effect would emerge as the dominant theory, these noted authorities acknowledge the possibility that the countervailing effect, known as the income effect, could in fact dominate. *See* Slemrod & Bakija, *supra* n. 6, at 98, 122-23; Bosworth, *supra* n. 119, at 131; Jerry A. Hausman, *Labor Supply*, in The Brookings Institution, *How Taxes Affect Economic Behavior* 27 (Henry J. Aaron & Joseph A. Pechman eds., The Brookings Inst. 1981). The income effect assumes that when taxes are decreased taxpayers will work less because the need for additional income is lessened.

122. Slemrod & Bakija, *supra* n. 6, at 122-23.

123. *The Economic Effects of Comprehensive Tax Reform*, app. B, http://www.cbo.gov/ show doc.cfm?index=36&sequence=8 (accessed Aug. 20, 2004).

124. *Id.*

omy causing work effort[125] at the individual level to collectively rise, resulting in a greater overall labor supply.[126] Finally, economic incentive theory claims that the increase in labor supply will positively improve overall productivity and output in the economy, which will have the effect of increasing real wage amounts in all sectors of the economy, including those in lower paying jobs. Consequently, supply-side proponents assume that taxpayers facing increased tax burdens under flat/consumption proposals along the lines of Armey/Shelby will not be discouraged from working because wage increases created from the promised economic growth will at least neutralize the extra tax burden.[127] However, no scientific proof conclusively demonstrates that lowering taxes will increase the overall labor supply. Economists only agree that lowering tax rates may affect incentives to work and in fact could discourage work.[128]

Proponents of supply-side economics rely on the portion of economic incentive theory, which claims that flat/consumption tax proposals along the lines of Armey/Shelby would increase capital formation by producing an environment more conducive to savings and investment. First, they argue that the tax burden on investment income ideally should be eliminated

125. *See id. infra* n. 127 (sources acknowledge that the data compiled does not indicate with any degree of certainty which trend will prove dominant, hence there is no reliable information from which to draw a conclusion on tax reforms' impact on labor supply).

126. Hall & Rabushka, *supra* n. 44, at 84; Slemrod & Bakija, *supra* n. 6, at 122-23; Hall & Rabushka, *The Flat Tax: A Simple, Progressive Consumption Tax*, in *Frontiers of Tax Reform*, *supra* n. 43, at 45; *Economic Effects of Comprehensive Tax Reform*, *supra* n. 123.

127. Hall & Rabushka, *The Flat Tax*, *supra* n. 44, at 93; Alan J. Auerbach, *Tax Reform, Capital Allocation, Efficiency, and Growth*, in *Economic Effects of Fundamental Tax Reform*, *supra* n. 117, at 56-58 (noting that proponents expect the higher burden imposed on the majority of taxpayers after the imposition of a flat/consumption tax to be neutralized by the increase in real wages following the economic expansion made possible by the tax relief granted to those individuals with the most wealth).

128. Nearly all research concludes that male labor supply responds hardly at all to changes in tax rates. Slemrod & Bakija, *supra* n. 6, at 125. Most economists conclude that income taxes cause little reduction in the supply of labor. Hausman, *supra* n. 121, at 27 (however, his study concludes that direct taxes on income significantly reduce labor supply and economic efficiency); Robert Triest, *Fundamental Tax Reform and Labor Supply*, in *Economic Effects of Fundamental Tax Reform*, *supra* n. 117, at 256 (most recent research concludes that taxes have very little effect on labor supply). Economic theory alone says very little about the net incentive effect on the labor supply because of the offsetting income and substitution effects. Bosworth, *supra* n. 119, at 131. However, most empirical research concludes that the labor supply of men is relatively nonresponsive while the labor supply of women seem to be more sensitive to change in tax rates. *Id.* at 132; *Tax Modeling Project*, *supra* n. 67, at 22, tbl. 1 (stating that economic models show positive results in the supply of labor when switching from the current progressive tax structure to a flatter rate); Nouriel Roubini, *Supply Side Economics: Do Tax Rate Cuts Increase Growth and Revenue and Reduce Budget Deficits? Or Is It Voodoo Economics All Over Again?*, http://pages.stern.nyu.edu/~nroubini/SUPPLY.htm (accessed Aug. 20, 2004) (supply-side proponents argue that taxes probably discourages work since it lowers the after tax return from work); *infra* app. C (illustrating that simulation models attempting to prove the substitution effect have significant flaws and therefore cannot be relied on).

or at least substantially reduced.[129] The economic incentive theory assumes that lower, or even better, nonexistent taxes on interest income and capital gains would encourage more savings. Higher rates of savings would increase available capital for businesses to invest and decrease real rates of interest resulting in significant stimulation in economic performance in all sectors of the economy.[130] Economic incentive theory also assumes that provisions in the proposals allowing businesses to currently expense all capital expenditures (rather than delay the deduction under the applicable depreciation schedule) would encourage greater capital investment, which would also stimulate the economy.[131]

They also argue that the flat tax proposals would produce greater economic efficiency because the preferential treatment of debt over equity as well as the double taxation of corporate profits under the current system causes distortions and discourages capital formation.[132] Although it is undoubtedly true that these features of the current system cause distortions, the current system could be changed (albeit with some difficulty, given the revenue loss that would occur from eliminating the current double taxation of corporate profits) to eliminate the bias favoring debt over equity and address the equity issues concerning the taxation of business organizations.[133]

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129. *See* Jorgenson, *supra* n. 119, at 181; *Summary of Flat Tax Proposal, Option One – Flat Tax 17%*, http://www.fiber.net/users/tax-reform/flat_tax.html (accessed Aug. 18, 2004) (arguing that under a flat tax regime, a tax would not be imposed upon any income realized from savings, capital gains, or interest, which would allegedly produce a substantial enhancement in capital formation).

130. "The economy would thrive under the improved incentives that the flat tax would provide." Hall & Rabushka, *supra* n. 43, at 53. "The high rates of the current tax system significantly impede capital formation" *Id.* at 36. Hall and Rabushka argue that the transition to a flat/consumption-based system would channel investment decisions influencing taxpayers to invest in the most beneficial uses of capital, therefore, resulting in an enhanced level of productivity in regards to capital. *Id.* at 47; The Fraser Institute, *Critical Issues Bulletin: Flat Tax Principles and Issues*, "Economic Considerations," http://oldfraser.lexi.net/publications/critical_issues/2001/flat_tax.html; *Summary of Flat Tax Proposal, Option One – Flat Tax 17%, supra* n. 129.

131. *See generally* Congressional Budget Office, *The Economic Effects of Comprehensive Tax Reform* ¶ 3, http://www.cbo.gov/showdoc.cfm?index=36&sequence=4 (July 1997); Hall & Rabushka, *supra* n. 44, at 63; Slemrod & Bakija, *supra* n. 6, at 198.

132. *See* Henry J. Aaron & William G. Gale, *Introduction*, in *Economic Effects of Fundamental Tax Reform*, *supra* n. 117, at 14-15; Hall & Rabushka, *supra* n. 43, at 46.

133. Some proponents of supply-side economics explain that many perceived flaws in the current income tax regime – such as the preferential treatment of debt over equity – could be modified or alleviated, without abandoning the entire regime, by removing certain deductions and credits that are widely perceived as unfair and overly draining on the national revenue stream. *See* Hall & Rabushka, *supra* n. 43, at 47 (arguing that the transition to a flat/consumption-based system would influence taxpayers to invest in the most beneficial uses of capital, therefore resulting in an enhanced level of productivity in regards to capital); George R. Zodrow & Peter Mieszkowski, *Introduction: The Fundamental Question in Fundamental Tax Reform*, in *United States Tax Reform in the 21st Century*, *supra* n. 67, at 7; *Summary of Flat Tax Proposal, Option One – Flat Tax 17%*, *supra* n. 129; The Fraser Inst., *supra* n. 130, at 2.

Finally, proponents of supply-side economics rely on the labor and capital formation prongs of economic incentive theory to conclude that entrepreneurial activity will increase because taxpayers will be more willing to take business risks if a flat/consumption tax proposal along the lines of Armey/Shelby is instituted. They assume that entrepreneurialism will increase as a corollary to the increase in capital in the market, coming from the increased savings and investment and that interest rates will be lower because of the increased pool of available capital.[134] Consequently, more investors will be ready and willing to invest in startup businesses because the passive income generated from those successful investments will enjoy far more favorable tax treatment than exists under the currently moderately progressive income tax regime. Additionally, the ability to expense all capital expenditures, rather than having to delay the deductions under the current depreciation schedules, will obviously encourage more risk-taking when decisions must be made whether to allocate capital towards these investments.[135] Moreover, the combination of the expected lower interest rates and the same flat tax rate applied to the hoped-for increased level of profits will encourage new business formations by persons currently in the workforce as wage earners.[136]

Proponents of supply-side economics rely primarily upon economic studies as support for their belief that lower taxes for taxpayers at the highest levels of income and wealth will result in a positive impact on the economy as a whole. These studies isolate certain economic variables in an attempt to analyze the impact of tax policy decisions on the economic incentives of work effort, capital formation, and entrepreneurial activities outlined in the economic incentive theory, which is the backbone of supply-side economics. Consequently, the legitimacy of these economic studies is crucial in determining whether or not the theory of supply-side economics can truly be relied on to produce the positive economic effects that it promises.[137]

134. Auerbach, *supra* n. 127, at 59.

135. *See* Slemrod & Bakija, *supra* n. 6, at 135, 199; *The Economic Effects of Comprehensive Tax Reform*, *supra* n. 123, at ¶ 3.

136. Triest, *supra* n. 128, at 268-69.

137. *Infra* app C.

APPENDIX C: ECONOMIC SIMULATION MODELS

I. DESCRIPTION OF ECONOMIC STUDIES RELIED ON TO SUPPORT ECONOMIC INCENTIVE THEORY

Economic studies use simulation models to demonstrate the consequences of altered variables on the economy at large.[138] Economic modeling provides a logical template in which analysts can isolate chains of cause and effect, and influence between numerous interacting elements of the economy. In addition to economic forecasting, analysts produce different scenarios in order to attempt and evaluate the effect of alternative tax policy proposals or weigh the logical integrity of promulgated theories and arguments.[139] Seemingly, these types of models are well-suited for economic studies because their perspective allows for modeling of how households and firms make decisions involving trade-offs between present and future actions. However, these models are not applied models in the sense that hard data regarding policy determinations cannot be gleaned from the results. Models are meant only to visually or mathematically represent a type of economic behavior, or provide a "picture" thereof. More specifically, these models are used to present an overall, broad picture of the potential effect of fundamental tax changes to the certain and specific variable in the economy while leaving other variables ignored.[140] Models tend to produce very precise answers, but they should not be given any more weight than "a more sophisticated kind of educated guess."[141] Furthermore, a model's usefulness depends upon the nature of the question for which an answer is sought. For example, a model may be good in reproducing actual levels of consumption and spending, but function as a poor indicator as to the manner in which these factors would respond to massive tax change.[142] Essentially, simulation models serve as rudimentary barometers from which analysts try and interpret simulated effects of fundamental tax reform.

Proponents of supply-side economics primarily rely on general equilibrium models as support for what effect fundamental tax reform will have on the economy at large. General equilibrium models are designed to attempt to capture important influences of taxes on diverse household choices about labor supply, savings, and the consumption of different commodities.[143] General equilibrium models are generally structured as life-cycle or

138. *See generally Tax Modeling Project*, *supra* n. 67.

139. *See generally* Evans, *supra* n. 67.

140. *Id.*; *Tax Modeling Project*, *supra* n. 67, at 11-12.

141. Slemrod & Bakija, *supra* n. 6, at 266.

142. Eric M. Engen & William G. Gale, *The Effects of Fundamental Tax Reform on Saving*, in *Economic Effects of Fundamental Tax Reform*, *supra* n. 117, at 115.

143. *See id.*; *see also* Diane Lim Rogers, *Assessing the Effects of Fundamental Tax Reform with the Fullerton-Rogers General Equilibrium Model*, in *Tax Modeling Project*, supra n. 67, at 61 (stating that as the model solves for the prices establishing general equilibrium, it captures the net impact of taxes when those consumer and producer behaviors are considered simultaneously.).

infinite-horizon models.[144] Life-cycle models such as Fullerton-Rogers assume that consumers see the future with perfect clarity. These types of models assume that individuals will know exactly how much they will earn over their lifetime, when they will retire, and when they will die.[145] In contrast, models based on an infinite-horizon perspective assume that individuals never die.[146] In addition to foresight, models also assume certain consumer decisions regarding how much to spend each period, how to allocate "spending" between leisure and consumption, and how much labor to supply, in accordance with assumptions of the form of lifetime utility and the values of other certain key parameters, such as the elasticity of substitution.[147] Models must also decide how individuals handle their savings decisions. Models assume that every individual in a like set of parameters will have the same goals for saving, whether it is saving for future purchases, retirement, or a rainy day.[148] Two of the most frequently cited general equilibrium models are the Fullerton-Rogers and Auerbach-Kotlikoff models.[149]

The Auerbach-Kotlikoff model analyzes the effect of tax reform on savings examined with a simulation model household saving behavior, which uses estimates of behavioral parameters and economic characteristics of households and the economy to develop quantitative predictions of savings behavior and its response to various types of tax reform.[150] Generally, the model demonstrates how taxes affect decisions about labor supply and the timing consumption, "which are based on the life-cycle theory of consumption in which people borrow or save to achieve an optimal timing of consumption over their lifetime."[151] Overall, the model illustrates how the effect of tax is dependant on the extent to which consumers are sensitive to changes in relative prices caused by tax reform.[152] The Auerbach-Kotlikoff model features 55 overlapping generations, with each agent living for 55 years (ages 30 to 75). It calculates the rational expectations steady states as well as transition paths of factor prices, consumption, labor supply, tax rates, and other economic variables. The three sectors used are households,

144. Gravelle, *supra* n. 67, at 28.

145. *See* Rogers, *supra* n. 143, at 49-50.

146. Gravelle, *supra* n. 67, at 28.

147. Rogers, *supra* n. 143, at 54-55.

148. *See The Economic Effects of Comprehensive Tax Reform*, *supra* n. 123; *see also* Gravelle, *supra* n. 67, at 44 (noting that the models rely on the elasticity of consumption bundles in different periods is always the same. This assumes that individuals will see consumption "thirty years apart as equally substitutable with consumption a year apart.").

149. *Infra* nn. 150-61, 164, 173-74, 176, 178, 184-86 (discussing the Fullerton-Rogers and Auerbach-Kotlikoff models).

150. Auerbach, *supra* n. 27, at 50-51.

151. Congressional Budget Office, *Two Papers on Fundamental Tax Reform*, intro. 4-5, http://www.cbo.gov/ftpdocs/2xx/doc266/twotax.pdf (Oct. 1997).

152. *Id.* at intro. 5.

firms, and the government (there is no monetary sector and all variables are real).[153]

In the household sector of the Auerbach-Kotlikoff model, "households decide how much to consume and how much to work in each period for given current and future after tax wages and interest rates."[154] Households can choose not to supply any labor by retiring or withdrawing from the labor force. Households are divided into 12 lifetime income classes (similar to Fullerton-Rogers). Classes 1 and 12 represent the bottom and top two percent of lifetime income; Classes 2 and 11 make up the remaining eight percent of top and bottom lifetime income decile. Classes 3 through 10 represent intermediate lifetime deciles (wages for each lifetime income class grow according to predictable fixed-wage profile). Unlike Fullerton-Rogers, wage profiles are set by individuals rather than by household wage income.[155]

In the production sector, firms are assumed to be perfectly competitive, and employ labor and capital such that profits are maximized. Auerbach-Kotlikoff features only one production sector, and therefore only a single good that is alternatively used for investment and consumption. In the government sector, the government collects revenue in order to spend on goods, services, transfers, and interest payments via consumption taxes, wage taxes, income taxes, and capital income taxes. Each of these taxes can be modeled as proportional or progressive and the government levies a payroll tax on wages to finance transfers to the elderly via Social Security. Federal, state, and local taxes are separately modeled. Additionally, interest payment on government debt and amount of government spending in simulations track baseline levels. Furthermore, in the government sector, federal, state, and local taxes are modeled separately with deficit/gross domestic product and government spending/gross domestic product constant in simulations, baseline.[156]

Similar to Auerbach-Kotlikoff, the Fullerton-Rogers General Equilibrium model seeks to analyze "important influences of taxes on diverse household choices about labor supply, savings, and consumption of different commodities" by assuming "utility maximization to find demands for commodities and supply of factors." The model further seeks to "capture the effect of taxes on each producer's use of land and capital" and assumes "profit maximization to find demands for factors." The model solves for

153. Auerbach et al., *Fundamental Tax Reform and Macroeconomic Performance,* in *Two Papers on Fundamental Tax Reform, supra* n. 151, at 3.

154. *Id.* at 4.

155. *Id.* at 4-5.

156. *Id.* at 57-62.

"general equilibrium prices to capture the net impact of taxes when those behaviors are considered simultaneously."[157]

The Fullerton-Rogers model distinguishes consumers into 12 groups according to their levels of lifetime income, all of which have the same nested, lifetime utility function with several levels of decision-making. Fullerton-Rogers specifies required minimum purchases and shares discretionary purchases for 17 different consumer goods by consumer age, resulting in consumption bundles that differ across age and lifetime-income categories. The model specifies a disaggregate production side, corporate and non-corporate producers, which incorporate 19 industries, and five types of capital and labor.[158] In the Fullerton-Rogers Model, the government conducts several functions: it pays transfers to individuals according to transfer profiles, produces an output for sale through an industry called "government enterprise," and "produces a free public good through a composite combination of its use of labor, capital, and purchases of each private industry output." Additionally, the government collects taxes.[159]

Many of the simulation models assume that individuals will maximize their lifetime utility. Taxpayers are able to maximize their utility because they have myopic expectations. Individuals in the Fullerton-Rogers model calculate the present value of their potential lifetime earnings based on myopic expectations, meaning that they believe that the current price will prevail in all future periods.[160] The maximization of utility creates an environment where all consumer decisions are rational and maximize their current and future income. Utility maximization also requires that the elasticity of substitution between consumption bundles in different periods always be the same. For example, individuals in the model see consumption 30 years from now versus consumption tomorrow as equally substitutable.[161] Consider an individual wanting to buy a pack of gum, but a tax was recently imposed on the purchase. The idea of utility maximization assumes that the taxpayer is just as likely to put off the gum purchase for 30 years as it is to wait for one week.[162]

II. Fundamental Flaws Inherent in Major Economic Studies

Mathematical models begin with precise assumptions about economic activity, and the results of models are restricted or even determined by these

157. Don Fullerton & Diane Lim Rogers, *Distributional Effects on a Lifetime Basis*, in *Distributional Analysis of Tax Policy* 262, 274-75 (David F. Bradford ed., AEI Press 1995).

158. Diane Lim Rogers, *Assessing the Effects of Tax Reform with the Fullerton-Rogers Model*, in *Two Papers on Fundamental Tax Reform*, *supra* n. 151, at 14-16.

159. Fullerton & Rogers, *supra* n. 157, at 278.

160. Rogers, *supra* n. 143, at 49-67.

161. Gravelle, *supra* n. 67, at 44.

162. *Id.*; *see also* Thurow, *supra* n. 67, at 216 (arguing that behavioral assumptions in economics are based on an outdated idea of rational utility maximization that has been rejected by sociologists and psychologists specializing in human behavior).

initial assumptions. If the initial assumption is wrong, misleading, or incomplete, the result will be in error, even if the logical integrity of the model is intact. Furthermore, models allow analysts to simplify economic situations. Since a real economy consists of innumerable interactions and data, analysts pull out key variables which seem to have the most importance. These factors are put into a logical scheme and other factors are omitted. However, these omitted variables do matter in the real economy, and the simplicity of the model is different than the real economy it is designed to replicate. Furthermore, mathematical models are useless unless they can be solved or manipulated to produce insightful results. Because of difficulties inherent in solving large mathematical systems, the underlying equations must often be linear, whereas real economic behavior does not lend itself to linear patterns. The real economy is complex and cannot be faithfully duplicated in an abstract model of human design.[163]

Economic models tend to abstract from reality, and even Alan Auerbach and Laurence Kotlikoff premise use of their model with the disclaimer ". . .we urge a cautious interpretation of our exact quantitative results."[164] It is difficult to rely on intertemporal models for predicting the effects of reform and for policy guidance. "The fundamental shortcoming of some of these intertemporal models, however, is that they tend to generate results that are at odds with empirical evidence about the responsiveness of savings and labor supply to changes in factor prices."[165] In other words, tax systems and economic behaviors are so extremely complicated that no workable model can begin to incorporate all of the relevant economic features.[166] Some of the simulation models imply large savings elasticities, in spite of the fact that most economic studies of consumption functions find that the savings elasticity is small. If a model implies that the savings elasticity is large, the results must be viewed with caution. Furthermore, caution should be used in interpreting the result of the models that employ a utility structure that allows for unrealistically large labor supply responses.[167] As articulated by two well-known economists:

> [s]imulation models have advantages in studying saving behavior because they formalize complex and interactive responses, but they suffer from at least two important shortcomings. First, not all economic agents behave as in formal economic models. Second, the results exclude consideration of a variety of issues that would make the model excessively complicated or unwieldy or that cannot readily be modeled. These problems should come as

163. *See* Evans, *supra* n. 67, at 12.

164. Auerbach et al., *supra* n. 153, at 20.

165. Gravelle, *supra* n. 67, at 44.

166. *See id.* at 31-34, 42-45.

167. Charles L. Ballard, *International Aspects of Tax Reform*, in *United States Tax Reform in the 21st Century*, *supra* n. 67, at 132.

> no surprise, as the purpose of an economic model is to extract the most important elements of a situation and omit others.[168]

General equilibrium models "force analysts to specify household preferences and production functions, require strong simplifying assumptions about behavior, and demand parameters for which empirical estimates do not exist. Furthermore, general equilibrium models use highly aggregated data. For that reason, they do not typically capture the effects of detailed changes in tax policy. . .or changes in personal exemptions."[169]

> Economists' analytical approaches to studying incidences have generally used static computable general equilibrium (CGE) models or life-cycle overlapping-generation models. General equilibrium models permit the calculation of compensating variations for different groups in the population at a point in time, while life-cycle simulation models calculate this across different lifetime-income groups or generations. As analytical devices, such models have been used to assess actual and potential tax reforms. They have not, however, been the principal guiding force in shaping distributional analysis presented to policy makers.[170]

Many well known economists admit that economic effects, the magnitude of which fundamental change in tax reform would bring, are beyond what economic models can actually simulate.[171]

In modeling, the more probabilities and factors involved, the less accurate the results will be. General equilibrium models adhere to this principle, which is manifested by some models accounting for a variety of households and one business sector, while others account for one household representative and multiple industries and entity types. Some models try to account for both, but economists generally agree that in doing so, they lose sophistication. For this reason, models are highly simplified and crude representations of the economy and the tax system. For example, people save for a variety of reasons and the U.S. tax system is extremely complicated, no single model can capture all of those motivations. A Congressional Budget Office Report indicates that:

> As a result, the designers of those models must decide which aspects of saving behavior and the tax code to emphasize. In the end, those decisions have significant effects on the quantitative predictions of the models. Some models may overstate the effects of switching to a consumption-based tax. That overstatement is particularly apt to occur if the models fail to recognize that the

168. Engen & Gale, *supra* n. 142, at 102.

169. Gale, Houser & Scholz, *supra* n. 117, at 282 (using a microsimulation model).

170. R. Glenn Hubbard, *Distributional Tables and Policy*, in *Distributional Analysis of Tax Policy*, *supra* n. 157, at 81, 83.

171. *See* Auerbach, *supra* n. 67, at "Shortcomings of the Model"; Barnes, *supra* n. 67, at 307; Evans, *supra* n. 67; Gravelle, *supra* n. 67, at 233-34; Reischauer, *supra* n. 67, at 300; Slemrod & Bakija, *supra* n. 6, at 266; Slemrod, *supra* n. 67, at 306; Thurow, *supra* n. 67, at xvii.

> hybrid nature of the current tax system already incorporates many of the saving incentives of a consumption tax. . . . About half of personal saving is already treated as it would be under a consumption tax.[172]

Inherent problems of general equilibrium models are highlighted by the creators of the Auerbach-Kotlikoff model, which incorporates many complex details of the real economy and relies only on a few exogenous 'deep' parameters specifying the utility and production function. This model cannot distinguish among different sectors since it assumes a single production sector that provides both consumption and investment goods. This is unlike other models such as Fullerton-Rogers or Jorgenson-Wilcoxen, both of which feature multiple sectors and can therefore capture substitution between housing and non-housing capital as well as the effect of reducing tax-differential between corporate and non-corporate activities. The overlapping generations model, underlying the Auerbach-Kotilikoff simulation, allows consumers to borrow against future resources without constraint (though some empirical evidence suggests that as much as 20% of the population faces binding borrowing constraints). The model employs fixed wage efficiency profiles for each earnings class and does not incorporate wage income uncertainty. Since uncertainty about future earnings could induce a build up of precautionary wealth, the model may over-predict post-reform savings response since precautionary savings are not sensitive to changes in the interest rate. The model assumes a certain lifespan until the age of 75 and implies availabilities of actuarially fair annuities, when in reality, those annuities do not exist and the lack thereof should give rise to additional saving against longevity uncertainty not reflected in this model.[173] Further exemplifying weaknesses inherent in the model, it only has one production sector and homogenous capital, and cannot consider either the impact of the shift away from housing investment that most of the proposals would encourage or the reduced tax differential between corporate and non-corporate activities. The creators of the model themselves admit that omission of these factors may understate the efficiency gains from tax reforms.[174]

Labor decisions in both models are mainly based upon an assumed variable called the "labor supply elasticity." The labor supply elasticity determines how responsive an individual will be towards the incentive to substitute work for leisure.[175] Retirement choices of the elderly also have an effect on the labor supply. Under the Fullerton-Rogers model, individuals

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172. *The Economic Effects of Comprehensive Tax Reform*, *supra* n. 123.

173. Auerbach et al., *supra* n. 153, at 20-23.

174. Alan J. Auerbach, *Tax Reform, Capital Allocation, Efficiency, and Growth*, in *Effects of Fundamental Tax Reform supra* n. 117, at 51.

175. *See generally* Eric Engen & William Gale, *Macroeconomic Effects of Fundamental Tax Reform: Simulations with a Stochastic Life-Cycle, Overlapping Generations, General Equilibrium Model*, in *Tax Modeling Project*, *supra* n. 67, at 101-119.

never fully retire, but the amount of leisure that is substituted for consumption is increased after the age of 60.[176] The Auerbach-Kotlikoff model allows the consumers to decide whether to work at all or retire.[177] However, models are not able to account for all the personal factors that go into labor decisions.[178] Individuals may change their labor decisions based on how much training or education they want to acquire given the occupation they would like to pursue. Models do not account for the interrelation and dependence of the labor supply choices of husband and wife. A wife's decision to increase work and earnings might motivate husbands to work more in order to increase their own family income. A spouse may also decrease work because the after tax income would be higher, enabling a spouse to stay at home because the family's need for a second income would be less. Labor decisions are also affected by children. Parents may not work in order to stay at home and take care of the kids or they may go back to work because the child reaches school age.[179] Some of the other variables that affect labor supply that are not accounted for in the simulation models are tenure with employer and union status.[180] Moreover models operate under the assumption that the decision whether to work more hours or accept a higher paying job is affected only by the marginal tax rate when in fact many factors, both personal and professional, contribute to these decisions.[181]

Models also assume that a higher after-tax rate of return is the sole determining factor in how individuals choose to save and invest. However, individuals choose to save and invest based on many personal and professional reasons unrelated to the tax structure. For example, regardless of the tax structure, different individuals save for retirement, bequests, and extravagant purchases at different levels for personal reasons that cannot be simulated.[182] In addition, people also save as a precautionary measure which is not very sensitive to tax reform because the wealth is accumulated for the sole purpose of safeguarding the individual against potential future downturns.[183] For example, the Auerbach-Kotlikoff model estimates savings for

176. *See generally* Rogers, *supra* n. 143, at 49-67.

177. *See generally* Alan J. Auerbach, Laurence J. Kotlikoff, Kent Smetters & Jan Walliser, *Fundamental Tax Reform and Macroeconomic Performance,* in *Tax Modeling Project, supra* n. 67, at 83-97.

178. Slemrod & Bakija, *supra* n. 6, at 126.

179. Henry J. Aaron & Joseph A. Pechman, *Introduction and Summary,* in *How Taxes Affect Economic Behavior, supra* n. 121, at 2-4.

180. Hausman, *supra* n. 121, at 68.

181. *See* Slemrod & Bakija, *supra* n. 6, at 123-24.

182. *See The Economic Effects of Comprehensive Tax Reform, supra* n. 123, at Appendix B, http://www.cbo.gov/showdoc.cfm?index=36&sequence=8.

183. Engen & Gale, *supra* n. 142, at 93; *Economic Effects of Comprehensive Tax Reform supra* n. 123 (The motive to save for the satisfaction of leaving bequests and "rule of thumb" saving is less sensitive to a change in tax reform than is the assumption that people are altruistic towards their children).

bequests based on income classes,[184] while the Fullerton-Rogers model keeps savings for bequests constant by including in the capital stock of the individual a fixed amount of inheritances and simulates the individual as saving enough to leave comparable bequests at death.[185] Alan Auerbach recognizes that these differences between the two models cause a disparity in the forecasted results of tax reform on savings. Since bequests in the Fullerton-Rogers model are constant and do not respond to changes in relative prices, the sensitivity of total savings will not be affected by overall prices in the economy. On the other hand, the Auerbach-Kotlikoff model will show a greater relationship between savings and prices.[186]

Simulation models fail to adequately account for the influence of international cash flows on the economy and its performance. One of the significant variations found in the simulation models is the methodology that each model uses regarding the role of international capital flow, which is the flow of foreign capital into the U.S. which supplements U.S. savings in financing domestic investment.[187] The results of the models when predicting economic activity in response to tax reform fluctuate considerably conditioned on the particular assumptions regarding the openness of global capital markets and the substitutability of portfolio choices for both domestic and foreign investors.[188]

Some models assume that there is no net change in international capital flow as a result of the altered system of taxation and that the U.S. is a closed economy that relies solely on domestic savings to finance investment and spur economic growth. This assumption fails to account for export and import cash flows, the reaction of other countries to the tax change, and any type of foreign investments. Other models assume that the U.S. is an open economy and that capital flows freely across international borders. It is generally agreed among scholars that neither assumption is wholly realistic for the U.S., but that the simulation results tend to demonstrate that international cash flows have a considerable amount of influence over the growth that could result from changes in tax laws.[189] The problem here is that economists can neither predict nor model behavior and reactions of other countries, leaving no clear answers to the actual effects that could ensue. In addition, all of the models that endeavor to simulate the role of international cash flows lack substantial detail in their portrayal of international taxation

184. Auerbach et al., *supra* n. 153, at 83-98.

185. Rogers, *supra* n. 143, at 61.

186. Auerbach et al., *supra* n. 153, at 94; *see also* Engen & Gale, *supra* n. 175, at 102 (Models do not usually take into account the already hybrid nature of the current tax system. For example, the models' estimate of tax reform's effect on saving may be inflated because so much of savings is already treated as it would be under a consumption tax because of tax-deferred plans such as Keoghs, 401(k)s, and pensions.); Gravelle, *supra* n. 67, at 51.

187. *Tax Modeling Project*, *supra* n. 67, at 40.

188. *See id.* at 40-42.

189. *Id.* at 41.

by including only a "few simplifying assumptions" to represent this massively complex system.[190] The assumptions actually made by those models that even consider international tax flows are also unrealistic. Some of the simulation models assume that net international capital flow increase by the amount that is necessary to raise the after-tax rate of return on capital back down to baseline level. Other models concede that the majority of capital formation caused by tax policy is a consequence of international capital flows based on the assumption that capital will continue to flow into the U.S. until the after-tax rate of return to capital returns to its pre-policy level.[191] The prevailing view acknowledged by most economists is that the state of modeling international capital flows is "rudimentary and uncertain."[192]

Simulation models also generally neglect to consider the importance of monetary policy on the level of efficiency and growth in the economy. The Fed's assessment of the consequences of fundamental tax restructuring is vital to the determination of economic growth under a tax system due to all of the conceivable ways that the Fed could react and how its reaction could significantly affect responses to the new tax change in the economy.[193] As explained by one author, "Fed policy assumptions which are more accommodative of initial price-level changes and, therefore, more stimulative to the economy early on eventually significantly alter the longer run growth path of GDP."[194] Most simulation models do not take into account how the Federal Reserve or money in general will react to the change including possible changes in interest rates caused by alterations to the tax rate. Most of these models also assume that government spending and deficits are constant at the baseline level and allow no fluctuation in these figures. In addition, models assume that the GDP, government debt, and interest on government debt remains at a constant rate with no fluctuations. The models also assume that there is no inflation in the economy and do not account for the interaction of inflation with the tax code. Finally, the models assume that the Federal Reserve will use monetary policy to attempt to maintain a full employment economy in the face of major tax reform, a prediction that is totally unsubstantiated by facts.[195]

Economic simulations models—which make their assumptions based on economic variables, as distinguished from studies, which make their assumptions based on modeling results—also make assumptions regarding government and the market which allocate an insufficient amount of em-

190. *Id.*

191. *Id.*

192. *Id.* at 44; *see generally* Zodrow & Mieszkowski, *supra* n. 133, at 8 (explaining that models also fail to take into account the complexity of international taxation).

193. *See Tax Modeling Project*, *supra* n. 67, at 19-20.

194. *Id.*

195. *See generally Tax Modeling Project*, *supra* n. 67, at 13, 34, 59.

phasis to the government influence in the market. Typical studies assume a perfect market where there are no obstacles to free trade, and they limit the factors affecting market trade and market price to supply and demand. For example, they do not consider any type of regulations that could affect the drive of the market like the Sherman Anti-Trust Act, Securities Exchange Acts, Federal Power Act, and the fair trade regulations. Simulation models also fail to consider the market consequences of how government expenditures of tax money affects market demand and prices.[196] In reality, government expenditures play a vital role in the economy by altering the market demand in various ways depending on what type of expenditure is made. Most of these models also assume that government spending and deficits are constant at the baseline level and allow no fluctuation in these figures. To enable this result, models assume deficit neutral proposals so that they do not have to consider the economic impact on the federal deficit, which is highly unfeasible. In addition, models assume that the GDP, government debt, and interest on government debt is at a constant rate. The general model assumption of a perfect market is highly unlikely and totally unrealistic. For example, some models assume the market only consists of a single capital stock which is perfectly malleable and can be reallocated among industries and final demand categories, including housing and consumer durables, at zero cost.[197] This type of underlying assumption implies that "capital will shift while between uses until the after-tax rate of return is equated across the economy."[198]

By dismissing these important factors, the models fail to accurately depict the consequences of fundamental tax reform. Economic models are not sufficiently advanced to provide a reliable set of estimates. As economist Joel Slemrod said, "macroeconomic modeling would lead to imprecise conclusions based on imperfect variables."[199]

196. Anderson, *supra* n. 36, at 90.
197. *See generally Tax Modeling Project*, *supra* n. 67, at 132.
198. *Id.* at 132.
199. Treasury Dept. Off. of Tax Analysis, *"New" Armey–Shelby Flat Tax Would Still Lose Money, Treasury Finds*, 70 Tax Notes 451-61 (Jan. 22, 1996).