FORTHCOMING PUBLICATIONS

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FEDERAL INCOME TAX ANTHOLOGY

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of its fundamental components. Complaining about this inadequacy in 1936, one scholar noted that the 1913 Tax Act left the definition of income in a state of confusion:

> Viewed from the vantage point of the present, the federal income tax law of 1913 seems an incredibly naive document. Today it seems astonishing that so many fundamental issues should have been so slightly considered or so blithely ignored. The law contained no precise and comprehensive description of the tax base.[6]

Because it was not adequately addressed by Congress, the process of building and shaping a definition of income was left largely to the Treasury Department and the federal courts. The judiciary is, however, distinctly ill-suited for such a role. The nature of the judicial process requires judges to address an issue piecemeal and under constraint of the particular facts of each case. The Treasury Department, although the best qualified to develop a useful, thoughtful definition of income, was, unfortunately, the least powerful of the participating entities.

Tax policy scholars have addressed the definition of income with voluminous results, but it is not clear that their suggestions have been heeded to any great extent. Some even have had the good sense to develop their own versions of the best theoretical definition of income, and then to discuss concessions to administrative and practical realities which reasonably might be made without unduly compromising the theoretical starting point.

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C. Henry C. Simons: Income

* * * Although their definitions have been labeled the "Haig-Simons definition of income," and generally accepted as the accretion definition of income upon which all subsequent discussions are based, the Simons formulation is cited far more frequently than [the] Haig [formulation] in modern tax policy literature.

In Simons' view, calculation of social income has a different purpose than calculation of personal income, and different definitions, therefore, [are] in order. Also, the requirement that social income equal the aggregate of individual incomes imposes the unpleasant restriction that gifts and certain capital gains (those based on scarcity factors) must be excluded from individual income because they are excluded from social income.

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* * * [H]is one-sentence definition of income * * * has been quoted almost as a ritual litany in tax policy studies during the last fifty years: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."[46] Because this definition finds income in consumption, and in any increase in net worth, it will lead to a true income tax and not to a consumption tax.

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[6] Haig, *Foreword* to R. MAGILL, TAXABLE INCOME at iii (1936).

[46] H. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938). * * *

* * * [U]nder Simons' definition, widely adopted as the most sound theoretical approach, income consists of consumption plus net saving (or minus net dissaving). * * * [T]his definition [is constrained by] explicit political, administrative, social, or economic decisions.

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NOTE

Although the Haig-Simons definition of income is widely accepted among economists and other income tax theorists, it has not been adopted in the Code. Indeed, many income tax provisions depart from the Haig-Simons ideal. What does the Haig-Simons definition leave out?

Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45 (1990)*

I. INTRODUCTION

The concept of income serves as a touchstone against which the rules of the current income tax can be evaluated and is, therefore, of critical importance in the debate over what those rules should be. The meaning of income is also of interest to those charting the distribution of income, so as to have a quantitative measure of the degree of economic inequality in a society. * * *

* * * The concept of income also has important uses in the social sciences, such as studying how income affects behavior.

Given the importance of these uses of the income concept, the manner in which income is defined can make a difference. * * *

The income concept that is now widely accepted by analysts was formulated by Henry Simons in the 1930's,[4] and is commonly referred to as Haig-Simons income, to acknowledge the prior contribution of Robert Haig. It holds that an individual's income is the sum of his consumption plus accumulation during the taxable period. Despite its wide acceptance, Haig-Simons income remains elusive and ambiguous, since the terms "consumption" and "accumulation" are open-ended. * * * Despite these theoretical objections, the term "economic income," or Haig-Simons income, is commonly employed as if it were a relatively well-defined or well-understood concept. The fact that some use economic income as a workable concept while others question its validity suggests that the nature of the concept is not well understood and has not been fully explored, despite the inordinate volume of literature on the subject. This article begins with an inquiry into the nature of the income concept appropriate for tax policy. A selective survey of the extensive literature on the definition of income suggests that there is confusion about the philosophical groundwork supporting the Haig-Simons concept, largely because the concept was borrowed from economics to be used in law. While the language used to define income has meaning in economic theory, that meaning collapses when it is applied in the real world.

[4] H. SIMONS, PERSONAL INCOME TAXATION 50 (1938).

An adequate groundwork for the income concept, however, can be provided by basing it on tax fairness. This approach can be traced to the seminal work by Simons, although Simons' reliance on the fairness criterion was ambiguous. While fairness may seem hopelessly vague, this article argues that the vagueness can be reduced by articulating criteria to be used in making judgments about fairness. Many of the arguments in the literature over how Haig-Simons income should be interpreted are, in fact, grounded in fairness concerns. The Haig-Simons formulation has survived over the years because people generally have considered it to be fair. Thus, the proposed fairness inquiry is not a complete departure from the types of arguments that have been made in deciding what is income. Rather, the focus on fairness is intended to sharpen and clarify the debate, and to make explicit what previously has been implicit.

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More fundamentally, the value of a fairness inquiry is not so much that it necessarily leads to an answer that is different from analysis based on the traditional Haig-Simons formulation, but that it clarifies the inquiry, exposing the considerations involved and the limits of the income concept and its appropriate use. The uses for the income concept proposed in this article are similar to the uses to which the Haig-Simons formulation has been put, although the focus on fairness helps clarify the proper use for the income concept. Departures by the actual tax system from the ideal may be desirable because there are tax policy considerations other than fairness. I do not propose that Congress either enact a statute that says "taxable income is whatever is considered fair" (that would be unworkable) or enact rules for specifying income that flow only from the concept of fairness as elaborated in this article (that would fail to make allowance for other concerns in formulating tax policy, such as administrability, efficiency and political constraints). Rather, legislators and tax policy analysts should use the fairness ideal as an aid in making tax policy choices.

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II. NATURE OF THE INCOME CONCEPT

A. Haig-Simons Tradition

In his seminal 1938 work, Simons says: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." Thus, income can be described as the sum of accumulation (that is, the change in the taxpayer's net wealth) plus consumption during the taxable period. While this definition does pin down the concept of income to some degree, it involves considerable ambiguity, given the open-endedness of the terms "consumption" and "wealth," and does not specify criteria for resolving the ambiguity. Despite (or perhaps because of) this ambiguity, the Haig-Simons formulation has been widely accepted. It is not clear, however, that it is appropriate to pay so much deference to Simons' formulation of the income concept. As a perusal of his book demonstrates, his was only one of numerous formulations by various writers, and even Simons himself defined income in different ways within the same work. To arrive at an understanding of income, it is necessary to begin by asking what the concept is about, and what criteria should be used in deciding whether a particular item should be taken into account in determining an individual's income.

* * * A careful reading of Simons suggests, however, that he did intend his definition to flow, at least in part, from judgments about tax equity. * * *

Nevertheless, Simons did not rely unequivocally on the criterion of equity. * * * Thus, for Simons, "objectivity" and "rigor" were important factors in defining income, even if the result might be considered inequitable. This view suggests that, in defining income, Simons' principal concern was to propose objective, general rules as a bulwark against ad hoc exceptions that would erode the tax base in response to political whim.

Other writers also have spoken of defining income in terms of equity. * * *

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The fact that economists * * * have tended to downplay the ambiguity of the income concept can be understood in light of the nature of economic theory. According to the assumptions of neoclassical economic theory, individuals maximize a "utility function," the components of which are commodities (goods and services, consumed now and in the future) and leisure. * * * Under this view of "economic man," one's economic well-being is determined by her consumption of goods and services and leisure. Income, defined as the increase over the time period in a particular individual's power to consume, is, therefore, an appropriate measure of economic well-being. The only shortcoming of the Haig-Simons income concept under this theory of income is that it omits some of the components of the utility function, in particular, leisure and public goods.

Thus, as a matter of neoclassical economic theory, the ideal measure of income would include leisure and would include in "consumption" all goods and services that are components of the utility function. * * *

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My quarrel with considering income as a measure of economic well-being, in the technical sense that is specified by a utility function, is that the concept of utility has meaning only in the abstraction of economic theory, and cannot be applied to the real life problem of equity in the distribution of the tax burden. Even if one grants that individual utility is a function of goods consumed and leisure, there is no way to measure levels of individual utility and, hence, of comparing one person's utility with that of another. More fundamentally, the notion that individuals maximize a utility function whose components consist of commodities and leisure may have some usefulness as a means of predicting consumer behavior and evaluating economic policy, but it holds no particular claim to being an accurate description of the well-being of real people. Moreover, even if the well-being of particular individuals could be quantified, it is not clear why we would want to base our tax system on such a measure. "Well-being" is not an operational concept and, even if it could be made operational, it is largely irrelevant to issues of tax policy. Someone with large amounts of money income may report a very low level of well-being, while someone with modest amounts of income may be blissfully happy. Surely the latter should not pay more tax than the former. * * *

B. Proposed Approach to Defining Income

1. The Role of Equity

It is often said that people with the same income should pay the same amount of tax. This can be true only if income is defined in terms of equity: Two individuals, *A* and *B*, should be considered as having the same income if, and only if, it is considered fair that *A* and *B* pay the same amount of tax. Defining income in these terms suggests why there has been so much dispute over the meaning of income. The inquiry into the meaning of income goes well beyond technical issues and involves fundamental value judgments about tax equity. Because people have different views of tax equity, there is no "true" concept of income. The best we can do is engage in reasoned debate and evaluate the implications of alternative assumptions about how to determine fairness, but we cannot prove that one set of assumptions is superior to another or is scientifically correct.

The above definition of income involves one peculiarity that should be noted. Under the terms of the definition, income could mean the same thing as consumption or wealth, or something else, depending on the criteria we choose for determining tax equity. This possibility certainly causes the concept of income, as I have defined it, to depart from income as the word has been used traditionally. That does not, however, bother me very much, first, because it exposes the ethical judgments that are being made in specifying income, and, second, because under the criteria for equity that most income tax analysts consider fair, income will fall squarely within what has traditionally been called income. Of course, people are free to argue that consumption or something else would be a fairer tax base. What I would like to bring to center stage is that arguments and judgments about equity are central in defining income and that income is best treated, at least for tax policy purposes, as not having meaning apart from equity.

Judgments about tax equity used in specifying income do not encompass all possible judgments about the equitable distribution of property in society. Considerations of fairness may call for taxes or other laws that redistribute property in addition to an annual income tax. * * *

2. *How to Decide What is Fair*

a. *Subjectivity of Fairness Judgments*

If the concept of income is based on fairness, one possible conclusion is that income cannot be pinned down any more precisely than, say, the idea of "good" art. This is not to say that fairness judgments are impossible to make. Just as people can choose among different pieces of art, so, too, can they categorize individuals according to their fair tax burdens. Under this approach, there could be as many ideas as to what income is as there are people to make the judgment, perhaps more. Moreover, even with respect to the fairness judgments of any one individual, it would be difficult, if not impossible, to set forth general rules explaining such judgments, just as we could not expect anyone to describe by general rules how she ranks artwork; the most we could expect to do would be to develop some general guidelines.

While in principle there is nothing to stop such chaos, in practice there has been rather broad agreement among tax analysts as to what items should be included in income, although the agreement has not been complete and some issues have been controversial. Based on this degree of consensus, it is possible to articulate some guidelines that can be used in making judgments about fairness in taxation. It is important, however, not to attribute too much conclusiveness to these guidelines. Just as general principles as to how to distinguish between good and bad art can be seriously deficient in many cases, so, too, it may be necessary to depart where appropriate from guidelines on measuring income that have been developed by academics. Moreover, it is important not to assert that a majority view in the scholarly community is necessarily superior to others. With this caveat, however, in deciding what is fair, it is useful to draw from the scholarly debate over the meaning of income that has taken place over the last 50 years or so.

b. *"Well-Being" as Standard of Fairness*

One possible approach to the question whether it is fair for individuals A and B to pay the same amount of tax is to ask whether A is "better off" or "happier" than B. For example, suppose that A and B both earn $30,000 per year and have roughly the same expenses, but that A has AIDS. Shouldn't A pay less tax than B? It is certainly plausible to propose that judgments about tax equity should be related to well-being. There are, however, at least two problems with this approach. First, well-being is notoriously difficult to define or measure. Second, even if it were possible to devise a measure for some aspects of well-being, well-being alone does not furnish additional capacity to pay tax. In the example above, supposing that A's illness does not occasion additional expense for A, both A and B may have about the same amount of discretionary income beyond their basic living expenses and, accordingly, can be said to have about the same capacity to pay income tax. Admittedly, B may consider himself better off than A, but that feeling of well-being is not something that can be transferred to the government in lieu of taxes. More fundamentally, it is not clear what it means to say that B is better off than A. B may feel better off not having AIDS than if he had AIDS, but it is difficult to say what one means by being better off than someone else, or how one could determine whether B is better off than A.

Such imponderables suggest that well-being, in the sense of how happy people feel, should not be used as a criterion for tax equity. Taxes are paid in money and tax equity is, therefore, appropriately based on monetary factors or on observable factors that can be translated into money.

c. *Expenditures That Do Not Confer Personal Benefit*

Continuing the above example, if A does have to incur additional expenses by reason of his illness, we could determine that this financial demand on A reduces his taxable capacity. This is not to say that we necessarily should take this approach. Looking at particular "involuntary" expenses of individuals is perilous because it is difficult to draw lines and impossible to tailor individually the concept of taxable capacity. As a matter of principle, however, it is worth exploring the possibility that it would be appropriate for two individuals with the same earnings to pay different amounts of tax, and hence to be considered as having different incomes, because one incurs expenditures that do not confer a personal benefit on him. * * *

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3. *Measurability*

Although the foundation for the concept of income is equity, another criterion, measurability, must come into play in defining income if income is to serve as an operational standard for an actual income tax. Income will be measurable if the amount of each individual's income can be ascertained by applying a formula based on objectively observable factors. Measurability is an important constraint in defining income. Absent this constraint, it might be preferable to determine each person's appropriate tax burden on an individualized basis, looking to the individual's entire financial and life circumstances. However, such a case-by-case approach simply is not possible in charting the income distribution of an entire country, nor is it usable as a benchmark in analyzing the tax system. The constraint of measurability means that each individual's taxable capacity, as determined with reference to equity alone, generally fails to correspond perfectly to the individual's income. The necessary consequence is that, in many cases, two individuals are treated as having the same taxable capacity, and hence the same income, even though if all the facts about them were known, it might be considered fairer for one of them to pay more tax than the other.

The criterion of measurability is similar to that of administrability. Often, a rule is adopted for the income tax, not because that rule results in the most equitable treatment, but because the equitable rule would be too complex to administer. * * *

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