Erasmus Journal for Philosophy and Economics,
Volume 11, Issue 2,
Autumn 2018, pp. 220-244.
https://doi.org/10.23941/ejpe.v11i2.327

The Domain of Desert Principles for Taxation

STEVEN M. SHEFFRIN
Tulane University

Abstract: Joseph Heath (2018) makes a strong case that the principles of fairness or desert that arise in social interactions have at best a loose connection to economic outcomes in decentralized markets. However, there is evidence that when people are given the opportunity—say, in collective bargaining situations—they will try to alter these market outcomes in favor of their own perceptions of justice, fairness, or desert. Taxation is an important domain in which the public can alter market outcomes. This paper explores to what extent desert can be used as a principle of tax policy. It analyzes tax policies that can be used to implement both individualized and categorical assessments of desert. I argue that there might be some room for tax policy at the broad, categorical level. Finally, using the Tax Cut and Jobs Act of 2017 as a case study, I explore whether merit or other bases for desert were embedded in the recent legislation. While there was evidence of attempts to implement ideas based on principles of deservingness in the legislation, they were not of the type necessary to sustain a merit-based society.

Keywords: desert, taxation, fairness, meritocracy, justice, Tax Cuts and Jobs Act of 2017

JEL Classification: H20, H24, H25

I. INTRODUCTION

In his essay in this volume, Joseph Heath (2018) makes a persuasive case that the principles of fairness and deservingness that arise in social interactions have at best a loose connection to economic outcomes in decentralized markets. This is not a new claim, but is made as a rebuttal to some recent discussion initiated by Gregory Mankiw (2010). In particular, Mankiw argues that market outcomes can be largely viewed as consistent with principles of desert and for that reason should be

AUTHOR'S NOTE: I would like to thank Kathleen Weaver for excellence research assistance on this project and for carefully reviewing the manuscript. Tom Mulligan and Huub Brouwer provided both encouragement and incisive comments on an initial draft of the paper. The anonymous referees also provided valuable comments.

generally considered as fair. In contrast, Heath makes the observation that when individuals in their collective capacity have the ability to reconfigure market outcomes, they often do so—for example, unions will narrow pay differentials compared to non-union employment, and municipal governments may initiate compensation schemes that tilt in the direction of recognition of acquired skills and away from pure market determination of wages. These desired deviations from market outcome are necessarily limited because of the need to recruit workers from the external labor market; but to the extent that they do occur, they reflect the presence of alternative views of fairness and desert that prevail in the relevant community, be it the union shop or local government. For Heath, this provides affirmation for his view that market outcomes do not map directly onto preferences that stem from interpersonal interactions or, using a term from Jürgen Habermas, the "lifeworld" (Heath 2018, 10).

In principle, the tax system can serve as a mechanism to alter market outcomes to incorporate principles of fairness or desert from the lifeworld. The nation can be seen as a community of the whole and use its taxation powers to reflect ideas of fairness and deservingness. Certainly, the prevalence of progressive taxation across the world can be understood in this light, reflecting values of equality of the citizenry. Equality norms are commonly understood, and discussions of taxation typically incorporate them in some fashion. For example, a standard application of optimal tax theory in economics attempts to maximize the sum of utility across individuals and seeks mechanisms to implement this goal subject to information and other constraints.[1] More recent work extends the optimal tax framework in a variety of directions.[2] But much less attention has been paid to ideas of desert. Can the tax system be used to implement a more refined notion of deservingness?

Several authors have suggested taxation can be used to implement a broad vision of desert. In their distinct ways, Gregory Mankiw (2010) and Thomas Mulligan (2018) each suggest a role for tax policy along these lines. For Mankiw, tax policy—with a few exceptions—should be based on principles that eschew redistribution from market outcomes

[1] See Kaplow (2008) for a comprehensive discussion.

[2] For example, Saez and Stantcheva (2016) have developed a more flexible approach to optimal taxation that can potentially include many different factors and viewpoints. A full discussion of their approach and other theories such as luck egalitarianism are beyond the scope of this paper.

and instead rely on taxes to cure externalities or provide public goods. While some redistribution can be a byproduct of such taxation, it is not its end goal (see Mankiw 2010). Since there is limited redistribution, Mankiw accepts the principle that market outcomes are largely deserved. By contrast, Mulligan would enlist taxation as a vehicle to promote his meritocratic vision. Pure rents would be taxed away, as would inheritances (Mulligan 2018). In earlier work, I explored from a traditional tax policy perspective a few prior attempts to justify taxation based on desert, including taxation of bequests or inheritances, consumption taxation, and taxation of “unearned income” from capital (2017, 154).

In this paper, I take a broader look at the potential scope and domain for using tax policy to implement a vision of desert. I consider both what I term ‘individual assessments’ and ‘categorical assessments’ as alternative tax policy strategies. Tax law is not made in a vacuum; there are important administrative and technical constraints that must be considered in implementing any policies. To further understand the role of desert as a component of tax policy and to serve as a case study, I draw on the evolution of selected provisions of the 2017 tax legislation as examples of the types of distinctions that legislatures actually wish to enact into tax bills. This case study illustrates the range of actions or behaviors that legislators may feel are ‘deserving’ or ‘undeserving’ and, importantly, highlight tradeoffs that must be made in any legislation between ultimate values and administrative feasibility.

My overall conclusion is that it is unlikely that desert can become a comprehensive foundation for developing a tax system. However, in selected cases, principles of desert based on categorical assessments can help refine tax policy so that desert becomes an element of the overall picture. In particular, a shift towards one type of consumption taxation can effectively tax windfalls and help move in the direction of desert-based taxation.

Before turning to the discussion of taxation, I first need to illustrate some of the conceptual and difficult issues in defining desert as they have been developed in the literature. This is not meant to be a definitive treatment of desert, but is necessary to set the stage for my discussion and analyses of desert-based tax policies.

II. PRINCIPLES AND PRACTICALITIES IN DESERT THEORY

There is both a philosophical and psychological perspective on desert. From the philosophical point of view, desert claims have the following structure: person A deserves some reward because of an action she has taken that aligns with certain principles.[3] These principles are known as the 'desert basis'. For example, A may deserve the income she earned because she exerted skill and effort in producing a service. In this case, exerting skill and effort in the production of a service is the desert basis.

In principle, there can be many different desert bases, but equity theory in psychology suggests that individuals strongly believe that outputs should be commensurate with inputs (Adams and Rosenbaum 1962; Pritchard, Dunnette, and Jorgenson 1972; Sheffrin 2013, chap. 2). In other words, there are deeply held beliefs that individuals should be rewarded for what they produce. There is abundant experimental and other empirical evidence for this principle of psychology (Sheffrin 2013, chap. 2; Mulligan 2018). It also appears in our political culture in the United States in the form of work requirements for able-bodied individuals to receive public benefits or, more broadly, "workfare" (Sheffrin 2013, 135).

The strength of this psychological force is what largely drives the underlying idea that Heath challenges in his paper, namely that market outcomes are deserved because they reflect the activity and effort of individuals. Liam Murphy and Thomas Nagel call this "everyday libertarianism" or the idea that individuals are entitled in some way to their earnings before tax, presumably because they earned them in the market and thus deserve their rewards (2002, 34). If it were not for the psychological principle of equity, these everyday notions would have much less force.

But as Heath has noted, the link between market outcomes and deservingness is quite tenuous. Here I want to focus on what I consider two of the most important problems with linking market outcomes and deservingness. First, markets allocate commodities and labor to their highest and best use—maximizing the value of a given set of resources—given underlying demand for goods and services. Prices and wages are determined in the process as a function of supply and demand. The difficulty here is that market demands depend on the initial distribution of income or endowments and, furthermore,

[3] See Miller (1999, 133) for a definition along these lines.

demands can shift for a host of reasons that are not clearly related to any notion of desert. To take one example, thirty years ago salaries for dermatologists were not much higher than those for doctors who specialize in internal medicine. Today, with changes in preferences for skin care and new technologies, the gap between the salaries of the two types of doctors has widened substantially.[4] Dermatologists in their 50s now earn relative salaries that they realistically could not have expected to earn when they made their original decisions on specialties. In what sense do those dermatologists deserve their higher salaries? We certainly understand from the principles of supply and demand why they earn their higher salaries, but what moral principle corresponds to this shift in demand?

The second problem with connecting market outcomes and deservingness is the role of luck or fortune—being in the right place at the right time or having fortuitous events influence one's market worth. Do individuals deserve high rewards just because they happened to be lucky? Generally, our intuition suggests they do not, although philosophers Christopher Freiman and Shaun Nichols have run experiments suggesting that in some circumstances, public opinion may recognize higher earnings stemming from natural advantages as deserved (2013, 127-128). They used surveys to probe public attitudes. When posed in the abstract, people do not believe that luck should influence earnings. However, in one experimental scenario, two young jazz singers were named and contrasted. Both worked hard but one had a genetic advantage that enabled her to earn more from her concert performances in the market. Respondents believed that the genetically-advantaged singer deserved the higher earnings from her performances.[5] Since genetic endowments are a form of luck, these experiments suggests that, in some cases, the public believes earnings that arise at least partly from luck are deserved.

This empirical finding is consistent with arguments offered by David Miller (1999, 143-147) on the role of luck and desert. Miller contrasts "integral" (143) luck versus "circumstantial" (144) luck. In the former, skill plays no role—the outcomes are purely random. In the latter case, individuals take actions that are influenced (but not dominated) by luck or opportunities. Miller argues that with circumstantial luck, our

[4] See Singer (2008) about the changing market for dermatologists.
[5] See also Goya-Tocchetto, Echols, and Wright (2016) who find that individuals do not care as much about natural luck as they do about socially generated luck.

intuitions often will credit the individual for the outcome, even if it has been influenced partly by chance.

However, even accepting these basic intuitions, it is still very difficult to analyze cases and make judgments where luck and efforts are mixed in various proportions. For a single individual, we may want to emphasize the effort they put into a project and downplay the effect of luck, particularly if the individual had persevered through difficult circumstances to achieve their goal. But at some point, as the proportion of chance increases, circumstantial luck will gravitate to integral luck.

It is also difficult to draw lines about what are fair versus unfair advantages. Consider the case of athletes competing in track and field. Here, natural or genetic advantages do not typically contravene our judgments of deservingness. Nor would adherence to a rigorous training program or a careful diet affect our judgments. But what about adding dietary supplements? How about other synthetic substances to facilitate training? Track and field organizations agonize about drawing the appropriate lines in this case.

For differences between groups, we may be less sympathetic to recognizing the role of luck. For earnings, would we want to claim that the entire salary differential between two occupations is justified only because fortuitous changes in demand raised the salaries of one group? In this case, our intuitions suggest that we would not.

III. USING TAXES TO IMPLEMENT DESERT NORMS

How could tax policy be used to implement a vision of desert? For the purposes of this discussion, we will measure desert by what I term qualified market outcomes. For market outcomes to be perceived as deserving, they must be directly related to effort and skill supplied by individuals, not dominated by luck or chance, and not economic rents. By economic rents, we mean any payments over and above what is necessary to secure the effort and skill required to produce the market outcome. This definition of desert attempts to reward people for the necessary effort and skill to produce a certain outcome, but does not justify all market returns. It excludes those returns due to pure luck and excess returns that would not be necessary to procure the required effort. It would preserve incentives for the full application of one's ability, but not provide any returns above that amount.

To refine this analysis, we can also add to the category of excluded rewards any income that is achieved through duplicitous means. This

could include outright dishonesty and false advertisements but also extend to rigged systems, such as when CEOs stack their compensation committees with their cronies. In none of these cases would we want to say that market outcomes are deserved.

Qualified market outcomes would be a necessary component in implementing a market-based meritocratic vision, but not a sufficient one. As Mulligan (2018) discusses in detail, social advantages would need to be neutralized—say through education and limiting inheritances—in order to translate qualified market outcomes to a full meritocracy. For the purposes of this paper, I will focus on tax policies that could implement desert for qualified market outcomes and put aside the extra steps necessary to generate a full meritocracy. I will use the term merit-based as a synonym for qualified market outcomes that do not necessarily generate a complete meritocracy.

There are two basic approaches that can be taken to design tax policies to make rewards more closely mirror desert. The first is based on individualized assessment (or, sometimes, group assessment) of actual market outcomes. This approach would focus on the particular incomes claimed by individuals or selected groups and use taxes to adjust them accordingly. For shorthand, we will call this individualized assessment. The second approach is more macro in nature. Here we would define different categories of income, and tax these categories of income differently. For shorthand, we will call this approach categorical assessment.

A. Individualized Assessment

Many of the examples used to illustrate desert theory are individual in nature. For example, does someone among a group of scientists who stumbles upon a new drug deserve the full rewards or should it be shared by the scientific community? Does a CEO deserve to earn all those stock options when his company prospers? These are examples of individualized assessments.

For any individualized assessment it is necessary to examine the market return and determine whether it is fair and consistent with desert principles. Practically, this will mean ascertaining what portion of any of the market return is pure economic rent—a payment above what is necessary to induce the observed amount of effort—or luck.

It is difficult to imagine a truly scientific way to accomplish this task. One could try to implement the following procedure. Take an

occupation—for example, doctors of internal medicine. Obtain large amounts of data on background characteristics—both personal characteristics and indicators of the nature of the workplace—measures of effort including hours of work, and total wage compensation. Then run typical wage regressions from the labor market literature, regressing the logarithm of wages on the full set of available characteristics.[6] In other words, the regression would try to control for what have been termed compensating wage differentials. Once this regression has been specified and estimated, it could then be used to determine a predicted wage for each individual that can be compared to the actual wage. The question we ask is whether this predicted wage is what individuals should be said to deserve, with any excess being economic rent.

Even in this rather simple situation with a relatively homogenous sample, there are some problematic details that need to be addressed. First, any regression equation fits the mean of the sample so that there are individuals who will be paid less and more than predicted. How do we interpret the case where individuals are underpaid? What exactly is negative rent? More generally, how do we know that any differences between actual and predicted wages do not reflect unobserved factors—in particular, the efforts made by the physicians? Finally, consider the interpretation of the variables that help predict wages. For example, suppose the regression showed that on average being a female physician or working in a smaller clinic led to lower wages. Are these differences fair and legitimate? Should they be accepted or taxed away?

Each of these questions would provoke considerable discussion and further debate. This is precisely the debate among economists as to whether there is economic discrimination. Economists have largely eschewed this wage equation approach and instead used other methods to explore discrimination, such as mailing resumes to potential employers that differ only on race or sex and determining if the potential employers respond differently.[7]

Moreover, the physician example would be a relatively easy case. How would you analyze the earnings of CEOs of say, midsize companies, or the earnings of sales representatives for drug companies? There will be considerable differences in compensation in each category. What type of regression model could be used to isolate the component of compensation due to rent? What variables would have explanatory

[6] For a survey of wage regressions, see Heckman, Lochner, and Todd (2003).
[7] See Bertrand and Mullainathan (2004) for a classic resume study.

power? And, finally, how would one interpret the results for an individual who scored above the predicted level? Would this represent luck, favoritism, or effort? Since well-trained econometricians cannot realistically provide answers to these issues, a bureaucratic organization charged with making such judgments would not have legitimacy.

The current tax law, as reflected in the Tax Cuts and Job Act of 2017, does implicitly make a somewhat crude attempt to classify salaries.[8] Compensation for certain corporate executives exceeding $1 million are not deductible from a corporation's income tax, thereby effectively raising the price of paying someone above $1 million to the company. Prior to the new tax legislation, there was an exception for incentive-based pay, but that was removed—indicating, in part, that the prior effort to fine-tune the tax penalties for high compensation was not perceived as working very well. In addition, the new legislation also enacted an excise tax on non-profits for salaries of executives over $1 million. One natural interpretation of these provisions in the new law is that lawmakers view salaries exceeding $1 million as somehow not as socially meritorious as salaries below $1 million, and the tax code is attempting to try to limit the higher salary payments. It is not clear whether lawmakers felt that the higher salaries were not deserved, but they certainly wanted to put institutions on notice that there was a higher price to pay for salaries exceeding $1 million. Note that while these tax provisions make paying salaries above $1 million more expensive, they do not prohibit them. Thus, they are not being treated as pure economic rent which would be taxed away fully.

Taxing rents for executives would be a difficult task. It is especially difficult to determine whether their earnings reflected true skill and effort, close relationships with their compensation committee, and/or being in the right place at the right time for the industry. In addition, the executive may, through judicious lobbying, bring more government contracts to their company, which would be a private gain but not necessarily a social gain.[9]

The excise tax on non-profits and the implicit tax on corporations are in addition to the taxes that individuals pay on the receipt of their salaries. Athletes, entertainers, and others who earn more than $1 million from prize money or royalties are only subject to the individual

[8] See Internal Revenue Code Section 162(m) as revised by the Tax Cuts and Jobs Act. Both the prior and new law could be seen as categorical methods.

[9] See Burak (2018) on attitudes towards executive compensation. She concludes that there is some support for pay for performance among the public.

income tax and not the additional tax on executives. Thus, whatever rationale there is for curbing executive compensation, it does not apply equally to all high earners.

There are dimensions other than pure compensation in which judgments would need to be made in a system based on desert. Consider again our top athletes and the restraints that are placed on them with respect to the drugs and supplements they are allowed to take. Some types of activity that athletes have engaged in to gain competitive advantages would clearly fail any fairness test. Replacing one's blood with freshly oxygenated blood—as some cyclists have done—would clearly run afoul of most norms.

However, as we noted above, athletes are expected to eat well and train extensively to take advantage of their natural genetic makeup. Many of the prohibited drugs allow athletes to train harder and do not magically confer advantages. Run-of-the-mill steroids that can be found in many weight rooms simply allow faster recovery periods from training. These have been banned for a long time and the consensus was that that these were dangerous and conferred an unfair advantage. But there are many subtler drugs whose effects are not as clear, making it more difficult to draw strict lines. And these lines evolve over time.

Take the case of Maria Sharapova, who had been taking a drug called meldonium for nearly a decade (The Guardian 2016). She claimed she was using the drug for a magnesium deficiency and a family history of diabetes. This drug, used primarily in the Baltic Countries and Russia, increases the flow of blood to parts of the body. Many competitors with Eastern European or Russian backgrounds had been regularly taking this drug. The World Anti-Doping Agency banned the drug on January 1, 2016 and Sharapova later was found to have tested positive for the drug. She claimed she had not been aware that the drug had entered the banned list. Originally, she was given a two-year suspension, but after an appeal the sentence was reduced. Sharapova clearly ran afoul of the rules in her profession, but, in a deeper sense, did her actions warrant sanctions if she had truly been taking the drug for medical reasons?

The International Tennis Federation was entitled to suspend her for a violation of their official rules, but the question is whether the suspension was arbitrary and unfair with respect to any potential advantage that she gained. The ever-changing drug regime puts the athletes at potential risk for often seemingly arbitrary and incidental actions that they may have taken.

While this example falls within a very specific context, it raises issues that transcend it. Suppose we develop a set of rules, say, for limits on CEO compensation, on the grounds that any payment above a certain threshold is presumably rent. In general, such a set of rules would be very complex, mirroring the complexities of compensation packages. Moreover, in response to the rules, firms would design new compensation packages to avoid the penalties from the rules—just as athletes do with regard to the drug regime, or taxpayers do with respect to the tax law. The result would be a system in constant flux. We would need a complex system of adjudication to separate legitimate compensation innovations from illegitimate ones designed just to evade the system. This almost certainly requires a formal legal structure—like the tax code—and a set of procedures to evaluate claims and allow appeals. The danger here is that we would introduce, into wide segments of the economy, the complexities we find now in the tax code and securities law, all in the name of trying to separate rent from deserved compensation. In practice, such a system would have to be more comprehensive and more complex than the tax law. Even if we had a strong epistemic foundation for separating out rent from other compensation, the complexity in drawing and enforcing lines could easily overwhelm the economic system. And it could cause easily cause economic inefficiencies and challenge the legitimacy of the state.

B. Categorical Assessment

An alternative to individualized assessments that would purport to separate out for each individual the rent component of their compensation would be to use the tax system to reach some broad-based categories of income flows and treat them differentially. We previewed one such categorization when we discussed above the $1 million threshold for treating economic compensation differentially. But there are other traditional tax and income categorizations that we may be able to use to implement a tax system based on desert. In some cases, categorical measures can target individual rents, but in other cases they are best at trying to tax windfall gains that accrue to individuals.[10]

[10] Windfall gains can be viewed as payouts that exceed the returns to risk-bearing. Measuring what precisely is a windfall and what is not, will depend on an accurate assessment of the returns to risk-taking activity.

The first and most obvious category of income that could be taxed at very high rates would be bequests and inheritance taxes. To the recipients of these intergenerational transfers, they are effectively pure rent. Increasing taxes on bequests or inheritances could be part of an overall reform to move the tax system closer to one based on merit and desert. But there are limits to what realistically can be accomplished in this domain both because of popular opinion and other structural factors that have been historically associated with the estate and gift tax.

First and foremost, the estate and gift tax is highly unpopular; indeed, many of those supporting abolition of the tax would never even actually have the size of an estate that would be subject to taxation (Graetz and Shapiro 2006). There are several reasons for this distaste for estate taxation. Generally, people apply the equity principle and believe they earned their wealth and should be able to dispose of it how they wish. Second, some believe that estate and gift taxation jeopardizes the American Dream by cutting off avenues of opportunity, even if they themselves would not be affected currently.[11]

Shifting the discussion from an estate and gift perspective to an inheritance perspective may alleviate some of the concerns from equity theory and may have additional benefits in terms of tax policy. It is less likely that the recipients of a bequest can make the claim that they deserve the funds because of their effort, even if it was their family's efforts that were the source of the funds. Moreover, inheritance taxes could also be more easily tailored to the individual circumstances of the recipients and potentially made progressive (Batchelder 2009).[12]

Another factor that limits revenue from the estate tax is the step-up in basis that occurs at death. Upon death, assets are valued at their current market value, not the value at which the asset was acquired. This eliminates any taxes on the appreciation of the asset during the time the asset was held by the deceased. In the past, this provision was justified because of the difficulties it caused with respect to accurate

[11] Sheffrin (2013, Chap. 4), discusses how some individuals believe that estate taxation will prevent them from earning and then dispensing large fortunes which they associate with intrinsic American values.

[12] However, there are difficulties in designing inheritance taxes as well, particularly if there is transfer of businesses to the heirs.

record keeping. However, changes in technology have made information about tax bases more readily available, which reduces this concern.[13]

I believe an even more profound difficulty with estate and gift taxation is that these taxes were designed to prevent dynastic transfer and thus, at least in the United States, have an unlimited deduction for charitable gifts or gifts to foundations. That is why the very wealthy rarely pay any substantial estate and gift taxation. For very large estates, many of the wealthy create private foundations (think of Bill Gates, George Soros, and the Koch brothers) or family foundations. These foundations can carry out the wishes of the grantors and effectively execute the vision of the donors. Moreover, there is no general prohibition of family members taking an active role in these institutions. There are also other complicated strategies the very wealthy use to avoid the estate tax—which is why many years ago it was dubbed a 'voluntary tax' (Cooper 1979). For this reason, the estate and gift tax never raised much revenue even when the exemption limits were considerably less than they are today. For example, in 1995, the estate and gift tax raised only $12.4 billion, or 0.88 percent of all federal tax revenue (Johnson and Mikow 1997, 82, Figure L). The expansion of the exemption thresholds that have transpired since 2001 and continued with the 2017 tax bill, effectively let the upper middle class enjoy the benefits that the very wealthy had always enjoyed.

What about windfall gains in general? Two of the most fundamental ways we can potentially structure our tax system—income versus consumption taxation—treat windfall gains differently. First, consider income taxation. Under a progressive individual income tax, windfalls will be partially taxed and the rate of taxation will increase with the size of the windfall. But the windfall will only be taxed if the income is actually realized for tax purposes. Wages are realized as they are received, but that is not true for capital income in general. If someone owns a stock that increases in value, the accrued gain is not taxed until the stock is sold.[14] At that time, it is realized for tax purposes. However, individuals have the option not to sell the appreciated stock, which is why we typically have lower tax rates on capital gains than for regular income. Even more importantly, individuals can borrow against their

[13] In 2010, taxpayers could elect a regime with a zero estate tax, but the step-up in basis would not apply. Thus, their heirs would pay taxes on the prior appreciation whenever they sold their assets.

[14] I abstract from the case in which the appreciation is due to the effort of a manager of a company.

appreciated stocks and use the proceeds for consumption. Upon death, the gains are effectively eliminated through the step-up in basis rule that removes any appreciation and assures that any stock that is inherited is valued for tax purposes at its current price. Thus, if a stock is sold immediately after one inherits it, there will be no capital gains taxation regardless of the past appreciation of the stock. This has led one tax scholar to describe avoiding the income tax as "buy, borrow, and die" (McCaffery 2002, 32). Windfalls thus escape taxation under today's income tax framework.[15]

Under a progressive consumption tax, individuals pay tax at a progressive rate on their income less their savings. If they borrow or dissave in order to consume, they will incur tax. One can think of this system as taking the current income tax and allowing a pretax deduction for net savings—just like we do for IRA's or 401Ks now.[16]

One nice and generally unappreciated feature of this class of consumption taxes is that they would reach windfall gains. Suppose, for example, that a person saved by putting funds into a stock which later greatly appreciated in value. When the person, or his descendants, attempts to access the funds for consumption, those funds will be taxed at the full consumption rate. Any returns above the normal rate of interest on the savings initially invested will effectively be fully taxed at the normal consumption tax rate. Only returns at the rate of interest will avoid tax. Thus, the progressive consumption tax allows normal returns on investments to escape taxation but fully taxes any returns above that and therefore taxes windfalls. This is an extra benefit to this model of consumption taxation.

Note that this model applies to regular IRAs and 401Ks, but not to Roth IRAs. The latter are known as exemption plans because they do not provide an initial deduction but exempt the entire return (including any windfalls) from taxation. Thus, in designing a tax system to be consistent with desert, it is important to choose the correct schemata for consumption taxation.

[15] This paragraph describes the U.S. tax treatment. Other countries manage the realization issue differently. The Netherlands taxes a hypothetical return on their assets that increases with invested capital. Another alternative that avoids the realization problem is retroactive taxation (see Auerbach 1991).

[16] There are a number of different ways to formulate a progressive consumption tax. Under an X-tax, labor income would be removed from the business tax base and taxed at progressive rates. In principle, there could be charitable contributions that are allowed as deductions. They can be constructed to either allow or deny gifts to heirs. If gifts are allowed as deductions, the theory is that the heirs will pay taxes when they consume. This is the position of McCaffery (2002).

The traditional value-added tax, a tax on consumption employed in most countries throughout the world (although not in the United States), also taxes windfalls. Value-added taxes allow for the expensing of investment (deducting the full cost of investment goods in the initial year) and thus effectively allow for a deduction for savings. However, value-added taxes have a flat rate structure, so they are not progressive consumption taxes.[17]

There is one other additional benefit of progressive consumption taxation over income taxation. The act of consumption is once removed from the act of earning income. Thus, a high rate of tax on consumption may not be perceived as confiscatory, where an equivalent rate on current earnings may seem so. This has led some commentators to claim that the consumption tax was the "last best hope for progressivity" (McCaffery and Hines 2010, 1037). Since consumption taxes exempt savings, their nominal rate of taxation must exceed the rate of a revenue equivalent income tax. The psychological factor favoring consumption taxes might be offset by the higher rate. The ultimate effect on progressivity is thus an empirical matter.

The consumption tax would apply taxes to qualified market income that is not saved, thus it would tax earnings that were deserved. However, it is hard to think of taxes that would raise sufficient revenue to fund a government that would not tax some deserved earnings. The distinguishing factor of a progressive consumption tax is that it does manage to tax windfalls, whereas the current income tax in the United States does not.

Historically, the United States tax system also made a distinction between "earned income" from wages and "unearned income" from capital income (Sheffrin 2013, 209). In the 1950s, taxes were higher on unearned income than on earned income. While this distinction may sometimes resonate with the public today (where heirs of fortunes live lives of leisure), it has no basis in theoretical discussion of taxation or economic theory. Capital income arises from savings which are essentially deferred consumption. Modern discussions of tax policy recognize and incorporate this insight. There are some strong economic rationales for taxing capital income at lower rates based on the

[17] Viard (2018) provides an accessible discussion of different forms of the value-added tax and how they tax above-normal or windfall returns.

inefficiency of taxing savings, although the case is not definitive.[18] The intellectual debate today focuses on whether there are gains in efficiency or equity from taxing capital income—not whether it is "earned" or "unearned".

Since capital gains are taxed at lower rates than earnings, the idle rich do seem to enjoy an advantage. However, if the public is concerned about the behavior of the idle rich, a progressive consumption tax would go a long way to rectifying the current situation. As the idle rich spent their funds, they would pay taxes at progressive consumption tax rates.

IV. FROM THEORY TO PRACTICE

While in theory, tax policy can aim to tilt towards a vision of desert, is that likely to be seen in practice? There are a number of reasons why actual tax policy may not reach or even aim for this goal.

The first basic reason is that a tax system's primary function is to raise funds for the state. Any tax preferences (tax expenditures) will cost revenue, so exempting certain activities or taxing them at lower rates will be costly. Of course, this can be offset by raising other tax rates or incorporating new items into the tax base. But these changes typically will incur political resistance and may make the tax system less efficient. In short, there are revenue constraints that may throttle a vision of desert.

A second key reason is the possibility of tax arbitrage. Unless tax legislation is put together carefully, it may be possible for taxpayers to take advantage of the preferences in the system to simply make money and drain the system of revenue. For example, an individual could borrow funds and deduct interest payments and invest in tax-exempt securities. Since the issuers of tax-exempt securities do not pay taxes on the receipt of interest, the net result of the transaction is a transfer of funds to the investor at the expense of the government. Current law explicitly prohibits these transactions and also places restrictions on individual borrowing generally.

Closely related to the idea of tax arbitrage is the risk that taxpayers will change their behavior in superficial ways, just to save on taxes. If it is less costly to pursue activities in a slightly different form, differential tax rates can induce change. In the tax law, this falls under the general

[18] See Bankman and Weisbach (2006) for the efficiency argument. Diamond and Saez (2011) make the point that capital income may be an indicator of ability, so it might be efficient to tax capital income.

category of form rather than substance. One classic example is to characterize financing as debt rather than equity so that interest payments can be deducted. If taxpayers change the real economic environment they face, then we generally view this as a legitimate response to differential taxes; however, if the mere form of an activity changes with no substantial changes in risk or the economic environment, then this behavior is characterized as merely a change in form and generally not permitted. The tax law must be fine-tuned to avoid promoting form over substance.

Finally, lawmakers may wish to use the tax system to pursue a vision of desert, but this vision may not conform to qualified market outcomes. Lawmakers may have other value schemes or alternative desert bases in mind.

The Tax Cut and Jobs Act of 2017 provides an interesting laboratory in which to explore these ideas. The bill was written by Republican legislators and staffers in the House and Senate. There were only a few public hearings and not much public exposure to early versions of the legislation. This allowed the preferences of the tax writers to have considerable leeway in designing the provision of the bill. Moreover, the House and the Senate each separately produced entire versions of their bill reflecting the preferences of their membership. The bills differed in interesting ways that allow us to see the preferences in the respective Chambers.

I used the official detailed summaries of the original House bill and the final conference bill that embodied the Senate's own positions to explore whether legislators took advantage of a major new tax bill to embed ideas of desert into the legislation and, if so, what types of desert.[19] I asked a non-tax professional to read through both the detailed descriptions provided by the Joint Committee on Taxation of the original House bill and the final conference report and identify areas in which she believed there were considerable value judgments being applied in the legislation.[20] We then went over her lists and eliminated provisions that could have been justified on normal tax policy grounds, such as economic efficiency or preventing arbitrage. We also avoided hyper-technical areas—such as some aspects of international taxation—

[19] United States Congress, Joint Committee on Taxation (2017a, 2017b). These are the detailed descriptions of the original House of Representatives' bill and the description of the conference bill.

[20] I thank Kathleen Weaver for her heroic efforts in carefully reviewing the near thousand pages of summaries of the bills.

whose provisions were based largely on other tax principles. As a result of this effort, we identified three broad areas for discussion, reflecting different aspects of the ways legislators embed values in tax bills. To preview our findings, none of these proposed legislative changes implied a vision for merit-based desert.[21]

In the first area we identified, the House aimed at incorporating social value judgments into legislation using family-based social norms as their desert bases. The House first proposed ending the current treatment of alimony payments, which are deductible to the payor and included in the income of the payee. That is, the person paying alimony can deduct the payments from their income before calculating their tax, but the recipient of the alimony payments treats them as income for tax purposes. The rationale the House gave for changing the law was that an old Supreme Court case from 1914 had invalidated this practice (*Gould v. Gould*, 245 U.S. 151, 1917). However, this rationale was specious, as Congress changed the tax law in 1942 to allow it.[22] At one time there were concerns expressed in the tax policy community that the recipients of alimony payments sometimes omitted them from their tax returns, but this has been easily corrected by requiring the payor to include the Social Security number of the payee on payor's return. There was no real basis for this provision other than to punish higher earners in divorces and make divorce more costly. Although the Senate did not originally suggest this provision, the final legislation reflected the House proposal with a one-year delay in enactment.

The second provision we highlighted that has a particular social norm as its basis, was a House proposal relating to Coverdell education accounts. Under existing law, income-eligible taxpayers can deposit funds into accounts that grow tax free and can be removed from these accounts tax free for spending on educational purposes. What the House proposed, was to end new contributions to the Coverdell accounts, but to allow contributions for currently unborn children that were in gestation. This clearly reflected an anti-abortion orientation of the tax writers for this bill.[23] In the final legislation, no changes were actually made to Coverdell accounts.

[21] The discussion around the bill focused primarily on investment incentives and not merit-based desert.
[22] See Davis (forthcoming) for a discussion of the history of this issue.
[23] In the United States, groups that oppose abortion would prefer using the term pro-life to anti-abortion.

With the proposals for changes to alimony and Coverdell accounts, we do have what can be seen as desert-based tax proposals. In this vision of desert, married couples were more deserving than divorced couples and unborn children were to be placed on par with those already born.[24] Neither proposal enacts a merit-based desert tax policy.

The next set of proposals we analyzed can be loosely grouped under the category of political desert, or the situation that occurs when benefits conveyed to parties because they are politically favored for ideological reasons.[25] Three proposals we identified that do have a distinctive ideological content also originated in the House bill. None of these were proposed by the Senate and none made it into final legislation. The three proposals we identified were; 1) the termination of the new market tax credit, 2) the repeal of the work opportunity tax credit, and 3) the repeal of the credit for plug-in electric drive motor vehicles.

All of these provisions had an ideological tinge. The new market tax credit is an Obama-era program that provided individual and corporate tax credits against federal income taxes for making Qualified Equity Investments in qualified community development entities. These entities serve low-income communities. Eligible projects have included financing small businesses, improving community facilities such as daycare centers, and increasing home ownership opportunities. Eliminating the credit would have eliminated the incentive for these programs.

The work opportunity tax credit provides incentive to hire from ten targeted groups, including those who receive certain public benefits, as well as other categories including ex-felons and those experiencing long-term unemployment. While eliminating this provision could be seen as simply removing tax credits generally, it is evident that the House provisions take away work incentives for disadvantaged groups.

Finally, the repeal of credit for plug-in electric drive motor vehicles clearly expresses a value judgment that the Federal government should no longer incentivize energy efficient cars or those with reduced carbon emissions. Again, it could be rationalized as a general dislike of credits, but it does seem like a logical extension of the skepticism of the harm caused by global warming and humans' role in its trajectory that many

[24] The proposed policy could simply reflect religious conservatism, but I suggest here that this also reflects some notion of deservingness, particularly for married versus divorced couples.

[25] The benefits should not be conveyed simply because they are well-connected—my use of the term political desert implies some ideological affinities.

Republican members of the House, as well as President Donald Trump, have expressed.

The fact that none of these proposals emerged in the Senate bill or in the final legislation can potentially be seen as evidence that these proposals reflected the ideological and political preferences of certain members of the House. Again, these proposals represented a view as to what was deserved—but here the criteria were largely based on traditional political grounds.

The third area we examined was a more fundamental aspect of the new tax law. A complex and significant component of the final legislation was the taxation of pass-through entities—partnerships, sole proprietorships, and other entities that can choose to be taxed as individuals and not as corporations thereby avoiding the corporate layer of tax. The final legislation provided a 20% deduction for pass-through income (that is, making only 80% of pass through income subject to tax), but with certain limitations. The underlying rationale for the deduction was that the overall legislation reduced corporate tax rates sharply. The small business community wanted to maintain parity and pushed strongly for corresponding reductions in taxation for businesses conducted in non-corporate forms. Whether this was absolutely necessary was a subject of debate, as corporate owners pay taxes on dividends they receive and potentially capital gains when they dispose of their shares. Taking into account this additional individual taxation, it is a close call whether the additional deduction for pass-throughs was needed in order to insure parity with corporations. However, the fact that the relative position of corporate versus non-corporate businesses would change with the reduction in the corporate tax rate provided strong political impetus for the pass-through deduction.

The key idea behind the deduction was to provide a tax cut for business income regardless of organizational form. The principal difficulty in drafting the legislation and providing a tax reduction for pass-throughs was to avoid the situation where lawyers, accountants, and other service providers would be taxed at the lower business rate and not as regular wage earners, as they would if they had worked for a corporation. Or, put another way, the tax preference for pass-through businesses was for capital income, not labor income. A corporation would deduct its wages from its taxable income and the wage earners would pay taxes at individual rates. The corporation would then pay tax

on its capital income, with wages excluded. The issue facing lawmakers was how pass-through businesses could be treated in a parallel fashion.

Both the Senate and House initially developed their own strategies for achieving this tax policy goal. The final legislation ended up closest to the Senate version. It provided a 20% deduction for pass-through businesses, but placed some income and other limits on this deduction. These provisions are complex, but here I want to highlight the restrictions for "specified service industries", which include firms in law, accounting, health, actuarial science, performing arts, consulting, athletics, and financial and brokerage services (Susswein 2018, 501). Individuals in these firms employed in these activities are entitled to the deduction, but only for incomes up to $315,000 for joint filers and $157,000 for single filers. These same restrictions apply to any other business for which "the principal asset of such trade or business is the reputation or skill of one of its employees or owners" (501). Other businesses were not subject to these particular limits, but there are also complex limitations based on payroll and assets that apply to all businesses.

By highlighting these types of businesses, lawmakers were following tax policy principles and trying to separate out wage income from capital income. They were not singling out certain types of businesses based on desert. The actual list of specified service businesses was largely taken from an obscure section of the tax code, Section 1202. That section refers to the partial exclusion of gain from income of the sales of stocks of certain small businesses.[26] The only difference is that Section 1202 also included engineering and architects. These two groups were not included in new tax law, as they successfully made the case that they typically had more capital investments in their businesses than the others on the list. The fact that the list was adopted from another section of the tax code dispels the notion that the particular definition of specified service businesses was motivated by partisan concerns.

To this point, it appears that tax policy reasons were primarily driving the pass-through provisions, including the choice of service industries subject to income restrictions. However, providing the full deduction for all businesses under the income limits can be seen as reflecting some notions of desert. The rhetoric surrounding the pass-through provisions in the tax bill highlighted the idea that it was important to provide a break for individuals operating small businesses.

---

[26] See Internal Revenue Code Section 1202 (e)3.

This was a clear value judgment. There is no obvious economic or merit-based reason to provide a tax break to a lawyer earning $100,000 who operates as a sole practitioner as compared to a lawyer working for corporation who earns the equivalent salary. Did the lawmakers want to encourage the entrepreneurial spirit of the sole practitioner? If so, this is more of a moral and social basis for desert than a purely economic one.

Many critics of the pass-through provisions, such as Dan Shaviro (2018), found them to be arbitrary, needlessly complex, and subject to gaming. In response to Shaviro, our discussion highlights that there was a basis in prior law for specifying the identity of the service businesses that were subject to restrictions. Moreover, historically, lawmakers have enacted a variety of tax breaks for small business.

In summary, it was difficult to find any merit desert-based provisions in the recently enacted tax law. There were clearly other social and political preferences expressed in the legislative process. But the natural constraints on tax policy, including raising revenue and avoiding tax arbitrage and gaming the tax system, do limit the scope for narrowly directed merit-based provisions.

V. CONCLUSION

While market outcomes connect only loosely with norms of fairness and economic desert, it is possible to envision tax policy as a mechanism to implement a merit-based market vision of desert. This paper explored the different ways the tax system could be used for such a purpose and whether actual tax policy—as exemplified in the most recent tax legislation—embodied these norms.

I first distinguished between individualized and categorical approaches to implementing merit-based desert norms. Although many discussions of desert focus on individual acts or behaviors, the practical difficulties of implementing any systematic approach along these lines is overwhelming. There was a bit more hope for some categorical approaches. While taxing inheritances or bequests seems to be a natural mechanism to reach economic rents, the revenue raised from these taxes is very small, at least as the current provisions are constituted with the step-up in basis and unlimited charitable deduction provisions. More promising would be revamping our tax system along the lines of a progressive consumption tax which has the consequence of taxing pure economic windfalls. This type of consumption tax, however, has never been implemented in its entirety in any country. It also would require

higher nominal taxes and major re-orientation of the tax code. Our current tax system embodies certain consumption tax features with its retirement provisions, offering a possible model for a broader system.

Finally, our exploration of the social and political norms embodied in the Tax Cut and Jobs Act of 2017 suggested that politicians did try to insert their preferences into tax law. However, these preferences were not based on a merit-based market variety, but, instead, reflected other social and political priorities. Just as Joseph Heath (2018) noted that when opportunities arise, unions and other groups exert their own values, so it appears do tax legislators.

REFERENCES

Adams, J. Stacey, and William B. Rosenbaum. 1962. "The Relationship of Worker Productivity to Cognitive Dissonance About Wage Inequities." *Journal of Applied Psychology* 46 (3): 161-164.

Auerbach, Alan. 1991. "Retrospective Capital Gains Taxation." *American Economic Review* 81 (1): 167-178.

Bankman, Joseph, and David Weisbach. 2006. "The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax." *Stanford Law Review* 58 (5): 1413-1456.

Batchelder, Lily L. 2009. "What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax." *N.Y.U. Tax Law Review* 63 (1): 1-112.

Bertrand, Marianne and Sendhil Mullainathan. 2004. "Are Emily and Greg More Employable than Lakisha and Jamal? A Field Experiment on Market Discrimination." *American Economic Review* 94 (4): 991-1013.

Burak, Esra. 2018. "Is the Sky the Limit? Fair Executive Pay as Performance Rises." *Social Problems* 65 (2): 211-230.

Cooper, George. 1979. *A Voluntary Tax?* Washington DC: The Brookings Institution.

Davis, Tessa R. Forthcoming. "A Human Capital Theory of Alimony and Tax." *George Mason Law Review,* 25 (2).

Diamond, Peter and Emmanuel Saez. 2011. "The Case for a Progressive Tax: From Basic Research to Policy Recommendation." *Journal of Economic Perspectives* 25 (4): 165-190.

Freiman, Christopher and Shaun Nichols. 2011. "Is Desert in the Details?" *Philosophy and Phenomenological Research* 82 (1): 121-133.

Gould v. Gould, 245 U.S. 151. Supreme Court of the United States. 1966.

Goya-Tocchetto, Daniela, Matthew Echols, and Jen Wright. 2016. "The Theory of Life and Moral Desert: An Empirical Investigation." *Philosophical Psychology* 29 (8): 1112-1127.

Graetz, Michael and Ian Shapiro. 2006. *Death by a Thousand Cuts*. Princeton, NJ: Princeton University Press.

The Guardian. 2016. "What is Meldonium and Why Did Maria Sharapova Take It?" Accessed March, 2018. <https://www.theguardian.com/sport/2016/mar/08/meldonium-maria-sharapova-failed-drugs-test>.

Heath, Joseph. 2018. “On The Very Idea of a Just Wage.” *Erasmus Journal for Philosophy and Economics* 11 (2): 1-33.

Heckman, James, Lance Lochner, and Petra Todd. 2003. “Fifty Years of Mincer Wage Regressions.” NBER Working Paper #9732.

Johnson, Barry and Jacob Mikow. 1997. “Federal Estate Tax Returns, 1995-1997.” IRS, Statistics of Income. Accessed March, 2018. <https://www.irs.gov/pub/irs-soi/97esart.pdf>.

Kaplow, Louis. 2008. *The Theory of Taxation and Public Economics.* Princeton, NJ: Princeton University Press.

Mankiw, N. Gregory. 2010. “Spreading the Wealth Around: Reflections Inspired by Joe the Plumber.” *Eastern Economic Journal* 36 (3): 285-298.

McCaffery, Edward J. 2002. *Fair Not Flat: How to Make the Tax System Better and Simpler*. Chicago, IL: University of Chicago Press.

McCaffery, Edward J., and James Hines. 2010. “The Last Best Hope for Progressivity in Tax.” *Southern California Law Review* 83 (5): 1031-1098.

Miller, David. 1999. *Principles of Social Justice*. Cambridge, MA: Harvard University Press.

Mulligan, Thomas. 2018. *Justice and the Meritocratic State*. New York, NY: Routledge.

Murphy, Liam, and Thomas Nagel. 2002. *The Myth of Ownership.* Oxford: Oxford University Press.

Pritchard, Robert, Marvin Dunnette, and Dale Jorgenson. 1972. “Effects of Perceptions of Equity and Inequity on Worker Performance and Satisfaction.” *Journal of Applied Psychology* 56 (1): 75-94.

Saez, Emmanuel, and Stefanie Stantcheva. 2016. “Generalized Social Marginal Welfare Weights for Optimal Tax Theory.” *American Economic Review* 106 (1): 24-45.

Shaviro, Daniel. 2018. “Evaluating the New U.S. Pass-Through Rules.” *British Tax Review* Issue 1: 49-67.

Sheffrin, Steven. 2013. *Tax Fairness and Folk Justice*. New York, NY: Cambridge University Press.

Sheffrin, Steven. 2017. “What Role Can Desert Play in Designing Tax Policies?” *Pittsburgh Law Review* 15 (1): 137-162.

Singer, Natasha. 2008. “For Top Medical Students, an Attractive Field.” *New York Times*, March 19, 2008. Accessed October 16, 2018. <https://www.nytimes.com/2008/03/19/fashion/19beauty.html>.

Susswein, Donald B. 2018. "Understanding the New Pass-through Rules." *Tax Notes*, January 22, 2018. < https://www.taxnotes.com/tax-notes/partnerships-and-other-passthrough-entities/understanding-new-passthrough-rules/2018/01/22/26s0k?highlight=susswein>.

United States Congress, Joint Committee on Taxation. 2017a. “Description of H.R.1, The “Tax Cuts and Jobs Act”.” JCX-50-17, November 3, 2017. Accessed March, 2018. <https://www.jct.gov/publications.html?func=fileinfo&id=5031>.

United States Congress, Joint Committee on Taxation. 2017b. “Joint Explanatory Statement of the Committee of Conference.” Joint Explanatory Statement, 115AD. 115th Congress, 1st session, document. Accessed March, 2018: <http://docs.house.gov/billsthisweek/20171218/Joint%20Explanatory%20Statement.pdf>.

Viard, Alan. 2018. "Too Clever by Half: The Politics and Optics of the Two Part VAT." *National Tax Journal* 71 (2): 399-416.

Steven M. Sheffrin is Professor of Economics, Affiliated Professor of Law, and Executive Director of the Murphy Institute, Tulane University. He has published 11 books and over 100 articles in the areas of macroeconomics and taxation. His current research interests focus on the interplay of economics and psychology in understanding the features of tax systems.
Contact e-mail: <smsheffrin@tulane.edu>