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And yet it moves: taxation and labour mobility in the 21st century

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AND YET IT MOVES:
TAXATION AND LABOR MOBILITY IN THE 21st CENTURY

Eppur si muove
-Galileo Galilei

Reuven S. Avi-Yonah[1]

ABSTRACT

A central premise of tax scholarship of the last thirty years has been the greater mobility of capital than labor. Recently, scholars such as Edward Kleinbard have recommended that the US adopt a variant of the "dual income tax" model used by the Scandinavian countries, under which income from capital is subject to significantly lower rates than labor income because of its supposedly greater mobility. This article argues that the premise upon which this argument is built is mistaken, because for individual US taxpayers (as opposed to corporations), there are significant limitations on their ability to avoid tax by moving their capital overseas. Moreover, if we focus on those taxpayers that pay the bulk of the income tax (i.e., the upper middle class and the rich), the data suggest that their ability to legally avoid taxation by expatriation is not significantly lower than their ability to evade it by moving capital, and lower income taxpayers are able to avoid both the income tax and the payroll tax (as well as a VAT) by emigration. The article then develops the policy implications, suggesting that (contrary to recent legislative trends) income from labor and capital should be subject to the same tax rates, but that these rates should be congruent with the price the US population is willing to pay for public services.

[1] Irwin I. Cohn Professor of Law, the University of Michigan. I would like to thank Kimberly Clausing, Itai Grinberg, Michelle Hanlon, Yoram Margalioth, Omri Marian, Eric Ohrn, Fadi Shaheen, David Wildasin, and participants in workshops at Oxford, Michigan and Tel Aviv for their comments. Special thanks are due to my research assistants Madeline Kayes and Zachee Pouga. All errors are mine.

Introduction

A central premise of tax scholarship of the last thirty years has been the greater mobility of capital than labor (the "capital/labor dichotomy assumption"). The tax competition literature, for example, generally begins with the statement that the current era of globalization (from 1980 onward) differs from the previous one in the late 19th and early 20th centuries because in the former period labor was as mobile as capital since there were no restrictions on immigration.[2] In our globalization, however, labor faces immigration laws that restrict its mobility, while capital is free to move anywhere it wants at the click of a mouse.[3]

Recently, important tax scholars such as Edward Kleinbard have drawn the natural policy conclusion and recommended that the US adopt a variant of the "dual income tax" model used by the Scandinavian countries, under which income from capital is subject to significantly lower rates than labor income because of its supposedly greater mobility.[4] For example, in Sweden labor income is taxed at a top marginal rate of 56.6% under the income tax and another 25% under the VAT, while income from capital (dividends, interest and capital gains) is taxed at a "mere" 30% and the corporate tax rate (which is generally assumed in this literature to fall on capital) is only 26%.[5] For the US, this argument suggests that we should (a) retain the 20% tax rate on dividends and capital gains, as enacted by the American Taxpayer Relief Act of 2012; (b) extend the 20% rate to interest; (c) lower the corporate tax, which at 35% is the highest in the OECD; and (d) if additional revenue is needed, increase the tax rate on labor, either by raising the income tax rate on wages above 39.6%, or by enacting a VAT, or some combination of both.

This article argues that the premise upon which this argument is built is mistaken, because for individual US taxpayers (as opposed to corporations), there are significant limitations on their ability to avoid tax by moving their capital overseas. Moreover, if we focus on those taxpayers that pay the bulk of the income tax (i.e., the upper middle class and the rich), the data suggest that their ability to legally avoid taxation by expatriation is not significantly lower than their ability to evade it by

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[2] Reuven S. Avi-Yonah, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 Harv. L. Rev. 1573 (2000). The capital/labor dichotomy assumption is for example adopted in the seminal article by J.A. Mirrlees, An Exploration in the Theory of Optimum Income Taxation, 38 Rev. Econ. Stud. 175, 176 (1971), which assumes that migration is impossible, although even then Mirrlees stated that this was an "assumption one would rather not make." See below for discussion of some modern economics literature questioning the validity of the capital/labor dichotomy assumption.

[3] See Jennifer Gordon, People are not Bananas: How Immigration Differs from Trade, 104 Nw. U. L. Rev. 1109, 1113 (2010). "[T]he regulation of migration differs from its trade and investment counterparts along two dimensions: It is more restrictive and it reflects a lower level of international coordination."

[4] Edward Kleinbard, "An American Dual Income Tax: Nordic Precedents," 5 *Northwestern Journal of Law and Social Policy* 41, 43 (2010) "Under one of a dual income tax system's two tax rate schedules, capital income is comprehensively defined and taxed at one relatively low proportional (flat) rate. Under the other schedule, labor income is taxed at progressive rates in both senses of the term."

[5] Seven-Olof Lodin, The Making of Tax Law: The Development of the Swedish Tax System (2012).

moving capital, and lower income taxpayers are able to avoid both the income tax and the payroll tax (as well as any potential US VAT) by emigration. The article will then develop the policy implications, suggesting that income from labor and capital should be subject to similar rates, but that these rates should be congruent with the price the US population is willing to pay for public services.

After this introduction, part 1 of the article summarizes the previous literature on why the US should tax capital income earned by its residents, whether capital gains or dividends should be subject to lower tax rates, and what tax rate should apply to inbound portfolio investment. Part 2 of the article examines capital mobility and argues that for individual US citizens and residents, the ability to escape the income and estate taxes by moving capital overseas without moving themselves (as the capital/labor dichotomy assumption suggests) is quite limited. Part 3 argues that immigration restrictions have become much more tenuous in recent years, and that for lower income US citizens and residents, moving abroad is all that is needed to escape both the income tax and the payroll tax (as well as a potential VAT). For richer US citizens, there is the additional requirement of abandoning their US citizenship, but that too is not particularly onerous and is quite attractive from a tax perspective despite recent legal changes designed to make it less so.

Part 4 of the article then draws the policy conclusion: In the US, income from capital should be taxed at the same rate as income from labor. What that rate should be is a central issue in every US election and should be left to the US electorate to decide on the basis of how many government services they are willing to pay for.

I. Should Capital be Taxed at All?

a. The Consumption vs. Income Tax Debate

Before we address the issue of relative mobility of labor vs. capital, it is necessary to answer several preliminary questions:

1. Should income from capital be taxed at all?
2. If it should be, are there good reasons unrelated to mobility to tax capital gains or dividends at a lower rate?
3. What about taxation of income from capital earned in the US by residents of other countries, i.e., inbound portfolio investment income?

The first question is basically the one that has been the central focus of US tax literature since 1974, i.e., should the income tax (which falls on both capital and labor) be replaced with a consumption tax (which exempts at least the normal return on capital from tax but taxes wages in full). This section summarizes the previous literature on this question and concludes that the case for not taxing capital remains unproven.

The U.S. individual income tax was enacted in 1913 to replace existing consumption taxes (tariffs) on the ground that they were regressive.[6] Until World War II, it was imposed mainly on upper income taxpayers and was imposed at low rates, compared with the current individual income tax rates.[7] Even after the War, with rates soaring to 91 percent, the income tax enjoyed considerable popularity as the fairest tax.[8] However, beginning with California's tax revolt in the early 1970s, an increasing barrage of criticism has been leveled at the income tax on grounds of inefficiency and complexity.[9] At the same time, perceptions of the income tax' fairness have been undermined by the increasing use of sophisticated tax shelters by the rich to reduce or eliminate their income tax liability.[10] While the 1986 Tax Reform achieved considerable simplification of the income tax by reducing its rates and expanding its base, subsequent enactments (especially in the late 1990s) have eroded the gains of the 1986 act and have once again prepared the ground for the advocates of radical tax reform to press for replacing the income tax with a consumption tax.[11]

In the legal academic literature, the recent debate on the appropriate tax base began with Prof. William Andrews' seminal 1974 article in the Harvard Law Review, published just as the decline of the income tax was beginning.[12] Before Andrews, legal tax scholars assumed that a consumption tax had to be regressive because it is based on sales and therefore cannot take into account the personal characteristics of the buyer. Andrews, building on earlier economics literature (e.g., by Nicholas Kaldor), showed that in principle it is possible to achieve a consumption tax with a progressive rate structure built in. He did this by showing that on the basis of certain assumptions (to be explored below), allowing taxpayers to deduct all of their savings and applying graduated rates to them when they consume these savings is equivalent to not taxing the income from those savings at all. Thus, under the Haig-Simons definition of income as consumption plus the increase in savings, exempting the income from savings is equivalent to only taxing consumption.

Prof. Alvin Warren replied to Andrews by arguing that a cash flow consumption tax, as proposed by Andrews, is equivalent to an exemption of the returns to saving, and

[6] U.S. Const. amend. XVI
[7] See Michael Hatfield, Legal Ethics and Federal Taxes, 1945-1965: Patriotism, Duties, and Advice, 12 Fla. Tax Rev 1 (2012) "Although the income tax began in 1913, it was World War II that created the modern income tax"
[8] Id. at 3. "Perhaps the most important different between the income tax then and now is that the system then enjoyed broad-based and bi-partisan support while imposing an extremely high top-end marginal rate of taxation (91-94 percent for most of this period)."
[9] See Reuven S. Avi-Yonah, The Report of the President's Advisory Panel on Federal Tax Reform: A Critical Assessment and a Proposal, 59 SMU L. Rev. 551 (2006)
[10] Id. at 552.
[11] Id. at 552.
[12] See William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113 (1974).

therefore only labor income will be taxed, which he considered unfair.[13] Prof. Barbara Fried added that the supposed unfairness of taxing income "twice" (once when earned and again when it produces interest) is illusory, since it depends on using subjective utility rather than wealth as a measure of income.[14]

In the voluminous literature that followed, proponents of the consumption tax have advanced three main arguments in its favor.[15] First, they argued that it promotes efficiency by eliminating the deadweight loss from a tax on saving. Second, they argued that a consumption tax would boost national productivity by increasing national savings. Third, they argued that the consumption tax is considerably simpler than an income tax.[16]

Opponents of the consumption tax have replied that the supposed efficiency gains of the consumption tax are exaggerated and depend crucially on imposing a one-time tax on accumulated wealth at the time of the transition from the income to the consumption tax, which is politically highly unlikely to happen. Moreover, the added incentive to save under a consumption tax depends on the crucial assumption that people do not have a set savings goal, because if they do they would decrease, rather than increase, their savings rate in response to a reduction of tax on savings. Moreover, the empirical evidence is ambiguous at best on whether tax decreases boost savings.[17] Finally, the administrative advantages of the consumption tax depend crucially on its structure and may be lost if Congress builds in exemptions like it did in the income tax.[18]

In recent years, the debate has shifted to three other issues, which will be discussed more extensively below. First, proponents of the consumption tax (beginning with Profs. Bankman and Griffith in 1992 and continuing more recently with Prof. David Weisbach) have argued that the actual difference between it and the income tax is minimal because neither can reach risky returns, and risk-free returns on capital have historically been very low.[19] Second, Prof. Ed McCaffery has emphasized another point of similarity between a cash flow consumption tax and an income tax,

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[13] See Alvin C. Warren, Fairness and a Consumption-Type or Cash Flow Personal Income Tax, 88 Harv. L. Rev. 931 (1975); William D. Andrews, Fairness and the Personal Income Tax: A Reply to Warren, 88 Harv. L. Rev. 947 (1975).

[14] Barbara H. Fried, Fairness and the Consumption Tax, 44 Stan. L. Rev. 961 (1992).

[15] For these arguments see generally Joseph Pechman (ed.), What Should be Taxed, Income or Expenditure? (1980).

[16] See, e.g., David Bradford, Blueprints for Basic Tax Reform (1976); David Bradford, The Choice between Income and Consumption Taxes, 16 Tax Notes 715 (1982); David Bradford, Untangling the Income Tax (1986).

[17] B. Doglas Bernheim, Taxation and Saving, NBER Working Paper 7061 p. 5 (1999).

[18] See Pechman, supra.

[19] Joseph Bankman and Thomas Griffith, Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter? 47 Tax L Rev 377 (1992); David Weisbach, The (Non-) Taxation of Risk, 58 Tax L Rev (2004).

in that they both reach inframarginal returns (rents), and therefore they can both be used to tax the rich, but the consumption tax is fairer because it taxes people only when they use their savings to enhance their lifestyle (and not when they use them to smooth their lifetime income patterns).[20] Finally, Prof. Dan Shaviro has argued that a consumption tax can achieve the same degree of progressivity as the income tax, even though it does not appear to tax unconsumed income.[21] Thus, proponents of the consumption tax argue that since the difference between an income tax and a properly structured consumption tax is minimal, but the consumption tax is administratively simpler than the income tax, it should be preferred. More recently, Profs. Bankman and Weisbach have argued that a consumption tax is always theoretically superior to an income tax, and Prof. Shaviro has argued that this view amounts to an academic "consensus."[22]

1. Should the Income Tax be Replaced by a Consumption Tax?

In this section, I propose to address three recent arguments in favor of replacing the income tax with a consumption tax. Fundamentally, these arguments boil down to one assertion: The consumption tax is not meaningfully different than the income tax in terms of its progressivity or ability to tax the rich. Therefore, not much will be lost if the consumption tax is adopted, and the relative administrative simplicity of the consumption tax favors its adoption.

The three arguments in favor of equating the consumption and the income tax are (a) that neither can reach the returns on risky investments; (b) that both can reach inframarginal returns, and (c) that both can achieve identical progressivity. I will address each in turn. However, before turning to these arguments, it is necessary to re-examine the fundamental rationale for having an income tax in the first place.

a. Why Tax Income?

The individual income tax was adopted in the US in 1913, when the Sixteenth Amendment empowered Congress to tax incomes and overturned the Supreme Court's *Pollock* decision of 1895, which held a previous attempt to tax incomes unconstitutional as a direct tax lacking apportionment.[23] Before the Sixteenth Amendment was adopted, the federal government relied for revenues primarily on

[20] Edward McCaffery, The Fair Timing of Tax, 102 Mich. L. Rev. (2004).
[21] Daniel Shaviro, Replacing the Income Tax with a Progressive Consumption Tax, 103 Tax Notes 91 (2004); see also Mitchell L. Engler, A Progressive Consumption Tax for Individuals, 54 Ala. L. Rev. 1205 (2003); Mitchell L. Engler, Progressive Consumption Taxes, 57 Hastings L. J. 55 (2005).
[22] Joseph Bankman & David Weisbach, The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax, 58 Stan. L. Rev. 1413 (2006); Daniel Shaviro, Beyond the Pro-Consumption Tax Consensus, 60 Stan. L. Rev. 745 (2007); Joseph Bankman and David Weisbach, Consumption Taxation is Still Superior to Income Taxation, 60 Stan. L. Rev. 789 (2007).
[23] U.S. Const. amend. XVI.

tariffs and excises, which served to protect American industry from competition and were imposed on consumption goods.[24]

The principal argument in favor of replacing the consumption-based tariff system with a personal income tax was that the tariffs were regressive.[25] Since the poor consume a higher percentage of their income than the rich, a consumption tax is generally more regressive than an income tax.[26] Economic developments in the late 19th and early 20th century significantly increased the gap between rich and poor, and supporters of the income tax (primarily from the Southern and Western, more agricultural states) felt that the industrialists of the North-East had grown rich behind protective tariffs and should bear a greater part of the burden of financing the government.[27] In addition, state personal property taxes had notoriously failed to reach intangible types of property like stock and bonds, further reducing the tax burden of the newly rich railroad, steel and oil magnates.

I have argued elsewhere that the principal reason for taxing the rich today is similar to one of the major reasons why the personal and corporate income taxes were enacted in the early 20th century: Both were perceived as having the potential of curbing excessive accumulations of political, economic and social power by the rich.[28]

There are two principal arguments why a liberal democratic state should curb excessive accumulations of private power. The first is the argument from *democracy*: In a democracy, all power should ultimately be accountable to the people. Private accumulations of power are by definition unaccountable, since the holders of power are neither elected by the people nor have their power delegated from the people's representatives. In fact, the American Revolution was founded on the conception that while people have natural, Lockean liberal rights to their property, undue concentrations of private power and wealth should be discouraged. This view found its expression in the republican creed of civic humanism, which emphasized public virtue as a balance to private rights. A virtuous republic, the

[24] See Gregory L Germain, Taxing Emotional Injury Recoveries: A Critical Analysis of Murphy v. Internal Revenue Service, 60 Ark. L. Rev. 185 (2007)"A careful review of tax history shows that the Supreme Court repeatedly recognized Congress's ability to tax transactions, whether involving the proceeds form sale or exchange of property or the proceeds from the using of human capital, as duties or excises long before the Sixteenth Amendment was adopted." (Pg 192).
[25] See Avi-Yonah supra note 9.
[26] See Brian Galle and Manuel Utset, Is Cap-and-Trade Fair to the Poor? Shortsighted Households and the Timing of Consumption Taxes, 79 Geo. Wash. L. Rev. 33 (2010) (Pg 42).
[27] See Stephanie Hunter McMahon, A Law with a Life of Its Own. The Development of Federal Income Tax States Through WWI, 7 Pitt. Tax Rev. 1 (2009) (Pg 20).
[28] The following is based on Reuven S. Avi-Yonah, Corporations, Society and the State: A Defense of the Corporate Tax, 90 Va. L. Rev. 1193 (2004); see also Reuven S. Avi-Yonah, Why Tax the Rich? Efficiency, Equity, and Progressive Taxation (Review of Joel Slemrod (ed.), Does Atlas Shrug? The Economic Consequences of Taxing the Rich, 2001), 111 Yale L J 1391 (2002).

Founders believed, was to be free from concentrations of economic power such as characterized England in the 18th century. Therefore, from the beginning of the republic, federal and state legislators used taxation to restrict privilege and to "affirm communal responsibilities, deepen citizenship, and demonstrate the fiscal virtues of a republican citizenry." As Dennis Ventry has written, "[t]he ideal of civic virtue created a unique form of ability-to-pay taxation that was hostile to excess accumulation and to citizens who asserted entitlement through birth…Inherited wealth, as well as gross concentrations of wealth (inherited or not), characterized an aristocratic society, not a free and virtuous republic."[29] In the 20th century, the same view was best expressed in the corporate context by Berle, who wrote that in a democracy like the United States "it becomes necessary to present a system (none has been presented) of law or government, or both, by which responsibility for control of national wealth and income is so apportioned and enforced that the community as a whole, or at least the great bulk of it, is properly taken care of. Otherwise the economic power now mobilized and massed under the corporate form… is simply handed over, weakly, to the present administrators with a pious wish that something nice will come of it all."[30]

The other principal argument against excessive private power is based on a liberal conception of *equality*. Michael Walzer has explained that when liberals talk about equality, they are not concerned with "simple equality", i.e., equalizing everyone's initial means.[31] Instead, they are advocating "complex equality," by which Walzer means that every social "sphere" should have its own appropriate distributive principles and that possession of goods relevant to one sphere should not automatically translate into dominance in other spheres as well. "In formal terms, complex equality means that no citizen's standing in one sphere or with regard to one social good can be undercut by his standing in some other sphere, with regard to some other good."[32] In our capitalist society, money is the "dominant good", and the people who possess it are the most likely to accumulate illegitimate power in other spheres, such as politics. "This dominant good is more or less systematically converted into all sorts of other things- opportunities, power, and reputation."[33] Walzer goes on to explain the insidious effects of money and why it needs to be curbed by redistribution, including redistributive taxation:

> Market imperialism requires another sort of redistribution, which is not so much a matter of drawing a line as of redrawing it. What is at issue now is the dominance of money outside its sphere, the ability of wealthy men and women to trade in indulgences, purchase state offices, corrupt the courts, exercise political power…the exercise of power belongs to the sphere of politics, while what goes on in the market should at least approximate an

[29] Dennis J. Ventry, Equity Versus Efficiency and the US Tax System in Historical Perspective, in Tax Justice: The Ongoing Debate (Thorndike & Ventry, eds., 2002), 28.
[30] A. A. Berle, For Whom Corporate Managers Are Trustees, 45 Harv L Rev 1365, 1368 (1932).
[31] Michael Walzer, Spheres of Justice: A Defense of Pluralism and Equality (1983).
[32] Walzer, at 19.
[33] Id., at 12.

> exchange between equals (a free exchange)…When money carries with it the control, not of things only but of people, too, it ceases to be a private resource.[34]

Nor, as we have noted above, is the power of money limited to direct political power:

> It would be a mistake to imagine, however, that money has political effects only when it "talks" to candidates and officials…It also has political effects closer to home, in the market itself and in its firms and enterprises…Even within the adversary relation of owners and workers, with unions and grievance procedures in place, owners may still exercise an illegitimate kind of power. They make all sorts of decisions that severely constrain and shape the lives of their employees (and their fellow citizens, too). Might not the enormous capital investment represented by plants, furnaces, machines, and assembly lines be better regarded as a political than an economic good? To say this doesn't mean that it can't be shared among individuals in a variety of ways, but only that it shouldn't carry the conventional entailments of ownership. Beyond a certain scale, the means of production are not properly called commodities… for they generate a kind of power that lifts them out of the economic sphere.[35]

Walzer thus advocates taxation as one means of restricting the market to its proper sphere (along with trade unions and limiting property rights). But he also recognizes the inherent limitations of all redistribution, since his aim is not to abolish the market: "All these redistributions redraw the line between politics and economics, and they do so in ways that strengthen the sphere of politics- the hand of citizens, that is, not necessarily the power of the state…But however strong their hand, citizens can't just make any decisions they please. The sphere of politics has its own boundaries…Hence redistribution can never produce simple equality, not so long as money and commodities still exist, and there is some legitimate social space within which they can be exchanged."[36]

The personal income tax is one means by which the state can regulate the accumulation of private power. As I have argued elsewhere, the tax achieves this function in two ways: by directly limiting the rate of private wealth accumulation (the "*limiting function*"), and by providing incentives and disincentives to particular activities by the rich (the "*regulatory function*"). For reasons explained below, both functions are necessary and related to each other, in the same way that both a brake and a steering wheel are necessary for driving a car.[37]

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[34] Id., at 120-21.
[35] Id., at 121-22.
[36] Id., at 122-23.
[37] See Avi-Yonah, Corporations, Society and the State, supra, 1246-1249.

First, the limiting function: Imagine first a 100% tax imposed on profits. Over time, such a tax would eliminate all sources of the power of the rich, since it would force them to use their existing resources to pay politicians and employees, and it would remove any incentive to accumulate further wealth. The power to tax is indeed potentially the power to destroy.

But a 100% tax is inconceivable. Taxation faces an inherent limit that was well expressed by Holmes when he stated that "the power to tax is not the power to destroy while this court sits." The constitution places limits on the power to tax, limits that are implicit already in *Dartmouth College*: The public sector may not use taxation to completely eliminate the private one. This is both a matter of constitutional law (a tax may be a taking if the rate exceeds any reasonable estimate of the state's contribution to private wealth creation) and a matter of practicality: We do not want to kill the goose that lays the golden eggs by imposing taxation at rates that create huge deadweight losses to the economy at large (the deadweight loss is approximately a square function of the tax rate). The precise limit of desirable taxation thus becomes the quintessential political question of our time, to be refought every four years at the ballot box.

Given that we cannot tax at 100%, what is the effect on private power of a lower tax rate, such as the current 39.6%? Even at that historically low rate, the income tax does significantly slow down the accumulation of private resources, which are the foundation of private power. For example, imposing a tax at 39.6% on assets invested at a 10% yield (compounded annually) over ten years results in approximately 27% less assets being available at the end of the period than would be available in the absence of the tax. Thus, taxation at lower rates can meaningfully restrict the build-up of assets that forms the base of the power of the rich, even when it does not destroy it. But since that power will continue to exist and grow at any reasonable rate of taxation, we also need the tax to perform a regulatory function.

Second, the regulatory function: The use of assets by the rich (i.e., their use of its power) may be impacted by the threat that the tax rate will be raised if it is perceived that the assets are not used for the betterment of society. This can be seen by the imposition of higher effective rates on certain forms of behavior Congress disapproved of, like bribes paid to foreign officials and participation in international boycotts.[38] In both cases, empirical research has suggested the tax penalties had a significant impact.[39] More recently, the threat of increased tax rates applied to US

[38] See I.R.C 999 (c) (1)

[39] See I.R.C 162 (c) (1); See James R. Hines, *Taxed Avoidance: American Participation in Unsanctioned International Boycotts.* NBER Working Paper, no. 6116. Cambridge, MA: National Bureau of Economic Research, Working Paper, 1997; id., *Forbidden Payment: Foreign Bribery and American Business After 1977*. NBER Working Paper,

corporations that moved their nominal place of incorporation to Bermuda seems to have sufficed to block one such "inversion" transaction and stop other corporations from adopting the same strategy.[40] Thus, it seems that taxation even at rates much less than 100% can suffice to regulate private power. But the rates cannot be set too low, because then the rich would not care sufficiently to avoid the tax. This is why we need the limiting function (i.e., set rates at sufficiently high levels for management to notice) for the regulatory function to work properly.

Finally, in addition to providing disincentives, the tax can be used to provide incentives as well. For example, investment incentives are provided as a way of bolstering the economy.[41] Another example is research and development, which has been shown by economists to produce significant positive externalities for society, which justify government in providing a subsidy via the tax code.[42] Now it is of course true that the government could subsidize these functions directly, rather than use tax expenditures, so that this cannot strictly be an argument for taxing the rich. However, that would require setting up an IRS-like agency to monitor the use of the subsidies, so that any simplification advantage from abolishing the income tax is diminished. And once the income tax is in place, it seems like an obvious and convenient vehicle to deliver the desired subsidies at little additional cost.[43]

Is the income tax the best vehicle for curbing excessive private power accumulation? An obvious alternative vehicle would be a direct wealth tax. However, in addition to concerns on its constitutionality, political experience since 1972 has shown that the American people are very averse to paying taxes on property, as indicated by the wave of property tax limitations and the near death experience of the estate tax.[44] Thus, the income tax remains the best way of reaching the sources of power of the rich, assuming that it can do so.

b. Risk: Is There a Meaningful Difference?

Can the income tax in fact tax the rich, or to put it another way, can it tax income from capital? If it cannot, then a strong argument can be made for replacing it with a consumption tax on administrative grounds, since if income from capital cannot be taxed an income tax has the same base as a consumption tax but is immensely more complicated (e.g., because it needs to account for basis).

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no. 5266. Cambridge, MA: National Bureau of Economic Research, Working Paper, 1995.

[40] See Steven H Goldman, Corporate Expatriation: A Case Analysis, 9 Fla Tax Rev. 71 (2008) (Pg 102)
[41] See Avi-Yonah supra note 9 at 559.
[42] Id., at 559.
[43] See David Weisbach & Jacob Nussim, The Integration of Tax and Spending Programs, 113 Yale L.J. 955 (2004).
[44] See Avi-Yonah supra note 9 at 559.

Beginning with Bankman and Griffith in 1992, a significant body of legal literature has argued that in fact the difference between income and consumption taxes is minimal, and therefore the consumption tax should be preferred on administrative grounds. Most recently, David Weisbach has argued that "a Haig-Simons tax is basically the same as a consumption tax (which imposes a zero tax on capital), and the debate between the two tax bases is not particularly meaningful. The decision might best be made on administrative grounds rather than on deep philosophical arguments about the proper distribution of the tax burden."[45]

The argument relied on by Bankman, Griffith, and Weisbach is based on an observation made by Domar and Musgrave in 1944, and expanded by many economists since then. Domar and Musgrave pointed out that if an individual is subject to (say) a 50% income tax on risky returns, he can eliminate that tax by increasing the amount invested, since the government shares equally in both his gains and his losses. Thus, suppose the individual makes a bet of $100 with an equal chance of winning and losing (e.g., a coin flip). Before tax, the individual would receive $100 if he wins and would pay $100 if he loses. If the government imposes a 50% Haig-Simons income tax, the individual would only receive $50 if he wins (since he pays $50 in tax to the government) but would only lose $50 if he loses (since the government would in effect pay him $50 by allowing him to deduct the $100 loss at a 50% tax rate). But if he could double the bet to $200, he would get $100 if he wins and pay $100 if he loses, putting him in the same position he was in if the tax was not imposed at all.

Bankman, Griffith and Weisbach expand this proposition to argue that a Haig-Simons income tax cannot be imposed on risky returns. They then go on to demonstrate that if the income tax can only be imposed on risk-free returns, since these have historically been very low (around 0.5%), the difference between an income tax and a consumption tax is so minuscule as to not be worth the argument.

Various commentators have recently taken issue with this line of argument. Thus, Prof. Reed Shuldiner argues that the model is misleading for several reasons.[46] First, in the case of investments rather than bets, grossing-up the investment is not costless: it involves both transaction costs and credit risk, since even rich individuals cannot borrow at the risk free rate of return. Second, he argues that the risk-free rate used by Bankman and Griffith is too low, because they used the period 1945-1972, in which unexpected inflation was high; from 1972 to 1999 the risk-free rate was 1.5% and from 1802 to 1997 it was 2.9%. Moreover, the term of the rate is important: it should match the term of the investment, and the real risk-free rate for 1972-1999 on ten year investments was 3.3%. Thus, the difference between the income and consumption tax, even on the assumptions underlying the Domar-Musgrave model, is more significant than previous commentators have assumed.

[45] Weisbach, supra; see Bankman and Griffith, supra.

[46] Reed Shuldiner, Taxation of Risky Investments, unpublished Ms. On file with author.

In addition, both Shuldiner and Prof. Larry Zelenak point out that the key assumptions underlying the model may not be accurate.[47] First, individuals do not always behave with the kind of perfect rationality assumed by the Domar-Musgrave analysis. Second, we do not have a Haig-Simons income tax, as assumed in the model, because there are various loss limitations imposed by the income tax.

First, individual behavior: Various empirical studies have attempted to examine whether individuals adjust their portfolios in the ways required for the Domar-Musgrave analysis to be correct. Weisbach surveys this literature and concludes that "the empirical evidence is insufficient to sway us one way or another."[48] More broadly, economists have studied generally how sensitive the behavior of the rich is to taxes and concluded that in many cases that sensitivity is surprisingly low. For example, in most of the empirical studies in Joel Slemrod's book on taxation and the rich, the expected tax avoidance behavior either did not materialize or was lower than expected.[49] There are many considerations that influence individual behavior beyond taxes, and transactions costs make a difference as well. Since the consumption tax advocates are using the Domar-Musgrave result to advocate a radical change in our tax law, it seems to me that the burden should be on them to show that the risky returns are in fact not reached by the income tax, rather than (as Weisbach suggests) on the advocates of the income tax to show that the Domar-Musgrave model is incorrect.

Second, loss limitations: The existing income tax imposes various limitations on losses, such as the at-risk, passive activity, and capital loss limitations. In addition, it imposes graduated (progressive) tax rates, so that losses can sometimes be deducted at different rates than the rates applied to income. All of these limitations violate the Domar-Musgrave assumptions and result in a positive tax rate being imposed on the return to risk under the existing income tax.

Various critics have rejected this argument on the ground that it is hard to find a normative justification for the particular pattern of taxing risk imposed by these limitations, except perhaps for progressive rates. In addition, Weisbach argues that this issue is irrelevant because the debate is about comparing Haig-Simons taxation to a consumption tax, not about the current income tax.

However, the key question in this debate is not whether we do or do not have a perfect income tax. The key issue is whether the existing income tax succeeds in taxing the rich in ways that a real consumption tax would not. A tax is just a means to an end, not an end by itself. If the purpose of having an income tax like the one we

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[47] Shuldiner, supra; Larry Zelenak, The Sometimes-Taxation of the Returns to Risk-Bearing Under a Progressive Income Tax, 59 SMU L. Rev. 879 (2006).

[48] Weisbach, supra. See also the empirical study by Terrence R. Chorvat, The Effect of Taxation of Risky Income on Investment Behavior (2005) (finding no confirmation of Domar/Musgrave model in pilot experiment using law students).

[49] See Joel Slemrod (ed.), Does Atlas Shrug? The Economic Consequences of Taxing the Rich (2001).

have is to tax the rich, as argued above, the key issue is whether it succeeds in doing so.

There is abundant empirical evidence that the income tax does in fact tax the rich. First, according to 2001 IRS data, the top 1% of the US population by adjusted gross income paid 33.89% of federal personal income tax, and the top 5% paid 53.25% (by comparison, the bottom 50% of the AGI distribution paid less than 4% of total income taxes collected). This is a significant increase from 1994, when the top 1% of taxpayers only paid 28.7% of federal personal income tax.[50] In 2004, even after President Bush's tax cuts, the top 1% still paid 32.3% of federal individual income taxes and the top 5% paid 53.7%.[51] Since (as indicated below) a very large portion of the income of the rich consists of risky returns, it is hard to explain these patterns if risky returns are in fact exempt from tax. In 2008, the top quintile paid 94.6% of federal individual income taxes, the highest percentage since 1979.[52]

Second, it appears likely that these significant payments by the rich are in large part the result of taxing risky returns to capital, not labor income or non-risky returns. There is a strong correlation between wealth and the percentage of an investor's portfolio allocated to risky assets, so that it is likely that a significant portion of the rich's income derives from risky assets. Specifically, the percentage of income from equity investments (dividends and capital gains), which are the most common type of risky asset, increases from 4% for taxpayers with income of $100,000 or less, to 11.5% for taxpayers with income from $100,000 to $500,000, 24.7% for income between $500,000 and $1 million, 37.6% for income between $1 and $10 million, and an impressive 61.4% for taxpayers whose income exceeds $10 million.[53] Another indication that the income tax does reach risky returns is that total revenues from the federal personal income tax rose dramatically in the internet bubble of the late 1990s, and fell dramatically as the bubble burst in 2000. Most of that rise and fall is attributable to realizations of risky assets in the bubble years.

It is not entirely clear *why* the return to risky assets is taxed under the existing income tax. A combination of loss limitations and limitations on investor behavior (such as transaction costs, credit risk, and myopia) may explain the observed pattern. However, the key issue is not why this result occurs but that in fact it occurs. The burden should be on the advocates of radical tax reform to show that the existing income tax (and not some theoretical construct like Haig-Simons) in fact fails to tax the rich on risky returns. It is after all the existing income tax that they seek to replace, not some ideal tax. If they can show that the top 1% by AGI will continue to bear over a third of the total burden of a consumption tax, then the reform would be more acceptable to those who believe in taxing the rich for the reasons stated above (or any other reasons).

[50] Joint Economic Committee, New IRS Data on Income and Tax Shares (2001).
[51] Congressional Budget Office (2004).
[52] Kirk Stark and Eric ZSolt, Tax Reform and the American Middle Class, 2013.
[53] Tax Policy Center (2004).

Moreover, it seems to us that this distribution of the burden makes the existing income tax normatively attractive even if its particular rules operate in sometimes erratic ways. Thus, I disagree with Profs. Deborah Schenk and Larry Zelenak, who argue that the existing tax on capital is too unpredictable to be normatively attractive.[54] We should look at the tax burden and its meaning from an aggregate, not from an individual perspective. A tax that is as progressive *in its overall outcome* as the existing income tax is worth defending even if its rules lead to strange results in individual cases. The key issue is the ultimate burden imposed on the rich, not the particular rules of the tax (progressivity, loss limitations, and the like).

Finally, a word of caution is in order. The risk argument advanced by Bankman, Griffith and Weisbach bears a lot of similarity to the argument used (e.g., by Weisbach) to justify the adoption of the "check the box" rule in 1997 for classifying foreign entities as branches, partnerships, or corporations. Weisbach and others argued that taxpayers can in fact achieve any result they want under the existing classification rules, so that it would save administrative costs to replace these rules with a simple election.[55] The results of this radical reform were catastrophic: it turns out that a vastly higher number of taxpayers made check the box elections and used classification to avoid the international tax rules. Apparently, there were significant transaction costs imposed under the pre-1997 regime that prevented taxpayers from achieving like results. This episode should lead us to be very cautious in relying on theoretical constructs like the Domar-Musgrave model to advocate replacing the income tax with a consumption tax because they are "just the same." For whatever reasons, the current income tax succeeds in taxing the rich. It is highly doubtful that any consumption tax would achieve the same outcome (although as we will see below, some are better than others).

c. Rents: Pre-paid vs. Post-paid Taxes

Much of the consumption tax literature relies on the familiar Cary Brown theorem, which is studied in every basic tax class.[56] The Cary Brown theorem demonstrates the theoretical equivalence, under certain assumptions, of pre-paid and post-paid consumption taxes in exempting the return to capital from tax. In a pre-paid tax, the tax is paid when the income is earned, just as in an income tax, but investment returns are exempt from tax. In a post-paid tax, a deduction is available for savings, so that income that is saved is not taxed, but investment returns are taxed when they are consumed.

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[54] See Zelenak, supra; Deborah H. Schenk, Saving the Income Tax with a Wealth Tax, 53 Tax L Rev 423 (2000).

[55] See David Weisbach, Line Drawing, Doctrine, and Efficiency in the Tax Law, 84 Cornell L Rev 1627 (1999).

[56] See Daniel Shaviro, Replacing the Income Tax with a Progressive Consumption Tax, 103 Tax Notes 1 (2004) (pg 99).

To take a common example, suppose taxpayer earns 100 subject to a tax of 50% and can invest it in a bond earning 10% per year. Under an income tax, the 100 of earnings are subject to tax of 50, and the remaining 50 are invested in the bond, yielding 55 after 1 year; the 5 of interest is subject to income tax (Mill's "double tax") leaving the taxpayer with only 52.5.

In a pre-paid consumption tax, the 100 of income is subject to tax of 50 when earned. The remaining 50 are invested in the bond, but when the additional 5 of interest is earned, they are exempt from tax, so that the taxpayer is left with 55.

In a post-paid consumption tax, the 100 of income are saved, and the resulting deduction eliminates the tax on the 100, so that the taxpayer can invest the entire 100 in the bond. However, when the bond is sold for 110 a year later and the 110 are consumed, they are subject to tax at 50%, leaving the taxpayer with the same 55 as in the previous example.

Hence, the Cary Brown theorem demonstrates that pre- and post-paid consumption taxes are equivalent, and both exempt the 5 return on the bond from tax. Since income from capital is exempt, under the Haig-Simons definition of income, both pre- and post-paid consumption taxes are also theoretically equivalent to a direct tax on consumption like the Retail Sales Tax.

The Cary Brown theorem makes two important assumptions. The first is that tax rates do not change between the time the income is saved and the time it is consumed. If the tax rate changes, the equivalence of pre- and post-paid consumption taxes does not hold, since a pre-paid tax applies the rate at the beginning of the year and a post-paid tax the rate at the end. However, this assumption may not matter too much since rates can either increase or decrease over time, so that it is unclear which form of the tax is more beneficial to the taxpayer.

The other assumption, however, has clear implications. That is the assumption that the taxpayer can invest the savings from taking the tax deduction in a post-paid tax at the same rate as the underlying investment. This holds true when the investment is a commonly available one like a bond, yielding what the economists call marginal (normal) returns. However, suppose the underlying investment is in a unique business opportunity, yielding what the economists call infra-marginal (extraordinary) returns, or rents. In that case, the investor may not be able to invest the tax savings at the same rate as the underlying investment because the size of the unique investment opportunity is limited, and the Cary Brown equivalence does not hold.

For example, suppose in the example above the underlying investment yields a 50% return but the tax savings can only be invested in a bond earning 10%. In a pre-paid tax, the taxpayer earns 100, pays 50 in tax, and invests the other 50 in the high-yielding opportunity, resulting after a year in a 25 return exempt from tax, for a net

after-tax of 75. In a post-paid tax, the investor earns 100 and does not pay tax because of the deduction for savings; however, of the 100, only 50 can be invested at a return of 50%, and the other 50 (the tax savings) are invested at 10%. The result is a yield after a year of 75 from the underlying investment and 55 from the tax saving, for a total of 130, and when these are consumed and are subject to tax at 50%, the taxpayer nets only 65. To put it another way, in a post-paid tax, only the normal yield is exempt from tax; the extraordinary yield is fully taxable.

Ed McCaffery uses this result to argue for a post-paid consumption tax.[57] In his view, such a tax is superior to an income tax because it does not tax the normal return to savings, but it is also superior to a pre-paid consumption tax because it does reach extraordinary returns to savings when they are consumed. Or to put it in other terms, the tax is deferred when savings are used to smooth income over a lifetime, but imposed when the savings are consumed above the return necessary for such smoothing.

While I disagree with McCaffery about taxing unconsumed earnings, for the reasons explained above (and elaborated further below), I agree with him regarding the superiority of post-paid over pre-paid consumption taxes because of their ability to reach rents. Rents should be subject to high taxation in part because they are hard to replicate (and thus the deadweight loss from taxing them is small) and in part because they depend on luck (such as the distribution of various talents). The key issue is how common are such rents. There is an abundant literature that suggests that rents are common for corporations, and that may be why most serious consumption tax proposals (but not some of them) support a post-paid (cash flow) consumption tax for corporations.

However, there is also evidence that in a "winner take all" society, rents are commonly earned by individuals as well.[58] Consumption tax advocates sometimes argue that such rents are a form of labor income, not income from capital.[59] Thus, the extraordinary returns earned by Bill Gates or Warren Buffett presumably result from their skill and luck and not primarily from capital invested (which in the case of Gates was minimal). However, it seems to me immaterial whether such rents earned by individuals are capital or labor income. They key issue is to ensure that they are taxed, and while the current income tax does not do a very good job in taxing them (primarily due to the realization requirement), it does a better job than a pre-paid consumption tax that exempts such rents altogether.[60] Whether a post-paid consumption tax can reach them depends on whether they are in fact consumed, which we will discuss below.

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[57] McCaffery, supra.
[58] See Jason Bordoff and Jason Furman, 2 Harv. L. & Pol'y Rev. 327 (Pg 350)
[59] Id at 350
[60] Of course, it might be a good idea to improve the existing income tax by marking to market publicly traded securities and derivatives whose value is easy to ascertain, like the assets held by Gates and Buffett. See David Miller, A "Progressive" Mark-to-Market System of Taxation (2005).

d. Regressivity: Can a Consumption Tax Achieve the Same Progressivity as an Income Tax?

Many consumption tax advocates argue that a properly structured consumption tax can be just as progressive as the income tax. The most promising candidate from this perspective is a post-paid consumption tax, because as we have seen it can impose progressive rates on both labor income and on rents when those are consumed. On the other hand, transactional consumption taxes like the RST cannot generally be progressive since they are imposed at a uniform rate and since the poor consume a higher proportion of their income than the rich. Nor can pre-paid consumption taxes be as progressive because they exempt rents even when those are consumed.

The key issue regarding regressivity is whether any consumption tax, even a post-paid one, can be as progressive as an income tax given that it does not by definition reach income that is not consumed. The super-rich do not consume a significant portion of their income during their lifetime, and an income tax can in principle tax these earnings (or at least the risk-free portion of them) whereas even a post-paid consumption tax does not.[61]

Dan Shaviro argues that this perception is mistaken because a consumption tax will always tax income whose consumption is deferred, even if it is deferred for a long time. He gives an example of taxpayers A and B who both consume $100,000 in a given year, but A has spent everything she earned whereas B has saved $1 million in the bank. Assuming a 50% consumption tax rate and 10% interest rate, A presumably earned $200,000 and B earned $1.2 million, and each paid $100,000 in tax. B's remaining $1 million grows to $1.1 million and when it is consumed B pays $550,000 in tax. Shaviro points out that this is the same additional $500,000 in tax liability B would have had had she consumed everything in year 1, increased by the interest rate of 10% to take into account the one year deferral. Thus, A and B are in fact treated the same.

More generally, Shaviro argues that any income is only worth what it can buy; "otherwise, it might as well be play money from the board games Monopoly or Life." Thus, it is wrong to argue that a consumption tax fails to reach the indirect benefits of wealth-holding, such as security, political power, or social standing; this non-sequitur "appears to rest on money illusion, or the mistaken belief that a dollar has inherent value, rather than being worth what it can buy."[62]

However, this argument ignores the fact that money can be used for other things than consumption. Most importantly, it can be used to acquire investments- both financial and real, such as manufacturing plants. And the key point made above is

[61] Theoretically, leaving accumulated wealth to one's heirs can be defined as a form of consumption, but none of the current consumption tax proposals does so.
[62] Shaviro, supra.

that the power of the rich, which is (in my view) the principal target of the income tax, rests primarily on their ability to invest, not to consume. For example, it is the ability of corporations to choose which locations to open plants and create jobs that makes politicians so solicitous of their welfare- more, in fact, than their direct political contributions. But even in the case of political contributions, it is unclear whether those will be reached by a consumption tax, since it can persuasively be argued that these are a form of investment rather than consumption. Thus, a consumption tax will only reach the small percentage of the power of the rich that depends directly on their ability to consume, such as their personal employees or businesses that provide consumer goods to them. It will not reach the much larger percentage of their power that depends on their ability to invest.

Theoretically, therefore, no consumption tax can achieve the goals of progressivity, which we have argued above are to curb the power of the rich, as well as an income tax. This does not mean that the current income tax does a very good job, although it appears from the data cited above to be quite progressive. Perhaps a consumption tax that taxes labor income at sharply graduated rates and also reaches actual consumption of saved income can be as progressive as the current income tax.[63] However, the burden should be on consumption tax advocates to show that this is indeed the case; the distributive tables of President Bush's steps toward a consumption tax suggest otherwise.[64] In addition, the income tax, because it reaches unconsumed income, can be made more progressive in ways that a consumption tax cannot, because it can reach the main source of the power of the rich- their unconsumed wealth.[65]

e. **Is an Ideal Consumption Tax Superior to an Income Tax?**

Professors Bankman and Weisbach have recently argued for the superiority of an ideal consumption tax over an ideal income tax on three grounds: First, that the consumption tax is more efficient because it does not discriminate between current and future consumption, while both income and consumption taxes have identical effect on work effort. Second, that the consumption tax is at least as good at redistribution as the income tax, and thus can equally satisfy vertical equity. Third, that the consumption tax is easier to administer than the income tax because it makes no attempt to tax income from capital and thus can omit many of the vexing complications that arise from such an attempt, like accounting for basis.[66]

The argument in regard to redistribution is addressed above. In regard to efficiency, Bankman and Weisbach rely on a 1976 paper by Atkinson and Stiglitz, to argue that it is incorrect to claim (as Jane Gravelle does, for example, in The Taxation of Capital

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[63] One should note, however, that the sharply graduated rates of such a tax come at a price, namely increased pressure on the labor/leisure tradeoff.
[64] See Avi-Yonah supra note 9.
[65] On ways to do this see Miller, supra.
[66] Joseph Bankman and David A. Weisbach, The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax, supra.; but see Reuven S. Avi-Yonah, The Three Goals of Taxation, 60 Tax L. Rev. 1 (2007).

Income (1994)) that there is a trade-off between reducing the disincentive to save by adopting a consumption tax, and reducing the incentive to work by increasing taxes on wages (to replace revenue lost as a result of exempting income from savings).[67] Bankman and Weisbach argue that this is untrue because the tax on income from savings also reduces work effort. But it is quite plausible to assume that people systematically value future taxes less than current taxes by more than the time value of money, and if so, the current tax on wages will reduce work effort more than the present value of the future tax on savings. Bankman and Weisbach seem to acknowledge this ("perhaps one can offer various psychological theories for why people misperceive the effect of various taxes"), but dismiss it because "the trade-off theory purports to apply classical economics."[68] However, the debate is about effects in the real world of replacing the income tax with a consumption tax, not in some ideal realm of classical economics.

Similarly, the argument in regard to administrability depends crucially on the actual consumption tax that will be adopted- the experience of other countries with the VAT indicates it has significant problems of complexity and administrability. David Gamage has recently pointed out that if one assumes that the transaction costs of avoiding taxes increase with the amount of tax to be avoided, then having two taxes with lower rates (income tax and VAT, for example) is superior to having only one tax at a higher rate, because taxpayers will then have an incentive to incur those higher transaction costs.[69]

The most recent contributions to this debate are two chapters in the UK Mirrlees Review, a comprehensive analysis of the UK tax system that resulted in two thick volumes, *Dimensions of Tax Design*[70] (review and analysis) and *Tax by Design*[71] (recommendations). Interestingly, these two volumes reach opposite conclusions regarding the desirability of taxing the normal return to capital (they agree that taxing rents is desirable). The chapter on capital income taxation in the first volume, by Banks and Diamond, summarizes recent economics literature and concludes that the case for not taxing capital income is not at all obvious in light of the many possible roles that capital income taxes might play. Banks and Diamond point out that the efficiency gains from moving to a consumption tax rely on not having any transition relief, which may be politically impossible; that the distortions of taxing capital may be minimized by the fact that a capital income tax may only reach the risk-free rate of return; that market imperfections may make capital income taxation more attractive; and that capital income may be an indicator of ability, even given labor income. This last argument, first developed by Saez, has been emphasized in recent work by Dan Shaviro and others. In addition, it can be argued

[67] Anthony B. Atkinson and Joseph E. Stiglitz, The Design of Tax Structure: Direct versus Indirect Taxation, 6 J. Pub. Econ. 55 (1976).

[68] Bankman & Weisbach, fn. 23; see also Shaviro, Beyond the Pro-Consumption Tax Consensus, supra.

[69] David Gamage, Optimal tax theory meets tax avoidance: A tentative defense of 'double taxation', working paper (2008).

[70] See Dimensions of Tax Design: The Mirrlees Review, Oxford University Press, © 2010, Oxford

[71] See Tax by Design, The Mirrlees Review, Oxford University Press, © 2011, Oxford

that taxing the returns to saving, by discouraging private saving, can help implement progressive labor income taxes by making it more painful for people with high ability not to work.

In the second volume of the Mirrlees Review, the editors summarize these findings by stating that—

> All of these arguments are well founded in economic theory. They justify levying some tax on the normal return to capital, though not necessarily at full income tax rates, as in a comprehensive income tax. However, there are several reasons to be cautious in applying these arguments immediately to policy.[72]

These reasons for caution, the editors argue, are that it is hard to know what the capital income tax rate should be, and not clear that having a small positive capital income tax rate provides sufficient benefit to justify the complexity of implementation. Thus, the editors of *Tax by Design* recommend not taxing the normal return to capital, contradicting the recommendation by Banks and Diamond in *Dimensions of Tax Design.*

If Nobel-Prize winning economists cannot agree on whether income from capital should be taxed and at what rate, then surely reasonable minds can differ on this question. But a radical reform such as switching from income to consumption taxation should require a high level of consensus. Moreover, as a practical matter, it seems unlikely that any of this economic analysis will lead to replacing the US income tax with a consumption tax. Even the 2005 Bush tax reform commission was unable to reach a consensus on exempting the normal return to capital from taxation.[73]

Instead, it is much more likely that the US will follow all the other members of the OECD and enact a consumption tax (the VAT) in addition to, and not as a replacement of, the income tax. Such a low rate VAT could be used to fund the entitlement programs, whose costs are the main medium- and long-term threat to our fiscal stability. The arguments for adopting an add-on VAT have been developed elsewhere.[74]

b. Taxation of Capital Gains

[72] Id., at 313
[73] See The President's Advisory Panel on Federal Tax Reform-Final Report, http://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_1_11-1.pdf (pg xiv)
[74] See Reuven S. Avi-Yonah, Symposium on Designing a Federal Vat: Part I: Summary and Recommendations, 63 Tax L. Rev. 285 (2010)(Pg 285).

Even if the consumption tax option is rejected, there may be other reasons to subject certain forms of income from capital to a lower rate than labor income. Specifically, we have usually taxed long-term capital gains at a lower rate than ordinary income. In addition, we have recently extended this lower rate to dividends as well. Are these departure from the norm justified? I will address each in turn.

There are four reasons why we may want to apply a lower rate to long-term capital gains than to ordinary income, as we have in fact done for most of the past century with the exception of 1986-1991. The first three stem from the realization requirement. If capital gains are only taxed upon realization, then (a) there is a "lock in" effect because taxpayers are reluctant to sell appreciated assets and trigger the capital gains tax, (b) some of the gain, especially on long-term assets, is illusory because we do not index basis to inflation; and (c) "bunching" the entire gain in one year (upon realization) may cause taxpayers to move to a higher tax bracket in a progressive tax system.[75]

However, none of these reasons strike me as persuasive, because they can all be dealt with by the relatively simple method of adopting a mark to market tax regime. Under mark to market or accrual taxation, there is no lock in effect because taxpayers pay tax (and basis increases) on the annual fluctuation in value of their assets. There is no gain due to inflation because all assets are taxed currently. And there is no bracket creep because there is no bunching of gain in the year of sale.

As David Miller and others have shown, such a mark to market system is perfectly feasible for most assets, because valuation and liquidity are not an issue for most asset types.[76] The big exception is owner occupied housing, but we exempt most such housing gains from capital gains tax in any case.[77]

The fourth reason rests on the assertion that cutting capital gains taxes helps capital formation and increases investments. I have seen no persuasive empirical evidence that this in is fact the case.[78] Recent studies in behavioral economics have suggested that institutional factors matter more in promoting savings than the tax rate on capital income, and that a series of specific tax-favored savings promotion schemes may be as or more effective in promoting savings as a broad-based consumption tax.[79]

c. Taxation of Dividends

[75] See George K Yin, Principles and Practices to Enhance Compliance and Enforcement of Personal Income Tax, 31 Va. Tax Rev. 381 (2012) (Pg 399)
[76] See David S Miller, A Progressive System of Mark-to-Market Taxation, 109 Tax Notes 1047 (2005) (Pg 1056).
[77] Id., at 1052, 1053.
[78] Bernheim, supra.
[79] Banks and Diamond, supra; Chris Sanchirico, Do Capital Income Taxes Hinder Growth, ILE Research Paper 13-6 (2013).

Historically, the US has generally taxed dividends at the same rate as ordinary income. This changed in 2003, when Congress adopted a 15% rate for dividends as well as capital gains. The rate for dividends went up to 20% under ATRA, which is about half the rate for ordinary income (and the same as the rate for capital gains).[80]

The rationale for taxing dividends at a lower rate is that this is a form of corporate/shareholder tax integration. Historically, there have been three reasons advanced for countries to adopt corporate/shareholder integration, to overcome biases in the classical system (under which corporate income is taxed at the corporate level and dividends are taxed in full at the shareholder level):

1. Under the classical system, there is a bias to conduct business in noncorporate forms, since they are not subject to double taxation (although this is mitigated if the individual rate exceeds the corporate rate, since in corporate form the individual tax can be deferred).

2. Under the classical system, there is a bias to avoid dividend distributions and instead retain earnings, thus avoiding the double tax (this bias is exacerbated when the individual rate exceeds the corporate rate);

3. Under the classical system, there is a bias in favor of capitalizing corporations with debt (producing deductible interest) rather than equity (producing nondeductible dividends).[81]

None of these reasons is completely convincing in the U.S. context, which may be a reason why the U.S. has maintained the classical system from 1936 to 2003 (and indeed strengthened it in 1986 with the repeal of the General Utilities doctrine, which enabled corporations to avoid corporate tax on a distribution of appreciated assets). First, the alleged bias against the corporate form is mitigated by the excess of the individual rate over the corporate rate (as is currently the case, and the gap will increase if the corporate rate is cut) and by the absence of strong provisions to prevent retentions in the domestic context. In addition, under current rules, the classical system applies primarily to large, publicly traded corporations, while small, closely held businesses are able to avoid the double tax even if they are in corporate form for nontax purposes. It is doubtful if there is sufficient substitutability between the two forms of business for the double tax to create much deadweight loss from the bias toward noncorporate form. The double tax is a price large businesses have to pay for access to the public equity markets and the liquidity that accompanies that access. Finally, to the extent that the corporate tax can be shifted to

[80] See Martin J. McMahon, Jr., Ira B. Shepard, and Daniel L. Simmons, Recent Developments in Federal Income Taxation: The Year 2010, 10 Fla. Tax Rev. 565 (2011) (Pg 616).
[81] See Avi-Yonah supra note 9.

consumers or to labor, the bias disappears, and even the Treasury's 1991 integration study has suggested that considerable shifting can take place. (The bias reappears again if noncorporate businesses can likewise shift the individual tax burden, but it seems plausible that the shifting potential of large multinationals is larger than that of small, closely held businesses.)[82]

Second, the bias in favor of retentions is mitigated by the ability of corporations to redeem shares from shareholders at the favorable capital gains rate, and by the fact that numerous shareholders are tax exempt or corporate (and thus do not pay a full tax on dividends). Indeed, even U.S. corporations that used to pay dividends have now generally moved to structured redemption programs addressed to their taxable individual shareholders. Other corporations (especially high-tech ones) retain all their earnings, but it is not clear that this is primarily tax motivated (corporations used to pay dividends under the same rules in the past). Finally, there is an unresolved debate among economists whether the dividend tax is capitalized into the price of the shares. If it is, then the retention bias applies only to new equity, but new equity is unlikely to pay dividends for nontax reasons.[83]

Third, the bias in favor of debt and against equity is a general problem of the income tax that should not be addressed only in the corporate tax area. Moreover, to address it completely it is necessary to make dividends not exempt, but rather deductible, a form of integration that is never adopted (in part because it would automatically extend integration to foreign and tax-exempt shareholders). If integration takes the normal forms of imputation or dividend exemption, there is still a difference in treatment between interest and dividends that can be manipulated.[84]

These arguments suggest that the US should resume taxing dividends as ordinary income. That is particularly true if capital gains are taxed as ordinary income as recommended above, because the best reason for the current 20% rate on dividends is that this is the rate for capital gains and therefore there is less pressure to distinguish capital gains from dividends.

However, if one nevertheless believes in integration, in my opinion the best way to achieve integration is to allow corporations to deduct dividends.[85] The case for dividend deduction has been developed elsewhere, but if dividends are deductible like interest, then both dividends and interest should be fully taxable as ordinary income to shareholders.

d. Inbound Portfolio Investment

The economics literature unanimously recommends that small open economies not subject inbound portfolio investment to income tax, because the mobility of such

[82] See Avi-Yonah supra note 9.
[83] See Avi-Yonah supra note 9.
[84] See Avi-Yonah supra note 9.
[85] Avi-Yonah and Chenchinski, The Case for Dividend Deduction, 65 Tax Lawyer 3 (2011).

capital means that any such tax will be shifted to labor in the source country and it is simpler to tax labor directly.[86] The US follows this recommendation for capital gains and interest, but not for dividends, which are subject to withholding at 15% or 30% (and this tax has recently been strengthened by Congress imposing it on dividend equivalent payments on derivatives).

In my opinion, portfolio capital mobility indicates that the US should not subject any inbound portfolio capital to tax, and withholding taxation should be abolished. It is cumbersome, complex, and raises little revenue. Nor is it needed to induce countries to enter into tax treaties with the US, because most countries that want such treaties (i.e., developed countries and large developing ones) already have them and the others (smaller developing countries) are unlikely to want them because they are uninterested in reducing US taxation on their mobile capital (which from their perspective represents undesirable capital flight).

Thus, the US should continue not to tax inbound portfolio interest and capital gains, and should extend this treatment to inbound portfolio dividends. There are, however, three caveats. First, the US should have robust mechanisms in place to ensure that payments to foreigners are truly to foreigners and not to US residents pretending to be foreigners. This means that US payors should obtain enough information to exchange with other countries to enable the US to ascertain who the beneficial owner of such payments is. FATCA is also helpful in this regard.[87] Second, the US should retain its ability to subject inbound **direct** investment to tax, because FDI has good reasons to be in the US and is therefore much less mobile. As Lowell and Wells have argued, this indicates that we should levy a base protecting tax on all deductible payments made to foreigners- interest, royalties, and if dividends are deductible, then on dividends as well.[88] Moreover, we should tax capital gains from the sale of controlling interests in US corporations, since these represent the present value of future US source active income from FDI.[89] Third, if the other OECD countries were willing to cooperate, we could reinstate conditional withholding on all payments to non-treaty countries, but refund the tax upon a showing that the income was declared to the taxpayer's country of residence. This would eliminate the tax haven problem without the need to place sanctions on small offshore jurisdictions and without driving portfolio investments elsewhere, because such investments are generally not made in countries outside the OECD.

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[86] See Ilan Benshalom, The Quest to Tax Interest Income in a Global Economy: Stages in the Development of International Income Taxation, 27 Va. Tax Rev. 631 (2008). (Pg 668).

[87] See Melissa A. Dizdarevic, The FATCA Provisions of The Hire Act: Boldly Going Where No Withholding Has Gone Before, 79 Fordham L. Rev. 2967 (2011) (Pg 2980).

[88] Lowell and Wells, supra.

[89] Avi-Yonah, Money on the Table: Why the U.S. Should Tax Inbound Capital Gains, 63 Tax Notes Int'l 41 (July 4, 2011).

The tax rate on inbound portfolio capital should therefore generally be zero. The tax rate on inbound labor is also zero: With the exception of artistes and athletes, the US (like other countries) does not tax labor income of those who come to it temporarily, unless their activities are so extensive that they become US tax residents (i.e., are present for 183 days in any given year or have a US trade or business/ permanent establishment). For inbound capital and labor, therefore, the main recommendation of this article (to tax them at the same rate) has largely been adopted already.[90]

But what about income from capital and labor earned by US residents? We now finally arrive at the main question posed by this article- should income of US residents from capital and labor be subject to different rates because of the capital/labor dichotomy assumption?

II. How Mobile is Capital?

A major reason for the capital/labor dichotomy assumption is the focus on corporate as opposed to individual taxation. There is in fact abundant evidence that US corporations can easily escape the onerous US corporate tax rate of 35% by moving their profits to lower taxed locations. For example, in November 2011 CTJ and ITEP released a report called "Corporate Taxpayers and Corporate Tax Dodgers, 2008-2010." After examining the 280 most profitable U.S. corporations, they found that the average effective federal income tax rate for this group was 18.5% in 2008-2010 and 17.3% in 2009-2010. In other words, 280 of the Fortune 500 companies were paying tax at half the 35% statutory rate. Some 78 of these companies paid no federal income tax between 2008 and 2010. General Electric, the largest corporation in the United States, reported some $10.450 billion in profits for 2008-2010 and yet paid no U.S. income tax during those years.[91]

A major reason for these low tax payments by leading US corporations was their ability to shift profits overseas. GE, for example, made most of its money in its GE Capital division, which books most of its profits in Barbados and benefits from the "active financing" exception to Subpart F (enacted in 1997 over President Clinton's veto). The Transfer Pricing study by the Joint Committee on Taxation (July, 2011) documented how six US multinationals used legal transfer pricing techniques to move most of their profits to low tax locations like Ireland, Luxembourg or Singapore.[92] As a result, deferral (the ability not to pay tax on profits booked offshore) is now the biggest US corporate tax expenditure, and $1.7 trillion of low-

[90] See IRC sec. 871 (a) (2).
[91] See Corporate Taxpayers and Corporate Tax Dodgers, 2008-2010. http://www.ctj.org/corporatetaxdodgers/CorporateTaxDodgersReport.pdf (Pg 24).
[92] See Present Law and Background Related To possible Income Shifting and Transfer Pricing, https://www.jct.gov/publications.html?func=startdown&id=3692

taxed profits of US multinationals are "trapped" overseas, since under current law bringing them back to the US would trigger a 35% tax penalty. In addition, corporations can move themselves overseas by shifting their headquarters there, and corporate residency is rather meaningless.[93]

But from the perspective of the capital/labor dichotomy assumption, this focus on the corporate tax is misleading, because after over 50 years of research economists cannot tell us who bears the burden of the corporate tax: Is it shareholders, or all capital providers (as Harberger argued in 1963), or labor, or consumers (i.e., labor), as more recent studies indicate? For distributional purposes Congress and Treasury assume that the corporate tax falls on capital, but their own studies suggest that it falls at least 50% on labor. My own guess is that it shifts based on market conditions (i.e., it falls on shareholders only when competition means that it cannot be shifted to consumers or employees), and therefore there is no answer that can possibly be given to the question, "does the corporate tax fall on capital or labor?". Moreover, the increasing ability of corporations to move jobs offshore suggests that they should be able to make labor bear more of the corporate tax burden.

Moreover, let us assume for the moment that the corporate tax does fall mostly on capital, as recent Treasury estimates and academic literature have suggested.[94] This by itself does not tell us anything about what should be the proper tax rate on dividends, capital gains and interest earned by individual taxpayers. If corporations can avoid the corporate tax by legally shifting income overseas, that suggests the corporate tax rate should be low, but it does not mean that individual capital providers to corporations should be subject to a lower tax rate than wage earners unless we thing they can also avoid tax on dividends, capital gains or interest by shifting those overseas. If anything, I would argue that if the corporate tax falls on capital but can be avoided by corporations, while individual capital providers to corporations cannot easily avoid tax on dividends, capital gains and interest, the correct policy response is to reduce the corporate tax rate and to increase the tax rate on dividends and capital gains.

We should therefore leave the corporate tax aside as irrelevant to the capital/labor dichotomy assumption (although I would support lowering the corporate tax rate, as both the Obama Administration and Republicans in Congress have proposed, precisely because corporate profits are in fact mobile and respond to tax rates). The

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[93] See Rachelle Y. Holmes, Deconstructing the Rules of Corporate Tax, 25 Akron Tax J. 1 (2010) (Pg 41-42)

[94] See Kimberly A. Clausing, Who Pays the Corporate Tax in a Global Economy? 66 Nat'l Tax J. 151 (2013); Jennifer Gravelle, Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis, 66 Nat'l Tax J. 185 (2013); Li Liu and Rosanne Altshuler, Measuring the Burden of the Corporate Income Tax Under Imperfect Competition, 66 Nat'l Tax J. 215 (2013); Julie-Anne Cronin, Emily Y. Lin, Laura Power, and Michael Cooper, Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology, 66 Nat'l Tax J. 239 (2103), also at http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2012-05-Distributing-the-corporate-Income-Tax-Methodology-May-2012.pdf.

relevant question for assessing the capital/labor dichotomy assumption is whether individual US residents and citizens can escape the income tax on dividends, interest and capital gains by moving their capital overseas **without moving themselves** (since, if they move themselves, this shows that labor is mobile and violates the assumption).

The answer to this question is generally no. First, US citizens and residents cannot legally escape the income or estate taxes by moving capital offshore, since (a) they are subject to income tax on all income ("from whatever source derived") and to estate tax on worldwide assets, and (b) if they try to earn their income through foreign corporations, whether controlled or not, they are still subject to tax under the quite onerous PFIC rules (which are much tougher than the analogous CFC rules for corporate taxpayers).[95]

Second, even if one could argue that US citizens and residents can in practice avoid these rules by hiding income in tax havens, they face a significant risk of getting caught: As illustrated by the recent UBS saga, if one banker spills the beans, they can and do go to jail. Most of the economics literature is not based on the assumption that most people would be willing to risk going to jail.

Third, recent changes to US law have made such illegal tax evasion considerably more difficult. FATCA, enacted in 2010, requires all foreign financial institutions to report directly to the IRS all accounts held by US citizens or residents. The penalty for non-compliance is a hefty 30% levy on the financial institution's US source income. In addition, the US has finally decided to make its own banks collect information on interest paid to non-residents, both because they may be residents pretending to be non-residents, and because the US wants to have information to exchange with treaty partners who have information on US residents.[96]

The highest published estimate of the ability of US citizens and residents to escape taxation by moving capital overseas is $50 billion in income tax evaded per year.[97] Even this upper bound estimate is a very small fraction of total income from capital earned by US citizens and residents. The IRS estimate of the "international tax gap", using better (non-public) data, was always much lower. And even I, as the originator of the $50 billion estimate, would now admit that in the post-FATCA environment, that figure is too high.

It is not impossible to escape FATCA. A US citizen or resident can still do it by earning income overseas in a financial institution that has no connections to the US and therefore is not intimidated by the 30% levy. But these institutions are hard to

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[95] See IRC sec 1291 (defines PFIC) and See IRC sec 951 (defines CFC)

[96] See Itai Grinberg, Emerging Countries and the Taxation of Offshore Accounts, working paper (2013).

[97] Avi-Yonah and Guttentag, Closing the International Tax Gap, in Max B. Sawicky (ed.), Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration, 99 (2005).

find, especially without moving abroad (which violates the capital/labor dichotomy assumption). Even the Iranians found that it was hard to receive payment for their oil without routing the money through the US financial system.

Thus, in my opinion the transaction costs for a US citizen or resident living in the US to escape taxation on capital income without moving abroad are now so high that capital from this perspective is not particularly mobile. It can still be moved, but it will in all likelihood be taxed.

III. How Immobile is Labor?

The second half of the capital/labor dichotomy assumption is that labor is immobile because of immigration restrictions. But this ignores the data that indicate that in the 21st century labor is quite mobile and borders are porous.[98]

First, for low earners, there is significant immigration, both legal and illegal. In the EU there are currently 47 million people (9.4% of the total population) who were born outside their country of residency, including 31 million (6.3%) born outside the EU. There are an estimated 11 million "undocumented" migrants in the US, in addition to the 29 million who migrated to the US legally. These 40 million immigrants represent over 10% of the current US population.[99]

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[98] For an early attempt to assume labor mobility see J.A. Mirrlees, Migration and Optimal Income Taxes, 18 J. Pub. Econ. 319 (1982). For recent economics literature that assumes that migration is possible see, e.g., Laurent Simula and Alain Trannoy, Optimal Income Tax Under the Threat of Migration by Top-Income Earners, 94 J. Pub. Econ. 163 (2009); Laurent Simula and Alain Trannoy, Shall we Keep the Highly Skilled at Home? The Optimal Income Tax Perspective, CESifo Working Paper 3326 (January 2011); Assaf Razin and Efraim Sadka, Fiscal and Migration Competition, NBER Working Paper 16224 (2010); P. Egger & D. M. Radulescu, The Influence of Labor Taxes on the Migration of Skilled Workers, 32 The World Economy 5 (2009); Henrik Kleven, Camille Landais, Emmanuel Saez and Esben Schultz, Taxation and International Migration of Top Earners: Evidence from the Foreigner Tax Scheme in Denmark, working paper (November 2011); Thomas Liebig and Alfonso Sousa-Poza, The Influence of Taxes on Migration: Evidence from Switzerland, 30 Cambridge J. Econ. 235 (2006). For a review of US state data that suggest that tax induced migration within the US is rare see Robert Tannenwald, Jon Shure and Nicholas Johnson, Tax Flight is a Myth: Higher State Taxes Bring More Revenue, Not More Migration, Center on Budget and Policy Priorities (August 4, 2011); but see Cristobal Young and Charles Varner, Millionaire Migration and State Taxation of Top Incomes: Evidence from a Natural Experiment, 64 Nat'l Tax J. 255 (2011); Jeffrey P. Thompson, Costly Migration and the Incidence of State and Local Taxes (PERI Working Papers, February 2011); Robert Whelan, An Analysis of Average and Marginal Income Tax Rates in Oregon and Effects on Household Location (ECONorthwest, June 2009); Jon Bakija and Joel Slemrod, Do the Rich Flee from High State Taxes? Evidence from Federal Estate Tax Returns (NBER Working Paper 10645, July 2004); Roger Cohen, Andrew Lai and Charles Seindel, Tax Flight Has Tangible Effects on Income Tax Revenue, State Tax Notes, Feb. 20, 2012; Karen Conway and Andrew Houtenville, Out with the Old, In with the Old: A Closer Look at Younger Versus Older Elderly Migration, 84 Soc. Sci. Q. 309 (2003); Paul Coomes and William H. Hoyt, Income Taxes and the Destination of Movers to Multistate MSA, 63 J. Urban Econ. 920 (2008); Kathleen Day and Stanley Winer, Policy-Induced Internal Migration: An Empirical Investigation of the Canadian Case, 13 Intl Tax Pub. Fin. 535 (2006).

[99] See Philip Martin and Elizabeth Midgley, Population Reference Bureau, Population Bulletin Update: Immigration In America 2010, at 1 (2010), available at http://www.prb.org/pdf10/immigration-update2010.pdf

Second, for high earners, who earn the vast bulk on income from capital, the restrictions on legal migration are almost non-existent. Most countries in the OECD welcome rich migrants.[100] About 340,000 income taxpayers have left France each year since 2000 to relocate to countries with lower income taxes like the UK, Luxembourg, Switzerland, the US and Canada. Before migrating, these individuals paid three times more taxes than the average French taxpayer.[101] In 2005, 145,000 taxpayers left Germany for the same reason.[102]

And what are the tax consequences of migration? For low earners migrating out of the US, the result is to legally escape all US taxation.[103] The payroll tax does not apply to US citizens and residents who move permanently overseas and work for non-US employers.[104] A VAT, since it is destination based, can likewise be avoided by simply moving offshore. And under section 911 of the Code, the first $92,900 of earned income of US citizens living overseas is exempt from US income tax, which covers the vast majority of the US middle class who only have labor income.[105]

For high earners, migration by itself is insufficient, because the US uniquely taxes its citizens on worldwide income even if they live permanently overseas.[106] I do not like this rule and have argued that it should be changed, but it is unlikely to be modified because it has been entrenched in US income tax law since the Civil War.[107] But upper income US citizens can still escape taxation by simply moving and then going to a US consulate and relinquishing their US citizenship. Since they can easily obtain citizenship in other OECD countries because all countries welcome rich migrants, the costs of such a move are not very high. A US passport is not more valuable, and in some ways less useful, than an EU, Australian or Canadian passport.[108]

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[100] OECD, International Mobility of the Highly Skilled, 2002; F. Docquier and A. Marfouk, International Migration by Education Attainment, 1990-2000, in International Migration, Remittances and the Brain Drain, World Bank 2005; Andrew Halkyard, Tax Incentives and the Migration of Skilled Labour: Another Tax Expenditure or a Failure of Tax Residence? 11 eJournal of Tax Research 23 (2013).

[101] Simula and Trannoy, 163. For an empirical study of the relationship of taxes to migration by highly skilled sports players see Nolan Kopkin, Tax Avoidance: How Income Tax Rates Affect the Labor Migration Decisions of NBA Free Agents, J. Sports Economics (Nov. 5, 2012); Henrik Kleven, Camille Landais and Emmanuel Saez, Taxation and International Migration of Superstars: Evidence from the European Football Market, NBER Working Paper 16545 (2010).

[102] Ibid.

[103] However, these taxpayers face higher non-tax barriers to migration than highly skilled individuals, so they are unlikely to migrate en masse. Razin and Sadka, supra.

[104] See Internal Revenue Service, Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad, found at http://www.irs.gov/pub/irs-pdf/p54.pdf

[105] See Internal Revenue Service, Foreign Earned Income Exclusion Requirements, found at http://www.irs.gov/businesses/small/international/article/0,,id=96817,00.html.

[106] See Michael K Kirsch, Taxing Citizens in a Global Economy, 82 N. Y. U. L. Rev. 443 (2007) (Pg 445)

[107] Id., at 449; Reuven S. Avi-Yonah, The Case Against Taxing Citizens, 58 Tax Notes Int'l 389 (May 3, 2010).

[108] Acott Andrew Bowman, Should I Stay or Should I Go? Tax Considerations in US Expatriation, 86-Oct Fla.B.J. 48 (2012).

Paradoxically, these costs have been diminished rather than increased by a legal change enacted in 2008 to make tax-motivated expatriation harder. Before 2008, to avoid continued taxation as a US resident, the expatriating citizen had to show a non-tax reason for expatriating. That proved to be easy and as far as I know the IRS has not been able to prevail in any case brought under Code section 877 before 2008.[109] Code section 877A, enacted on a bipartisan basis in 2008, imposed an exit tax on rich expatriates: Any wealthy US citizen who moved abroad and renounced citizenship is now subject to a deemed sale of all their assets. The result can be seen in the following table, which shows how many US citizens gave up their citizenship in each year since 1998:

YEAR	NUMBER	SOURCES
1998	450	63 Fed. Reg. 42906 (Aug. 11, 1998); 63 Fed. Reg. 56696 (Oct. 22, 1998); 64 Fed. Reg. 3339 (Jan. 21, 1999); 64 Fed. Reg. 48894 (Sept. 8, 1999); 65 Fed. Reg. 15041 (Mar. 20, 2000)
1999	435	64 Fed. Reg. 19858 (Apr. 22, 1999); 64 Fed. Reg. 38944 (July 20, 1999); 64 Fed. Reg. 56837 (Oct. 21, 1999); 65 Fed. Reg. 5020 (Feb. 2, 2000)
2000	432	65 Fed. Reg. 35423 (June 2, 2000); 65 Fed. Reg. 48913 (Sept. 24, 2001); 65 Fed. Reg. 50050 (Aug. 16, 2000); 65 Fed. Reg. 80494 (Dec. 21, 2000)
2001	491	66 Fed. Reg. 48912, 48917 (Sept. 24, 2001); 67 Fed. Reg. 11374, 11375 (Mar. 13, 2002)
2002	503	67 Fed. Reg. 193621 (Apr. 22, 2002); 67 Fed. Reg. 47889 (July 22, 2002); 67 Fed. Reg. 66456 (Oct. 31, 2002); 68 Fed. Reg. 4549 (Jan .29, 2003)
2003	569	68 Fed. Reg. 23180 (Apr. 30, 2003); 68 Fed. Reg. 44840 (July 30, 2003); 69 Fed. Reg. 61906, 61910 (Oct. 21, 2004)
2004	631	69 Fed. Reg. 61907, 61908, 61909 (Oct. 21, 2004); 70 Fed. Reg. 5511 (Feb. 2, 2005)
2005	761	70 Fed. Reg. 23295 (May 4, 2005); 70 Fed. Reg. 68511 (Nov. 10, 2005); 71 Fed. Reg. 6312 (Feb. 7, 2006); 71 Fed. Reg. 68901 (Nov. 28, 2006)
2006	278	71 Fed. Reg. 25648 (May 1, 2006); 71 Fed. Reg.50993 (Aug. 28, 2006); 71 Fed. Reg.63857 (Oct. 31, 2006); 72 Fed. Reg.5103 (Feb. 2, 2007)
2007	470	72 Fed. Reg. 26687 (May 10, 2007); 72 Fed. Reg. 44228 (Aug. 7, 2007); 72 Fed. Reg. 63237 (Nov. 8, 2008); 73 Fed. Reg. 7631 (Feb. 8, 2008)
2008	231	73 Fed. Reg. 26190 (May 8, 2008); 73 Fed. Reg. 43285 (July 24, 2008); 73 Fed. Reg. 65036 (Oct. 31, 2008); 74 Fed. Reg. 6219 (Feb. 5, 2009)

[109] See Steven J Arsenault, Surviving a Heart Attack: Expatriation and the Tax Policy Implications of the New Exit Tax, 24 Akron Tax J. 37 (2009) (Pg 46).

2009	741	74 Fed. Reg. 20105 (April 30, 2009); 74 Fed. Reg. 35911 (July 21, 2009); 74 Fed. Reg. 60039 (Nov. 19, 2009); 75 Fed. Reg. 9028 (Feb. 26, 2010)
2010	1391	75 Fed. Reg. 28853 (May 24, 2010); 75 Fed. Reg. 69158, 69160 (Nov. 10, 2010); 76 Fed. Reg. 7907 (Feb. 11, 2011)
2011	1780	76 Fed. Reg. 27175 (May 20, 2011); 76 Fed. Reg. 46898 (Aug. 3, 2011); 76 Fed. Reg. 66361 (Oct. 26, 2011); 77 Fed. Reg. 5308 (Feb. 2, 2012)

What is clear from this table is that expatriations went down in 2008 (when the law was being considered in Congress), and then increased dramatically. The average expatriation rate in 1998-2008 was 477. The average expatriation rate in 2009-2011 was 1304, over 2.7 times as much.

The reason for this increase was that after 2008 expatriation was no longer a shameful act. Instead, it became an act with a price set by the government. Rich US citizens living overseas could make the calculation: Is the current exit tax I have to pay more or less than the present value of my future US taxes, both income and estate tax, taking into account the likely future trend of US tax rates and the tax rate in the country I live in? In many cases, the argument for expatriating became overwhelming, despite patriotic misgivings.

Thus, I believe that labor is as mobile or more mobile than capital from the perspective of its ability to escape US taxation by moving.[110] The same applies to other countries that have an exit tax on moving and do not tax citizens living permanently overseas. The capital/labor dichotomy assumption is wrong, and labor, like Galileo's Earth, does move despite all the claims to the contrary.

IV. Policy Implications

The policy implications of the above argument are simple: We should go back to Charles Tiebout's famous conclusion from 1956 that if people are mobile, countries should set tax rates to reflect the taste of their residents, and those residents that do not like the resulting choice (which is established by democratic elections) should be free to move to other countries whose choices they like better.[111]

For the US, the immediate policy implications are that we should (a) set the tax rate on dividends and capital gains to be the same as the tax rate for interest and wages, which is a significant simplification over current law because then we do not have to

[110] Capital is of course much more mobile than labor in the sense that the costs of moving it are much lower, which is why the returns to capital are much more similar among countries than the returns to labor. But that does not mean that capital can escape US taxation more easily than labor, which is the point of those who use the capital/labor dichotomy assumption to argue for lower taxes on income from capital.
[111] Charles Tiebout, A Pure Theory of Local Expenditures, 64 J. Pol. Econ. 416, 418 (1956).

worry about distinguishing (at the recipient level) dividends from interest, dividends from capital gains, and dividends/capital gains from wages; (b) have an election every four years in which the proper rate for taxing all income is debated and decided; (c) let people who do not like the result move overseas, and stop taxing them there even if they retain US citizenship, since they no longer obtain significant services from the US government. However, as long as we do not mark assets to market, we should impose an exit tax on such migrants, to the extent that the unrealized appreciation in their assets was economically earned while they were US residents.

The recently enacted American Taxpayer Relief Act of 2012 has permanently enshrined in the tax code the pernicious distinction between ordinary income (taxed at almost 40%) and capital gains and dividends (taxed at about half that rate). This distinction is very difficult to police in practice and completely unnecessary, since (as argued above) all the reasons for taxing capital at a lower rate than ordinary income are shaky at best. We should go back to the rate structure of the 1986 Tax Reform Act, which imposed the same tax rate (28%) on ordinary income (including dividends and interest) and capital gains. This is a much more defensible rate at a time where individuals are increasingly mobile, and should attract to this country some of the world's abundant talent.

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