Klein: Policy Analysis of the Federal Income Tax

J. Clifton Fleming Jr.

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BOOK REVIEW


Reviewed by J. Clifton Fleming, Jr.†

Canon 8 of the American Bar Association’s Code of Professional Responsibility states that “[a] lawyer should assist in improving the legal system.” Relevant Ethical Considerations expand on the meaning of Canon 8 as follows:

By reason of education and experience, lawyers are especially qualified to recognize deficiencies in the legal system and to initiate corrective measures therein. Thus they should participate in proposing and supporting legislation and programs to improve the system, without regard to the general interests or desires of clients or former clients.

The Ethical Considerations also explain that lawyers “should encourage the simplification of laws and the repeal or amendment of laws that are outmoded. Likewise, legal procedures should be improved whenever experience indicates a change is needed.”

If law students are to be trained to carry out their prospective law-reform duty as described in the foregoing passages with respect to improving the federal income tax system, and if the current bar is to adequately discharge its obligation in this regard, there ought to be a volume to which both students and practitioners can go for comprehensive explication of the federal income tax’s fundamental policy considerations. Professor William A. Klein’s Policy Analysis of the Federal Income Tax attempts to meet these needs. Although it fails to completely achieve the desired ends, the book’s accomplishments are sufficiently substantial to make it an impressive and highly stimulating piece of work.

* Professor of Law, University of California at Los Angeles. A.B., 1952; L.L.B., 1957, Harvard University. Member of the District of Columbia and Wisconsin Bars.
† Professor of Law, J. Reuben Clark Law School, Brigham Young University. B.S., 1964, Brigham Young University; J.D., 1967, George Washington University. Member of the Washington Bar.
1. ABA Code of Professional Responsibility, Canon 8.
2. ABA Code of Professional Responsibility, EC 8-1.
I.

In spite of its overall strength, the book begins weakly. Klein states that his objective is to "explicate the basic principles, theories and tools of analysis that are needed for sensible, serious discussion of federal income tax policy." Given that objective, an evaluation of the income tax's relative merits vis-à-vis other forms of taxation would be in order. Klein recognizes this point by stating that "[i]t is useful . . . to begin with an effort . . . to put the structural problems in a broader perspective, to ask why it is that we want to tax people on the basis of their incomes . . . [and] to examine some alternatives . . . ."

Unfortunately, Klein fails to follow through. After a short, inconclusive paragraph dealing with taxes based on benefit, he states that "we will make no further effort to examine the proper scope for application of the benefit principle." An additional disclaimer of any design to investigate sumptuary taxes as an alternative to the income tax is followed by an initially promising investigation of the head tax. Klein points out that the head tax has no disincentive effect on work and is probably no more difficult to assess and enforce than the income tax. But having created a modest feeling of warmth in the reader for a tax which, because of its past association in this country with attempts to prevent blacks from voting, has been viewed by many as a pariah of the revenue world, Klein summarily dismisses further inquiry into the subject with the following statement:

The appeal of the head tax diminishes rapidly, however, even for a primitive society, as we begin to take account of the fact that people will have differing physical capabilities, and will, consequently, differ in their capacities to contribute. As we begin to think along those lines and to extrapolate to a complex industrial society, we are drawn more and more toward traditional notions of ability to pay.

The head tax has features which make it unattractive to many. But the foregoing is hardly an adequate rejection of the tax as an

5. Id.
7. W. Klein, supra note 4, at 1.
8. Id. at 2. For a discussion of problems encountered in using the benefit principle to allocate the tax burden, see W. Blum & H. Kalven, THE UNEASY CASE FOR PROGRESSIVE TAXATION 35-39 (1953) [hereinafter cited as Blum].
10. Id. at 3.
11. Id. at 4.
alternative to the income tax, particularly in a book which pur-
ports to be devoted to "basic principles." 12

After also dismissing taxes on wealth as a subject for investi-
gation, Klein finally arrives at the following:

We will proceed for now on the assumption that in shaping our
tax system we have properly selected income as the appropriate
objective measure of ability to pay.

... [W]e are now in a position to make more concrete a
general principle of justice. The general principle—one that
needs no defense—is that similarly situated people should be
treated similarly, that equals should be treated equally. In our
tax system we have decided that equality refers to ability to pay
and that for ability to pay we substitute income. Thus, we de-
rive the principle of horizontal equity: the justness of the system
is measured in part by the extent to which people with equal
incomes pay equal taxes. 13

Again, for a book devoted to analysis of fundamentals, the forego-
ing is an inadequate explanation of why the income tax is to be
preferred over other taxes. The unadorned invocation of the term
"ability to pay" does little more than call to mind Louis Eisen-
stein's assertion that "[t]o speak forcefully of ability to pay is
merely to indulge in evasive rhetoric." 14 Without considerable
explanation, "ability to pay" possesses little intrinsic meaning
and no obvious claims for being considered an unassailable foun-
dation on which to build a tax system. 15 In addition, the term can
be used as forcefully in behalf of an estate tax or property tax as
in behalf of an income tax. Klein has simply made a declaration
of faith in favor of the income tax and has asked the rest of us to
go along without seeing the proof. I am prepared to do so, but in
directing students and others to material which will illuminate
the relative advantages of the income tax, I shall have to recom-
mend sources other than Professor Klein's book.

12. Id. at xvii.
13. Id. at 7 (emphasis in original).
15. For discussion of the weaknesses of "ability to pay" as a tax policy guide, see
BLUM, supra note 8, at 64-68; L. EISENSTEIN, supra note 14, at 3-56.

Klein's use of "ability to pay" at this point is puzzling, since he ultimately deprecates
it as follows:

[The concept of ability to pay] ... is a concept that seems to me to have
meaning for people who accept the justness of the initial distribution of the
rewards under capitalism—but not quite. It is a concept for people who feel that
inequality is natural enough but who are groping for a way of expressing their
uneasiness about it without going too far.

W. KLEIN, supra note 4, at 43.
II.

Fortunately, the book quickly recovers from this unpromising beginning when Klein moves to the ambitious task of constructing an objective justification for progressive income taxation. The notion that an income tax should be progressive has clung to our tax system with unremitting tenacity in spite of the fact that progression has some undeniable vices and that no one has yet succeeded in building an incontrovertible case in its favor. In fact, the difficulties of doing so led Louis Eisenstein to conclude that the task should be abandoned. He urged, instead, a frank recognition that the existence of progression and the degree of progression in the income tax simply represent the result of a political struggle between various groups in our society engaged in efforts to shift the tax burden from themselves to others and that the principle of progression has no objective basis.

Although a realist, Klein is unwilling to take Eisenstein's advice. Klein argues that if a successful case is to be constructed for progression, one must openly recognize that progression is an income redistribution device which can be justified only by first establishing that the present distribution of income under our economic system is unjust. Such an undertaking might lure the investigator into an attack on capitalism itself. Klein, however, eschews this path. He accepts capitalism for its unmatched capacity to produce goods and services, but asserts that the distribution of capitalism's benefits is unjust and that some way must be found to redistribute those benefits without impairing the incentives which make the system so productive. In Klein's words, "we will want to ask in what directions and how far we can depart from the distribution of rewards under capitalism, to achieve greater fairness, without destroying or too significantly impairing capitalism's capacity to deliver the goods."

16. See Blum, supra note 8, at 14-28.
17. The traditional arguments for progression are thoroughly reviewed and effectively criticized in Blum, supra note 8.
19. Klein states:

Even if total utility can be increased by taking from you to give to another who is less well off but still not poverty stricken, where is the justice in doing so if you assume the justice of the initial distribution? That is, suppose that you start with the assumption that each person deserves what he or she earns. How can it be ethical, or if you prefer, just, to take from one and give to the other?

W. Klein, supra note 4, at 21. See also Blum, supra note 8, at 80.
21. Id. at 26.
The conclusion that the rewards of capitalism are distributed unfairly is reached by using an argument derived from Rawlsian original-position analysis.\textsuperscript{22} Klein asserts that people possessing no knowledge of their comparative advantages over each other and no knowledge as to how well they will succeed in the future would bargain with each other for a distribution of rewards under their economic system, which gave all who worked equally hard the same reward.\textsuperscript{23} This bargain would be arrived at between people who, because of these stipulations of ignorance, were trying to protect their unknown interests by constructing the most intrinsically just system possible. Klein believes, therefore, that the terms of this bargain represent mankind's conception of a fair distribution of income.\textsuperscript{24}

This argument is buttressed with another aspect of Rawlsian theory. Klein asserts that since the possession of greater talent than one's fellows is a chance, undeserved attribute, it is unjust for greater talent to result in greater income per se.\textsuperscript{25} He argues that under a perfectly fair system, inequalities in income should arise only from inequalities in effort—\textit{i.e.}, hours worked\textsuperscript{26}—and asserts that most inequalities in income among members of our society arise from unequal talent rather than from unequal effort and are, therefore, unfair.\textsuperscript{27}

At this point, Klein recognizes that his argument needs a refinement to adjust for the realities of human behavior. He states:

\begin{quote}
The logic of the preceding analysis suggests that the \textit{[famous concert] pianist should receive no more than the dish-}
\end{quote}

\begin{footnotes}
\item[23.] W. Klein, \textit{supra} note 4, at 26-29.
\item[24.] \textit{Id.} at 28-30.
\item[25.] Klein states that:
\begin{quote}
One might simply appeal directly to intuition in support of the proposition that talent as such does not for reasons of fairness require added reward . . . . Rawls puts it in terms of deservedness, saying that it "is perfectly obvious and has long been agreed to . . . [and] is one of the fixed points of our moral judgments that no one deserves his place in the distribution of natural assets any more than he deserves his initial starting place in society . . . ." Each of these statements seems to appeal only to a basic intuitive acceptance of the proposition that there is no just connection between one's natural talents and one's economic position.
\end{quote}
\textit{Id.} at 29. For criticism of this view, see R. Nozick, \textit{Anarchy, State and Utopia} 160-61, 213-27 (1974).
\item[26.] W. Klein, \textit{supra} note 4, at 30, 36.
\item[27.] \textit{Id.} at 32.
\end{footnotes}
washer for equal hours of work—unless as unfortunately seems likely, it seems necessary to provide such rewards in order to elicit the services. In other words, while fairness points toward equality, efficiency may not . . . .

Klein goes on to explain that it may be necessary to reward talented people unequally in order to get them to produce at a level which maximizes benefits to society, but suggests that the additional reward necessary to accomplish this end is less than the additional rewards received by talented persons under the present system.

His conclusion is that in a fair system, the level of income each member should receive (or be allowed to retain) for services is the amount received by the least talented member of society working the same number of hours, plus any additional income necessary to induce the individual in question to perform at an increased level which, after deducting that additional income, will leave society with the greatest net aggregate benefit. Stated differently, society should establish a basic hourly wage applicable to all members. Each member would then receive an amount of income equal to the number of hours worked times the basic wage, plus any minimum additional inducement which must be paid to get him to increase his efforts to a level which results in the greatest net benefit to society. Any income received or retained by a person above this level represents an unfair distribution of the economic system’s rewards. Klein believes that indi-

28. Id. (emphasis in original).
29. Id. at 32-35. See generally Blum, supra note 8, at 51-53; J. Rawls, supra note 22, at 150-51.
30. W. Klein, supra note 4, at 32-35. This suggestion is supported by studies minimizing the impact of high tax rates on willingness to work. See R. Barlow, H. Brazer & J. Morgan, Economic Behavior of the Affluent (1966); G. Break, Income Tax Rates and Incentives to Work and to Invest in House Comm. on Ways and Means, Tax Revision Compendium 2247 (Comm. Print 1959).
31. Klein’s approach to investment income is discussed infra. He does not suggest a definitive solution for the proper income tax treatment of gifts and inheritances. See W. Klein, supra note 4, at 43-45.
32. W. Klein, supra note 4, at 34, 36, 39. Klein recognizes that his system judges fairness in terms of the creation and distribution of economically measurable quantities and admits that some may object on grounds that a system can produce more important things than material goods and that equal distribution of economic income fails to ameliorate the noneconomic inequalities existing between people such as differences in physical skills and capabilities, etc. He dismisses these objections, however, by arguing that since they elude any economic measurement, there is no practical way for an economic system to deal with them and that in creating an economic system which maximizes total output and achieves a more equitable distribution of income, a substantial gain has been achieved even if other problems are left unresolved. Id. at 25-26, 38-39.
individuals in our society receive and retain a good deal of income above this fair level and that these individuals are concentrated in the higher income classes. Since progressive taxation tends to reduce these unjustified inequalities, it is desirable as a device for assisting our system in achieving greater fairness. In Klein’s words:

What all this leads to is the proposition that the case for progression is by no means an uneasy one. It is based on a commitment to fairness in the distribution of the rewards for natural talent plus the judgment that most of the economic inequality that will be reduced by progression will be inequality attributable to differences in talent rather than differences in effort, as well as on the judgment that the gains in fairness achieved by progression will outweigh any losses in efficiency.

Klein’s well-developed theory is not without serious weaknesses. In order to know how much of a person’s total income should be subjected to redistribution, we first must deduct the income to which he is entitled for his hours of work, plus any minimum additional income which must be paid him to stimulate a higher level of effort for the net benefit of society. This latter factor is the problem. How are we to tell how much additional income, if any, a given taxpayer should be allowed to retain over his basic hourly wage in order to induce him to a level of effort which yields a net benefit in output for all remaining taxpayers? It should be clear from the history of income taxation in America that we cannot rely on the taxpayer to accurately report the minimum amount of additional reward he requires. Nor am I aware of any objective system of measurement. The only apparent way to resolve this problem is to allow the remaining members of society to define the additional inducement which the taxpayer in question should receive by bidding for his services in a free market. Thus Klein’s theory, which was intended to move us away from a marketplace allocation of income, takes us back to the marketplace. Since there is no conceivable way to sepa-

33. W. Klein, supra note 4, at 32, 35.
34. Id. at 35.
35. To the extent Klein’s theory is based on Rawls’, it partakes of the infirmities asserted by Rawls’ critics. See, e.g., R. Nozick, Anarchy, State and Utopia 183-231 (1974). But since Klein’s theory is directed to matters of taxation, I am examining it principally from a tax standpoint and am avoiding a general critique of the Rawlsian system.
36. Klein seems to recognize this without appreciating its impact on his theory. W. Klein, supra note 4, at 33.
rate a talented taxpayer's marketplace income into its constituent elements under Klein's system—i.e., basic income for hours worked, minimum additional inducement, and unjust payment for advantages in talent—there is no way to determine the portion of a taxpayer's income which should be redistributed.\textsuperscript{37} The only path around this problem is to drop the minimum additional inducement element from Klein's system and allow taxpayers to receive or retain only income based on total hours worked at the uniformly applicable wage rate. My hunch is that the cost in economic efficiency from this approach would greatly exceed the value of any gains in fairness.\textsuperscript{38}

Klein's system has an additional Achilles' heel. He argues that since a distribution of income based on hours worked at the basic wage plus minimum additional inducement is just, and in no need of redistribution, a person who foregoes the pleasure of presently consuming his just income by investing it and exposing it to the risk of loss should be allowed to receive his investment return tax-free. Stated differently, the return on investment of justly distributed income should not be subject to redistribution.\textsuperscript{39} From this analysis, Klein draws the following conclusion:

If a person works as a dishwasher and uses part of his earnings to buy piano lessons, his return on that investment (but not the return from his natural talent) should be free from taxation, as should the return on the investment of his leisure in practice (training). Investment of leisure in training oneself is analogous to effort in the nature of giving of oneself. To the extent one believes (as I do not) that most differences in reward under capitalism are attributable to such investments, the case for a progressive income tax is undercut.\textsuperscript{40}

Even if we agree with Klein that most income inequalities are due to differences in natural talent rather than differences in effort or differences in talent created through invested effort, the fact remains that few of the "natural" talents which produce high incomes would be as productive without a considerable invest-

\textsuperscript{37} Compare Blum, supra note 8, at 67.

\textsuperscript{38} The literature suggesting that high rates of taxation do not seriously affect willingness to work, see note 30 supra, seems inapplicable at this point since effective rates of taxation have never, in this country at least, approached the level which would seem required to bring about an income redistribution giving all taxpayers an equal income for equal hours worked. See R. Goode, The Individual Income Tax 283-85 (1964); [1974] Econ. Rep. of the President 139-41.

\textsuperscript{39} W. Klein, supra note 4, at 39-41.

\textsuperscript{40} Id. at 41.
ment in practice and training. At least my experience with bright undergraduates who are unwilling to expend the effort necessary to become successful law students and with bright law students who are unwilling to devote the time required to become good practitioners leads me to that conclusion. Since virtually every high income producing talent becomes such through the invested effort required to bring it to fruition, and since efforts devoted to training and education frequently fail to produce income at the time the effort is expended, higher economic rewards to the possessors of such developed talent are, at least in part, rewards for either additional effort or undercompensated past effort. Lacking any method for breaking a talented person’s income from services into (i) the rewards for present effort, prior invested effort, and invested income (which should not be redistributed) and (ii) the reward for possessing raw talent (which should be redistributed), we are unable to tell which portion of his income should be shifted from him to others.

We might dismiss the foregoing deficiencies by saying that Klein’s theory is not intended to provide a guide to a working income tax system but is merely designed to show that the free market distribution of income is unjust and that some progression is in order to mitigate this unfairness. It is not enough, however, to say that some progression should exist. The difficult issue which a useful theory must answer is how progressive the system should be. If we employ too much progression, then we presumably redistribute income which taxpayers should be allowed to retain under Klein’s system. Unfortunately, Klein’s theory provides no way of ascertaining the dividing line between “too much” and “too little.”

For the foregoing reasons, I find Professor Klein’s defense of progression wanting. He has, however, moved the debate over progression away from declining marginal utility of money analysis and loose talk about ability to pay to more fundamental questions of redistribution. His theory represents a sophisticated structure, which deserves careful attention by anyone seeking the still undiscovered objective case for progression.

42. Compare Blum, supra note 8, at 45-46, 81.
43. For an exhaustive critique of attempts to justify progression through declining marginal utility of money analysis, see Blum, supra note 8, at 39-63.
III.

Turning from his analysis of progression, Professor Klein introduces the reader to the case for an income tax based on consumption by including extensive excerpts from Professor Andrews' stimulating article on the subject. Interspersed among these excerpts are useful comments by Professor Klein. This portion of the book serves to alert the reader to the existence of other types of income taxes and their relative advantages.

Klein next examines tax policy criteria, chiefly by reproducing Judge Sneed's thoughtful article on the subject. He then uses extensive excerpts from Professor Bittker's wry demolition of the comprehensive tax base concept to argue that the comprehensive tax base concept fails to provide a useful guide for consistent answers to questions of tax policy. Klein's evident position is that there is no general formula which provides such answers and that the desirability of each exclusion, deduction, and preferential rate proposed and existing under the income tax law must be resolved by ad hoc application of the policy criteria provided by Judge Sneed and others.

The remaining two-thirds of the book is devoted primarily to reproduction of law review articles and book excerpts, and some new work by Professor Klein, which provide examples of the rigorous application of sound analysis to a wide range of fundamental income tax issues, such as the deduction for travel and entertainment expenses, the charitable contribution deduction, the medical expense deduction, the proposals for a credit or deduction for education expenses, the exemption for municipal bond interest, accelerated depreciation, the investment credit, the capital gains preference, and income splitting. Included in this material are helpful sections on the incidence and effect of the corporate income tax and the effect of the income tax on incentives to work. For the patient reader, all of the foregoing provides a rigorous and stimulating set of exercises in tax policy analysis that should be useful to law students and practitioners.

In fact, this material is so uniformly good that only reluctantly will I suggest an addition. Klein correctly observes that "most participants in current [tax policy] debates probably

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have never engaged in any systematic examination of basic philosophic and economic guideposts. They take sides in battles without adequately understanding how the outcome will affect the war, and what the war is all about.47 One of the principal reasons for this lack of understanding by participants in tax policy controversies is that arguments over tax policy are traditionally clothed in rhetoric which is at best uninformative and at worst misleading. Yet the rhetoric is so regularly heard that many believe it actually means something. Louis Eisenstein's *The Ideologies of Taxation,*48 in spite of its obvious flaws,49 made an important contribution to the study of tax policy by systematically laying bare the emptiness of traditional dogma. The already considerable usefulness of Professor Klein's book would have been enhanced by reproduction of portions of Eisenstein's work.

IV.

Professor Klein's book is not an encyclopedia of tax policy for quick reference. Consequently, it will not be useful to most practitioners and, therefore, will not satisfy one of the goals which motivated its creation.50 Tax practitioners, however, who take time to use it and law students laboring without choice under the whips and goads of tax teachers will find the book to be a comprehensive, intellectually demanding survey of both the fundamental issues of income tax policy and the tools necessary for resolution.

Although I have found fault with portions of the book, the space devoted to this review should be an obvious testimony to the book's challenging and stimulating content, which outweighs my criticisms on any scales sufficient to measure such things. Professor Klein has produced an important, high quality piece of work, and I recommend it to anyone seriously seeking an understanding of income tax policy.

47. W. Klein, *supra* note 4, at 1.
48. Note 14 *supra.