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Nam, Jeesoo

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Taxing Option Luck

Jeesoo Nam*

As economic inequality reaches new heights every decade, academics stress the importance of the tax system in matters of equity. In contemporary winner-take-all markets, much of the massive income and wealth accumulated by the rich are the result of deliberate and calculated economic gambles that turned out in their favor. Yet theories of distributive justice such as Ronald Dworkin's brute luck egalitarianism have committed themselves to the position that even if these market outcomes are the results of luck, the unequal outcomes are justified insofar as investors chose to take such risks.

This Article argues, in contrast to the aforementioned theories, that inequalities resulting from option luck, the luck involved in deliberate and calculated gambles, remain unjust. This theory entails novel arguments in favor of imposing additional tax burdens on the most well-off members of our society and taxing capital income by demonstrating the extent to which unequal market outcomes are undeserved. Technological developments have led to winner-take-all markets in which even small amounts of option luck can lead to a wide divergence in results. A further tax imposed on the winners of such markets helps neutralize the economic inequalities resulting from luck. Differences in capital income are partly unjust because differential returns to investments are attributable, in large part, to chance. A tax on capital income compresses the distribution of these returns by lowering the returns to winning bets (by taxing such returns) and the losses of losing bets (by allowing deductions for such losses).

* Visiting Assistant Professor of Tax Law, New York University School of Law. I would like to thank Anne Alstott, Joseph Bankman, Lily Batchelder, Greg Cui, Noël Cunningham, Steven Dean, William Eskridge, Mitchell Kane, Sarah Lawsky, Yair Listokin, Laurie Malman, Liam Murphy, Takayuki Nagato, Daniel Shaviro, John Steines, David Weisbach, Minkeun Woo, and participants in the NYU – Lawyering Scholarship Colloquium. Any errors are mine and mine alone.

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INTRODUCTION

In September of 2016, just weeks after the Rio Olympics, Congress passed a bill exempting prizes awarded to athletes at the Olympic games from the federal income tax.[1] The law, now I.R.C. § 74(d), is an exception to I.R.C. § 74(a), the general provision which explicitly includes "prizes and awards" as the recipient's income. The bill passed the Senate unanimously and the House with near unanimous support (415 to 1).[2] The massive support the bill received in Congress contrasted starkly with how tax policy analysts perceived the new legislation.

The political rhetoric surrounding the bill—Chuck Schumer painting the Internal Revenue Service (IRS) as formerly "punishing" national heroes via taxation, for example—made little sense to tax scholars.[3] The IRS, after all, is not

[1] H.R. 5946, 114th Cong. (2016).

[2] *Id.*; *H.R.5946 – United States Appreciation for Olympians and Paralympians Act of 2016*, CONGRESS.GOV, https://www.congress.gov/bill/114th-congress/house-bill/5946/all-actions?overview=closed#tabs [https://perma.cc/Y6ZA-ARWR] (last visited Nov. 29, 2020).

[3] *See, e.g.*, Adam Chodorow, *Olympians Don't Need a Tax Break*, SLATE (Aug. 26, 2016, 5:34 PM), http://www.slate.com/articles/business/moneybox/2016/08/giving_olympians_a_tax_break_is_bad_for_america.html [https://perma.cc/HQN2-SVZ5]; Ira Stoll, *Pols Deserve Olympic Medal in Sport of Fiscal Hypocrisy for the Latest Tax Scheme*, N.Y. SUN (Aug. 15, 2016), http://www.nysun.com/national/pols-deserve-olympic-medal-in-fiscal-hypocrisy/89686/ [https://web.archive.org/web/20201106084105/https://www.nysun.com/national/pols-deserve-olympic-medal-in-fiscalhypocrisy/89686/].

a penal institution, and the imposition of tax is not an imposition of punishment.[4] If anything, it seems that carving out this exception to the income tax is the injustice, given that Olympic victories involve a substantial amount of luck.[5] Winning a gold medal at the Olympics requires almost everything to go right. Part of what needs to go right is unending effort on the part of the athlete—the claim that luck is involved is analytically distinct from the claim that effort is not involved—but the athlete must likewise be the winner of several lotteries. The athlete is greatly helped if he or she wins the genetic lottery, guaranteeing the physical attributes necessary to perform at the highest levels, and the parenting lottery, which gives athletes access to high levels of professional training at young ages. These are *brute luck* lotteries: lotteries for which the participants never chose to "play the odds," so to speak.[6] Children do not choose which genes to be born with or, for the most part, the qualities of their parents.[7] And there are other lotteries that influence the outcome as well. Who could forget the darling of the Rio Olympics, Chinese swimmer Fu Yuanhui, revealing in an interview that her performance sunk after her period began?[8] One's day-to-day physical condition matters and is to a large extent outside of one's control. There is similarly luck in the quality of one's coach or training program. Given the fact that there is always less than full information about the different coaching options available, it makes it a gamble as to who can really provide the most value-added. However, such *option luck* differs from brute luck in that the participant chose to play the lottery.[9] A coach might turn out to be good or bad, but insofar as the athlete was aware of the risk, he cast the die.

Given the massive amount of brute and option luck involved, we may question to what extent it is effort that divides a gold medalist from a fourth-place finisher going home empty-handed.[10] There is no doubt that a gold medal winner worked hard to stand on the podium, but surely so has the fourth-place finisher. And if the difference is largely a matter of luck, then common-sense fairness dictates that government should work to close the gap between the economic

[4] *See* LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP: TAXES AND JUSTICE 31–37 (2002).

[5] Stoll, *supra* note 3.

[6] RONALD DWORKIN, SOVEREIGN VIRTUE: THE THEORY OF PRACTICE AND EQUALITY 73 (2000).

[7] I take it as prima facie plausible that the quality of one's parents is partly influenced by decisions children make. For instance, the decision of a child to fight with his parent may make the parent more tired and, thus, worse at parenting. In such a case, the resulting parent qualities would not be a matter of brute luck, but rather option luck.

[8] Tom Phillips, *'It's Because I Had My Period': Swimmer Fu Yuanhui Praised for Breaking Taboo*, GUARDIAN (Aug. 15, 2016, 11:27 PM), https://www.theguardian.com/sport/2016/aug/16/chinese-swimmer-fu-yuanhui-praised-for-breaking-periods-taboo [https://perma.cc/KAN6-BXK6].

[9] DWORKIN, *supra* note 6.

[10] For an extensive discussion of causation from both a legal and metaphysical perspective, see generally MICHAEL S. MOORE, CAUSATION AND RESPONSIBILITY: AN ESSAY IN LAW, MORALS, AND METAPHYSICS (2009).

outcomes of the lucky and unlucky. Yet I.R.C. § 74(d) does quite the opposite. By exempting Olympic award income from taxation, lucky winners get an even greater reward from their luck than they otherwise would have.

The proposition that there is something unfair about a person being worse off or better off merely as a matter of luck is prominent not only in the common sense of laymen,[11] but also the literature in legal theory and moral and political philosophy.[12] Of particular interest to tax scholars is how the idea relates to distributive justice, the area of political philosophy which examines how we ought to distribute the benefits and burdens of a society among its members through institutional design.[13] *Luck egalitarians* believe that differential results brought about by luck are unjust.[14] Therefore, the government has at least a prima facie obligation to neutralize the effects of luck on citizens. There are, broadly speaking, two methods of neutralization. The first method neutralizes bad luck by providing assistance to the unlucky. We might, for example, provide additional educational resources to the children of underprivileged families. The second method neutralizes good luck by taxing the lucky. We might, for example, repeal I.R.C. § 74(d) and tax Olympic gold medalists on their income.

Admittedly, from a revenue perspective, the Olympic prize exception is so small as to be nearly irrelevant. The United States Olympic Committee provides $37,500 for each gold medal earned at the Olympics, and a very small percentage of U.S. taxpayers win gold medals.[15] The cash prizes may be significant to the individual athletes receiving them, but the Olympic prize tax base is small potatoes to the public fisc. In total, the entire bill was estimated to decrease revenues by just $3 million over ten years.[16]

What the Olympic example highlights, more importantly, is the intuitive notion behind luck egalitarianism that we do not deserve the results of luck. This intuition can be transferred to other areas of economic activity that do serve as significant tax bases. This Article argues in Part III that the principle of luck

[11] Alexander W. Cappelen, James Konow, Erik Ø. Sørensen & Bertil Tungodden, *Just Luck: An Experimental Study of Risk-Taking and Fairness*, 103 AM. ECON. REV. 1398, 1400 (2013).

[12] *E.g.*, BRIAN BARRY, POLITICAL ARGUMENT 74 (2010); JOHN RAWLS, A THEORY OF JUSTICE 64 (rev. ed. 1999); WOJCIECH SADURSKI, GIVING DESERT ITS DUE: SOCIAL JUSTICE AND LEGAL THEORY 116–17, 122 (1985) ("The general underlying aim of this conception of desert is to screen out all those factors that are 'unearned', that are beyond human control, that are dictated by dumb luck, and for which a person cannot claim any credit.").

[13] Jeesoo Nam, *Biomedical Enhancements as Justice*, 29 BIOETHICS 126, 126 (2015).

[14] See Part II, for a more detailed description of luck egalitarianism.

[15] Brandon Penny, *U.S. Olympic Committee Significantly Increases Payments to Athletes for Olympic/Paralympic, World Medals*, TEAM USA (Dec. 13, 2016, 6:19 PM), https://www.teamusa.org/News/2016/December/13/US-Olympic-Committee-Significantly-Increases-Payments-To-Athletes-For-Olympic-World-Medals [https://perma.cc/C9UB-RACP].

[16] CONG. BUDGET OFF., COST ESTIMATE: H.R 5946, UNITED STATES APPRECIATION FOR OLYMPIANS AND PARALYMPIANS ACT 1 (2016), https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/costestimate/hr5946.pdf [https://perma.cc/HV8Y-ZDKR].

egalitarianism justifies taxing the most well-off members of our society at a greater rate and taxing capital income, drawing upon research in economics and finance regarding the ubiquity of luck in such market outcomes. Both of these tax issues are perennial hot topics[17] and, in their latest foray into the zeitgeist, came to the forefront of the public's attention with the initial rise of Senator Elizabeth Warren's popularity for the 2020 Democratic presidential nomination.[18] Senator Warren's revenue proposals focused largely on taxing the rich and increasing taxes on savings and returns to investments.[19]

Both public figures and academics have staked out positions contrary to the theory of luck egalitarianism as well as its aforementioned implications for tax policy. Commentators have bristled at the burdens levied on the wealthy by Senator Warren's proposals.[20] Often, such discomfort is premised on the view that market outcomes are presumptively just and the most industrious among us are rewarded.[21] Others, following Ronald Dworkin's seminal works, disagree because

[17] The literature on these topics is rich and includes ALAN J. AUERBACH & LAURENCE J. KOTLIKOFF, DYNAMIC FISCAL POLICY 64–87 (1987); JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY WITH SOME OF THEIR APPLICATIONS TO SOCIAL PHILOSOPHY 806–37 (William James Ashley ed., new ed. 1923) (1848); William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1113–15 (1974); Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006); Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952); Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961 (1992); Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979); Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 STAN. L. REV. 745 (2007); Alvin Warren, *Would a Consumption Tax Be Fairer than an Income Tax?*, 89 YALE L.J. 1081 (1980). This list does not exhaust the many important contributions to the debate.

[18] *See, e.g.*, The Ed. Bd., Opinion, *The Billionaires Are Getting Nervous*, N.Y. TIMES (Nov. 8, 2019), https://www.nytimes.com/2019/11/08/opinion/sunday/bill-gates-warren-tax.html [https://perma.cc/E2YV-LVAY].

[19] Erica York & Garrett Watson, *Reviewing Elizabeth Warren's Tax Proposals to Fund Medicare for All*, TAX FOUND. (Nov. 1, 2019), https://taxfoundation.org/elizabeth-warren-medicare-for-all-tax-proposals/ [https://perma.cc/8PLN-KJ9M].

[20] Some of the public bristling has come directly from the wealthy themselves. The Ed. Bd., *supra* note 18. Worry about the progressivity of tax more generally is not limited to just the lay public. The connection between economic inequality and progressive taxation has made the topic an important object of study by tax scholars. *See* Blum & Kalven, *supra* note 17, at 520.

[21] *See* Patricia Cohen, *Warren Would Take Billionaires Down a Few Billion Pegs*, N.Y. TIMES (Nov. 16, 2019), https://www.nytimes.com/2019/11/10/business/economy/warren-billionaires-wealth-tax.html [https://perma.cc/S3QB-DTPP] (discussing the grounds of such discomfort). Such thoughts, of course, are not new. President George W. Bush has said that his tax cuts let Americans "keep more of their hard-earned dollars." George W. Bush, President, White House, President's Radio Address (Apr. 15, 2006), https://georgewbush-whitehouse.archives.gov/news/releases/2006/04/text/20060415.html [https://perma.cc/9SM2-KGL5]. There are also other reasons commentators have levied to criticize Senator Warren's plan, such as the disincentives it would create for investment. Jim Tankersley, *Warren Health Plan Tightens Democrats' Embrace of Tax Increases*, N.Y. TIMES (Nov. 2, 2019), https://www.nytimes.com/2019/11/02/business/elizabeth-warren-health-care-plan.html [https://perma.cc/N59W-YJ4H] ("Conservative critics say they would cripple business investment, slow economic growth and dissuade future entrepreneurs.").

they think that luck results in unjust outcomes only when the risk was not deliberately taken (i.e., brute luck).[22] (I call the view that only brute luck leads to unjust outcomes *brute luck egalitarianism* and the view that both brute luck and option luck can lead to unjust outcomes *luck egalitarianism*.[23])

On this view, insofar as individuals deliberately chose to take on risks in their business ventures, their enormous winnings from market competitions and capital investments are justified.[24] The policy implication of such a view is that we cannot tax wealthy winners of risky market competitions any differently from impoverished losers of such competitions so long as both the winner and loser, ex ante, had a fair shot at winning.[25] Such iron fetters prevent, on grounds of principle, meaningful taxation of the wealthy.

In order to determine whether these critics are right, we must think carefully about the nature of distributive justice, the corresponding role of desert with regard to the economic outcomes of our actions, and the positive facts regarding the sources of inequality.

This Article argues against the Dworkinian position that brute luck is the only kind of luck which leads to unjust distributions of benefits and burdens. Unjust distributions can arise even when the risks are deliberately taken on (i.e., result from option luck). This Article then analyzes the tax system from the perspective of luck egalitarianism, focusing on the injustice of option luck. My normative analysis of option luck generates novel arguments in favor of taxing capital income and the most well-off members of our society. Although legal scholarship has had much to say about taxing brute luck,[26] this Article is the first to bring focused, systematic attention to how the tax law might be structured to account for option luck.

The remainder of this Article proceeds in four parts. Part I briefly explains the two concepts fundamental to the tax law: base and rate. It discusses the nature

[22] DWORKIN, *supra* note 6, at 73–78; *cf.* BRUCE ACKERMAN & ANNE ALSTOTT, THE STAKEHOLDER SOCIETY 96–97 (1999) (stating wealth inequality would be legitimate when there is genuine equal opportunity).

[23] *See* Peter Vallentyne, *Brute Luck, Option Luck, and Equality of Initial Opportunities*, 112 ETHICS 529, 540 n.17 (2002) ("It is misleading to call [brute luck egalitarianism just] 'luck egalitarianism,' since it does not call for equalizing option luck.").

[24] To the extent that such results are brought about by brute luck, such as differences in natural ability, brute luck egalitarians would, analytically, find differential outcomes to be unjust. *See infra* Section II.B.

[25] *See infra* Section II.B.

[26] The literature detailing the taxation of brute luck includes MURPHY & NAGEL, *supra* note 4, at 103–07; Anne L. Alstott, *Equal Opportunity and Inheritance Taxation*, 121 HARV. L. REV. 469 (2007); Barbara H. Fried, *Compared to What? Taxing Brute Luck and Other Second-Best Problems*, 53 TAX L. REV. 377, 385–95 (2000); Eric Rakowski, *Can Wealth Taxes Be Justified?*, 53 TAX L. REV. 263, 353–54 (2000); Lawrence Zelenak, *Taxing Endowment*, 55 DUKE L.J. 1145, 1153–81 (2006).

of progressive taxation and the role of capital in distinguishing between the commonly considered tax bases: wealth, wage, income, and consumption.

Part II outlines and argues in favor of a broad conception of luck egalitarianism. It teases out the theoretical nuances of the common-sense principle that it is unfair for a person to be made better or worse off than others purely as a matter of luck. I further argue that such unfairness persists even for those who chose to take such risks. Justice does not depend on the option luck/brute luck distinction.

Part III considers the design of tax law to achieve luck egalitarian aims. One way the government would be able to further such goals is greater taxation of the most well-off members of our society. The dynamics of winner-take-all markets create a wide divergence in economic outcomes between winners and losers, and the highly competitive nature of such markets makes it nearly impossible to win without luck on one's side. Another way the government would be able to further luck egalitarian goals is the taxation of capital income. The received wisdom from financial economics is that most investments have a lottery-like component, which separates winners and losers on the basis of luck. I explain that these differential effects can be partly neutralized by the imposition of an income tax, thereby promoting distributive justice under the luck egalitarian conception.

Part IV adds to the ongoing debate in tax scholarship about whether taxpayer behavior shifts in response to a capital income tax to eliminate the effects of imposing such a tax. From the critic's point of view, a taxpayer will respond to a tax on capital income by taking on more risk, thereby counteracting the tax's purpose of neutralizing the impact of luck. A key premise of the critic's view is that individuals are ultimately motivated by a financial incentive to undo the effects of a capital income tax. In response, I argue that taxpayers have both primary and derivative moral reason not to eliminate the effects of a tax on capital income. Contrary to the standard picture of the IRS and taxpayer as cat and mouse, I put forth that tax law is better understood as a collaborative enterprise between state and citizen. We know that we each have an obligation to contribute towards a societal pool to fund government functions, but it is very hard to figure out what the size of such a contribution should be. Citizens have, as a group, employed legislative and administrative agents to resolve the difficult moral problem of the appropriate level of how much they ought to contribute. To voluntarily eliminate the effects of imposing a tax on capital income would run counter to the taxpayer's moral aim of providing the appropriate amount to the societal pool. This sketch is the first step of a long-term project detailing the proper relation between taxpayer and state.

I consider the main contributions of this Article to be the introduction to the tax literature of several conceptual tools for policy analysis. The Article lays out both positive and normative features of option luck and outlines the proper boundaries of a luck egalitarian theory of justice. The Article also puts forth a view of how taxpayers ought to conceive of the tax law as a collaborative enterprise, which is novel to tax scholarship. Although such tools are used herein to demonstrate that a tax on the most well-off members of our society and a tax on capital income can be justified on the grounds of luck egalitarianism, given their theoretical nature, they can be used generally across various contexts. My hope is that these contributions will serve as helpful resources for future thinking about the tax law and other areas of law important for distributive justice, such as health care and education policy.

I. BASE AND RATE AS THE FOUNDATIONS OF TAX LAW

The concerns of this Article regarding capital income and the relative tax burdens of the rich and poor are, put in more technical language, proposals about the tax base and the tax rate. The concepts of base and rate constitute the foundations of tax law.[27] A tax base is a set of properties (such as the property of being a citizen for purposes of a head tax or one's labor income in a wage tax), the instantiation of which is taxed by the government.[28] The tax rate determines the amount that a taxpayer must pay to the government, typically given some qualities of the taxpayer (such as her level of income, her marital status, her elections made,[29] etc.), for the instantiated property being taxed. Even the simplest tax system must determine what to tax and how much to tax it.

A. Progressive Tax Rates

Our current income tax system has a facially progressive rate structure. A taxpayer must pay greater amounts of tax for each additional dollar of income earned as the taxpayer moves up the income brackets.[30] In substance, however, the calculation of one's tax liability is a complex function dependent on what kind of income one has, which can violate progressivity. For instance, if one's income is composed entirely of long-term capital gains, one will have lower tax liability than those with slightly less income derived entirely from employment.[31] One alternative to a progressive rate structure would be a flat rate structure, under which the amount of tax paid for each dollar of income earned does not change

[27] Query whether these two pillars are indeed two. I suppose that the rate concept could subsume the base concept since to be excluded from the tax base is equivalent to having a tax rate of zero, and to be included in the tax base is equivalent to having a nonzero tax rate. Nevertheless, I follow the standard treatment in tax policy literature of distinguishing between the concepts of base and rate. Better to risk being redundant than to risk being incomplete.

[28] Joel Slemrod defines the concept of a tax base as those "events or states of the world [that] trigger tax liability." Joel Slemrod, *Tax Compliance and Enforcement*, 57 J. ECON. LITERATURE 904, 905 (2019). Events and states of the world are properties on a broad construal of properties, i.e., properties as ways of being.

[29] *E.g.*, Treas. Reg. § 301.7701-3(a) (2019).

[30] I.R.C. § 1.

[31] I.R.C. § 1(h), (j).

with respect to the taxpayer's income.[32] How to measure the overall progressivity of the tax system is a contentious matter, but one estimate, by economists Emmanuel Saez and Gabriel Zucman, measures tax burden as a proportion of income to be mostly flat with respect to pretax income level.[33] Surprisingly, the top 400 Americans with the highest pretax income paid a lower tax rate than the rest of the population.[34]

Progressive taxes are often justified on utilitarian grounds by appealing to the assumption of declining marginal utility.[35] There are variations on the theme (at least one of which extends as far back as the eighteenth-century philosopher Jeremy Bentham),[36] but here is a straightforward utilitarian version of the argument. Suppose one thinks that laws should maximize the total utility of a society. According to the assumption of declining marginal utility, taking away a dollar from a rich person brings him less disutility than taking away a dollar from a poor person.[37] That dollar is, in a sense, worth less to the rich person than the poor person. Putting those two theses together, tax law ought to redistribute from the rich to the poor, where the marginal dollar can provide more utility.[38]

Although often made, the assumption of declining marginal utility has not

[32] Research into optimal income tax models, flowing from J.A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175 (1971), have implications for the tax rate. In this Article, I am more concerned with desert than maximizing welfare, so I put aside discussions of optimal income tax models for the purpose of expository expedience.

[33] EMMANUEL SAEZ & GABRIEL ZUCMAN, THE TRIUMPH OF INJUSTICE: HOW THE RICH DODGE TAXES AND HOW TO MAKE THEM PAY 14–15 (2019) [hereinafter SAEZ & ZUCMAN, THE TRIUMPH OF INJUSTICE]; Emmanuel Saez & Gabriel Zucman, Opinion, *How to Tax Our Way Back to Justice*, N.Y. Times (Oct. 11, 2019) [hereinafter Saez & Zucman, *How to Tax Our Way Back to Justice*], https://www.nytimes.com/2019/10/11/opinion/sunday/wealth-income-tax-rate.html [https://perma.cc/7B7G-SQXQ]. Estimating tax burdens necessitates making difficult decisions about both how we measure the tax burden of an income group as well as how to make precise the vague concept of one's overall tax burden. *See also* Garrett Watson, *Saez and Zucman's Latest Estimates of Tax Burdens Don't Fully Consider the Impact of Taxes on Saving and Investment*, TAX FOUND. (Oct. 28, 2019), https://taxfoundation.org/emmanuel-saez-gabriel-zucman-triumph-of-injustice/ [https://perma.cc/75BV-2SFZ] (criticizing the decisions made by Saez and Zucman in their estimates with emphasis on the importance of taking into account transfers in a holistic view of the fiscal system). An alternate estimate by the Congressional Budget Office calculates the average federal tax rate to be progressive. CONG. BUDGET OFF., PROJECTED CHANGES IN THE DISTRIBUTION OF HOUSEHOLD INCOME, 2016 TO 2021, at 17 (2019), https://www.cbo.gov/system/files/2019-12/55941-CBO-Household-Income.pdf [https://perma.cc/XP4R-575H].

[34] SAEZ & ZUCMAN, THE TRIUMPH OF INJUSTICE, *supra* note 33, at 14–15; Saez & Zucman, *How to Tax Our Way Back to Justice*, *supra* note 33. Saez and Zucman detail their methodology in SAEZ & ZUCMAN, THE TRIUMPH OF INJUSTICE, *supra* note 33, at 6, https://eml.berkeley.edu/~saez/SZ2019Appendix.pdf [https://perma.cc/V4RX-3PHH] (specifying in the online appendix of the book that they are analyzing "the top 400 adults with the highest pre-tax income" and that "the top 400 in pre-tax income and the top 400 in wealth are essentially the same").

[35] Sarah B. Lawsky, *On the Edge: Declining Marginal Utility and Tax Policy*, 95 MINN. L. REV. 904, 908 (2011).

[36] *See* MILL, *supra* note 17, at 806.

[37] Lawsky, *supra* note 35, at 904, 915.

[38] *Id.* at 917.

been conclusively supported by argument.[39] There is evidence that marginal utility may be increasing rather than decreasing at some levels of income.[40] If the utilitarian argument is to be consistently followed, then the tax law ought to redistribute from the poor to the rich wherever marginal utility is locally increasing.[41]

Progressive taxes, given their role of redistributing tax burdens from poor taxpayers to rich taxpayers, may alternatively be justified on nonreductive egalitarian grounds as a partial solution to the massive and continually growing economic inequality in the United States.[42] The top 1% of income earners earn 20% of all income.[43] The top .01% of income earners have an average income of $28 million while the bottom 50% have an average income of $16,200.[44] The gains to income since 1980 have been almost entirely captured by the top half of income earners.[45] There is something prima facie unsettling about such a disparity in market outcomes. Under what set of theoretical commitments and empirical propositions could such large divides in market outcomes be justified?

B. Tax Bases: The Role of Capital

On the issue of tax base, there have been two fierce debates. The first debate concerns what the tax base ought to be. As a matter of straight tax theory, there are no limits to what the tax base can be. A government has the capacity to tax an individual on the basis of any property's instantiation in the world. As a practical matter, however, there are really just four candidate tax base categories that are in serious consideration for organizing national tax systems: income, wage, wealth, and consumption.[46] Within each category are several variations of the central idea that ties the category together. These variations often arise due to the rule of law's need to define hard borders at the penumbra of these vague concepts of income, wage, wealth, and consumption, as well as the practical limitations on enforcing an ideal income tax, ideal wealth tax, etc. For instance, two tax bases

[39] *See also* MILL, *supra* note 17, at 807 ("It may be said, indeed, that to take 100*l.* from 1000*l.* . . . is a heavier impost than 1000*l.* taken from 10,000*l.* . . . . But this doctrine seems to me too disputable altogether . . . .").

[40] Lawsky, *supra* note 35, at 904, 937.

[41] *Id.* at 941.

[42] Blum & Kalven, *supra* note 17, at 487. For one to view this account as "alternative" to the marginal utility account, one would need to deny that the concern regarding inequality reduces to a concern about marginal utility.

[43] Thomas Piketty, Emmanuel Saez & Gabriel Zucman, *Distributional National Accounts: Methods and Estimates for the United States*, 133 Q.J. ECON. 553, 575 tbl.1 (2018).

[44] *Id.*

[45] *Id.* at 577.

[46] MICHAEL J. GRAETZ, DEBORAH H. SCHENK & ANNE L. ALSTOTT, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 38 (8th ed. 2018). In practice, countries rely on a mix of tax bases. *See also* JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 552–53 (5th ed. 2016) (discussing the multiple tax bases at play for countries in the Organization for Economic Cooperation and Development).

may both fall under the income tax category but differ on whether to provide a deduction for the donation of gifts. I mention such differences only so that we can set them aside. This Article deals not with the intracategory differences, but instead an important intercategory difference. A central theme in deciding between these four bases, and a key topic of this Article, is the taxation of savings and the yield from savings (i.e., capital income).[47]

A brief discussion on how such taxes are connected to the four candidate tax bases will be worthwhile. Consider first wage and wealth as bases of taxation. By definition, labor and capital are distinct factors of production.[48] Therefore, an ideal wage tax would exclude capital income from taxation.[49] A wealth tax, however, taxes savings indirectly.[50] Since savings are just the accretions to one's wealth, the amount one has saved is a component of wealth until such amounts are spent or transferred to another.

Academically, more attention has been given to the role of savings in distinguishing between the tax bases of income and consumption. Income, under the dominant Haig-Simons formulation, was defined by Henry Simons himself as

> the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning.[51]

Put this way, it is easy to see that the debate between an income tax and a consumption tax is really a debate about taxing the accretion to wealth (i.e., savings).[52] Unlike a consumption tax, which taxes only the portion of income consumed, an income tax is indifferent as to whether a taxpayer's income is consumed or saved as it taxes all income. The tax on savings is what differentiates

[47] Bankman & Weisbach, *supra* note 17, at 1417. In this Article, I sometimes use the terms *savings* and *investments* interchangeably, which glosses over some subtleties. *Cf. id.* (treating the distinction between an income tax and a consumption tax as "the taxation of the return to savings or capital income" and, thus, the consumption tax as equivalent to a tax on labor); David A. Weisbach, *Ironing Out the Flat Tax*, 52 STAN. L. REV. 599, 603 (2000) ("The change in savings in a given period is equal to the difference between amounts saved and amounts withdrawn from savings to be used for consumption. We can measure this difference by measuring difference in receipts from the sale of investments and the outlays for the purchase of investments.").

[48] David A. Weisbach, *A Guide to the GOP Tax Plan – The Way to a Better Way*, 8 COLUM. J. TAX L. 171, 182 (2017).

[49] As a practical matter, whether income was derived from labor or capital is often hard to discern.

[50] *See, e.g.*, ACKERMAN & ALSTOTT, *supra* note 22, at 94–112 (a concrete wealth tax proposal).

[51] HENRY CALVERT SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938).

[52] Weisbach, *supra* note 48 (citing NICHOLAS KALDOR, AN EXPENDITURE TAX (1955) as the first to make this observation).

an income tax from a consumption tax. To move from a consumption tax to an income tax, we could impose a tax on savings. By the same identity, to move from an income tax to a consumption tax, we could provide a deduction for savings.[53] Such a tax system would be a cash flow consumption tax.[54]

Having explicated the relation between each candidate tax base and either the taxation of savings or the taxation of the yield from savings, it will be worthwhile to now briefly explicate the interrelation between the tax on savings and the tax on the yield from savings. Following the Cary Brown theorem, under certain conditions, a deduction for savings is equivalent to a tax exemption for the yield from savings.[55] That means that, under those conditions, a yield exemption tax would be equivalent to a cash flow consumption tax. Such conditions importantly include the identity of applicable tax rates, the taxpayer realizing the full benefit of a deduction for savings (e.g., through a tax that provides full refunds for negative amounts), and the reinvestment of the tax benefit gained from an exemption at the same rate of return.[56]

An example will help to illustrate this equivalence. Suppose that there is no tax on capital income. Under this regime, a taxpayer decides to save just $5 in Period 1 by purchasing a portion of Greenacre for investment, which provides a market rate of return. In table 1 below, this $5 amount is enclosed in parentheses to represent a negative amount for the investor. In Period 2, the value of Greenacre quadruples. The taxpayer's investment is worth $20, yielding a profit of $15 once the initial $5 cost is subtracted.

Table 1: Investment in Yield Exemption

Greenacre

	Period 1	Period 2	After-tax profit
Investor	(5)	20	15
Government	0	0	0

Suppose now that the government, instead of exempting capital income, had provided a deduction for any amounts saved. Suppose further that there is otherwise a tax of 50% imposed on income. These two positions constitute a cash

[53] *See* Weisbach, *supra* note 48, at 182 ("An income tax with a deduction for savings (that is, a consumption tax) is simply a tax on cash flows.").

[54] *Id.*

[55] E. Cary Brown, *Business-Income Taxation and Investment Incentives*, *in* INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN E. HANSEN 300, 301 (Lloyd A. Metzler ed., 1948).

[56] GRAETZ ET AL., *supra* note 46, at 317; Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, TAX NOTES 91, 99 (Apr. 5, 2004), https://www.taxnotes.com/tax-notes-today/fundamental-tax-system-structure/replacing-income-tax-progressive-consumption-tax/2004/04/06/ynbt [https://perma.cc/G8GF-93KA]. Graetz denies that the premises will hold, and therefore doubts the conclusion derived from such premises. Graetz, *supra* note 17, at 1602.

flow consumption tax.[57] If the taxpayer wants to replicate the result of the yield exemption system, he could invest $10 in Greenacre in Period 1. Notice that the extra $5 invested is just the value of the deduction for savings (50% of $10 saved) that the taxpayer receives in this alternate system.[58] That means that the after-tax cost of purchasing that portion of Greenacre was just $5. In Period 2, that investment is worth $40, all of which is taxable income since the cost of the investment was already deducted. The cash flow tax would take 50% of that, leaving $20 in the taxpayer's pocket. After subtracting the after-tax cost of the investment, this results in an after-tax yield of $15, replicating the end result of the taxpayer's situation in the yield exemption system. Notice also that the government's outcomes in the deduction scenario would be equivalent to the government simply choosing to invest $5 in Greenacre.

Table 2: Investment with Deduction

Greenacre

	Period 1	Period 2	After-tax profit
Investor	(10)	40	15
Government	(5)	20	15

The importance of capital as a factor of production in both the national and global economy cannot be overstated. Capital income accounts for 20–30% of U.S. national income depending on the year, and similar proportions are estimated for other countries as well.[59] Capital income from equity and bonds has replaced labor income as the key driver of income inequality in the United States.[60] The top 0.1% of income earners derive more than two-thirds of their income from capital while the bottom 90% derive less than 20% of their income from capital.[61]

Given the importance of capital in the economy, it ought to be no surprise that the normative question of whether we ought to tax savings and capital income has a rich literature.[62] Both John Stuart Mill and Thomas Hobbes argued

[57] Weisbach, *supra* note 48.

[58] To replicate the yield exemption tax, a taxpayer must invest x / *(1-t)* where x is the amount he would have invested in a taxless world and t is the tax rate imposed in the cash flow tax. GRAETZ ET AL., *supra* note 46, at 316.

[59] Piketty et al., *supra* note 43, at 595 (citing Loukas Karabarbounis & Brent Neiman, *The Global Decline of the Labor Share*, 129 Q.J. ECON. 61 (2014)).

[60] *Id.* at 557, 595.

[61] *Id.* at 595–96. This analysis is disputed by some economists. Matthew Smith, Danny Yagan, Owen Zidar & Eric Zwick, *Capitalists in the Twenty-First Century*, 134 Q.J. ECON. 1675 (2019).

[62] The literature includes Andrews, *supra* note 17; Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17 (1996); Fried, *supra* note 17; Graetz, *supra* note 17; Warren, *supra* note 17. Joseph Bankman and David Weisbach have called the choice between an income tax and a consumption tax "[p]erhaps the single most important tax policy

that savings should be excluded from the tax base.[63] Their arguments are familiar despite their age, focusing on the unfairness of taxing income whose benefit (consumption) has yet to be reaped, the ill economic effects of discouraging savings, and double taxation of the same earnings.[64]

The idea of excluding savings or the yield from savings from the tax base remains intensely popular in today's tax scholarship.[65] In contemporary discussion, the main positive arguments in favor of exempting capital income from taxation are simplicity and efficiency.[66]

In terms of simplicity, the implementation of an ideal income tax would impose a tremendous accounting burden. [67] Since accretions to wealth are considered income, any appreciation or depreciation of value in property held by a taxpayer must be taxed. In order for such a tax to be imposed, the change in value needs to be measured. Measurement of the change in value is a difficult task for many assets, such as real property or machinery.[68] If an income tax system relied on self-reporting of such changes in value, the difficulty of enforcing correct calculations would advantage the most odious of taxpayers who aim to defraud by underreporting appreciations and overreporting depreciations.[69]

Another advantage of exempting capital income is the economic inefficiency of the tax. The key insight is that a tax on capital income will distort both labor and savings decisions while a tax on labor income only does not distort savings

decision." Bankman & Weisbach, *supra* note 17, at 1414 (citing also the above authority among others at 1414 n.1).

[63] THOMAS HOBBES, LEVIATHAN 266–67 (Clarendon Press 1958) (1651); MILL, *supra* note 17, at 821–37

[64] HOBBES, *supra* note 63; MILL, *supra* note 17, at 821–37; Robert B. Ekelund Jr. & Douglas M. Walker, *J.S. Mill on the Income Tax Exemption and Inheritance Taxes: The Evidence Reconsidered*, 28 HIST. POL. ECON. 559, 563 (1996).

[65] Shaviro, *supra* note 17, at 745 ("In the last two decades, the dominant norm in fundamental tax reform has shifted from income taxation to consumption taxation, among academics no less than policymakers."); *see, e.g.*, Martin Feldstein, *The Welfare Cost of Capital Income Taxation*, 86 J. POL. ECON. S29, S37–39 (1978).

[66] *See, e.g.*, DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 313–15 (1986); JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE GREAT DEBATE OVER TAX REFORM 184–97 (2d ed. 2000).

[67] In practice, our income tax system strays from the ideal by taxing appreciations to property when such property is sold or exchanged by the taxpayer. I.R.C. § 1001(a); Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554 (1991). Such a rule, called the *realization requirement*, has its own issues. *See generally* Weisbach, *supra* note 48 (discussing the administrative and compliance issues that stem from having a realization-based income tax). For a discussion of the complexity that can arise from consumption taxes, see generally Deborah L. Paul, *The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?*, 76 N.C. L. REV. 151 (1997).

[68] As one example of a complication, machinery might lose value from wear and tear. *See, e.g.*, *Depreciation*, A DICTIONARY OF FINANCE AND BANKING (6th ed. 2018), https://www.oxfordreference.com/view/10.1093/acref/9780198789741.001.0001/acref-9780198789741-e-1011?rskey=SS6YRO&result=1 [https://perma.cc/R8EC-G2DM].

[69] GRAETZ ET AL., *supra* note 46, at 30.

decisions.[70] A standard economic perspective on savings treats it as reallocating consumption across time, often for the purpose of intertemporal consumption smoothing.[71] A tax on capital income distorts work effort by lowering the payoff for working when such income would be saved and used for future consumption.[72] The relative neutrality of exempting capital income makes such a policy more efficient.[73]

The popularity of exempting capital income from tax is not limited to academia. Although attempts to make a complete switch from the federal income tax to a consumption tax have not been successful,[74] legislators consistently push for, and have been partly successful in getting, both lower tax rates on capital income and greater availability of deductions for amounts saved. Consider, for example, the favorable treatment of many kinds of savings and capital income in the current tax code. As is commonly known, lower rates are available for long-term capital gains, and interest on state and local bonds are excluded entirely.[75] The Tax Cuts and Jobs Act, passed in 2017, lowered the corporate tax rate (a tax on capital income) from a top marginal rate of 35% to 21%[76] and offered a 100% "bonus depreciation" on qualified property (the equivalent of providing an immediate deduction for qualified investments).[77] The taxation of savings is a key issue not just academically, but politically as well.

Income tax proponents on the other side of the aisle argue that the taxation of savings will create more just outcomes in the distribution of tax burdens. Since holding investments in itself is a source of influence and stability, including savings in the tax base leads to a better measure of social outcomes and, thus, better distributional consequences.[78] These proponents prioritize the equalizing

[70] Bankman & Weisbach, *supra* note 17, at 1422–28.

[71] GRUBER, *supra* note 46, at 685–86.

[72] Bankman & Weisbach, *supra* note 17, at 1422–28.

[73] *But cf.* GRUBER, *supra* note 46, at 799 (discussing the literature on using savings as a way to target high-ability individuals "and efficiently redistribute from high-skill to low-skill individuals").

[74] ACKERMAN & ALSTOTT, *supra* note 22, at 78–79 (calling a national sales tax "a fiscal favorite of conservatives"). Rep. Billy Tauzin's (D-LA) National Retail Sales Tax is one such plan. WILLIAM G. GALE, EVAN F. KOENIG, DIANE LIM ROGERS & JOHN SABELHAUS, TAXING GOVERNMENT IN A NATIONAL RETAIL SALES TAX (Cong. Budget Off., Working Paper No. 1999-5, 1998), https://www.cbo.gov/sites/default/files/105th-congress-1997-1998/workingpaper/19995_0.pdf [https://perma.cc/3CGE-S4ZG].

[75] I.R.C. § 103 excludes state and local bond interest from gross income. I.R.C. § 1(h), (j)(5) reduces the tax rate on long-term capital gains. The incidence of a tax is critical to any analysis of tax policy, but evidence on incidence is mixed. *See, e.g.*, BENJAMIN H. HARRIS, TAX POL'Y CTR., CORPORATE TAX INCIDENCE AND ITS IMPLICATIONS FOR PROGRESSIVITY (2009), https://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/1001349-Corporate-Tax-Incidence-and-Its-Implications-for-Progressivity.PDF [https://perma.cc/37XJ-LUXM].

[76] I.R.C. § 11(b). "The corporate tax, for example, is paid by shareholders, because it reduces the amount of profit they can receive in dividends or reinvest in their companies." Saez & Zucman, *How to Tax Our Way Back to Justice*, *supra* note 33.

[77] I.R.C. § 168(k).

[78] Anne L. Alstott, *The Uneasy Liberal Case Against Income and Wealth Transfer Taxation: A*

effects of the income tax over the aforementioned points of simplicity and efficiency.

Interestingly enough, a second debate has arisen connected to the ebb and flow of the first. This second debate concerns whether the taxation of savings makes very much of a difference if at all. The central idea at stake here, and further explicated in Section IV.A below, is whether the imposition of a tax on capital income would elicit a countervailing response from the taxpayer to put himself in roughly the same position he would be in a system with no tax on capital income.[79] If so, then that would mean the imposition of a tax on capital income does not significantly change tax burdens, making such a tax neither more just nor less just. As a distributional matter, the tax would be nearly impotent. To the people who believe this thesis, the great similarity in tax burden between the taxation and nontaxation of savings is a strong point in favor of excluding savings from the tax base. Since the main argument in favor of an income tax depends on its distributive consequences, if it turns out that there are no such distributive consequences, then aforementioned considerations of simplicity would favor a consumption tax. The benefit of the income tax system was that it was supposed to bring about distributive justice at the price of this added complexity, but if the taxation of capital income has no effects on distribution, then we will have paid the coin of complexity to purchase nothing at all.

II. LUCK EGALITARIANISM

If one looks into an introductory text on tax law, he is likely to come across something similar to the following criteria by which we measure the merit of different tax policies: efficiency, equity, and simplicity.[80] Equity itself is divided into two kinds of equity: horizontal equity and vertical equity.[81] According to the criterion of vertical equity, those with greater ability to pay should bear heavier tax burdens than those with lesser ability to pay.[82] The starting point that we use to measure ability to pay is most often the current tax base of income, but it need not be.[83] Ability to pay is not obviously synonymous with income and could otherwise

Response to Professor McCaffery, 51 TAX L. REV. 363, 371 (1996); Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931, 946 (1975).

[79] *See generally* Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q.J. ECON. 388 (1944) (setting out the theory underlying this behavioral response); Joseph Bankman & 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) (teasing out the implications of the theory for the question of tax base); David A. Weisbach, *The (Non)Taxation of Risk*, 58 TAX L. REV. 1, 5 (2004) (discussing the assumptions of the theory). The ideas in the accompanying paragraph are explored much more in-depth *infra* in Section IV.A.

[80] GRAETZ ET AL., *supra* note 46, at 28–31.

[81] *Id.*

[82] *Id.* at 28.

[83] *Id.*

be measured by wealth, earnings potential, etc.[84] Horizontal equity is achieved when individuals who have the same relevant characteristics, typically the same ability to pay, pay the same amount of taxes.[85]

Yet these concepts cannot be the whole of thinking about equity. Take, for example, the hedonistic utilitarian who claims that taxation ought to, like every other legal policy, maximize the sum total of happiness in the world.[86] Insofar as the government must take a dollar from someone, they must take it from the one for whom this would cause the least displeasure. The utilitarian claim is not a claim about vertical equity. It does not state anything about how relative ability to pay relates to the proper rate of taxation other than to say that the two things are unrelated. If the poor man cares not much for money and the wealthy man is filled with avarice, then hedonistic utilitarianism demands we tax the poor man before the rich man, even though the relative ability to pay is clearly the other way around. The utilitarian claim is also not a claim about horizontal equity. For all the utilitarian cares, two people with equal ability to pay might pay wildly different taxes depending on how much displeasure each gets from loss of wealth. Yet surely, the utilitarian thesis is a claim about equity broadly construed, for the general concern of equity is to ask how we ought to distribute the benefits and burdens of a society amongst its members in the interests of justice.

The problem with traditional conceptions of vertical equity in tax policy is that they are outcome based. On such outcome-based views of tax justice, one's tax liability ought to be based on how "well-off" that person is vis-à-vis his peers, a relational feature of the distribution of outcomes.[87] Someone with high income, wealth, etc. ought to pay greater taxes than someone with low income, wealth, etc.[88] Yet we know that desert and outcome are crosscutting concepts.[89] Some wealthy individuals deserve to be poor. Some poor individuals deserve to be wealthy. Some wealthy individuals deserve to be wealthy. Some poor individuals deserve to be poor.

Outcome-based theories of justice conflict with ordinary intuitions about justice because they ignore the process by which those outcomes arose.[90] An arsonist setting fire to a stranger's house and a bystander rescuing a child from a burning building may both suffer the outcome of severe burn injuries, but we may say that the arsonist deserves such injury while the bystander does not.[91] The

[84] *Id.* at 29.

[85] *Id.* at 28.

[86] *See generally* Torbjörn Tännsjö, *Classical Hedonistic Utilitarianism*, 81 PHIL. STUD. 97 (1996).

[87] ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 153–54 (1974).

[88] GRAETZ ET AL., *supra* note 46, at 28.

[89] NOZICK, *supra* note 87, at 154–55.

[90] *See id.*

[91] Nir Eyal, *Egalitarian Justice and Innocent Choice*, 2 J. ETHICS & SOC. PHIL. 1, 3–4 (2007) (supporting the proposition that it is unjust to let the bystander's burdens lie where they have fallen).

arsonist and the rescuer had the same outcome, but through different processes. We may consequently wish to provide a tax credit for the amount of any medical bills of rescuers while denying such credit to arsonists. This would be a process-based approach to tax policy. Although tax systems generally use outcome-based metrics for tax liability, this is permissible as a second-best metric when process is hard to measure.[92] It may, for instance, be difficult in practice for the government to distinguish between rescuers and nonrescuers.

A. Luck Corrodes Desert

Luck egalitarianism is part of a process-based approach to justice that therefore also does not neatly fit into the boxes of vertical and horizontal equity. Luck egalitarianism aims to neutralize the effects of luck, and therefore is concerned with whether the process behind an outcome was or was not determined by luck. The thesis is driven by the principle that one should not be left worse off than others as a result of that which was outside of one's control.[93] A variety of cases illustrate this intuition. In 2015, sixteen-year-old Hunter Treschl was wading in waist-high water off the coast of North Carolina when he was suddenly attacked by a shark.[94] Instantaneously, his arm was torn off his body.[95] Although Treschl survived the attack, he lost the use of his dominant arm.[96] Surely, it is unjust that Treschl suffered this grave injury. He does not deserve the loss of his arm. Treschl suffered a bout of horrendous luck. How chance events turn out is by definition outside of our control, and the resultant consequences are morally arbitrary. But Treschl is just one of billions whose lives are affected by bad luck of one sort or another. Luck is absolutely pervasive. Some die in infancy, others stub their toes in the dark. The natural course of life does not distribute burdens according to just deserts. And just as bad consequences can be distributed by chance, so can good consequences. Having the right sorts of parents, having

[92] Those who take process to be an important determinant of justice still concede that the government can more easily collect information about market outcome rather than the facts about process that matter. ACKERMAN & ALSTOTT, *supra* note 22, at 97. On that account, we might take an outcome-based approach to justice in designing the general tax system (as exemplified by using income as the primary metric of outcome in a tax system) and use that as a foundation from which to make alterations based on our information about process. *See id.* at 155–77; Nicholas Barry, *Reassessing Luck Egalitarianism*, 70 J. POL. 136, 146–47, 147 n.36 (2008). This was political philosopher John Rawls's view as well. MURPHY & NAGEL, *supra* note 4, at 55 ("Rawls is skeptical that there are feasible institutions that could detect the extent to which people's fortunes are due entirely to their choices. That in turn leads him to support the difference principle . . . ."). To the extent that we do have insight on the process, however, we should make alterations to the income tax to reflect that. Rough justice, as the saying goes, is better than no justice at all.

[93] The general idea is widely held. *See supra* note 12 and accompanying text.

[94] Katie Bosland, *North Carolina Shark Attack Victim Hunter Treschl 'Didn't Feel Anything*,*'* ABC NEWS (June 25, 2015, 6:14 AM), http://abcnews.go.com/US/north-carolina-shark-attack-victim-hunter-treschl-didnt/story?id=32018640 [https://perma.cc/GF5M-7RTZ].

[95] *Id.*

[96] *Id.*

the right genes, and being in a good day-to-day condition on the most important days were all lucky consequences previously discussed in relation to athletes.

With the general intuitions driving luck egalitarianism in place, we ought to examine the contours of the theory. At the margins, two questions are posed. First, on what line do we demarcate that which is gained through luck and that which is not? For the purposes of applied political philosophy, where it is particularly important to be theory neutral, it will suffice to use some common-sense notion of luck, that which is best defined negatively as the absence of effort and control over the results.[97] More important for this Article is distinguishing between a basic act and the resultant causal consequences as a matter of how much luck is involved.

Save for those who suffer from tragic disability or bind, we typically have remarkable control over the movement of our body. Such movements are generally undertaken for the purpose of accomplishing some causal result other than such movement, so we may consider such bodily movements *basic acts*. Yet we do not have such control over the results of such basic acts. One chooses to do some basic act which he believes to have a certain array of possible causal consequences; which of those consequences ends up being the causal result of his act always depends on factors external to the actor. For example, an arrow's hitting a bullseye, in part, must depend on the absence of a sudden gust of wind. The further those consequences ripple away from us, the greater the influence of interfering factors, and the less control we have over which result occurs.

B. Option Luck and Brute Luck

A second contour question is essential to the agenda-setting of this Article. Is all luck unjust or only some? In answering this question, Ronald Dworkin famously distinguishes between lucky consequences brought about through a "deliberate and calculated gamble," *option luck*, and those which were not, *brute*

[97] This definition preempts a possible counterargument that everything is a matter of luck since one does not choose whether one is genetically predisposed to contribute a lot of effort. All desert theorists must reject hard determinism, the radical view that we are not responsible for any of our actions since our actions are all causally determined by events outside of our control (e.g., the circumstances of our birth). SADURSKI, *supra* note 12. By the negative definition of luck, the fact that someone was genetically predisposed to contribute lots of effort will not dissolve his desert in the outcome of his effort. His genetic predisposition to expend effort does not entail the absence of his effort in determining the outcome, and therefore, by definition, the results of his effort are not the results of luck. Using more technical language, we may say that the *determined by* relation is not transitive—even if luck determines genetics and genetics determines effort outcome, that does not entail that luck determines effort outcome. So long as there was effort, it does not matter what cause brought that effort about. The backstop against hard determinism must be placed somewhere, and effort and choice arising from one's character are the best locations to place it. *See* DAVID LEWIS, *Evil for Freedom's Sake?*, *in* PAPERS IN ETHICS AND SOCIAL PHILOSOPHY 101, 109–10 (2000) (presenting arguments both for and against this position regarding character and hard determinism).

luck.[98] The astute reader will recall that this distinction was earlier introduced in the context of the genetic makeup of athletes (as brute luck) and the quality of their coach (as option luck).[99] Dworkin went on to argue that option luck was not unjust although brute luck was.[100] This Article will argue for and operate under a more inclusive conception of justice under which both option luck and brute luck are unjust.[101] For clarity, I again make explicit here that I intend to use the term *brute luck egalitarianism* to denote the point of view that differential results arising only from brute luck are unjust; I intend to use the term *luck egalitarianism* to denote the point of view that differential results of both brute luck and option luck are unjust.[102]

Dworkin's aim with this philosophical distinction was to support his thesis of resource egalitarianism.[103] Suppose we start with an initial equal distribution of resources across the members of a society. Even so, events outside of our control will befall us as a matter of good or bad luck, thereby making the members unequal in outcomes. For example, one might be struck by an unpredictable bolt of lightning. When disadvantages result from brute luck, Dworkin argued, justice demands they be corrected.[104] The fundamental insight was to embed personal responsibility within a theory of justice that respects egalitarian values. [105] Balancing these competing virtues is a central task of modern liberal theories of distributive justice.

Significant ink has been spilled by respected authors to address the issue of brute luck in the law from a brute luck egalitarian perspective.[106] Often, these authors concern themselves with the ideal of equalizing our initial resources or opportunities in life—such as genetic makeup, parenting, and education—the distribution of which is not a matter of our choice.[107] We might call such approaches *starting point egalitarianism*, for they seek to make equal the starting points from which we are able to approach life.[108] Comparatively, there has been quite little said about the proper response towards option luck. The tax literature

[98] DWORKIN, *supra* note 6, at 73.

[99] *See supra* pp. 3–4.

[100] DWORKIN, *supra* note 6, at 74–78; Ronald Dworkin, *What Is Equality? Part 2: Equality of Resources*, 10 PHIL. & PUB. AFFS. 283, 292–99 (1981).

[101] These arguments will be reasons in favor of luck egalitarianism over brute luck egalitarianism. They do not concern the various other conceptions of justice, some of which are briefly discussed in Part II.

[102] *See* Vallentyne, *supra* note 23, at 540 n.17 ("It is misleading to call [brute luck egalitarianism just] 'luck egalitarianism,' since it does not call for equalizing option luck.").

[103] Barry, *supra* note 92, at 137.

[104] DWORKIN, *supra* note 6.

[105] G.A. Cohen, *On the Currency of Egalitarian Justice*, 99 ETHICS 906, 933 (1989).

[106] For the literature specifically on brute luck and taxation, see sources cited *supra* note 26.

[107] For an illuminating discussion of such a framework in relation to tax law, see ACKERMAN & ALSTOTT, *supra* note 22.

[108] For a helpful discussion of the distinction between brute luck egalitarianism and starting point egalitarianism, see Vallentyne, *supra* note 23, at 538–39.

lacks a thorough inquiry into the philosophical foundations and the applications of neutralizing option luck. Thus, my aim in this Article is to set out in systematic fashion both the theory of distributive justice underlying these ideas as well as how society can use the institutions of tax law to correct for the injustice brought about by differential option luck.

Before getting to any normative matters about the right political response towards option luck, some exposition, beginning with standard examples, will make the idea of option luck easier to work with. A standard example of brute luck is genetics and their resulting influence on one's phenotype. Mutation in the HBB gene, for instance, causes sickle cell disease.[109] Whether one has this mutation is a matter of brute luck. Other standard examples include the quality of one's parents and the country in which one is born. The standard examples of option luck, on the other hand, are riding a motorcycle without a helmet, purchasing a lottery ticket, and the like. The question of theory is whether these categories are distinct in kind and, if so, the nature of that distinction and its role in distributive justice.

As a short motto, Dworkin's "deliberate and calculated gamble" phrasing describes the idea behind option luck with some degree of success.[110] At least on the surface, the motto can work to split the prototypical cases just laid out along the appropriate lines. When one purchases a lottery ticket at the bodega, he surely makes a deliberate gamble. If he has full information, then it is also calculated. The same surely cannot be said of one's having the HBB gene mutation that causes sickle cell disease. One cannot point to the presence of any deliberate or calculated gamble on the part of the patient who has sickle cell disease that led to his status as such. Yet, the success is a limited one, for what it is to be deliberate and calculated is itself quite vague. For instance, how are we to classify the cases in which the individual is unaware of the fact that the action he is considering has a certain risk attached to it?

Dworkin, thankfully, attempts to provide further exposition of the vague motto. Option luck, per Dworkin, is the result of "accepting an isolated risk he or she should have anticipated and might have declined."[111] What is most striking of this exposition is how broadly he draws the boundaries of what it takes for a gamble to be deliberate and calculated. Dworkin explicitly includes as deliberate not only those risks that the individual knew about, but also those risks that the individual should have anticipated.[112] And similar to the idea of negligence implicating fault in tort and criminal law, this entails that an individual is

[109] Martin H. Steinberg, *Overview of Sickle Cell Anemia Pathophysiology*, *in* SICKLE CELL ANEMIA: FROM BASIC SCIENCE TO CLINICAL PRACTICE 49, 49 (Fernando Ferreira Costa & Nicola Conran eds., 2016).

[110] DWORKIN, *supra* note 22, at 73.

[111] *Id.*

[112] *Id.*

responsible for the outcomes of his actions even if he was completely unaware of the risk entailed, so long as that unknown risk should have been known.[113]

This broad definition of option luck leads to the first counterargument to the brute luck egalitarian position. *Pace* Dworkin, responsibility and desert require some conscious mental state by the actor of the outcome.[114] This is why we ordinarily take ignorance of the relevant facts to be a standard excuse to responsibility.[115] On any sensible notion of responsibility and desert, one cannot be responsible for outcomes that never crossed one's mind. Even on Dworkin's own terms, it is quite puzzling how one could be acting in a "deliberate and calculated" manner with regard to a risk when he is unaware of that risk.[116] Having the wrong information seems straightforwardly antithetical to the idea of a calculated gamble. The fault of negligence regards accidents, not deliberate acts.[117]

When the concepts of option luck and brute luck are subjected to close scrutiny, their supposed relation to desert falls apart.[118] Both option luck and brute luck create unjust outcomes.[119] The remainder of Part II presents further arguments in favor of luck egalitarianism, particularly in contrast to brute luck egalitarianism, and brings definition to the boundaries of the luck egalitarian theory.

Closely examined at the level of case intuition, brute luck egalitarianism's harsh stance on victims of bad option luck is hard to stomach. Return to the case of Hunter Treschl.[120] Suppose that Hunter knew that there was some minute probability of a shark attack if he chose to go for a swim that day. Presumably, this is the case for most of us when we go for a swim at the beach. Despite the risk, Hunter decided to wade out into the water only to suffer the catastrophic shark attack. Hunter's injury, by definition, resulted from option luck. Does the fact that

[113] Matt King, *The Problem with Negligence*, 35 SOC. THEORY & PRAC. 577, 587 (2009) ("[N]egligence is defined by a *lack* of conscious mental states, an unconscious inattention, and there need be no choices or decisions that contribute to that inattention."). The theoretical underpinnings of negligence and responsibility are discussed more generally in H.L.A. HART, *Negligence, Mens Rea, and Criminal Responsibility*, *in* PUNISHMENT AND RESPONSIBILITY: ESSAYS IN THE PHILOSOPHY OF LAW 136, 136 (2d ed. 2008); Michael S. Moore & Heidi M. Hurd, *Punishing the Awkward, the Stupid, the Weak, and the Selfish: The Culpability of Negligence*, 5 CRIM. L. & PHIL. 147, 147–48 (2011).

[114] King, *supra* note 113, at 579.

[115] *Id.*

[116] This idea is developed further in King, *supra* note 113, at 578–82, and also in Moore & Hurd, *supra* note 113, at 147–48.

[117] *See supra* note 113 and accompanying text.

[118] In the philosophy literature, this position has been argued by Barry, *supra* note 92, at 145–46.

[119] This version of luck egalitarianism is consistent with, though not identical to, theories of distributive justice, which take effort or sacrifice as the proper basis for desert. A well-developed example of such a theory is presented in SADURSKI, *supra* note 12, at 116–57. Whereas the effort-basis views are positive theories of desert, outlining what matters for desert, luck egalitarianism is a negative theory of desert outlining what does not matter for desert.

[120] *See supra* note 94 and accompanying text.

he acted with knowledge of the risk justify Hunter's loss of limb? Is his bad luck deserved insofar as it was a risk taken on knowingly? Surely not. Intuitively, Treschl's loss of limb is the kind of bad luck he does not deserve to bear whether he knew the risk before going to the beach or not.[121] That he, rather than any other swimmer that day, was bitten was morally arbitrary. The brute luck egalitarian conclusion that Hunter's tragic situation comports with justice is at odds with common sense.

Just as there is bad option luck, there is good option luck. It is a common refrain of tax academics that the tax system must have some way to reach into the pockets of people like Bill Gates.[122] Inequality between the most well-off and the least well-off members of society has exploded since the 1970s, and the tax system plays a critical role in the redistribution of economic outcomes.[123] But it is hard to see how a brute luck theorist like Dworkin would be able to justify much of a tax on the wealthy at all. One reason that Bill Gates is wealthy is that he took multiple deliberate and calculated gambles that turned out in his favor. Gates's wealth is partly a matter of option luck.[124]

If two people both have an equal shot of winning a competition that they voluntarily entered, then no matter how well the winner does or how poorly the loser does, brute luck egalitarianism cannot distinguish among them as a matter of justice. The results of such a competition are, by definition, not the results of brute luck. That means that if a competitor of Bill Gates had an ex ante identical chance of winning the race for software dominance as Gates did, then even if that competitor ends up destitute and Bill Gates ends up absurdly wealthy, brute luck egalitarianism cannot justify taxing the two individuals differently on that basis.

In Section III.A, *infra*, I discuss the research in economics that supports and explains the role of option luck in creating massive gaps in wealth. For now, consider the following half-fantastical thought experiment. Suppose that at the time of Bill Gates's birth, 100 children with the same amount of brute luck as Gates were also born. These 100 "brute luck equivalents" had roughly the same natural talents, roughly the same childhood upbringing, none are killed by unexpected earthquakes, etc. Let us further stipulate that all brute luck equivalents also exert roughly the same effort into their well-being. Would all 100 equivalents achieve a level of success equal to founding Microsoft? Surely not.

[121] For a similar objection and further discussion, see Marc Fleurbaey, *Equal Opportunity or Equal Social Outcome?*, 11 ECON. & PHIL. 25, 40 (1995). This objection is sometimes called the *harshness* objection. *E.g.*, Kristin Voigt, *The Harshness Objection: Is Luck Egalitarianism Too Harsh on the Victims of Option Luck?*, 10 ETHICAL THEORY & MORAL PRAC. 389, 390 (2007).

[122] *See, e.g.*, Shaviro, *supra* note 56, at 97.

[123] Piketty et al., *supra* note 43.

[124] *See* Alstott, *supra* note 26, at 500. For now, I make no suppositions of whether Gates's income is from labor or capital.

In fact, it is naturally plausible that some of those lives may turn out to be quite average. Let us suppose that one equivalent, despite his brute luck advantages in life, ends up (as a matter of option luck) struggling with alcoholism and a job that pays a yearly salary of $50,000.

Recall that, for the brute luck egalitarian, only differential results of brute luck are unjust. If two people with the same amount of brute luck earn divergent rewards in the marketplace, then the one with bad outcomes has no claim of unfairness against the one with good outcomes.[125] By stipulation, Bill Gates and his alcoholic brute luck equivalent had the same amount of brute luck. The brute luck theorist is therefore committed to the position that the two should bear the same tax liability, lest they violate horizontal equity on their own terms.[126] What is the amount of tax liability that can be imposed on both individuals that will make a dent in Bill Gates's wealth without suffocating the alcoholic brute luck equivalent? There is none. For instance, we could impose an annual tax liability of $50,000 on both of them, but it would only leave the brute luck equivalent destitute while making absolutely no difference to Gates. For brute luck egalitarianism to justify significant taxes on Gates, it must turn out to be the case that everyone who had as much brute luck as Gates ended up at least within the same financial ballpark so that they could bear the same tax burden as Gates without being suffocated by it.

But how likely is it that everyone who had as much luck as Gates ended up being similarly successful? Because there are so many members in our society, there are likely several who have had as much brute luck as Gates. Even if one thinks that Bill Gates had such spectacular brute luck that he is in the brute luckiest top 0.001% of the population, in our United States population of 328 million people, that would still mean that there are more than 3,000 others who had just as much brute luck.[127] Furthermore, economic inequality is so steep at the top that extremely few could be considered within Gates's financial ballpark. Currently, Gates has a net worth of $111 billion (and Jeff Bezos has a net worth of $179 billion) while the 25th wealthiest American has a net worth of "only" $17 billion.[128] Thus, we see that it does not take much to be comparatively much poorer than Bill Gates. Putting these premises together, there is almost certainly at

[125] Vallentyne, *supra* note 23, at 547.

[126] *See* Marc Fleurbaey, *Egalitarian Opportunities*, 20 LAW & PHIL. 499, 506 (2001); Barbara H. Fried, *Ex Ante/Ex Post*, 13 J. CONTEMP. LEGAL ISSUES 123, 160 (2003); Vallentyne, *supra* note 23, at 550 ("Brute luck egalitarians, that is, have tended to endorse something like the following principle of accountability: . . . If, prior to any coercive transfers, two agents are identical with respect to the factors for which justice requires equalization, then justice requires that the two agents have the same coercive transfers (e.g., taxes or subsidies).").

[127] *QuickFacts*, U.S. CENSUS BUREAU, https://www.census.gov/quickfacts/fact/table/US/PST045218 [https://perma.cc/3EST-FLG9] (last visited Aug. 4, 2019).

[128] *The Definitive Ranking of the Wealthiest Americans in 2020*, FORBES, https://www.forbes.com/forbes-400/ [https://perma.cc/4BWS-LLNL] (last visited Mar. 27, 2021).

least one person who had at least as much brute luck as Bill Gates and ended up doing much worse financially than Gates. Brute luck egalitarianism entails that either the person who is doing much worse than Gates must be imposed an insanely high tax liability (to get at the wealth of Bill Gates) or that we ought not tax Bill Gates very much at all (to prevent overburdening the person doing much worse than Gates). Brute luck egalitarianism is stuck between Scylla and Charybdis, and the ship must be abandoned.

In response, a critic of luck egalitarianism might pose to me a similarly structured counterargument. Suppose that we have set up a society in which only effort determines one's economic outcomes. Suppose further that the competition for software dominance involved no luck at all, but still could result in just one winner. Gates, again the winner, expended 101 units of effort and Competitor expended 100 units of effort. Wouldn't luck egalitarianism be unequipped to tax Gates and Competitor differently on such facts no matter how wealthy Gates is?

A few things can be said about such a criticism. First, one should note that, to the extent this may be a problem, the same problem applies with equal force to brute luck egalitarianism as well. As the problem assumes away luck, brute luck egalitarian justice requires no redistribution.[129] Thus, the criticism is no way to distinguish between the two central views at stake here. Second, a hard-liner who takes the equalization of luck as not only necessary but also sufficient for a just society should respond that once one sees what is going on in such a scenario, any trouble disappears. If Competitor had chosen to put in two more units of effort, he would have won. *Ex hypothesi*, Competitor knew how much effort Gates was putting in; if he didn't know, then it would have been a matter of chance, from Competitor's perspective, whether he or Gates put in more effort by the end of the competition, thereby contradicting our starting supposition. Once we tease out these facts about a luck-neutral society, the criticism does not seem too tough a pill to swallow. If Competitor knew he was going to lose and decided that the additional units of effort were not worth the benefits of winning the competition, then it seems to me at least not objectionable to say that Competitor has no claim for any part of Gates's winnings from the race. Third, one could take the equalization of luck as a necessary, but not sufficient, condition for a just distribution of benefits and burdens. If one further thinks that outcomes should be distributed *in proportion to* effort for sufficiency, then Competitor does have a claim against Gates if he ends up with nothing and Gates ends up rich. Such a distribution would not be in proportion to effort. That the equalization of option luck is merely necessary for a just distribution will motivate the policy arguments of this Article and is the primary distinction against the brute luck egalitarians, who deny that the equalization of option luck is necessary.[130]

[129] *See* text accompanying note 102.

[130] *See supra* note 119.

C. Defining the Boundaries of Luck Egalitarianism

Positive arguments like those above are important touchstones for thinking about issues of justice. We must also consequently ask whether there is some line of reasoning to demonstrate that the pull to find option luck as unjust is misleading. Dworkin himself proposes two candidates that might play this role. The first candidate counterexample to my thesis that both brute and option luck ought to be neutralized is premised on the idea of gambles as a desired activity, which would be ruined by a system of redistribution.[131] Surely, if a man goes into a casino to play multiple rounds of roulette, it would serve no liberal purpose for the government to step in and redistribute all earnings such that the man leaves the casino with exactly the amount with which he came in. Gambler walks up to the table, plops down $100 on red, the dealer takes his chip, spins the roulette, the ball lands in a hole, the government gives Gambler back his $100, and everyone has wasted their time. In such a world, no one would play roulette. Such a system of redistribution would "deprive both [the winner and the loser] of lives they prefer." [132] Luck neutralization for the casino gambler is nonsense. I wholeheartedly agree. One exception to the general rule that luck leads to unjust inequalities is when risk is what makes the activity good.[133] Risk can be an end rather than a means. For certain choices, the risk attached is not a cost to be stomached in pursuit of some other benefit, but risk itself is the benefit sought after. Gambling in a casino is at times an example of the latter.[134]

One heuristic to determine whether the risk is a benefit or a cost is to ask whether the agent making the choice in a state of ideal reasoning would accept or decline the offer to perfectly insure against the risk for "free" so that he ends up with the expected value of the gamble no matter what.[135] The gambler, I am certain, would actively reject the insurance. All the insurance would do is guarantee that he loses five cents on every dollar he bets on roulette.[136] The risk of loss is what makes the act of gambling enjoyable.[137] The risk, as such, is the thing desired rather than a cost one bears to achieve some other good. I suspect that other decisions, such as skydiving or drag racing, may be similar. Contrast this

[131] DWORKIN, *supra* note 6, at 75.

[132] *Id.*

[133] *See* Barry, *supra* note 92, at 138 (focusing on when a participant chooses a gamble proper).

[134] *See also* DWORKIN, *supra* note 6, at 95–96 (noting that some gambling is explained by "value to uncertainty for its own sake," while acknowledging there are other explanations for gambling as well).

[135] Barry, *supra* note 92, at 138–39.

[136] This is the expected value of all bets in roulette, with the exception of the top line or basket bets, which have an expected value of negative eight cents on the dollar. *Roulette*, WIKIPEDIA, https://en.wikipedia.org/wiki/Roulette#Bet_odds_table [https://perma.cc/K5UB-SJP8] (last visited Oct. 24, 2019).

[137] "The sole purpose of gambling . . . is to convert a sure thing . . . into a risky bet." Fried, *supra* note 126, at 144.

to the risk a law firm associate takes by devoting thousands of hours to specialize in a complex area of law (such as tax law) that Congress may a few years later decide to radically simplify, thereby eliminating demand for sophisticated experts. For her, the risk attached to her investment in specialization is an unavoidable cost rather than the thing sought after. She takes on the risk only as a means, not as an end.

By levying the criticism of desired gambling, the critic has, in some sense, got the right idea. I must revise my earlier principle. Not all outcomes determined by luck are unjust. Upon pressure by the gambling counterexample, I must concede that there is no injustice in allowing those who desired the risk of loss to bear the losses that they risked. Whereas Dworkin thought that a gamble being deliberate and calculated was sufficient to make the results just, I take it that one must actually desire the risk of a gamble (as marked by rejecting the offer to insure) in order for the results to be just.[138]

A second counterargument against the position that option luck is unjust is that it would be unfair to let those who willingly partake in risky ventures, even if partaken *despite* the risk, lay their burdens against those who chose to lead lives of safety.[139] To illustrate, we can again return to Hunter Treschl deciding to wade into waist-high waters off the coast of North Carolina. There does indeed seem to be some injustice if the government comes to collect money for Treschl's medical bills from those individuals who abstained from the pleasures of swimming precisely to guard against the risk of a shark attack. The person who stayed at home due to his fear of sharks has already paid the price of not being able to enjoy a nice swim. Again, I agree wholeheartedly with the critic. However, unlike the first counterargument, I do not take this second one to require a reformation of the luck egalitarian principle to exclude certain luck corrections. Instead, it requires a clarification about how the luck egalitarian program ought to proceed. Luck egalitarianism can sidestep the concern of unfairly burdening the safe actors by keeping risk within the pool of people who have taken identical or near-identical risks as opposed to equalizing outcomes between risk-takers and non-

[138] The discussion on gambling reinforces the idea that luck egalitarianism is not a paternalistic theory. Paternalist government action corrects for the short-sightedness of individuals—when an individual desires something that is not good for them. Luck egalitarianism has nothing to say about whether gambling in a casino is good for the gambler and, therefore, has no paternalistic reason to prohibit individuals from gambling. Luck egalitarianism is concerned purely with the justice of a distribution of benefits and burdens. Luck egalitarianism is not itself paternalistic, but is neither incompatible with paternalism. The administration of government requires principles outside of distributive justice, and these other principles, whatever they may be, might require limitations on gambling. Dworkin also thought that principles outside of brute luck egalitarianism would justify placing limitations on hazardous gambling. *See* DWORKIN, *supra* note 6, at 75; Ronald Dworkin, *Sovereign Virtue Revisited*, 113 ETHICS 106, 114–15 (2002).

[139] DWORKIN, *supra* note 6, at 74.

risk-takers.[140] We might call such corrections the neutralization of *intraclass* differential luck.[141]

In this Part, I have laid out the normative framework of luck egalitarianism and sketched a defense of the view that differential option luck ought to be neutralized within the risk class. This Article seeks not only to defend luck egalitarianism, but also to analyze tax law from its perspective. In some sense, the picture I have laid out in this Part is an ideal picture. As with many issues of distributive justice, figuring out how our legal institutions can effect these visions will require compromise away from the ideal given our limitations in information, ability, and transaction costs.

III. POLICY

A. Taxing the Rich

The practical limitations of information, ability, and transaction costs, along with some conceptual concerns, will lead to what may aptly be called *implementation problems*. Implementation problems arise due to the fact that laws must be written and enforced by human beings following some general rule of law principles. Whereas the conceptual issues with luck egalitarianism concerned what would be the best way to distribute benefits and burdens if we could distribute them in any way we wanted, the implementation problems deal with whether we can, in fact, distribute benefits and burdens in the way our best theoretical account demands. We have a theory which, at an abstract level, dictates who gets what; now how do we design the concrete legal institutions to do that? In this Part, I deal with the principal implementation problem of information and how two tax policies, taxing capital income and taxing the rich, get around the problem.

As usual, it will be easier to grasp these problems through examining a particular proposal. Consider the apparent flaws in the most straightforward

[140] Barry, *supra* note 92, at 146. In effect, this amounts to requiring individuals to insure against risk taken on as a means. (Recall that risk taken on as an end need not be equalized.) Any theory of justice must limit freedoms that would violate that theory of justice upon exercise. For instance, brute luck egalitarians must limit the freedom to give large inheritances to children insofar as doing so would upset any equality of brute luck. *See* Barbara Fried, *Wilt Chamberlain Revisited: Nozick's "Justice in Transfer" and the Problem of Market-Based Distribution*, 24 PHIL. & PUB. AFFS. 226, 235 (1995).

[141] This theoretical reformation leads to an interesting consequence regarding insurance in the private marketplace. Since people who have chosen to purchase insurance are in a different risk class than those who have not chosen to purchase insurance, the government's neutralization of intraclass risk works as a kind of default public option for insurance. Under an ideal luck neutralization system, those who have not insured against a risk are de facto insured by the government's neutralization of their luck. But this does not mean that there is no role for private insurance. If private insurers can carry out the task more efficiently than the government, then this cost-saving can be split for the benefit of purchasers of private insurance and thereby provides reason to purchase private insurance.

application of luck egalitarian principles in tax law: a 100% tax on all lucky income. The principal limitation on creating a luck egalitarian tax seems to be the information problem. The theory dictates that society distribute benefits and burdens so as to remove the effects of luck, and a 100% tax on lucky income would, ideally, accomplish that goal. But how would such a rule be enforced in practice? It is difficult, as a matter of empirical inquiry, to determine how much of one's income (understood in the broad Haig-Simons sense) is a matter of luck and how much is a matter of effort.[142] That is why Congress could not simply legislate for there to be a 100% tax on all lucky income. Tax compliance would require a tremendous amount of information about luck and its effects that we just do not have. Whether the determinants of our income are a matter of chance is an empirical inquiry, and it would be unreasonable for the governing body, much less individual taxpayers, to have to perform that investigation for all taxable income.

Grounded in the plausible premise that the income tax has been working passably well thus far, we might then respond to the information problem by taking a conservative approach that hews closely to the current regime of income taxation.[143] There are two ways to conservatively approach luck egalitarian revisions to the tax code. First, we might limit changes to areas where we are fairly confident luck plays a role. If we have great confidence that there is some substantial amount of luck involved in Olympic victory, to make use of a previous example, we should levy additional taxes on Olympic victories first. Second, we might simply have a more conservative tax rate than what we think justice demands in those areas where we are uncertain about the effects of luck. If we have .5 credence that 30% of Group *X*'s income is determined by luck and .5 credence that 15% of Group *X*'s income is determined by luck, for example, then a conservative approach would be to tax them in a way that neutralizes just 15% of their income. Both tactics, as is the mark of conservative tax policies, must purchase the security that those we are taxing do indeed deserve to be taxed, at the cost of undertaxing people who deserve a heavier tax burden.

There is both theoretical and empirical research in social science, typically economics, on the role luck plays in societal outcomes. One consistent line of such research shows that we can be confident that the most well-off members of society are so well-off partly as a matter of luck. This result is explained by two factors. First, the development of technology has created winner-take-all markets in which winners of market competition obtain vast riches. Second, given the size of such global markets, winning market competitions with the highest prizes almost certainly requires some element of luck.

[142] This is a problem for the effects of both brute luck and option luck. *See* ACKERMAN & ALSTOTT, *supra* note 22, at 97.

[143] The idea of income tax as a second-best solution is discussed *supra* note 92 and accompanying text.

Modern developments in technology, broadly construed, have created the opportunity for large disparities in pecuniary rewards with respect to small differences in performance.[144] Take, for example, advances in transportation. When shipping costs were high, manufacturers could exercise monopolistic power over their local regions since distant competitors had difficulty providing their goods in the local market.[145] As the technology for transportation improved, shipping costs decreased, thus diminishing the monopolistic power of local manufacturers.[146] The best producers, who need only have the slightest edge over their competitors, could now capture the entire industry's income regardless of where buyers were located while their competitors floundered.[147] Other developments akin to transportation include lower tariff barriers and rapid developments in communication technology, including the Internet.[148] Overall, such developments in technology have led to winner-take-all markets, markets in which performance relative to competitors is critical and payoffs are radically concentrated at the top.[149]

As competition for the large payouts at the top slots of winner-take-all markets grows more intense, we can have confidence that the winners are beneficiaries of luck. The reason why winning intense competitions with a wide competitor base requires luck was alluded to earlier in the discussion of placing first in the Olympics.[150] At the highest levels of competition, almost everything needs to go right in order for a competitor to win.[151] Part of that everything will be a matter of luck. That is why world records for events such as the 100-meter dash are almost always set with the help of tailwinds.[152] Of course, none of this is to say that effort is not a major part of the equation. But as the pool of competitors increases, there will be more and more people who put in almost as much effort as the person who ends up putting in the most effort, and it will be a matter of luck which of those people end up winning the competition. Since competitors choose to enter such competitions, the results are, at least partly, a matter of option luck.

One common way of getting a better grasp of the role of luck is to use mathematical models embedding different assumptions about how such competitions might work.[153] When we look at the results of such simulations, it

[144] ROBERT H. FRANK, SUCCESS AND LUCK: GOOD FORTUNE AND THE MYTH OF MERITOCRACY 40–55 (2016).

[145] *See id.* at 42.

[146] *Id.*

[147] *Id.*

[148] *Id.* at 42–44.

[149] *Id.* at 42–46.

[150] *See supra* Introduction.

[151] FRANK, *supra* note 144, at 63.

[152] *See* INT'L ASS'N OF ATHLETICS FED'NS, IAAF WORLD ATHLETICS CHAMPIONSHIPS DOHA 2019: STATISTICS HANDBOOK 680–81 (Mark Butler ed., 2019).

[153] *See, e.g.*, Alessandro Pluchino, Alessio Emanuele Biondo & Andrea Rapisarda, *Talent*

turns out that the role of luck is quite robust. One example of such a model illuminating the aforementioned intuition about luck in competition is described by the economist Robert H. Frank:

> [W]hichever contestant has the highest total performance score wins the contest. Performance, in turn, depends in varying degrees on talent, effort, and luck. One of the simulations examines a baseline case with 100,000 contestants and in which luck counts for only 2 percent of total performance. The remaining 98 percent is accounted for in equal parts by ability and effort. Each contestant's ability, effort, and luck values are independently drawn random numbers that are equally likely to lie anywhere between 0 and 100. The average luck score of contest winners in that simulation is 90.23, and 78.1 percent of winners did *not* have the highest combined total of talent and effort values.[154]

Even in a model in which luck is stipulated to determine just 2% of the performance, the winners of the competition had an average luck score of 90.[155] Since luck was distributed uniformly in these simulations, the luck score represents the percentage of the population that had less luck than that individual. That means the winners, on average, had more luck than 90% of their competitors. In a variant of the model in which the role of luck was stipulated to determine 10% of performance, the average luck score of winners went up to 97.[156]

Such analysis gives us some confidence in the proposition that the most well-off members of society, whether their wealth was won in the marketplace or as inheritance, were beneficiaries of good fortune.[157] Furthermore, the analysis should not be considered as standing alone, as it also accords with other evidence that the most well-off have been beneficiaries of luck.[158] Since the differential results of luck are unjust, luck egalitarianism provides a positive reason for laying

Versus Luck: The Role of Randomness in Success and Failure, 21 ADVANCES COMPLEX SYS., July 27, 2018, at 1, 5–7.

[154] FRANK, *supra* note 144, at 65–66.

[155] *Id.*

[156] *Id.* at 156 fig.A1.1.

[157] The proposition includes a disjunction. I have argued for one of the disjuncts—that concerning wealth won in the marketplace. I take it the second disjunct is widely agreed upon since the features of one's parents are largely outside of one's control. *See* ERIC RAKOWSKI, EQUAL JUSTICE 159–60 (1991).

[158] *E.g.*, Lily Batchelder & David Kamin, *Policy Options for Taxing the Rich*, *in* MAINTAINING THE STRENGTH OF AMERICAN CAPITALISM 200, 201 (Melissa S. Kearney & Amy Ganz eds., 2019) (noting that economic outcomes are determined by factors such as race and parents' economic advantage); Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q.J. ECON. 901, 902 (2001) (finding that when companies earn extra revenue from luck, CEOs will capture some of those profits as compensation for themselves); Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259, 276 (1983) ("The empirical evidence shows that inherited wealth accounts for at least half the net worth of wealthy men and for most of the net worth of wealthy women. Enormous one-shot gains explain most of the remainder of the significant wealth advantages of the truly rich.").

an additional tax burden on the most well-off members of society.[159] By definition, such a tax scheme would be a progressive tax scheme.

In this way, luck egalitarianism, by accounting for the differential results of option luck, diverges in tax policy implications from brute luck egalitarianism. As discussed in Section II.B, brute luck egalitarianism cannot justify a greater tax on the winners of a chancy competition if the entrants of the competition each had an equal shot at winning. Luck egalitarianism, which does not distinguish between option luck and brute luck, requires taxing the winners of such competitions differently. Given that technological advances increasingly widen the divide between the winners and losers of market competition, this distinction between the rival theories is of critical importance.

B. A Tax on Capital Income and the Neutralization Thesis

There is another arena in which we are quite confident that elements of luck are embedded. On the modern understanding of finance, the real (inflation-adjusted) return on market-priced investment can be decomposed into the following constituent parts.[160] First, investments require investors to defer the use of their income for consumption, and they must therefore be compensated for their waiting.[161] This rate of return is unrelated to risk or is *risk free*. The prime example of a nearly riskless asset (without risk premium) is a U.S. Treasury bond.[162] Given that the United States has essentially no default risk, all of the return on the asset is certain.[163]

The second and third components of investment returns are tied to risk-bearing. Most investment options are not riskless in the way that Treasury bonds are. In these alternative cases, investors are being paid to take on the risk a seller will offload. It is helpful to think of the returns to risk-bearing as having two

[159] The implications of winner-take-all markets for progressive taxation have been discussed in non-luck egalitarian contexts. *See, e.g.*, Martin J. McMahon, Jr. & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1, 10 (1998) (arguing for progressive taxation on grounds of economic efficiency and welfarism); Neil H. Buchanan, *The Case Against Income Averaging*, 25 VA. TAX REV. 1151, 1214–16 (2006).

[160] Shaviro, *supra* note 56, at 101. None of the four candidate tax bases include inflation since inflation is not income, consumption, wealth, or wage. Although many investments might leave opportunity to collect above-market returns by being underpriced (and the investor knows that it is underpriced), it is not clear how such gains would relate to luck. It appears that it would depend on how the investor came to know that the asset was underpriced and to what extent that process involved effort. *See* Fried, *supra* note 26, at 394. For the purpose of this Article, I assume all assets are correctly priced by the market, and there are no above-market returns to be had. As an empirical matter, estimates of the availability of such returns are sparse. Weisbach, *supra* note 47, at 606 n.12.

[161] Shaviro, *supra* note 56, at 101.

[162] *See* David F. Bradford, *Consumption Taxes: Some Fundamental Transition Issues*, *in* FRONTIERS OF TAX REFORM 123, 128–29 (Michael J. Boskin ed., 1996).

[163] *See* Stephen M. Penner, Note, *International Investment and the Prudent Investor Rule: The Trustee's Duty to Consider International Investment Vehicles*, 16 MICH. J. INT'L L. 601, 629 (1995).

components: ex ante and ex post.[164] The ex ante component, the *risk premium*, is the amount the buyer of risk is compensated for his assuming additional risk before the risk plays out.[165] The ex post component is the amount gained or lost by virtue of the risk playing out.[166]

It is easiest to conceptualize these components of returns to risk-bearing with an example. Suppose Larry, because of the particularities of his business, knows that there is a .5 probability that he will suffer a $5 loss tomorrow and a .5 probability that he will gain $5 tomorrow. Although the expected dollar value of the possible events is $0 (the sum of the products of possible outcomes and their probabilities of occurrence),[167] because Larry is risk averse, he prefers a certainty of getting $0 tomorrow rather than the win or lose probabilistic event. Thus, he arranges a deal with John in which John, in effect, insures Larry against risk—if Larry suffers the bad outcome, John will pay him $4; if Larry gets the good outcome, Larry will pay John $6. No matter what happens, Larry will have net $1 less tomorrow than he does today.[168] Essentially, Larry has agreed to pay John $1 tomorrow in order to secure certainty about the future and have John bear all of the risk instead. John gets the $1 payment of ex ante return no matter what; his ex post return will be either a gain of $5 or a loss of $5.

Although returns to most, or perhaps all, investments have both riskless and risk-related components, it is important as a conceptual matter to understand the decomposition between the two types of return. For risky assets, given the fact that what one is being paid for is to bear risk, two people who bore the same risk may end up in wildly different positions through no fault of their own.[169] As an analytic matter, this is precisely the imposition of chance that they are being paid to bear. Suppose, to add to the previous hypothetical, that Mary, operating a completely unrelated venture, faces an independent but identical probabilistic distribution of outcomes as Larry. Mary pays Sean $1 to bear this risk using the same deal structure Larry and John had. Naturally, since Mary's venture is independent of Larry's, it could be that Larry gets the good outcome tomorrow while Mary gets the bad outcome. Given their insurance contracts, Sean would be down $4 while John would be up $6. By events outside of their control, there was a $10 disparity of income created between two people who took the same risks.

[164] Shaviro, *supra* note 56, at 101.

[165] *See id.*

[166] *See id.*

[167] $(\$5 * 50\%) + (-\$5 * 50\%) = 0.$

[168] In the bad outcome, his ledger is: $-\$5 + \$4 = -\$1$. In the good outcome, his ledger is: $\$5 – \$6 = -\$1$.

[169] Graetz, *supra* note 17, at 1601.

Luck egalitarianism places a prima facie burden on the state to neutralize such differential luck.[170]

Although the above examples used the idea of an insurance contract, investment products are not much different. Research on returns to capital investment show that most of the returns are comprised of payment for risk-bearing because the riskless rate is quite low, hovering near zero.[171] Investors are paid mostly for their bearing some portion of the investment's risk and paid further upon the risk playing out. And insofar as these investments involve risk, investors with identical ex ante positions can end up with wildly different ex post outcomes purely as a matter of luck. Given the minor role that riskless rates play, differential results among investors are largely the result of luck. In large part, an understanding of returns to capital as largely composed of returns to risk-bearing quells the first fears of the information problem.

Let us run through an example of how a tax on investment income would be able to create greater equity between two investors who were ex ante identical. First, let us make some simplifying assumptions. Suppose that the riskless rate is 0. This supposition, which is not far from the truth, will guarantee that the real returns on investment will be completely from returns to risk-bearing. Suppose further that an individual investor may purchase as much or as little of Greenacre and Blackacre as possible. In Period 1, the investments between Greenacre and Blackacre are ex ante indistinguishable. From the Period 1 ex ante perspective, both investments will either be worth four times the initial investment (the winning scenario) or be worthless in Period 2 (the losing scenario), each with .5 probability occurrence. Ex post, it turns out to be the case that Greenacre gets the winning scenario and Blackacre gets the losing scenario. Everyone is risk averse.

In Period 1, Greg invests $5 in Greenacre, and Barry invests $5 in Blackacre. As before, negative numbers are denoted in the tables below by their enclosure in parentheses. In a tax system which does not tax returns on investment, the flow of cash would be as follows.

[170] *See supra* Section II.A. Sean and John are different from the situation of the casino gambler in that they presumably would take "free" insurance if it were offered to them (leaving them with the expected value of their bet of $1), whereas a roulette player would not.

[171] Bradford, *supra* note 162, at 129; Weisbach, *supra* note 79, at 24.

Table 3: Investment in Yield Exemption

Greenacre

	Period 1	Period 2	After-tax profit
Investor	(5)	20	15
Government	0	0	0

Blackacre

	Period 1	Period 2	After-tax profit
Investor	(5)	0	(5)
Government	0	0	0

In Period 1, Greg pays $5 to invest. In Period 2, the price of the asset goes up to $20. His net profit is $15.[172] For Barry, he pays $5 in Period 1 for something that declines in value to $0 in Period 2, so his net profit is a loss of $5. This means that purely from luck, *ex hypothesi*, there is created a $20 difference in outcomes between the two investors.[173]

Now suppose that the investments were made in an income tax system which taxes capital income. The tax rate is 50% on all income with full loss offsets.

Table 4: Investment in Income Tax

Greenacre

	Period 1	Period 2	After-tax profit
Investor	(5)	20	7.5
Government	0	7.5	7.5

Blackacre

	Period 1	Period 2	After-tax profit
Investor	(5)	0	(2.5)
Government	0	(2.5)	(2.5)

To purchase a portion of Greenacre, Greg will pay $5 in Period 1. In Period 2, the investment will be worth $20. In an ideal income tax system (without a realization requirement), this represents $15 of income from the investment.[174] Thus, the government will collect a tax of 50% on the income, a total of $7.50.

[172] This is the price of the asset in Period 2 minus the price of the asset in Period 1.

[173] *$15 – (-$5) = $20*.

[174] *See supra* Section I.B (discussing the taxation of accretions to wealth in an ideal income tax).

After everything is said and done, the government will end up with a net profit of $7.50 from the tax on Greg, and Greg will end up with an after-tax profit of $7.50 which accounts for the money he had to pay in taxes and the money he used to purchase the investment.[175] Unfortunately for Barry, he will end up with a worthless asset in Period 2. Again, in an ideal income tax, since Barry has a loss of $5 on his investment, 50% of that will be paid to him by the government as a loss offset.[176] In an ideal income tax, just as positive income leads to positive tax liability (i.e*.,* obligation of the taxpayer to pay the government) at the income tax rate, a loss or negative income leads to negative tax liability (i.e., obligation of the government to pay the taxpayer) at the income tax rate.[177] Therefore, the government loses $2.50 on the taxation of Barry in Period 2, and Barry gains $2.50.[178] This leaves Barry with an after-tax loss of just $2.50.[179] The differential effects of luck on Barry and Greg have been reduced to a divide of just $10 in the income tax system.[180]

In this example, an income tax reduced the difference between Greg and Barry by $10 compared to the system in which there was no tax on the yield from investments. This is because the income tax makes those who have income worse off and those who lose income better off. Thus, the income tax can play the role of neutralizing intraclass differential luck. Call this *the Neutralization Thesis*.

> **NEUTRALIZATION THESIS**: A tax on capital income neutralizes the luck differential in investment outcomes in comparison to a taxless system.

The Neutralization Thesis, when paired with the normative theory of luck egalitarianism, provides a strong reason to tax capital income.[181] A tax on capital income will alleviate the unjust differential results that arise as a matter of luck in investment outcomes.

[175] *$20 – $5 – $7.50 = $7.50.*

[176] *See supra* Section I.B (discussing the taxation of accretions).

[177] In our actual income tax system, such offsets are provided for by loss deductions. I.R.C. § 165.

[178] *$5 * 50% = $2.50.*

[179] Barry's $5 pretax loss is offset by the $2.50 loss offset he gets paid by the government.

[180] *$7.50 – (-$2.50) = $10.*

[181] However, the fact that such a reason exists is not to say that the luck egalitarian ideals are matched perfectly with an income tax. For instance, riskless returns, to which the arguments in this Section do not apply, are still taxed under an income tax system. Ideally, a pure luck egalitarian system would exclude those components of returns to investment income which are unrelated to luck. This sort of issue is similar to any attempt by the tax code to effectuate a foundational principle by use of a heuristic measure. Insofar as the heuristic will not map on exactly to the foundational principle, then there will be errors in taxation. Take, for example, any of the loss limitation rules involving sales between family members in I.R.C. § 267. If the family members really are an economic unit, then such rules rightly limit losses. If the family members are estranged and, in economic substance, unrelated parties, then the tax law errs in denying the loss deduction.

IV. Taxpayer Responses to a Tax on Capital Income

A. A Critique of the Neutralization Thesis

In the previous Section, I claimed that the tax on capital income helps neutralize differential luck on the premise that income tax taxes both the riskless return and the returns to bearing risk. I labeled the proposition that the tax compresses the distribution of investment outcomes the Neutralization Thesis. There is no consensus on the Neutralization Thesis in the legal literature.[182] There is a vocal push arising from work in public finance against the idea that a tax on capital income taxes returns to risk bearing.[183] The central notion of this critique revolves around the idea that investors can change their behavior in response to an income tax such that they would be left in the same after-tax position with regard to the returns to risk bearing as in a no-tax world (yield exemption).[184] This Section summarizes the key points of this critique of the Neutralization Thesis, keeping in mind the differences between an income tax, a yield exemption tax, and a consumption tax. The details can get very technical, but the discussion here is intended to be informal, aiming mostly to bring out the key intuitions behind the critique of the Neutralization Thesis. The following Section then explains why we ought not expect the sort of behavioral responses that the critique of the Neutralization Thesis anticipates.

1. An Illustration of the Critique with an Income Tax

As previously done, suppose that every other source of return on investment is 0 so that we can focus at the moment on just the risk component. As before, there are two assets, Greenacre and Blackacre, both of which will return either four times the initial investment one period after purchase or become worthless.

Let us again begin with how a $5 purchase of Greenacre and Blackacre, respectively, pay out when there are no taxes at play.

[182] Weisbach, *supra* note 79, at 3.

[183] The literature is large and includes Bankman & Griffith, *supra* note 79; Domar & Musgrave, *supra* note 79; Weisbach, *supra* note 79.

[184] *See* Bankman & Griffith, *supra* note 79, at 378 ("[I]nvestors in risky assets are able to offset the effects of government taxation of the risk premium by changing their investment portfolios.").

Table 5: Investment in Yield Exemption

Greenacre

	Period 1	Period 2	After-tax profit
Investor	(5)	20	15
Government	0	0	0

Blackacre

	Period 1	Period 2	After-tax profit
Investor	(5)	0	(5)
Government	0	0	0

There is a $20 gap between the investor who purchased Greenacre and the investor who purchased Blackacre.[185]

In the previous Section, I showed how Greg and Barry might be made more equal by a tax on capital income if they both invested $5. The tax essentially transferred part of Greg's lucky earnings to Barry's pocket. Opponents of the Neutralization Thesis contend that the error of the thesis is in thinking that Greg and Barry would invest $5 in the properties in an income tax system, the same way they invested in a yield exemption tax. Opponents of the Neutralization Thesis contend that what matters to Greg and Barry is after-tax outcomes, and the investors have the ability to adjust their investment such that their after-tax outcomes are identical for both the income tax and yield exemption tax regime.[186]

Consider just Greg's ex ante situation for the moment. Greg originally found it appropriate to invest just $5 in Greenacre, a quadruple or nothing bet across two periods. This would leave him with either $15 in profit or with a net loss of $5 (the loss represented by enclosure in parentheses).[187] If Greg is faced with a 50% tax on his capital income, notice what his ex ante prospects are for a larger $10 investment in Greenacre.

[185] *$15 – (-$5) = $20*.

[186] Domar & Musgrave, *supra* note 79, at 389–91.

[187] If the bet is successful, the investment will be worth $20, which is $15 more than the initial purchase price. If the bet is unsuccessful, the investment will be worth $0 and he will have lost his $5 initial investment.

Table 6: Investment in Income Tax (Grossed-Up)

Win

	Period 1	Period 2	After-tax profit
Investor	(10)	40	15
Government	0	15	15

Loss

	Period 1	Period 2	After-tax profit
Investor	(10)	0	(5)
Government	0	(5)	(5)

Greg's after-tax outcomes in the income tax system from an investment of $10 are identical to the outcomes of the yield exemption system from an investment of $5. Although pretax gains and losses doubled to $30 and $10,[188] a 50% tax rate offsets half of those amounts. Therefore, the government imposes an additional tax liability on Greg of $15 if Greg wins[189] and reduces Greg's tax liability by $5 via the deduction for losses if Greg loses.[190] If after-tax outcomes are the sole driver of Greg's investment, then he will respond to the imposition of the tax by merely doubling his investment to replicate what he would have received in a yield exemption system.

Notice the investor has to pay more, but we can assume that he will shift money he was investing without risk to the risky investment since he will actually bear the same amount of after-tax risk only after grossing up.[191] Put in portfolio terms, the investment portfolio is reapportioned between risky and riskless assets such that the investor ends up bearing the same amount of risk as he would without tax. The motivating idea behind all of this is that income tax reduces the yield (numerator), but it also reduces the risk (denominator) by the same rate such that the amount of money the investor is paid per unit of risk does not change.[192] Therefore, an investor can simply increase the amount of risk he takes on to be left in the identical position as a taxless system.

We have now laid out enough of the example to see why some might deny the Neutralization Thesis. As illustrated by table 9 "Investment in Income Tax (Grossed-Up)," if both Greg and Barry respond to the imposition of an income tax by changing their investment portfolios to replicate the exact after-tax outcomes of the portfolio they would have held in a yield exemption tax by

[188] The gain is calculated: *$40 – $10 = $30*. The loss is calculated as: *$10 – $0 = $10*.

[189] *$30 * 50% = $15*.

[190] *$10 * 50% = $5*. *See supra* note 177 and accompanying text.

[191] Domar & Musgrave, *supra* note 79, at 391. Or, if he did not have riskless investments and can borrow at the riskless rate of 0, he will be able to replicate the outcome.

[192] *Id.* at 390.

investing \$10 instead of \$5, then Greg and Barry will again be divided by \$20 once Greenacre wins and Blackacre loses.[193] The luck-induced differential outcomes have not been neutralized. But notice this result is not just the denial of the Neutralization Thesis. According to this model, the income tax is identical in its effects to the absence of any tax on capital income regarding the returns to risk-bearing. Call the premises that lead to these conclusions the *equivalence premises*. Such premises include zero transactions costs, adjustments by rational actors in accordance with their pecuniary self-interest, and corresponding adjustments by the government.[194] When the equivalence premises hold, income tax and yield exemption tax have identical effects with respect to risky returns. Only when the equivalence premises do not hold, as demonstrated in the previous Section, will the equivalence between income tax and yield exemption break.

2. An Illustration of the Critique with Consumption Taxes

Finally, this analysis can be extended to the tax base that occupies much academic discussion: the cash flow consumption tax.[195] Theoretically speaking, the difference between a consumption tax and an income tax can be understood as a difference in the time at which the investor gets to recover the basis in her property.[196] (Practically speaking, there are a myriad of differences flowing from how different the two taxes would be administratively, some of which was covered in Section I.B.) Recall the aforementioned breakdown of income into consumption plus savings. From that relationship, we can derive that an income tax with a deduction for savings is a tax on consumption. A cash flow consumption tax allows for immediate recovery of basis on an investment—thereby exempting the amount saved from taxation—whereas the income tax allows for recovery of basis only upon sale.[197] This means that the difference between a cash flow consumption tax and an income tax can be understood as one of timing.[198] The benefit of this difference in timing is priced by the riskless rate, which we have assumed to be 0 in these hypotheticals. With respect to returns to risk-bearing, then, the cash flow consumption tax should conceptually track the features of the income tax. Thus, everything just stated about the income tax can be said again about the cash flow tax. To demonstrate by example, consider the following replication of the after-tax outcomes of the yield exemption tax using a \$10 investment with cash flow consumption taxes in

[193] *\$15 – (-\$5) = \$20*.

[194] Weisbach, *supra* note 79, at 32.

[195] For a more extensive explication of the cash flow consumption tax and its contrasts against the income tax, see *supra* Section I.B.

[196] Weisbach, *supra* note 47, at 604.

[197] U.S. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 9 (1977).

[198] *See* Weisbach, *supra* note 47, at 604 ("[T]he major difference between an income tax and a consumption tax is the timing of basis recovery.").

place. Again, since the riskless rate is 0, the investor can invest the same amount of money that he would have in an income tax system.

Table 7: Investment in Cash Flow Tax (Grossed-Up)

Win

	Period 1	Period 2	After-tax profit
Investor	(10)	40	15
Government	(5)	20	15

Loss

	Period 1	Period 2	After-tax profit
Investor	(10)	0	(5)
Government	(5)	0	(5)

The only differences between the cash flow system and the income tax, speaking in an after-tax manner, are the periods in which Greg got to recover the basis and, consequently, when the government had to "pay" for such basis recovery. In the income tax, all of this occurs in Period 2. In the cash flow tax, all of this occurs in Period 1 where the taxpayer is provided an immediate deduction for the cost of the investment, which, at a tax rate of 50%, is the equivalent of a $5 transfer from the government to the taxpayer.[199] However, if the riskless rate is stipulated away as we have done here, the after-tax outcomes are identical and the difference of timing fails to make a difference.

But because the after-tax outcomes of the cash flow tax and the income tax are identical when the amount of money initially invested is held fixed, in the case where the equivalence premises break and investors do not adjust their portfolios in response to an imposition of tax, cash flow tax and income tax will remain aligned in neutralizing the differential outcomes from risky investing.[200] Both tax systems will be different from the yield exemption system, which cannot play such a neutralizing role. This is a particularly important point since the cash flow tax is sometimes thought to be the equivalent of a yield exemption tax or some rough approximation thereof.[201]

[199] *$10 * 50% = $5.*

[200] Strictly speaking, the conditions for "grossing-up" for a cash flow taxpayer are different, but substantively, the reasons for thinking that an investor would gross up with respect to risky investments in a cash flow system and not an income tax system or vice versa are sparse. For a detailed discussion, see Shaviro, *supra* note 56, at 101–03, 101 n.40 (citing Bradford, *supra* note 162, at 129); William M. Gentry & R. Glenn Hubbard, *Distributional Implications of Introducing a Broad-Based Consumption Tax*, 11 TAX POL'Y & ECON. 1, 7 (1997). One possible differentiating factor is discussed *infra* Section IV.B.2.

[201] *See supra* Section I.B (discussing the Cary Brown theorem in relation to the equivalence between a cash flow consumption tax and yield exemption).

Looking at the ex ante outcomes of the Greenacre investment will demonstrate how the equivalence between the three taxes breaks when the investors do not adjust their portfolios in response to an imposition of tax. Two of these tables will be reminiscent of the discussion in the previous Section in which I originally introduced the idea that an income tax would neutralize luck. There, I had implicitly supposed that, contra the alternative model, Greg does not gross up his investments in response to a tax on his yield. The final table ties in the cash flow tax, which we already know to be equivalent to the income tax when the riskless rate is 0. This will demonstrate the key differences between the tax systems. In the next Section, I discuss some reasons why the equivalence premises may fail to hold.

To begin, recall that there is a $20 difference between the winning situation and the losing situation of the Greenacre investment in a yield exemption tax.[202]

Table 8: Investment in Yield Exemption

Win

	Period 1	Period 2	After-tax profit
Investor	(5)	20	15
Government	0	0	0

Loss

	Period 1	Period 2	After-tax profit
Investor	(5)	0	(5)
Government	0	0	0

If Greg makes the same investment (i.e., he does not gross up to negate the effects of the income tax), then the expected difference between winning and losing is reduced to just $10.[203]

[202] *$15 – (-$5) = $20.*

[203] $*7.50 – (-$2.50) = $10.*

Table 9: Investment in Income Tax (No Gross-Up)

Win

	Period 1	Period 2	After-tax profit
Investor	(5)	20	7.5
Government	0	7.5	7.5

Loss

	Period 1	Period 2	After-tax profit
Investor	(5)	0	(2.5)
Government	0	(2.5)	(2.5)

Greg is now worse off if he wins compared to the corresponding yield exemption outcome anticipated, but better off if he loses. These differences reflect the realized outcomes by Greg and Barry since one wins and the other loses once the bet plays out. As noted then, this would create greater intraclass equity as the gap between the winner and the loser narrows from $20 in the yield exemption case to only $10 in the income tax case.[204]

As noted earlier, the income tax is identical to the cash flow tax with regard to returns to bearing risk.

Table 10. Investment in Cash Flow Tax (No Gross-Up)

Win

	Period 1	Period 2	After-tax profit
Investor	(5)	20	7.5
Government	(2.5)	10	7.5

Loss

	Period 1	Period 2	After-tax profit
Investor	(5)	0	(2.5)
Government	(2.5)	0	(2.5)

The after-tax outcomes of the cash flow tax and the income tax are identical once the amount invested is held fixed. Thus, when investors do not adjust their portfolios, cash flow tax and income tax will remain aligned and both will be different from the yield exemption tax. As the examples have demonstrated, the yield exemption tax is less equitable within a risk class than both the income tax and the cash flow consumption tax if the investors do not gross up in response to a tax on capital income. Contingent on taxpayer behavior, this serves as a strong

[204] *See supra* Section III.B.

reason against lowering taxes on capital income, though, as demonstrated in this Section, not as a reason against providing deductions for savings.

B. The Critique's Oversights

Like many fields of legal scholarship, a lot of the capital income tax debate has focused around certain idealizations. The challenge to the claim that a tax on capital income neutralizes the effects of luck (i.e., the Neutralization Thesis) has been no different. And as we have seen, given some premises about financial preference/behavior, what I have labeled the *equivalence premises*, a yield exemption tax is equivalent to both a consumption tax and an income tax with regard to returns to risk-bearing. If taxpayers do not adjust their investment portfolios in response to the imposition of tax, the tax on capital income creates more just outcomes than exempting the yield from taxation.

Tax scholar David Weisbach, who denies the Neutralization Thesis, makes several lucid points regarding the very issue of the equivalence premises and their plausibility.[205] This Section considers his insightful discussion of one key premise of the model: individuals respond to an imposition of tax on capital income by trying to maximize their after-tax economic consequences.[206] Is this premise true? The empirical research is nowhere near conclusive one way or the other specifically on the effects of tax on the sorts of portfolio adjustments at issue here.[207] Furthermore, the evidence on the general responsiveness of taxpayers to changes in capital income tax rates offers little guidance.[208] As public finance economist Jonathan Gruber succinctly put it, "economists aren't even in agreement on whether income taxes have a negative, zero, or even positive impact on savings."[209]

So then why do Weisbach and others deny the Neutralization Thesis that a tax on capital income neutralizes the luck differential in investment outcomes? Without firm empirical ground to stand on, Weisbach instead puts forward a priori arguments in favor of the equivalence premises that support the Neutralization Thesis. Indeed, Weisbach states a couple of reasons to buy into the verisimilitude of the equivalence premises. Though they provide valuable insight into one way of thinking, these are ultimately points on which reasonable people can disagree.

[205] Weisbach, *supra* note 79.

[206] Weisbach, *supra* note 79, at 44.

[207] GRUBER, *supra* note 46, at 718.

[208] *Id.* at 688–90, 707; *see* Weisbach, *supra* note 79, at 107; *see also, e.g.*, SLEMROD & BAKIJA, *supra* note 66, at 112–13 (discussing the research on after-tax returns to savings and the rate at which taxpayers save).

[209] GRUBER, *supra* note 46, at 688–90.

First, he rightly notes that we are affected by our post-tax outcomes rather than our pretax outcomes.[210] At the end of the day, the money in our pocket to spend is what is left after the government has taken its share. Then he pairs this fact with the premise that individuals are ultimately motivated by those things that affect them to reach the conclusion that taxpayers will respond to an income tax by replicating the no-tax outcomes.[211]

Here, the auxiliary premise seems faulty. There may be many ways to throw a wrench in the gears of possible incentives. For example, the actor may have something less than full information. If a taxpayer thinks that he is making a riskless bet as he invests in Greenacre, then he will fail to be motivated by his new post-tax outcomes. Even if we grant Weisbach's claim that post-tax outcomes rather than pretax outcomes are ultimately what affect our finances, cases of ignorance demonstrate that these final post-tax outcomes are not necessarily motivating.[212]

Weisbach's second argument relies on consistency across theories. Recall from earlier the notion commonly found in tax discussions that an immediate deduction on riskless investments is roughly like not being taxed on the yield from that investment.[213] This thesis also requires the assumption that individuals will respond to the switch between a yield exemption and an immediate deduction by appropriately adjusting one's portfolio to equalize post-tax outcomes in both systems. Weisbach correspondingly says that if we think such assumptions hold to equalize the value of a tax deduction with an exemption from tax for the yield, then there is no principled reason to assume it does not hold with respect to income tax and risk-bearing.[214]

This second point, understood as a conditional, is roughly right. As I will argue *infra*, there may be contingent special reasons to think this sort of portfolio adjustment will not occur in the case of a tax levied on capital income, even if it does occur in the case of a deduction for savings. Regardless, in those cases in which such contingent special reasons do not apply, I deny the antecedent of the conditional. I do not expect taxpayers to adjust their portfolios to make equivalent a deduction for savings and a yield exemption.[215] Unless there is reason to buy the antecedent, there is no reason to buy the consequent.

Finally, Weisbach makes the point that "claims that individuals do not adjust need a theory explaining how individuals do behave . . . . Without an alternative

[210] Weisbach, *supra* note 79, at 44.

[211] *Id.*

[212] If Weisbach's further premise is that people are reflective and have a tendency to correct any errors in their reasons-responsiveness, this will ultimately support the Neutralization Thesis. *See infra* Sections IV.B.1, IV.B.2.

[213] See *supra* Section I.B for a brief discussion of the Cary-Brown theorem.

[214] Weisbach, *supra* note 79, at 7, 22.

[215] *See also* Graetz, *supra* note 17, at 1601–02 (denying the equivalence between an immediate deduction and a yield exemption).

theory, the standard theory may be the best we have."[216] Is the idea of pecuniary motive the best story we have for predicting taxpayer behavior? There are, as we would all agree, nonpecuniary reasons for action. Relying on such nonpecuniary motives, in the rest of this Section, I flesh out what an alternate story of human behavior might look like in which taxpayers do not respond to an income tax by grossing up. On my understanding, the tax system represents a delegation of responsibilities beneficial to the taxpayer, and to subvert the system's ends defeats the purpose of delegation and is thereby counter-rational. This portrait is the first step in my larger project of understanding the proper relations of political morality between state and taxpayer.

1. Rational Behavior

Before getting to these positive arguments regarding what we ought to expect from taxpayers, it will be worthwhile to examine what kind of story might satisfy the request at hand. Since the subjects of our inquiry are human beings and their behavior, we have some special reason to doubt that empirical evidence of irrational behavior is conclusive of future irrational behavior in contrast to induction on properties (broadly construed) of objects more typically. This is so because, presumably, humans are reflective and can correct for irrational behavior once discovered.

For instance, hypothetically, a psychologist may have thus far observed that Karl has been acting in accordance with the gambler's fallacy. The gambler's fallacy is the mistaken belief that a probabilistic outcome's occurrence makes it less likely to occur in the near future even when those events are independent (e.g., "This coin has come up heads three times in a row, so I'm sure the next flip is going to be tails.").[217] If we want to make predictions about how Karl will act in the future, our evidence of his acting in accordance with gambler's fallacy in the past provides some reason to think that Karl will act similarly in the future. But such a prediction is only good until Karl realizes the error of his belief and corrects his behavior. After that, a prediction that Karl will follow the dictates of gambler's fallacy would be mistaken. Therefore, predictions of irrationality are unstable in a way that predictions of rationality are not.

This mark against evidence of irrationality is rather unusual. The same mark does not appear for most other subjects—the charge of an electron is not so subject to self-revision since electrons cannot decide to change their charge. Our ability to reflect on our behavior and guide ourselves through reason makes us

[216] Weisbach, *supra* note 79, at 44.

[217] Charles T. Clotfelter & Philip J. Cook, *The "Gambler's Fallacy" in Lottery Play*, 39 MGMT. SCI. 1521, 1521 (1993).

unique.[218] Predicting human behavior through folk psychology must make room for the reasons-responsiveness of our decisions.

Therefore, our best tax policy must take into account both the empirical evidence of how people currently behave with regard to tax laws and whatever reasons they may have to change their behavior. I aim to provide exposition of the latter sort. In the remainder of this Article, I will explain and argue in favor of the final lemma: the balance of reasons weighs against undermining the tax law. Whereas Weisbach states that taxpayers who fail to adjust their portfolios in response to an imposition of tax "are making systematic mistakes," I contend that the actions of such taxpayers are consistent with a broader view of rationality that takes moral reasons into account.[219]

2. Broad Rationality and the Neutralization Thesis

Scholars are sometimes too quick to paint people as Holmesian bad men,[220] whose lust for theft is contained only by the stick of criminal punishment.[221] If that is right, if all laws are merely ways to impose costs (or benefits) for choosing one or another action, then it does seem plausible that individuals would respond to the imposition of an income tax by readjusting their position to negate its effects. So long as the IRS does not come after them, the bad men are happy to take whatever benefits they can. But surely most of us are not like the bad men. For us, the threat of criminal sanctions is not the reason we refrain from theft. When we consider the perspective of taxpayers, we ought to take into consideration that people either desire or consider it a constraint that they pay their fair share into the stock of public funds as a matter of social responsibility rather than to maximize financial profits.[222] Once we shift our perspective thus, we will find both primary and derivative moral reasons not to undermine the tax law.[223]

[218] 1 ARISTOTLE, NICOMACHEAN ETHICS 18–20 (C.D.C. Reeve trans., Hackett Publ'g Co. 2014) (c. 384 B.C.E.).

[219] Weisbach, *supra* note 79, at 44.

[220] Oliver Wendell Holmes, Jr., *The Path of the Law*, 1 BOS. L. SCH. MAG., Feb. 1897, at 1, 3 ("If you want to know the law and nothing else you must look at it as a bad man, who cares only for the material consequences which such knowledge enables him to predict . . . .").

[221] *See also* H.L.A. HART, *Legal Responsibility and Excuses*, *in* PUNISHMENT AND RESPONSIBILITY: ESSAYS IN THE PHILOSOPHY OF LAW, *supra* note 113, at 28, 44–45 (noting the characterization of the law as a goad as misleading).

[222] *See infra* note 227 and accompanying text.

[223] Here, I do not mean to indicate that derivative moral reasons are means distinct from the ends. Obeying the tax law requires, in most cases, paying taxes and paying taxes is the "end" of contributing to the common pool. I am merely indicating that the derivative moral reason to obey the tax law would not exist but for the moral obligation to contribute to the common pool, and is thereby derived from the primary moral reason.

The first reason is that we have a prima facie moral obligation not to undermine the law. John Rawls calls such an obligation the "duty of justice."[224] Laws, of course, can be undermined by violation of their literal meaning and by violation of their purpose.[225] The primary purpose of an income tax, in contrast to a yield exemption tax, is the taxation of capital income.[226] And, surely, to neutralize an imposition of tax on capital income so as to put oneself in the same position as one would be in a taxless state of affairs would violate such purposes. If Rawls is right about the duty of justice, then this is quite a powerful reason in favor of respecting law's purpose because moral obligations provide reasons with lexical priority over self-interest.[227] One is not permitted to, say, set fire to another's property no matter how much profit the arson might bring him.

The duty of justice can be justified on multiple grounds. Of these I take the following argument to be the strongest. The duty of justice follows from a more general principle not to harm those who make sacrifices to cooperate with us. The tax law is not a random collection of rules; the laws are meant to put into effect principles of justice. When citizens skirt the tax law, it upsets the pattern by which benefits and burdens are to be distributed.[228] The duty of justice thus works to connect the justice of social institutions, here the tax law, with individuals' responsibilities towards such social institutions. Once we have cooperated to set up just social institutions, it is then morally impermissible for individuals to

[224] RAWLS, *supra* note 12, at 99. For a discussion of the duty of justice and natural duties more generally, see *id.* at 98–101. Rawls uses the "undermine" language to describe the duty of justice in *id.* at 302. The duty of justice has a rich history in legal academia extending back to Plato's *Crito*. PLATO, CRITO (c. 399 B.C.E.), *reprinted in* PLATO: COMPLETE WORKS 37 (John M. Cooper & D.S. Hutchinson eds., G.M.A. Grube trans., Hackett Publ'g Co. 1997).

[225] For example, a tax minimization strategy is considered an abusive tax shelter if it goes against the purpose of the tax law. Shannon Weeks McCormack, *Tax Shelters and Statutory Interpretation: A Much Needed Purposive Approach*, 2009 U. ILL. L. REV. 697, 703 (2009).

[226] Since my arguments defending the Neutralization Thesis rely intimately on the purpose of the tax law, one may thus question whether the arguments I have raised for a tax on capital income will apply to the consumption tax. As I have shown in Section IV.A.2, a cash flow consumption tax can neutralize the differential effects of luck on capital income if taxpayers do not adjust their portfolios in response. Therefore, a legislature may, for instance, move from a yield exemption system to a cash flow tax with the purpose of taxing returns to risk-bearing. In those cases, the arguments presented in this Section would apply. However, in cases where deductions for savings are given for other reasons, such as increasing investment, the arguments presented here would not apply.

[227] *See* NOZICK, *supra* note 87, at 29 (discussing rights as constraints); Ronald Dworkin, *Rights as Trumps*, *in* ARGUING ABOUT LAW 335, 335−36 (Aileen Kavanagh & John Oberdiek eds., 2009) (situating rights as trumping background justifications).

[228] *See also* James M. Delaney, *Where Ethics Merge with Substantive Law—An Analysis of Tax Motivated Transactions*, 38 IND. L. REV. 295, 295–96 (2005) ("The proliferation of [tax shelters that follow the letter of the law but violate its spirit] is detrimental to the U.S. system of taxation and is in conflict with the policy reasons underlying the creation of the progressive tax system in the United States."); *cf.* S. REP. NO. 99-313, at 713–18 (1986) (discussing the unfair distribution of burdens that can arise from legal avoidance of tax).

undermine those very institutions. As Socrates states in the *Crito*, undermining the law mistreats the fellow members of our society.[229]

On this picture, the rearrangement of one's portfolio in response to a tax on capital income is normatively categorized like tax evasion—in that they both undermine the law—rather than permissible tax planning. Tax planning, so long as it does not violate the purposes of the tax law, does not constitute a violation of the duty of justice.

The second plausible story about law-following continues with the idea that laws are supposed to offer genuine guidance for our behavior rather than mere conditional threats.[230] For all but the most radical anarchists, we understand that we have a moral obligation to contribute our fair share towards a common pool of resources from which we can fund government expenditures, broadly construed, such as national defense and welfare programs. Of course, it is quite difficult to figure out what constitutes our fair share. Even getting at a rough approximation would require intense study of political theory and its application in a manner that ordinary citizens cannot afford.

So instead, we delegate the deliberation on what constitutes a fair contribution to individuals in the legislature and the Treasury, whose job it is to provide expert guidance on such matters.[231] The deal we make with these experts can be characterized in the first-person thus: I am no longer going to worry about what constitutes my fair share towards the common pool. Instead, I am just going to live my life in the pretax world, and at the end of the year, you will calculate for me the amount that political morality demands I pay.[232] Since following the tax law serves the citizen's primary moral end of contributing a sufficient amount towards the common pool, he has a derivative moral reason to follow the tax law.

On this picture of the first-person perspective on law, which has been called *epistemic internalization*,[233] it makes no sense to nullify the purpose of the tax law. Suppose you have a $5,000 tax burden at the end of the year as determined by the federal government. If you knew that you could get away with wholesale tax evasion without anyone, including the government, being ever the wiser, would

[229] PLATO, *supra* note 224, at 44.

[230] Rebecca Stone offers many ways that we may be "good men" in her paper. *See* Rebecca Stone, *Legal Design for the "Good Man*,*"* 102 VA. L. REV. 1767, 1784–86 (2016). Here, I present a picture that is particular to tax law using Stone's ideas about "epistemic internalizers." *Id.*

[231] *See also* SCOTT J. SHAPIRO, LEGALITY 154–92 (2011) (discussing social planning generally and the delegation of social planning within the context of analytic jurisprudence).

[232] This feature also explains one advantage of having an ex post tax on risk over a sovereign's command for the citizenry to reduce risk. Although, ideally, they would have roughly similar outcomes regarding risk, the ex post tax would not require any effort on the part of the citizen to comply. If there were a command to take on less risk, the citizen would need to consider how much risk he would have taken on had the law not been implemented, then calculate further how to organize his portfolio of investments to meet the command.

[233] Stone, *supra* note 230, at 1776–77.

you?[234] For the Holmesian bad man, the answer is yes. The reason to follow the law for the bad man is that the law is backed by a very large stick.[235] As soon as the stick can be avoided, there is no more reason left to follow the law. For the epistemic internalizer, however, the avoidance of sanction is neither here nor there. Nullifying the demands of the tax law goes against the whole reason we delegated the deliberation to the experts in the legislature and the Treasury in the first place. The internalizer just wants to pay his fair share without having the burden of deliberating on the matter himself, so whatever the IRS demands at the end of the day is what he will pay.

The same can be said for grossing up to nullify the legislature's decision to impose a tax on capital income.[236] If the imposition of a tax on capital income is justified under luck egalitarian principles, then it would defeat the purpose of having delegated away the political deliberation to respond by increasing the effects of luck in a way that would perfectly negate the imposition of a tax on capital income. From the point of view of epistemic internalization, tax law is not some fight between one side trying to take money and the other side trying to keep it. The tax law is a cooperative effort that represents an earnest attempt to settle a question of political morality in a reasonably expedient way.[237]

This is a way of thinking about the tax law distinct from the dominant frameworks of distributive justice and economic efficiency. Justice and efficiency are important concerns of the state but certainly not the only ones. Legal theorists, dating back at least to Aristotle in Book X of the *Nichomachean Ethics*, have thought that one of law's critical functions is to facilitate moral action on the part of its citizens. Typically, such a function is the subject of scholarship in criminal law; criminal law's conduct rules are plainly meant to guide behavior.[238] Of course, there is no reason to think that criminal law, and more generally the imposition of punishments for bad behavior, should be the only moral compass available in the law.

[234] *Cf.* PLATO, REPUBLIC (c. 375 B.C.E.), *reprinted in* PLATO: COMPLETE WORKS, *supra* note 224, at 971, 1000–01 (discussing the parable of the ring of Gyges and the moral nature of man).

[235] Holmes, *supra* note 220.

[236] Whether this argument also applies to a cash flow consumption tax is discussed *supra* note 225.

[237] Note here that I am not of the view that all tax laws are to be viewed this way. The picture I have presented is a simplification. Some tax laws are passed for the purpose of encouraging or discouraging certain behaviors. Tax benefits for investments in qualified opportunity zones, I.R.C. § 1400Z-2, would be an example of such a tax. The purpose of the law is to encourage investments in designated low-income communities. Such rules are made with the intent that taxpayers take the rules into consideration in deciding their behaviors rather than taking stock at the end of the year. My position is that such laws, in the U.S. federal tax system, are exceptions rather than the rule. As a practical matter, they must be. Human cognition is a finite resource, and it surely cannot be expected of the general public to understand and plan around the thousands of rules that compose the Internal Revenue Code of 1986, as amended.

[238] *E.g.*, John Gardner, *Introduction* to H.L.A. HART, PUNISHMENT AND RESPONSIBILITY: ESSAYS IN THE PHILOSOPHY OF LAW, *supra* note 113, at xiii, xlii–xliii.

On my picture of tax law, the government can provide moral guidance without relying on sanction. In essence, the rules of tax law form a kind of "self-help" tool—a tool which aids individuals in meeting the moral responsibilities that citizens grasp that they have but have difficulty defining. Individuals who recognize their social obligations can expediently fulfill them by following the rules set out in the tax code. For most of us, filling out an IRS Form 1040-EZ is a more manageable way to figure out our social obligations than reasoning from first principles.

And so we have these two competing pictures of human psychology with respect to the law. These differences in psychological stipulation entail different behaviors with respect to the law. On a narrow conception of rationality, there is financial reason to undermine the imposition of a tax on capital income, and it is irrational to have the same investment portfolio in both an income tax and a yield exemption tax. On my broader conception of rationality, the taxpayer, despite there being financial reasons to do otherwise, has primary and derivative moral reasons not to undermine the tax law. The primary moral reason, the duty of justice, applies to all taxpayers, and the derivative moral reason applies to those taxpayers who are epistemic internalizers with respect to the tax law. Naturally, moral reasons have lexical priority over prudential reasons.[239] Maintaining the same portfolio across an income tax and a yield exemption tax is rational on the broader conception that takes into account our moral reasons for action. Any prediction about investor behavior must take this balance of reasons into account.[240]

In this Section, I have provided both negative arguments that the equivalence conditions are false as well as two positive reasons that citizens have to deviate from the behavior dictated by the equivalence premises. My aim was to paint an alternate picture of taxpayer rationality in contrast to the standard economic one that pervades the literature. By focusing purely on financial incentives without considering moral sources of motivation, the critique of the Neutralization Thesis fails to see that the balance of reasons weighs against investors adjusting their portfolios in response to the imposition of a tax on capital income. Insofar as my arguments in favor of the moral reasons are sound, we have good reason to support the Neutralization Thesis.

CONCLUSION

In this Article, I have sketched the foundations of a theory of distributive justice and how it may be applied in the tax law. I argued in favor of the truth of luck egalitarianism in a manner that put option luck on the same level as brute luck in that both are causes of unjust distributions. Brute luck egalitarianism, on

[239] *See supra* note 227 and accompanying text.

[240] *See supra* Section IV.B.1.

the other hand, is both too harsh on the victims of bad option luck and is unnecessarily handicapped in taxing the beneficiaries of good option luck. A nuanced luck egalitarianism better accords with our intuitions of distributive justice.

From here, I discussed how the tax law might present an opportune vehicle for reducing differential outcomes from option luck by way of taxing the most well-off members of society and capital income. Winner-take-all markets have created large gaps in economic outcome for small differences in performance. Given the intensity of such competitions, we have good reason to believe that the largest winners in the marketplace have been beneficiaries of luck. Therefore, a tax on the most well-off members of society would help mitigate the differential effects of luck. Given that most returns to investment come from bearing risk rather than postponing the availability of one's wealth, capital income can vary wildly between winners and losers. The income tax system neutralizes the differential effects of luck by sharing the wins and losses of investors.

In the final part of my argument, I considered a popular critique of the Neutralization Thesis arising from work in public finance. According to the critique, taxpayers will respond to the imposition of a tax on capital income by eliminating the effect of such a tax through adjustments to their portfolio of investments. Ultimately, I rejected the plausibility of the argument and offered an alternate way to think about the perspective of taxpayers. Taxpayers have, under the duty of justice, a primary moral obligation not to undermine the law. Furthermore, the tax law provides a solution to the epistemic problem of how much one ought to contribute towards the societal pool. Therefore, taxpayers have derivative moral reason, flowing from their primary moral obligation to make the contribution to the societal pool, not to undermine the imposition of a tax on capital income.

If my arguments are sound, then recent trends in America towards lower taxes on capital income and the most well-off members of society are worrying from the perspective of luck egalitarianism. I certainly do not take myself to have provided an all-things-considered argument in favor of the capital income tax and a tax on the most well-off. Distributive justice, although an important virtue of social institutions,[241] is not the only factor that legislators should consider in writing laws. If I am right, however, then there is at least one strong pro tanto reason in their favor.

[241] RAWLS, *supra* note 12, at 3.