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“Bifurcation Blues: The Perils of Leaving Redistribution Aside.”

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SCHEDULE FOR 2013 NYU TAX POLICY COLLOQUIUM

(All sessions meet on Tuesdays from 4-5:50 pm in Vanderbilt 208, NYU Law School)

1. January 22 – David Kamin, NYU Law School, "Are We There Yet?: On a Path to Closing America's Long-Run Deficit."

2. **January 29 – Edward McCaffery, USC Law School, "Bifurcation Blues: The Perils of Leaving Redistribution Aside."**

3. February 5 – Jake Brooks, Georgetown Law School, "Taxation, Risk, and Portfolio Choice: The Treatment of Returns to Risk Under a Normative Income Tax."

4. February 12 – Lilian Faulhaber, Boston University School of Law, "Charitable Giving, Tax Expenditures, and the Fiscal Future of the European Union."

5. February 26 – Peter Diamond, MIT Economics Department, "The Case for a Progressive Tax: From Basic Research to Policy Recommendations."

6. March 5 – Darien Shanske, University of California at Hastings College of Law, "A Proposal for a New Property Tax Infrastructure."

7. March 12 – Dhammika Dharmapala, U. of Illinois Law School, "Competitive Neutrality among Debt-Financed Multinational Firms."

8. March 26 – Sarah Lawsky, University of California at Irvine Law School, "Unknown Probabilities and the Tax Law."

9. April 2 – Alan Viard, American Enterprise Institute, "Progressive Consumption Taxation: The Choice of Tax Design."

10. April 9 – Brian Galle, Boston College Law School, "A Nudge is a Price."

11. April 16 – Leslie Robinson, Tuck Business School, Dartmouth College, "Internal Ownership Structures of Multinational Firms."

12. April 23 – Larry Bartels, Department of Political Science, Vanderbilt University, "Inequality as a Political Issue in the 2012 Election."

13. April 30 – Itai Grinberg, Georgetown Law School, "A Governance Structure to Mediate the Battle Over Taxing Offshore Accounts."

14. May 7 – Raj Chetty, Harvard Economics Department, "Active vs. Passive Decisions and Crowd-Out in Retirement Savings Accounts: Evidence from Denmark."

Bifurcation Blues: The Perils of Leaving Redistribution Aside

Edward J. McCaffery[1]

1. Opening Notes

At the core of neoclassical economics and law and economics theory, evident in the writings of such distinguished scholars and intellectuals as Adam Smith, Richard Musgrave, Ronald Coase, Richard Posner, Louis Kaplow, Steven Shavell, and a host of others, lies an apparently sensible division of analytic labor. Virtually all legal rules pertaining to economic issues affect both the *allocation* of social resources and their *distribution*. Tracking the logic of the two great welfare theorems, economics and law and economics have bifurcated these two dimensions of policy. The simple idea is that, in facing any particular choice, a policymaker should make the most allocatively efficient decision, or set the most allocatively efficient rule, such that all resources can flow to their highest and best use and users. This initial step, alone, will make the celebrated "social pie" as big as possible.[2] Then, to the extent that a policymaker has distributional concerns, she can redistribute *elsewhere*, at a later time and place and via different legal mechanisms, off the base of the greater social pie

[1] Robert C. Packard Trustee Chair in Law, Economics and Political Science, USC Gould School of Law, and Visiting Professor of Law and Economics, California Institute of Technology. This draft is being presented at a tax policy seminar at New York University Law School. It is still very early and in particular lacks the necessary and appropriate citations at this time.

[2] Importantly, neoclassical welfare economics tends to state this goal in ordinal, utilitarian terms, such that the "social pie" consists of the sum of individual utilities, a psychic phenomenon; the modern law and economics movement [Posner, Kaplow and Shavell] has converted this into a cardinal measure, the market value of goods and services – the same measure that a real-world government, concerned with the real-world phenomenon of money, cares about. Additional details and citations on the bifurcation strategy are found *infra* in Section 3.1. See Edward J. McCaffery, Slouching Towards Equality, Yale L. J. (1993) for discussion of efficiency norms.

created in the initial step. Thus the famous Coase theorem can be held to state that, absent transaction costs, efficiency happens, regardless of the initial allocation of property rights – a proposition that deliberately and consciously sets aside distributional concerns.

Louis Kaplow and Steven Shavell have notably pushed this bifurcated logic to its extreme of clarity and force, arguing in articles and their book, *Fairness versus Welfare*,[3] that normative analysis of private law rules in such fields as contracts, torts, property, and legal procedure should look solely to allocative efficiency, and that redistribution should take place through the tax system. Kaplow and Shavell's analysis has met with much criticism, from such scholars as Ronen Avraham, Howard Chang, Jon Hanson, Christine Jolls, Kyle Loque, Chris Sanchirico, and many others, mainly as a matter of first-best theory. I do not mean to take any stand in those attendant debates in this Article. Indeed, I am prepared to concede that the strategy of bifurcation is a sound one, in first-best theory. But we do not live in a world of first-best theory. My ambition in this article is to focus on the real-world of tax policy in the United States over a significant stretch of time, and to note the interrelated practical, political, and perceptual perils of leaving redistribution "aside." The basic, commonsensical point is that, in the political structure and climate of contemporary America, real-world tax policy is not up to the burdens that the bifurcation strategy places on it – it is not, that is, situated to redistribute in any meaningful way. While this is a large topic with many subparts, subplots, twists, and turns – many of which I at least touch on below – the most consistent and important theme is that U.S. tax policy, for at least a *century* by now,[4]

[3] LOUIS KAPLOW AND STEVEN SHAVELL, FAIRNESS VERSUS WELFARE, (Cambridge, Mass: Harvard University Press, 2002)

[4] February 2013 marks the one hundred year anniversary of the ratification of the XVIth Amendment, enabling the modern income tax.

has been unwilling and unable to address the most important measure of inequality, namely wealth inequality, in any really meaningful way.

The perils of bifurcation for the cause of redistribution come in two broad stages. In the first stage, which typically and by its nature transpires in relatively sanguine economic times – that is, without the need for major tax increases being on the table – tax reform tends to ignore redistribution altogether, often times under an explicit mandate that tax policy changes be "distributionally neutral," or to involve redistribution that is more symbolic than real. Tax law changes for the past many decades by now have not touched issues of wealth inequality. Tax increases during peace or good times are rare in any event and tend to feature broad-based, low-salient taxes and infra-marginal changes. The income tax, in particular, has proven to be politically difficult to raise during good times, with the historically important exception of the annual increases that came from a failure to index the Internal Revenue Code's ("IRC") rate brackets for inflation, a policy ended by the Economic Recovery Tax Act of 1981 ("ERTA") but not made effective until later.

Redistribution during good times suffers from practical, political, and perceptual problems, three "p's." The **practical** problem, simply stated, is that there is not much money, for the fisc, in redistributive taxes, certainly not in any apparently plausible political change to the status quo to insert more redistribution into the system. The rich are too few, and they have too many choices in their economic affairs, such that they can often avoid the brunt of real-world tax increases. Worse, the means by which the rich can rearrange their affairs to avoid the burden of highly progressive taxes on themselves – especially the ability for these rich, individually, or their capital, impersonally, to exit and move offshore – can end up leaving the attempt at taxing them counter-productive, in strictly fiscal terms. Further, the best – most practical and efficient – mechanism for implementing redistribution through the tax system, as articulated by the elegant mathematical theory of optimal income tax analysis, namely the use of lump-sum cash transfers known as "demogrants,"[5] is not generally available to real-world policymakers. Finally, adding to all these practical problems is the stubborn fact that taxing the rich in general, their wealth or assets in particular, is far more administratively difficult and costly than taxing the masses. In good times, it hardly seems worth the trouble.

Politically, too, the cause of redistribution's peril relates to money. But now it is not the money of the fisc, as it was in the practical component of the peril. In the political arena, the cash of relevance is the ever-important money needed and demanded by politicians to fuel their ever-more expensive campaigns. The now standard special-interest model of politics, as developed by Mancur Olsen and others, suggests that small groups with high stakes in a political issue will form groups to lobby for or against a relevant change. The costly and difficult attempts to tax the rich are not worth it to politicians who depend on the campaign contributions of these very rich. While a more sophisticated understanding of the symbiotic relationship between legislators and special interests, predators and prey, in both directions, suggests that politicians will sometimes attack special interest groups, or propose to do so, in order to generate the occasion for extracting contributions, and to make the threat of harming/not-helping realistic, politicians cannot survive in this age of money by consistently – and effectively – taxing money. And so they do not.

[5] Bankman and Griffith, Murphy and Nagel.

This then leads to the third "p," **perception**. Redistributive taxes suffer from two types of perceptual problems. On the one hand, highly progressive and, by definition, individuated taxes have a high degree of "salience" and tend to make their targets into "identifiable victims." This feeds into and is fed by the political component of the problem. Small groups of rich people make for good special interest formation opportunities. The special interest group once formed can turn around and play up the salient and sympathetic aspects of the small group (thus, notoriously, "farmers and small businesses" became poster-children for death-tax repeal efforts). On the other hand, the redistributive effects of fiscal policy are generally poorly understood, and a panoply of cognitive heuristics and biases – such as the tendency to confuse average and marginal rates, sub-additivity, a disaggregation bias, and an isolation effect -- combine and conspire to make it relatively easy for tax law changes to *appear* to be significantly more redistributive than they in fact are. We will see many examples of this below.

And so we face a triad of "p's," each pointing against significant redistribution, and all working together.[6] It is sometimes said for example that the various heuristics and biases we see in real-world tax systems are *ad hoc*, and operate at cross purposes. In fact the biases we see manifest in tax have grown up and evolved alongside the practical and political problems. The system we in fact have is set up to appear more progressive than it actually is, for perfectly predictable practical and political reasons. Hidden and other low-salient taxes contribute vast sums to the fisc. A continued focus on the highest marginal rate level under

[6] This is one of the principal themes I want to advance in this Article. Others, including myself and coauthors, have looked at the practical (Bird and Zolt, Slemrod, Graetz, McCaffery and Hines), political (Doernberg and McChesney, McCaffery and Cohen, McCaffery) and perceptual (McCaffery and Baron, Kornhauser) problems with effecting redistribution through tax. I mean to show the interactions among these causes over a significant stretch of time, and to consider the situation of redistribution in contemporary America.

the income tax on *reported taxable income* masks the contrary facts that the role of the income tax overall has been declining; that reported income is a highly flawed measure of anything that really matters, especially for the wealthy who hold assets; and that the rich – just like the not-rich – benefit from infra-marginal rate cuts to the income tax. Thus, in several examples that we will look at in the next section, we see on the brink of the fiscal cliff the relatively progressive Obama Administration raising taxes on the middle class via a largely hidden tax increase, while gutting the only real wealth tax we have had in America, all the while taking pains to rhetorically position its changes as progressive and redistributive.

The first stage of redistribution's peril thus involves further postponing and re-positioning the redistributive task. A second peril of bifurcation then arises: the strategy not only means that, when we get to redistribution, we will not get it "right," because we will substitute rhetoric and perception for reality, it also means – has meant – *that we may not get to redistribution at all*, in time. For by the time we get around to doing meaningful – or impactful, at least – tax reform, redistribution is not the major issue. The day of distribution never comes. Facing a self-imposed "fiscal cliff" at the dawn of 2013 – a phenomenon that occurred because of years of postponing, in stage one of the bifurcation blues – the U.S. government needed revenue, or the appearance of revenue, and fast. Having postponed doing anything about the other blade in the fiscal scissors, the government also needed to cut public spending, and fast. Both the tax increases and the spending cuts are likely to come at the expense of redistribution, again, for practical (this is where the money is), political (this is where the money is) and perceptual reasons. Apparently large but actually nominally small – symbolic almost – changes on taxing the rich are paired with small in magnitude, large in total, hidden tax increases for all taxpayers, especially the middle-class. And this is what we got, in the Tax Reform Act of 2012 "TRA 2012"), as I shall discuss extensively below.

In short and in sum, the strategy of bifurcation, so elegant and attractive in theory, has been a disaster for advocates of greater redistribution in practice. Now it seems as if the redistributive ship has sailed. Politicians faced with a status quo largely of their own making – illustrating the importance of agenda setting and timing in politics[7] – now joined and encouraged by the media and many academics, are considering more changes that will not add much if at all to furthering the goal of economic equality, and certainly will not address wealth inequality. Fiscal policy in times of crisis tends to pit the middle class against the poor, with middle-class tax increases – such as the national-level consumption or value-added tax ("VAT") that seems to be slouching ever closer towards us – being needed to save entitlement and other spending programs that help all, including the poor. The changes get scored or perceived as "progressive" because the middle class has more economic resources than the poor. Meantime, the rich get left off the hook – and the really rich stay off it altogether.

If we are serious about changing this situation – and there comes a time when we might just have to admit that we are not serious about doing so – it is time to change the way we do things, fiscally, beginning with the way we think about things. We need a cure for the bifurcation blues.

[7] See Baron and McCaffery, Starving the Beast, discussing the apparent political strategy of separating tax cuts from spending cuts, leading to tax cuts in good economic times, and spending cuts down the road. This of course is another form of bifurcation that has put redistribution in peril.

Section 2 helps to further set the stage and underscore the importance of the issue by discussing three recent case studies of policy changes or proposals: the so-called Buffet Rule, the expiration of the "payroll tax holiday" as part of the fiscal cliff package, and the near-death of the death tax. Section 3 starts with some statements of the bifurcation strategy and then goes through at some length the practical, political and perceptual problems with the strategy in practice. Section 4 sets out three doctrinal trends, evident over a long period of time, including a century in the case of the income tax: the rise of the payroll tax, the movement of the income tax towards a wage tax, and the death of the death tax. Section 5 then previews some coming attractions, discussing the most likely tax policy changes yet to come: the further attack on "tax expenditures" under the income tax, the addition of a national-level sales or VAT tax, corporate tax reform, and "low salient" taxes in general. Section 6 concludes with a restatement of the problem of the bifurcation blues, and notes, if only for the sake of hope, some possibilities for a cure.

2. Humming a Few Bars: Three Contemporary Case Studies

2.1 Fact and Fiction in the Buffet Rule

In mid-October 2011 (the time to file tax returns of choice for the *cognoscenti*, after the automatic six-month extension from April's initial tax day), Warren Buffet, the so-called oracle of Omaha and the wizard behind Berkshire Hathaway, disclosed that his 2010 tax return included $62.9 million of adjusted gross income and $39.8 million of taxable income, and that he paid tax of $6.9 million, for a federal effective tax rate of 17.3% on his taxable income and just under 11% on his adjusted gross income.[8] Buffet graciously pointed out that this effective tax rate was lower than his secretary, who had not earned quite so much money. There was much gnashing of teeth. After another measure to raise tax rates on the rich failed, President Obama proposed the "Buffet Rule," applying an effective tax rate of 30% to millionaires. The liberal Citizens for Tax Justice announced that the rule would raise $50 billion a year, and that it would affect only the top 0.08 percent of taxpayers[9] – as we shall see throughout, this is the new metric for scoring the progressivity of tax policy changes, looking at how much of a putative tax increase would be borne by the top few percent of income earners. The Buffet Rule came up to a vote in the House in April, 2012 – tax time, of course – only to go, predictably enough, nowhere.[10]

Had the Buffet rule been in effect, Buffet's 2010 taxes would have risen to almost $12 million, nearly double, based on his $39.8 million of reported taxable income, and over $18 million based on adjusted gross income – the difference in Buffet's case between adjusted gross and actually taxable income being attributable most likely to large charitable contributions, whose deductibility was negatively impacted by TRA 2012 and which remain

88 Laura Saunders, *What Did Warren Buffet Really Earn?*, Wall St. Journal Blog, October 19, 2011, available at http://blogs.wsj.com/totalreturn/2011/10/19/what-did-warren-buffett-really-earn/.

9 CTJ Calculates Buffet Rule would raise $50 billion in One Year and Affect Just The Richest 0.08% of Taxpayers, January 27, 2012, available at <http://www.ctj.org/taxjusticedigest/archive/2012/01/ctj_calculates_buffett_rule_wo.php>

10 See Edward J. McCaffery, The Buffet Rule is Going Nowhere, CNN Opinion On-line, available at <http://www.cnn.com/2012/04/16/opinion/mccaffery-buffett-rule/index.html>

in further jeopardy.[11] The rule would appear to force billionaires like Buffet to pay 30% of all their income in taxes.

Except that, well, it wouldn't. By far the largest component of Buffet's "income," in an economic sense, came from the *untaxed* "mere appreciation" in his asset and wealth holdings. Publically available records indicate that Buffet's Berkshire Hathaway shares, alone, rose by $8 *billion* in 2010. That is $8,000,000,000. Even a tax of $18 million (that is $18,000,000) – the Buffet Rule applied to its fullest plausible measure, adjusted gross income -- makes up far, far less than 1% of Buffet's real income: 0.225%, to be exact.[12] The Buffet Rule, which, politically, went nowhere in any event, was far more symbolic than real, because it applied to the easily manipulable measure of reported taxable income, and not to real, economic income. Put in other, stark, terms, Buffet still would have made – and kept -- over $8 billion *after taxes* in 2010 had the most onerous version of the Buffet Rule been in place.

Unrealized appreciation is the 800 pound gorilla in this story.[13] Under the income tax, and at least since the seminal Supreme Court opinion of *Eisner v. Macomber*,[14] the change in value of an existing asset does not have to be reported as "income" until and unless there has been a "realization" event. This provides the first step in what I have dubbed Tax Planning 101, the simple tax-driven advice to buy/borrow/die. In Step One, an individual such as Buffet buys an asset, such as real estate, growth stocks, or shares in Berkshire

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[11] See *infra* Section 4.1.

[12] See David Miller's piece in Huffington Post.

[13] Jesse Drucker in Bloomberg News, quoting Edward J. McCaffery

[14] 252 U.S. 189 (1920).

Hathaway, which rises in value without producing a taxable cash income stream – Berkshire Hathaway notoriously pays no dividends. This takes advantage of the realization requirement of *Eisner v. Macomber*. In Step Two, the taxpayer borrows – income-tax free, by virtue of the basic structure of an income tax – to finance her lifestyle. In Step Three, she dies, rejoicing at the death as her assets – and debt – pass along to her heirs. The assets are acquired by the heirs tax-free, under IRC Section 102, and with a fully stepped-up basis, under IRC Section 1014. They can now be sold tax-free and the debts paid off.

Played right, Tax Planning 101 means no federal taxes – no payroll tax, because the player does not "work" in a traditional sense; no income tax, for the convergence of income tax rules just noted; and no gift or estate tax, because the estate tax is a net tax, on assets minus liabilities held at death, and, properly played and planned, Tax Planning 101 does not leave a large enough net estate on any deathbed to generate tax. The essential elements of Tax Planning 101 have been in place for nearly 100 years, and have never seriously been challenged. This leaves unrealized appreciation as the 800 hundred pound gorilla in the room, a major item of theoretical "income" left altogether out of the tax base – and out of virtually all contemporary discussions of "base broadening" and loophole closing, such as in the repeated calls to limit personal deductions under the income tax -- meaning, mainly, the deductions for home mortgage interest, employer-provided health care, state and local taxes, charitable contributions and pension plans. Unlike these classic tax expenditures, which largely affect wage-earners, the non-taxation of unrealized appreciation affects – in a highly beneficial manner – those wealthy individuals who live off financial capital, not traditional "work."

For advocates of real, meaningful redistribution in tax, the realization requirement in particular, and each step in Tax Planning 101 in general, ought to be considered a very large problem, a massive "tax expenditure" as it were. But there has been no serious attempt – ever – to corral any of it, as we shall consider further below, in Section 4.2. Tax reform in 2010 and 2012 has actually made the problem *worse*, as we shall also consider below, in Section 2.3.

The Buffet Rule illustrates the practical, political and perceptual point that it matters what one is looking at. By focusing on reported taxable income, it is easy to miss the real story, for those really rich Americans who can afford to live off of their existing wealth. The Buffet Rule would force Warren Buffet to pay an effective tax rate of 30% on his reported earnings. But nothing would force him to show any significant amount of his wealth as reported income in the first place. When the TRA 2012 was ultimately able to raise tax rates on the high income – individuals/married couples having taxable income of $400,000/$450,000 and up – it fell primarily on high wage-earners, and then it encountered another set of perceptual problems. It *appears* that the rich are being more burdened, and the wage-earning rich begin to look sympathetic, like "Joe the Plumber." Or they threaten to pack their bags, like the high-ranking golfer Phil Mickelson.[15] Yet the tax increase does not mean all that much to those, like Buffet himself, who can hide their real income from the IRS, perfectly legally. In short and in sum, Warren Buffet was able to advocate for a tax

[15] Hank Gola, Phil Mickelson talks of 'drastic changes' amid new California tax rules, but apologizes for making opinion on 'personal matter' public, NY Daily News, January 22, 2013, <http://www.nydailynews.com/sports/more-sports/phil-rants-recants-tax-raise-article-1.1244850#ixzz2IjBxpJJf>. Mickelson is not alone. See Robert W. Wood, Phil Mickelson is not Alone in Fleeing Taxes, Forbes, January 21, 2013, available at <http://www.forbes.com/sites/robertwood/2013/01/21/phil-mickelson-is-not-alone-in-fleeing-taxes/>

increase on the rich that would not affect him much at all. The Oracle of Omaha is no dummy.

2.2 The Hidden Tax Increase of the Tax Reform Act of 2012

As the nation careened toward its self-created fiscal cliff, and the press was full of febrile leaks and rumors of impending deals and the state of negotiations between the Obama Administration and the Democrats, on one side, and the House Majority Leader John Boehner (R-Oh) and the Republicans on the other, both sides faced a problem, and a strictly rhetorical one: How to "score" the tax changes being considered.

The Bush tax cuts of 2001 (EGTRRA) and 2003 were each set to expire on January 1, 2013, meaning a return to brackets and rate levels as obtained in the Year 2000. Given that both parties clearly and consistently agreed that "no taxpayer earning less than $250,000" should see a tax increase, there was *no* chance that what Congress would ultimately enact would be anything other than a tax *cut*, on balance. Since, as the law stood, all income taxpayers were set to face a tax increase, and since all political roads were leading to a resolution in which only *some* of them would actually get what was due under the law (that is, the "rich," or "high income"), then the new law cutting the taxes of most while leaving in place the already-legislated tax increases of a few would have to be a tax *decrease*. This is indeed how the Congressional Budget Office officially "scored" TRA 2012. Only that would not do, politically.

So both sides, happily aided and abetted by the media, began talking about what they were doing as changes *from the 2012 baseline* – 2012 being a year in which both the 2001 and 2003 tax cuts were in full force. In effect, this conceit perfectly stood reality on its head: it scored the tax changes to be enacted as if the Bush era tax cuts were *permanent*, as opposed to what they were, which was *expiring*. But, more importantly, it would allow both sides to claim a tax increase on the rich from the failure to extend their tax breaks, while not highlighting the sound analytic fact that everyone else was getting a tax cut. It also bears noting – as the media generally did not – that the tax breaks that came from continuing the *lower* rate brackets and levels *also* helped the rich or upper-income. Indeed, as an analytic fact of the matter, those in the highest marginal rate bracket are to receive the *maximum* dollar benefit from the lower rate bracket cuts (or continuation of the cuts, as it were), since they have a "full ride" through all those rate brackets. This is in contrast to what would have happened with the Buffet Rule, which aimed to set an *average* or *effective* tax rate, cutting across – rendering moot – the lower rate brackets for upper-income earners. But then we have just seen what happened to the Buffet Rule.

Still, all that might just be another story of business as usual inside the Beltway, not playing a major role in our ongoing narrative, except for the twists and turns occasioned by one further inconvenient truth. Taxes on January 1, 2013 were *also* set to go up by virtue of the expiration of the "payroll tax holiday" that President Obama had gotten enacted for 2011, and which Congress had extended, in late 2011, for 2012. The "holiday" was a 2% break from the 6.2% employee share of the social security payroll tax, applicable to earnings (in 2012) up to approximately $110,000 per individual. The "holiday" could thus save an individual over $2,000 -- $4,000 for a couple each of whom earned $100,000. This provision was set to expire, just like EGTRRA, only both sides, Democrats and Republicans, very quietly agreed to let it die a quiet death.

Recall that the resolution of the rhetorical embarrassment over EGTRRA, just discussed, was to use a 2012 baseline and measure increases off it. This same accounting construct – measuring changes from 2012's law -- would allow President Obama to count the tax increases from the payroll tax holiday's expiration as, well, tax increases. This would seem to be a *good* thing, as politicians were scrambling to meet proposed revenue-raising targets. More specifically, President Obama had led with a proposed revenue-raising target of $1.6 trillion, over ten years (all tax increases get scored over a ten year period, these days), Republicans had countered with $800 billion, and both sides seemed to be inching towards the obvious and inevitable compromise figure of $1.2 trillion.

Only there was a problem: "counting" the payroll tax holiday's expiration as a tax increase would undercut the government's claims about the progressivity of the fiscal cliff deal. As we just saw in the discussion of the Buffet Rule, by what seems to be a universally agreed upon convention these days, "progressivity" is measured and reported in a certain definite way, as what percentage of a tax increase is borne by a certain percentage of the population, sorted by income level. The favorite percentage, a seeming relic of the "Occupy" movement, is 1%; another option, evident in discussions over the Buffet Rule, is the round number of one million dollars. Thus the gift and estate tax, which we shall discuss next, is routinely called "the most progressive tax" in America. We could devise a more progressive tax, using these measures, simply by taxing the wealthiest American $1.00. Then we could say, perfectly correctly, that 100% of the new tax was born by something like the top .0001% of the income distribution. That would be pretty silly, of course. But it is what we do.

In any event, back to Obama's payroll tax problem. The optics of meaningful aggregate tax increases and deficit reduction – not to mention logical consistency – suggested "counting" the increase. But the optics of redistribution suggested not, in order to maintain a rhetorical claim about the "top 2%" bearing all of the new burdens. The truth was going to be what the truth was going to be – the payroll tax holiday was going to expire – but the (misleading) optics of redistribution prevailed. The Obama Administration did not "count" the tax increases from the payroll tax holiday's expiration as part of the tax increases, although this meant, logically, the numbers being used can only be described as "tax increases over a 2012 baseline, but not including matters not addressed in a new law," or something like that. The Republicans, hardly chafing at the bit to tout any tax increase, readily played along.

What are the dollars and cents of all this? Official reports and the mainstream media reported tax increases from TRA ranging from $600 to $700 billion – a sum total below even the Republicans' opening bid -- almost all falling on the "rich" in some sense. Here is an illustrative description, from the progressive group, Center for American Progress:

> The American Taxpayer Relief Act of 2012—the fiscal cliff legislation agreed to in a deal between President Obama and Senate Minority Leader Mitch McConnell (R-KY)—will raise approximately $617 billion in higher revenues from 2013-to 2022, compared to what the tax code would have generated if we had simply extended all the Bush tax cuts, which were scheduled to expire at the end of 2012. More than 90 percent of the increase will come from households making at least $1 million a year.[16]

[16] Michael Linden and Michael Ettlinger, *Revenue from Fiscal Cliff Deal in Context*, Center for American Progress, Jan. 3, 2013, available at <http://www.americanprogress.org/issues/economy/news/2013/01/03/48872/revenue-from-the-fiscal-cliff-deal-in-context/>

As for the expiration of the payroll tax holiday? This was estimated to bring in an additional $100 billion *a year*, meaning $1 trillion over a decade, such that President Obama could have claimed to make his $1.6 trillion mark after all. But he did not -- because only a very small percent of the $1 trillion gained from letting the payroll tax cut expire would come from households making at least $1 million a year, or even $450,000.

In sum, roughly 62.5% of the aggregate tax increase in the fiscal cliff package came from a tax that applies to wage earnings, only, and which has a floor of 0 (meaning it applies to the first dollar earned, regardless of family size or anything else) and a ceiling of $110,000. But this major tax increase was not listed in the official reports or scoring, in order to maintain a *rhetorical* claim that 90% of the tax increases would fall on millionaires only. It is also bears noting that, while those who earn high incomes from wages will also, just like the poor and middle classes, see a tax increase off of the 2012 baseline on their first $110,000 or so of earnings, these same upper-income individuals also benefit from the perpetuation of the Bush-era tax cuts *below* the $400,000/$450,000, another point typically obscured in public political discussions around the fiscal cliff deal. In any event, here we have, not a hidden tax – although the payroll tax is much better hidden than the income tax in multiple regards[17] -- but a *hidden tax increase*, buried in the self-serving rhetoric of both parties inside the Beltway.

Ultimately, the press did pick up on the fact that the payroll tax was going up for all wage-earners, and markets worried about the effects of the payroll tax holiday's expiration on consumer spending, yet politicians may have won the gamble, again for perceptual

[1717] McCaffery, Cognitive Theory and Tax, UCLA 1994, pointing out that payroll tax system is favored in part because it is labeled a "contribution," is seemingly paid half by one's employer, comes out of paychecks automatically, requires no annual form or indeed forms at all for most workers, and does not depend on varying marginal rates.

reasons. After all, a worker earning a middle-income wage of $50,000 a year, paid twice monthly, will see her paycheck fall by about $40 a period – hardly cause for celebration, but then again, the worker may well feel that she isn't as bad off as say Phil Mickelson. The whole thing recalls a real-life tax policy story from the World War II era – the creation of a 90% tax bracket, in which there appear to have been few if any real taxpayers, but which made *other*, infra-marginal, tax rates look more bearable.[18] American workers can now grit their teeth and bear the $40 a paycheck hit, knowing – or thinking – that the really rich had been hit harder. The moral of the story? In times of need, look to broad-based, low-salient taxes – or tax increases.

2.3 The Non-Death Death of the Death Tax

While TRA 2012 and the wider fiscal cliff deal was loudly raising income tax rates on the top 1% of income earners, and quietly raising payroll tax rates on just about everybody, it was also continuing the saga of the very slow death of the wealth transfer tax system: the gift, estate, and generation-skipping taxes, which I shall sometimes refer to collectively as the "estate" or, colloquially, "death" tax.[19] (At points in the analysis, however, it is important to mark the distinction among the three separate taxes, as I shall below.) A deep look at estate tax reform shows the political and perceptual games in full force and effect, all the while propping up and shaping a tax that raises little if any revenue for the fisc. Worse, the tax, as left on permanent life support after TRA 2012, provides a handy roadmap for the creation

[18] McCaffery, Cognitive Theory and Tax.

[19] Graetz and Shapiro, Death by a Thousand Cuts, Edward J. McCaffery, The Dirty Little Secret of (Estate) Tax Reform, Stanford Law Review On-Line, 2012. This subsection borrows from the extended analysis in Edward J. McCaffery, Distraction From Distractions by Distraction: Reimagining Estate Tax Reform, 2013, available on ssrn, forthcoming in Pepperdine Law Review.

and indefinite perpetuation of dynastic wealth – exactly the opposite of the best intentions of the tax to begin with, but an understandable result of the political forces surrounding the tax. Worst of all, the entire saga of estate tax reform shows an important opportunity to do something real lost, in the continuation of the "stepped up" basis rule of IRC Section 1014 – providing the last step in Tax Planning 101's buy/borrow/die.

The story of estate tax reform as it has led to the status quo can begin in many different places, but we can start in 1994, when the well-named Death Tax Elimination Act, H.R. 8, (initially introduced as part of H.R. 2717, The Family Heritage Preservation Act) was introduced by Representative Christopher Cox (R-Ca) into Congress. Over the next six years there were several votes, culminating in Bill Clinton's veto of a bill to kill the death tax that had passed both the House and Senate, with significant Democratic support. Then came George Bush, a Republican House and Senate, and near-certain repeal. Only we got the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") instead. This Act gradually weakened the gift and estate tax, raising its exemption levels and lowering its rates, until 2009, when the exemption was set to be $3.5 million and the rate 45%.

The only technical statutory matters came into play during the fiscal cliff negotiations were the tax's rate and its exemption levels – and whether or not these exemption levels would apply to lifetime gifts as well as to death-bed transfers, that is, in both the gift and estate taxes. The exemption levels noted throughout are per individual donor/transferor; married couples, with proper planning, can double them. The discussions around the TRA 2012 were about exemption levels (specifically, $3.5 million, Obama's opening bid, versus $5 million, the 2012 status quo (actually, $5,120,000, with a year of inflation indexing off a 2011 baseline, per TRA 2010) with – spoiler alert! -- $5 million prevailing) and rates (specifically, 45%, Obama's opening bid, versus 35%, the 2012 status quo and Republican opening, with – spoiler alert! -- 40% emerging as the slightly surprising compromised answer). In the analysis of this Article, I am interjecting the relevance of the difference between a "carryover" basis, as exists for gifts (meaning that the donee takes the donor's basis, and hence any built-in gain is preserved, IRC Section 1015), versus a "stepped up" basis, as we have for assets passing from a decedent, (meaning that the donee/transferee's basis is the asset's fair market value, such that all built-in gain has disappeared for tax purposes, IRC Section 1014). To be clear, this issue was not on any table inside the Beltway as the nation careened towards its self-created fiscal cliff. Indeed, like the Chicago Cubs winning the World Series, true carryover basis through death does not seem to be in the cards at any time.

Back to the running narrative: in 2010 there was to be no estate tax at all under EGTRRA -- an infinite exemption, as it were -- at the "cost" of a carryover basis rather than the traditional stepped up one. EGTRRA was then set to expire after 2010, bringing, in 2011, a return to a $1 million exemption and a 55% rate for gift and estate taxes. There were many votes during the first decade of this century, but none stuck. As EGTRRA played itself out, the law seemed headed to a place considered unimaginable to many: a year without an estate tax at all. Surely, something would have to happen to prevent that extreme result from obtaining.

Only it did not. The Year 2009 saw no end-of-the year patch or fix to the situation that EGTRRA had left us in. What follows is a point that some observers of Congress and the estate tax saga fail to understand. Many interested persons concluded that a divided and highly partisan Congress simply never acts, such that, now, in 2013, we would be seeing a return to the pre EGTRRA levels of a $1 million exemption and a 55% rate – the inertial default. For such observers, what happened at the end of 2009 – that is, nothing –became the decisive proof of the pudding. But looking at things over a slightly wider lens of time, we see a different pattern. Congress does not act when tax *decreases* result from inaction. Hence, the inaction in 2009 and at the beginning of 2010. Congress does act when tax *increases* would result from inaction. Hence, there was Congressional action at the end of 2010 to create and extend the $5 million exemption and 35% rate of the estate tax (TRA 2010); 2011, to renew the "payroll tax holiday;" and 2012, to prevent all of the Bush-era tax cuts from expiring in a massive tax increase (TRA 2012).

The particular bill from 2010 bears closer analysis. For one thing, TRA 2010 retroactively gave estates for decedents who died in 2010, like George Steinbrenner, a choice: accept the no estate tax/carryover basis regime provided for by EGTRRA, or instead chose a $5 million exemption, "portable" between spouses, and a 35% rate, with stepped-up basis. The very fact that this was a choice – not to mention that many families chose the latter, nominally taxable, option -- shows how deep the concerns over basis step up run. We get back to those below.

TRA 2010 did one more thing: it "reunified" the gift, estate, and generation-skipping exemption levels, which had been torn asunder by EGTRRA. Prior to EGTRRA and for some time, the exemption level was the same for *inter vivos* transfers, under the gift tax, and death-time ones, under the estate tax, as well as for generation-skipping taxes once those came into play in the Tax Reform Act of 1986. EGTRRA, however, kept the gift tax exemption level at $1 million, including in its no-estate-tax year, 2010. What this meant, in practice, was that one had to die to take advantage of the higher exemption levels. It also kept alive a meaningful political threat that the estate tax could one day come back in fuller force, since the living could not use large exemption levels to whittle down their estates.[20]

Now is as good place as any to make the general point that exemption levels under the gift and estate tax *do not come down*. They have not since 1935, when the exemption for both went from $50,000 to $40,000. Setting that one year aside, and if we ignore the "infinity" of 2010, and count it instead as a $5 million exemption, there has been a steady increase. Figure 1 shows the history of the exemption level under the estate tax, in nominal dollars.

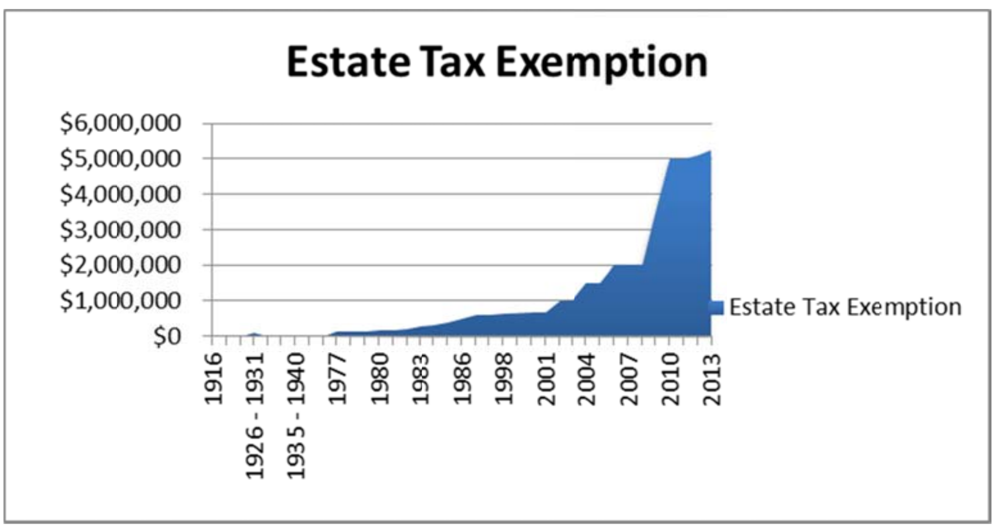

Figure 1: Estate tax exemption, 1916-2013

[20] See McCaffery and Cohen, Shakedown at Gucci Gulch.

TRA 2010 changed the pattern established under EGTRRA. It very importantly – and rather quietly – reunified the three transfer taxes, making their exemption levels $5 million each, indexed for inflation off a 2011 baseline (thus the exemptions rose to $5,120,000 in 2012). In other words, while TRA 2010 technically continued the estate tax exemption of 2010 for another two years, with indexing, *it increased more than five-fold* the gift and generation-skipping exemptions. Figure 2 shows the estate and gift tax exemption levels since 1976. Note the gap between the two, evident since 2006, and closed – at the estate tax's higher level, in 2011.

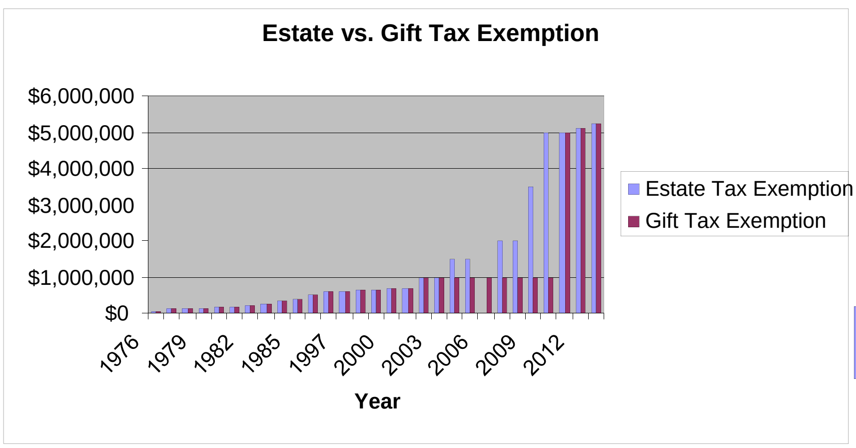

Figure 1: Gift and estate tax exemptions 1976-present

This was a very big deal, and suggests that a major lobbying force had entered the room: the dynasty trust crowd. "Dynasty" or "perpetual trusts" are one of the great unintended consequences of all time in tax law, which is saying quite a bit. They sprung into life after the Tax Reform Act of 1986 finally shut down a "loophole" in the transfer tax system. Gift and estate taxes apply to beneficent transfers. Normally, these go from parent, Generation 1, to child, Generation 2. At some point thereafter, Generation 2 faces its estate planning issues, and passes some wealth along to Generation 3, and so on. The gift and estate tax stands ready at each transfer to come down on large transmissions. But truly wealthy families can afford to "skip" generations. Thus grandparents, in Generation 1, can pass wealth onto grandchildren, in Generation 3, "skipping" the need to pay taxes at Generation 2. Estate planners, being a clever breed, devised ways to make these transfers in trust, with Generation 2 having limited but significant access – the family getting their cake and eating it, too. The Tax Reform Act of 1986 (TRA 1986) added a "generation-skipping tax" to stop the perceived abuse, such that transfers from Generation 1 to Generation 3 or lower would bear a double transfer tax.

Only there was an exemption level for generation-skipping taxes, too, initially set at $1 million per transferor. And this exemption provided a roadmap: a couple would place $2 million or more (with "fractional share discounts" and other valuation techniques to be discussed below) into a generation-skipping tax-exempt trust, never to pay transfer tax. The next question for many wealthy families and their advisors was, How long could such trusts last? The initial answer was for as long as the rule against perpetuities allows. But this answer was considered unsatisfactory for the enlightened, and so the next step was to eliminate the rule against perpetuities in many jurisdictions, provided that the assets be placed in trust, that the trustee have the power to dispose of particular assets – and, usually, that the trustee be local. Because private individuals can choose any state law to govern their private contracts or trusts, wealthy individuals in New York, California, Illinois and the like were soon flocking to dynasty or perpetual trusts in faraway places such as Delaware, Alaska, and South Dakota. By 2004, one study suggested that there were $100 billion in dynasty trusts, mainly in South Dakota.[21] Today, South Dakota, with a large presence of Citibank, is the state with the highest banking deposits. Not coincidentally, Senator Tim Johnson, a Democrat from South Dakota, is chairman of the Senate Banking Committee.

Dynasty Trusts and the financiers who run them – as well as insurance companies, who often sell "second to die" life insurance policies on wealthy married couples as the (highly income-tax favored) asset to be held in dynasty trusts, were huge winners from TRA 2010. Instead of being able to put down $2 million for a dynasty trust or insurance policy, it appeared – perhaps for two years only! – that the same couple could now lay down $10 million. Anecdotal evidence shared with this author suggests that, for major banks and trust companies, the number of dynasty trusts created in 2012 more than quadrupled.

In any event, all that had come before set the stage for the "fiscal cliff" slated for January 1, 2013, when EGTRAA, which had been extended by TRA 2010 for two years, was set to expire. Insofar as the estate tax was concerned, the law as written meant a return to the $1 million exemption and 55% rate of pre EGTRRA times. Some practitioners, aided by the media, stirred up fears that this would indeed happen, leading to aggressive planning under the large gift-tax exemption in place for 2012. This was precisely the situation that could *not* obtain under the initial ten EGTRRA years, because the gift tax exemption had stayed frozen at $1 million.

But, in point of fact, a full return to Year 2000 levels never seemed to be in the cards. President Obama, as he had in his 2008 platform, consistently staked out a position at a $3.5 million exemption and a 45% rate – the 2009 status quo. In December 2012, Obama

[21] Shazenbach and Sitkoff.

reiterated his stance, and commentators "scored" the proposal as raising $119 billion over ten years, from the 2012 baseline. The next day, however, Senator Max Baucus, the Democratic Chairman of the Senate Finance Committee, came out in dissent, supporting a perpetuation of the status quo – a $5 million exemption, indexed off 2011, and a 35% rate. And it appears that is what would have happened, with a late leak suggesting that there was a deal brokered by Vice President Biden and Senator Mitch McConnell (R-Ky) at a $5 million exemption and 35% rate. The same purported deal featured a return to the top pre-EGTRRA marginal income tax rate of 39.6% for individuals/married couples earning more than $400,000/$450,000. At this point Senator Tom Harkin (D-Ia), objecting from the left, took to the floor of the Senate and stated that the purported deal was too much of a give-away to the rich, with its $400,000/$450,000 floor on tax rate increases for singles and married couples, and its $5 million, 35% rate on estates: more specifically, that he could accept one, but not both, of these levels. The next the public heard, the deal was struck with the Senate overwhelmingly approving TRA 2012 with a triple-transfer-tax exemption of $5 million, and a rate of 40% (and the income tax rate levels as leaked). Senator Harkin was among the 8 Senators voting "no." "Moderate Democrats from farm states" were credited in the press with insisting that the exemption levels remain unified and indexed for inflation – with South Dakota and Montana possibly counting as "farm states."

At the end of the day, the raise in the gift and estate tax rate to 40% was "scored" as a tax increase of $19 billion over 10 years, which is a little hard to believe, given that the Tax Policy Center has estimated that the estate tax will bring in $10.6 billion in 2011, with essentially the same law in place as in 2013, with the exception of the 40% rate. As time goes by, the very large gift and generation-skipping exemptions have the capacity to greatly shrink the estate tax's base. Meantime, to put the $19 billion over ten years in perspective, the expiration of the 2% payroll tax holiday is said to bring in $100 billion – a year – as we have just discussed. Thus the government got $1 trillion from a massive middle-class tax increase, in America's least progressive major tax, and, perhaps, $19 billion from its "most progressive" tax, the latter contributing about 2 cents on the dollar.

An estate tax exemption of $5,250,000 per person, $10,500,000 per married couple, as TRA 2012 left us, post indexing, means that something like 99.7% of decedents' families need have no concern with the tax. But – and here is the point to get to – 100% of decedents will be able to pass on assets with a stepped-up basis to their heirs. Recall that in 2010 most families chose what has now become the entrenched law ("permanent" apparently meaning "at least two years," like a California marriage), with its $5 million exemption and stepped-up basis, rather than a world of no estate tax and a carryover basis. If we imagine that the terminal EGTRRA year was an option for the estate tax, the overwhelming majority of wealthy families "won" by moving to the regime with the death tax not quite dead. Looked at another way, EGTRRA itself as written reflected a policy judgment that, without any estate tax, there should be no stepped-up basis, the plan for 2010. What we are left with, after TRA 2010 and 2012, however, it is a wealth transfer tax that is irrelevant for the vast majority of even wealthy individuals and families – and stepped-up basis.

In point of fact, however, or at least common sense, with far fewer than 1% of decedents even paying an estate tax, the case for allowing the game of unrealized appreciation to move from one of deferral to one of escape – as Section 1014 allows it to do

– is precarious at best. Canada of all places has gone to a rule of capital gains on death – making death a realization event. This deserves consideration in America, as well. Short of that, a systematic repeal of Section 1014 and a master rule of carryover basis as provided for gifts under Section 1015 would widen the tax base by bringing in previously untaxed capital appreciation. So it would raise revenue. Joseph Dodge and Jay Soled have suggested that the problem of overstating basis – taxpayers simply listing an incorrectly high basis in their sold assets – costs the US government $25 billion a year, and possibly more.[22] Without the burden of a meaningful estate tax to audit and administer, the IRS can devote additional resources to monitoring the problem of over and misstated basis. A clear statutory presumption that basis shall be zero unless the taxpayer can produce adequate records – a serious substantiation requirement, such as we now have for travel and entertainment expense deductions under the income tax – could also help. Either a realization-on-death or a consistent carryover basis rule, while not being an ideal solution, would at least practically advance some measure of redistribution.

Only don't hold your breath. A repeal of Section 1014 seems not to have been on the table at all in the fiscal cliff deal. In an analysis published in the influential *Tax Notes* within weeks of the fiscal cliff deal, the highly respected journalist and commentator Martin Sullivan had this to say:

> Regarding capital gains realizations at death, there are enormous administrative and compliance issues in switching from step-up to carryover basis. If Congress wants to increase taxes on the wealthy, these practical issues should

[22] Dodge and Soled.

> prompt it to favor an increase in the estate tax rather than a new tax on capital gains at death.[23]

Now let us set aside the facts that the preference for capital gains is said to cost the government $128 billion a year, in contrast to estate tax revenues under $11 billion, or that even this amount for the capital gains preference is vastly understated if we were to compare the status quo to a world without a realization requirement, as by using a "mark-to-market" system, which would have compelled Warren Buffet to report at least an additional $8 billion from 2010 alone.[24] Set aside, too, the fact that TRA 2010 and 2012 are almost certain to have made the problem of unrealized appreciation *worse*: the gorilla grew, to perhaps one thousand pounds. The incentive to gift away appreciated assets has now greatly diminished, with a rising capital gains rate (from 15% in 2012 to 23.8% in 2013 for upper-income taxpayers) and a vanishing estate tax. This will make "lock in" – the tendency for the wealthy to cling on to appreciated assets until death, holding them out of the free flow of assets that is best for allocative efficiency -- a greater problem. Focus instead on the fact that the thoughtful Sullivan, looking to the matter of untaxed appreciation, concludes – and quickly, easily – that the "administrative and compliance" issues in repealing stepped-up basis would be "enormous," and that he recommends instead an increase in the estate tax – which has just been, effectively, killed, except for the dynasty trust crowd and their clients, and which has *never been raised*. There is a saying, loosely attributed to Voltaire, that we should not let the perfect be the enemy of the good, to which I shall return. Here, in Sullivan's

[23] Martin A. Sullivan, *Realistically Aggressive Tax Reform*, Tax Notes, January 14, 2013.

[24] On mark to market, see Shakow, Knoll, Miller, Auerbach.

recommendations for addressing the problem of untaxed appreciation, we seem to be letting the impossible be the enemy of anything real.

And so, at the end of the day, the fiscal cliff left us with this: a 5%, in absolute terms, increase on a tax that almost no one will pay; the persistence of the tax as a symbol of redistribution and a real roadmap to the creation and perpetuation of dynasty trusts; and a stepped-up basis on death rule that will assure the rich person's game of deferral can end in the holy grail of escape. *Sic transit gloria mundi*.

3 The Refrain: Practical, Political and Perceptual Problems of Bifurcation

The stories just told, centering on tax policy proposals and actual reforms over the last couple of years, have been of a piece and a point. We see real tax increases on the masses (the expiration of the payroll tax holiday) enacted in a quiet fashion, low-salient increases on a broad base. We hear *talk* of taxing the rich, rhetorically shaped and ultimately watered down, in the Buffet Rule. In its place, we raise marginal rates for the very upper-income, while allowing them – as the Buffet Rule would not have done – to retain the benefits of the lower Bush-era rate levels and brackets, infra-marginal to them. We see a mainly symbolic tax on the wealthy, the estate tax, left lingering, as a symbol of doing *something*, a rhetorical prop. All the while the important, highly pro-taxpayer rule of stepped-up basis for assets transferred on death, which had made some sense in a world with a vigorous estate tax, endures without reason. But we see no serious attempt – no politically viable *proposal* – to truly raise the tax burdens on the rich. We do nothing about wealth inequality, likely making it worse. Tax Planning 101 stays intact; Warren Buffet escapes tax reform largely unscathed.

With these stories and examples to draw on, this Section gives more detail and analysis on the bifurcation strategy and its practical, political and perceptual problems.

3.1 The Bifurcation Strategy, Redux

As a matter of ideal theory, how should society redistribute wealth? In particular, what role should tax systems play?[25]

The two welfare theorems of neo-classical economics suggest a certain, definitive answer to these questions. The first theorem holds, in essence, that free markets reach welfare maximizing or, equivalently, "pareto optimal" allocations of resources. The second theorem holds that a suitable distribution or redistribution of initial entitlements can lead to different positions along the social optimum or, equivalently, paretian frontier.[26] Practitioners of law and economics, most extensively Kaplow and Shavell, have used these two theorems to develop a comprehensive agenda for law reform.[27] The answer to optimal redistribution

[25] It is compelling to consider that tax or other "redistributive" programs are better understood as setting the normatively appropriate initial distribution of material resources, as opposed to their redistribution. See for example LIAM MURPHY AND THOMAS NAGEL, THE MYTH OF OWNERSHIP: TAXES AND JUSTICE (New York: Oxford University Press, 2002); David Duff, CANADIAN JOURNAL OF LAW AND JURISPRUDENCE, JANUARY 2005. For ease of exposition, however, I follow convention and write about the distributive prong of the optimal welfare economics approach as being "redistributive."

[26] See for example ROBIN W. BOADWAY AND NEIL BRUCE, WELFARE ECONOMICS, (Oxford, UK: Basil Blackwell, 1984); JOSEPH E. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR, 3RD EDITION (New York: W.W. Norton & Company, 2000), 60–61. For a more general discussion of the two welfare theorems and an application to income tax policy, see Kyle Loque & Ronen Avraham, Redistributing Optimally: Of Tax Rules, Legal Rules, and Insurance, 56 TAX L. REV. 157 (2003).

[27] Kaplow and Shavell first proposed that the tax system be used as the exclusive means for redistribution in Why The Legal System Is Less Efficient Than the Income Tax in Redistributing Income, 23 JOURN. LEGAL STUD. 667 (1994); see also Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income, 29 J. LEGAL STUD. 821 (2000); *Fairness versus Welfare*, *supra*.

has two parts. One, laws should be arranged so as to maximize social welfare, that is, broadly, to serve "efficiency." Two, the tax system should be used to redistribute social resources so as to maximize the sum of individual well-being, that is, again broadly, to serve "equity." The two-part approach satisfies a paretian constraint: the greater social pie facilitated by the first step can be used in the second step's redistribution to assure that no one is harmed by any reform.

This optimal welfare economics approach depends on a simple, stark contrast between the allocative and redistributive functions of government, with efficiency norms serving as the sole guide to the former. Importantly, whatever one chooses as an optimal distribution of end-state resources to serve the equity goal — whatever the social welfare function is, in more formal terms — collective well-being can only but improve by following the two prongs.

This is what I am calling the bifurcation strategy: the idea that it is wise to separate out questions of distribution from consideration of legal rules, generally, and to leave matters of redistribution to the tax system, more particularly. There are many other ways in which policy discussions that could affect redistribution get bifurcated, but they are all related in a certain logical sense. Thus, importantly, tax policy theory – as most clearly articulated in the elegant mathematical models of optimal income tax analysis, for which the British economist

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Economists had long been making similar arguments. See, e.g. Arnold C. Harberger, On the Use of Distributional Weights in Social Cost-Benefit Analysis, 86 J. POL. ECON. S87 (1978). For criticisms of the Kaplow-Shavell argument, see Chris William Sanchirico, Deconstructing the New Efficiency Rationale, 86 CORNELL LAW REV. 1003 (2001); Chris William Sanchirico, Taxes versus Legal Rules as Instruments for Equity: A More Equitable View, 29 J. LEGAL STUD. 797 (2000); Loque & Avraham, supra; Ronan Avraham, David Fortius, & Kyle Logue, Revisiting the Roles of Legal Rules and Tax Rules in Income Redistribution: A Response to Kaplow & Shavell, 89 IOWA LAW REVIEW 1125 (2004); for one among several replies by Kaplow and Shavell, see Louis Kaplow and Steven Shavell, Should Legal Rules Favor the Poor? Clarifying the Role of the Income Tax in Redistributing Income, 29 J. LEGAL STUD. 821 (2000).

James Mirrlees was awarded a Nobel Prize in Economics[28] -- has its *own* bifurcation strategy. Optimal income tax theory is concerned with allocative questions, too, and the efficiency losses that can come from high marginal rates, particularly and especially on the "top" of the income distribution scale. Thus it is worth noting, as I shall further below, that the most discussed and, for that matter, enacted change that affects the rich – raising marginal tax rates on upper income taxpayers, as in the enacted TRA 2012 – is *directly contrary* to the recommendations of economic theory. Indeed, the Buffet Rule would have done better on this front, essentially substituting a flat 30% rate for the marginal rate bracket structure, which would also be the marginal rate on the next dollar earned – lower than the 39.6% rate under TRA 2012.

Here is another point in the tale where the dots, or p's, all get connected: the **practical** fact that high marginal tax rates on the rich can be distorting fuels into the **perception** if not the reality that the rich will, indeed, flee – either from the jurisdiction (Phil Mickelson, Gerard Depardieu, The Beatles) or from productive activity ("Joe the Plumber" for want of a real example) – which then makes it **politically** difficult to do what elected politicians do not really want to do, anyway, which is to really, effectively tax the rich. Thus, again in "good" times, in the first stage of the perils of the bifurcation strategy, tax reform is styled as being "distributionally neutral," with "efficiency" or a "pro-growth" agenda as the primary goal. This, in a nutshell, explains the great Republican Administration tax reforms of Reagan, 1981's ERTA and the TRA 1986, and of George W. Bush, 2001's EGTRRA and the

[2828] Mirrlees 1971-72, see also Ramsey, Diamond. In legal literature, Bankman and Griffith, McCaffery and Hines.

2003 Jobs and Growth Tax Relief Reconciliation Act ("JGTRRA") – it being no coincidence that Bush's great tax-cutting acts have "growth" in their official titles.

This leads into another dimension of bifurcation. Tax policy discussions get bifurcated in time as well as in logical space. Within tax, as alluded to above, the bifurcation between efficiency (or "pro growth") and redistributive agendas gets separated in time, as major tax reform is shaped in an initial phase under a "distributionally neutral" but "pro-growth" constraint. Tax and spending decisions get bifurcated as well. What happens next is that the "pro-growth" changes of the initial phase (here, the roughly quarter century between Reagan's taking office and the younger Bush leaving it, 1981-2008) combine with the continued expansion of spending programs (Medicare subpart D, the prescription-drug benefit passed under George W. Bush; Obamacare), to produce a perceived fiscal crisis. And then we get the types of changes discussed above and throughout: major middle class tax increases, and symbolic gestures for the rich. We also, quite possibly, will get spending cuts unimaginable without the environment of crisis.

There is reason to believe that these perceptions have all played out under a conscious, deliberate strategy. The idea, evident behind the slogan of "starving the beast," is that it is very difficult to cut spending programs once in place -- unless the programs must be paid for by highly salient tax increases.[29] The strategy of cutting taxes, today, under a distributionally neutral/pro-growth mandate, in order to cut spending *tomorrow*, works in part because of perceptual phenomena centered around the status quo – as in the status quo bias,

[29] Baron and McCaffery, Starving the Beast, Norquist.

or reference-dependent utilities.[30] The idea, as with most behavioral economics ones, is commonsensical: people like things the way they are. Given a proposal to cut both taxes and spending, at one and the same time, most citizens will say "no," because the pain of the spending cut exceeds the pleasure of the potential tax cut. Given a straight-up vote on a tax cut, today, however, citizens go along – not thinking about the eventual payback, perhaps out of myopia or short-sightedness, or allowing an optimism bias to suggest that spending cuts will never be needed, because the tax cuts will lead to growth as we "grow our way" out of them: a well-noted set of cognitive tendencies, here happily fueled by political "promises" that this is just what will happen. Then when the day comes and something has to be done, and now the choices are tax *increases* or spending cuts, the citizen, moved by tax and loss aversion, agrees to support spending cuts. Because of the agenda setting – the bifurcation of issues – a preference reversal has transpired, and citizens come to accept spending cuts that they would not have initially. Advocates of greater redistribution are left with a bad case of the bifurcation blues, and little else.

3.2 Practical Problems

There is a familiar joke about a drunken sailor, looking for his wallet under a lamp-post. A passerby asks where the sailor lost his wallet. "Over there," replies the sailor, pointing some distance down the road. "Then why are you looking here?," asks the quizzical third party. "Because this is where the light is," replies the equally bewildered sailor.

When it comes to the fisc, neither the money nor the light suggests taxing the rich. There are a series of practical problems in even attempting to do so, beginning with the

[30] Rabin; Kahneman and Tversky; McCaffery and Baron.

observation from optimal income tax theory (and elsewhere) just noted: incentives matter. High marginal tax rates on labor discourage labor. It is noteworthy that Mirrlees published his Nobel-winning analysis of optimal income tax in 1971; within a decade, a solid chorus of economists had joined the band,[31] and we got Ronald Reagan and the great tax acts of 1981 (ERTA) and 1986. The top marginal rate on income, which had stayed at 90% from World War II until 1963, when John F. Kennedy cut ("slashed"?) it to 70%, fell, first to 50% (1981) and then to 28% (1986, after a "bubble" of 33% ran out – a particular feature actually mimicking optimal income tax results). Even with George H.W. Bush's quivering lips, the highest stated income tax rate bracket has never again hit 40%, the new Maginot line. It reached 39.6% under Bill Clinton (actually, a 36% rate with a 10% "surcharge" that quickly got translated into what it is, a 39.6% rate), and having just gotten back there under Obama and TRA 2012. Indeed, it bears noting that President Obama has never even *proposed* exceeding 40% for the highest income tax rate, and the Buffet Rule, in all of its incarnations, has also stayed below that level. The estate tax, as noted above, now has a 40% rate, meaning that a billionaire – without planning, mind you – can only pass $600 million to her heirs, who will at least get a fully stepped-up basis to soothe their wounded wallets.

Let us, briefly, take a closer look at optimal income tax theory, for it embodies the first practical problems with attempting to tax the rich: one, the efficiency-oriented concern with avoiding high marginal tax rates on highly elastic individuals, and, two, and related, the unavailability of the economist's first-best means for achieving more redistribution, namely, demogrants.

[3131] McCaffery and Hines, and sources cited therein.

The major implications of the Mirrlees model and its considerable progeny are that, given a redistributive social welfare function and with certain standard assumptions, the marginal tax rate on labor earnings should attain its peak in the middle of the income range and be declining at the upper ranges of income, even possibly reaching zero on the last dollar earned by the highest wage-earner (though Mirrlees himself did not have this top rate of zero).[32] While there is great disagreement about the precise contours of the rate curve – such that Arthur Laffer, famously, could reduce it to a simple single-peaked curve -- there is little argument that marginal tax rates end up declining over the upper income range. Matti Tuomala, a prominent proponent of the optimal tax tradition, has put it simply that:

> . . . one of the main conclusions to be drawn from the Mirrleesian optimal non-linear income tax model is that it is difficult (if at all possible) to find a convincing argument for a progressive marginal rate structure throughout.[33]

Mirrlees himself included simulations in his seminal 1971 paper that featured peak (that is, highest tax rates, typically on the lower-middle income class) and highest end (that is, tax rates for the highest income) marginal tax rates of 26 and 16; 20 and 15; 28 and 19; 34 and 20; 39 and 21; and 60 and 49.45 These peak-highest end rate pairs show not only the considerable range of possible outcomes under an optimal tax analysis (depending on the social welfare and individual utility functions used), but also the general pattern of peaking then falling. Later analysis pushed the case out to finding a zero rate---even, in the case of

[32] The zero top marginal rate was first identified by Efraim Sadka, On Income Distribution, Incentive Effects, and Optimal Income Taxation, 43 REVIEW OF ECONOMIC STUDIES 261 (1976), and Jesus K. Seade, On the Shape of Optimal Tax Schedules, 7 JOURNAL OF PUBLIC ECONOMICS 203 (1977).

[33] MATTI TUOMALA, OPTIMAL INCOME TAX AND REDISTRIBUTION (1990), at 14. See also Kaplow 2006 and 2008; Auerbach and Hines.

one model advanced by the Nobel laureate Joseph Stiglitz, a negative rate---for the highest earner/most able citizen.[34]

The intuitions behind the complex mathematics of optimal income tax models are easy enough to state. The pattern of tax rates reflects a tradeoff between the distorting effects of taxes on labor supply decis ions, on the one hand, and the benefits of producing and then redistributing income via the tax system, on the other. While higher marginal tax rates at low income levels have the undesirable feature of discouraging work effort by low-ability taxpayers---one aspect of many of the models is that some citizens will rationally chose not to work---they also offer the prospect of raising significant tax revenue from all taxpayers, including the high income or ability ones, for whom the higher rates are infra-marginal. That is, the high tax rates on low levels of income occur well "before" the high income/ability taxpayers make their marginal decisions about additional work effort. If a well educated lawyer can earn $250,000 a year, for example, her marginal work decisions---should she work those extra hours towards the end of the year to get a larger bonus, say---are unlikely to be affected by a high marginal rate on her first $50,000 of income.

Again this is an area where TRA 2012 got it backwards, from an economic sense, looking at the income tax alone – it kept the infra-marginal rate brackets at their low EGTRRA and JGTRRA levels, and then raised the highest marginal rate bracket, on individuals earning more than $400,000, to 39.6%. The Buffet Rule as proposed would have scored better on optimal tax grounds, because, while it keeps the marginal rate on the next dollar earned at 30%, it also would have the effect of raising infra-marginal rates for these

[34] Stiglitz, 1982. See also Seade 1977.

high earners. Overall, however, the U.S. tax system *does* appear to have an "optimal" rate structure, in that the payroll taxes, considering the incidence of the employer share, add some 15.3% (6.2% payroll tax, doubled, plus 1.45% medicare tax, doubled), but this amount drops by 12.4% at $110,000 or so, not to mention various "phaseouts," such as the loss of earned income tax credits (EITCs), that have the effect of adding to the marginal rates, making the marginal rate for many working poor perilously close to 100%.[35]

In any event, once the government has of money from the labor tax rates, it can then redistribute it to all citizens, including the poor, via what the literature has come to call "demogrants." These are simply lump-sum grants to all citizens – the "lump sum" component meaning that the grant does not vary with anything that the citizen does or does not do and so, by design, does not distort any prices or affect any incentives (income effects aside). The *net* of taxes and transfers is then progressive, or redistributive. In the analysis, high marginal tax rates at upper incomes, in contrast, while they also distort labor supply, raise only modest amounts of revenue, because they apply only to a small fraction of the labor force. Unless the labor supply of the rich is unusually *un*responsive to taxes, that is, inelastic---and the opposite is likely to be the case--- tax rates applying to upper-income levels attempt to tax what is a very elastic as well as small base. Hence optimal income taxation entails declining marginal tax rates over the upper ranges of the income distribution.

Suppose that our well-paid lawyer from the prior paragraph faces a 90% rate on any earnings over her $250,000 pay. Now would she work those extra hours in December, say, giving up time with family and friends in order to keep 10 cents on the dollar? In the limiting

[35] Shaviro, McCaffery.

case, it is better—for all, under the standard Paretian condition—for a worker to work than not to work simply for tax reasons. Hence the zero tax rate on the last dollar earned by the otherwise fully-deterred highest potential wage earner. Another way to express the same concept is that there is nothing for society to gain by imposing a positive marginal tax rate on the most able worker, and thereby distorting her labor supply, since such taxes yield no greater revenue than less distorting alternatives. It is always better to eliminate the taxation of the last dollar earned by the most affluent taxpayer, paying for this reduction by increasing the taxation of income just below that level, since doing so creates fewer labor market distortions.

And so the elegant findings of optimal income tax theory merge with a more popular sense of things, aided by such public intellectuals as Arthur Laffer and Martin Feldstein, that high marginal tax rates on the upper income levels are not wise. The idea helps inform the Bush and Reagan, pro-growth, tax cuts. Stories of people or companies fleeing jurisdictions saliently drive home the point. "Joe the Plumber" pops up on the hustings to block candidate Obama from getting too redistributive (John McCain sneeringly refers to him as "redistributionist in chief," a title that likely polls poorly for Obama) – and no one is much bothered by the fact that "Joe the Plumber" is not even a plumber, and wouldn't even by subject to the higher tax rates. Again, bifurcation is in play -- the understanding of tax rates is driven by a pro-growth, efficiency-oriented agenda. Demogrants will do the work of redistribution.

Only, well, we don't have anything very much like a demogrant – certainly no large cash transfer program. And we are almost certain not to get one. Grafting a demogrant onto the status quo would be the need for a massive tax increase, at a time when we are already scrambling to make ends meet, and most existing tax systems seem close to be tapped out. A pure cash transfer program would also be politically and perceptually difficult for American citizens to understand and accept, and it would be rather easy for the government to cut it to use for other spending programs or to reduce taxes. Once again, we seem only to get to the first step in the bifurcation strategy – the other shoe, of real redistribution, never falls.

Some prominent advocates of redistribution make a mistake. They consider optimal tax theory, and see that it uses declining marginal tax rates plus demogrants to effect meaningful redistribution. But given that we do not have and are almost certain never to have a pure demogrant program, they conclude that the case for declining marginal rates is moot. The moral and political philosophers Liam Murphy and Thomas Nagel characteristically state this case in the strongest and most colorful language:

> But there is one very important point to make about economists' lessons on the distinction between ends and means. *If we are told that lower marginal rates coupled with a demogrant would be better even from the point of view of a strongly egalitarian theory of justice than graduated rates with a high marginal rate at the top, that gives us absolutely no reason to abandon high marginal rates without introducing a demogrant. This is blindingly obvious.* But in practice the point is frequently ignored. It is frequently claimed, for example by Joseph Stiglitz, that the conclusions of optimal tax theory were an influence on the trend to much lower marginal tax rates in the 1980s. This trend has been linked not with a greater role for tax transfers, but rather the reverse. No one concerned with welfare, not even utilitarians, can regard the growing inequality that has characterized the last two decades in the United States as an improvement from the point of view of justice. It is possible that, in its short-run practical consequences, economists' interest in the behavioral effects of taxation has done more

> harm than good to the cause of social justice. (emphasis added).[36]

Murphy and Nagel are certainly right to point to – and they are well within their rights to rue – the fact of "growing inequality" in the United States, and to see tax policy as a central part of the story. But they are wrong in the highlighted language, in finding it "blindingly obvious" to Murphy and Nagel that there is "absolutely no reason to abandon high marginal rates without introducing a demogrant." There is a reason, and a strong one – efficiency. Having a revenue need, derived from *whatever* source, the optimal tax framework teaches a policymaker how most efficiently to meet it. And so there is, indeed, a reason---a compelling one---why policymakers should choose a pattern of declining marginal tax rates under a wage tax, even without demogrants. Optimal tax's insight that a "high marginal rate at the top" can be socially inefficient—wasteful---has nothing logically to do with the use of demogrants or not. The two components can be – and have been – bifurcated.

Here then is the essence of the practical problems of redistribution: it is hard to raise marginal tax rates on the top of the income distribution, because this has the potential to distort real economic growth. Many of the rich will shift assets and activities to avoid the new taxes; Joel Slemrod and others have pointed out that reported taxable income is far more elastic, or variable, than real income.[37] This clearly seems to be the case for capital gains and dividend taxes, both of rich were raised at the fiscal cliff, from 15% in 2012 to 23.8% (with the Obama-care surcharge) to 23.8%. But it is comparatively easy to push

[36] Murphy and Nagel.

[37] Slemrod.

towards non-dividend bearing stocks, or to isolate dividend-bearing ones in nontaxable accounts such as pension plans and individual retirement accounts (IRAs), and to altogether avoid capital gains, as in playing a Tax Planning 101 strategy. Further, the clear advance notice led many wealthy people so inclined to realize their gains or get their dividends in 2012.

Another component of the bifurcation strategy is worth noting at this point. We have seen above and throughout that, in an initial phase, efficiency or "growth" is pursued, through tax cuts in particular. Spending continues to increase, however, and the country does not "grow itself out" of the spending cuts. Indeed, as a *fiscal* crisis looms, the overall macro-economy is also weak, for not unrelated reasons. Then, in phase two, not only the pressing exigencies of the fiscal crisis but also the lingering, and intense, concerns over growth make redistribution impractical. The government is held hostage by its concern over growth, and low tax rates on the rich are the ransom.

The negative impacts on growth and efficiency (combined with the perception of such, discussed below) are by no means the only practical problem facing the putatively redistributive lawmaker. It is also the case that taxes on the rich, especially taxes that go directly at wealth, are far more costly to administer, and invite greater noncompliance, than broad-based taxes on the middle. Joel Slemrod has pointed out what may seem rather obviously, namely that compliance improves with third-party reporting, as in the W-2s that employers send in – as a condition of getting their own tax deduction. We saw Martin Sullivan of *Tax Notes*, above, backing off from even a suggestion of the repealing the stepped-up basis rule of IRC Section 1014 because of the "enormous" administrative and compliance costs. Richard Bird and Eric Zolt, in giving tax policy advice to developing countries, strongly and sensibly suggest that these nations obtain redistribution through spending programs, rather than through complex and costly individuated taxes. [38] All well and good, except that, in the U.S., that ship – carrying with it too perhaps the potential of demogrants – has already sailed. Indeed, the day for spending cuts is coming, too – and it will not be a day full of redistributive hopes.

3.3 Political Problems

There is no need to repeat here a discussion of the special interest model of politics in general, or tax policy in particular. Suffice it to say that the rich are far better able than the rest of us to form groups to lobby for tax breaks or against tax increases. Linda Cohen and I have written about the politics of estate tax reform, suggesting that Congress has an interest in teeing up matters of high stakes to small groups, and then stringing them along to get campaign contributions. That's our story, and I am sticking to it – with the observation that, by the time TRA 2012 got around to making the gift and estate tax exemption levels of 2011 "permanent," the financiers behind dynasty trusts had risen to the level of a significant lobbying force. In any event, there is clearly not much money to be had in "soaking the rich," especially as any proposal to do so, given the practical and perceptual realities noted throughout, would be a long-shot to happen in any event. Rational people do not have to pay much for longshots.

The timing and agenda setting of issues which features prominently in the bifurcation blues – tax cuts now, spending cuts later; efficiency norms now, redistribution

[38] Bird and Zolt.

later – also has political dimensions and is, after all, the result of our democratic processes. And while it may be that antigovernment partisans such as Grover Norquist designed and implemented the entire plan from the start, a more compelling explanation is that matters got rolled out for political reasons. No one likes his taxes raised, so politicians try to avoid doing that. Tax reform generally involves salient tax cuts and, where needed, low-salient tax increases. In good times, when taxes are being cut, the citizenry is fairly content, and willing to accept "distributionally neutral" tax reform that benefits all. The people even show sympathy for Joe the Plumber, and overwhelmingly oppose the estate tax. Tax increases do not come until we face a gun to our collective head, and then the atmosphere of crisis drives out concerns over redistribution.

3.4 Perceptual Problems

Jonathan Baron and I have conducted many experiments and written extensively now joined by many others in a growing field of behavioral public finance or behavioral tax. This section mainly lists some perceptual tendencies and suggests how they play into the bifurcation blues. As noted above, there are two broad tendencies at work: one makes direct attempts at taxing the rich hard, and the other makes tax strategies that have the *appearance* of taxing rich attractive.

Before getting into the laundry list, I want to counter the sense that this is, indeed, just a laundry list. A common and facile critique of the "behavioral turn" in law and economics is that the biases are *ad hoc* and operate at cross-purposes, often canceling each other out. But in fact most biases have clear directions, and are not random. Even putting aside the general issue of whether biases are systematic or not, when it comes to tax in and redistributive mechanisms in particular, the perceptual phenomenon occur in a setting hand-in-hand with the practical and the political – nothing is truly random. The practical and political effects just canvassed are real. Thus it ought not surprise us that actual tax policy, playing to the practical and political realities that it is hard to tax the rich, does not really tax the rich -- but appears to. Indeed, it would be surprising if tax system in an advanced capitalist economy did not somehow reflect widespread cognitive errors and illusion.

In any event, here are some of the perceptual problems with redistribution.

Salience refers to the mental or psychic impact that some fact of interest has on a target population – it refers to what we pay attention to. The income tax, with its high marginal tax rates and dreaded annual form, is the most salient of taxes. Other taxes are hidden to various degrees – partly hidden, such as the employer's share of the payroll tax, or fully hidden. Attempts to tax the rich are, almost by definition, highly salient. Other things being equal, democratic politics favors low-salient taxes.

Identifiable victim bias: related to salience – many cognitive phenomenon are – is the identifiable victim bias.[39] The idea is that we feel more strongly about harms when "we can put a face to them." Many are willing to pay money to save Wille the stranded whale, or Jessica (the young girl trapped in a well); raising money for nameless AIDS victims in Africa is more challenging. In tax policy, the highly salient attempts to tax the rich lead to clearly indentifiable victims, like the mythical Joe the Plumber or the perhaps equally mythical "farmers and family businesses" complaining about the estate tax.

[39] Loewenstein and Strnad.

Confusion of average and marginal tax rates: many studies have shown that people routinely confuse average and marginal tax rates. Thus, people *think* that being in a 39.6% bracket means that all of one's income is taxed at that rate. This confusion has several effects. It leads people, even the media, to ignore or neglect the infra-marginal benefits that the upper income got in TRA by perpetuation of the lower infra-marginal rate brackets. It likely leads many people to believe that TRA 2012, with its restoration of the pre-Bush era rate of 39.6% on incomes over $400,000 to be more progressive and redistributive than the Buffet Rule, setting an effective or average tax rate of 30%, whereas, for all but a very small percent of even the upper income, this is not the case. And, more generally, it may lead many people to accept their own tax burdens, such as the increase in payroll taxes effective January 1, 2013, as being tolerable, because it appears as if the upper-income have been hit even harder. Thus, again, we recall the fact that in the midst of World War II, the US government put a 90% rate bracket in place under the income tax – in which virtually no one was. But if you think others are paying 90%, 50% looks like a bargain.

Disaggregation bias: in some studies of direct relevance to the bifurcation blues, Baron and I looked at what happens when a tax system is split in two. We asked people what their preferred tax system on labor earnings would be. Then we told them that there were in fact two means of tax wages – through a payroll tax and an income tax. We stated each tax raised half the amount. Then we gave them rate structures, sometimes for the payroll tax, sometimes for the income. We asked them to set the other tax, and sometimes to restate the total. We found that, very consistently, subjects did not re-add the two systems together. Confronted with a flat or regressive wage tax, that is, they did not compensate by making the income tax more progressive. All this illustrates what we call an *isolation effect* – people look at things isolation, as if with blinders on. They have intuitions at how progressive a tax system should be, and, whatever tax they happen to be looking at, they want it to have their preferred pattern. Clearly this tendency is exacerbated and exploited by the political process, as in the semantic juggling needed to make the fiscal cliff deal *look* like it was a tax increase on the rich, under the income tax. The expiration of the payroll tax holiday was happily, consciously, left offstage.

Masking: "masking" is our term for another effect, related to the disaggregation bias, and central to the bifurcation blues. The idea is that much redistribution, as Bird and Zolt and others have noticed, is effected through spending programs. When those spending programs are cut, then, there is not only an allocative effect (government gets out of the business of providing the good or service) but also a redistributive one. Our question was whether subjects, prompted to do so, would "correct" for the level of redistribution in the residual tax system following a spending cut or "privatization." Again, not surprisingly, we found that ordinary subjects could not. Interestingly, they by and large did correct the tax system to make it more progressive, but not by nearly enough to keep the level of redistribution constant by replacing the "masked" with transparent redistribution. This bodes ill for advocates of redistribution as the second shoe in the fiscal cliff crisis – the spending one – is about to fall.

Hidden tax bias: finally, it should go largely without saying that, given all the perceptual biases in tax, people and politicians prefer their taxes to be hidden. And so many of them are. The leading example is the corporate tax which, basically, no one knows who pays – certainly corporations themselves do not, because these are legal fictions. Real taxes come out of real pockets. But whose? Still, getting corporations to "pay their fair share" has long been a mantra, mainly of progressives seeking greater redistribution. As with other low-salient taxes, this game may indeed support the continuation of spending programs that are progressive in effect. But the corporate tax has not and as presently constituted cannot do much to get at the rich and wealthy in America.

[Note to Readers: Here is the point where I must mainly stop for now; I simply sketch out what I intend to say in the remaining sections. Thanks.]

4 A Long Time Coming: A Peak at a Century of Tax Policy

4.1 Rise of the Payroll Tax

Year	Individual Income	Corporate Income	Payroll	Other	Total
1945	8.3	7.2	1.6	3.3	20.4
2010	6.3	1.3	6.0	1.5	15.1

Table 1: Federal government receipts, by source, as percent of GDP

Table I rather simply tells an important basic story: the income tax more or less maxed out as a percent of GDP in 1945, after WW II, while the payroll tax kept increasing. More specifically, looking to 2010 – a year when total federal receipts were too low, as many have pointed out, to avoid the fiscal crisis – the individual income tax has fallen by 2% of GDP since 1945, whereas the payroll tax has risen by 4.4%, an increase over 350%. Until President Obama's payroll tax cut holiday in 2011-12, the tax was the one major American one that had *never* been cut, in stark contrast with the individual and corporate income taxes, and the gift and estate tax, as noted above. And we know what happened to the payroll tax holiday.

4.2 From Class to Mass to Class: Movement of Income Tax to Wage Tax

Carolyn Jones wrote an important law review article nearly a quarter-century ago, chronicling the income tax's movement from a "class" tax, at its inception, to a "mass tax" during WW II.[40] Standing at the 100th year anniversary of the ratification of the XVIth Amendment, I would like to extend Jones's analysis out in time, and point out how the income tax has, again, become a class tax. Only the "class" has changed, from upper to middle. Lower –income Americans are, of course, mainly off the income tax rolls, with the important exception of needing to file to get the EITC. But the truly rich have escaped too, via Tax Planning 101. Each element of buy/borrow/die has been in place for most of the century, and each seems well-positioned to continue, as in the perpetuation of the stepped-up basis rule without a real estate tax to justify it.

4.3 Near Death of the Death Tax

Mainly a quick reprise of the discussions of the gift and estate tax, above, and a longer lens of time showing its gradual demise into irrelevance.

[40] Carolyn C. Jones, Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II, 37 Buffalo Law Review 685 (1989).

5 A Preview of Coming Attractions

5.1 Continued Attack on "Tax Expenditures"

It seems obvious that this is coming, signaled by Obama and endorsed by many. A strategy harking back to Stanley Surrey but evident in various advisory panels (2004, Simpson-Bowles). Like other items in this section, it may be a good idea, but it largely continues theme of perfecting the income tax as a wage tax, on upper earners. Unrealized appreciation not typically considered a "tax expenditure." Little if any real attempt to get at the wealthy.

5.2 Repeal of Homer's Tax Cuts?

The various tax breaks enacted for the middle class are now at risk. Bartels, Stark and Zolt.

5.3 Corporate (and Business) Tax Reform

Also coming.

5.4 Slouching Towards a VAT?

Maybe coming?

6 Putting Things Back Together: Hope for Hope's Sake?

I am well aware that many, perhaps most, will consider the normative ambitions of this Article – to get real, meaningful redistribution in America in general, by finding a way to tax the wealthy in particular – to be hopeless. There are two strands of skepticism.

One transcends all time: the idea that this is just how it works, that the rich always get away with things, that inequality arises in any advanced society and then pushes itself out to extremes. In a happy version of this tale, private fortunes ultimately dissipate such that inequality evens out over time. In a less happy version, inequality continues to increase until the society collapses of its own weight, in some revolution or other crisis.

A second skeptical strand is more particular in time, and so ostensibly more hopeful. It holds that, while redistribution is a noble end and maybe even possible, not now. Now is not the time for class warfare, for taking from the rich. The fiscal cliff has set us in a stage of crisis, and we must act, practically, now. These well-meaning skeptics argue against letting the perfect be the enemy of the food. Staring a fiscal crisis in the eyes, redistribution today suggests taxing the middle class to save the poor.

To the first strand, I do not have much to say, except that this seems unduly hopeless and deterministic. History is full of surprises, as John Rawls has written, and we may never know when a progressive moment is going to hit us until it does so. But we can be ready, and it is clear that we need to think harder and better about seizing the day when and if the day ever comes.

As to the second strand, this may indeed be right, that now is not the time, and we need better middle-class taxation to save the state. But then the mistakes for redistributionists can be seen looking backwards in time, to the opportunities lost for affecting redistribution and addressing the issues before we ever got to the near crisis we are. Perhaps it is too late for us. Hopefully it is not too late for those who come after us.

In any event, what is the cure for the bifurcation blues? All that we have seen has followed from the decisions to separate out redistribution in logical space and time. We should stop doing so. We should connect tax and spending, and all taxes. And we need to get serious about the problems of wealth inequality, and the possibilities for its amelioration, or the gorilla will take over the entire room.

[more specific conclusions to come]