

# CONSTITUTIONAL REVIEW AND TAX LAW: AN ANALYTICAL FRAMEWORK

YOSEPH EDREY\*

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\* Dean, *Ramat Gan Law School*; Professor of Law, *Haiifa University Faculty of Law* (on leave); LL.B, LL.M, Ph.D., *The Hebrew University of Jerusalem Faculty of Law*.

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#### FOREWORD: JANET

My first meeting with Janet Spragens was one of those rare occasions where five minutes after I met her, I felt that she was my best friend. I felt that I had known her for most of my life, that I could trust her for the rest of my life, and that I loved her. I loved her wonderful and cheerful spirit, her smile, her eyes, and her beauty. My wife, Bella, and I became best friends with Janet as soon as we met her. There was not one time that Bella and I came to the United States—and we came quite often—that we skipped seeing Janet, whether it was in California, Massachusetts, Michigan, or of course, Washington, D.C. The Washington College of Law (“WCL”) has become like a second home to Bella and I, due to Janet, Claudio Grossman, Elliott Milstein, Andy Pike, Paul Rice, Padideh Ala’i, Herman Schwartz, Danny Bradlow, Bob Dinerstein, Peter Jaszi, Nancy Abramowitz and the rest of the great faculty.

I remember how happy we were when Janet came to visit us in Israel. Janet was so joyful when we strolled on the shore or climbed to the top of Carmel Mountain. I remember how excited we all were when she became the head of Haifa—the WCL summer program in Israel—and we planned the first course for our Haifa students.

Janet was a great and sincere friend. When she heard that we were coming to Washington, D.C. last summer, she insisted we use her

apartment. Knowing how bashful I am, she wanted to talk to Bella (“Oh Yossi, put Bella on the phone.”), and explained to both of us that we were actually doing her a favor by keeping an eye on her place while she was away in Chile.

Besides being a human-loving “mench,” Janet was a great colleague. The clinic she founded gained much admiration and an impressive reputation. The students at Michigan were extremely excited after Janet gave a lecture there, and Janet was so proud and pleased when at least half the class approached her and asked to join the clinic at WCL.

I remember how open-minded, supportive, and encouraging she was, how quickly she came to realize the importance of comparative research and teaching, and how enthusiastic she was when I asked her to join me in writing a paper or teaching a course together. No doubt, Janet appreciated the meaning of globalization and international cooperation. She once even risked her life while trying to reach out and bridge the gaps between the Israelis and the Palestinians. Janet went by herself to the Western Bank and met with four deans from Palestinian law schools. That was not enough; she was able to convince some of them to meet with me, a dean of an Israeli law school, as long as the meeting remained confidential. The purpose was to build a triangle of cooperation between law schools. Janet never gave up and she always thought in terms of international cooperation and global approaches to legal problems. Janet was also extremely curious about the Israeli legal system and its multidimensional sources—how the Israelis could teach and function within a system that is a product of Jewish law, Turkish-Ottoman law, European civil law, and Anglo-American common law.

Hence, as a small token of great appreciation, I ask your permission to share with you, briefly, some thoughts about the United States Constitution based on an Eighteenth Century British scholar’s definition of a good tax system, integrated by a law professor from the torn Middle East with European methodology. The purpose of this Article is to offer a roadmap for a constitutional discussion regarding the meaning of the “four canons of good tax,” based on modern tax policies, tax legislation and concepts of optimum taxation.

#### I. THE CONSTITUTION AND THE POWER TO LEVY TAXES

The U.S. legal system has led us to accept the notion that every legal discussion should begin with a constitutional framework. The

government has the authority to do only what the constitution allows it to do.<sup>1</sup> The limitations on the government's power have two dimensions: formal and substantial. The former deals with mere authorization—whether the government has been granted the power to act. The latter deals with the question of “how”—what is the right and appropriate way the government should act and exercise its power according to constitutional rights and interests? After all, the government, including the legislature, has to follow constitutional guidelines and respect rights and interests such as equal protection and property rights. Constitutional review of tax legislation in the United States has developed in what I would describe as a narrow and formal approach, rather than a substantial one.

Article I, Section 9 of the Constitution states, “No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census of Enumeration herein before directed to be taken.”<sup>2</sup> Consequently, when the United States levied income tax, the Supreme Court eliminated it in *Pollock v. Farmers' Loan & Trust Co.*<sup>3</sup> The Court ruled that a particular type of *income tax* (a tax on income derived from property) was actually a *direct tax* and had to be levied in proportion to each state's population.<sup>4</sup> In 1913, the Sixteenth Amendment removed the requirement that taxes on incomes have to be apportioned by population.<sup>5</sup>

Recently, the Court of Appeals for the District of Columbia Circuit held that damages awarded to compensate a taxpayer for emotional distress do not constitute “income” within the meaning of the Sixteenth Amendment.<sup>6</sup> According to the court, there is no gain derived from such compensation,<sup>7</sup> and therefore it is exempt from

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1. See THE FEDERALIST NO. 78, at 467 (Alexander Hamilton) (Clinton Rossiter ed., 1961) (“No legislative act, therefore, contrary to the Constitution, can be valid.”).

2. U.S. CONST. art. I, § 9, cl. 4.

3. 157 U.S. 429 (1895), *modified*, 158 U.S. 601 (1895). For a comprehensive discussion about the historical developments of taxes and the Supreme Court's evolving stance on what constitutes a direct tax see Bruce Ackerman, *Taxation and the Constitution*, 99 COLUM. L. REV. 1 (1999).

4. *Pollock*, 157 U.S. at 573-74, 581, 582-83.

5. See U.S. CONST. amend. XVI (“The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”).

6. *Murphy v. IRS*, 460 F.3d 79, 88 (2006), *vacated*, *Murphy v. IRS*, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006) (vacating the prior opinion and scheduling oral arguments for Apr. 23, 2007).

7. Citing the Supreme Court, the court in *Murphy* stated that the first consideration was whether the compensatory damages awarded to the taxpayer were

income taxes the same way compensation for physical injuries are exempt.<sup>8</sup> Further discussion of this case and its difficulties is unnecessary,<sup>9</sup> as is a further discussion of Section 9 of Article I and the meaning and scope of the Sixteenth Amendment.

This Article offers a more comprehensive and substantial approach to constitutional review of the general power to tax and the way tax laws should comply with constitutional rights and principles.<sup>10</sup> The power of Congress to levy taxes is not confined to income taxes; it is broader and much more general. Article I, Section 8 of the Constitution describes the general power of Congress in terms of tax laws as follows: “The Congress shall have Power To lay and collect

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a substitute for a “normally untaxed personal . . . quality, good, or asset.” *Id.* at 88 (citing *O’Gilvie v. United States*, 519 U.S. 79, 86 (1996)). To make this determination, the circuit courts ask, “In lieu of what were the damages awarded?” *Id.* (citing *Raytheon Prod. Corp. v. Comm’r*, 144 F.2d 110, 113 (1st Cir. 1944)); *see also* *Francisco v. United States*, 267 F.3d 303, 319 (3d Cir. 2001) (treating *Raytheon’s* “in lieu of” test as authoritative); *Tribune Publ’g Co. v. United States*, 836 F.2d 1176, 1178 (9th Cir. 1988) (applying the “in lieu of” test to determine whether settlement proceeds were income); *Gilbertz v. United States*, 808 F.2d 1374, 1378 (10th Cir. 1987) (adopting the “in lieu of” test to determine whether compensatory damages were income). If the money the taxpayer received was in lieu of something normally untaxed, it was neither a gain nor an “accession to wealth,” and could not be income under the Sixteenth Amendment. *Murphy*, 460 F.3d at 88 (citing *Comm’r v. Glenshaw Glass*, 348 U.S. 426, 430-31 (1955)). The damages awarded in *Murphy* were to make *Murphy* “emotionally and reputationally whole,” not as compensation for lost wages or other taxable earnings. *Id.* Emotional well-being and good reputation are not taxable, so compensation to restore these qualities could not be taxable income either. *Id.* The court found that the compensation received by the taxpayer in *Murphy* was not income and, thus, the Sixteenth Amendment did not allow Congress to tax such compensation. *Id.*

8. *Id.* at 92.

9. The case raises some serious problems concerning the definition of income and the relationship between capital assets, realization, income and capital recovery, which do not need to be addressed for the purposes of this article. *Id.* at 84-87.

10. Note that the approach presented in this Article is different from Ackerman’s, *supra* note 3. Though the social goals are shared, the approach is different. Here, the approach is that a constitutional review of tax laws might, and should, promote social goals and distributive justice. In my “foreign” mind, I am convinced that the American legal community should leave behind the “tainted origins” of Section 9 of Article I of the U.S. Constitution, as described by Ackerman, *supra* note 3, at 4, 7-13. Further, the American legal community should recognize modern insights from financial economics. These modern insights lead to the conclusion that income is equal to current consumption and savings (for future consumption), which is equal to net wealth, since net wealth is equal to the present value of future income. *See, e.g.*, HARVEY S. ROSEN, *PUBLIC FINANCE* 139, 336-37 (6th ed. 2002) (defining income and explaining the way income is determined). The only difference between these three tax bases is a matter of timing and the significance of the timing depends on the interest rate. *Id.*; *see infra* Part VII.D, and accompanying notes.

Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States . . . .”<sup>11</sup>

This provision contains more than it seems at first glance. First, it says that *only* the legislature has the power to lay taxes.<sup>12</sup> The legislature represents the people; hence, a tax should be levied only if there is a collective consent of the people, the taxpayers.<sup>13</sup> Second, any tax should be enacted only for the provision of the “common defense and general welfare.”<sup>14</sup> My underlying assumption here is quite clear and straightforward: tax laws are not immune from judicial review and constitutional limitations restrict the power to impose taxes. Taxes should be scrutinized, via judicial review, like any other act of Congress. Any tax may be unconstitutional if it does not provide for the common defense and general welfare, or if it does not represent the collective consent.<sup>15</sup> Furthermore, a tax should not violate any other constitutional rights or interests, e.g., property or equal protection rights.

## II. NO TAXATION WITHOUT REPRESENTATION: THE PUBLIC CONSENT

The famous catchphrase “no taxation without representation,”<sup>16</sup> which symbolizes the beginning of U.S. independence, has a substantial legal, constitutional, and even economic, significance in

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11. U.S. CONST. art. I, § 8, cl. 1.

12. *Id.*; see THE FEDERALIST NO. 48, at 308 (James Madison) (Clinton Rossiter ed., 1961) (asserting that powers belonging to one branch of government, here the legislature, belong to that branch, and the other branches should not administer or have an overruling influence on the power, here taxation, granted specifically to one branch).

13. YOSEPH M. EDREY, BASIC LAW: THE STATE’S ECONOMY 34-60 (2004). *Accord* THE FEDERALIST NO. 22, at 152 (Alexander Hamilton) (Clinton Rossiter ed., 1961) (“The fabric of American empire ought to rest on the solid basis of *the consent of the people.*”) (emphasis added); THE FEDERALIST NO. 33, at 203-04 (Alexander Hamilton) (Clinton Rossiter ed., 1961) (explaining that the government and its constituents determine whether there has been a proper exercise of powers, and, if not, the people must take “measures to redress the injury done to the Constitution,” using the nature of the power granted to the government to determine whether a law is appropriate).

14. U.S. CONST. art. I, § 8, cl. 1.

15. See DANIEL A. SMITH, TAX CRUSADERS AND THE POLITICS OF DIRECT DEMOCRACY 18, 22-23 (1998) (discussing the tension between taxation and democratic government, and the American understanding of tax payment as a political act). See, e.g., MICHAEL J. GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX 22-23 (1997) (marking on historical instances in England and in the United States involving tax revolts due to insufficient consent by the people).

16. See Smith, *supra* note 15, at 22-23 (noting that taxation without consent was a cause of the Revolutionary War, as well as the importance of the phrase “taxation without representation”); see also THE DECLARATION OF INDEPENDENCE para. 19 (U.S. 1776) (“For imposing Taxes on us without our Consent”).

our times. In a liberal society, no person is asked to pay any payment without consent.<sup>17</sup> The fact that any tax in a democracy may be levied only by an act of the legislature, which is elected by the people to serve as the public's agents, means that the tax is the product of a collective consent to pay the price for public goods and services offered by the elected government. Based on the notion of a Social Contract, people are willing to enter into the social contract and obey the sovereign only if its acts and actions improve their lives and enhance their welfare.<sup>18</sup> Consequently, under each tax law, there is an underlying assumption that all taxpayers accept the tax.

Of course, this is only an assumption. One may defy the assumption if no reasonable member of society would agree to pay the challenged tax.<sup>19</sup> The quality of a tax, its merits and its purpose must be studied to accept the assumption that a given tax is based on reasonable consent. Taxes are the price for goods and services we purchase from the government. As Justice Holmes put it so beautifully, "I like to pay taxes. They are the price we pay for civilized society."<sup>20</sup>

### III. THE FOUR CANONS OF GOOD TAX AS CONSTITUTIONAL PRINCIPLES

Taxes are indeed the price society is willing to pay. Yet, members of society are not willing to pay any tax, but only reasonable taxes—a fair and sensible price for purchasing public goods and services provided by the government.<sup>21</sup> Therefore, a tax levied by the

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17. See JOHN LOCKE, TWO TREATISES OF GOVERNMENT 186-87 (Mark Goldie ed., Everyman 1993) (1690) (expounding on how the supreme power cannot take property without the consent of the people because one purpose of government is the preservation of property, and it would be absurd for people to enter into a governmental structure if the government could arbitrarily take property from the people).

18. See generally JEAN-JACQUES ROUSSEAU, THE SOCIAL CONTRACT 54-60 (Christopher Betts ed., Oxford Univ. Press 1994) (1762) (explaining that via the social contract, each individual gives up their individual rights to become a part of the whole of society and explaining that "duty and self-interest oblige both contracting parties [the individual and the whole] to give each other mutual assistance").

19. *Contra* GRAETZ, *supra* note 15, at 22-23 (describing the Whiskey Rebellion of 1794, a tax resistance movement catalyzed by the distilled-spirits tax imposed by Alexander Hamilton in 1791; the rebellion was suppressed, demonstrating the ability of the government to enforce its ability to impose taxes).

20. *Compañía Gen. de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting); GRAETZ, *supra* note 15, at 6. The IRS engraved Justice Holmes' statement above the entrance of its main building.

21. See Dennis J. Ventry, Jr., *Equity versus Efficiency and the U.S. Tax System in Historical Perspective*, in *TAX JUSTICE: THE ONGOING DEBATE* 25, 27 (Joseph J. Thorndike

government should follow some basic guidelines that represent the sensible conclusions that members of society agree to accept as part of the social contract. Adam Smith taught us<sup>22</sup> that taxes in a democratic-liberal society should follow four basic attributes (“canons or maxims of good tax”)<sup>23</sup> and should be:

1. Certain and not arbitrary;
2. Considerate of the convenience for the contributor;
3. Efficient; and
4. Fair and Equitable.<sup>24</sup>

If a tax does not contain one or more of the above canons, the assumption regarding its reasonableness is in doubt.

A clear analysis of the tax system and tax justification should be done in a methodological, systematic and multistage way. It should begin in the constitutional provisions and end in the modern meaning of the four canons, which represent the contractual relationship between the state and its members. The analysis is systematic where the income tax system has a strong, sensible and logical base. If a “good tax system” and the four canons are accepted, it presents a solid structure for a decision-making process to determine whether a tax violates or infringes upon constitutional rights and interests.

The current income tax system may serve as a case study. The following flow chart begins with the constitutional framework: the formal authority to legislate, as well as the substantial requirements regarding the content of laws, which should follow constitutional rights and principles. Article 1, Section 8 of the U.S. Constitution grants Congress the authority to legislate, thus, when Congress levies a tax, the authority requirement is met.<sup>25</sup> The constitutional rights,

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& Dennis J. Ventry, Jr. eds., 2002) (stating that Americans perceive taxation as an instrument of social justice—imposing higher burdens on those with higher incomes and wealth).

22. Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations* 777-79 (Edward Cannan ed., The Modern Library, New York 1937) (1784).

23. Economists suggest some other criteria, like neutrality and fluctuality, so the tax system can change easily according to the economic system’s needs. Everybody agrees, however, that fairness is the most fundamental requirement, for ethical and economic efficiency reasons. *See, e.g.*, JOSEPH E. STIGLITZ, *ECONOMICS OF THE PUBLIC SECTOR* 456-70 (3d ed. 2000) (discussing the properties of a good tax system, and explaining the necessity of efficiency, flexibility, political responsibility, and fairness).

24. A. SMITH, *supra* note 22. For a basic discussion of horizontal and vertical equity, see *infra* note 27.

25. U.S. CONST. art. I, § 8, cl. 1.

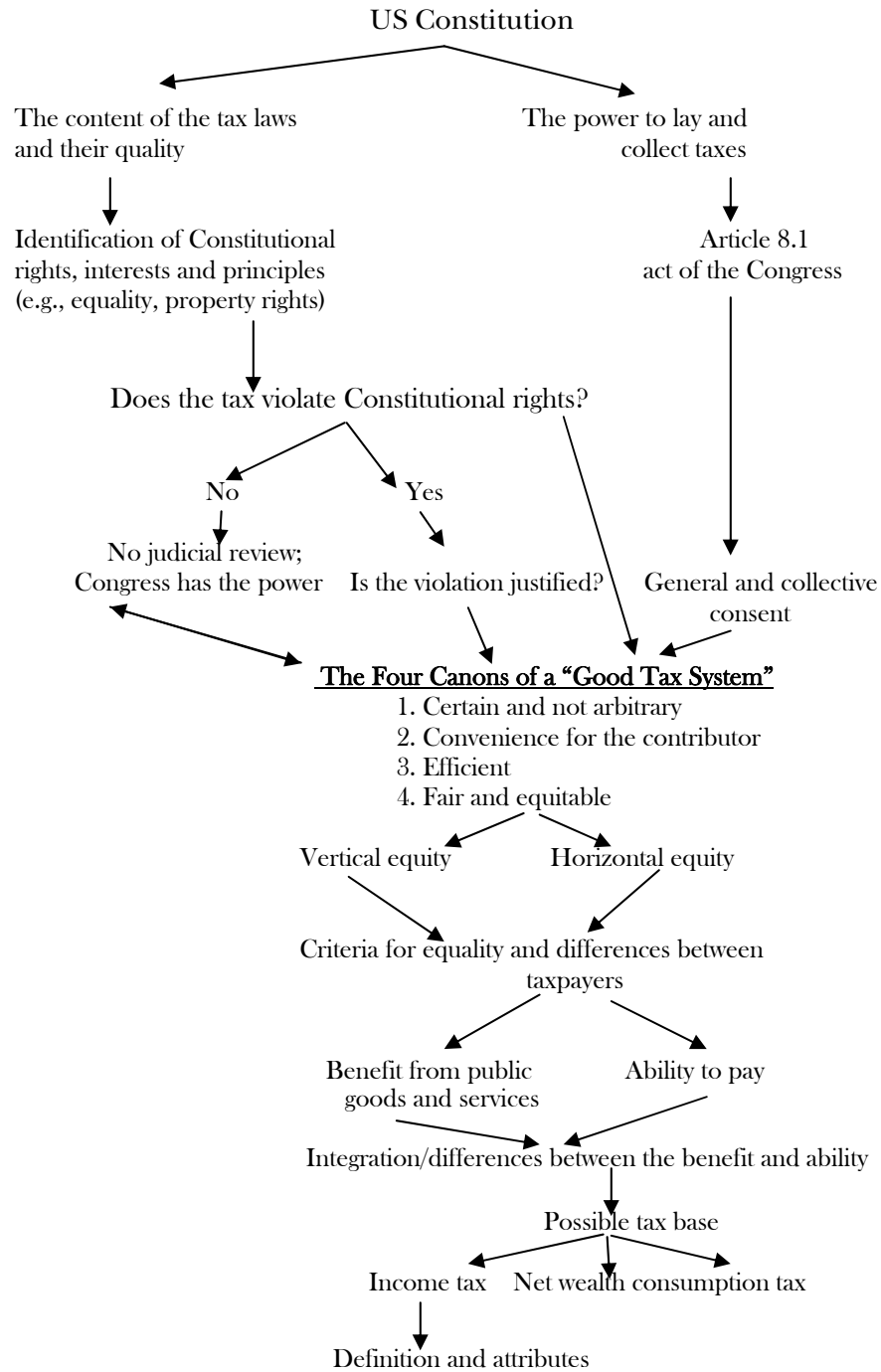
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principles and interests that must be observed are found throughout the U.S. Constitution and its amendments. The next inquiry is whether the tax represents the public consent and whether the tax violates constitutional rights, interests or principles. If there is a violation, the violation must be justified.

The flow chart below illustrates that answering these questions requires a discussion of the four canons of a good tax. The modern meaning of these canons will be discussed below, including the requirement of fairness that is embodied in the horizontal and vertical principles of equity. These principles require, among others, criteria to reach equality, given the differences between taxpayers. These criteria might be the benefits derived from the government's public goods and services or the ability to pay. This discussion leads to the conclusion that these criteria are not in conflict, but rather may be integrated into one measurement. In light of such integrated measurement, the preferred tax base can be chosen and shaped to comply with the Constitutional requirements.



#### IV. POSSIBLE TAX VIOLATIONS OF CONSTITUTIONAL RIGHTS

Any tax may potentially violate constitutional rights and interests. This Article deals only with a framework for judicial review of tax laws, and therefore, the discussion is confined only to two types of rights: equal protection rights and property rights.

##### A. *Equal Protection*

In a modern democratic community, legislation should respect and acknowledge the fundamental right to equal treatment under laws. “Because it is in the nature of laws to classify or discriminate, the principle of equality demands ‘treating likes alike’. This is also the case for tax legislation which, like all legislation, must conform to the demand of principles of equality[.]”<sup>26</sup> In modern thought, horizontal equity and vertical equity<sup>27</sup> represent the notion of Aristotelian formal justice used in tax law and tax policy.<sup>28</sup> For constitutional deliberation, one question is whether a tax law that

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26. J.L.M. Gribnau & C. Peters, Introduction, in *Legal Protection Against Discriminatory Tax Legislation: The Struggle for Equality in European Tax Law I* (Hans L.M. Gribnau ed., Kluwer Law International 2003) [hereinafter *Equality in Europe*] (noting the connections between tax law, democracy, and equity).

27. See RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 223-31 (5th ed. 1989) (defining horizontal equity as making people with equal capacity to pay the same amount in tax and vertical equity as making people with greater ability to pay more, followed by a discussion of the uses of both); see also LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* 13-16, 37-39 (2002) (explaining briefly the differences between horizontal and vertical equity and how they relate to fairness); Kevin A. Kordana & David H. Tabachnick, *Tax and the Philosopher's Stone*, 89 VA. TAX REV. 647, 662-63 (2003) (reviewing LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* 13-16, 37-39 (2002) and criticizing the discussion of horizontal equity); cf. Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW & POLY INT'L BUS. 145, 163-88 (1998) (defining horizontal and vertical equity as two varieties of “interindividual equity,” and discussing them as they relate to a unitary fiscal setting and a multijurisdictional setting, in contrast with the idea of international equity); Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607 (1993) (comparing the answers to the question of whether horizontal equity has independent significance apart from vertical equity given by Richard Musgrave, who answers in the affirmative, and Louis Kaplow, who answers in the negative).

28. See Aristotle, *Equality and Inequality*, in *POLITICAL THOUGHT* 226, 226-27 (Michael Rosen & Jonathan Wolff eds., 1999) (“All men hold that justice is some kind of equality . . . a certain distribution to certain persons, and must be equal for equals.”). For a more sophisticated approach regarding equality and taxes, see MICHAEL WALZER, *SPHERES OF JUSTICE: A DEFENSE OF PLURALISM AND EQUALITY* (1983) (discussing taxation as it relates to various spheres of life and justice within them).

does not follow the principles of horizontal equity violates the equal protection clause. This inquiry yields two interesting questions: what are the criteria for equality (“equal taxpayers”) and what are the differences between taxpayers (“unequal taxpayers”)? Another question, which requires no further discussion, deals with “vertical equity” and the progressive tax system.<sup>29</sup> Even though there is no scientific evidence that a progressive tax system accomplishes equal sacrifice, it is based on the common and acceptable concept of equality,<sup>30</sup> whether we accept the ability to pay or the benefit principle as the justification for taxes.<sup>31</sup>

### B. *Property Rights*

According to one popular argument, any tax is, by definition, a violation of constitutional property rights. It takes wealth from the taxpayer and transfers it to the government in a confiscatory fashion. As I will try to argue later, there are several ways to reject such a narrow or even shallow observation.

## V. THE MODERN MEANING OF THE FOUR CANONS

### A. *A Tax Should Be Certain and Not Arbitrary*

#### 1. *Retroactive taxes*

As mentioned, one of the underlying assumptions for any legal norm, including tax law, is consent. For tax legislation purposes, a tax may be considered as if it fulfills the consent requirement, as long as it can be reasonably assumed that the taxpayers agree to pay it. Such an assumption is reasonable only if the taxpayers know the price in advance, have the ability to consider it, to use a cost-benefit analysis, and to appreciate whether the price is right and set in an acceptable way. No reasonable person agrees to purchase any good before knowing its price and value. In modern constitutional

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29. See, e.g., C. Eugene Steuerle, *And Equal (Tax) Justice for All?*, in *TAX JUSTICE: THE ONGOING DEBATE* 253, 253-83 (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002) (considering the importance of tax equity as it relates to justice and lawmaking, including a discussion of horizontal and vertical equity and progressive tax systems).

30. See JOEL SLEMRD & JON BAKIJA, *TAXING OURSELVES* 57-68 (3d ed. 2004) (discussing fairness in the tax system, including vertical equity, the benefit principle, the ability to pay principle, and progressivity).

31. For a further brief discussion, see *infra* Part VIII.

meaning: “No Bill of Attainder or ex post facto Law Shall be passed.”<sup>32</sup> The same rule applies to tax laws. A modern application of the Social Contract’s concept is embodied within the rule under which the government has to present its annual budget to the public and its representatives, and receive their consent every year.<sup>33</sup>

## 2. *Certainty and the realization requirement*

Modern financial economics defines “income” as the total value of current and future *consumption*,<sup>34</sup> while “net wealth” equals the present value of future income.<sup>35</sup> Hence, these three tax bases are basically identical. The only difference between them is timing, and the significance of timing depends on the interest rate.<sup>36</sup> As will be discussed below, one reason income is preferable over net wealth as the principal tax base is the certainty requirement. A tax on net wealth would require a process for evaluating the value of the taxpayer’s total assets (minus liabilities). Using a “capitalization process,” the asset’s value equals the present value of the future stream of income it can produce.<sup>37</sup> In other words, taxing net wealth requires measuring the following:

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32. U.S. CONST. art. I, sec. 9, cl. 3. *See generally* Charles B. Hochman, *The Supreme Court and The Constitutionality of Retroactive Legislation*, 73 HARV. L. REV. 692 (1960) (exploring the Supreme Court’s approach to retroactive legislation affecting existing rights, including attaching new rights and duties to already completed transactions, as well as declaring preexisting obligations unenforceable in the future).

33. *See* Cheryl Block, *Pathologies at the Intersection of the Budget and Tax Legislative Processes*, 43 B.C. L. REV. 863, 870-83 (2002) (discussing the relationship between the tax legislation process and the budget, including the way the budget is proposed by the President, changed and eventually passed by Congress, according to the rules of Congress).

34. *See, e.g.*, GRAETZ, *supra* note 15, at 198-200 (pointing out that a consumption tax would not impose a burden on savings whereas an income tax imposes equal tax burdens on those who choose to spend and those who choose to save).

35. Bruce Johnsen & Moin A. Yahya, *The Evolution of Sherman Act Jurisdiction: A Roadmap for Competitive Federalism*, 7 U. PA. J. CONST. L. 403, 462 n. 250 (2004) (citing D. Bruce Johnsen, *Wealth is Value*, 15 J. LEGAL STUD. 263, 268-70).

36. *See, e.g.*, HARVEY S. ROSEN, PUBLIC FINANCE 255 (6th ed. 2002) (explaining that a consumption tax affects sources of income and redistributes income accordingly); Edward McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 819-21 (2005) (noting that for those who do not save money, income precisely equals consumption, and even for those who do save, taxes on prepaid consumption and postpaid consumption are the same as taxes on income except for the interest rate factor); REUVEN S. AVI-YONAH, THREE GOALS OF TAXATION (Sept. 2, 2005), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=796776#PaperDownload](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=796776#PaperDownload) (outlining the three major goals of taxation and arguing that the United States should use both an income tax and a consumption tax).

37. *See* Michael J. Waggoner, *Eliminating the Capital Gains Preference. Part I: The Problems of Inflation, Bunching and Lock-In*, 48 U. COLO. L. REV. 313, 358 n. 80 (1977)

- a) The future stream of income that the asset—including human capital—will produce;
- b) The length of time the asset produces its income;
- c) The asset's salvage value at the end of its useful life; and
- d) The rate of interest used for capitalization.

The difficulty that arises from calculating the value of every taxpayer's assets by the aforementioned method is that it is based entirely on estimates rather than certain measurable facts. In addition to tangible and intangible assets, a comprehensive tax system should also tax the value of human capital. Hence, a person's future income from future labor should also be included in asset values.

Needless to say, estimating values occurs primarily when dealing with future income, i.e., potential income. Assuming the certainty requirement is a significant attribute of a good tax system, taxing actual or *realized*<sup>38</sup> income is preferable to taxing net wealth, which includes speculative future income.

### B. Convenience for the Contributor

#### 1. Human dignity, discretionary power to consume and personal exemption

The convenience requirement contains two major components. The first relates to the constitutional concept of Human Dignity, a core principle in many modern constitutions.<sup>39</sup> It is unnecessary to

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(stating that the value of property which produces income may be determined by capitalizing the income expected from the property).

38. Note that the above analysis leads to the conclusion that the realization requirement under any income tax system is a substantial attribute and not a mere accounting requirement.

39. See, e.g., Grundgesetz für die Bundesrepublik Deutschland [GG] [federal constitution] art. 1, § 1 (declaring that, "Human dignity is inviolable. To respect and to protect it is the duty of all state authority."); Draft Treaty Establishing a Constitution for Europe, Article II-1 (June 13 and July 10, 2003), available at [http://europa.eu.int/constitution/futurum/constitution/part2/title1/index\\_en.htm#Article1](http://europa.eu.int/constitution/futurum/constitution/part2/title1/index_en.htm#Article1) (reiterating that, "Human dignity is inviolable", and it must be respected and protected); cf. Declaration on the Ratification of the Treaty Establishing a Constitution for Europe (2005), available at [http://www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/en/ec/85325.pdf](http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/85325.pdf) (adopting and ratifying *the Treaty Establishing a Constitution for Europe*); Basic Law: Human Dignity and Liberty, 1992, S.H. 1391 art. 1 (stating that the Israeli Basic Laws recognize the value of the human being, and the sanctity life and freedom); *Furman v. Georgia*, 408 U.S. 238, 270 (1972) (Brennan, J., concurring) ("The State, even

discuss this concept in depth; rather, it suffices to understand that a tax that drives a person into poverty violates this constitutional concept. For example, the Carter Commission in Canada defines the tax base as those with the “discretionary power to consume.”<sup>40</sup> Thus, the government should not tax non-discretionary consumption—that which is necessary for a minimum standard of living. Generally, income tax systems throughout the world allow a minimum amount of income free of tax. In the United States, this concept is found in the personal exemption,<sup>41</sup> the standard deduction granted to all individual taxpayers and their dependents,<sup>42</sup> and of course the Earned Income Tax Credit<sup>43</sup> which is the center of activity in the Janet R. Spragens Federal Tax Clinic at WCL.

## 2. *Timing and tax payments*

Another aspect of the convenience requirement involves timing and the availability of funds to pay taxes. The practical meaning of this convenience criterion is that a person without a liquid means of payment should not be required to pay taxes. This rule has dual aspects: (1) the realization requirement, which is a substantive rule derived from the canon of certainty;<sup>44</sup> and (2) the availability of a means for payment. Hence, mere appreciation of property before its sale should not be taxable, since it may force taxpayers to sell property unwillingly or under pressure.

In some cases, even when income is realized, a taxpayer receives income in kind instead of cash. A sensible tax system should allow a taxpayer to defer tax payments (plus reasonable interest) until the asset received is sold. For example, when an employee receives options or stocks in return for labor, income is realized when the employee provides services; yet, difficulties in paying taxes may still exist.<sup>45</sup> Again, if the taxpayer has to sell the asset received under

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when punishing its citizens, must treat them with respect for their intrinsic worth as human beings.”).

40. *Report of the Royal Commission on Taxation of Income* (1966) (K.L. Carter, Chair), Ottawa, Queen’s Printer.

41. 26 I.R.C. §§ 63(b)(2), 151 (2000).

42. *Id.* § 63(c).

43. *Id.* § 32.

44. *Supra* n.38

45. Note that if the tax is withheld, the taxpayer’s net income might be too low. For example, suppose the taxpayer’s monthly wage is \$5,000 in cash and \$5,000 in stock. Assume that the total tax on the first \$5,000 is \$750, that the marginal tax rate on any income above \$5,000 is 40%, and the tax liability on the stock, assuming it is

pressure or unwillingly, significant losses may result. One sensible solution would be to allow the taxpayer to defer payments until after selling the asset, but subject to ordinary tax rates rather than favorable capital gains' tax rates.

### C. *Efficient*

#### 1. *Efficiency of tax administration*

The basic understanding of the efficiency criterion is very simple: the costs of administering and collecting a tax should be as low as possible so that a large fraction of what is taken from taxpayers is not used up.<sup>46</sup>

#### 2. *Optimal taxation*

In modern times, efficiency means exactly what the U.S. Constitution requires from taxes: general welfare. Public finance theory concludes that every tax—excluding poll taxes—creates some economic distortion and hence leads to deadweight loss or excess burden, i.e., the loss of welfare is greater than government revenues.<sup>47</sup> For the purpose of this Article, it is suffice to quickly summarize the constitutional requirement that emerges: any tax that produces welfare smaller than the deadweight loss it produces is unconstitutional.

#### 3. *Efficiency, general welfare and property rights*

The basic importance of recognizing property rights may be explained as follows: “Without laws defining property rights, only the exercise of force would stop one individual from stealing from another. Without the ability to protect property, individuals would have little incentive to accumulate assets. Needless to say, economic

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subject to withholding hence subject to grossing up process, is  $5000 * 0.4 / 0.6 = \$3,333$ . Adding \$750 on the cash income leaves taxpayer with a net cash income of  $\$5,000 - (3,333 + 750) = \$916.6$  and stock with a market value of \$5,000.

46. See, e.g., Adrian J. Sawyer, *Electronic Commerce: International Policy Implications for Revenue Authorities and Governments*, 19 VA. TAX REV. 73, 83-84 (1999) (noting that administrative efficiency requires governments and tax administrators to facilitate cost-effective tax collection processes).

47. See generally ROSEN, *supra* note 36, at 282 (illustrating that an increase in consumption tax distorts economic decisions and diminishes the demand for a particular item and therefore results in a loss of welfare beyond the tax revenues collected).

activities would be severely restricted.”<sup>48</sup> In short, without property rights, there would be no incentive to do work that produces and increases the national income and the welfare of the community. Of course, alternative justifications for recognizing property rights exist which will be discussed below.

#### D. Fair and Equitable

As mentioned already, under the fairness requirement, a tax should comply with the principles of horizontal and vertical equity. Equal taxpayers should pay equal tax amounts and unequal taxpayers should pay different tax amounts. The question is whether any constitutional principles or rules can be extracted from these theoretical, yet accepted, guidelines.

### VI. NON-DISCRIMINATION AND EQUALITY

Internationally, very few national courts have decided that tax laws or tax provisions that violate the principles of horizontal equity also infringe constitutional principles such as the non-discrimination clause, freedom of occupation and even property rights.

Professor Dieter Birk, from the University of Munster presents the German experience:

The German Constitution contains not only the rule of equality before the law, it also obliges the legislator to distribute the tax burden equally . . . . Equality of the tax burden is only achieved if the tax bases differentiate according to individual capacity. Equal taxation means different taxation according to individual financial capacity (ability to pay principle).<sup>49</sup>

In 1991, the German Federal Constitutional Court upheld a previous decision, and held that the Constitution obligated the government to make taxation just and equitable, and that withholding taxes on wages, but not on interest, violated the constitutional right to equality.<sup>50</sup> Furthermore,

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48. STIGLITZ, *supra* note 23, at 28.

49. Dieter Birk, *The Limited Impact of the Principle of Equality on Tax Law*, in EQUALITY IN EUROPE, *supra* note 26, at 45; see J.W. van Berge, *Equality: Applying the Principle of Non-discrimination (Article 14 ECHR, Article 26 ICCPR)*, in EQUALITY IN EUROPE, *supra* note 26, at 55 (applying the principle of non-discrimination as embodied in the European Convention on the Protection of Human Rights and Fundamental Freedoms and the International Covenant on Civil and Political Rights).

50. Leif Muten, *International Experience of How Taxes Influence the Movement of Private Capital*, 8 TAX NOTES' INT'L 743, 746 (1994).

In a number of cases, the Federal [German] Constitutional Court has acknowledge[d] that inevitable special charges through obligations to pay alimony, especially for children, reduce the capacity of the taxable subject, and that the legislator violates the principle of equality if it does not take such an obligation into account.<sup>51</sup>

However, Birk and other European scholars admit, “the principle of equality has had a limited impact on tax law.”<sup>52</sup> Other European countries have demonstrated significant reluctance to follow the German way,<sup>53</sup> mainly due to a cognizance of the American *Lochner* lesson:<sup>54</sup> “the courts generally take care that they do not infringe upon the legislature’s prerogative to determine the objective of government policy.”<sup>55</sup>

The Israeli Supreme Court has adopted an interesting approach. In *Kaniel v. Minister of Justice*, a math professor filed a petition to the Supreme Court of Justice.<sup>56</sup> The professor argued that the tax reform of 2003,<sup>57</sup> which introduced significant tax preferences for capital

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51. Birk, *supra* note 45, at 49. Note, however, that in similar circumstances, U.S. courts have denied such an argument. See generally *Lunding v. New York City Tax Appeals Tribunal*, 522 U.S. 287 (1998) (confirming that a State may constitutionally disallow alimony deductions from personal income taxes as long as it does so for residents and non-residents alike).

52. See Birk, *supra* note 45, at 52 (outlining the three reasons as: (1) the variety of living conditions; (2) taxes serve also to promote social and governmental goals (tax incentives); and (3) the principle of equality leaves a margin for many different political aims and purpose-oriented differentiations).

53. *Id.* at 59.

54. See *Lochner v. New York*, 198 U.S. 45 (1905) (holding that a New York law limiting the number of hours a baker could work was unconstitutional and finding that the “right to free contract” is implicit in the due process clause of the Fourteenth Amendment). But see *Williamson v. Lee Optical of Oklahoma*, 348 U.S. 483 (1955) (taking a much broader view of the government’s power to regulate economic activities); *W. Coast Hotel v. Parish*, 300 U.S. 379 (1936); *Nebbia v. New York*, 291 U.S. 502 (1934); cf. LAURENCE H. TRIBE, *AMERICAN CONSTITUTIONAL LAW* (2d ed. The Foundation Press, Inc. 1988), 570–71, 769 (explaining the legal theories underlying the *Lochner* era and discussing the demise of the era). But cf. Joseph William Singer, *No Right to Exclude: Public Accommodations and Private Property*, 90 NW. U. L. REV. 1283, 1389-95 (1996) (comparing the end of the *Lochner* era, which marked an era of increased government regulation over economic relations, with the contemporaneous emergence of the Jim Crow era in which the government was reluctant to regulate property rights on the basis of race).

55. J.L.M. Gribnau & J. Saddiki, Protection of European Taxpayers by the Principle of Equality, in *EQUALITY IN EUROPE*, *supra* note 26, at 94; Marco Greggi, *The Masa Investment Group as a ‘Nec Plus Ultra’ Case for the Application of the European Convention on Human Rights to Tax Law?*, 35 *INTERTAX* 348, 348 (2007).

56. HCJ 9333/03 Professor Shemuel Kaniel et al. v. Government of Israel [2005], available at [tp://www.nevo.co.il/serve/home/it/UserFrm.asp?type=1&system=1&Spl=True&Prog=DisplayDoc&DocID=233842&cp=1/](http://www.nevo.co.il/serve/home/it/UserFrm.asp?type=1&system=1&Spl=True&Prog=DisplayDoc&DocID=233842&cp=1/).

57. Income Tax Reform, 2002, S.H. 1863.

gains (mainly a lower tax rate of fifteen percent, as opposed to the fifty percent top marginal tax rate for ordinary income), violated basic constitutional rights and principles, specifically the property rights of those who pay the 50% tax rate, equality and the freedom of occupation.<sup>58</sup>

The Israeli Supreme Court did not reject any of the petitioner's arguments.<sup>59</sup> Headed by President Barak, the court acknowledged that tax laws, like any other legislative acts, are subject to judicial-constitutional review.<sup>60</sup> The court then examined the discrimination argument. While it refrained from making a clear and definite decision, the court was willing to assume that in the area of tax law, the principles of horizontal and vertical equity should apply.<sup>61</sup> Furthermore, the court used the ability to pay principle as a criterion for measuring equality and differences between taxpayers.<sup>62</sup> Hence, if two taxpayers have the same amount of ability—one has capital gains and the other ordinary income from labor—they should both bear the same tax burden.<sup>63</sup> Under this theory, the court could then consider tax preferences for capital gains to be a violation of constitutional rights and principles. Yet, under Israeli constitutional law, a mere violation of a constitutional right or interest is not enough to declare a law void.<sup>64</sup> Instead, the court must examine a law through the "limitation clause," and determine whether a violation of the constitutional right or interest is justified under the circumstances.<sup>65</sup>

In *Kaniel*, the court found that "for the time being," the apparent violation was justified since it maintained the right balance between the harm to the individual who was taxed in a discriminatory way, and the benefit to the public—increased international investment in Israel

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58. Basic Law: Human Dignity and Liberty, 1992 S.H. 1391; Basic Law: Freedom of Occupation, 1994 S.H. 1454.

59. *Kaniel*, *supra* note 56.

60. *Id.* ¶ 13.

61. *Id.* ¶ 22.

62. *Id.*

63. *Id.*

64. See Basic Law: Human Dignity and Liberty, art. 8, 1992 S.H. 150 (asserting that the government may restrict Basic Law rights if it is for a proper purpose and for a period and extent no greater than required).

65. *Id.*; see also Basic Law: Freedom of Occupation, art. 4, 1994 S.H. 90 (declaring that, "There shall be no violation of rights under this Basic Law except by a law befitting the values of the State of Israel, enacted for a proper purpose, and to an extent no greater than is required.").

and stabilization of the stock exchange.<sup>66</sup> According to the court, the tax reforms served important public purposes, to both the states, the community and the taxpayers, by helping to maintain a solid infrastructure for common life and for a social framework that sought to protect and promote human rights.<sup>67</sup> “For the time being I am convinced that there is a good balance between the violation of the equal treatment on the one hand and goals of lower tax rates on the other. The lower tax rates maintain the right balance.”<sup>68</sup>

Yet the court left the door open for judicial review in the future.

There is not enough experience for evaluating the tax reform’s success and prospect, since it was enacted fairly recently, so my stated conclusion may change. It is possible that as time passes a new reality will be created where the violation of equality to further societal goals will no longer be appropriate. Under the current circumstances, however, I cannot conclude that this balancing act is incorrect.<sup>69</sup>

U.S. courts are similarly reluctant to subject tax law to constitutional review. For example, in *Klaassen v. Commissioner*,<sup>70</sup> the tax commissioner denied the taxpayers—a family with ten children—certain deductions, due to the Alternative Minimum Tax (“AMT”) system,<sup>71</sup> including personal exemptions for each child and full deductions for medical and local taxes.<sup>72</sup> The taxpayers raised two constitutional challenges.<sup>73</sup> First, by disallowing personal exemptions for their children, the taxpayers argued that the statute impermissibly burdened their free exercise of religion.<sup>74</sup> Second, they contended that the Internal Revenue Code violated their rights to equal

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66. *Kaniel*, *supra* note 56, at ¶¶ 27-28.

67. *Id.*

68. *Id.* ¶ 29.

69. *Id.*

70. *Klaassen v. Comm’r*, No. 98-9035, 1999 U.S. App. LEXIS 6320 (10th Cir. April 7, 1999).

71. I.R.C. section 55 imposes an alternative minimum tax, which is the difference between the “tentative minimum tax” and the “regular tax.” I.R.C. §§ 55(b)(2), 56, 57 (2000). In order to compute the tentative minimum tax, certain adjustments (increases) are made to the taxpayer’s taxable income. *Id.* If this adjusted figure, termed the “alternative minimum taxable income,” is less than \$150,000, and a joint return is involved, the taxpayers are entitled to a \$45,000 exemption/deduction. I.R.C. §§ 55(b)(A)(ii), 55(d) (2000). The tentative minimum tax is then calculated as 26% of the difference, i.e. the amount by which the alternative minimum taxable income exceeds the \$45,000 exemption. I.R.C. § 55(b)(1)(A)(i)(I), (b)(2), (d)(1)(A)(i) (2000).

72. *Klaassen*, 1999 U.S. App. LEXIS 6320, at \*4.

73. *Id.* at \*8.

74. *Id.*

protection and due process because it did not allow them to take full deductions for medical and local taxes, whereas such deductions were permissible for families with similar income, but fewer than eight children.<sup>75</sup> Basing its conclusion on the “presumption of constitutionality” doctrine, the Tenth Circuit Court of Appeals rejected both arguments.<sup>76</sup> The court began by explaining that in creating classifications and distinctions in tax statutes, the legislature is given especially broad latitude.<sup>77</sup> However, the court also noted that “the Free Exercise Clause of the First Amendment [is] an absolute prohibition against governmental regulation of religious beliefs.”<sup>78</sup> This, however, does not necessarily make the law unconstitutional.<sup>79</sup> As long as the law is neutral and generally applicable, the fact that it may make the observance of some religious beliefs more expensive, does not render it unconstitutional.<sup>80</sup> Lastly, the court noted that deductions are a matter of legislative grace.<sup>81</sup> Thus, a taxpayer may overcome the presumption of constitutionality “only by the most explicit demonstration that a classification is a hostile and oppressive discrimination against particular persons and classes.”<sup>82</sup>

However, the Supreme Court has clearly instructed that courts must view such contentions with great care.<sup>83</sup> “Even a substantial burden would be justified by the ‘broad public interest in maintaining a sound tax system,’ free of the ‘myriad exceptions flowing from a wide variety of religious beliefs.’”<sup>84</sup> Congress enacted the AMT for the legitimate government purpose of establishing a taxation method for income that falls outside the scope of the regular tax system.<sup>85</sup> The Tenth Circuit therefore found no equal protection

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75. *Id.*

76. *Id.* at \*9-12 (explaining that “[t]ax legislation carries a ‘presumption of constitutionality,’” and implicitly concluding that the *Klaassens* failed to overcome this presumption).

77. *Id.* at \* 9 (citing *Regan v. Taxation With Representation of Washington*, 461 U.S. 540, 547 (1983)).

78. *Id.* (quoting *Bob Jones Univ. v. United States*, 461 U.S. 574, 603 (1983)).

79. *Id.* (citations omitted).

80. *Id.* (citing *Black v. Comm’r*, 69 T.C. 505, 510 (1977)); *cf.* *United States v. Lee*, 455 U.S. 252, 257-58 (1982) (“[n]ot all burdens on religion are unconstitutional . . . [t]he state may justify a limitation on religious liberty by showing that it is essential to accomplish an overriding governmental interest.”).

81. *Klaassen*, 1999 U.S. App. LEXIS 6320, at \*10 (citing *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)).

82. *Id.* (quoting *Madden v. Kentucky*, 309 U.S. 83, 88 (1940)).

83. *Id.* (citation omitted).

84. *Id.* (quoting *Hernandez v. Comm’r*, 490 U.S. 680, 699-700 (1989)).

85. *Id.* at \*7-8, 12.

or due process violation because the AMT provisions bore a rational relation to a legitimate government purpose.<sup>86</sup>

There are two major reasons for the reluctance to subject tax laws to constitutional review, one of which Professor Bruce Ackerman has expressed very clearly.<sup>87</sup> Since the origins of Article I, Section 8 of the U.S. Constitution are tainted by a compromise that was aimed to preserve slavery, it represents radical-conservative values. Furthermore, since the founding fathers were influenced by laissez-faire ideas, any kind of constitutional review might lead to conservative limitations on tax legislation. Such limitations may even lead to a comprehensive constitutional attack on the progressive tax system.

As a foreign scholar, I am not adequately equipped to discuss the interpretation of the U.S. Constitution in detail. However, it seems odd that modern interpretation is still confined to the original intent and legislative history, rather than to a dynamic and adaptable interpretation that may better serve the needs and purposes of a modern life in the Twenty-first Century.<sup>88</sup> In addition, the total and radical conservative approach that is currently applied to constitutional interpretation, is far removed from the ideas that originated from classical liberal writers such as John Locke and Adam Smith. These writers were very sensitive to the ideas of welfare and social justice. Lastly, there is a very strong and persuasive argument that the redistribution of wealth or "tax justice" serves a significant role in protecting and promoting democratic values.<sup>89</sup>

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86. *Id.* at \*12 (citations omitted).

87. See Ackerman, *supra* note 3, at 7-11 (describing how the determination about whether and how black slaves should be counted for representation purposes influenced the enactment of Article I, section 8).

88. See generally AHARON BARAK, JUDICIAL DISCRETION (Yadin Kaufmann trans., Yale Univ. Press 1989) (1987) (arguing that while judicial discretion is limited, in hard cases, a judge's judicial philosophy—the product of his or her experiences and worldview—determines the final choice); President Aharon Barak, *Foreword: A Judge on Judging: The Role of a Supreme Court in a Democracy*, 116 HARV. L. REV. 16, 85-91 (2002) (discussing fundamental principles inherent in any legal system that judges are influenced by and rely on in interpreting legal texts).

89. See Ventry, *supra* note 21, at 25 (noting taxation's role as a social instrument when the United States industrialized during the nineteenth century); see generally AVI-YONAH, *supra* note 36, at 3 (explaining the controversial use of taxation as a redistributive tool for reducing the unequal distribution of income and wealth that results in a market-based economy); WALZER, *supra* note 28.

A. *Criteria for Equal and Unequal Taxpayers*

There is a tendency to accept the notion that in order for tax laws to pass constitutional muster, they must follow the principles of horizontal and vertical equity. It therefore seems necessary to identify the criteria to apply when comparing different taxpayers, in order to determine whether they are equal or different. This question of criteria should be dealt with in a strict methodology, by beginning with a baseline that produces a possible answer. The inquiry must focus on the purpose of the tax system. I do not intend to elaborate on the question by providing all possible answers (such as redistribution, social justice, promotion of social or economic policy, etc.).<sup>90</sup> Instead, I would offer a very narrow approach. The purpose of a tax system in a democratic society is to finance the policies of the elected government.<sup>91</sup> However, the democratic society must adhere to the constitutional constraints imposed on the executive and legislature branches when implementing this purpose.

B. *The Benefit and Ability Principles*

The sole purpose of the elected government is to serve the public and provide it with a basket of public goods and services. The fact that the public elects the legislature indicates that the public is interested in that basket. In terms of the economic aspects of the social contract and public consent, the public expresses its consent every year. For example, the executive branch must propose an annual budget, and the public's agents, the legislature, approve or disapprove it. Without such approval, the government cannot function.<sup>92</sup>

Once the public approves the basket, it has to pay for it. In other words, taxes are the price for purchasing public goods and services. If this is the case, the answer to the question "how much" should be very simple according to the *benefit* we derive from public goods and services the government provides. On the other hand, ever since John S. Mill, we tend to use the ability-to-pay doctrine.<sup>93</sup> Very well-

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90. See generally MURPHY & NAGEL, *supra* note 27; Steuerle, *supra* note 29.

91. Rieven Avi-Yonah states that there are three goals: (1) to raise revenue for government activities, (2) to mitigate unequal distributions of wealth, and (3) to regulate private economic activity. AVI-YONAH, *supra* note 36. Yet it is clear that the last two are part of the policy of the elected government. *Id.*

92. 2 U.S.C. §§ 632, 634 (2000); see Block, *supra* note 33, at 872-77 (detailing the steps of the modern federal budget process).

93. See Steuerle, *supra* note 29, at 257-58 (explaining the ability-to-pay doctrine).

known literature exists that addresses the *ability-to-pay* justification, however, that literature will not be analyzed here.<sup>94</sup> Instead, this discussion will confine itself to the proposition that both benefit and ability-to-pay principles can co-exist.

Some literature treats the benefit and the ability as contradictions. This is illustrated by the suggestion that the more you have (greater ability) the less you need public goods and services. Hence, the taxpayer with the greater ability enjoys the least amount of government goods and services while the taxpayer with the least ability receives the greatest benefit from the government (welfare programs, etc.). I beg to differ. I join those who believe that there are no significant differences between the benefit principle (from public goods and services) and the ability to pay. I, like others before me, believe that they lead to the same conclusion:<sup>95</sup> the greater ability a taxpayer has, the greater benefit the taxpayer derives from the government's provision of public goods and services.

This equation is not new. Adam Smith proposed it in his book, *An Inquiry into the Nature and Causes of the Wealth of Nations*.<sup>96</sup> It argues for the benefit principle, and yet Smith connected it to ability as well:

The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state. The expense of government to the individuals of a great nation, is like the expense of a great estate, who are all obliged in proportion to respective interests to the estate.<sup>97</sup>

However, some commentators were confused, and argued:

In the first place, this passage [was] hopelessly confused in presenting as if they were identical two very different criteria for justice or propriety in taxation: the 'ability-to-pay' and the 'benefit' principles. Smith maintains that people's ability to pay taxes is proportionate to income: and that benefits derived from the state are proportional in the same way. Yet he offers no justification for either of these dubious propositions.<sup>98</sup>

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94. See *supra* note 27 and accompanying text.

95. See, e.g., Steuerle, *supra* note 29.

96. A. SMITH, *supra* note 22, at 310.

97. *Id.*

98. See generally MURRAY N. ROTHBARD, *THE CELEBRATED ADAM SMITH, AN AUSTRIAN PERSPECTIVE ON THE HISTORY OF ECONOMIC THOUGHT* (Edward Elgar Press 1995), ch. 16.

Yet, an analysis that employs the old “Locke labor justification” for the right of property, together with the new “Economic Allegiance” doctrine and the modern tools of economic analysis integrated into the “Joint Project” concept,<sup>99</sup> may demonstrate that these two principles are very well connected.<sup>100</sup>

To present this argument, I use the income tax as a case study. First, note that the term “income” may be defined in either of two ways.<sup>101</sup> It may be defined from its “uses side,” which focuses on the ways we use income—current and future consumption (and future consumption is of course savings).<sup>102</sup> It may also be defined from its “source side,” which focuses on the income producing process, i.e., the origin of the income.<sup>103</sup>

1. *Income from the uses side is facilitated by the role of government services*

The basic and most important goods and services the government provides are national security (aimed to protect human life,<sup>104</sup> public and private property), law and order, recognition and protection of property rights, and the power to enforce contracts. The more property citizens have, the more they have to lose. To put it in a very simple way: a taxpayer with one million dollars enjoys an economic benefit from the government equal to \$1,000,000; a taxpayer with one thousand dollars enjoys an economic benefit valued at only \$1,000, etc. Therefore, the value of government protection is proportional to an individual citizen’s property value.

Furthermore, the accumulation of vast amounts of wealth is facilitated by the existence of concepts like limited liability and the corporation, concepts that would not exist without government intervention. This demonstrates the large benefit that the owners of such entities derive from the existence of government. It is not a

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99. See *infra* Part VII.

100. See Steuerle, *supra* note 29, at 261.

101. See Daniel Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, 103 TAX NOTES 91, 97-99 (2004) (describing an interesting distinction between income and consumption).

102. Since we are born empty-handed and leave empty-handed, we consume all (economic) income we produce. During our lifetime income is equal to consumption and during a certain taxable year income is equal to consumption plus saving. See Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 46 (1990) (citation omitted).

103. See I.R.C. § 61(a) (2000) (“[G]ross income means all income from whatever source derived.”).

104. This factor can be taken out of the equation, assuming that the economic value of every human life in our community is equal.

contradiction to state that citizens with a greater ability to pay for government services also derive greater benefits from those very same services on the uses side of the equation.

2. *Income from the sources side is dependent upon the relative strength of social capital*

Income is a product of the factors/means of production. As we see below, any entity that uses a means of production is entitled to economic return. Under modern economic analysis, income is derived mainly from three types of means/factors of production: (1) real capital, (2) human capital (labor), and (3) social capital.<sup>105</sup> I will limit my focus to social capital. At its core, social capital represents the conditions and institutions that are the byproducts of an organized community that can be leveraged by members of that community for their special benefit.

Social capital enables participants to act together more effectively to pursue common goals and facilitates the production, sale, and consumption of the goods and services that are products of economic behavior.<sup>106</sup> It enhances the performance of institutions and firms through the rapid diffusion of knowledge between individuals, communities, as well as within and between firms. Furthermore, social capital is an effective tool for individuals, as well as legal and

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105. See GARY S. BECKER, ACCOUNTING FOR TASTES 4-5 (Harvard Univ. Press 1996) (defining personal capital as the relevant past consumption and other personal experiences that affect current and future utilities, and social capital as the influence of past actions by peers and others in an individual social network and control system; human capital incorporates both personal and social capital); ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, THE WELL-BEING OF NATIONS: THE ROLE OF HUMAN AND SOCIAL CAPITAL 12-13 (2001) [hereinafter ORG. FOR ECON. CO-OPERATION AND DEV.] (defining human capital as the knowledge, skills, and health of individuals, and social capital as the norms and institutions that facilitate cooperation within or between groups); Jonathan Temple, *Growth Effects of Education and Social Capital in the OECD Countries* 24-25 (Org. for Econ. Co-Operation and Dev., Econ. Dep't., Working Paper No. 263, 2000) (attempting to measure the relative effectiveness of social capital in various countries by using polling data inquiring about the relative trust members of a community had of each other), available at <http://www.oecd.org/dataoecd/15/20/1885700.pdf>.

106. See ROBERT PUTNAM, BOWLING ALONE: THE COLLAPSE AND REVIVAL OF AMERICAN COMMUNITY 288-89 (Simon and Schuster 2000) (illustrating how social capital facilitates collective action by aiding citizens to resolve collective problems, allowing groups to expend resources more efficiently, increasing awareness of the interconnectivity of society, and serving as a conduit for the flow of helpful information); see also ORG. FOR ECON. CO-OPERATION AND DEV., *supra* note 105, at 41 (refining the definition of social capital to mean the values and understandings that relate to the dispositions and attitudes that inform the objective behavior of actors who enter into associative activity).

economic entities, to adapt to rapid economic and social changes.<sup>107</sup> Especially for individuals, the creation of communication infrastructures is crucial in sharing valuable information about the labor and financial markets and locating new opportunities.

In modern democratic societies, elected governments are in charge of the quality of the social capital.<sup>108</sup> The quality of social capital is determined, *inter alia*, by national security, social stability, the existence of organized and efficient markets, and an effective legal system.<sup>109</sup> The better the social capital, the greater economic opportunity the taxpayer has. Hence, good governance creates better conditions for economic activity.<sup>110</sup>

Those who use these conditions successfully earn more; thus, they benefit more from the government. There is a direct connection between the benefit a taxpayer derives from the government and the taxpayer's economic ability; the government provides social capital and the taxpayer provides real and human capital. This relationship, or "Joint Project," creates a direct connection between the benefit a taxpayer derives from the government and the taxpayer's ability to pay for those benefits. The "Joint Project" is a prime example that both from the "uses side" (the consumption process), and the "sources side" (the income production process) emerges the same conclusion: those with the greater ability to pay also derive a greater benefit from government goods and services.

#### VII. PROPERTY RIGHTS AND THE JOINT PROJECT CONCEPT

One may argue that any tax, by definition, infringes upon property rights since it transfers wealth from the taxpayer to the government.<sup>111</sup>

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107. See *ORG. FOR ECON. CO-OPERATION AND DEV.*, *supra* note 105, at 57-58 (explaining that social capital allows business networks to generate long-term benefits by reducing overhead, increasing information sharing, and facilitating adaptation to changing demands of customers).

108. See *infra* notes 130, 145 and accompanying text (observing that the success of entrepreneurs and business organizations is dependent upon social organizations and individuals that are independent of such entrepreneurs and businesses).

109. See *infra* Part VII.B in text and accompanying notes (arguing that social capital is a fundamental precondition for the transformation of labor into wealth and consumption).

110. Even governments that limit their functions to narrow fields like the national security enhance social capital. See *ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA* 26-27 (Basic Books 1974) (describing the minimal state approach that limits governmental functions to protecting citizens against violence, theft and fraud, and enforcing contracts).

111. For further discussion (and rejections) on arguments that taxation is an infringement on property, and the rejection of those arguments, see Yoseph Edrey, *A*

However, only a tax that fails to follow the above canons of a good tax can be regarded as a non-consensual payment to the government. Such a tax could then be considered a confiscation by the government, subject to constitutional review.<sup>112</sup>

I do not intend to get into the complex issue of defining property, nor to elaborate all the common justifications for private property.<sup>113</sup> Instead, I refer briefly to the classical labor justification of John Locke.<sup>114</sup>

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*Declarative and a Constructed Constitution—the Right for Property Under the Israeli Constitutional Law and its location on the ‘Constitutional Rights’ Scale*, 28 MISHPATIM 461 (1997); Klaus Vogel, *The Justification for Taxation: A Forgotten Question*, 33 AM. J. JURIS. 19, 22-23, 57 (1988) (rejecting the notion that income taxation is unjustified as a form of forced labor, and instead insisting that taxation is legitimized as a return to the State of that portion of the economic value the State helped produced in the first place).

112. See *supra* Part V and accompanying notes (describing in detail that the canons of a good tax require a tax to be certain and not arbitrary, efficient, fair and equitable, and considers the convenience for the contributor).

113. See generally G.W.F. HEGEL, *ELEMENTS OF THE PHILOSOPHY OF RIGHTS* 81 (A.W. Wood ed., H.B. Nisbet trans., Cambridge Univ. Press 1991) (1821) (arguing that the possession of private property is established when a person puts their will into an “external sphere,” a thing without personality, rights, or freedom, and that person’s right to use that thing is recognized by others); Alan Ryan, *Self Ownership, Autonomy and Property Rights*, 11 SOC. PHIL. & POL’Y 241, 252 (1944) (describing the dilemma of self-ownership found in the works of Hegel and Kant, and asserting that the discussion of ownership by both philosophers is based on the distinction between the utilitarian drive to put the objects around us to good use and the rational goals of institutions that result from this use). For the scope and meaning of property rights under the German Constitution, see DANIEL P. KOMMERS, *THE CONSTITUTIONAL JURISPRUDENCE OF THE FEDERAL REPUBLIC OF GERMANY* 250-54 (2d ed. 1997) (explaining that the German approach to property rights stipulates that since property is associated with liberty and personhood, Germany cannot change the Civil Code to constrict the core of that freedom). Note that while the German Constitution protects the right to property, that right is subject to certain duties. See Grundgesetz für die Bundesrepublik Deutschland [GG] [federal constitution] art. 14, § 2 (“Property entails obligations. Its use shall also serve the public good”).

114. On a different approach, see e.g., JEAN-JACQUES ROUSSEAU, *THE SOCIAL CONTRACT*, 55 (Christopher Betts trans., Oxford Univ. Press 1994) (1762) (seeing the formation of the social pact as the “complete transfer of each associate [of the social pact], with all his rights, to the whole community”). Such an abandonment of human rights for the sake of the collective will is not meant to reduce each individual’s welfare or power but to increase them. It is meant to protect each individual’s liberty. Rousseau ends Book I of *The Social Contract* with an observation that the social pact, far from destroying natural equality, “substitutes moral and legal equality for whatever degree of physical inequality nature has put among men, they may be unequal in strength or intelligence, but all become equal through agreed convention and by right.” *Id.* at 62.

A. *John Locke and the Labor Justification for Property*

John Locke's labor justification for the right to private property is based upon several fundamental ideas:<sup>115</sup>

- (1) Humans have an inalienable right to control the destiny of their personality and their body.<sup>116</sup>
- (2) Property was originally given to humans in common.<sup>117</sup>
- (3) Given the above, humans have a right of ownership over the products of their labor and over the external expression of their potentiality.<sup>118</sup>
- (4) The right acquired through labor is superior to the original common right.<sup>119</sup>
- (5) Consequently, humans have an exclusive right of proprietorship over things in which they have invested their labor. Therefore, property is a natural right in the sense that it is created even in the absence of a government and a legal system.<sup>120</sup>

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115. Incidentally, Locke's reasoning raises substantial difficulties. In my opinion, the commonly asserted parallel between Locke's liberal approach and capitalism is not obvious. This parallel contradicts social democratic attitudes by asserting that a libertarian approach is necessarily a capitalistic one. For a fascinating discussion of Locke's reasoning, see James Tully, *A Discourse on Property: John Locke and His Adversaries* 168 (Cambridge Univ. Press 1980) (arguing that Locke's theory of property justified private property only insofar as it is a prudential means of bringing about a just distribution of property in accordance with the natural right to enjoy the product of one's own labor); Jeremy Waldron, *The Right to Private Property* 251-52 (Oxford Univ. Press 1988) (concluding that the core of Locke's theory is a specific right of an individual to acquire property so that others may not take it without consent, but that the only general right an individual has is to be guaranteed a subsistence if it is unavailable; in extreme situations the individuals are justified in taking the surplus goods of others for their own benefit); Ryan, *supra* note 113, at 247-48 (questioning the premise of self-ownership as the basis of libertarianism by illustrating that Locke's reliance on an individual's moral obligations to a network of social and often legal ties runs counter to individual autonomy).

116. See JOHN LOCKE, *TWO TREATISES OF GOVERNMENT* 127 (Mark Goldie ed., Everyman 1993) (1689) ("Whether we consider natural reason, which tells us, that men, being once born, have a right to their preservation.").

117. See *id.* at 128 ("Though the earth, and all inferior creatures be common to all men, yet every man has a property in his own person.").

118. See *id.* ("Whatsoever then he removes out of the state that nature hath provided. . . he hath mixed his labour with, and joined to it something that is his own, and thereby makes it his property.").

119. See *id.* at 134-35 ("[B]ut supposing the world given as it was to the children of men in common, we see how labour could make men distinct titles to several parcels of it, for their private uses; wherein there could be no doubt of right.").

120. See *id.* at 137 (observing that prior to the creation of compacts and law, man was able to create a right of property in the state of nature from those things previously held in common by all mankind). But see 1 JEREMY BENTHAM, *THEORY OF LEGISLATION* 113 (Richard Hildreth trans., 2004) (1802) ("Property and law are born

- (6) Humans have a right to keep the work of their hands to themselves, or to trade it for assets produced by others. Their right in the assets that they acquire is complete.<sup>121</sup>
- (7) The right to property is subject to two limitations:
  - (a) An individual's property is contingent upon not excluding or denying the necessities required by others.<sup>122</sup>
  - (b) Man acquires property only according to his needs.<sup>123</sup>

Upon careful analysis, Locke's qualification of the right to property as a natural right is not as absolute as it might seem. Indeed, under Locke's approach man acquires an absolute and exclusive right in the entire asset through adding to its value by way of labor.<sup>124</sup> However, even if we assume that this was the original intent, the ultimate conclusion derived from the inner logic of Locke's approach, is considerably different.

Where one individual improves an asset, that individual is the sole owner, whereas when someone works with another, the asset belongs to both. Moreover, where a group works together to improve an asset, each has a right to the asset. Thus, the important conclusion is that an individual's right to property is limited to the component that the individual adds through labor. In other words, the natural right of private property is restricted to the "added value" that an individual augments to the original asset.

Essentially, this means that an individual only has an exclusive right to the components of the property that can be attributed solely to that individual's labor. Consequently, under Locke's approach, one can only conclude that there is a natural right in property insofar as it represents the fruit of an individual's labor, and not that there is an inherent natural right to property in and of itself. Furthermore, if a group of people combines their labor and capital to produce wealth, assets, or property, they all have a common right in it.

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together, and die together. Before laws were made there was no property; take away laws, and property ceases.").

121. See LOCKE, *supra* note 116, at 138 ("[E]veryone had a right (as hath been said) to as much as he could use, and had a property right in all that he could effect with his labour.").

122. See *id.* at 133-34 (explaining that in the state of nature man could appropriate as much as he needed, but if such appropriations went to waste he offended the natural law because he invaded his neighbor's share of the common property).

123. See *id.* at 138 (arguing that it was both foolish and dishonest for a man to hoard up more than he could use).

124. See *id.* at 128 (arguing that whatever man removes out of the state of nature through his labor has, "joined to it something that is his own, and thereby makes it his property. . . that excludes the common right of other men").

*B. The Labor Justification and the Joint Project Concept:  
Towards Private and Public Property*

Today's economic reality and level of knowledge allow us to advance a step further, where property is not limited to the value added by labor alone, but also through the investment of the fruits of that labor: real capital. When individuals invest the fruits of their labor, the investment stands to yield a new gain, which also becomes their property. A similar situation occurs when two people unite to form a joint venture in which one partner contributes work and labor while the other makes a financial investment.<sup>125</sup> The firm, which is actually a nexus of contracts, is an example of this joint venture and embodies the "Joint Project" concept.<sup>126</sup> Furthermore, labor itself, in modern life is not enough. In order to transform the fruits of labor into wealth and consumption, basic preconditions (i.e. social capital) exist that are necessary to facilitate the transformation of labor into other goods and services we need to purchase from others.

Modern economics provides greater insight into the income production process, which in turn allows for a more accurate identification of each individual's contribution to the production process.<sup>127</sup> For example, suppose that a book sells for the market

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125. One may argue, of course, that the same rationale is behind the community property concept.

126. For instance, the profits of a firm are shared by all those who invested in it according to their contractual input. The parties to these contracts comprise of all the individuals that take part in the various factors of production. This includes the investors in the firm who are its owners, and receive dividends, interest, rent, royalties and even wages. It also includes those who rented assets, whether tangible or intangible, and receive rent or royalties, and those who rented their human capital in exchange for wages. This approach sees the firm as consisting of all those who have invested in the process of income production and expect a return on their investment. The firm is a system of contracts between the individuals of the different factors of production, who act out of personal motives and interest, but also realize that their economic future depends on efficient cooperation. See Yoseph Edrey, *Taxation of International Activity: FDAP, ECI and the Dual Capacity of an Employee as a Taxpayer*, 15 VA. TAX REV. 653, 664-65 (1996) (arguing that the firm is a joint venture of investors, including employees, seeking returns). On the theory of the firm, see R.H. Coase, THE NATURE OF FIRM, 4 ECONOMICA 386, 392 (1937) (theorizing that firms emerge where long term contracts are necessary to organize modes of production, and the harnessing of production factors within a single unit lowers production costs); Michael C. Jensen & William H. Meekling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976) (defining the firm as a "legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals...are brought into equilibrium within the framework of contractual relations").

127. See Edrey, *supra* note 126, at 665 (explaining that a firm paying dividends, interest, royalties, rent, or salary, is distributing the income it produced to all those that 'invested' in the firm). The concept of the firm sheds light on the income

price of \$100. Certainly, no one can argue that the entire \$100 belongs to the author. Rather, part of this sum must be used to pay wages to printers, editors, proof-readers, interest on loans granted to facilitate the publishing process, and rent to the owner of the building used by the publisher. Marketing and advertising agencies must also be paid, as well as the designers and producers of the paper on which the book is published.

Furthermore, there is an additional step involving the writer. One may assume that the writing of a book itself does not result in the right to its economic value, but merely the right to its creation. Therefore, the economic value is determined by the economic process of selling the book (and having a realized income instead of a potential or future income), or developing its potential to sell in the future. In economic terms, the existence of demand for the book is a crucial factor in determining its economic value. Had the author written the book in a community of illiterates, there is little chance it would sell. Indeed, the value of such a book will increase proportionally to the development and progression of the educational system and the community's rate of literacy.

Likewise, a publisher will not be able to distribute and market the book unless there is a physical infrastructure that allows for both the shipment of merchandise and the establishment of a venue where shoppers may purchase the book. In addition, without an education the author would presumably not have been able to write. Furthermore, the ability to write in part stems from the social environment and community in which the author resides. Thus, it might be that the local government provides a safe and secure environment. From the uses side of the economic equation, the above author would like to sell the book in order to consume as many goods and services of the highest quality possible. Hence, the author has to live in a community that provides the best conditions for achieving such an end.

At this point, we have arrived at the notion that an individual's property—accumulated or consumed—is not dependent merely on his labor, but also on social capital. In sum, as a producer of wealth, the author owes an economic allegiance to the community in which

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production process insofar as the firm consists of discrete elements working together to manufacture goods or services. *See* Coase, *supra* note 126, at 390-93 (describing the firm as an organization of inter-related production factors driven by the desire to reduce overall costs).

the processes of production take place. As a consumer, the author owes an “economic allegiance” to the community, which enables the author to enjoy the benefits of his or her labor, consumption, and saving.<sup>128</sup>

Returning to the Lockean approach, the fruits of the labor stemming from a worker’s product are actually the fruits of the labor stemming from a multitude of sources, public (social capital) and private (human and real capital), which contributed to the process of producing the income. As such, each of these factors seemingly has a right in the final product.

Nevertheless, a practical question remains as to how the property of each of the contributors is to be identified. In other words, it is not the law of nature that dictates the precise distribution of property. The law of nature merely establishes the principle that a human must not be denied the results of his or her labor. The proper implementation of this principle is a matter for legislation, based on the public’s consent, and subject to fundamental human rights. All these concepts and doctrines are very well connected to tax legislation and tax policy.

### C. *Towards a Modern Synthesis of Human and Social Capital*

A modern analysis of the causes for wealth and its production provides yet another viewpoint justifying the protection of property rights.<sup>129</sup> Richard Posner’s analysis of how wealth and property originated in modern society begins with the words of Hegel, stressing that economic rights are “luxuries enabled by social organization.”<sup>130</sup> This analysis leads to the conclusion that the property of an average man or woman is not exclusively the result of human capital (i.e. his or her own work, deeds, and personal contributions). Rather, social capital, (i.e., the society and community in which an individual lives and works, and the opportunities which they thereby create), is an extremely influential factor in the acquisition of property. As the economist Arthur Okun explains:

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128. See *infra* Part VII.D and accompanying notes (detailing the theory that a taxpayer owes “economic allegiance” to the state that provides the conditions necessary for the creation of wealth).

129. For a comprehensive discussion, see Edrey, *supra* note 111.

130. Richard A. Posner, Hegel and Employment at Will: A Comment, 10 CARDOZO L. REV. 1625, 1626 (1988-1989).

The productive contribution of the service I could sell in a hypothetical competitive market depends on four sets of elements: (1) the skills and assets that I have acquired through my lifetime; (2) the abilities and talents with which I was born; (3) the effort I am willing to expend; and (4) the supply and demand situation for other services related to the ones I can offer.<sup>131</sup>

However, the skills and talents a person acquires are available only in a community with strong and substantial social capital. For instance, "Henry Ford's mass-produced automobile was a great success in a country with a high average income, three thousand miles for unimpeded driving, an alert and ambitious work force, and a government that could protect travelers and enforce the rules of the road. It would be a loser in Libya."<sup>132</sup>

Okun's point may be exemplified by comparing two individuals who share identical talents and qualities but live in societies of different economic status. Indeed, the two do not stand to gain the same income, property and other economic achievements, since an individual living in an advanced and wealthy community will most likely profit more than an individual living in a poor, underdeveloped one.<sup>133</sup> Thus, an individual's wealth depends not on skills and abilities alone, but primarily on the abilities of other individuals in the community and the economic strength of the community itself.

As a result, a "modern synthesis" concludes that property rights are not only basic and natural rights, but also the result of communal life and social interaction. Furthermore, a modern synthesis relies on a utilitarian justification for the recognition and protection of property rights. Recognizing private property is beneficial to a community because it creates an incentive for individuals to utilize their skills to increase their wealth and add value to their assets.

#### *D. The Concept of Economic Allegiance*

In 1923, a special professional committee composed of four world-renowned tax experts submitted a report to the League of Nations<sup>134</sup>

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131. ARTHUR OKUN, *EQUALITY AND EFFICIENCY* 42 (Brookings Inst. 1975).

132. *Id.* at 46.

133. See Posner, *supra* note 130, at 1626 (noting that an individual's right to property in a wealthy society is not "natural," because property and wealth is a product of social interactions enabled by the contributions of other members of society and not based solely on individual effort).

134. See W.H. Coates, *League of Nations Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp*, 87 J. ROYAL STAT. SOC'Y 99, 99 (1924) (noting that Professor Bruins of the Commercial

in order to make its recommendation with regard to the taxation of international activity.<sup>135</sup> A significant part of the report was based on a book written by one of the committee's members, Professor Edwin R. A. Seligman.<sup>136</sup> In his book, Professor Seligman developed the doctrine of economic allegiance,<sup>137</sup> and thereafter, it served as a cornerstone for the committee.<sup>138</sup> The doctrine is based on four primary theories: (1) the base of a modern income tax system is the faculty theory, or the ability to pay;<sup>139</sup> (2) ability to pay is determined according to a person's wealth, income and consumption;<sup>140</sup> (3) a taxpayer owes economic allegiance to those states or countries that provide the conditions to create the taxpayer's wealth;<sup>141</sup> and (4) the production process, which is composed of three stages:

- a) The actual physical production process;
- b) The materialization of the physical production, resulting in products with economic value; and
- c) The use of wealth for investment or consumption.<sup>142</sup>

It is quite evident that the second stage of the production process, where the product receives its own economic value, is extremely significant. Without it, all human efforts to produce goods and services would be essentially futile. This process indeed depends not only on the existence of a legal system that recognizes the property

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University in Rotterdam, Professor Senator Einaudi of Turin University, Professor Seligman of Columbia University in New York, and Sir Josiah Stamp, K.B.E. of London University, were the four expert economists invited to report to the League of Nations).

135. *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp*, League of Nations Doc. E.F.S.73F.19 (1923) [hereinafter *Report on Double Taxation*], available at [http://www.law.wayne.edu/tad/Documents/League/League\\_Tech\\_Experts.pdf](http://www.law.wayne.edu/tad/Documents/League/League_Tech_Experts.pdf).

136. EDWIN R.A. SELIGMAN, *ESSAYS IN TAXATION* 15 (Macmillan Co. 8th ed. 1913) (1905).

137. *Id.*

138. *See Report on Double Taxation, supra* note 135.

139. *See* SELIGMAN, *supra* note 136, at 338-39 (noting that the ability or faculty theory measures an individual's duty to support the government according to the individual's ability to pay, and observing that the ability to pay theory itself is based on the principle of equal sacrifice).

140. *See id.* at 18 (explaining that traditionally, expenditures, property, and product were indicative of an individual's ability to pay, but over time, income came to be the most equitable means of determining an individual's ability to pay).

141. *See id.* at 15 (emphasizing that it is an individual's duty as a citizen to support the government proportional to the individual's ability to support him or herself). *But see id.* at 57 (pointing out that the state can live without the individual, but that the individual cannot live without the state).

142. *See id.* at 57-58 (noting that the test of an individual's ability to pay is not dependent on property as a measure, but rather, the product reaped from the property).

and protects it, but also on the existence of an economic market that maintains economic demand, efficiency of trade, and the presence of suitable consumers.<sup>143</sup> Without this maintenance, the production process is worthless, except for the purpose of self-sufficiency. In sum, no real wealth can be produced without the existence of a well-organized state.<sup>144</sup>

The evident connection between Locke's traditional labor justification, the modern synthesis, and the doctrine of economic allegiance leads us to a discussion of the joint project, public property, and the tax as a profit-sharing mechanism.

*E. The Joint Project Concept and Public Property*

In modern society, people do not live and work in their own secluded environments. For instance, a law professor produces income through teaching, only because the community in which the professor lives makes it economically possible to earn a living in such fashion, assuming the professor lives in a community that provides the infrastructure needed to work as a law professor. In order to teach, the professor needs a class of students who want to study the legal system, such that the sine qua non for the professor to teach, is the very existence of a legal system provided for and maintained by the public. In order to publish research, the professor needs an audience of readers who come from a society that has invested in educational programs, beginning with nursery school, and continuing through to the university level. Furthermore, the professor would be unable to teach classes without the provision of roads, buildings, public transportation, safety, security and other public services provided by the state.

Similarly, a computer engineer would have no use for computer engineering skills as a means of generating income if not for the existence of an educational and technological infrastructure.

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143. OKUN, *supra* note 131, at 46.

144. See Vogel, *supra* note 111, at 39 (commenting on the impossibility of a community to support its individuals through economic progress if the individuals residing within the community do not return part of the benefits derived from economic progress, and pointing out that the law is the "order and measure" of such progress); see also OKUN, *supra* note 131, at 46 (stating that production is based on an interdependent system of individual contributors); SELIGMAN, *supra* note 136, at 18 (asserting that any large-scale tax system is doomed to fail unless it is in harmony with the economic conditions that shape society); Posner, *supra* note 130, at 1626 (arguing that individual wealth is dependent on the standard of living established by the collective skills and efforts of society).

Indeed, it is necessary that society invest in both training people, who may use their skills and benefit from them, and in technological improvements, which make training and resulting work possible. For example, it would be impossible for the computer engineer to produce income in a society without clients capable of using computer-engineering services. Bill Gates could not have developed his products without the existence of training institutions, public research and development centers, universities and research institutions, and an educated and skilled population capable of using the products his company produces.<sup>145</sup>

Moreover, economic, productive, and efficient activity is possible where risks to businesses are minimized because of, *inter alia*, good legal and educational systems. Indeed, new developments and inventions, as well as technological improvements, are most often made in countries where a solid base for scientific research exists, primarily through academic institutions. These developments call for a revised analysis of the distribution of a community's aggregate wealth, not as a matter of distributive justice, morals or ethics,<sup>146</sup> but rather from the more liberal premise that each social entity is entitled to a yield on its investment. Therefore, one should consider a joint endeavor within a modern community,<sup>147</sup> in which the individual works as part of a partnership with the community he or she lives and operates in. The community invests in the needed infrastructure; the individual adds human and real capital; and the yielded income belongs to both. It is therefore reasonable to assume the existence of a partnership or joint project between an individual and the community in which the individual lives and works. This concept of a joint project requires the assumption that there is a contract or social pact between an individual and the community, which calls for the reasonable division of the wealth created by both the individual and the community.

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145. Presumably, Bill Gates' enterprise would not have succeeded in Libya either. See OKUN, *supra* note 131, at 46 (referring to Henry Ford's automobile empire).

146. See MURPHY & NAGEL, *supra* note 27, at 59 (distinguishing between a tax system founded on principles of distributive justice, morals, and ethics as one that reflects a social solidarity ideal, and a tax system based on ideas of just desert as one that reflects a self-reliance ideal).

147. A similar idea exists in parts of the modern legal system with regard to community property laws. See William T. Hancock, *A Look at Community Property Law*, 34 VA. L. REV. 417, 418-19 (1948) (explaining that a marital union is analogous to a community, such that husband and wife are equally contributing individuals within the marital community, and thus, are entitled to equal interests in the marital property).

Once the joint project is recognized, the only remaining question to be answered is to what extent the portions of wealth created by the parties should be allocated to the community, and to the individual. The answer is of course, an accepted tax system, which is based on the guidelines of a good tax.<sup>148</sup> Hence, the circle is closed.

#### F. *Tax as a Profit-Sharing Mechanism*

Taxes in modern society are based on the concept of “[n]o taxation without representation.”<sup>149</sup> Representation in democratic societies stands for consent, such that this concept essentially means “no taxation without consent.”<sup>150</sup> Indeed, consent is achieved through legislation. Clearly, tax legislation is limited like any other type of legislation. Tax laws should not violate constitutional rights, be used as means for confiscation, or violate principles of equality or human dignity. Instead, tax laws are intended to afford the revenue needed to implement the elected government’s policy, provided that the laws are based on certain accepted canons of a good tax system.<sup>151</sup> Thus, as long as it is based on equitable and reasonable principles, a tax is not construed as a violation of the right to property, but rather as a profit-sharing mechanism used to distribute wealth created through the joint project between an individual and the community in which the individual lives.

The same rationale applies not only to income tax laws, but to property and consumption taxes as well. The worth of a tract of land is derived from its possible uses, which depends primarily on the standard of living within the state, as well as the quality of its economic system. The land’s value also depends on a variety of other factors, including the abundance of public infrastructure systems in

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148. A. SMITH, *supra* note 22, at 777-78.

149. See, e.g., Thomas C. Grey, *Property and Need: The Welfare State and Theories of Distributive Justice*, 28 STAN. L. REV. 877, 881 n.12 (1976) (referring to the slogan used by American Revolutionists to convey their disfavor of property taxes imposed without their consent).

150. *Id.*; see Edrey, *supra* note 111. I argue that the full concept of “no taxation without consent” is indeed, “no *payment* without consent.” Payment is not confined to taxes, duties, charges or fees payable to the government and its agencies, but also includes payment charged in the private market in a non-market economy. That is to say, anti-trust laws are aimed to protect private property not only against the government but also against powerful economic, non-democratic forces. EDREY, *supra* note 13, at ch.1.

151. See generally Vogel, *supra* note 111, at 19-59 (providing a comprehensive discussion of the basic canons and rules that justify tax laws); EDREY, *supra* note 13, at ch. 1.

the area, such as roads, sewage, or foresting; the opportunity to enjoy public services like sanitation and environmental protection; and of course, the recognition of land ownership and the legal enforcement of the right to such ownership.<sup>152</sup> Indeed, all these variables and their features depend on the quality of a community and its government, and on the quality of the social capital.

### VIII. PROGRESSIVITY AND NON-DISCRIMINATION

Perhaps one way to understand the reluctance to subject tax laws to constitutional review might be that as long as there is no clear evidence that a progressive tax system fails to achieve equal sacrifice,<sup>153</sup> progressivity violates the principles of equality.<sup>154</sup> There is no need to elaborate on this issue here, so I have confined myself to a few short comments.<sup>155</sup>

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152. The laws pertaining to the expropriation of land may be explained in a similar fashion. A portion of land that is expropriated genuinely for public use (i.e., for roads, beaches, or conservation sites) is not a taking of individual property, but rather, an apportionment of property between the individual and society. Edrey, *supra* note 13, at ch. 2. Yet another approach is to understand that an individual's possession of land is conditional. The individual retains ownership of the land so long as the general public, which participated in liberating or purchasing it, relinquishes its own rights in the land. Charles Sampford & David Wood, *Tax, Justice and the Priority of Property*, in 23 POZNA STUD. IN THE PHIL. OF THE SCI. & THE HUMAN. 181-208 (Wojciech Sadurski ed., 1991). One may claim, however, that this is not the case where property is expropriated for the use of not the general public, but for other individuals. Expropriation of land in such cases might be for the purpose of settling groups of a certain religion, ethnic background or nationality, or for the purpose of transferring land to private buyers. These expropriation uses should be considered a violation of property because essentially, the property is taken away from one individual and passed to another. As a result, such an expropriation may be considered an act of discrimination, or other violation of basic rights—namely, the right to equal protection of the laws. See MURPHY & NAGEL, *supra* note 27, at 43 (summarizing the Lockean view that the right to property is a fundamental right derived from individual sovereignty, such that violation of the right to property destroys the basic right of individual sovereignty).

153. See *id.* at 24-28 (explaining that the concept of equal sacrifice is that it is more fair for the affluent to pay more taxes than the poor because the affluent have more to sacrifice).

154. See WALTER J. BLUM & HARRY KALVEN, JR., *THE UNEASY CASE FOR PROGRESSIVE TAXATION* 15-17 (Univ. of Chicago Press 1953) (observing the benefits of progressive taxation as it is, and pointing out the adverse effect that steeper progressive taxation would have on equal sacrifice).

155. See generally Richard A. Musgrave, *Equity and the Case for Progressive Taxation*, in TAX JUSTICE: THE ONGOING DEBATE 9-23 (Joseph J. Thorndike & Dennis J. Ventry Jr., eds., The Urban Inst. Press 2002) (providing a comprehensive and current discussion about the progressive tax system); EUGENE C. STEUERLE, *CONTEMPORARY U.S. TAX POLICY* 129-31 (The Urban Inst. 2004) (discussing the progressive tax system as an achievement of tax reform).

A) A Progressive tax system is a means to promote principles of justice as normative ethical values. Pre-tax income is a myth, and as such, has no moral significance. As a just society we have to promote social justice and a major goal of the tax system is to do exactly that.<sup>156</sup>

B) Equality is violated by the free market. Equal human beings earn different amounts of income and are able to consume different standards of living. The role of a responsible government is to try to restore equality.<sup>157</sup> The only question that is left is how much society has to pay in order to promote equality. While trying to measure the optimal size of a hole in a leaky bucket that was supposed to carry money from the rich to the poor,<sup>158</sup> Okun stated, “[i]f both equality and efficiency are valued, and neither takes absolute priority over the other, then, in places where they conflict, compromises ought to be struck. In such cases, some equality will be sacrificed for the sake of efficiency, and some efficiency for the sake of equality.”<sup>159</sup>

The Constitution accepts the notion of compromise and leaves the balancing process to be decided by the legislature within the realm of the political process.

C) A progressive tax system is a means to achieve fairness—one of the components indicating the public’s consent to pay taxes—through principles of equity,<sup>160</sup> especially vertical equity.<sup>161</sup> Equity is achieved through the notion of equal sacrifice and the assumption that the marginal utility of wealth is diminishing.<sup>162</sup>

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156. See MURPHY & NAGEL, *supra* note 27, at 58 (asserting that no government could legitimately claim to promote general welfare and social justice without being prepared to finance these ends with taxes); see also *id.* at 70 (maintaining that any system that uses taxation as a means of furthering social justice necessarily promotes the individual pursuit of wealth in the interest of the collective benefit to society).

157. See OKUN, *supra* note 131, at 88-89 (suggesting that government interference with the economy sacrifices efficiency for equality, whereas efficiency tends to be prized by laissez-faire economists at the expense of equality).

158. See *id.* at 91 (describing the leaky bucket experiment).

159. *Id.* at 88.

160. Equity is a unidimensional, measurable, and even objective criteria, whereas justice is a multidimensional and subjective concept. See Thomas M. Porcano, *Distributive Justice and Tax Policy*, 59 ACCT. REV. 619, 620 (1984) (highlighting the deficiency of equity rules because of their unidimensional nature, and thus concluding that when determining how much an individual deserves to pay or receive, justice rules should apply).

161. See STEUERLE, *supra* note 155, at 253 (explaining that the term “vertical equity” is associated with progressivity and the idea that those individuals in society who need more, should receive more from the government; in turn, those who have more, should give more).

162. *Id.*; see MURPHY & NAGEL, *supra* note 27, at 24 (noting that whether or not the equal sacrifice principle leads to a proportional or progressive tax scheme depends on the rate at which the marginal value of money diminishes).

D) A progressive tax system is also justified by the joint project concept and the tax as a profit-sharing mechanism<sup>163</sup> on the sources side.<sup>164</sup> In other words, those who produce a higher amount of income use more social capital and therefore, have to pay a higher amount of taxes as a return to the public.

E) A progressive tax system is also justified by the benefit principle on the uses side.<sup>165</sup> Essentially, those who have more are better able to enjoy major public goods and services, like recognition of property and provision of security via law enforcement.<sup>166</sup> As a result, those who benefit more have to pay more.

#### GENERAL AND SUBTLE CONCLUSIONS

In this short presentation, which is dedicated to Professor Janet Spragens, I have tried to offer a few ideas aimed at increasing and promoting constitutional review of tax laws. As opposed to a surprising trend that I have found in the United States, I argue that such review is supposed to serve the promotion of social policy, distributive justice, and equality. I have attempted to show that based on the mere language of Article I, section 8 of the U.S. Constitution, together with insights developed during the last two centuries, any tax—whether it is a tax on income, consumption, or property—should aim to provide *for the common defense and general welfare*. Thus, a tax, as any other payment for purchasing goods and services in the marketplace, has to be based on the notion of consent; whether such consent is direct and personal, or indirect and collective through the legislative process. In order to assume that a tax is indeed based on indirect consent, we have to agree that the tax is based on certain accepted attributes—that is, that the tax follows the four canons of a good tax.<sup>167</sup> Today, those canons continue to have constitutional meaning and dimension. The most prominent one is the fairness requirement.<sup>168</sup> Here I join those who believe that the two criteria for horizontal and vertical equity, namely economic ability and the

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163. See *supra* Part VII.F (elaborating on the collaborative nature of the joint project and the tax as a profit-sharing mechanism between the individual and the community).

164. See *supra* Part VI.C.2 (examining income as a factor or means of production).

165. See *supra* Part VI.C.1 (providing a full discussion of the benefit principle).

166. See *supra* Part VI.C.2 (stating that the provision of security and law enforcement are indicative of the quality of social capital).

167. See A. SMITH, *supra* note 22, at 777-78 (detailing the four canons of tax).

168. *Id.* at 778.

benefit principles, are not in conflict with each other, but actually have common ground and complete each other.

I further conclude that a tax is subject to constitutional review if it violates constitutional rights and interests, even if it meets the consent requirement. I used as a case study, property rights and constitutional equality. I argued that a good tax system does not violate property rights. On the uses side, taxes serve as the price for the government's provision of public goods and services. On the sources side, taxes serve as profit-sharing mechanisms for private and social means of production. In both cases, it is quite evident that taxpayers who have greater wealth and income enjoy more public goods and services. Hence, there is no real threat that sound and reasonable constitutional review will strike down a progressive tax system.

I also discussed the basic understanding that there are two major constitutional principles that seem to be contradictory: economic freedom and efficiency, and equality. In addition, I mentioned the idea that over-accumulation of wealth represents a significant threat to democracy; thus, a mere redistributive justice policy promotes the constitutional interest of democratic values. The right and optimal balance between freedom, efficiency, democracy and equality is left to the legislature and the political arena. Nevertheless, it is clear that total economic efficiency while giving up equality is not constitutionally accepted, and vice versa—complete equality on the account of freedom, efficiency and democracy is also unconstitutional.

A subtle conclusion may emerge from the above discussion. A preferred tax rate, especially on capital gains and capital income (which are typical to wealthy taxpayers), may be considered a violation of the constitutional right of equality. As mentioned above, some foreign courts have already reached this conclusion.<sup>169</sup>

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169. See *supra* note 89 and accompanying text.