What Should Be Redistributed in a Redistributive Income Tax?: Retrospective Comments on the Carter Commission Report

by Michael J. McIntyre
Professor of Law
Wayne State University

In W. Neil Brooks, Ed., THE QUEST FOR TAX REFORM: THE ROYAL COMMISSION ON TAXATION TWENTY YEARS LATER, Carswell, Toronto (1988), pp. 189-209.

Table of Contents

What Should Be Redistributed in a Redistributive Income Tax?: Retrospective Comments on the Carter Commission Report

1. Introduction 189

2. Design Features of an Ideal Personal Income Tax 191
   (a) Sorting Rules 191
      (i) *Taxable Unit Rules* 191
      (ii) *Tax Base Rules* 192
      (iii) *Income Attribution Rules* 193
      (iv) *Taxable Period Rules* 194
   (b) Imposition Rules 195

3. Critique of Carter Commission Proposals 195
   (a) The Discretionary Income Concept 195
      (i) *Redistribution of Haig-Simons Income* 196
      (ii) *Taxation of Economies-of-Scale Benefits* 197
   (b) The Family as a Taxable Unit 200
   (c) Income Attribution Within the Family 201
   (d) The Flat Rate Proposal 202

4. Redistribution and the Design of an Ideal Income Tax System 203
   (a) Design of an Ideal Rate Structure 203
   (b) Implications of a Redistributive Tax Policy for the Design of Sorting Rules 205
      (i) *Redistribution and the Design of the Tax Base* 205
      (ii) *Redistribution and Income Splitting* 206

5. Conclusion 208

What Should Be Redistributed in a Redistributive Income Tax?: Retrospective Comments on the Carter Commission Report

Michael J. McIntyre[*]

1. Introduction

In its landmark Report, the Carter Commission embraced the goal of a redistributive income tax. An ideal income tax, the Report asserted, should "achieve a more equitable distribution of output,"[1] which would be accomplished by allocating tax burdens "in proportion to ability-to-pay."[2] To meet its ability-to-pay criteria, the Report states, "the government must seek to impose progressive marginal tax rates on all additions to personal economic power, without regard to the source of those increments in power."[3] An intended result would be a redistribution of economic power, especially in favour of low-income families.[4]

To achieve its distributional objectives, the Carter Commission proposed that income taxes be assessed with respect to the "discretionary income" of each taxpayer at a flat rate of 50 percent.[5] It defined discretionary income as the taxpayer's Haig-Simons income — consumption plus net change in savings — for the taxable period,[6] minus an amount necessary to maintain "the appropriate standard of living" of the taxpayer.[7] Amounts necessary to achieve an appropriate standard of living — referred to in this paper as non-discretionary expenditures — were assumed by the Commission to increase with income but not to exceed $100,000.[8]

---

* Faculty of Law, Wayne State University.

1 Canada, Royal Commission on Taxation, Report, Vol. 2 (Ottawa: Queen's Printer, 1966) (Chair: K. LeM. Carter) at 10 (hereinafter "Carter Report"). The Royal Commission on Taxation is often referred to as the Carter Commission after its Chairman, Kenneth LeM. Carter.

2 *Ibid.,* at 5.

3 *Ibid.*

4 *Ibid.* An absolute improvement of the well-being of the poor depends upon the government's transfer policy, not on its tax policy. Tax policy decisions, however, can improve the relative position of poor persons and can prevent the income tax system from causing an absolute decline in their well-being.

5 For illustrative purposes only, the Commission proposed a flat rate of 50 per cent. *Ibid.,* vol. 3 at 10. It contemplated that the Canadian government might select a lower or higher rate, depending upon revenue needs. The Commission suggested, however, that rates over 50 per cent would be undesirable on effi ciency grounds.

6 *Ibid* at 23.

7 *Ibid.*, at 5.

8 *Ibid.,* at 8. In 1986 dollars, the cap would be $390,000. The Report notes that the $100,000 cap is "obviously arbitrary." No explanation is given for favouring $100,000 over other equally arbitrary amounts, such as $10,000 or $10,000,000. The choice of the cap, however, was critical because it largely determined the extent to which the tax system would produce a redistribution of income.

As part of its redistributive scheme, the Carter Commission envisioned that family members — marital partners and their minor children — would be taxable as a unit on their aggregate incomes.[9] The amount of the deduction for non-discretionary expenditures would be greater for families than for unattached individuals with the same Haig-Simons income. For example, a husband and wife with Haig-Simons income of $20,000 would be allowed a deduction of $12,046 for non-discretionary expenditures, while a single person with the same Haig-Simons income would be allowed a deduction of only $9,970.[10]

The Carter Commission Report showed in some detail that the distributional results of its ideal system could be achieved in a more traditional Haig-Simons income tax system — that is, in a system that did not allow a deduction for non-discretionary expenditures. The traditional Haig-Simons system would employ two graduated rate schedules, one for families and one for unattached individuals.[11] In Chapter 11 of its Report, the Carter Commission endorsed separate rate schedules for unattached individuals and families, apparently for reasons of administrative convenience. It maintained that those rate schedules should be justified by reference to its discretionary income model.

The Carter Commission designed its discretionary income model according to five criteria. It referred to those criteria as its ability-to-pay principles. Embodied in those criteria were two assumptions: first, that the tax burdens imposed on families and unattached individuals should be proportional to their discretionary income; and second, that discretionary income of a taxable unit increases as the Haig-Simons income of a taxable unit increases.[12] None of the ability-to-pay principles explicitly asserts that redistribution of Haig-Simons income is a proper goal of a personal income tax.

In Part 2 of this paper, I set forth an alternative to the discretionary income model developed by the Carter Commission. In Part 3, I offer a critique of the Carter Commission's proposals for taxing family units on their discretionary income, using [*191] the model developed in Part 2 as my analytical framework. In Part 4, I suggest how a society's redistributive goals should inform the design of its personal income tax system.

---

9 *Ibid.,* at 12-13.

10 Figures computed from *ibid.,* at 15 (Table 7-2).

11 See *ibid.,* at 11 (Table 7-1).

12 The following five propositions constituted the ability-to-pay principles adopted by the Commission:

> 1. Families and unattached individuals should be treated as the basic tax-paying units, that is the entities with potential ability-to-pay.
>
> 2. Taxes should be allocated among tax units in proportion to ability to pay. Specifically, the tax allocated to unit A should bear the same relationship to the tax allocated to unit B, that the ability-to-pay of A bears to the ability-to-pay of B.
>
> 3. The ability-to-pay of a tax unit should be assumed to be proportionate to its discretionary income. In other words, the ability-to-pay of unit A should be assumed to bear the same relationship to the ability-to-pay of unit B, that the discretionary income of A bears to the discretionary income of B.
>
> 4. The discretionary income of a tax unit should be assumed to be equal to the total income of the unit multiplied by the fraction of that income available for the discretionary use of the unit.
>
> 5. It should be assumed that, other things being equal, the greater the income of a tax unit the larger will be the fraction of that income available for discretionary use.

Ibid., at 6.

2. Design Features of an Ideal Personal Income Tax

The fairness of any tax provision ultimately depends upon the fairness of the distribution of tax burdens that it helps produce. Consequently, every valid argument for or against a tax provision on fairness grounds must incorporate, implicitly or explicitly, some assumptions about the features of the tax system in which the provision would operate. The model income tax system set forth in this Part provides an analytical framework for stating and evaluating those assumptions.[13] My model is compatible with a very wide range of views about the goals of an ideal income tax system.

My model for an ideal income tax system establishes three categories of tax rules: sorting rules, imposition rules, and tax expenditure rules. The sorting rules are divided into four subcategories, each with a clearly defined function. In a coherent income tax system, a tax provision would fall into one, and only one, of those categories or subcategories.

The function of sorting rules in my model is to rank taxpayers according to their economic well-being. The design of sorting rules is discussed in section A, below. The imposition rules serve to impose tax burdens on taxpayers with respect to their ranking by the sorting rules. The imposition rules are discussed in section B. In my model, taxpayers would employ the sorting rules to compute their taxable income. They would then employ the imposition rules to determine the amount of tax due with respect to their taxable income.

The residual category of rules in my system is the tax expenditure rules. A tax expenditure is a provision of an income tax system that has not been designed to serve either a sorting function or an imposition function. Tax expenditure rules are not essential features of a ideal personal income tax and are not discussed further in this paper.[14]

(a) Sorting Rules

The sorting rules of my model income tax system can be divided into four subcategories: taxable unit rules, tax base rules, income attribution rules, and taxable period rules. Those subcategories are discussed in the subsections below.

(i) *Taxable Unit Rules*

A taxable unit is a class of which the members are formally subject to taxation. The taxable unit rules in my model would define that class. They would also specify that the members of that class would be formally subject to tax.

The function of the taxable unit rules is to link the burdens formally imposed by the tax system to the persons (or entities) that the tax system is supposed to treat fairly. [*192] Thus, if the purpose of the tax is to impose fair tax burdens on certain entities, such as corporations or family units, then the proper taxable unit would be a class comprised of such entities. The proper taxable unit would be a

---

13 My model for an ideal income tax system is developed in detail in a forthcoming treatise on the taxation of the family.

14 For an extensive discussion of my methodology for identifying tax expenditure rules in a variety of contexts, see M.J. McIntyre, "A Solution to the Problem of Defining a Tax Expenditure" (1980), 14 U.C. Davis L. Rev. 79.

class comprised of individuals if the purpose of the tax is to impose fair tax burdens on individual human beings.

To impose fair tax burdens on human beings, a tax system does not necessarily have to make the individual the only taxable unit. The techniques used for imposing fair tax burden are not fundamental. It would be unobjectionable, for example, for a tax system to tax corporations, trusts, or family units, as long as the resulting tax burdens imposed on individuals were justified. That is, legal entities or other collective entities might be proper conduits for imposing tax burdens on individuals.

My model, nevertheless, would not use family units, corporations, or other entities to impose fair tax burdens on individuals. In evaluating a tax system that made some entity a taxable unit, I would recast the system as a functionally equivalent system in which the individual was the only taxable unit.[15]

(ii) *Tax Base Rules*

In this paper, I use the term "tax base" to mean the class of economic benefits with respect to which a taxpayer is made taxable. The traditional starting point in defining an ideal income tax base is the Haig-Simons income concept.

The famous definition of income proposed by Henry Simons provides a formula, albeit an incomplete one, that each taxpayer would apply to compute his or her taxable income. According to that formula, $I = C + (NW_1 - NW_0)$, where I is the taxpayer's income sources for the taxable period, C is the market value of the taxpayer's consumption for the period, and $NW_1 - NW_0$ is the change in the market value of the taxpayer's assets from the start of the taxable period (NW_0) to the end of that period (NW_1).[16]

It is implicit in this formula that the base of a Haig-Simons income tax is consumption and savings, measured by market values. That is, the material benefits that matter in ranking taxpayers according to their well-being are the market value of their consumption and the market value of their savings.

As a shorthand, I refer to the base of an income tax as taxable income. That shorthand is common, but it can be confusing, because the term "taxable income" has at least two meanings in the tax literature. It is used as I have used it — to refer to the base of an income tax; it is also used to refer to the numerical quantity that a taxpayer would obtain by applying the four subcategories of sorting rules discussed in this section. Obviously the base of an income tax is not a number, or even a collection of numbers.

My model tax system would use the tax base rules as the exclusive mechanism for specifying the economic benefits properly subject to taxation. For example, if the economies-of-scale benefits obtained from communal living by family members are determined, as the Carter Commission contended, to be a proper

---

15 For an example of how the marital unit system of the United States can be recast, for purposes of analysis, as a functionally equivalent system in which individuals are the only taxpayers, see M.J. McIntyre, "Fairness to Family Members Under Current Tax Reform Proposals" (1985), 4 Am. J. Tax Policy 155.

16 To reflect the fact that the computation of income, consumption, and savings are dependent on the choice of the taxable unit and the taxable period, the formula might be written as follows: $I(t,p) = C(t,p) + [NW_1(t,p) - NW_0(t,p)]$, where (t,p) represents the fact that the amount of income, consumption, and savings computed by the formula is the income of some taxpayer, t, over some taxable period, p.

object of taxation, [*193] then those benefits should be subject to taxation through the tax base rules, not through some other mechanism, such as a preferential tax rate for persons not enjoying such benefits.

(iii) *Income Attribution Rules*

The income attribution rules of my model would link economic benefits included in the tax base with the taxpayers whose well-being is augmented by those economic benefits. Two principles have been advanced for attributing income to taxpayers. One, called the benefit principle, would attribute income to the person who enjoys the material benefits that the income finances. In a Haig-Simons income tax system, it would tax consumption to the consumer and savings to the saver.

The other attribution principle, called the control principle, would attribute an item of income to the person who exercises primary control over it. In a Haig-Simons system, the control principle would make consumption taxable to each person who controls an item of income from its creation to its ultimate disposition.

In my model, the proper taxpayer on an item of income is the person who obtains the economic benefit that justifies the inclusion of that income item in the tax base. An item of income can provide a host of economic benefits, not all of which are enjoyed by the same person.

Consider, for example, the economic benefits obtainable from wages. The wages can finance consumption and savings. They can give the earner, and perhaps some other persons, such as a spouse, the power to consume or save. They can improve the marriage prospects of the earner, or of the earner's children, grandchildren, or other relatives. They can increase the political influence of the earner and, perhaps, the influence of members of the earner's family. The list of possible benefits from income could go on and on. It should be obvious, however, that many of the benefits on the list would not warrant the inclusion of wages in a person's taxable income.

I have argued in some detail elsewhere that the benefit principle should govern the design of income attribution rules.[17] Under the benefit principle, consumption would be taxable to the consumer and savings would be taxable to the saver. In a nutshell, the case for the benefit principle rests on the judgment that items of consumption and savings are properly taxable because of the consumption and savings benefits they provide to the consumer and the saver.

Some commentators have suggested that Haig-Simons income should be defined in terms of the power to consume and the power to save, whether or not that power is exercised. The Report of the Carter Commission has language suggesting that interpretation of the Haig-Simons income definition.[18] The

---

17 See M.J. McIntyre & O. Oldman, "Taxation of the Family in a Comprehensive and Simplified Income Tax" (1977), 90 Harvard L. Rev. 1573. See also M.J. McIntyre, "Tax Consequences of Family Sharing Practices Under New York Law: A Critique and a Proposal for Reform," (1985), 49 Albany L. Rev. 275 at 281, 339, 340; McIntyre, *supra,* note 15.

18 See, *e.g.,* Carter Report, vol. 3, *supra,* note 1, at 32 (defining ability to pay as "the total power of [a taxpayer] to command goods and services for personal use").

Report's advocacy of a "double tax" on gifts may be interpreted as support for a tax on the power to consume or save.[19] [*194]

If an income tax system has a tax base defined in terms of the power to consume or save, it should attribute income to taxpayers according to the control principle. That is, if the power to consume or save is the relevant standard for determining economic position, then the proper taxpayer on such power should be the person who obtains it.

A tax base defined in terms of the power to consume or save, should not have any appeal to a well-informed intuition. Such a base would include all types of potential consumption and potential savings. It would include the potential income forgone by those who retire early or who charge low fees for their services to the disadvantaged. It would include the gains forgone by those who choose a moderately compensated profession, such as teaching, over a highly compensated profession, such as investment banking. That is, it would include all of the benefits that individuals could have obtained by maximizing their gains from marketplace activity without reference to the outcomes of their actual conduct. Some academics have supported such a tax base, but I doubt that it could command support from the taxpaying public.

(iv) *Taxable Period Rules*

The taxable period is the interval over which income is measured. By convention, it is the calendar year in virtually all income tax systems. My model leaves open the choice of the taxable period.

There are two types of taxable period rules in my model — the rules specifying the taxable period, and the rules attributing items of income to a particular taxable period. Most tax systems rely heavily on accounting conventions developed for financial reporting purposes to allocating income among taxable periods.

Many commentators, including the authors of the Carter Report, assert that the choice of the taxable period is "inherently arbitrary."[20] That claim is too broad. Some commentators, for example, have argued on principle for a taxable period of a lifetime.[21] It should be obvious that a taxable period longer than the average lifetime of taxpayers — a taxable period of 1,000 years, for example — would be absurd. What can be said, however, is that from a range of reasonable alternatives, the choice of the calendar year as the taxable period is based on convention and administrative convenience rather than on principle.

---

19 I would attribute the Carter Commission's endorsement in principle of a double tax on gifts to its view that gift giving produces imputed income to the donor. Under the benefit principle, imputed income from gift giving would be taxable to the donor because the donor presumably enjoys its benefits. The control principle would require that the donor be taxable on income used to finance a gift and on the imputed income from making a gift. The donee would also be taxable on the receipt of the gift, resulting in three levels of tax on gifts. The Carter Commission recommended only two levels of tax on gifts, and then contrived to provide an exemption for the overwhelming majority of gifts.

20 *Ibid.*, at 23.

21 Adoption of the lifetime as the taxable period would, in effect, convert an income tax into a consumption tax, assuming that bequests at death would be treated as consumption to the deceased.

What makes the choice of the taxable period arbitrary, at least to some degree, is that tax theorists have not yet determined the proper function of taxable period rules in an ideal income tax. Nor have they determined the proper role of current payment schemes in an ideal income tax. Making the taxable period very short tends to increase the significance of the rules for attributing income to a particular taxable period, especially if the rate schedule *is* steeply graduated. With a long taxable period, taxpayers [*195] subject to withholding on their wages would bear a greater tax burden than otherwise similarly situated taxpayers whose incomes come from unrealized gains or from other gains not subject to withholding.

(b) Imposition Rules

The paradigm imposition rule in my model system is the tax rate schedule. Under some conditions, tax credits would serve an imposition function. For example, an ideal income tax would provide for a credit for taxes withheld and, under some conditions, might allow a credit for income taxes paid to foreign tax jurisdictions. Refundable credits and credits given to encourage investment would be classified under tax expenditure rules rather than imposition rules in my model.

Assuming that the society supports a redistributive tax policy, my model requires that taxable income be defined in terms of the economic benefits that the society wishes to redistribute. It would be improper, in my model, to use the rate structure to adjust for perceived deficiencies in the definition of taxable income. The proper remedy for any such deficiencies would be an adjustment in the sorting rules.

3. Critique of Carter Commission Proposals

In this Part, I discuss four features of the tax system proposed by the Carter Commission. Section (a) employs the analytical framework set forth in Part 2 to illuminate some flaws in the concept of discretionary income. Section (b) provides a criticism of the Commission's decision to make the family a taxable unit. Section (c) discusses the lack of formal income attribution rules in the Carter Commission's model. I examine the proposal for a flat rate tax on discretionary income in section (d).

(a) The Discretionary Income Concept

The Carter Commission proposed that taxpayers be taxable on their discre tionary income. To compute their discretionary income, taxpayers would first com pute the amount of their Haig-Simons income, applying the four categories of sorting rules set forth in Part 2, above. They would then subtract from that amount their non-discretionary expenditures.

The proposed deduction for non-discretionary expenditures would serve two distinct functions in my model income tax system. First, it would provide for some redistribution of Haig-Simons income, improving the economic position of those on the bottom half of the income scale relative to those on the top half of that scale. To the extent it serves that function, it should be classified as an imposition rule.

The second function of the deduction for non-discretionary expenditures would be to adjust the tax burdens otherwise imposed on family members for the economies-of-scale benefits they allegedly obtain from communal living. A tax provision serving that latter function would be classified as a tax base rule in my model system.

In subsection (i), below, I explain why the deduction for non-discretionary expenditures is an inappropriate method for achieving a redistribution of income. Subsection (ii) explains why the implicit taxation of family members on imputed income arising from communal living is inappropriate. [*196]

(i) *Redistribution of Haig-Simons Income*

To separate the issue of redistribution from the issue of the proper treatment of economies-of-scale benefits, it is useful to consider the consequences of the discretionary income concept in a world populated entirely by unattached individuals. In such a world, the only function of the deduction for non-discretionary expenditures would be to provide for some degree of redistribution of Haig-Simons income. The amount of redistribution would depend on the formula for computing the exclusion for non-discretionary expenditures and on the tax rate applied to discretionary income. Actual expenditures by taxpayers for their subsistence needs would have no impact on their tax liability.

In the imagined world of unattached individuals, the deduction for non-discretionary expenditures would not operate as a sorting rule. The amount of the deduction, being a function of each taxpayer's Haig-Simons income, would not be determined until after taxpayers had already been ranked by their Haig-Simons income. Nor would the deduction change the ranking of taxpayers established by the sorting rules. It would operate as an imposition rule and should be evaluated as one. That is, it should be evaluated by reference to its effectiveness in imposing proper tax burdens on individuals with respect to their Haig-Simons income. Assuming the distributional consequences of the deduction are considered to be proper, then the deduction would be proper.

To justify a deduction for non-discretionary expenditures that would be functionally equivalent to graduated tax rates, the Carter Commission was required to indulge two assumptions. First, it assumed that non-discretionary expenditures of taxpayers increase with Haig-Simons income; and second, it assumed that, above some low limit, the non-discretionary expenditures of taxpayers are a decreasing percentage of Haig-Simons income.[22] No attempt was made to support those assumptions, either with empirical evidence or with an appeal to intuition.

By casting its redistributive mechanism in the form of a deduction for non-discretionary expenditures, the Carter Commission has invited analysts to make the degree of control that taxpayers have over their expenditures a significant factor in determining their taxable capacity. Such an invitation should be rejected. It should not matter, for example, in determining the amount of an individual's taxable consumption, that the taxpayer feels compelled by his or her social status to throw lavish parties for friends and acquaintances. Nor should it matter, in fixing tax liability, that a society matron would "just die" if she had to appear

22 A corollary of the Carter Commission's fourth and fifth ability-to-pay principles, set forth in note 12, *supra,* is that non-discretionary expenditures increase with income but that the ratio of non-discretionary expenditures to Haig-Simons income declines with income.

publicly in last year's gown. Taxpayers with money income should be assumed in most cases to have bought what they wanted. Indeed, control over spending choices is an inherent consequence of having money income.

The conceptual weakness of the discretionary income concept is nicely illustrated by the Carter Commission's assertion that upper-income taxpayers have greater non-discretionary expenditures than poor persons. Intuition would suggest the opposite. A poor person, in order to satisfy basic needs, has limited choices in the food he can buy and the housing he can rent. A rich person has almost unlimited choices. He can buy a [*197] big house, or he can rent a cold-water flat; he can eat lobster or potatoes, and he can have his strawberries with or without cream. With very few exceptions, everything that a middle-income or upper-income person buys is the result of a free, unfettered choice. Almost nothing is non-discretionary.

To justify the redistributive policy it favoured, the Carter Commission was forced to argue that the "appropriate standard of living" for a taxpayer is a function of that taxpayer's Haig-Simons income.[23] That proposition, taken seriously, implies that money confers moral worth, that a level of consumption that would be "appropriate" for one individual would be "inappropriate" for someone with less income. Of course, the Carter Commission did not take that anti-egalitarian position. It apparently was struggling to state its preference for graduated rates without offending those Canadians who opposed a redistributive tax policy. There is some irony, however, in its adoption of anti-egalitarian language to defend its egalitarian position on redistribution.

(ii) *Taxation of Economies-of-Scale Benefits*

The Carter Commission proposed that family members be allowed a smaller deduction for non-discretionary expenditures than would be granted to similarly situated single persons. The purpose was to impose an implicit tax on the economies-of-scale benefits that family members allegedly obtain from communal living. The Carter Commission did not explain exactly what the economies-of-scale benefits are, other than to assert that two people living together typically have lower *per capita* costs for maintaining their household than a single person living alone. Apparently the benefits represent an economic gain, over market value, that most family members are thought to obtain from sharing housing and other consumer durables.

The proposal to tax economies-of-scale benefits is difficult to justify for four reasons. First, it is incompatible with the common interpretation of the Haig-Simons income concept. That concept, as formulated by Henry Simons, states that the value of consumption and savings is to be determined by reference to market prices.[24] Economies-of-scale benefits, however, are benefits obtained by extracting benefits from communal purchases in excess of their market costs.

Second, marital or family status does not provide a useful proxy for the receipt of economies-of-scale benefits. It may be that families, on average, obtain

---

23 Carter Report, vol. 3, *supra,* note 1, at 7.

24 See H. Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938), at 50. Simons states that "[t]he essential connotation of income, to repeat, is *gain* — gain *to* someone during a specified period and measured according to objective market standards. *Ibid.,* at 51 (emphasis in original).

more economies-of-scale benefits, although that proposition is difficult to test. Assuming the benefits come from communal living, however, it would appear that the large numbers of unattached individuals who share quarters with one or more friends also obtain economies-of-scale benefits from communal activities.

Third, economies-of-scale benefits are akin to many other economic benefits that are not subject to taxation. An example would be consumer surplus. [25] Assuming that the exclusion of consumer surplus and similar economic benefits from taxable income is proper, it would seem appropriate to exempt from taxation the benefits that family members allegedly obtain from sharing consumer durables. [*198]

Fourth, substantial anecdotal evidence suggests that communal living is not all peaches and cream. Sharing a house and sharing a toothbrush may have some benefits, but they also have costs. A loss of privacy and a loss of independence are two of the costs often associated with communal living.

To impose a tax on the economies-of-scale benefits allegedly enjoyed by married persons, the Commission was forced to speculate about the distribution of those benefits within the taxpaying population. At very low income levels, the Commission indulged the assumption that unattached individuals, on average, obtained greater economies-of-scale benefits than married persons.[26] To tax unattached individuals indirectly on their presumptive economies-of-scale benefits, the Carter Commission proposed that the *per capita* exemption granted to unattached individuals be $50 less than the *per capita* exemption given to married persons.[27]

The Carter Commission also assumed that middle-class married persons enjoy large amounts of economies-of-scale benefits. Those benefits were thought to diminish at high income levels.[28] To tax the economies-of-scale benefits of married persons, the Carter Commission proposed that married persons be required to pay tax on their aggregate incomes according to a special family unit rate schedule. That schedule was constructed so that a married couple would pay higher taxes on its income than two unattached individuals with the same aggregate income. As a result of the rate schedule, a marriage penalty was imposed on marital partners with substantially equal incomes.[29]

Although the Carter Commission sought to justify its separate rate schedules for unattached individuals and families by reference to its assumptions about the amount of economies-of-scale benefits obtained by married persons, it did not quantify those assumptions. I have made the calculations necessary to quantify those assumptions for taxpayers at representative income levels. The results are shown in Table 1, below. In making my calculations, I have had to make an assumption about how marital partners share income. Given the assumption of the

---

25 Consumer surplus is usually defined as the difference between the value of goods or services to an individual and the market price of those goods or services.

26 Carter Report, vol. 3, *supra,* note 1, at 15-16.

27 See *ibid.,* at 170 (Table 11-4), 174 (Table 11-6).

28 *Ibid.,* at 14-16.

29 The marriage penalty is usually defined as the extra tax that marital partners would pay over what they would have paid as unmarried persons. The maximum marriage penalty is imposed on marital partners with equal separate incomes.

Carter Commission that family members pool resources fully,[30] I have assumed a 50-50 division of income between husband and wife.[31]

As Table 1 shows, the family unit rate schedule is not compatible with the Carter Commission's stated intuitions about the extent to which married couples enjoy economies-of-scale benefits. Marital partners who would be near the top of the income scale in 1966 are implicitly taxed on large amounts of imputed income, although the Commission guessed that those persons would obtain very little economic advantage from communal living. Middle class couples with incomes between $5,000 and $20,000 ($19,500 and $78,000 in 1986 dollars) were taxable on only a modest amount [*199] of imputed income, despite the opinion of the Commission that such couples were the chief recipients of economies-of-scale benefits.

TABLE 1
Imputed Income from Economies-of-Scale Benefits Implicitly Added to Taxable Income of Married Couples by Carter Commission, 1966 and 1986 Dollars*

Taxable Marital Income		Amount of Marriage Penalty		Amount of Imputed Income		Imputed Income As Percent of Taxable Income
1966 $	1986 $	1966 $	1986 $	1966 $	1986$	
3,000	11,700	-3	-12	-18	-70	-0.6
5,000	19,500	17	66	100	390	2
10,000	39,000	17	66	74	289	0.7
20,000	78,000	67	261	239	932	1.2
40,000	156,000	1,047	4,083	2,991	11,665	7.5
100,000	390,000	5,247	20,463	11,925	46,508	11.9
200,000	780,000	8,447	32,943	16,894	65,887	8.4
400,000	1,560,000	8,447	32,943	16,894	65,887	4.2

(figures rounded)
Source: Computed from Carter Report, vol. 3, *supra,* note 1, Tables 11-4 and 11-6.
* 1966 dollars converted into 1986 dollars using an inflation factor of 3.9.

Despite the attention paid to the discretionary income concept in many parts of its Report, the Carter Commission apparently paid little attention to that concept in designing its rate structure. The high marriage penalty proposed for high income was a necessary consequence of the Commission's assumption that all Haig-Simons income of a taxable unit in excess of $100,000 constitutes discretionary income. The low marriage penalty for middle-income couples apparently was due to the Commission's attempt to reduce the tax incentive for middle-class Canadians to emigrate to the United States.[32] *Sub silentia,* the Carter Commission adopted nearly full income splitting for low-income and middle-income taxpayers because of perceived competitive pressures from the United States.

30 Carter Report, vol. 3, *supra,* note 1, at 13: "In most families incomes are pooled, major decisions are collective, and responsibilities are shared."

31 For a defence of the 50-50 pooling premise, see Mclntyre, *supra,* note 17 at 286-290.

32 Carter Report, vol. 3, *supra,* note 1, at 154, 158-162.

(b) The Family as a Taxable Unit

The Carter Commission proposed that the individuals who would be taxable as members of a family unit would be marital partners and their minor children. Other individuals would be taxable on their separate incomes. That is, the ideal taxable unit, according to the Carter Commission, would be a class comprised of family units and unattached individuals.

The taxable unit proposed by the Carter Commission would be improper in my tax model. As explained in Part 2, the function of the taxable unit in my model is to relate the burdens of the income tax to the persons who are to be treated fairly by the tax. Those persons are individuals. That is, the objective of an income tax is to be fair to {*200] individual human beings, not to the corporations they may own or the family groups to which they may belong. The most direct method for taxing individuals fairly is to impose tax burdens on them directly.

Of course, there would be no fundamental objection to the taxation of families as a unit if the tax burdens on family members were fair. The fairness of an income tax depends upon the distribution of burdens it produces, not on the techniques used to produce those burdens. The Carter Commission, however, did not contend that its use of the family as a taxable unit was simply a technique for taxing individual family members. It suggested, instead, that the family itself was a proper focus of fairness for an income tax.

The Carter Commission did not originate the idea that families should be taxable as entities in a personal income tax. It is somewhat curious, however, that it embraced that idea, given the antipathy it showed toward the taxation of other entities, such as corporations. Indeed, the case against taxing the family as an entity is much stronger than the case against taxing the corporation as an entity, for a family has no substance and no taxable capacity apart from the individuals who comprise it.[33]

According to a popular maxim, referred to in tax literature as the horizontal equity principle, equals should be treated equally. Commentators have long noted that the concept of horizontal equity is empty unless some definition is given to the term "equals" and some rule is made for measuring equality of position. In an income tax, equality of position would be defined in terms of taxable income. I believe that the term "equals" should be defined to mean human beings in the same economic position — that is, individual human beings with the same taxable income.

Through its rules for computing discretionary income, the Carter Commission provided that a family would not bear the same tax as an unattached individual with the same Haig-Simons income. That is, it did not treat an individual and a family as equal simply because they had the same amount of Haig-Simons income, just as it would not have treated a marathon runner as the equal of a race horse with the same annual earnings. The discretionary income concept,

---

33 The Carter Commission asserted, in arguing against the corporate income tax, that people, not entities, pay taxes. That assertion, properly understood, is a tautology. That is, it is an assertion that the burden of an income tax, measured by its effects on the consumption and savings of people, always falls on people. It would also be tautological to claim that only corporations pay taxes, as long as that assertion were understood to mean that the burden of an income tax, measured by its effects on the ability of corporations to pay dividends, always falls on corporations. The real reason for taxing people is that the income tax, as an instrument of distributive justice, is concerned with the fair distribution of tax burdens on people.

however, does not provide a useful analytical framework for determining how family members should be taxed relative to unattached individuals, for reasons discussed above.

(c) Income Attribution Within the Family

The Carter Commission was clearly unhappy with the *ad hoc* rules that Canada was employing to attribute income to family members. In a nutshell, those rules taxed earned income to the earner and property income to the property owner. Because of family solidarity, many taxpayers were able to reduce their taxes otherwise due by shifting income from a family member in a high tax bracket to a family member in a [*201] lower tax bracket. Tax avoidance was particularly easy for families with significant amounts of property income. Canada had enacted anti-avoidance legislation to curb abuses, but the legislation was widely viewed as complex and ineffective.

No fundamental changes were proposed, nevertheless, in Canada's income attribution rules. The Carter Commission sought to avoid the problems of fairness presented by those rules through its proposal for taxing the family as a unit. Under that proposal, the tax burden imposed on a family member would be a function of the aggregate income of the family unit, without reference to the separate incomes of the family members.

In my model for an ideal income tax system, the family unit rule proposed by the Carter Commission would be classified as an income attribution rule. In effect, the rule would impose tax burdens on family members in accordance with the share of the family income that they presumptively enjoyed. In defence of its family unit rule, the Carter Commission assumed that family members fully pool their resources. A reasonable inference, therefore, is that each family member would share equally in the aggregate income of the family, without regard to the source of that income. Thus, in my model, I would treat the family unit rule as an income splitting rule, at least for married couples.

In theory, the splitting formula implicit in the Carter Commission's family unit rule could be determined from the rate schedule proposed for family units. Determining the splitting formula is difficult in practice, however, because the Carter Commission used the rate schedule to tax family members on the benefits allegedly obtained from communal living. As shown in Table 1, above, the rate schedule can be explained as a schedule incorporating full income splitting for married couples and also as imposing a tax on married persons with respect to certain amounts of imputed income.

The Carter Commission discussed income attribution rules only in the context of income tax avoidance. Much of the language of the Report — its emphasis on the power to consume and save as the measure of taxable capacity, for example — is compatible with the case for the control principle.

In its actual recommendations, however, the Carter Commission comes rather close to an endorsement of the benefit principle. Its rate schedule for families is best understood as an income splitting mechanism, and the case for income splitting is grounded on the benefit principle. Its decision not to tax both the donor and the donee on gifts made within the family is consistent with the benefit principle and inconsistent with the control principle. And its proposed allowances

for children are best understood as techniques for taxing children rather than their parents on the income spent on their behalf.[34]

Reform of Canada's chaotic system of separate filing has been complicated over the past twenty years by the anti-reform stance of the Canadian feminist movement. The claim is repeatedly made that a joint filing system tends to perpetuate outdated views on the proper role of women in society. The fact is that the Canadian system has always had many joint filing features, especially in its relief provisions for low-income families and dependants. Those features have not perpetuated false stereotypes — they have provided appropriate tax relief to individuals in need. A majority of those receiving that tax relief are women. [*202]

In the United States, many women's organizations — on all parts of the political spectrum — have been supportive of the reforms of family taxation in the 1986 tax Act. Those reforms expanded the relief provisions for households headed by a single parent. They also increased the tax relief for low-income married couples and for persons with dependants. Important structural changes were made in the rate schedules to reduce the marriage penalties of prior law. All of these changes provide benefits to large numbers of women. They are compatible with the theory underlying the joint filing rule, and incompatible with the theory underlying separate filing.

(d) The Flat Rate Proposal

The Carter Commission proposed a flat rate tax assessed against the discretionary income of unattached individuals and family units. That flat rate proposal is functionally equivalent to a proposal for a graduate tax on Haig-Simons income, and would be so classified in my model.

No theory was presented by the Carter Commission to justify its rate structure. Although some utilitarian principles can be read into parts of its Report, the Commission did not endorse utilitarianism or any other theory of distributive justice. The reluctance of the Carter Commission to invoke a theory of justice for its organizing principles is understandable. There is no consensus theory of justice, at least in part because all of the theories yet developed have some important flaws. Moreover, the theories that have been developed do not provide much guidance for the design of an income tax.

The Commission apparently drew its organizing principles from its own intuitions about the design of a fair income tax.[35] It made no serious effort, however, to defend those principles, or even to explain why other commentators should find them intuitively appealing. The apparent assumption was that Canadians supported a progressive income tax, as evidenced by the political support given to graduated tax rates. That is, progression was simply a political fact of life in Canada.

The decision of the Carter Commission to achieve its redistributive goal through its definition of discretionary income was unfortunate. By so doing, the Carter Commission invited speculation about the percentage of a taxpayer's

34 For a discussion of the use of dependency deductions as a technique for taxing children rather than their parents on income spent on their behalf, see McIntyre & Oldman, *supra,* note 17, at 1602-1607.

35 The Carter Report, vol. 3, *supra,* note 1, at 5, expressed "an earnest hope that the ability-to-pay principles in which we believe, and from which we have derived our major recommendations, commend themselves to most Canadians".

income available for discretionary expenditures. Such speculation is irrelevant to the case for progressivity. That case ultimately rests upon a judgment that the degree of inequality in the distribution of income produced by a market economy is undesirable, for ethical or aesthetic reasons.

4. Redistribution and the Design of an Ideal Income Tax System

In this part, I show how the goal of redistribution should inform the choice of imposition rules and sorting rules in an ideal income tax system. Section (a) discusses the design of an ideal rate structure. Section (b) discusses the design of tax base rules and income attribution rules in an ideal income tax system. In both sections, I employ the tax model set forth in Part 2 as my analytical framework. That model facilitates the [*203] construction of a income tax system in which all of the constituent parts operate in concert to achieve a redistribution of market income.

(a) Design of an Ideal Rate Structure

The intuition underlying the case for progressivity is that the distribution of income resulting from market forces is, in Henry Simons' famous phrase, "distinctly evil or unlovely."[36] That is, the inequalities of the marketplace offend the moral or aesthetic values of the citizenry. By reducing inequalities in the distribution of income, a progressive income tax would promote social justice or social welfare, or perhaps both.[37]

Equality of outcomes — that is, equal distribution of income — should not be an absolute goal for a society. In determining the moral and aesthetic claims for redistribution of income, it is relevant to consider the causes of inequality. Inequality of income resulting from informed and free choices of individuals may be less offensive than inequality resulting from unequal opportunities and unequal luck. Indeed, the elimination of all inequalities in the distribution of income may be objectionable on moral and aesthetic grounds.

Some inequalities in the distribution of income are unquestionably the result of inequalities of opportunity. For example, individuals differ in their natural talents, in the amount of wealth they have inherited, in the training they have received from their parents and teachers, and in countless other ways that affect their ability to make money. Using the income tax to reduce inequalities of outcome resulting from inequalities of opportunity has considerable intuitive appeal.

It is also appealing to use the income tax to reduce the inequalities resulting from differences in luck. A good farmer might lose money, due to trade policies and other factors outside his control. Conversely, a farmer in otherwise similar circumstances might make a fortune by being lucky enough to be growing hay where some developer wants to build a shopping centre. Such unfairnesses in life cannot be eliminated. They can, and perhaps should, be reduced, however, through the use of a redistributive income tax.

---

36 Simons, *supra,* note 24, at 19.

37 The central assumption of utilitarianism is that social justice and social welfare are synonymous. Critics of utilitarianism complain that it assumes, at least implicitly, that all societal preferences are morally equivalent.

Some inequalities in outcome, nevertheless, appear to be justified, on both moral and aesthetic grounds. It would appear proper, for example, that a taxi driver working eighty hours a week would have more income than a taxi driver who chooses to work only thirty hours a week. More generally, some of the differences in outcomes that result from preferences for leisure over work, or for easy work over hard work, appear to be proper. The elimination of all such differences in outcome may be evil and unlovely.

Of course an income tax cannot be designed to distinguish outcomes that are merited from those that are unmerited.[38] By indulging some assumptions, however, tax [*204] analysts can design a rate structure that minimizes the redistribution of merited outcomes and maximizes the redistribution of unmerited outcomes. Such a rate structure would have the following features.

First, it would tax the poor at a zero rate. The assumption justifying the zero rate is that poverty is largely an unmerited outcome resulting from below-average opportunities to earn income, or from bad luck. [39] Second, the structure would have a flat rate for middle-income taxpayers. The zero rate would result in some progressivity within the middle-income group. Substantial redistribution would be avoided on the assumption that the causes of inequalities of income within that income range cannot be established. Third, it would impose relatively high marginal tax rates on high income individuals. Those high rates would be justified on the assumption that most individuals who earn high incomes have been blessed with unmerited good fortune. Fourth, the top marginal rate would not exceed a rate of 50 to 60 per cent. The cap on the top marginal rate would be justified on the assumption that some part of the income obtained by high-income individuals is merited.

Some modification in the above system might be made due to possible disincentive consequences of high marginal rates. The economic literature, however, has yet to document that rates below 50 to 60 per cent are required on efficiency grounds.[40] In any event, it is important to establish an ideal tax structure based on moral and aesthetic grounds before attempting to measure the efficiency

---

38 Some commentators have proposed an endowment tax as the ideal tax system. An endowment tax is a type of wealth tax assessed at birth with respect to the discounted value of an individual's lifetime wealth, including human capital. Such a tax could not be administered, and the base cannot even be described, except in extremely general terms. An endowment tax would also be unfair in several important respects. First, it would not adjust tax burdens for differences in outcomes resulting from luck. Second, it would compel individuals with valuable human capital to maximize their returns from that human capital; otherwise they would be unable to pay the tax assessed on them.

An endowment tax would also be remarkably inefficient, for it would discourage economic activity that provides its rewards in goods that could not be transferred to the government in satisfaction of the tax. Ironically, the endowment tax has been proposed by economists who would give decisive weight to efficiency in the design of an income tax.

39 Of course, society might favour a zero rate on the poor for moral or aesthetic reasons even if individuals freely choose to be poor.

40 In the two decades since the publication of the Report of the Carter Commission, analysts have improved their modelling tools for estimating the efficiency costs of alternative tax structures. No consensus has yet emerged, however, as to what would be the optimal tax structure for an income tax system. See J. Slemrod, "Do We Know How Progressive the Income Tax System Should Be?" (1983), 36 Nat. Tax J. 361 (concluding that the optimal tax literature provides little or no guidance to policy-makers in designing a graduate rate structure with a top marginal rate below 60 per cent).

costs of a rate structure. An efficient tax system should maximize moral and aesthetic values as well as traditional economic goods and services.

The rate structure suggested above is similar in some respects to the graduated rate structure that is implicit in the Carter Commission's proposal for a flat rate tax on discretionary income. Like the Carter Commission's implicit rate schedule, my system would exempt the poor and would impose taxes on high-income persons at a high rate. The Carter Commission, however, would have employed steeply graduated taxes in the middle-income ranges. That feature of the Carter Commission's rate schedule appears to be explained by its preference for symmetry rather than by any substantive policy objective.[41] [*205]

(b) Implications of a Redistributive Tax Policy for the Design of Sorting Rules

The sorting rules of a redistributive income tax should be designed so as to advance the goal of redistribution. In particular, the redistributive goal should inform the design of the tax base and the design of the system of family taxation. In subsection (i), below, I explain why a redistributive income tax system would not include esoteric forms of imputed income in the tax base. In subsection (ii), I explain why a redistributive income tax system would adjust tax burdens for the voluntary redistribution that typically takes place within families.

(i) *Redistribution and the Design of the Tax Base*

Over the past several decades, economists have greatly expanded the concept of income used for purposes of economic analysis. They are now prepared to treat any real or potential benefit as economic income as long as it can influence the economic choices of an individual. For example, the imputed benefit from having a wife with a pretty nose can be treated as income in some contexts because that benefit might help explain certain decisions to marry. This expansion of the economic concept of income has allowed economists to study the economic component of human conduct in many new contexts, particularly in contexts where individuals contend for rewards outside of the marketplace.

Unfortunately, many tax analysts have assumed that the expanded concept of economic income should be used, at least in theory, for defining the base of an ideal income tax. They would expand the traditional Haig-Simons income concept to include consumption and savings benefits that have no discernible market value.[42] These analysts have not attempted to explain why the definition of income developed for purposes of economic analysis should be used to define an ideal tax base. They have apparently made the assumption that the goals of the two definitions are the same. That assumption is improper.[43]

---

41 See Carter Report, vol. 3, *supra,* note 1, at 205, n. 2: "Setting the rate schedule . . . can be facilitated by using semi-logarithmic paper to plot the marginal tax rates against the logarithm of income, because equal changes in the logarithm of income are equivalent to equal percentage changes in income."

42 Tax analysts who attempt to define taxable capacity in terms of the economic concept of income come to a dead end. That is, they are led to endorse a tax that is patently unfair and that would be impossible to administer. In the tax literature, that dead end is called the endowment tax. See *supra,* note 38, for a description of the endowment tax.

43 A commitment to a naive form of utilitarianism in which all preferences are morally equivalent seems to be a occupational hazard for economists. Needless to say, the form of utilitarianism (continued...)

For purposes of economic analysis, income must be defined in terms of expectations. That is, what matters is the benefit that an individual can anticipate receiving from alternative economic choices, discounted to the present. In contrast, income for tax purposes must be defined in terms of outcomes. It must be susceptible to measurement over some period. It must, moreover, be compatible with the redistributive goal of the income tax.

As discussed above, the case for a redistributive tax policy rests on moral or aesthetic objections to the distribution of economic benefits produced by the marketplace. It does not appear to be based on objections to the distribution of economic benefits obtained outside of the market. No one argues, for example, that the existing distribution of economic benefits from having a wife with a pretty nose is "distinctly evil or unlovely." Nor is there a public outcry about the unequal accumulation of [*206] benefits from self-performed services. It seems to me that moral and aesthetic objections to the pre-tax distribution of income are raised because of the unequal accumulation of money income and in-kind benefits by those who have exploited their economic advantages through marketplace exchanges.[44]

Assuming that redistribution of marketplace rewards is the proper goal of a redistributive tax policy, it follows that taxable income should be defined in terms of marketplace rewards.[45] Those who accumulate economic benefits by contemplating their navel or by taking care of their children would not be required to share those economic benefits with their fellow citizens. The gains subject to the "tax-transfer reshuffle" should be "market-determined incomes"[46] because it is market-determined incomes that are thought to be improperly distributed.

(ii) *Redistribution and Income Splitting*

The Carter Commission proposed that members of a family be taxed as a unit, in part to protect the progressivity of the income tax. The Commission believed, quite correctly, that Canada's separate filing system was allowing some family members, especially those with significant amounts of income from property, to avoid the bite of the graduated rate structure by shifting income to a family member in a lower tax bracket. The taxation of families as a unit would eliminate the advantage of shifting income from one member of a family unit to another.

An income splitting system would also eliminate the advantages obtainable from the use of income shifting devices. An income splitting system, moreover,

---

43 (...continued)
taught in Economics 101 has been rejected by most philosophers and was never embraced by the educated masses.

44 The distribution of non-market benefits generally cannot be controlled by the dead hand from the grave, because benefits that by their nature are non-transferable cannot be bequeathed.

45 It may be that some forms of imputed income should be taxable in a redistributive income tax. A case might be made, for example, for taxing imputed income from home ownership, on the ground that it arises on account of an individual's purchase of a house (or building supplies) in the market economy. In a frontier society, however, the case for taxing imputed income from home ownership would be weak, assuming that individuals were living in log cabins and that they constructed those cabins themselves from logs cut in public forests.

46 These phrases are from A. Okun, "Further Thoughts on Equality and Efficiency" excerpted in M.J. Mclntyre, F.E.A. Sander & D. Westfall, *Readings in Federal Taxation,* 2d. ed. (Mineola, N.Y.: Foundation Press, 1983), at 77-78.

would make individuals the only formal taxpayers, thereby avoiding the problems with a family unit system discussed in Part 3. Some commentators have objected to income splitting, however, on the ground that it undermines the progressivity of the income tax. In their view, income splitting simply extends to all families the improper tax benefit that family members would obtain in a separate filing system through the use of income shifting devices.

Despite claims to the contrary, an income splitting rule is compatible with the goal of a redistributive income tax, assuming that the income splitting formula accurately reflects the actual sharing practices of family members. A tax system using an income splitting formula would sort individuals according to the income they enjoy or control[47] after voluntary transfers among family members have taken place. Sorting after voluntary [*207] transfers (gifts) is proper, assuming that the goal of a redistributive income tax is to reduce the unlovely or evil distribution of market income. The two examples below illustrate why sorting after gifts is proper.

For the first example, consider a society, ABC, comprised of three unrelated individuals, A, B, and C. Before taxes, A has income for the relevant taxable period of $90, B of $50, and C of $30. The society has a strong aesthetic preference for equality, which it is prepared to vindicate with a steeply progressive income tax. To vindicate A's own preference for equality, A gives income of $20 to B, with the result that A and B each has income, after the gift, of $70.

Assuming a revenue target of $20, how should ABC design its progressive income tax? The income splitting answer would be to impose a tax of $ 10 on A and B. That is, A, B, and C would be ranked for tax purposes with respect to their incomes after gifts. The result after the tax-gift reshuffle would be that A and B would have equal incomes, and C's position, relative to A, would have improved. Thus the reasonable goals of a redistributive tax policy would be achieved. Any further reduction in inequalities could not be achieved without raising the revenue target or having the government make transfer payments to C.

The alternative to an income-splitting plan would be a separate filing system in which graduated rates would be imposed on income prior to the gift from A to B. Assuming that the goal is to maximize the redistribution of pre-gift income, a tax of $20 would be imposed on A, thereby reducing A's income to $70. Assuming A still makes the gift of $20 to B, the post-gift distribution would be less equal than the distribution under the income splitting plan. That is, after the taxes imposed by the separate filing system, A would have $50, B would have $70, and C would have $30. Of course, a preference for equality would no longer motivate A to make a gift of $20 to B. Assuming A made no gift, the distribution would be $70 for A, $50 for B, and $30 for C. The distribution resulting from the income-splitting plan could be duplicated only if A were to make a gift of $10 to B after the tax system had finished its business.

The example above illustrates two points: first, voluntary transfers promote the goal of redistribution of market income; and second, a tax system that imposed taxes on individuals with respect to their incomes after gifts is compatible

47 Income splitting should be the system of choice for those who would attribute income to taxpayers according to the benefit principle. Advocates of the control principle should also favour income splitting if they conclude that control within the family is shared. There can be little doubt that most families share the benefits of family income to a considerable degree. That is, husbands and wives usually share the same living quarters, children are fed and clothed by their parents, and so forth. The extent to which control is shared within a family is less known, in part because the concept of control is not well defined.

with the goal of redistribution. The example below shows that in a more complex society, the goal of redistribution is best achieved by imposing taxes on post-gift income.

For the second example, assume that society ABCD has the three members described in the first example, plus a fourth member, D, who has income of $85. Assume also that ABCD has revenue needs of $20 and has a strong aesthetic preference for equality. Unlike A, D's preference for equality is not strong enough to induce D to make any gifts. A makes a gift to B of $20, with the result that, after gifts, A and B each have income of $70, and D has income of $85.

If ABCD adopted an income splitting rule, it would maximize redistribution by imposing a tax of $16.67 on D and a tax of $1.67 on A and B.[48] The result would be that A, B, and D would each have after-tax income of $68.33 and C would have after-tax [*208] income of $30. A separate filing system that sought to maximize redistribution would impose a tax of $12.50 on A and a tax of $7.50 on D.[49] Assuming no gift from A to B, the after-tax distribution would be $77.50 for A and D, $50 for B, and $30 for C. A gift from A to B would reduce or even eliminate the inequality between A and B, but it would create an inequality between A and D. That is, the tax on pre-gift income would necessarily produce less equality of distribution than a tax on post-gift income.

In real societies, most individuals are not moved by their preference for equality to make substantial voluntary transfers to middle-class individuals outside their family circle. Transfers within families, however, are commonplace. The fact that most real gifts are made to family members does not undermine the point illustrated by the examples above. The motive for gifts is essentially irrelevant. In those examples, a tax on post-gift income would result in more equal distribution of market income than a tax on pre-gift income, even if A and B were a married couple.

Whatever the motive, voluntary transfers from high-income individuals to lower-income individuals promote the goal of redistribution of market income. An income tax system concerned with redistribution should attempt to complement the redistribution resulting from voluntary transfers. A tax system that ignored voluntary transfers would tend to create unwarranted inequalities in income between family members who share and unattached individuals who do not share.

5. Conclusion

The Carter Commission proposed that Canada adopt a redistributive income tax. In form, its proposal was for a flat rate tax on discretionary income. Everyone has understood that proposal, however, to call for a steeply progressive tax on Haig-Simons income.

Political developments in Canada and in the United States over the past twenty years suggest that Canada is unlikely to accept, in the near term, a proposal for steeply progressive rates assessed on a Haig-Simons tax base. Developments in economics have suggested that the social welfare costs of high marginal rates may be somewhat greater than the Carter Commission assumed in 1966. Neither the

---

48 D's income in excess of A's ($15) would be confiscated, and A, B, and D would each pay one-third of the remaining tax of $5.

49 The income of A in excess of D's income ($90-$85) would be confiscated, and A and D would share equally in the additional tax of $15.

political developments nor the economic developments, however, undercut the case on moral or aesthetic grounds for the Carter Commission's proposal.

In formulating its ideal tax system, the Carter Commission made two questionable choices. First, it made the definition of income formulated by economists for purposes of economic analysis the touchstone for defining the tax base of an ideal income tax. That choice led the Commission to favour multiple levels of taxation on income transferred by gift. It also led the Commission to favour the taxation of imputed income arising from nonmarket transactions. Fortunately, the Commission was able to find practical excuses for not including the taxation of such benefits in the set of proposals it made to the Canadian government.

Second, the Commission proposed to make the family, rather than the members of the family, the focus of fairness in its ideal personal tax system. Again the good practical sense of the Commission saved it from the consequences of its questionable [*209] theory. By manipulating its definition of discretionary income and by making some unexplained refinements in its family rate schedule, the Commission ended up with a proposal that was functionally equivalent, at low- and middle-income levels, to marital income splitting. That is, it was a good proposal.

The Carter Commission was correct to propose reform of Canada's system of separate filing. In 1966, married individuals with substantial property income and many self-employed married individuals were mocking the system. They were routinely avoiding its high nominal tax through the use of a wide variety of income shifting mechanisms. The standard tax guidebooks sold at variety store magazine racks explained how to beat the system. Those guidebooks tell the same story today.