The debate about overhauling the federal tax system is, at the most fundamental level, a debate about the proper tax base — in effect, the proper economic definition of income. The statutory history of the income tax has generally relied on a definition of income imputed to the “common man,” a definition which the Supreme Court effectively ratified in the 1921 Eisner v. Macomber case. However, as the survey results reported in Figure 1 indicate, the popular definition of income — when compared with scientifically consistent definitions of income — is replete with internal inconsistencies. Indeed, for purposes of taxation, only one scientifically consistent definition of income exists — that definition which underpins current federal pension laws, also known as “yield income.”

Survey Design and Results

The Tax Foundation collected 104 completed copies of the survey shown as Figure 1. Most of the survey questions were taken from a similar survey published in a 1942 book by Irving and Herbert W. Fisher, titled Constructive Income Taxation: A Proposal for Reform. The survey was replicated, in part, to assess the continuity of the “common man’s” definition of income over time. The results of the two surveys were virtually identical.

The aggregate results of the Tax Foundation survey (as a percent of the answers received) were placed next to each available response of Figure 1. The sample of results was also truncated to include only the responses of those people likely to be more familiar with the details of tax law: accountants, financiers, and lawyers. In this truncated sample, the most popular responses remained the same, but the shares of such responses increased.

Putting the Survey Responses in Context

Only two definitions of income have logical consistency — “accretion income” and “yield income.” Yield income constitutes a definitional subset of accretion income. With the exception of questions 10 and 11, the survey was designed to limit answers to either the yield or accretion definition of income, with an “undecided” response allowed for each question. Questions 10 and 11 allowed for a response based upon the make-shift realization criterion of income. [An extended discussion about the intellectual lineage of accretion and yield income may be found in the Tax Foundation Background Paper No. 17 (March 1997), titled “The Concept of Income Revisited: An Investigation into the Double Taxation of Saving.”]

Accretion income also goes by the name of Haig-Simons income, in tribute to the writings of economists Robert M. Haig and Henry C. Simons. Over a designated accounting period, accretion income equates to:

Money earned but not saved + Net capital accumulation (whether through new saving or changes in the market value of existing savings).

The term “accretion” evolved out of Haig's reference to the accretion of value in a person’s wealth (capital accumulation) over an accounting period. The philosophical essence of the Haig-Simons standard involves the acquisition of economic power, the power to command goods and services produced in the economy, regardless of whether or not such power is actually exercised. In the tax laws to date, because of its link to accounting practice, the concept of accretion income has pre-
For Questions 2 through 9 and Questions 12 through 16, responses to “A” equate to a definition of “yield income,” while responses to “B” equate to a definition of “accretion income.” For Questions 10 and 11, a response to “A” equates to a definition of “yield income,” a response to “B” equates to a definition of “realization income,” and a response to “C” equates to a definition of “accretion income.”
definition of income. However, from the viewpoint of economics, this convention fails to measure actual income properly. Instead, it creates an ideal standard that bookkeepers set up for reference — it treats all capital as fixed and all “income” as a perpetual annuity. In reality, however, both capital and income are variable.

From the viewpoint of a business enterprise, the accounting practice that spawned the notion of accretion income has two important benefits. First, it enables businesspeople to compare their various operations to a fixed standard. Second, it shows, at a glance, what the history of an enterprise has been with regard to capital accumulation — and, therefore, its prospects for generating future actual income.

From the viewpoint of economics, however, accretion income (and, by extension, the realization criterion) has two major drawbacks. First, it fails to distinguish between capital and income, two economic concepts which are reciprocally related but mutually exclusive categories. Second, counting capital accumulation as income results in the double counting of actual economic income — and, therefore, double taxation. (Ironically, one can employ double-entry bookkeeping — the bulwark of accounting theory and practice — to demonstrate these economic shortcomings of accretion income.)

The Important Differences Between Capital and Income

Capital accumulation, under a rigorous scientific definition, cannot belong to the category called income. The value of capital is determined by the present (or discounted) value of expected future income. Income, therefore, is that which people capitalize. The practice of counting capital accumulation (saving) as income, therefore, ultimately results in double counting. It counts as current that which by definition is future — and counts it as current again when the future arrives.

Key differences exist between capital and income. Each difference relates to the all-important fact that additions to capital have no independent existence apart from the value of the flow of expected future income. The value of capital will vary based upon (1) the time period in which each item of expected income accrues, (2) the variation in the size of each item of expected income in the flow, and (3) the rate of interest used to discount the flow. Two other points are crucial. First, items of actual income can be varied at will, each independently of the others. However, additions to capital cannot be known until the flow-pattern of all of the actual income is known. Second, the flow of expected income does not vary with respect to the interest rate. However, to a significant degree, the value of additions to capital does depend on the interest rate.

As a general principle, then, the value of capital at the beginning of any accounting period is composed of the sum of two parts. The first part is the discounted value of the income accruing during that period. The second part is the discounted value of the capital at the end of that period. But, it is vital to understand that this end-period capital value is equal to the discounted value of all subsequent income. Additions to capital are capitalized income, not income itself.

An examination of Figure 3 helps illustrate this robust principle. Figure 3 shows an annuity which has an expected income of $1,000 for the first 14 years and $2,000 in perpetuity thereafter. Assuming an interest (or discount) rate of five percent, the price (or initial capital value) of this annuity is equal to $30,101. As Figure 3 shows, the annuity will have a capital accumulation phase over the first 14 years, at which point the capital value will grow to $40,000 — the capital value of a perpetual annuity that pays $2,000 in actual income per year with a five percent rate of interest.

One can demonstrate that the $9,899 of capital accumulation (or the annual additions that sum to $9,899) does not play the same role in the capitalization process as the actual payments of expected income designated by the annuity. That is, income and additions to capital represent fundamentally different things — so they cannot both belong to the category called income.

A straightforward demonstration of this fact comes from recalculating the price (initial capital value) of this annuity assuming that the additions to capital are income. Making such an assumption means that the numbers in the columns labeled “Additions to Capital” and “Income” are summed together and that the resulting time series (flow) is discounted at a five-percent rate of interest. The resulting present value becomes $36,836 instead of the correct valuation of $30,101.

The initial capital value increases by $6,734 when saving counts as income because double counting takes place. Items — additions to capital — that represent the discounted value of future income are being counted as items of current income. Moreover, this double counting takes place on a
Implications of the Popular Definition of Income for Tax Policy

With the exception of questions 10 through 12, all of the survey questions were taken from a similar survey published in Irving and Herbert Fisher's 1942 book Constructive Income Taxation: A Proposal for Reform. When the Fisher brothers conducted their survey, they received 100 survey responses with aggregate results virtually identical to the results of this survey. Along with adding confidence to the representative nature of the sample size, the results attest to the force of language as a social institution, even if the notions conveyed by that institution have many technical inconsistencies. The results also reaffirm the conclusion reached by the Fishers (p. 119):

To found our whole system of income taxation, as legislated and as judicially interpreted, on the common man's notions, so hybrid, self-inconsistent, confused, uncertain, and vague is preposterous — just as preposterous as for physicists to found their theory of thermodynamics on what the common man thinks is "heat."

The popular definition of income, like the accretion income standard, is inherently biased against saving. Because it fails to distinguish between capital and income, it double counts actual income and, therefore, double taxes capital accumulation. The important point about the survey results is that the "common man" has a technically confused definition of income. The point is that the institutionalization of his definition has resulted in destructive fiscal policy.

Physicists have ignored the "common man's" technically inadequate definition of "heat" and both the science of thermodynamics and the common man have benefited. People throughout the country warm their homes in the winter by using heat pumps that suck "heat" from the cold outside air.

On the other hand, economists (along with legislators and judges) have embraced the "common man's" technically inadequate definition of income and both the science of economics and the common man have suffered. The current body of tax law double taxes thrift and embodies too much complexity because it relies on a faulty definition of income. Taxpayers can eliminate the double taxation of their savings and mitigate tax-law complexity by recognizing that the tax laws which relate to money earmarked for retirement embody not the special treatment of "income" but the economically correct definition of income for tax policy.