Reforming Tax Policy for the Wealthiest One Percent

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In recent years, income inequality in the United States has reached levels not seen since the Gilded Age. Families in the top one percent are taking home an increasingly large slice of the income pie, rising to about 20% of total income during the 2000s. At the same time, the budgets of public agencies are being slashed, leaving many of the most vulnerable Americans without vital services. Drawing on my recent research, this brief connects these two trends and argues that policymakers should consider reforms to the current tax system to simultaneously counter runaway income inequality and better support the embattled public sector.

From Earnings to Investments

As the share of all income claimed by Americans in the one percent grew, the sources of their earnings also changed. In the 1990s, most income earned by elite families came from salaries and entrepreneurial activities. But by the 2000s, gains from investments were equally important to these elites. In part, this was due to the rise in executive compensation and the practice of providing top executives with stock-based compensation. But even if such compensation is excluded from consideration, almost half of the total income earned by the top one percent comes from investments.

The underlying reason is the rapid growth of financial wealth among the already wealthy. In the early 1990s, about one in twenty very high-earning families had financial investments worth over $2 million. By 2010 that portion had grown to one in two. This shift is remarkable, and indicates that the dotcom crash and the 2008 financial crisis appear to have done little to stall rapid wealth accumulation at the top.

Legal Tax Dodges

The consequences of a shift toward investment earnings at the top go beyond individual fortunes, because they also undermine public finances in several ways.

- Families in the top one percent can pay taxes at a lower rate, because *earnings from long-term capital gains and from what are called “qualified dividends” are taxed below the rates applied to top incomes from other sources.* In order to be eligible for these discounts that can cut tax burdens by one-third or more, investors must be able to hold their investments for a specified time period, typically for one year or less. These are not particularly burdensome requirements, but if investors satisfy them they can pay less than a high-income worker would for the same amount of income.

- *Other forms of investment income – such as interest on municipal bonds and unrealized capital gains – are exempt from taxation altogether.* Unrealized capital gains are “paper profits” that investors enjoy but have not technically transformed into real profits by selling their investments. Until these profits are realized, there is no tax. Recognizing this loophole, companies have increasingly turned to stock buybacks rather than dividends to reward investors, allowing those that hold their investment to enjoy tax-free appreciation.

Beyond these explicit tax preferences, investment income is also easier to shelter from the tax authorities than other types of income. Such income is not subject to payroll taxes, and so does not contribute to financing Social Security or Medicare, as regular wages and salaries do. Investments can also be put in special shelters, such as trusts or Individual Retirement Accounts to further protect assets from taxation and public scrutiny. For most people with modest incomes, the use of such shelters may make sense as a way to provide for a child with special needs or to accumulate a modest nest egg for retirement. But in the hands of the one percent, such shelters produce notorious abuses such as Mitt Romney’s Individual Retirement Account valued at between $20 million and $102 million, which will continue to grow tax-free.

All of the tax dodges I have just outlined are perfectly legal. In addition, of course, many wealthy investors illegally avoid tax obligations simply by hiding their true wealth and income. Unfortunately, such criminal tax dodges have become easier to accomplish, because financial services firms now operate globally, secret jurisdictions have proliferated, and tax enforcement has faltered in many countries, including the United States.

Equity Requires Rewarding Work Not Tax Avoidance

The guiding principle for a more equitable U.S. tax system must be to reward earnings from work rather than gains from tax avoidance and the manipulation of the tax code. I suggest several policy changes to control runaway income inequality and bolster public finances:

- **End preferential tax treatment for certain types of investment income.** Tax all income at comparable rates regardless of whether it comes from wages and salaries or investments.
- **Implement a wealth tax** for households or corporations or both, in order to eliminate tax evasion through the unrealized capital gains loophole.
- **Reform tax-deferred vehicles** such as Individual Retirement Accounts or so-called 529 college savings plans, so that they primarily benefit families with modest means and can no longer be used as giant loopholes for the one percent to avoid taxes.
- **Increase funding for tax enforcement and focus on large-scale tax defrauders**, rather than on working-class families and the poor, from whom little is to be gained.
- To help **eliminate international tax havens**, premise any international trade agreements on comprehensive cooperation and information sharing.

By simplifying tax rules and eliminating loopholes that primarily benefit the wealthiest one percent, these proposals have the potential to strengthen American democracy, replenish vital public agencies, and increase the transparency and fairness of U.S. public finances.

Read more in Michael Nau, "Economic Elites, Investments, and Income Inequality." *Social Forces* 92 (2013): 437-461.