EconoFact Chats: How the Tax System Favors the Very Rich – And What To Do About It
William G. Gale, Brookings Institution
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Michael Klein
I'm Michael Klein, executive editor of EconoFact, a non-partisan, web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein
Bill Gale begins a commentary that he published on the website of the Brookings Institution by quoting the famous exchange between F. Scott Fitzgerald and Ernest Hemingway. Fitzgerald says, the rich are very different than you and me, and Hemingway replies, yes, they have more money. But Bill also points out that Hemingway could have said, if he lived today, and if he was a public finance economist, they pay far less of their income in taxes. Not as pithy, perhaps, but accurate. Bill is a public finance economist, and in fact is widely recognized as one of the country's top experts on tax policy. The Brookings commentary he recently published points to the differences in how the very wealthy earn their income as compared to the rest of us, and the tax implications of these differences. Also, he shows how the tax code favors the rich. Bill has been a guest on EconoFact chats several times before. I'd also like to mention that Bill is the author of the important and engaging book, *Fiscal Therapy, Curing Americans' Debt Addiction and Investing in the Future*. Bill, welcome back once again to EconoFact Chats.

Bill Gale
Thank you very much. It's a pleasure to be here.

Michael Klein
Well, it's great to have you back on. So Hemingway was right, the rich have more money, but in what way do they earn their income, and how is that distinct from other people?

Bill Gale
Well, essentially very, very high income households, and I'm not talking about the top 1%, I'm talking about the 0.1%, that is the one in 1,000, or the 0.001%, the one in 10,000. They're different from most people, not only in the level of income they earn, but in the type of income they bring in. At the very highest echelons, income is much more in the form of capital gains, dividends, interest payments, and business income, whether it's from sole proprietorship or partnerships. For almost all people in the country, the bottom 80%, 90% of the income distribution, the vast portion of their money, of their income comes from either wages or pensions or social security. For the very top, it's very different, and wages are just not a very big share.

Michael Klein
Bill, what kind of dollar figures are we talking about here if we think about the 1 in 1,000, or the 1 in 10,000?

Bill Gale
1 in 100 would be about $700,000 in adjusted gross income, maybe $750,000. 1 in 1,000 would be $3 million in annual income, and 1 in 10,000 would be about $10 million in annual income. Of course, wealth is probably much higher.

Michael Klein
Yeah, that's an important distinction. The people who have high income, I guess, would also tend to have high wealth. That's correct, right?

Bill Gale
That's right. It's not a one-to-one correlation, especially if you define income in a comprehensive manner, and not in the limited manner the tax system defines it, you'd find a very high correlation between high income and high wealth.

Michael Klein
Let's talk about how taxing regular income differs across different sources of income. First, what are the tax rates on regular income? I know they differ by income level, but generally, what are the tax rates?

Bill Gale
Once you get into the taxable income range where you have to pay taxes, the statutory rates vary from 10% to 37%. There are a couple of add-on taxes at the top, which boost the rate to over 40% on certain types of income.

Michael Klein
And is this the marginal tax rate or the average tax rate? And can you describe the difference between the two?

Bill Gale
That is a very important distinction. We're talking about the marginal tax rate. We're talking about the tax rate on an additional dollar of income. Average tax rates are much lower because people have deductions they can take. They get credits for earned income or for having kids. And then the income tax only starts at a 10% rate at the lowest taxable level. The average tax rate, that's the share of taxes…the share of income that people pay in taxes is much lower, typically, than the marginal rate, which is the rate they pay on the next dollar of income.

Michael Klein
So if you were making, say, I don't know, $100,000, the first bit of that is taxed at a lower rate, then there's a bit that's taxed at a higher rate, then the marginal tax rate might be, I don't know, 25%, 30% on the last $10,000 or so. So it works out that you add up those and take the average, and that would be quite a bit lower, correct?

Bill Gale
Correct.

Michael Klein
So what about tax rates on businesses? How do those compare to tax rates on individual income?

Bill Gale
So the tax rates I mentioned earlier essentially apply to wage income, and of course payroll tax rates apply to wage income as well. Business income is subject to a deduction, a 20% deduction that was created in the 2017 Tax Act on qualified business income, where certain businesses qualify, certain businesses don't, but on qualified business income, there's a 20% reduction. So that 37% rate is cut essentially to 29.6%.

Michael Klein
And again, that's a marginal rate?

Bill Gale
That's a marginal rate, right. So essentially a dollar, someone that has income that puts them in that tax bracket, if they earn their next dollar in the form of wages, they'd pay 37%. If they earn the next dollar in the form of business income, they'd pay 29.6%. Moving forward, if they earn that extra dollar in terms of capital gains or dividends, they'd pay an even lower rate.

Michael Klein
And as you mentioned, when you talked about the personal income tax, deductions are very important. So it's not how much you take, it's your, as you said, your adjusted gross income after you're taking out deductions. And I imagine there are lots of deductions for businesses.

Bill Gale
Yeah, one of the ways to avoid taxes is have a business and fill it with expenses that some of which might be thought of personal expenses, but are hard to audit. In fact, there's some evidence that the creation of non-corporate businesses, what we call pass-through businesses, that are sole proprietorship or partnerships, there's some evidence that the creation of these things goes up when tax rates go up. And the interpretation is that they provide ways to shelter or reduce taxes.

Michael Klein
In fact, you have an EconoFact memo about pass-through entities, businesses that aren't organized as traditional corporations. Could you talk a little bit more about that, please, Bill?

Bill Gale
Sure. About half of business income in the country accrues to corporations, which get all the publicity, but the other half accrues to these pass through organizations or partnerships or LLCs or S corporations or sole proprietorships, you know, mom and pop shops. About 95% of all businesses are pass-throughs. 5% are C corporations or corporations, but of course the corporations are much larger, so they account for an equal share of total business income. And the reason this is important from a tax perspective is that there's a separate tax on corporate income, whereas pass-throughs are called pass-throughs because the business entity itself does not face a layer of tax. Rather, the income the business earns is attributed to its owners and passed through to the owners who then pay individual income tax on it.

Michael Klein
And does this result in lower taxes than they otherwise pay?

Bill Gale
Certainly the taxes in the pass-through sector are lower than the combined taxes that are paid in the corporate sector, but not by very much because the corporate sector is now subject to a 21% rate, whereas pass-throughs are subject to up to a 29% rate. But then of course, corporate income gets taxed again when individuals either sell their stock and get capital gains, or when they receive dividends and have to report that as income.

Michael Klein
So you said Bill that they're paying these pass-through income taxes as if they're individual taxes, but are there distinctions between the way that or the amount that they would pay on pass-through income and wage or salary income?

Bill Gale
Certainly. Wages are taxed at higher overall rates than the tax rate on owners of pass-through business income. And so you have this situation where business owners have incentives to report the income that they earn as business income rather than wages.

Michael Klein
This covers income from businesses. What about income from investments, interest income, dividend income, capital gains? How are these sources of income taxed as compared to wage income?

Bill Gale
Capital gains and dividends are taxed at highly preferred rates in the low 20s. That is in part because corporate capital gains and dividends are already taxed at the corporate level. But for non-corporate capital gains, there's a real benefit there.

Michael Klein
So people use the phrase bottom line, but here I guess that's really appropriate because it is the bottom line. So bottom line, what does this say about the distributional effects of the tax code…the richer paying less in taxes than the middle class?

Bill Gale
The average tax rate on income generally rises with income. That is the tax system is generally progressive. The share of income that goes to taxes goes up as income goes up. However, at the very, very top, it does not appear to remain that way. If someone gets all their income in capital gains or dividends or pass-through income, then their tax rate is going to be lower than someone who gets all their income in the form of wages, essentially undermining the progressivity of the system at the very top.

Michael Klein
So Warren Buffett famously said that he pays less in taxes than his secretary. Is that the kind of effect that you're describing?

Bill Gale
Yes, yes. And it's even worse when one thinks about all the forms of income that are not taxed that accrue to the wealthy, the most obvious one being unrealized capital gains. There's a lot of ways to avoid taxes at the very top. One of the most common strategies is what one tax lawyer dubbed ‘buy, borrow, die.’ And the idea is that someone has a lot of assets, if they want to consume out of those assets, normally you'd think they'd need to sell the assets and trigger capital gains taxes, but they don't actually have to do that. They can just put up the assets as collateral and borrow the money. And then when they pay it back over whatever, but when they die, then the basis that's used to determine the taxable part of a capital gain that's boosted to the current value. So, it's called basis step-up so that the capital gain is never taxed ever under the income tax. So, there are strategies that are commonly and aggressively used by extraordinarily affluent people to not just reduce taxes, but to eliminate taxes.

Michael Klein
So this brings us to the topic of inheritances. And I imagine this represents a very important way in which wealth is passed down from one generation to the next, which means that it reinforces income inequality, since the children of the rich themselves become rich through inheriting their parents' wealth.

Bill Gale
Yeah, intergenerational transfers are largely a scenario of the extremely rich giving to the very rich. The extremely rich being the people in their 70s and 80s or 90s who are passing on wealth in terms of their estate, and the very rich being their kids in their 40s, 50s, and 60s who are already doing quite well.

Michael Klein
You already mentioned, Bill, the step-up basis and the way that people can avoid taxes. Are there other options they have to avoid taxes that would not be available to the rest of us?

Bill Gale
Well, the borrowing against your assets rather than cashing them in is certainly one strategy like that. And I mean, you could talk to an attorney, a tax attorney for the wealthy, and come up with all sorts of mechanisms. I know there are enormous number of ways to avoid or substantially reduce one's estate tax liability. You know, there's a lot of sheltering and income tax. We're talking about legal sheltering here. There's also a lot of evasion, which is illegal sheltering. But even within the confines of the law, there's a lot of tax avoidance.

Michael Klein
On the subject of evasion, you have an EconoFact memo that I found really compelling. In the memo, you discuss how funding the IRS can actually give you very big returns in terms of taxes, because if the IRS can try to investigate greater evasion, more tax money would come in. So I guess that's relevant along this dimension as well, right?

Bill Gale
Yeah. And a lot of that revenue would come from very high income, very high wealth taxpayers, yes.

Michael Klein
And yet there are efforts in Congress to defund the IRS.

Bill Gale
Yeah. The Republicans, not to put too fine a point on it, have tried several times to defund the IRS. The latest scheme being that they couldn't provide aid to Israel unless they cut IRS funding. I mean, there's no question that if the IRS has more resources, has the resources that it has been allocated, there's no question it can go after tax cheats and bring in substantial amounts of revenue, much more than it costs to fund the IRS work.

Michael Klein
So it sounds like a good investment to me.

Bill Gale
Yeah, it is. And evasion is enormous. It's estimated to be about 3% of GDP, which is on the order of $600, $700 billion a year. Now, you're never going to collect all of that, just like you're never going to eliminate all crime, but even just making a huge dent in that would raise a substantial amount of money, especially over 10 or 20-year period.

Michael Klein
And if that were done more, I would imagine people would be more worried about trying to illegally evade taxes. So it's not only catching people, but it has a deterrent effect as well.

Bill Gale
Yes, that's correct. That is widely believed to be correct. Let me put it that way. It's sort of like a demonstration effect. I don't know that there's good evidence on that, but it is widely believed that there's not just the direct effect of the money that is collected, but the indirect effect on how aggressive taxpayers are in terms of trying to avoid/evade taxes.

Michael Klein
So you're a researcher. Maybe you could just get a grant to go and interview tax cheats and ask them how scared they would be.

Bill Gale
I would have to include travel funds to very exotic places.

Michael Klein
And maybe a Kevlar vest. So that points to a real inequity in the tax system that wealthy people have both ways to get around the tax system legally, and there seems to be more evasion among the rich. What are some ways to address this and fix a problem, Bill?

Bill Gale
Well, the most obvious way to address evasion is to give the IRS the funds that it needs to investigate all this. And the Inflation Reduction Act did that, and we'll see if that funding sticks. There are a variety of other ways to do this. They're simple, quote unquote, simple like repealing the business deduction would go a long way toward raising tax burdens on the extraordinary affluent. Taxing capital gains at death would be another policy that would have big direct effects, but also indirect effects, because there's much less reason to defer capital gains until death if they're going to be taxed at death. Right now, the main reason to defer capital gains until death is then that the capital gains liability is wiped out. And the third thing I'll mention, which might strike people as counterintuitive, but imposing a value added tax, or essentially a consumption tax would get at the lifestyles of the wealthy. That is, you can borrow money and avoid income tax, but if you're going to spend it on a lavish lifestyle, then it would be subject to a consumption tax. So that's a third way. And a fourth way, which I particularly favor, is to eliminate the estate tax, which is so full of holes, it's almost nonsensical at this point, and just treat inheritance as received as income. And so if somebody receives an inheritance of five million dollars, you stick that in income and you pay income tax on it. So there's lots of options. Not surprisingly, there are lots of ideas on the shelf for how to do this.

Michael Klein
So there are lots of options. And in today's environment, tax revenues are well below government spending and there's rising inequality. So it seems like the time is opportune to have some of these changes brought about. But in fact, do you see that there's any chance of any of these passing Congress?

Bill Gale
The factors you just mentioned are all correct and they talk to the need for doing this. Whether Congress will do any of this right now seems much less likely. And I'll just give you one example of why. In 2017, when a lot of these, a lot of provisions to benefit the wealthy were implemented in the Tax Cut and Jobs Act under Republican Congress…Republican White House, every Democrat in Congress voted against it in both the House and the Senate. And then in 2021, when the Democrats regained control of both houses in Congress and the White House, they didn't change any of the provisions. They didn't repeal any of the provisions. And so I think, I just think it's very hard for Congress to talk about tax increases, especially because tax increases, to the extent they generate revenues, they just kind of go into the void. Nobody knows what the money is spent. Are you boosting defense spending when you do this? Are you reducing debt? Are you helping education? It's never really clear. So I think one meta strategy for generating support for some of these tax increases would be to say what the money is going to be used for, to earmark the funds for specific purposes. This is especially true if you're taxing the wealthy because if you're earmarking the funds for opportunity or mobility for lower modern income households, then the tax on the wealthy becomes much more compelling because you can see how it makes sense for that to finance a program that increases opportunity or mobility.

Michael Klein
Well, Bill, I hope that the commentary that you wrote for Brookings and this interview, it becomes widely known and helps motivate some of the changes that are going to be really important as we're facing a ballooning debt burden and a way in which that threatens things like

financial stability and perhaps even the economic opportunities for our children and grandchildren. So thanks very much for joining me once again on EconoFact Chats, Bill. I always learn a lot and enjoy speaking with you.

Bill Gale
Thank you. It's always a pleasure to be here.

Michael Klein
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