The Economic Context for President Biden's Tax Proposals.

President Biden has proposed changes in the tax code and how that code is enforced to ensure that the tax burden is fairly shared by all. As wealth has increasingly accumulated for those at the top of the distribution, the tax code—the rates and rules that determine tax liabilities—has increasingly favored portfolios over paychecks. At the same time, resources for tax authorities to track compliance have been reduced, with the beneficiaries largely those whose income mostly comes from non-labor sources. Correcting these inequities will help raise the revenues necessary to invest in broadly-shared prosperity, while also injecting a much-needed dose of fairness into the code. Importantly, it will do so without raising taxes on anyone whose income is less than $400,000.

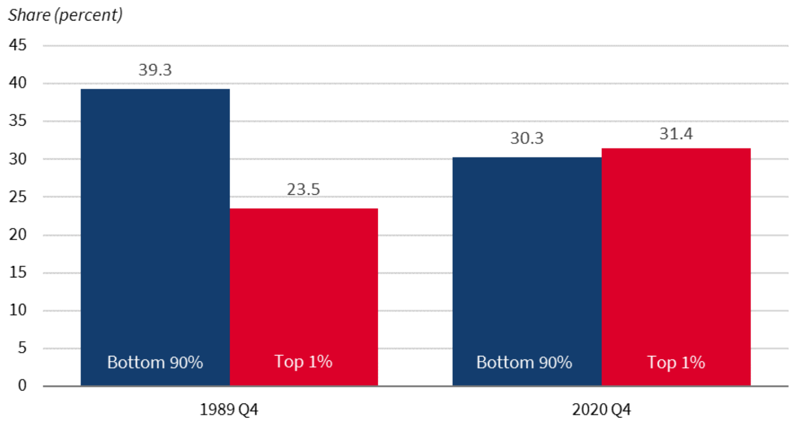
This blog examines key problems driving unfairness in the tax system and explains how the President's tax reform proposals will address these problems. It focuses on the importance of collecting taxes on personal income that is earned from investment rather than earnings.[1] As President Biden has put it—we should reward work, not wealth. His proposed reforms to tax capital income and increase tax compliance by the wealthy do just that.

Problem #1: The increased concentration of wealth

The fact that wealth has become increasingly concentrated in the United States in recent decades has been the subject of extensive economic research. According to the Federal Reserve's Distributional Financial Accounts, the top 1 percent's share of wealth has increased from 23.5 percent in 1989 to 31.4 percent in 2020 (Figure 1). Since these are changes in shares, one group's gain must be another group's loss: the share of wealth held by the bottom 90 percent fell from 39.3 percent in 1989 to 30.3 percent in 2019. American wealth gaps are particularly wide when viewed through a lens of racial inequity: an Urban Institute analysis found that in 2019, the median white family had eight times the wealth of the typical Black family and five times the wealth of the typical Latinx family.

[1] This blog does not discuss proposed changes in the corporate tax structure. For more on those proposals, see this recent Treasury Department document.

Figure 1. Share of Wealth Held by the Bottom 90% and Top 1%



Source: Federal Reserve Distributional Financial Accounts.

Problem #2: Favorable treatment of income from wealth versus income from earnings

For the majority of American households, most income comes from earnings, and most wealth comes from whatever savings they can put aside from those earnings after they have paid the bills. Congressional Budget Office data show, for example, that for households in the middle three quintiles of the income scale (the 20th to the 80th percentiles), labor earnings account for 68 percent of income. For the wealthiest households, however, most income derives from non-labor sources. In fact, for the very wealthiest households, those in the top 0.01 percent, labor compensation amounts to just 13 percent of income.

In other words, most of the income of the richest households comes not from work, but from other sources, including business income and investment gains. However, these sources of income, and investment gains in particular, are taxed at significantly lower rates than labor earnings. The top tax rate for long-term capital gains[2] and dividends paid from stock holdings is 20 percent (23.8 percent including the net investment income tax or NIIT). In contrast, the top rate on earnings is 37 percent (40.8 percent including NIIT). Because capital income is concentrated among those at the top of the distribution, these are the beneficiaries of the tax code's current preferences for capital relative to labor income.

The fact that income from wealth is increasingly concentrated and privileged by the tax code is one reason, along with the broader tax cuts that occurred in 2017, why traditional linkages between economic growth and revenue flows to the U.S. Treasury have diminished in recent years. In 2019, historical relationships would have predicted Federal revenues of about 19 percent of GDP.[3] Instead, they came in at just 16 percent of the economy, a difference in today's GDP terms of over $600 billion in one year. To put it plainly, favorable tax treatment for capital income has dramatically limited the revenues available to pay for critical investments like infrastructure, education and health care.

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[2] Short-term capital gains on equities bought and sold in a single tax year are taxed at the same rate as income.
[3] The 19 percent in the text is the result of an update in the model described here: My attempt to cut through the fog of our fiscal debate - The Washington Post

In addition to the preferential rate for investment gains, wealthy taxpayers also benefit from preferences that allow them to exclude investment gains from their income entirely. Shareholders only report investment gains as income when they sell corporate stocks or other assets and thus "realize" the gain. A shareholder whose stock has increased in value but who has not sold the stock is said to have "unrealized" gains. Because shareholders can choose when to sell their stocks, this means that they can essentially decide when—and if—they want to pay taxes on their investment gains. The most extreme example of this is the "stepped-up basis" loophole, which allows unrealized gains of the wealthy to be passed tax free down to their heirs. To state the obvious, such a privilege does not extend to working Americans, who do not get to choose whether they would like to pay taxes on their wages today or defer those taxes to some later date.

Problem #3: Non-labor income and tax non-compliance

There is one other very important difference between labor and non-labor income that has great bearing on the President's proposals: that of non-compliance with the rules of the tax code. Investment income is not only taxed at a lower rate than labor income, in many cases, taxes due on investment income are not collected at all. This is because for some of the wealthiest Americans, income accrues disproportionately in opaque categories where the IRS has no way to verify that taxes are being paid properly. In contrast, research by tax economist Natasha Sarin, now a Deputy Assistant Secretary at the U.S. Treasury Department, finds labor income is closely reported to the IRS. Therefore, when it comes to paychecks, there is little by the way of noncompliance (about 1 percent). But for non-labor income, that share falls steeply. According to the Treasury Department, "up to 55 percent of taxes owed on these less visible income streams is unpaid, with disproportionate levels of non-compliance for those at the top of the income distribution."

How the Biden tax agenda addresses these problems

President Biden's tax proposals are crafted to address increasingly concentrated wealth that is both favorably treated by the code and under-reported. In order to tax wealth at the same rate as work, he proposes to raise the tax rate on realized capital gains and dividends to the same rate as earnings for the top 0.3 percent of Americans.

This change promotes fairness in the code. In addition, research on the history of changes in capital gains taxation finds economically small longer-term responses both in terms of revenues and investment. Regarding revenues, one of the latest and most comprehensive analyses tapped extensive variation across time (1980-2016) and place (U.S. states), finding a relatively low long-term response between changes in capital gains rates and revenue flows to the Treasury. Translating this "elasticity" into a revenue-maximizing capital gains tax rate, Agersnap and Zidar estimate that rate to be between 38 and 47 percent.

Regarding investment impacts, Danny Yagan, currently the chief economist in the Biden budget office, found in a 2015 paper that the very large 2003 cut in the rate on dividend income "caused zero change in corporate investment and employee compensation." Similarly, there is a substantial body of analysis showing the lack of evidence for an increase in business investment associated with the large corporate tax cut in 2017. It should also be stressed that the findings

from these analyses came from tax changes that affected many more taxpayers than the President's narrowly targeted proposals.

The President's plan also deals with the wealth deferral problem by closing the "stepped-up basis" loophole discussed above. For those with unrealized capital gains over $1 million, and for capital gains on assets not donated to charity, transfers of appreciated wealth by gift or at death would be treated as realization events.[4] Finally, the American Families Plan proposes a ramping up of IRS capacity and a broad system of financial institution reporting to cast greater light on the types of under-reported, non-labor income that are most likely to be held by the well-off.

The President has prescribed a set of tax changes that address the increased concentration of wealth, the highly favorable treatment of non-labor income by the current tax code, and the under-reporting of such income, all of which today are contributing to a system that underperforms in terms of both revenues and fairness.

[4] Exemptions exist, including a $1 million per-person exclusion on property transferred by gift or held at death. Details of the administration's tax proposals are available in the Treasury Department "Green Book."