Simple Income Tax Rate Increases Could Be Key to Taxing Wealthy

Zachary Liscow (Yale University) and Edward Fox (University of Michigan) have a new paper titled: "The Role of Unrealized Gains and Borrowing in the Taxation of the Rich." Their research shows most income earned by the top 1% is already taxed, challenging the current focus on taxing new things.

Private wealth in the United States has ballooned over the past two decades. The number of billionaires has more than doubled and millionaires have tripled since 2000. Meanwhile, the national debt has increased by $30 trillion. Today, servicing that debt costs about $890 billion—roughly one Defense Department's-worth—per year. The explosion of both private wealth and public debt has caused people across the political spectrum to argue for creative new ways to fund the government. Critics of the current tax system argue that the 'realization rule' creates a loophole for the wealthy to borrow against unsold appreciated assets—like stocks and real estate—without having to pay taxes. However, research by economists from Yale and the University of Michigan analyzing income measures that look at the impact of unrealized gains on the tax base from 2000 to 2022, reveals that much of the income of the top 1% is, in fact, taxed. This means that, among all of the novel ways to raise taxes on the rich (such as taxing wealth or unsold gains), one effective method is also very simple: raising rates on already-taxable income.

Measuring the 1%'s Income

- Most assessments of income in the U.S. look at adjusted gross income (AGI). This is a reasonably good measure for 90% of the population. But it's less useful for the top 10% of earners because it does not capture unrealized gains and losses, which accounts for roughly 25%- 50% of their wealth.
- Fox and Liscow measure 'economic income,' which includes AGI as well as untaxed changes in the value of unsold assets each year—unrealized gains.
- And unlike most other studies that measure economic income, they do not assume standard rates of return on assets; they estimate the actual unrealized gains and losses of each income group.

The Rich DO Pay Taxes

- There are many examples of the ultra wealthy using tax loopholes to pay low tax rates. From 2014-2018, for example, the combined assets of Elon Musk, Jeff Bezos, and Warren Buffett increased in value more than $137 billion. In that same period, their income as recognized by the tax system was just $5.7 billion primarily due to the realization rule—a mere 4% of their economic income. But stories like this are outliers.

- When measuring economic income, current tax structures capture a majority of the ultra wealthy's annual income over the last 20 years:
  - Wealth-holders in the 90-99th percentiles are taxed on 75% of their economic income;
  - Those in the 99.0-99.9th percentiles are taxed on 67% of their economic income; and
  - Those in the top 0.1% are taxed on 50.2% of their economic income.
- This is not to say that unrealized gains for America's wealthiest households are not significant—they are, especially as wealth increases. But contrary to the popular narrative of the rich largely avoiding taxes because they sit on growing assets that they do not sell, the data show that a majority of their economic activity is subject to ordinary and capital gains taxes.

Traditional measures of the American tax base fail to incorporate unrealized gains. But even when untaxed performance on assets is added to these measures, the ultra wealthy are still subject to a progressive tax rate.

Borrowing Liquidity?

- Media outlets often report on billionaires borrowing vast sums of money to finance both their lavish lifestyles and their business endeavors—like Elon Musk borrowing $1 billion from Space-X and $500 million from banks backed by his appreciated shares or Larry Ellison pledging shares worth $46 billion to support borrowing.
- This is indicative of the tax advantages of what tax scholars label the "Buy, Borrow, Die" strategy: wealthy Americans buy assets, borrow against those assets to get tax-free liquid cash to spend, and then use the "step-up" rule when they die to avoid paying income taxes on unsold gains.

"Buy, ~~Borrow~~ Save, Die"

- In reality, the ultra wealthy do not borrow against a large fraction of their unsold gains. On average from 2004 to 2022, the top 1% of wealth-holders only borrowed 1-2% of their annual economic income, while unsold gains were about 40% of it.
- Borrowing while holding unrealized gains is, in fact, more of a middle-class activity than an ultra-wealthy one: Americans in the 50-90th percentiles borrowed 42% of their unrealized gains in 2022, compared to just 4% for the top 1% of wealth-holders.
- In most cases, the ultra wealthy don't need to borrow, because their liquid, taxable income—salaries, business income, and capital gains—is significantly higher than their annual consumption.
- The primary tax avoidance strategy for the top 1% is not to borrow, but simply not to sell appreciated assets.

Borrowing against unrealized gains plays a significantly smaller role in tax avoidance strategies for the ultra wealthy than previously imagined. In fact, the majority of annual income for the rich comes from taxable sources.

Income Taxes Are Surprisingly Effective

- Using our updated model of economic income, data over the past two decades show that the current income tax base captures 60% of the economic income of the top 1% of wealth holders in the United States, and 70% adjusting for inflation.
- Even with this new metric that includes unrealized gains, average income tax rates remain largely progressive—meaning the ultra wealthy pay more in taxes as a share of their income than lower wealth groups.
- And the rich don't avoid higher taxes primarily through borrowing; they just earn substantially more than they consume on an annual basis.

Tax the Rich, the Old Fashioned Way: Raise Rates

- Innovative methods of taxing the ultra wealthy, like targeting unrealized gains and borrowing, would certainly raise substantial amounts of tax revenues.
- But navigating the complex economic and political challenges to these novel approaches can distract from a simpler truth: raising ordinary and capital gains tax rates for the top 1% would also significantly increase tax revenue.