

# THE DEATH OF THE EFFICIENCY-EQUITY TRADEOFF?: A COMMENTARY ON MCMAHON'S *THE MATTHEW EFFECT AND FEDERAL TAXATION*

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**Abstract:** Professor Martin J. McMahon, Jr.'s Article on the Matthew effect presents an important and timely argument about decreasing the income inequality in the United States through the federal tax system. His contention that the rich tend to get richer is widely supported by both economic and social theories. But Professor McMahon may be too sanguine about Congress's ability to increase top marginal tax rates significantly without adversely affecting economic output. In particular, concerns about the validity of the long-term studies on which he relies, and the failure to account fully for the special circumstances of very high-income taxpayers, suggest that only modest rate adjustments would be desirable.

## INTRODUCTION

Professor Martin J. McMahon, Jr.'s outstanding Article, *The Matthew Effect and Federal Taxation*, is an important and timely work.<sup>1</sup> It brings together a great deal of disparate research, and integrates it into an argument of immense policy significance.<sup>2</sup> One can only hope that it proves influential in the debates regarding the restructuring of our tax rules that are likely to play out over the remainder of the decade. As will be clear, I have some reservations about endorsing the full measure of Professor McMahon's prescriptions. Nevertheless, his research provides a solid base for inclining toward somewhat greater progressivity in our income tax structure, reversing the tax policy tendencies of recent years.

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<sup>1</sup> See generally Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993 (2004).

<sup>2</sup> See generally *id.*

## I. INCREASING INCOME INEQUALITY AND WEALTH CONCENTRATION

The core phenomenon identified—that the rich tend to get richer—is indeed widely prevalent and has been accelerating in the United States in recent years.<sup>3</sup> Professor McMahon devotes about the first two-fifths of his Article to the most thorough documentation of this pattern that I have seen, drawing on evidence from Census Bureau reports, Federal Reserve studies, Internal Revenue Service (“IRS”) statistics, and a good deal of private research.<sup>4</sup> He makes an overwhelming case.

Increasing wealth concentration seems, in many ways, to be a natural phenomenon. Theorists from a relatively new field, called “econophysics,” have experimented recently with computer models that assume an initially equal distribution of resources, and have observed what happens when random outcomes are developed from successive iterations of zero-sum trading games.<sup>5</sup> Although one might expect that the repeated random sorting of outcomes would produce a pattern of wealth-holding resembling a normal distribution, in fact, the asymptotic tendency is for a single member of the trading community eventually to hold all the resources.<sup>6</sup>

That exact result may not be very robust; tinkering with the assumed conditions would likely produce somewhat different outcomes. But upon reflection the outcome is not necessarily counterintuitive. Somewhat fancifully, one can even imagine replicating it in a laboratory. For instance, we give Rat A an amount of cheese equal to twice his normal caloric needs, while Rat B receives only a subsistence diet during the same initial time period. Rat A consumes some of his excess allocation, but also saves some. If we assume interest-bearing cheese, the dynamics of a growing disparity in wealth take off exponentially. And if Rat A mates exclusively at the local rat country club, and sends his little rat progeny to the best rat schools, where they learn the best techniques for maze-running, thereby winning still more cheese, we would surely obtain by no later than the third generation a group of young rats who, to paraphrase the words of Jim

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<sup>3</sup> *Id.* at 993–94.

<sup>4</sup> *Id.* at 998–1044.

<sup>5</sup> An accessible summary of this research is contained in Brian Hayes, *Follow the Money*, 90 AM. SCIENTIST 400 (2002). The bulk of the material so summarized is published in journals, such as the *European Physical Journal*, which presumably are read infrequently by tax professionals. See *id.* at 405.

<sup>6</sup> *Id.* at 401.

Hightower, are born on third base and think they've hit a triple.<sup>7</sup> The need for a rat estate tax would at that point be clear to all, except perhaps for those in Rat A's line of descent.

I may be guilty of anthropomorphizing; at least I would be if this were really about rats. The point is that a tendency toward increasing wealth concentration does, indeed, seem very natural in human society. The concentration process does not even appear to depend on differences in talent or other endowments, although those no doubt exist and exacerbate the concentration tendencies. But even if we assume that only random elements determine outcomes in the initial stages of a society's economic activity, those elements will generate disparate savings opportunities that will, in future iterations, generate investment income that will exacerbate income inequality in subsequent periods. And because only people who are reasonably well off can afford to save very much of their incomes, even a modest amount of income inequality will tend over time to create a greater degree of wealth inequality. This tendency does not seem to have any natural internal economic limits.

There are likely to be political limits to this tendency, however. In a society resembling a state of nature, a person of increasing wealth would have to devote ever greater shares of that wealth to protect it from those who would appropriate it. In a more developed society, especially one governed by a democratic political system, the commonwealth will presumably have something to say about the degree to which wealth disparities are tolerable. Even in non-democratic societies, wars and revolutions have a way of correcting intolerable wealth disparities sooner or later.

## II. THE IMPACT OF THE BUSH (II) TAX POLICIES

Strangely, the *political* limits are not much in evidence today. After documenting the significant and growing disparities in income and wealth distribution, Professor McMahon examines the effects of the tax policies of the last few years, as reflected in the major tax acts of 2001 through 2003.<sup>8</sup> These acts are largely the work of the current Bush administration and the Republican majorities in both houses of Congress. Professor McMahon demonstrates the impressive extent to

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<sup>7</sup> Roxanne Roberts, *Like Father, Like Sons: The Bushes Have Become the Nation's Most Prominent Political Dynasty*, WASH. POST, Dec. 16, 2000, at C4 (attributing phrase to Texas Democrat, Jim Hightower, with regard to former President, George H.W. Bush).

<sup>8</sup> McMahon, *supra* note 1, at 1044-73.

which these acts have favored high-income and high-wealth taxpayers, thus contributing to the increasing after-tax income and wealth disparities already existing when the new administration took office in 2001.<sup>9</sup> This is not shocking news to anyone who has been paying attention, but it is useful to have it laid out as convincingly and comprehensively as it has been in his Article.

Because we live in a democratic society, one might be tempted to conclude that the increasing income and wealth concentration of recent years is, in fact, within the limits our society is willing to tolerate; indeed, far from trying to reduce the disparities, recent tax policy seems to be encouraging them consciously, with at least tacit support from the electorate. Of course, the current administration did not win even a plurality of the votes in the last presidential election. So perhaps the effects of recent tax legislation reflect no more than a technical defect in our democratic structures, which deviate from the outcomes that a more direct democracy (one without an electoral college, for example) would produce.

But the democratic defect may run deeper than that. As James Repetti has argued, democracy in an electronic age is influenced increasingly by campaign contributions.<sup>10</sup> Because they have much more disposable income and wealth than those in lesser circumstances, the rich are in a better position to advance their causes through electoral processes.

The current administration also has exploited the fact that most voters have only a crude understanding of the tax system. This has allowed the administration, with Congress's help, to enact legislation that might not be favored by a majority of Americans if they actually understood its contents. But what many voters know is the following: (1) they got a \$600 bonus, paid as a separate "refund" check, in 2001, and (2) their tax rates were reduced in 2003.<sup>11</sup> As for other tax policy debates, many voters apparently dismiss or significantly discount much of what they hear as mere partisan bickering. Thus, very modest tax cuts for middle-income taxpayers have established some minimal level of support for a package of tax changes, the overall effects of which disproportionately favor wealthy taxpayers.

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<sup>9</sup> *Id.*

<sup>10</sup> James R. Repetti, *Democracy, Taxes, and Wealth*, 76 N.Y.U. L. REV. 825, 843-49 (2001).

<sup>11</sup> This change is noted prominently on the cover page of the Form 1040 instructions for 2003, and described first among the 2003 changes summarized on page 14 of those instructions. INTERNAL REVENUE SERV., 2003 1040 INSTRUCTIONS 1, 14 (2003), available at <http://www.irs.gov/pub/irs-pdf/i1040.pdf>.

### III. EQUITY AND EFFICIENCY: NO TRADEOFF AFTER ALL?

If he did no more than document as solidly as he has that income inequality and wealth concentration are alarmingly large, and still growing, Professor McMahon would have done a great service. But the succeeding sections of his Article are much more ambitious. They begin by summarizing and integrating work over the last decade or so that seems to say that much of what we thought we knew about the impact of taxes on behavior simply isn't true.<sup>12</sup> The conventional wisdom Professor McMahon now questions goes back to at least A.C. Pigou.<sup>13</sup> It was crisply summarized by Henry Simons in his famous 1938 treatise on income tax as follows: "[I]t is reasonable to expect that every gain, through taxation, in better distribution will be accompanied by some loss in production."<sup>14</sup> This sense is reflected in the very title of Arthur M. Okun's influential book, *Equality and Efficiency: The Big Tradeoff*<sup>15</sup> And it is deeply embedded in John Rawls's sense that society should be organized to produce an income distribution that provides the highest possible income to the lowest-income individual—his so-called "maximin" approach.<sup>16</sup>

So the notion that we can accomplish some redistribution through the combination of tax and revenue programs, but only at the expense of total output, has a long and impressive pedigree, supported by the theories and research of a widely diverse group of scholars. A hypothetical illustration may be useful in demonstrating some of the dynamics of what we may call the "conventional wisdom" model of the impact of tax rates on total production. Suppose that a two-person society consists of A, a relatively high-output worker, who could produce 150 units of output per year, and B, a lower-output worker who produces 100 units per year. Suppose further that the tax rules of the society are that all output in excess of 100 units is taxed at some specified marginal rate, and that the output so collected from the high-output worker is distributed to the lower-output worker. Finally, suppose that the following table expresses the relationship between the tax rate and the output of the higher-output worker.<sup>17</sup>

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<sup>12</sup> McMahon, *supra* note 1, at 1074–99.

<sup>13</sup> A.C. PIGOU, A STUDY IN PUBLIC FINANCE 59–63 (1928).

<sup>14</sup> HENRY C. SIMONS, PERSONAL INCOME TAXATION 19 (1938).

<sup>15</sup> See generally ARTHUR M. OKUN, EQUALITY AND EFFICIENCY: THE BIG TRADEOFF (1975).

<sup>16</sup> JOHN RAWLS, A THEORY OF JUSTICE 152–57 (1971).

<sup>17</sup> This particular model assumes that taxes have no impact on the less productive worker because that is an unnecessary complication. One notes, however, that there might be a negative impact on the lower-output worker's willingness to work as well.

| Marginal Tax Rates   |        |        |        |        |
|----------------------|--------|--------|--------|--------|
|                      | 0%     | 30%    | 40%    | 50%    |
| A's Pre-Tax Output   | 150    | 140    | 130    | 120    |
| A's Tax              | 0      | 12     | 12     | 10     |
| A's Post-Tax Output  | 150    | 128    | 118    | 110    |
| B's Pre-Tax Output   | 100    | 100    | 100    | 100    |
| B's Negative Tax     | 0      | 12     | 12     | 10     |
| B's Post-Tax Income  | 100    | 112    | 112    | 110    |
| After-Tax Ratio, A:B | 1.50:1 | 1.14:1 | 1.06:1 | 1.00:1 |
| Total Output         | 250    | 240    | 230    | 220    |

This hypothetical society raises some interesting questions. For example, would the move from a 30% rate to a 40% rate be justified? Both meet the maximin condition. But the move is Pareto inefficient because it makes *A* worse off without improving the absolute situation of *B*. It does lessen inequality, however, as measured by the ratio of after-tax incomes. If reducing inequality is this society's predominant goal, then even the 50% rate could be justified.

Most theorists—including Rawls—would not push redistribution that far. But in the late 1970s, an argument began to emerge that the U.S. individual tax rates were actually beyond the point at which a maximin state would be achieved. More specifically, it was asserted that tax rates were then so high that, paradoxically, revenues could be increased by reducing tax rates.<sup>18</sup> This was the argument made by proponents of the Laffer Curve, (Figure 1), so named in honor of Arthur Laffer, the economist who supposedly laid it out on a cocktail napkin for an aide to President Gerald Ford.<sup>19</sup>

<sup>18</sup> See Jude Wanniski, *Taxes, Revenues, and the "Laffer Curve,"* 50 PUB. INT. 3, 4 (1978).

<sup>19</sup> See *id.* at 3. On his website, Jude Wanniski explains that he first watched Arthur Laffer scribble the Laffer Curve on a cocktail napkin in 1974 for Vice President Dick Cheney, then an aide to President Gerald Ford. Jude Wanniski, *Fall 2003 SSU Lesson #5 The Laffer Curve*, at <http://wanniski.com/showarticle.asp?articleid=2965> (Oct. 3, 2003).

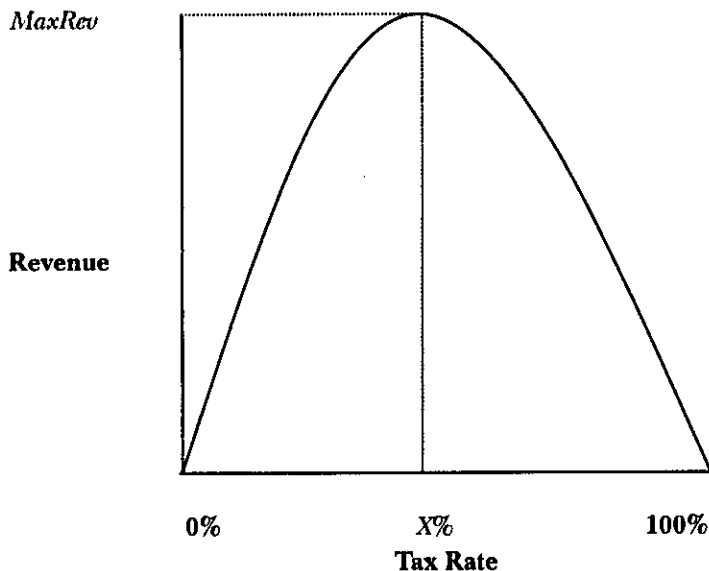


Figure 1: The Laffer Curve

As can be seen, the curve shows revenue rising more or less proportionally with the tax rate at relatively low rates, with revenue continuing to rise, but less steeply, as rates ascend into a middle area. Finally, as rates increase beyond  $X\%$ , they enter what Laffer called the prohibitive zone. Beyond that point, revenues actually fall as rates continue to rise, presumably because tax avoidance measures eat into the tax base to a degree that higher rates cannot offset.

Of course, there were two quite separate assertions contained in Laffer's argument. The first was that the generally parabolic shape of the curve represents the relationship between tax rates and revenue accurately. The second was that the U.S. tax system had reached that tipping point and was operating in the prohibitive zone.<sup>20</sup>

The first assertion has been less controversial than the second. After all, even Adam Smith has noted, in the context of a system of differential excise taxes, that high tax rates, "by diminishing the con-

<sup>20</sup> Actually, there were several other questions that might have been raised, but weren't, in part because it was politically useful to be vague about questions like, What rate are we talking about? The single highest marginal rate in the income tax? Or the marginal rate faced by the average taxpayer? And does the effect vary depending on the type of income, or on other characteristics of the person who earns it? Et cetera. Some of these will be considered below.

sumption of the taxed commodities . . . frequently afford a smaller revenue to government than what might be drawn from more moderate taxes."<sup>21</sup> That is a clear assertion that the Laffer Curve has the right shape. And until recently, an unbroken line of both economic theory and empirical research seemed to support that sense.

But there were, and still are, important differences of opinion on the second question—whether the U.S. income tax was ever in the prohibitive zone? Professor McMahon comes down on the side of the skeptics, saying flatly that the Laffer Curve has been “discredited.”<sup>22</sup> Indeed, Professor McMahon undertakes in his Article a broad attack on the very idea that tax rates discourage the production of income from either capital or labor, thus calling into question even the assumed parabolic shape of the relationship between tax rates and total revenues.<sup>23</sup>

His attack is based in large part on recent studies by economists casting doubt on the impact of tax rate changes.<sup>24</sup> The Laffer Curve depends on sharp behavioral responses—which erode or augment the tax base—to rate changes. But the recent research suggests modest, or even non-existent, responses.<sup>25</sup> That is an exhilarating possibility for one who would like to use higher tax rates to achieve income and wealth redistribution. It amounts to no less than the repeal of the trade-off between equity and efficiency.

Although I share Professor McMahon’s predispositions on this topic, I am less sanguine than he is about the data. My doubts stem from the following two separate sources: (1) technical concerns about long-run research; and (2) a sense that analysis of the behavior of very high-income, high-wealth individuals presents special problems that Professor McMahon may not have fully taken into account.

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<sup>21</sup> ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 552 (J.C. Bullock ed., P.F. Collier & Son 1909) (1776).

<sup>22</sup> McMahon, *supra* note 1, at 1076.

<sup>23</sup> *Id.* at 1077–95.

<sup>24</sup> *Id.*; see Joel Slemrod, *The Dynamic Tax Economist*, 56 THE TAX LAWYER 611, 613 (2003); see also EMMANUEL SAEZ, REPORTED INCOMES AND MARGINAL TAX RATES, 1960–2000: EVIDENCE AND POLICY IMPLICATIONS 4 (Nat’l Bureau of Econ. Research, Working Paper No. 10273, 2004), available at <http://papers.nber.org/papers/w10273.pdf>. See generally Frank Sammartino & David Weiner, *Recent Evidence on Taxpayer’s Response to the Rate Increases in the 1990s*, 50 NAT’L TAX J. 683 (1997).

<sup>25</sup> See Slemrod, *supra* note 24, at 613; see also SAEZ, *supra* note 24, at 4. See generally Sammartino & Weiner, *supra* note 24, at 683.

## IV. LONG-TERM VERSUS SHORT-TERM VIEWS

My methodological concern is simply that Professor McMahon may be relying too much on studies that purport to look at long-run tax elasticities.<sup>26</sup> A bit of a division in the economic science has arisen as to tax elasticities in the last decade or so and can be summarized as follows. An analyst can focus very tightly on the time period surrounding a tax change, in order to hold as much else constant as possible. For example, one could study the effect of a tax cut on charitable giving by comparing the level of such gifts in the year immediately before the tax change with the level in the year immediately following. Such studies have shown relatively high tax elasticities, suggesting a strong response to rate changes.<sup>27</sup>

But those studies have been criticized as revealing only short-term effects. Taxpayers may simply be timing charitable gifts that they would make in any case to coincide with the periods in which the tax effects are most generous. Thus, in the face of fluctuating rates, taxpayers wait until rates are high to make their gifts, and reduce charitable giving when rates are low. Such game-playing is largely a short-term phenomenon, because if rates remain unchanged for some time following the rate change under study, giving tends to revert to previous levels, or nearly so.<sup>28</sup>

Although there is no doubt much truth in this argument, there are other problems with trying to prove "permanent" effects by analysis of long-term data. One problem is that the background economic facts change over time, and the more time a study encompasses, the more change one can expect to find. Analysts try to account for those changes that can be identified and measured, but there is always some uncertainty about whether important variables have been omitted or have not been accounted for adequately.

As one considers social and economic changes over the last several decades, several changes that might influence long-term economic data come to mind. Married women's increased participation in the labor force, and women's concomitant increase in investments in their hu-

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<sup>26</sup> See McMahon, *supra* note 1, at 1077-95.

<sup>27</sup> See, e.g., Martin Feldstein & Charles Clotfelter, *Tax Incentives for Charitable Contributions in the United States*, 5 J. PUB. ECON. 1, 24 (1976) (presenting the first study to model and measure these effects rigorously).

<sup>28</sup> See, e.g., William C. Randolph, *Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions*, 103 J. POL. ECON. 709, 709-10 (1995).

man capital, is one that may have salience.<sup>29</sup> The net annual gains in prices of stocks have fluctuated dramatically over the last several decades; this could also be a confounding factor.<sup>30</sup> Increased globalization and the increased efficiency of communications and information processing could also present confounding factors to long-term studies.<sup>31</sup>

## V. THE VERY SPECIAL CASE OF VERY HIGH-WEALTH INDIVIDUALS

My second concern relates to the degree to which overall data may obscure aspects of the behavior of very high-income, high-wealth individuals. An example is the assertion by Professor McMahon that the Laffer Curve has been discredited.<sup>32</sup> Certainly the revenue data in the years following the Economic Recovery Tax Act of 1981<sup>33</sup>—the act most closely associated with the Laffer Curve justification—appear to show a significant decline.<sup>34</sup> This indicates that the pre-1981 rate structure overall almost certainly was not in the prohibitive zone of the Laffer Curve.

But analysis of high-income taxpayers has been much more equivocal. Supply-side economists, such as Lawrence Lindsay, found that the rate cuts phased in during the early 1980s did produce a

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<sup>29</sup> For example, Professor McMahon argues that as tax rates have fallen, so has the average work week, suggesting a direct rather than the predicted inverse relationship of tax rates and hours worked. See McMahon, *supra* note 1, at 1082. Although hours per employee could be declining, hours per household could be increasing if female labor force participation is increasing.

<sup>30</sup> For example, because personal savings as conventionally measured does not include unrealized gains or losses in assets, studies of savings as a function of tax rates may miss the fact that in years of rapid growth in stock values, taxpayers may have believed (perhaps correctly) that the increasing values of their portfolios obviated the need for additional savings.

<sup>31</sup> For example, the greatly increased sophistication in capital markets, powered in part by technological change, has led to much-increased use of exotic financial instruments like hedge funds, collars, and the now-proscribed "short sales against the box." These devices made it even easier for high-wealth individuals to avoid being taxed on their capital gains. Because these devices were growing in use just as capital gains rates were falling, they could have complicated the view of capital gains tax rates as a determinant of capital gains realization rates.

<sup>32</sup> McMahon, *supra* note 1, at 1076.

<sup>33</sup> Pub. L. No. 97-34, 95 Stat. 172 (1981) (codified as amended in scattered sections of 26 U.S.C.).

<sup>34</sup> Less than two years after the passage of the 1981 Act, the President's Council of Economic Advisors indicated frankly that "[t]he Federal budget deficit has become a major problem for the American economy." ECONOMIC REPORT OF THE PRESIDENT 26 (1983). Tables included as an appendix to that report indicated that the fiscal year 1983 budget deficit was expected to be \$201.1 billion, nearly four times the size of the fiscal year 1981 deficit of \$59.1 billion. *Id.* at 251.

markedly positive revenue response among high-bracket taxpayers, confirming the prohibitive zone presumption for that subgroup of taxpayers.<sup>35</sup> Economists at the Congressional Budget Office (the "CBO")—hardly a hotbed of supply-siders—appear to have agreed with these findings.<sup>36</sup> Even Joel Slemrod and Jon Bakija, who wrote the source Professor McMahon cites for the proposition that the Laffer Curve has been discredited, concede that the increase in incomes of high-income taxpayers in the years following the Tax Reform Act of 1986<sup>37</sup>—the second of the dramatic rate cuts undertaken during the Reagan administration—was due in substantial part to the effects of the tax cuts.<sup>38</sup> To be fair, Slemrod and Bakija offer explanations other than the Laffer Curve for much or all of the effect.<sup>39</sup> Nevertheless, in their section on the effect of rate changes on high-bracket taxpayers, they note that "[t]he evidence from years surrounding announced or anticipated tax changes clearly reveals a mixture of timing responses *and the more permanent responses to tax changes*, and it is difficult to sort out one from the other."<sup>40</sup> As to high-bracket taxpayers, then, this is hardly the repudiation of the Pigou/Okun/Rawls/Laffer relationship that Professor McMahon seems to suggest.<sup>41</sup>

And it is high-bracket taxpayers that we are mostly concerned with in considering the issue of whether the tax system can be used to lessen the existing income and wealth disparities. In Part VIII of his Article, Professor McMahon urges a return to a more steeply graduated rate structure and repeal of preferences for capital gains.<sup>42</sup> But if those changes produce little additional revenue, not much redistribution can be accomplished. We could still reduce inequality to some degree, but we would be doing so by lowering high incomes without raising low ones. The ethical desirability of such a move is dubious.

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<sup>35</sup> LAWRENCE B. LINDSEY, *THE GROWTH EXPERIMENT: HOW THE NEW TAX POLICY IS TRANSFORMING THE U.S. ECONOMY* 81–92 (1990).

<sup>36</sup> Rosemarie M. Neilson et al., *CBO Replies to Lindsey*, 35 *TAX NOTES* 496, 501 (1987).

<sup>37</sup> Pub. L. No. 99-514, 100 Stat. 2085 (1986) (codified as amended in scattered sections of 26 U.S.C.).

<sup>38</sup> JOEL SLEMRD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES* 147 (3d ed. 2004) (stating that "the sharpness of the increase [in incomes of high-bracket taxpayers] right around 1986 suggests that the tax cut [in that year] was a major factor in the increase"); McMahon, *supra* note 1, at 1076 n.339.

<sup>39</sup> SLEMRD & BAKIJA, *supra* note 38, at 147.

<sup>40</sup> *Id.* at 149 (emphasis added).

<sup>41</sup> See McMahon, *supra* note 1, at 1076.

<sup>42</sup> *Id.* at 1122–28.

## VI. RISING ABOVE THE DATA

In the absence of proof that raising taxes on the wealthy would actually produce significant additional revenue, one is forced to rely on intuition. One way to inform one's intuition about this issue is to consider some aspects of the Laffer Curve analysis described above. The Laffer Curve represents the effects of tax elasticity—the marginal tax rate diminishes the net price at which taxpayers can sell their labor, or rent their capital, and thus discourages those activities. But it is clear that the shape of the Laffer Curve varies among taxpayers, as well as for different types of income. It makes sense, then, to think of the set of Laffer Curves that may represent taxpayer responses in several of the most likely paradigms.

By far the most common paradigm for the general population is income from full-time employment. As to such income, one would expect relatively low tax elasticity. After all, most full-time employment situations simply do not offer much flexibility in terms of the amount of labor the taxpayer can sell. Few full-time employees would have the option of working 35-hour weeks when taxes are high, or 45-hour weeks when taxes are low.

Income from employment, however, is much less significant, as a proportion of income, for very high-income taxpayers than for those in less lofty income ranges. According to IRS statistics, 75.2% of all income of taxpayers with adjusted gross incomes below \$1 million was from wage and salary income.<sup>43</sup> But only 31.1% of the income of taxpayers above the \$1 million level was from wage and salary sources.<sup>44</sup> In the top category, among those with incomes above \$10 million, only 25.2% of income was from those sources.<sup>45</sup>

What is the primary source of income among the wealthy? In large part, their income is derived from capital gains. While taxpayers with adjusted gross incomes below \$1 million received only 2.9% of their 2001 income in the form of capital gains, taxpayers above that level received fully 31.8% of their income in that form.<sup>46</sup> In fact, among taxpayers in the highest category—with adjusted gross in-

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<sup>43</sup> These calculations are based on INTERNAL REVENUE SERV., TAX YEAR 2001: INDIVIDUAL INCOME TAX RETURNS tbl.1.4, available at <http://www.irs.gov/taxstats/article/0,,id=96586,00.html> (last visited Oct. 15, 2004).

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

comes in excess of \$10 million—more than half of their aggregate income (50.5%) was in the form of capital gains.<sup>47</sup>

This is terribly significant, because the most important circumstance to be considered in constructing a Laffer Curve specific to a particular type of income is the ease with which the tax on that type of income can be avoided. And in a tax system with a realization requirement, the tax on capital gains is by far the easiest to avoid—one simply avoids having the realization event that would trigger the tax.<sup>48</sup> One crucially important aspect of this is that, in most cases, avoiding a tax requires avoidance of the income itself. One refuses, for example, an opportunity to work overtime hours, thus avoiding the tax on the income one might have had, but at the cost of losing the after-tax income as well. In the case of capital gains tax avoidance, however, the income is still there; it just hasn't been converted to cash.

The wealthy are skilled at avoiding realization events and would become more so in the face of higher rates. If they need liquidity, the wealthy can usually borrow against the assets in their portfolios without generating a realization event. If they wish to diversify their portfolios to guard against the risks of having too much of the portfolio invested in a single type of asset (such as founder's stock in a corporation), there are a variety of ways to proceed.<sup>49</sup> The devices available are not perfect substitutes for a sale of the asset and can be somewhat costly. Thus, we continue to see taxpayers realizing some taxable capital gains. But if we were to both increase overall marginal rates to something in excess of 40%, and repeal the special rates for capital gains, we would nearly triple the rate—now generally only 15%—applicable to most capital gains. It is simply unreasonable to think that the effect of such changes on realization rates would be anything short of dramatic.<sup>50</sup>

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<sup>47</sup> *Id.*

<sup>48</sup> Because section 1014 of the Internal Revenue Code generally gives heirs a basis equal to the value of the asset at the testator's death, accrued gains need never be taxed to anyone if the asset is held until death. See I.R.C. § 1014(a) (2000).

<sup>49</sup> A full description of the methods is beyond the scope of this Commentary. For this purpose, a simple device is to contribute the stock in question to a partnership formed with others who are in the same position, but have different assets to contribute. The contribution to the partnership ordinarily will not be a realization event, and the interest in the partnership will be more diversified than the assets that each partner contributes to it.

<sup>50</sup> Note that since 1981, the maximum rate on long-term capital gains has never been higher than 28%, and, until last year, never lower than 20%. Thus, any econometric studies of data within the last twenty-three years could have examined only a narrow range of rate changes. Even assuming that the studies that show relatively low responses to capital gains changes are accurate, it would still involve a good deal of unscientific extrapolation to infer that rates in the 30% range and above would not produce more dramatic taxpayer responses.

Capital gains are the extreme example, but it is generally true that tax burdens on income from capital are easier to avoid than those imposed on income from labor. And that is critically important if the goal is to extract more revenue from the very rich, whose income is largely derived from capital rather than labor. Among other things, it is often possible to convert potential ordinary income from capital into capital gains, such as by adjustment of dividend policies of corporations that the taxpayer controls or can influence. It is also easier to evade taxes with respect to capital income than with respect to labor income. The latter is typically received from a U.S. payor who reports the payment to the IRS. But it is relatively easy to get capital out of the United States, in which case evading tax on the income from that capital is as simple as opening a numbered account in one of the several off-shore jurisdictions catering to the market for this form of evasion.<sup>51</sup>

### CONCLUSION

In summary, I remain skeptical that trying to increase tax rates on high-income taxpayers to anything resembling the pre-1986 levels would be very effective in significantly reducing the income inequality and wealth concentration problems we face. Nevertheless, Professor McMahon's analysis does show that we need not be terribly nervous about modest adjustments in rate structures. His analysis of the data does suggest that a return to the rate structure that applied before 2001 might well improve equity at little or no cost in terms of economic output or growth.<sup>52</sup> Beyond that, who knows?

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<sup>51</sup> See McMahon, *supra* note 1, at 1078–80. Professor McMahon argues that if enforcement is the problem, then better enforcement is the solution. *Id.* at 1079. But I don't think it is that simple. Enforcement has sizable costs in terms of direct government resources, private compliance costs, and psychic losses due to intrusions and loss of privacy that may be imposed on both compliant and noncompliant taxpayers. (For example, customs agents could thoroughly search every American citizen or resident who leaves the country to assure that individuals are not carrying more than the permitted amounts of cash, or high-value commodities such as diamonds. But for every misbehaving taxpayer we found, we would have needlessly inconvenienced hundreds of individuals who had no intention of funding off-shore accounts.) One notes as well that enforcement costs are themselves partly a function of tax rates—as rates increase, so do the gains from cheating, and so too will the enforcement costs necessary to maintain acceptable compliance levels.

<sup>52</sup> See *id.* at 1074–99.