Taxing 'Bigness'

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Often we examine the nature of our tax systems by reference to some idealized tax and then analyze the deviations. Thus we might define the individual income tax by reference to a tax on pure income and then note the zillion departures from that pure system.

An alternative approach is to let the features of the actual tax system define just what has been created without initial reference to some ideal. Then we can ask whether the objectives apparent in that system are really being met. The latter approach essentially starts with our revealed preferences, or at least the preferences of those elected officials responsible for the system we have been bequeathed.

I suggest that there are three major features of our multi-tiered tax structure that together reveal a fundamental distrust of "bigness." They are (1) the graduated rate structure in the individual income tax; (2) the corporate income tax; and (3) the estate and gift tax. Much of our tax system can then be understood as front-door and back-door attempts to restrict the actions of individuals and businesses that have attained a certain size—mostly, but not always, measured by income, wealth, or attainment of corporate status. What I will not assess here is whether that is an appropriate target or whether the tax system is better than antitrust laws and other mechanisms to try to limit the power of those who are "big" by some measure.

Let's begin with the individual income tax. Its graduated rate structure attempts to assess a higher tax rate on those with higher incomes. It does succeed in that effort, but only so far. For practical reasons, one top marginal rate applies to income beyond a certain level. Thus, one might argue that the income tax is progressive up to perhaps a few hundred thousand dollars of income, but is flat after that point. Moreover, when excise and social security taxes are taken into account, the system as a whole is much flatter than when income taxes are considered by themselves.

Complicating matters still more is that most capital income is recognized on a voluntary basis. If one examines the portfolios of most wealthy individuals, most assets are held in the form of corporate stock or real estate. In the case of stock, most returns are in the form of capital gains that often are not recognized. In the case of real estate, borrowing and the deducting interest—in particular, the inflationary part of the interest rate—tend to offset much of the income that otherwise would be recognized. Many billionaires typically recognize only a few million dollars of income a year—with the rest accruing in the value of their portfolios. Complicating matters still more is that at the top it has become even more difficult today to separate capital from labor income.

When it comes to labor income, most received by middle and upper classes is subject to individual income taxation. But even here there are many exceptions. Many successful farmers accrue much of their income in the value of land—"cash poor and land rich" is a common designation with implications for the tax system as well as the farmer.

Some capital-intensive self-employed business persons might also be able to leverage up assets so that current deductions are taken against an increased value of assets that is not recognized immediately for tax purposes. Stock options also pose the question of whether they represent capital or labor income; either way, they often offer the individual (but not necessarily the business) an opportunity to defer tax on income.

Next, consider the corporate income tax. Tax policy experts have often railed against the needless double taxation of income from corporations versus income of noncorporate enterprises, interest income, some foreign source income, and most wage income. Yet integration of corporate and individual income taxes and other reforms to alleviate the double taxation have been hard to achieve, especially in the United States. That is mainly because such reforms are viewed as providing benefits to those who are "big." The corporate income tax, adopted even before the individual income tax, was clearly intended, at least in part, as an attack on those corporations that had grown large and powerful at the end of the 19th and beginning of the 20th centuries.

However, the tax system does not tax "big" organizations or rich individuals evenly. Large partnerships and special corporate or limited liability companies are not treated as corporations subject to corporate income tax. Moreover, the recent growth in corporate tax shelters seems to make use of mechanisms that leverage up interest deductions or foreign income or partnership income in ways that allow income to escape one or more levels of taxation.

Further, when corporate taxes are assessed, they often impose burdens on owners of pension assets or owners of modest amounts of corporate stock. Those individuals can easily pay at higher rates than many who are more wealthy, such as those with large amounts of partnership assets.

In the broadest sense, however, corporate tax collections are by far the largest source of taxation of capital or capital income. Corporate tax collections are quite significant when compared to collections of individual taxes on capital income or estate taxes.

But while estate taxes are small relative to most other forms of taxation, they still may be one of the few ways that taxes are assessed on the wealthiest individuals who do not recognize income during their lives and then are forgiven any tax on any accrued capital gains at death. Of course, here, too, much tax can be avoided, especially by judicious use of various deductions and transfer possibilities before death. Recently, the University of Michigan Office of Tax Policy and the Brookings Institution held a conference on the estate and gift tax. Participants constantly noted that individuals with similar wealth could be taxed very differently through the existing estate and gift tax system. What they did not necessarily conclude was that the irregularities here were any larger or more egregious than those that apply to the rest of the ways the tax system attempts to tax capital and capital owners.

The attack on bigness in the estate tax is revealed especially by the complete marital deduction (which tries to prevent the tax from being assessed more than once a generation), the charitable deduction (which essentially allows the tax to be forgiven if one shares with the public and not simply with one's own family or friends), and the very large exclusion amount that is allowed before any tax is assessed on the remainder.

In summary, if one wants to understand much of the existing tax structure, recognize it for better or worse as an attack on bigness.

Other Publications by the Authors

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