OPINION POINT

Diagnosis of and Proposed Remedies for Structural Problems in the Federal Tax System

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Under the 2012 rate schedule, the federal income tax system is nominally progressive, but actually operates as a dual tax system. Although the rate schedule is progressive for all taxable income up to $388,350, it functions as a flat tax for higher income levels. This article sets forth four major problems with the current system—inequitable tax rates, distorted political processes, weakened economic resiliency, and increased volatility. It then proposes two remedies—additional marginal rates and an adjustable transaction tax.

Inequitable Tax Rates

The federal income tax system is inequitable because people in significantly different income groups are taxed as if they were similarly situated. Notwithstanding the application of the alternative minimum tax, individuals in the highest tax bracket pay a flat tax for all taxable income earned over $388,350 and even lower rates for dividend and long-term capital gain income. As a result, taxpayers who are in drastically different economic positions may pay the same marginal rate of tax. For example, individuals with $500,000 in taxable income pay the same rate of tax on all taxable income over $388,350 as individuals with taxable income of more than $500 million. In contrast, individuals with $500,000 in taxable income are in a higher marginal bracket than are individuals reporting $100,000 in taxable income. Individuals earning $500,000 are more like individuals earning $100,000 than they are like individuals earning $500 million because their economic positions are closer together. The Code is inconsistent because it treats individuals earning $500,000 differently from individuals earning $100,000 but treats these same individuals identically to individuals earning $500 million.

This is inequitable because fairness requires that similarly situated people should be treated similarly. While this is a simplified view of fairness because what "similarly situated" means is purely a contextual question, this view of fairness holds true because the disparity in income between individuals earning $500,000 and individuals earning $500 million is not *de minimis*. It is significant enough to call into question the justification for similar treatment under the Code, especially when individuals who are more similarly situated are treated dissimilarly.

Distorted Political Processes

The current federal income tax system distorts political processes by creating political incentives that are not in line with the reality of the true distribution of income. Because the Code treats income groups in drastically different economic positions similarly by grouping them into the same tax bracket, these income groups have the incentive to vote similarly on measures aimed at the highest tax bracket even though they would have differing political incentives if their tax treatment were more in accord with the true distribution of income. For example, individuals with taxable incomes of $1 million and $100 million would have an incentive to vote similarly in response to a proposed tax increase on individuals in the highest tax bracket because they would both be similarly affected by the increase. If these same individuals were not in the same tax bracket, they would not have the same incentive to vote similarly because, depending on how the tax brackets would be reconfigured, an increase in taxes on the highest tax bracket would not affect them in similar fashion.

In contrast, the Code further distorts the political process by treating some similarly situated income groups dissimilarly and creating diverging political incentives among these relatively similar groups. For example, under the current configuration of the Code, an individual with taxable income of $100,000 and an individual with taxable income of $1 million would not have the same incentive to vote similarly in response to a proposed tax increase on individuals in the highest tax bracket because the increase would not affect them similarly. Given that the individual with taxable income of $1 million would have the same incentive to vote similarly on this increase as an individual with taxable income of $100 million, these incentives are inaccurately aligned under the Code. Individuals with taxable incomes of $1 million are relatively more similarly situated to individuals with taxable incomes of $100,000 than to individuals with taxable incomes of $100 million because their economic positions are closer together.

Weakened Economic Resiliency

Economic resiliency is the policy-induced ability of an economy to withstand or recover from the effect of

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exogenous shocks. The current federal income tax system weakens economic resiliency by limiting the availability of government services and diluting the sustainability of market demand. Generally, the health of the economy is contingent on having robust markets for goods and services. During poor economic conditions, businesses can be forced to contract, or even close, because of the lack of revenue. Under Keynesian economic theory, individually rational microeconomic behavior by individual firms, such as laying off workers, can lead to inefficient aggregate macroeconomic outcomes in which the economy operates below its potential output and growth rate. Unemployment stemming from economic contraction can exacerbate economic recessions because without solvent consumers, the demand for goods and services is weakened and private revenue streams are diminished. As unemployment rises, economies can enter a downward spiral in which poor private revenue streams necessitate contraction, which reduces private revenue streams even further, which in turn, necessitates additional contraction.

In the midst of economic contraction, government subsidies, such as unemployment insurance, and public investment, such as the construction of public works, can ensure that the cycle of productivity continues without significant disruption. Government subsidies and public investment help to sustain aggregate market demand and avoid a glut in supply by making resources available to maintain a least a minimum level of consumption. However, low rates of taxation dilute the ability for governments to grant subsidies and initiate investments, which can prolong contraction or stall recovery when the economy is weak and the private sector is unable to independently produce jobs at a rate that would maintain the integrity of market demand. While taxation alone cannot stimulate the economy in poor economic conditions, a reliable social safety net is necessary because at least a minimal level of consumption is needed to ensure the ongoing viability of productive processes and the economy as a whole.

Increased Volatility

The current federal income tax system exacerbates volatility in the market because it encourages "boom and bust" economic cycles by perpetuating excessive capital concentrations among upper-echelon income groups. It creates excessive capital concentrations by allowing upper-echelon income groups to retain a greater percentage of capital than they would if they were subject to a progressive tax imposed at a higher rate. Generally, as capital is concentrated, the utility of that capital to its owner is diminished. The diminishing utility of capital is an important concept because less care is likely to be exercised as more capital is accrued. Maximizing rates of return, and not ensuring stable incremental growth, increasingly drives speculation in the market when assets are overwhelmingly controlled by upper-echelon income groups because the incentive to invest with an aversion to risk diminishes as capital becomes increasingly concentrated.

The willingness to assume risk is good for economic growth because it enhances market liquidity and increases levels of investment by attracting capital into the market. But excessive risk-taking is bad for the economy because it increases the likelihood that prices will become distorted due to the lack of prudence in making investment decisions. These distortions in pricing eventually lead to radical market corrections (market crashes) through which market prices ultimately revert to levels that are more in line with their actual value. Excessive capital concentrations create more volatility in markets because, as capital is accrued in upper-echelon income groups, there is less incentive to invest capital with the prudence and aversion to risk that is necessary to minimize volatility and ensure economic stability.

Remedy: Additional Tax Brackets

Congress should amend the Code to create new tax brackets that incrementally increase the marginal rate of tax beyond the $388,350 threshold to realistically reflect the levels of income generated beyond the highest current rate. For example, the Code could include brackets, and correspondingly progressive tax rates, for individuals earning $1 million to $5 million, $5 million to $10 million, etc. This amendment should also require the recalculation of tax rates and brackets to be performed at fixed intervals to ensure that tax rate brackets accurately reflect true income distribution. Ultimately, the actual brackets created and the rate schedule set should be determined by using independent estimates extrapolated from historical data and statistical projections in order to accurately reflect contemporary income distributions and adequately provide for the nation's security and welfare.

Creating additional tax brackets would promote more fairness in tax assessments because it would subject upper-echelon income groups, who are assessed a flat tax for all taxable income beyond the $388,350 threshold, to the same progressive tax treatment that characterizes tax assessment for income groups under that threshold. This would be more equitable because treating upper-echelon income groups differently from all other income groups without sufficient justification is arbitrary, capricious, and functions to perpetuate inequality in the distribution of wealth by allowing these groups to retain a larger percentage of their income than if they were subjected to the same progressive tax treatment that characterizes tax assessment for every other income group.

Creating additional tax brackets, and correspondingly progressive tax rates, would generate additional governmental revenue because upper-echelon income groups would pay higher rates of tax on their taxable income. Currently, ordinary

taxable income above $388,350 is taxed at a 35% rate. Thus, an individual with $100 million is in the 35% marginal rate bracket. Under this proposal, that individual would be subject to a higher rate of tax, with the actual rate depending on how the additional tax brackets and correspondingly progressive rate schedule are reconfigured. The increased rate should result in higher governmental revenue.

Amending the Code to require that the Service regularly recalculate tax brackets and progressive rate schedules would create greater flexibility in determining the rate structure over time. It would allow the Service to adapt the structural configuration of the Code to changing demographic conditions. As the distribution of wealth changes, currency values fluctuate, and the particular revenue requirements of the nation's welfare and security ebb and flow, it is important to have a mechanism by which the Code can be tailored to meet changing needs and rapidly evolving circumstances. Giving the Service the power to create additional tax brackets and new rate schedules would allow for more precision in shaping the Code to raise revenue from particular income groups as the need arises. The power to create additional tax brackets would allow the government to distinguish between income groups in the highest tax bracket who are in significantly different economic positions. Under an amended version of the Code, it would be possible to lower taxes for the individual with $1 million in taxable income and raise taxes for the individual with $100 million in taxable income. Income groups in vastly disparate economic positions could then be treated distinctly and would no longer be treated as a monolith.

Amending the Code to reflect the true distribution of income would correct distortions in the political marketplace because it would generate a more accurate set of political incentives. Under the current system, income groups in the highest tax bracket, but who are in vastly disparate economic positions, have the same political incentives with regard to tax because they have identical marginal tax rates. Because of the large economic disparities between these income groups, these incentives would diverge if these groups were situated in tax brackets that more precisely accounted for significant economic differences between them. Amending the Code to create additional tax brackets that account for the true economic positions of income groups in the highest tax bracket would produce political incentives that would more accurately reflect the political interests of each distinct group.

Remedy: Adjustable Transaction Tax

A tax levied on all securities transactions would be a means to control volatility. However, instead of a fixed transaction tax, the transaction tax should be assessed at an adjustable rate controlled by an independent regulatory agency to be used, in real-time, to regulate the rate of market activity. Generally, an adjustable transaction tax would function to increase or decrease the rate of market activity depending on the rate set by the regulator. Higher transaction tax rates would tend to slow economic activity because investors would receive a lower rate of return on the sale of their assets. Lower transaction tax rates would tend to spur economic activity because investors would receive a higher rate of return on the sale of their assets. The power to adjust the transaction tax rate would minimize volatility because an independent regulator with the power to adjust the rate in real-time can manage the rate of market activity by raising and lowering the rate in response to changing conditions in the market.

If independent regulators have control over the transaction tax rate, they could respond to fluctuations in the market more rapidly and with greater effect than under the current system. The government does not currently have a regulatory mechanism through which it could directly influence the rate of market activity in real-time in response to rapid changes in the market. Regulatory mechanisms, such as the imposition of securities laws or actions by the Federal Reserve, only have an indirect effect on market activity because they are not specifically tailored to directly affect the cost structure of individual transactions conducted in the market in real-time. In contrast, the institution of a transaction tax that could be adjusted in real-time would give regulators a direct means to influence costs and affect the decision-making of investors by adding or subtracting value from the general cost structure of a specific transaction through raising or lowering the transaction tax.

The power to regulate in real-time is especially important because it gives regulators sufficient flexibility to immediately respond to rapidly changing market conditions. For example, in the event that the market is about to crash, a regulatory agency could effectively close markets before a crash by setting the transaction tax rate at a level that would completely chill all market activity. Under neo-classical economic theory, crashes operate as a correction mechanism to restore artificially high market prices to levels approximately in line with their actual value. However, such radical corrections, while theoretically beneficial in the long run, operate to discourage investment because the lack of certainty in the integrity of the market reduces consumer confidence. Regardless of how low prices are ultimately set, consumers may never choose to invest in the market if their confidence in the integrity of the market is never restored. This can have a disastrous effect on the economy because economic recovery is difficult to achieve in the absence of consumer confidence.

While some difference between market value and actual value is healthy

because it provides room for economic growth, the adjustable transaction tax would reduce the potential for market crashes because the regulator could use the tax to gradually manage the ratio between the market value and the actual value before these values grow too disparate to be sustainable. Under this alternative framework of economic growth, the “boom-and-bust” economic paradigm would be replaced by a model of economic growth that emphasizes stability and mitigates the potential for market crashes.

There are two ways by which a transaction tax could be levied. First, the transaction tax rate could be set as a percentage-based *ad valorem* tax, as measured by the following formula: (Rate of Tax) x (Total Value of Assets) = (Total Revenue). For example, with regard to a single transaction, if the transaction tax rate was set at 1% for the sale of stocks valued at $1000, the amount of revenue generated would be $10. Alternatively, the transaction tax rate could be set as a flat amount per transaction tax, as measured by the following formula: (Tax per Transaction) x (Number of Transactions) = (Total Revenue). For example, if the tax rate was set at $1 and 10 transactions were conducted, the amount of revenue generated would be $10. With regard to both an *ad valorem* transaction tax and a flat amount per transaction tax, the projected gain would have to exceed the amount of tax in order for a transaction to be rational. Considering the diversity of the types of transactions being conducted in the market, the type of rate utilized by the regulator should vary depending on the type of transaction being taxed because different types of transactions may require different forms of regulatory control.

The adjustable transaction tax would generate a significant amount of revenue because of the enormous value of assets being exchanged and the sheer volume of trades. However, the adjustable transaction tax rate should not be established for the sole purpose of raising revenue because improper management of the rate could distort prices in a manner that could chill investment if the rate was set at a level in excess of what is necessary to ensure stable economic growth. Rather, the rate should be set at a value that would operate as a means to control volatility within the market as market conditions change because the long-run utility of using the rate as a form of regulatory policy to encourage stable economic growth outweighs the short-term advantages and inherent risks of using the rate to raise revenue.

Additional tax brackets and correspondingly progressive tax rates would promote fairness, increase revenue, create greater flexibility in determining the rate structure over time, and correct distortions in the political marketplace.

Conclusion

The current configuration of the Code governs taxpayers under two distinct systems of tax, a progressive tax system for taxable incomes up to $388,350 and a flat tax system for higher taxable incomes. This is problematic for several reasons. First, it unfairly provides similar tax treatment for all income groups in the highest tax bracket despite their vastly different economic positions. Second, it disturbs the functioning of political processes through the distortion of political incentives. Third, it weakens economic resiliency because, in poor economic times, low rates of taxation have the tendency to dilute government revenue streams that are necessary to institute policy measures which would help to sustain market demand and ensure the ongoing viability of the productivity cycle. Fourth, it increases volatility by permitting upper-echelon income groups to concentrate capital, which leads to greater uncertainty in the market because the diminishing utility of capital encourages higher levels of risk-taking investment behavior.

Congress should address these problems by amending the Code to create additional tax brackets and correspondingly progressive tax rates that more accurately account for income distribution within the highest tax bracket. Additional tax brackets and correspondingly progressive tax rates would promote fairness, increase revenue, create greater flexibility in determining the rate structure over time, and correct distortions in the political marketplace. Congress should also enact an adjustable transaction tax controlled by an independent regulator in real-time. The adjustable transaction tax would raise revenue, minimize volatility, encourage stable economic growth, mitigate the possibility of market crashes, and give the government the direct power to immediately respond to rapidly changing market conditions as they occur. Although these reforms would not correct all of the complications that can arise in the functioning of economic and political processes, they would help to solidify our economic foundation and improve the quality of the political marketplace. ■