

THE LUKE EFFECT AND FEDERAL TAXATION: A COMMENTARY ON MCMAHON'S *THE MATTHEW EFFECT AND FEDERAL TAXATION*

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Abstract: Professor Martin J. McMahon, Jr.'s Article demonstrates that the rich are getting richer and the poor poorer in the United States, that something must be done to deal with increasing income inequality, and that income tax rates should be more progressive. Increasing tax rates on the super-rich as he suggests, however, will not eliminate these problems by itself. There is no way to decrease income inequality without increasing rate progressivity on a wider range of taxpayers. To do so would be politically problematic, and it therefore seems unlikely that these problems can be solved through the federal tax system.

INTRODUCTION

A substantial portion of Professor Martin J. McMahon, Jr.'s Article is devoted to a presentation of empirical data to prove the Matthew effect—that in the past twenty-five years in the United States the rich have been getting richer and the poor poorer.¹ Professor McMahon does a superb job of marshaling the evidence to show the increasing concentration of income and wealth in the top 1% of taxpayers and particularly in the top of that top 1%.² His primary point is that the super-rich are getting even richer and at a faster rate than are the rich.³

I. PROFESSOR MCMAHON'S PROPOSITIONS

Professor McMahon first demonstrates the increasing disparities in before-tax income.⁴ The data he assembles certainly confirm that the

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¹ Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993, 993-94 (2004).

² *See id.* at 998-1012.

³ *Id.*

⁴ *Id.*

size of the slice of the pie commandeered by the top income cohorts is increasing.⁵ My only comment with respect to this presentation is that most of the data Professor McMahon uses probably understate the phenomenon. Except for the statistics on wealth, the remaining data are based on various noncomprehensive definitions of income.⁶ For example, the most detailed data that Professor McMahon presents are the Congressional Budget Office (the “CBO”) data, and its measure of “income” does not include unrealized appreciation.⁷ That also is true of the Internal Revenue Service (the “IRS”) data, which use adjusted gross income.⁸ Professor McMahon notes that the key to joining the “Fortunate 400” is capital gains.⁹ In the top one-half of 1% of income cohorts, capital gains approach or exceed 20% of income.¹⁰

Nevertheless, the dominant form of income for all income cohorts remains wage income.¹¹ At least in the two top quintiles, that is partially because unrealized capital appreciation is excluded. If realized capital gains and periodic income from capital are highly concentrated in the highest income cohorts, then one can safely assume that unrealized capital gains are also highly concentrated in the highest income cohorts.¹² This is borne out by Professor McMahon’s presentation of data with respect to wealth.¹³ Although these data do not perfectly correlate

⁵ See *id.*

⁶ McMahon, *supra* note 1, at 999.

⁷ See CONG. BUDGET OFFICE, EFFECTIVE FEDERAL TAX RATES, 1997 TO 2000, at 3–4 (2003).

⁸ See, e.g., INTERNAL REVENUE SERV., TAX YEAR 2001: INDIVIDUAL INCOME TAX RETURNS 13–15, 18 (2004), available at <http://www.irs.gov/taxstats/article/0,,id=96586,00.html> (last visited Oct. 15, 2004). Congress’s definition of adjusted gross income does not include unrealized appreciation. See I.R.C. § 61 (2000) (defining gross income); *Id.* § 62 (defining adjusted gross income).

⁹ McMahon, *supra* note 1, at 1006. The “Fortunate 400” are the four hundred taxpayers reporting the highest individual income. See Michael Parisi & Michael Strudler, Internal Revenue Serv., *The 400 Individual Income Tax Returns Reporting the Highest Adjusted Gross Incomes Each Year, 1992–2000*, STATISTICS OF INCOME BULL., Spring 2003, at 7–9, available at <http://www.irs.gov/pub/irs-soi/00in400h.pdf>; Martin A. Sullivan, *The Rich Get Soaked While the Super Rich Slide*, 101 TAX NOTES 581, 581 (2003).

¹⁰ McMahon, *supra* note 1, at 1006.

¹¹ See Thomas Piketty & Emmanuel Saez, *Income Inequality in the United States, 1913–1918*, 68 Q.J. ECON. 1, 15 tbl.III (2003).

¹² The only possible exception is home ownership, which would occur in quintiles other than the top one, but probably not in the bottom quintile, which is the focus of concern.

¹³ See McMahon, *supra* note 1, at 1019. Data from the Survey of Consumer Finances indicate that approximately one-third of wealth is held by the top 1%, one-third by the next 9%, and one-third by the bottom 90%, of which the lowest 50% held only 3% of the total wealth. *Id.* The data indicate that the top group holds a disproportionate share of stocks, bonds, and real estate investments, which are likely to include unrealized appreciation. Arthur B. Kennickell, *A Rolling Tide: Changes in the Distribution of Wealth in the U.S.*,

with economic income, the data cited by Professor McMahon do include some unrealized appreciation and show that wealth is even more highly concentrated than income.¹⁴ Thus, taking unrealized appreciation into account would probably increase the income gap.

Professor McMahon also presents data to demonstrate the increasing disparity between the top and bottom in after-tax income.¹⁵ Again, the data confirm Professor McMahon's basic argument that the gulf between the rich (particularly the super-rich) and the poor is rapidly increasing.¹⁶ I have no quarrel with the basic proposition, but to accurately measure the income gap, one needs to take into account transfers from the government as well as transfers to the government. Although the CBO's definition of income includes the value of income received in kind, such as Medicare and Medicaid, food stamps, and the like,¹⁷ the definition of after-tax income is not exhaustive. The IRS data do not measure governmental transfers except to the extent of transfers through the tax system, such as the earned income tax credit.¹⁸ I do not believe that a completely accurate definition would change Professor McMahon's basic point about the size of the gap, but a comprehensive definition would be essential to defining a solution.

One conclusion that Professor McMahon draws from the data is that "the federal tax system has failed to respond adequately to take into account ever increasing income inequality."¹⁹ It is hard to argue with the conclusion that the tax system has not eroded the gap, although reasonable people can differ as to whether it should do so.²⁰ Professor McMahon clearly believes it should.²¹ Near the end of his Article he urges us "to reverse the Matthew Effect" by increasing progressivity.²² He proposes to do so by increasing marginal rates for the rich and especially for the super-rich.²³

1989–2001, at 15 (2003), available at <http://www.federalreserve.gov/pubs/oss/oss2/papers/concentration.2001.10.pdf>.

¹⁴ Compare, e.g., McMahon, *supra* note 1, at 1001 (presenting data on income), with McMahon, *supra* note 1, at 1019 (presenting data on wealth).

¹⁵ *Id.* at 1012–16.

¹⁶ *Id.*

¹⁷ See CONG. BUDGET OFFICE, *supra* note 7, at 3–4.

¹⁸ See INTERNAL REVENUE SERV., *supra* note 8, at 96–97.

¹⁹ McMahon, *supra* note 1, at 996.

²⁰ I agree with Professor McMahon and others who support progressivity, but I have nothing to add to his recitation of the arguments.

²¹ McMahon, *supra* note 1, at 1128.

²² *Id.*

²³ *Id.* at 1122–28.

II. AN ANALYSIS OF PROFESSOR McMAHON'S CONCLUSION

Although I agree with three of Professor McMahon's propositions—that the rich are getting richer and the poor relatively poorer, that something must be done to deal with increasing income inequality, and that income tax rates should be more progressive²⁴—I disagree with the suggestion that increasing the tax rates on the super-rich will reverse the Matthew effect. Professor McMahon's real concern is with redistributing the tax burden more equitably, and to that end he favors increased progressivity.²⁵ But increased progressivity alone will not eliminate the income gap or the Matthew effect,²⁶ although it is an essential piece of the solution. To eliminate the income gap, progressivity must be coupled with redistribution. What we take from Peter we must give to Paul.

Progressive tax rates redistribute the tax burden. Progressivity results in redistribution because those in the lowest quintile bear little or very little of the obligation to fund public goods. Although progressivity is an important source of redistribution, it does very little to address the income gap. The bottom 20% of filers, for example, already bear almost none of the federal income tax burden,²⁷ and there are many who do not need to file and thus have no tax liability. Despite this redistribution of the tax burden, there remains a significant income gap.

Suppose that the marginal rates on the top quintile were increased sufficiently so that the rate on the bottom quintile of filers was reduced to zero. That would constitute a significant increase in progressivity. Without more, however, the income position of the bottom quintile would barely change. Table 1 illustrates this.

²⁴ *Id.* at 993–98.

²⁵ *See id.* at 1101.

²⁶ These are not the same. Even if the rich did not get any richer nor the poor any poorer, there would still be a significant—and unacceptable—income gap.

²⁷ *See* INTERNAL REVENUE SERV., *supra* note 8, at tbl.1.1, col. 15.

<i>Income in Cohort</i>	<i>Number Returns</i>	<i>Current Tax Liability</i>	<i>Average Per Return</i>	<i>Income Without Tax</i>
\$0	1,438,000	\$91,634,000	\$64	\$6064
\$0–1000	1,838,000	\$1,276,000	\$1	\$6501
\$1000–2000	2,642,000	\$34,403,000	\$13	\$7513
\$2000–3000	2,729,000	\$40,200,000	\$15	\$8515
\$3000–4000	2,696,000	\$31,406,000	\$12	\$9512
\$4000–5000	2,687,000	\$51,777,000	\$19	\$10,519
\$5000–6000	2,463,000	\$98,418,000	\$40	\$11,540
\$6000–7000	2,492,000	\$153,259,000	\$62	\$12,562
\$7000–8000	2,523,000	\$193,524,000	\$77	\$13,577
\$8000–9000	2,453,000	\$251,982,000	\$103	\$14,603
\$9000–10,000	2,424,000	\$363,092,000	\$150	\$15,650
\$10,000–11,000	2,479,238	\$482,851,000	\$195	\$16,695
\$11,000–12,000	2,290,492	\$621,691,000	\$271	\$17,771
	31,154,730	\$2,415,513,000		
<i>AGI by Cohort</i>	<i>Number/Returns</i>	<i>Additional Tax/Return</i>		
\$500,000–1,000,000	354,612			
\$1,000,000–1,500,000	85,193			
\$1,500,000–2,000,000	36,326			
\$2,000,000–5,000,000	51,964			
\$5,000,000–10,000,000	12,205			
Over \$10,000,000	6811			
	547,111	\$4415		

Table 1 uses IRS statistics for 2001,²⁹ the most recent year available, and assumes that the 2001 federal income tax liability for the bottom quintile was not assessed. Using an average tax per return in each cohort, the unassessed tax is assumed to increase the income of each individual in the cohort.³⁰ The figures in column five represent the income for each cohort if no federal income taxes were levied.³¹ It is only in the last cohort that taxes drag the cohort below the poverty level. Even if federal income tax liability were eliminated, all other cohorts would fall below

²⁸ Table 1 is calculated using IRS figures for the 2001 tax year. *See generally* INTERNAL REVENUE SERV., *supra* note 8.

²⁹ *See generally id.*

³⁰ The tax liability in column three is divided by the number of returns in column two to get the average tax per return for each cohort.

³¹ As explained further below, each taxpayer in the cohort is presumed to have the mid-level of income for the cohort and to have \$6000 of current government benefits constituting income (although not taxable income). Thus, someone in the second cohort starts with \$6500 of income.

the poverty level.³² The federal income tax revenue from the bottom quintile was \$2.4 billion. If each taxpayer in the top quintile paid an equal share of the decrease, each would owe \$4415 more in taxes. That would take about a 1% across-the-board increase in marginal tax rates in the top cohorts. A result that leaves the bottom 20% below the poverty level and the top with no real dent in their incomes does not exactly put a brake on the Matthew effect.

Whether the disparity between the top and bottom quintiles would decrease depends on whether the government would do anything differently than it currently does with the \$2.4 billion collected from the top quintile rather than the bottom quintile. If rates were made even more progressive than necessary to eliminate the tax liability of the bottom quintile, then any change in income disparities would depend on what the government did with the additional funds. If, for example, the funds were allocated in exactly the way that they are allocated currently, or if they were all directed toward military spending, the income gap would still be huge.³³ And recall that the taxes paid by the bottom 20% are roughly 0.1% of the total individual income taxes collected—not enough to have any effect on the income gap.³⁴

To eliminate the gap—through government intervention—the government not only must collect significant additional taxes from the rich, but it also must redistribute what it collects through cash, goods, or services to those in the bottom quintiles. In other words, we must agree not only to increased progressive rates, but also to the redistribution of tax revenue to the poor.

III. WHY REDISTRIBUTION MUST ACCOMPANY PROGRESSIVE RATES TO ELIMINATE INCOME GAP: A THOUGHT EXPERIMENT

To get a sense of why redistribution must accompany progressive rates, consider the following thought experiment, which is designed to show how eliminating the income gap through the tax system might be accomplished. This extremely modest experiment asks what kind of

³² See U.S. DEP'T OF HEALTH & HUMAN SERVS., THE 2001 HHS POVERTY GUIDELINES, at <http://aspe.hhs.gov/poverty/01poverty.htm> (last updated May 3, 2004) (presenting data from Annual Update of the HHS Poverty Guidelines, 66 Fed. Reg. 10,695 (Feb. 16, 2001)). In 2001, the poverty level for a family of four was \$17,650. *Id.*

³³ It is likely that no matter what the government did with the additional revenues, there would be some change in the income gap. For example, if all of the funds were dedicated to the military, it is possible that military salaries would increase, raising the income of privates at the bottom of the income scale.

³⁴ See INTERNAL REVENUE SERV., *supra* note 8, at tbl.1.1, col. 15.

progressivity would be needed to insure that most individuals in the United States would have “income” above the poverty level.³⁵ Those with income below the poverty level would receive a demogrant (a cash grant from the government) to make up the difference.

To test the proposition, I used the IRS statistics for 2001,³⁶ and the Department of Health and Human Services poverty guidelines.³⁷ In 2001, the poverty level was \$17,650 for a family of four and \$8590 for a single individual.³⁸ The status of individuals is determined by using their adjusted gross income (“AGI”). To account for current government transfers, I assumed that everyone with \$12,000 AGI or less already has nontaxable government transfers of \$6000, funded by current revenues.³⁹ Thus, someone (in a family) with AGI of \$11,650 would be ineligible for a demogrant; an individual with AGI of \$2590 would be ineligible.⁴⁰ To determine the total amount of revenue needed, I arbitrarily decided that everyone in each cohort has the midpoint level of AGI. Thus, the cohort with AGI between \$0 and \$1000 includes 1,800,000 people, with each assumed to have \$500 of income and \$6000 of nontaxable benefits.

To further simplify, I assumed that one-quarter of the individuals in each cohort are single and three-quarters constitute families of four.⁴¹ Thus, one-quarter of the individuals in this cohort would need

³⁵ This approach would do very little to eliminate either the income gap or the Matthew effect, but even this limited effort will serve to illustrate the basic point—that it would be very difficult to eliminate either through the tax system.

³⁶ See INTERNAL REVENUE SERV., *supra* note 8, at tbl.1.1, col. 1. These statistics include the number of taxpayers in each income cohort. *Id.* At the bottom on the income scale, each cohort has a \$1000 range; at the top end, they jump by \$500,000 to \$5 million with everyone over \$10 million landing in the same cohort. *Id.* As Professor McMahon points out, that lumps the super-rich with the merely rich. See McMahon, *supra* note 1, at 1002.

³⁷ U.S. DEP’T OF HEALTH & HUMAN SERVS., *supra* note 32.

³⁸ *Id.* To make the experiment simple, I have used only two of the guidelines, one for individuals and one for families. It is thus too high for some small families to escape poverty and too low for large families.

³⁹ This could be in kind transfers such as food stamps or tax benefits such as the earned income tax credit.

⁴⁰ In practice, stopping the demogrant abruptly without a phase-out is unworkable because it is inefficient and unfair, but adding a phase-out would not change the basic proposition.

⁴¹ It is impossible to tell exactly how many individuals and families fall into each poverty category. The U.S. Census Bureau reports extensive data about those in poverty, but does not break the data out into cohorts matching the poverty guidelines. The figures for 2001 roughly indicate that individuals without families make up about one-quarter of the total number of people living in poverty. BUREAU OF LABOR & STATISTICS & BUREAU OF THE CENSUS, *Detailed Poverty Tables: 2001 P60 Package*, in CURRENT POPULATION SURVEY,

a demogrant of \$2090 to bring them to the \$8590 poverty level and three-quarters would need \$11,150 to bring them to the \$17,650 poverty level.⁴² Table 2 shows the calculation of the amount of government revenues needed to accomplish this. As seen in the right-hand column, the amount required is \$140 billion.

Table 2: Demogrant Needed to Bring Bottom 20% to Poverty Level/IRS Statistics⁴³

Income in Cohort	Number Returns	Amount of Grant		Total/Cohort
		3/4 Family of Four	1/4 Single	
\$0	1,438,000	\$11,650	\$2590	\$13,495,630,000
\$0–1000	1,838,000	\$11,150	\$2090	\$16,330,630,000
\$1000–2000	2,642,000	\$10,150	\$1090	\$20,112,225,000
\$2000–3000	2,729,000	\$9150	\$90	\$18,727,762,500
\$3000–4000	2,696,000	\$8150	\$0	\$16,479,300,000
\$4000–5000	2,687,000	\$7150	\$0	\$14,409,037,500
\$5000–6000	2,463,000	\$6150	\$0	\$11,360,587,500
\$6000–7000	2,492,000	\$5150	\$0	\$9,625,350,000
\$7000–8000	2,523,000	\$4150	\$0	\$7,852,837,500
\$8000–9000	2,453,000	\$3150	\$0	\$5,795,212,500
\$9000–10,000	2,424,000	\$2150	\$0	\$3,908,700,000
\$10,000–11,000	2,479,238	\$1150	\$0	\$2,138,342,775
\$11,000–12,000	2,290,492	\$150	\$0	\$257,680,350
				\$140,493,295,625

Now apply Professor McMahon's suggestion that we increase the marginal rates on income exceeding \$500,000.⁴⁴ The current effective tax rate is approximately 20% to 24% for this group.⁴⁵ I assumed that current taxes collected fund both public goods and any redistribution that produces the current income status. If we want additional government redistribution, we need additional tax revenue.⁴⁶ Table 3

ANNUAL DEMOGRAPHIC SUPPLEMENT (Sept. 2002), <http://ferret.bls.census.gov/macro/032002/pov/toc.htm> (last revised July 14, 2004).

⁴² This is not to suggest that this is a good way to accomplish the goal of providing minimum incomes. A demogrant to those with no incomes and a guaranteed minimum income has work disincentive effects. The income effect of a demogrant would discourage labor efforts.

⁴³ Table 2 is calculated using IRS figures for the 2001 tax year. See generally INTERNAL REVENUE SERV., *supra* note 8.

⁴⁴ McMahon, *supra* note 1, at 997.

⁴⁵ See I.R.C. § 1 (2000).

⁴⁶ The point of this exercise is to see how the income gap might be eliminated through direct redistribution through the tax system. That is not the only way, of course, to accomplish this. Redistribution might be accomplished, for example, by significantly increasing the incentives for charitable giving, particularly to those organizations that increase the "income" or the standard of living of those in the bottom cohorts.

shows what would happen if we significantly increased the marginal brackets applying to the “rich,” that is, those whose AGI falls in cohorts above \$500,000. An example of the necessary marginal tax schedule is in the last column. I arbitrarily assumed that everyone in a cohort had the average income of the cohort.⁴⁷ So, for example, in the first cohort, each of the 354,612 returns would owe an additional amount of taxes equal to \$13,382 or a total of \$4.7 billion additional revenue.⁴⁸

<i>AGI by Cohort</i>	<i>Number/Returns</i>	<i>Taxable Income</i>	<i>Income Per Return</i>
\$500,000–1,000,000	354,612	\$211,318,031,000	\$533,455
\$1,000,000–1,500,000	85,193	\$91,492,389,000	\$919,429
\$1,500,000–2,000,000	36,326	\$55,760,182,000	\$1,250,733
\$2,000,000–5,000,000	51,964	\$138,523,230,000	\$2,074,695
\$5,000,000–10,000,000	12,205	\$74,551,405,000	\$4,233,470
Over \$10,000,000	6811	\$153,369,759,000	\$13,675,413
	547,111	\$725,014,996,000	
<i>Additional Tax</i>	<i>Total Additional Tax</i>	<i>Tax Schedule</i>	
\$13,382	\$4,745,406,467	\$500,000–1,000,000	40%
\$167,772	\$14,292,969,073	\$1,000,000–1,500,000	43%
\$307,815	\$11,181,694,592	\$1,500,000–2,000,000	46%
\$683,841	\$35,535,134,510	\$2,000,000–5,000,000	52%
\$1,806,404	\$22,047,165,702	\$5,000,000–10,000,000	60%
\$7,594,018	\$51,722,859,663	Over \$10,000,000	65%
	\$139,525,230,006		

These calculations illustrate why eliminating the tax gap through increased progressivity cannot be done on the back of the super-rich alone. With this rate schedule, imposing additional taxes on the top

⁴⁷ Column four is calculated by dividing the number of returns in the second column into the total taxable income for the cohort in the third column. The number of returns and taxable income in each cohort is found in INTERNAL REVENUE SERV., *supra* note 8, at tbl.1.1, cols. 1–2. Note that the number of returns with taxable income in each cohort is less than the number of returns with the same AGI in each cohort because itemized deductions reduced the AGI. *See id.*

⁴⁸ Column six is calculated by applying the top marginal tax rate in the last column to the amount of income that exceeds the minimum in the cohort and multiplying the result by the number of returns. For example, each individual in the first cohort is assumed to have \$533,455 of taxable income. The amount exceeding \$500,000 or \$33,455 would be subject to a 40% marginal rate, producing an additional tax of \$13,382 for each return. The additional tax owed by the 354,612 individuals in this cohort produces \$4.7 billion more in revenue. One effect of using this averaging rule is that average taxable income per return falls below the minimum for the cohort for several of the cohorts.

⁴⁹ Table 3 is calculated using IRS figures for the 2001 tax year. *See generally* INTERNAL REVENUE SERV., *supra* note 8. I ran similar calculations with the CBO numbers and ended up in approximately the same place.

cohort would not fund even this modest redistribution.⁵⁰ Although the super-rich would fund slightly less than 40% of the tax increase, higher rates on all taxpayers with income above \$500,000 would be necessary to fund this redistribution.

Another possibility is simply to apply a surtax on the rich. Table 4 shows that one would need a 92% surtax on the super-rich (those above \$10 million) in order to fund this redistribution. Alternatively, a surtax of 31% on all taxpayers with income over \$500,000 would also fund the redistribution.⁵¹ The surtax on the super-rich would have the greatest effect on the income gap. A 92% surtax on all income exceeding \$500,000 comes very close to government confiscation of that income and essentially would set a cap on labor income. A significant problem with a 92% surtax is the effect on labor and savings decisions. On the one hand, substantially increasing progressivity may be welfare-enhancing because the welfare of the poor is increased more than the welfare of the rich is decreased. On the other hand, any disincentive effect could offset the change to welfare. Ideally, the government would choose an optimal rate,⁵² but it is highly likely that the optimal rate would be well below 92%, thus precluding the use of a surtax on the rich to fund this redistribution.

<i>AGI by Cohort</i>	<i>Taxable Income</i>
500,000–1,000,000	211,318,031,000
1,000,000–1,500,000	91,492,389,000
1,500,000–2,000,000	55,760,182,000
2,000,000–5,000,000	138,523,230,000
5,000,000–10,000,000	74,551,405,000
Over 10,000,000	153,369,759,000
TOTAL	\$725,014,996,000
92% surtax on super-rich	\$137,967,118,280
31% surtax on rich	\$139,952,443,760

⁵⁰ The revenue produced by a top marginal rate of 65% on the cohort with AGI over \$10 million is only \$51 billion. The amount of revenue necessary cannot even be produced with marginal rates running from 50% to 90% on the super-rich. There is nothing that precludes extremely progressive rates on the super-rich, although this calculation does not include other taxes such as Social Security and Medicare taxes, state income taxes, sales and property taxes, corporate taxes, excise taxes, and the like.

⁵¹ The surtax is calculated by multiplying the surtax rate times all income that exceeds \$500,000.

⁵² See generally J.A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175 (1971). The notion behind the experiment is not to choose the optimal rate but to show that it would have to be fairly high.

⁵³ Table 4 is calculated using IRS figures for the 2001 tax year. See generally INTERNAL REVENUE SERV., *supra* note 8.

A third possibility is to increase effective rates by widening the tax base.⁵⁴ One obvious potential target is capital income. Although the tax burden on capital is not significant,⁵⁵ the revenue is potentially substantial.⁵⁶ But while it may be worthwhile to subject capital to taxation for equity reasons,⁵⁷ Congress has created numerous avenues of escape that either defer taxation of capital or exempt it.⁵⁸ There are also myriad ways that investors currently avoid taxation without the benefit of statutory authority.⁵⁹ Shoring up the current rules for taxing periodic income and realized appreciation would contribute to progressivity, particularly because the bulk of capital is held by the wealthy. Subjecting unrealized appreciation to capital income also could widen the base.

Although the theoretical reasons to widen the base are strong, there are some serious practical problems.⁶⁰ Furthermore, the increase in global markets makes it increasingly difficult for the United States to tax capital income. Closing other loopholes, particularly those used by the wealthy, would also increase revenues, but the basic point is the same. Increasing the tax burden on the wealthy by widening the base will change the relative income tax burdens, but will not change the income gap.

⁵⁴ Professor McMahon proposes eliminating the preferential rates on capital gains. McMahon, *supra* note 1, at 1127–28.

⁵⁵ See, e.g., Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?*, 47 TAX L. REV. 377, 393–95 (1992). For proofs of the proposition that given certain assumptions, an income tax imposes a burden only on the risk-free return, see Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17, 29–39 (1996), and Alvin C. Warren, Jr., *How Much Capital Income Taxed Under an Income Tax Is Exempt Under a Cash Flow Tax?*, 52 TAX L. REV. 1, 6–13 (1996).

⁵⁶ When subject to a nominal tax on capital, investors will make portfolio adjustments such that the tax burden is no more than the nominal rate times the risk-free rate on their entire portfolio. The risk premium bears no tax burden. Investors accomplish this by scaling up the amount of their risky investments. Unless the government adjusts its portfolio, the government becomes a “co-investor” in the larger amount of risky investment and its expected return; that is, revenue rises.

⁵⁷ Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 TAX L. REV. 423, 456–74 (2000).

⁵⁸ See, e.g., I.R.C. § 168 (2000) (accelerating depreciation); *Id.* § 179 (same); *Id.* § 354 (deferring taxation of gains); *Id.* § 1031 (same); *Id.* § 103 (exempting certain interest).

⁵⁹ For example, taxpayers often use financial instruments to defer the tax on unrealized appreciation by monetizing the gain without an appreciation event. One example is an equity swap.

⁶⁰ See Deborah H. Schenk, *A Positive Analysis of the Realization Rule*, 57 TAX L. REV. (355 2004).

IV. THREE LESSONS FROM THE THOUGHT EXPERIMENT

I draw three lessons from this thought experiment. First, even if the entire tax burden were lifted from the poor by increasing the progressivity of rates on the rich, there would be little effect on the income gap. Second, even fairly radical redistribution—demogrants financed by more progressive tax rates to ensure that everyone's income exceeds the poverty level—would have little effect on the income gap. Keep in mind that this is actually minimal redistribution if what we really want to do is attack income inequality. In the thought experiment, there would be roughly 20% of families with \$17,000, and approximately 0.5% would have average after-tax incomes ranging from \$337,500 to \$6,350,000.⁶¹

Third, a dramatic change in the income gap cannot be funded by Bill Gates and Warren Buffett alone. The reason is the Luke effect. The Gospel of Luke repeats Matthew's warning that the rich will get richer and the poor poorer. But it also includes the following passage: Jesus says to a rich man, "Sell all that you own and distribute the money to the poor, and you will have treasure in heaven' But when he heard this, [the rich man] became sad; for he was very rich."⁶² Jesus replied, "Indeed, it is easier for a camel to go through the eye of a needle than for someone who is rich to enter the kingdom of God."⁶³ To put this more colloquially, the rich love their money and will not give it up easily.

Professor McMahon essentially suggests that we will avoid the Luke effect by giving it up for them. As he proposes, we could impose more steeply progressive rates on those earning above \$500,000. This much probably seems plausible to most of us because the tax rates would be imposed on "the rich," by which we mean those who are richer than we are. But consider the increase in rates on the rich necessary to achieve even modest redistribution—redistribution that would have only limited effect on the income gap. In today's political climate it is hard to imagine tax rates rising to 65%, even if they only applied to the super-rich. The political viability of such a tax increase would not seem to be enhanced if it were enacted for the explicit purpose of redistribution to the poor. And the disincentive effect of essentially confiscating all wages exceeding \$500,000 would surely take a high surtax on only the super-rich off the table.

⁶¹ Table 1, *supra* note 28.

⁶² *Luke* 18:22–23 (New Revised Standard).

⁶³ *Id.* at 18:25.

Widening the base as the means of increasing progressivity would also seem to run smack into the Luke effect. Eliminating any of the three largest “tax expenditures”—breaks for home ownership, medical care, and pension contributions—would increase all three revenues and progressivity significantly. But neither approach seems politically viable, and both probably contribute to the well-being of lower and middle cohorts.

CONCLUSION

The lesson of my thought experiment is that it will be very difficult to eliminate the Matthew effect through the federal tax system. We cannot avoid the Luke effect by focusing only on the super-rich. We must do it to ourselves. There is no way to decrease the income gap in any meaningful manner without increasing the progressivity of rates applying to those far down the food chain. And the additional revenue collected from increasing progressivity would need to be redistributed in benefits to the poor. Eliminating the Matthew effect through the tax system requires two extremely difficult steps. Indeed, it may be much easier for a camel to go through the eye of a needle.

