Nov. 19 -

Dear Ostrom Workshop readers:

I'm so grateful for the opportunity to present at the Workshop. This paper is still in its early stages. I'm still working through the arguments, and, having presented the paper twice (first, two weeks ago, and again just today) it's clear to me that it will be two papers. Also it's clear that I still have a lot of work ahead of me. So thanks in advance for your willingness to read a very rough draft. But I much prefer presenting work at a stage when I can actually still make fundamental changes to the paper.

The first paper (the first half of this draft) will argue that "alpha" is a useful third category of income in addition to labor and capital, that "alpha" best accounts for the rise of U.S. income inequality, and that "alpha" is often taxed at low capital gains rates.

The second paper (the second half of this draft) will set forth a normative theory of capital income taxation, with a uniform rate structure from whatever source derived. This is really where the tax literature began 100 years ago. But the literature has moved away from uniformity over the last fifty years, towards exemption of capital income. The facts on the ground suggest to me that we ought to move back to basics.

Finally, a note on the background of this project. This draft was prepared for Tax Law Review symposium on tax and entrepreneurship. It consolidates a lot of my prior work on the tax treatment of private equity and venture capital. But the related motivation is to advance my thinking for a book I'm writing about entrepreneurship and inequality. If alpha, not capital, explains the rise in inequality, what follows? The policy prescriptions that follow from this claim are more complex than, say, the global wealth tax suggested by Piketty in *Capital in the Twenty-First Century*. We like entrepreneurship and we do not want to tax it away. If inequality of human capital is the problem, what is the best solution? Tax is only a small part of the broader set of policy prescriptions we might consider, as we cannot and would not want to tax and redistribute human capital. So I equally welcome your comments, critiques, and suggestions on this paper or on the broader topic of entrepreneurship and inequality.

— Vic

ARTICLE

ALPHA: LABOR IS THE NEW CAPITAL

Victor Fleischer[1]

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Professor Fleischer is the author of the *Standard Deduction* column for THE NEW YORK TIMES. His columns are available at http://www.nytimes.com/column/standard-deduction.

ABSTRACT

What taxpayers report as capital gains income is often a form of labor income in disguise. This is especially true at the very top of the income distribution, where a large and rising share of national income is derived from partnership allocations of carried interest, the sale of founders' stock, and the sale of investment services partnership interests.

Rich people sometimes say they are lightly taxed because they have investment income. This is not always true. Often, they are lightly taxed because corporate executives, founders of technology companies, and investment fund managers earn income that measures the value of their labor by reference to the value of a capital asset, thus transforming labor income into capital gains. This kind of income—what I call *alpha* income—accounts for the lion's share of the recent rise of income inequality in the United States. *Alpha* income often has positive attributes, like aligning the incentives of managers and shareholders. But it is, I argue, qualitatively different from both wage income on the one hand and portfolio investment income on the other in ways that are critical to understanding inequality, tax policy, entrepreneurship, and asset management.

Recognizing that the capital gains preference is largely a preference for *alpha* income strengthens the case for abolishing the capital gains preference. The old justifications for the preference are even weaker in this new light. A tax on *alpha* is not a second tax on saved income. Economic income from *alpha* is sometimes taxed at the corporate level, but to no greater extent than the income of rank-and-file employees who pay tax at ordinary rates. Nor is a favorable tax rate on *alpha* necessary to incentivize investment in risky ventures.

Even the last pillar of the capital gains preference—the revenue loss and efficiency cost that occurs when investors are "locked in" to appreciated assets—does not justify the preference as a general matter. Entrepreneurs and fund managers do not control the timing of their capital gains income in the same way that portfolio investors control dispositions of appreciated assets.

I. INTRODUCTION

Capital gains income is often a form of labor income in disguise. This is especially true at the very top of the income distribution, among the top one percent of the top one percent. When Mark Zuckerberg sells shares of Facebook, the capital gain he reports on his tax return represents the realized value of the hard work, ideas, and leadership that he provided to Facebook. It does not represent a return on whatever small financial investment he made with after-tax savings while sitting in a Harvard dorm room.[2]

The same is true on Wall Street, where the blurring of labor income and investment income has become an art form. When Blackstone CEO Stephen Schwarzman receives an allocation of carried interest from a Blackstone private equity fund, the income mostly reflects a return on his labor efforts, not his financial investment. Yet it is taxed at capital gains rates.[3] When Carlyle founder David Rubenstein sells his partnership equity for a capital gain, most of the value he receives is derived from the goodwill of the business—value that has arisen from the labor contributions of Mr. Rubenstein and his colleagues, not from their financial contributions to the firm.

I call this kind of income "*alpha*" income to distinguish it from regular wage income on the one hand and investment income on the other. I define *alpha* income as the element of human capital (usually labor effort, but sometimes intellectual capital) embedded in variable financial returns. *Alpha* is typically observable as an abnormally high return on a financial investment where the excess return reflects the taxpayer's contributions of labor or human capital and not merely a return to risk-bearing or a payment for the use of capital. Think of *alpha* as "sweat equity" for rich people.

Alpha income often has an entrepreneurial element. The founders of companies in Silicon Valley typically invest little cash themselves. In lieu of high wages, they instead accept compensation in the form

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[2] Victor Fleischer, Taxing Founders' Stock, UCLA L. Rev.

[3] Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private Equity Funds, 83 NYU L Rev 1 (2008); Victor Fleischer, Taxing Blackstone, Tax L Rev (2008).

of common stock. If a company succeeds, the value of its common stock increases, often generating high returns for the founders.[4]

Alpha income need not be entrepreneurial, however. A CEO who comes in to turn around a distressed company often receives equity compensation that resembles cheap founders' stock; the initial value of the common stock is pushed down by debt and preferred stock in the capital structure. If the turnaround efforts work, the value of the common stock increases, reflecting the efforts of the management team. The CEO's income thus may be similarly characterized as *alpha* income even if derived from in an old economy business.

I borrow the term *alpha* from finance, where *alpha* refers to the measure of above-market or "excess" risk-adjusted returns. In finance, *alpha* is distinguished from *beta*, which is the measure of the systematic risk of investing in the capital markets. *Alpha* is most often associated with alternative asset classes, like real estate funds or "absolute return" hedge funds, where returns are not closely correlated with prevailing equity market conditions. In the context of institutional investing, *alpha* represents the value that a successful investment fund manager provides to investors. For purposes of this Article, however, I use the term more generically to refer to other types of labor-related abnormal returns as well, like the gains realized from selling a family-owned business.

Two types of *alpha* income—gains from the sale of founders' stock and partnership allocations of capital gains to fund managers—together account for the lion's share of the top-end increase in income inequality in the United States. Rich people sometimes say that they are lightly taxed because they have investment income. That isn't exactly true. The rich are lightly taxed because a certain type of labor income—*alpha* income—is often taxed at low capital gains rates.

The recipients of *alpha* income often justify this result with circular reasoning. During Mitt Romney's 2012 presidential campaign, he explained he was taxed at a low rate because his income came from investments. When pressed by reporters, a Romney adviser explained, "His position on carried interest is that it's capital gains in-

[4] As I discuss in more detail below, the stock price of a successful start-up typically reflects the value of entrepreneurial or quasi-monopoly rents associated with advances in technology or business processes.

come, and capital gains should be treated as capital gains."[5] Other private equity chiefs claim that it is unfair to complain about inequity caused by current law. "I think it's a little unfair for people to say you're not paying your fair share of taxes," Carlyle's David Rubenstein said to CNN. "I'm paying what I'm supposed to pay. Change the law, and I'll pay what I'm supposed to pay."[6]

A description of current law is obviously not a serious argument for the way the rules should work. There are more serious arguments in favor of the capital gains preference, and it is those arguments that I focus on in this Article.

Recognizing that the capital gains preference is largely a preference for *alpha* income strengthens the case for eliminating the capital gains preference. The usual arguments in favor of a capital gains preference include:

(1) a capital gains preference encourages savings over consumption,
(2) capital gains are often inflationary, not real,
(3) capital gains are a tax on income that has already been taxed once as salary,
(4) capital gains represent a double tax because income is taxed at the entity (business) level,
(5) a capital gains preference is necessary to compensate investors for risk, and
(6) the capital gains preference is necessary to mitigate lock-in.

These arguments are even weaker in the context of *alpha*:

[5] See http://www.bloomberg.com/news/articles/2012-01-24/romney-paid-13-9-percent-tax-rate-on-21-6-million-2010-income.

[6] See http://money.cnn.com/2012/04/03/markets/taxes-carlyle-rubenstein/.
There is nothing wrong, of course, with simply paying the taxes that are due. But I do think it is hypocritical to imply that one is simply accepting what Congress has decided on the one hand while, on the other hand, heavily influencing what Congress has decided. Mr. Rubenstein, Mr. Schwarzman, and other private equity leaders have worked hard to ensure that current law is favorable for private equity. The Private Equity Council, formed in 2007 by Bain Capital, Blackstone, Carlyle, and a handful of other large private equity firms, was formed as private equity's first trade association in the United States, and it was initially focused only on the tax treatment of carried interest. It has changed its name to the Private Equity Growth Capital Council. Since 2007, the group has spent over $24 million on lobbying expenses, primarily on tax issues. See Open Secrets, Annual Lobbying by Private Equity Growth Capital Council, available at https://www.opensecrets.org/lobby/clientsum.php?id=D000036835&year=2014.

(1) *alpha* income is not a return to after-tax savings,
(2) inflation represents a tiny portion of *alpha*, more than offset by the benefits of deferral,
(3) a tax on *alpha* does not represent a second tax on an investment of after-tax savings, but a first tax on labor income,
(4) *alpha* is only sometimes burdened by corporate tax, and only to the same extent as rank-and-file employees,
(5) riskiness does not justify a capital gains preference on labor income—just ask anyone who works on commission and pays tax at ordinary rates.

Even (6), the last pillar of the capital gains preference—the tendency of investors to hold on to appreciated assets, also known as the lock-in effect—does not categorically justify the capital gains preference for *alpha* income. Entrepreneurs and fund managers often do not control the timing of income in the same way that a portfolio investor controls the timing of asset sales. Concern about lock-in is real and legitimate, but it can be addressed more sensibly than through an unlimited across-the-board capital gains preference.

The primary contribution of this Article is to make a new case for abolishing the distinction between labor income and capital income. The following new facts motivate the case for reform:

(1) capital gains are often a form of labor income in disguise, or what I call "*alpha*,"
(2) *alpha* represents a significant portion of capital gains, particularly at the very top of the income distribution, attributable largely to the carried interest of investment fund managers and the sale of stock or partnership equity by founders,
(3) *alpha* has more than doubled in the last twenty years and represents a significant cause of the increase in top-end income inequality in the United States,
(4) income inequality is troubling at the very top of the income distribution, where it creates dynastic wealth and threatens the democratic political process, and
(5) taxing *alpha* income often represents the first and last opportunity to impose tax on income at the top end.

If one wants to reduce top-end income inequality in the United States, the simplest, fairest, and most effective approach would be to repeal the capital gains preference.

It may not be obvious why it is important to focus on *alpha* when setting capital gains policy. Capital gains policy, after all, has always been discussed with portfolio investors in mind. The main reason to focus on *alpha* is because capital gains are concentrated at the top of the income distribution, and if the tax system is to play a role in mitigating inequality, we must tax the income at the very top.

A second reason to focus on *alpha* is that, from an efficiency perspective, portfolio investors are often tax-indifferent or act as if they are. Portfolio investors display some sensitivity to tax rates, but not as much as one might expect. Because their performance is judged based on pre-tax returns, mutual fund managers and other asset managers are not very sensitive to the impact of taxes on their clients' investments.[7] *Alpha* income, not portfolio income, is the relevant lens through which Congress should set capital gains policy.

To be sure, not all *alpha* income goes to the top one percent of the one percent. As Professor Gentry shows in his contribution to this volume, many households have active business income, some of which generates capital gains. Congress has historically demonstrated particular concern about the impact of capital gains taxes on small business. Family-owned businesses provide convenient cover for the ultra-rich, and concern for small business should not be given undue weight. But it may be a necessary concession, as a matter of politics if not principle, to provide a more limited tax shelter for small business.[8] Section 1202 of the current tax code provides a possible model for small business relief.[9]

This Article contributes to the literature in four ways. First, I make a descriptive claim, mostly new to the academic literature, that

[7] Treasury/JCT paper on capital gains realizations.

[8] This is not a paper about ideal theory. In an ideal world—with perfect political institutions full of selfless politicians assisted by selfless agents working with perfect information to advance the public interest—I believe the tax system would be simple. The capital gains preference would be repealed, corporate and shareholder-level taxes would be integrated, the realization doctrine would be replaced with a mark-to-market system, and the tax system would not distinguish between labor income and capital income. This Article is not addressed to that ideal world. While I recognize the importance of scholarship that addresses ideal theory, it may be more useful at this point in the scholarly debate to work through potential reforms that more fully account for institutional detail and connect to the legitimate political preferences of voters.

[9] Section 1202 allows investors in "qualified small business stock" to exclude up to $10 million in gains from the sale of stock. See infra part x.

a significant amount of capital gains income at the very top end of the income distribution represents a return on human capital, not financial capital. This claim is important because it changes how we might account for and respond to increasing income inequality, including capital gains policy.

Second, I provide a normative theory for taxing labor income and capital income uniformly. While there are sound theoretical efficiency-based arguments for taxing capital income at a lower rate than labor income, the difficulty of distinguishing between labor and capital income weakens the efficiency case for the capital gains preference. The phenomenon of *alpha* income is concentrated at the top end of the income spectrum, strengthening the equity-based argument for taxing income uniformly.

Third, I offer a concrete policy proposal that balances the goals of simplicity and fairness with concerns, whether principled or political, about the impact of capital gains taxes on small business entrepreneurs.

Finally, I make a methodological contribution by emphasizing the importance of institutional detail in analyzing tax policy arguments. The capital gains literature rarely makes clear who investors are or what they invest in. As a result, the literature leaves us more informed in theory than in fact. The 1993 *Tax Law Review* colloquium on capital gains, for example, brought together the brightest minds in tax, and many of the arguments found in that volume remain sound, insightful, and internally compelling. But some necessary facts are missing. The colloquium contained no references to private equity funds, venture capital, hedge funds, founders' stock, or goodwill. It contained just one reference to real estate. Institutional detail can be useful in providing economists and policymakers with a better understanding of the world as we find it.

II. The Conventional Wisdom

In 1993, the *Tax Law Review* published a colloquium issue on capital gains.[10] In *The Case for a Capital Gains Preference*, Noel Cunningham and Deborah Schenk laid out the strongest case. They acknowledged it wasn't that strong.[11] They argued that an ideal income tax would have no preference for capital gains. The hard question, as they saw it, was whether a preference is desirable assuming an imperfect income tax and a lack of political will to adopt optimal corrections.[12] They concluded that the lock-in effect justified the preference as a second-best alternative, explaining that it is "almost certainly efficient and probably promotes equity."[13] Other scholars were less certain.[14]

Daniel Shaviro made a more forceful defense of the capital gains preference in his contribution, *Uneasiness and Capital Gains*. Professor Shaviro argued that the difficult question is the empirical one, namely whether the capital gains preference raises revenue over the long term, accounting for both the elasticity of realizations and the plan-

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[10] See Deborah H. Schenk, *Colloquium on Capital Gains: Foreword*, 48 Tax L. Rev. 315, 315 (1993) ("A tax preference for capital gains is an idea with remarkable staying power. After a brief period in which the United States treated capital gains identically to ordinary income, a significant rate differential is once again an important feature of the tax landscape. No doubt one of the reasons the preference resurfaces is that there is no consensus on its wisdom or utility.").

[11] See Noel B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 Tax L. Rev. 319 (1993).

[12] See *Foreword*, supra note 2, at 315; Cunningham & Schenk, supra note 2.

[13] See *Foreword*, supra note 2, at 315; Cunningham & Schenk, supra note 2.

[14] See Daniel Halperin, *A Capital Gains Preference is Not Even a Second-Best Solution*, 48 Tax L. Rev. 381 (1993) (arguing that superior solutions are available and the distortions arising out of the capital gains preference are serious); George R. Zodrow, *Economic Analyses of Capital Gains Taxation: Realizations, Revenues, Efficiency and Equity,* 48 Tax. L. Rev. 419 (1993) (urging caution in extrapolating from economic studies on realizations); Alan J. Auerbach, Commentary, 48 Tax L. Rev. 529 (focusing attention on accrual taxation); David F. Bradford, Commentary, 48 Tax. L. Rev. 533 (suggesting alternative methods of obtaining revenue estimates); Reed Shuldiner, *Indexing the Tax Code,* 48 Tax L. Rev. 537; Robert H. Scarborough, *Risk, Diversification and the Design of Loss Limitations under a Realization-Based Income Tax*, 48 Tax. L. Rev. 677; See also Daniel Shaviro, *Uneasiness and Capital Gains*, 48 Tax L. Rev. 393 (1993) (arguing that the question is empirical and that if a lower capital gains preference generated sufficient revenue to reduce the ordinary income rate, then the preference is justified notwithstanding equity objections).

ning and gamesmanship incentives a preference creates.[15] If a rate cut raises revenue, Professor Shaviro argued, then a preference is obviously justified.[16] "Genuinely revenue-raising rate reduction is nearly always desirable," Professor Shaviro noted, "absent greater external effects than any that seem present here."[17] Other scholars, like Eric Zolt, have similarly explained that non-uniform tax rates may be justified by differences in the mobility of labor versus capital.[18]

The literature has changed little in the last two decades. The most significant new line of argument has been drawn from the public finance insight that, under certain assumptions, the income tax only burdens the risk-free rate of return.[19] Such a conclusion tends to lead one to prefer a consumption tax as an ideal base.[20] In turn, preferring a consumption tax base might lead to a conclusion that an income tax with a capital gains preference brings one closer to the ideal than an income tax with no capital gains preference.[21]

This Article parts ways with almost all of the existing literature. The problem I see is that, with just a few exceptions, scholars assume that the capital gains preference matters because of its effects on portfolio investors, not its effects on founders, executives, and fund

[15] Shaviro, supra note x, at 393.

[16] Id.

[17] Id.

[18] Zolt, Uneasy Case for Uniform Taxation.

[19] Domar Musgrave etc; Joseph Bankman & Thomas Griffith, Is the Debate Between and Income Tax and Consumption Tax a Debate About Risk? Does it Matter?, 47 Tax L. Rev. 377 (1992).

[20] Bankman & Griffith; Noel B. Cunningham, The Taxation of Capital Income and the Choice of Tax Base, Tax L. Rev. 17, 21 (1996) ("the burden on capital income under an [ideal] income tax does not depend on the success of an investor's investments").

[21] As I discuss below, there are many reasons to think that, as a matter of second best, an income tax with a capital gains preference brings us closer to an ideal consumption tax baseline than an income tax with a capital gains preference.

Among mainstream tax academics working within an income tax framework, the capital gains debate has largely settled into a debate about the elasticity of portfolio income. Whatever the merits of an income tax, taxing capital gains at a high rate seems pointless if the main effect is to lead portfolio investors to hold winners and sell losers.

managers.[22] The literature generally assumes that what is reported as capital income is, in fact, a return on capital. Often it is not.

Recognizing the source of capital gains as something that is neither pure labor nor pure capital is important to both equity and efficiency arguments about capital gains.

First, consider the traditional efficiency argument that taxing capital gains at higher rates merely causes deadweight loss. This argument is more questionable today. Entrepreneurs and fund managers are not as sensitive to tax rates as portfolio investors.[23]

Second, consider the traditional fairness argument that compares consumers and savers. In the context of *alpha* income, the argument has no relevance at all. A portfolio investor investing after-tax dollars can reasonably argue that a tax on capital gains is like an extra tax on savings, unfairly distorting the savings/consumption margin. *Alpha* recipients cannot make that argument—their capital gains come from labor, not savings.

Moreover, the equity arguments against a capital gains preference take on new force in light of recent increases in income inequality.[24] If the capital gains preference exacerbates top-end inequality, then it may contribute to social harms associated with income and wealth inequality.[25]

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[22] Exceptions include Poterba, Gentry, Keuschnigg & Nielsen, Cummings & Johan.

[23] Cite to recent JCT paper. The assumption that capital gains is portfolio income, for example, has thoroughly infected the work of government economists. This assumption turns out to be a critical point for estimating the revenue effects of certain proposed tax changes. Elasticity estimates based on observations of portfolio investor behavior do not accurately predict the behavior of laborers and entrepreneurs. As such, the maximum revenue-raising rate is likely considerably higher than the traditional econometric models predict, and the revenue potential from repealing the capital gains preference greater than assumed.

[24] For example, today it is harder to say, as Professor Shaviro said in 1993, that there are no "external effects" that would justify eliminating the capital gains preference.

[25] To be more direct: suppose that raising the capital gains rate from twenty to fifty percent would reduce revenue. There are nontrivial reasons to think that a reduction in inequality would improve democracy, opportunity, and social welfare, even absent additional revenue to pay for social programs or a reduction in other tax rates. I don't find these equity arguments grounded in an analysis of downstream social costs as compelling as the simple argument grounded in uniform taxation, but they can no longer be simply brushed aside.

Alpha also puts the relationship between capital gains and progressivity in a new light. Most people prefer that a tax system be either progressive or flat (proportional), not regressive. Repealing the capital gains preference is essential to avoiding a regressive tax rate structure on labor income. Similarly, even if consumption is taken as the ideal tax base, few would advocate for a regressive rate structure. And yet, under current law, a billionaire entrepreneur can, with adequate estate planning foresight, pass on the entirety of his unconsumed wealth to his heirs with no tax paid at all, and with very low taxes paid on his consumed wealth. This result violates most people's conception of equity with ordinary wage earners. Such a result is more easily justified by ideology and hero worship than evidence-based tax policy.[26]

It is not surprising that the tax literature has not fully incorporated the transformation of the technology and finance industries that in turn have reshaped income inequality in the United States. Recall what was happening in 1993, when the *Tax Law Review* convened the last major colloquium on capital gains. Marc Andressen introduced Mosaic—soon to become Netscape—ushering in the consumer Internet era. So-called "second generation" mobile phone systems were introduced, and the first person-to-person SMS text message was sent. Finance, too, was just starting to change. There were about 200 venture capital firms, 150 private equity firms, and perhaps 1,000 hedge funds, together managing about $300 billion in alternative assets.[27]

Today, Internet- and mobile-related assets are worth trillions. The Internet bubble inflated, then popped, and now spits out unicorns and deca-corns. There are over a thousand venture capital firms, over a thousand buyout firms, and eight thousand hedge funds, together managing about $7 trillion in assets.[28] We should not be surprised that the tax literature has not caught up with new face of capital gains.

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[26] Victor Fleischer, Job Creationism: Entrepreneurship, Hero Worship, and Tax Policy (forthcoming 2016).

[27] See World Economic Forum, *Alternative Investments 2020, An Introduction to Alternative Investments* 8 (2015).

[28] See World Economic Forum, *Alternative Investments 2020, An Introduction to Alternative Investments* 8 (2015).

It may be true, as Thomas Piketty asserts in *Capital*, that $r > g$. But r does not flow to investors alone. It also flows to labor, in the form of *alpha*.

III. LABOR IS THE NEW CAPITAL

In this Section, I provide evidence in support of my descriptive claim that an increasing portion of capital gains at the very top of the income distribution is *alpha*.

A. What Alpha Looks Like

To illustrate how labor generates capital gains, it may be useful to begin with two examples from private equity. Blackstone is a publicly-traded partnership with $272 billion in assets under management.[29] Its private equity division raises most of its capital from public pension funds; 37 million retirees—more than half of all U.S. retirees—have part of their retirement money managed by Blackstone.[30]

Consider Blackstone Capital Partners IV, a private equity fund managed by the Blackstone Group. Blackstone raised the fund in 2002-03, raising $6.5 billion in capital. As of the end of 2014, with most investments exited, the fund reported a net IRR of 37%, for an investment multiple of 2.8x. This means that over the course of twelve years, the $6.5 billion invested into Fund IV turned into $18.2 billion, generating about $11.7 billion in investment income, almost all in the form of capital gains.

Of that $11.7 billion in investment gains, only about ten percent is taxed at the preferential rate for individuals. The primary reason is that most of the capital gains are allocated to tax-exempt investors. State pension funds, private pension funds, sovereign wealth funds, and university endowments provide about 80% of the capital for a typical fund. Another 10-15% is made up of taxable corporations, like commercial banks, investment banks, and insurance companies. Corporations, of course, do not enjoy a preferential rate on capital gains, but instead pay tax at the usual corporate rate of 35%. Only about 6%

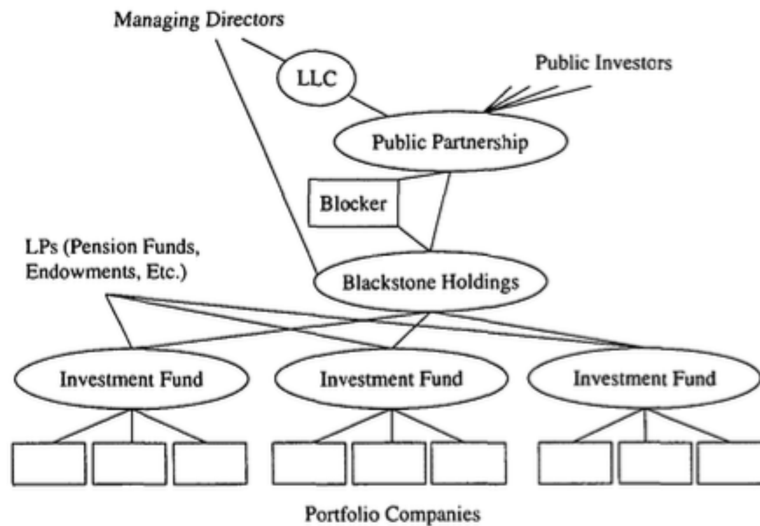
[29] It is taxed as a partnership, not a C Corporation. See Victor Fleischer, Taxing Blackstone, Tax L. Rev.

[30] 2014 BX Investor Day at 58.

of investment capital is provided by U.S. individuals who might benefit from the capital gains preference.[31]

Where the capital gains preference really has an impact is on the individuals who earn income through their labor efforts. This occurs at two levels. At the bottom of the structure, executives who manage BCP IV's portfolio companies like Kosmos Energy, SunGard, or Merlin Entertainments are largely compensated with common stock or stock options. Although the grant of stock gives rise to ordinary income on vesting or at the time of a § 83(b) election, executives typically receive shares at a low price reflecting leverage in the capital structure and, sometimes, the presence of preferred stock. Appreciation in the value of the common stock, when it occurs after vesting, gives rise to capital gains income. The executive team might hold between 5% and 20% of the equity in the portfolio company, depending on the size of the company and its history.

Figure 1



In addition, Blackstone receives "two and twenty" for managing the fund: a one to two percent annual management fee, and a twenty percent carried interest, or share of fund profits. Once the fund clears an eight percent hurdle rate, additional income (known as the catch-up

[31] SEC, Private Funds Statistics, 4Q 2014.

amount) is allocated to Blackstone until it receives twenty percent of the overall profits in the fund.

Figure 2: Blackstone Capital Partners IV (estimated)

Investor / Executive	Initial Investment	Net Income	Capital Gains	Capital Gains Tax	% of Capital Gains Tax Paid	Benefit of Capital Gains Prefere nce
Tax-Exempts	$5.2B	$9.36B	$9.36B	0	0	
Taxable LPs (C Corps)	$0.65B	$1.17B	$1.17B	$0.41B	34%	
Taxable LPs (Family Offices)	$0.65B	$1.17B	$1.17B	$0.23B	19%	28%
Blackstone	$5MM	$3.51B	$2.34B	$0.46B	38%	57%
CEO & Mgmt	0	$1.17B	$0.58B	$0.12B	10%	15%
Total	$6.5B	$16.38B	$14.62B	$1.22B	100%	100%

In this example,[32] about 72% of the estimated realized capital gains subject to the capital gains preference represent a return on human capital—labor efforts—and not a return on financial investment.

The same result holds true for funds that don't do quite as well. Blackstone formed Capital Partners V in good times, in July 2006, raising a record $21.7 billion in capital. In 2008-09, the financial crisis hammered equity prices. The fund held investments for a longer period than normal. Still, many investments turned around, and as of the time this writing, the fund now reports an IRR, net of fees, of 9 percent, and an investment multiple of 1.5x. Some high-profile investments, like Hilton Hotels and Sea World, turned out better than

[32] (In this example, I assume that all returns to investors are capital gains or qualified dividends, that Blackstone receives half as much in management fees, transaction fees, and monitoring fees as it receives in carry, and that the management teams owned 10% of portfolio company equity, recognizing half as ordinary income and half as capital gains income.)

expected.[33] In the end, over the course of ten years, the $21.7 billion invested into Fund V turned into $32.6 billion, net of fees, generating about $10.9 billion in capital gains.

Figure 3: Blackstone Capital Partners V (estimated)						
Investor / Executive	Initial Investment	Net Income	Capital Gains	Capital Gains Tax $	% of Capital Gains Tax	Benefit of Capital Gains Preference
Tax-Exempts	$17.36B	$8.68B	$8.68B	0	0	
Taxable LPs (C Corps)	$2.17B	$1.09B	$1.09B	$0.38B	30%	
Taxable LPs (Family Offices)	$2.17B	$1.09B	$1.09B	$0.22B	17%	24%
Blackstone Managers	$0.22B	$4.09B	$2.73B	$0.55B	44%	63%
CEO & Mgmt	0	$1.09B	$.55B	$0.11B	9%	13%
Total	$21.7B	$44B	$40B	$1.26B	100%	100%

About 74% of the the realized capital gains subject to the preferential rate are attributable to *alpha* income, not investment income.

How representative are the capital gains of *BCP IV* and *BCP V* of capital gains in the twenty-first century? It is hard to know with any degree of precision because gains from carried interest, founder stock, and other forms of *alpha* are not reported separately on tax returns.[34] But as I discuss below, the available data from the IRS Statistics of Income division suggest that the outcomes described above in the Blackstone example are not unusual. It represents a common norm at the high end of the income spectrum, not an aberration.

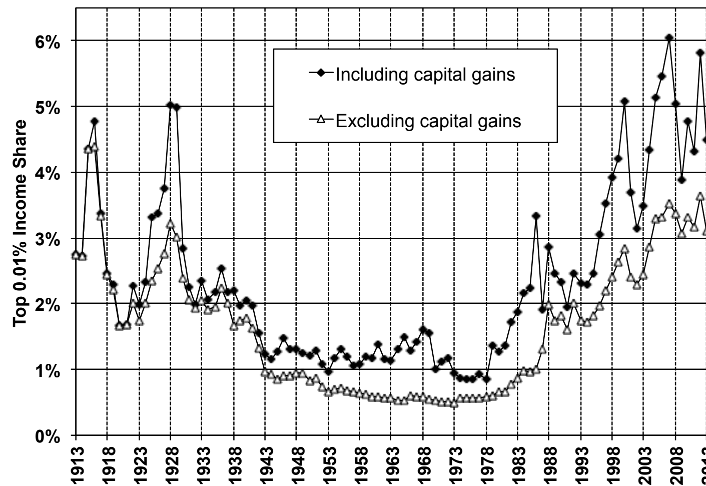
[33] See http://dealbook.nytimes.com/2014/01/30/for-blackstone-a-pot-of-gold-remains-out-of-reach/?_r=0

[34] NYT column.

IRS Statistics of Income data

Consider the following data from economists Thomas Piketty & Emmanuel Saez describing the composition of income at the very top. The top tenth of the top one percent—about 165,000 households with an income of greater that $1.9 million a year—is largely responsible shaping the inequality curve upwards. Within this group, the shape of the curve is driven largely by the top one percent of the top one percent—16,500 households with income greater than $9.75 million a year.

Figure 4: The Top 0.01%



The Top 0.01% Income Share, 1913-2014

- Income is defined as market income including (or excluding) capital gains. Note that capital gains includes allocations of partnership capital gain.
- In 2014, top .01% includes the 16,500 top families with annual income above $9.75m.

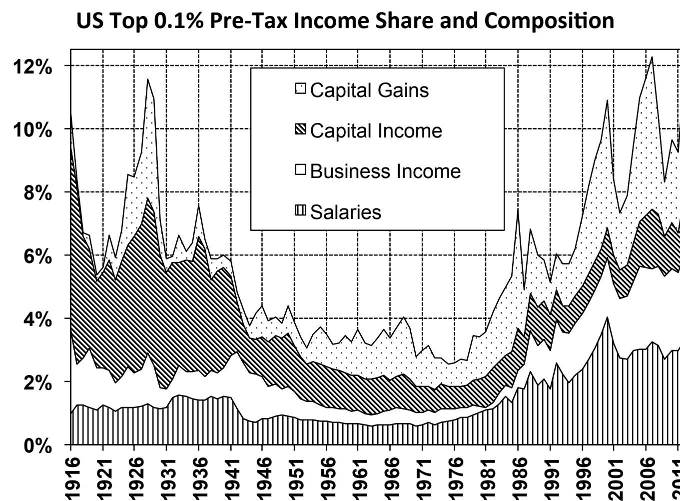
Source: Piketty & Saez 2003 (updated 2014)

Note that in the data used by Piketty & Saez, partnership allocations of capital gain are *not* categorized as "business income" (income from partnerships and S Corporations), but are instead reported as capital gains. Once it is recognized that a significant part of reported

capital gains includes carried interest and income from the sale of founders' stock, it is fairly obvious that the majority of the increase is attributable to labor income or *alpha* income, not investment income. Carried interest alone generates about $100 billion a year of capital gains income, or about 1/8 of all reported capital gains.[35]

Now look at Figure 5, below, describing the sources of income for the broader group at the top—the top 0.1%. Each band includes elements of *alpha*. The top band, capital gains, reflects both investment income and *alpha*, such as gains from founders' stock, sales of partnership interests, and S Corporation stock. The next band, capital income, includes income from interest, dividends, rents and royalties. This dividend amounts include not just portfolio dividends, but also "dividend recapitalizations" undertaken by private equity funds. The third band, business income, is passthrough income—that is, income from partnerships (including investment funds), subchapter S corporations, and a trivial amount of self-employment income. The bottom band, salaries, includes not just wages but also the value of equity compensation at the time it is awarded to executives.

Figure 5: The Top Tenth of the Top One Percent



It is difficult to break down the income data with precision because items like carried interest and dividend recapitalizations are not

[35] NYT estimate.

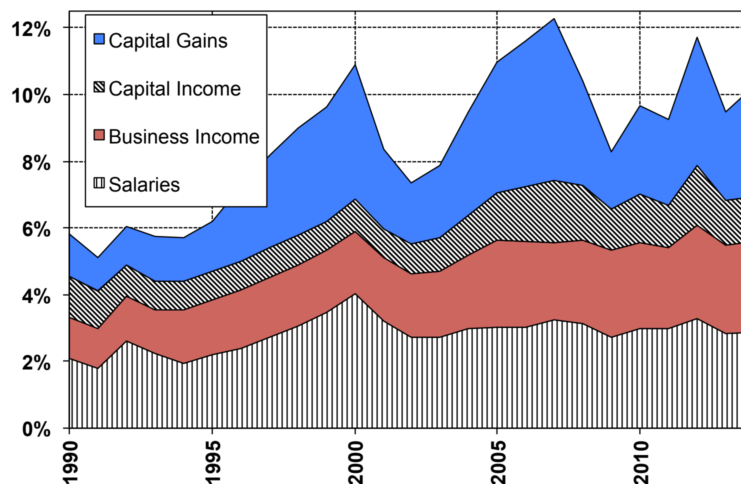
separately reported on tax returns, but merely appear as items like capital gains, partnership income, or dividend income. But several observations still emerge.

The rise of income inequality is attributable mostly to alpha, not portfolio investment, and is mostly observed in the increase in capital gains, passthrough income, and executive compensation. Some portion of *alpha* is taxed at capital gains, divided in some amount between gains from founder stock, sales of partnership equity, and stock in closely-held businesses on the one hand and gains from investments on the other.

The increase in "business income" is potentially attributable to two trends; the reorganization of many closely-held firms into S Corporations following the Tax Reform Act of 1986, and the explosive growth of investment funds. As I show below, most of the increase is attributable to the rise of alternative asset classes, not from C Corporations converting into S Corporations.

Consider Figure 6. From 1990 to 2014, the total share of income in this group increased from 5.8% of all U.S. income to 10.2% of all U.S. income, an increase of 76%. The increase is mostly attributable to capital gains (blue) and passthrough income (red). Capital gains in this group increased from 1.26% of all U.S. income to 3.3% of all U.S income, an increase of 161%. Passthrough income in this group increased from 1.25% of all U.S. income to 2.73% of all U.S. income, an increase of 118%. Together, the two categories increased from 2.5% to 6.03%, or 3.5 percentage points. This represents 80% of the rise in inequality for the top tenth of the top one percent.

Figure 6: The Top 0.1% in the Private Equity Era



Source: Piketty and Saez, 2003 updated to 2013. Series based on pre-tax cash market income including or excluding realized capital gains, and always excluding government transfers.

What Figure 6 shows is that the surge of income inequality parallels the expansion of private equity and asset management industries since 1990, reflected in the data as partnership income and capital gains. Capital income (which is mostly portfolio income like interest) increased only modestly, while capital gains more than doubled—a result that is difficult to understand if capital gains were mostly portfolio income.

Executive salaries, like portfolio income, have increased only modestly since 1990, by less than 0.5 percentage points. The "pay for performance" revolution in executive pay has important implications for corporate governance, and the effect on inequality can be observed in passing in 2000, when stock prices surged during the dot com bubble, inflating the value of stock awards. But generally speaking corporate executive pay, to the extent it is taxed as ordinary income and captured in figure 6 under "salaries," does *not* account for the rise in inequality.

More granular reporting of different kinds of income (carried interest, dividend recapitalizations, investment services partnership income, etc.) would allow the Treasury and the Joint Committee on Taxation to provide more precise information about the nature of inequality today. It would also provide for better elasticity estimates for both *alpha* income and portfolio income. Until reporting requirements change, the best we can do in the meantime is make inferences based on available I.R.S. data, journalists' accounts, and industry data. In the sections that follow, I describe how different forms of *alpha* income appear to account for a large proportion of capital gains among the highest income earners.

B. Founders' Stock

Founders' stock represents one of the two key ways in which labor is the new capital. At the very top of the income distribution, a large proportion of gains comes from the sale of stock in a company that was founded by the taxpayer or a relative of the taxpayer. It rarely represents good stock-picking by a portfolio investor.

Distinguishing between portfolio income and *alpha* is not an easy task. It is especially challenging when an entrepreneur contributes both labor and capital to a venture, as is often the case. One possible approach is to take the entrepreneur's initial financial investment and

impute a high but reasonable rate of return, say, ten percent, reflecting the high cost of capital for risky ventures. To the extent that gains exceed this rate of return, the gains reflect contributions of labor effort, entrepreneurial rents, or monopoly rents, not simple investment gains. Another approach is to look at the financial returns achieved by early stage investors who contributed only money and use that figure as a measure of the return to capital.

In practice, the I.R.S. does not provide sufficient information to get precise estimates of *alpha* income. But, at least at a high level of generality, data from the I.R.S. and from journalist accounts show that much of what is reported as capital gains represents *alpha* income from the sale of founders' stock.

I.R.S. data. Capital gains are heavily concentrated at the very top of the income distribution, among the top 0.01%. Individuals with more than $10 million in adjusted gross income in 2012 reported $265 billion taxable net capital gains, or about 43% of the total capital gains reported for all taxable returns, or $619 billion. They reported $256 billion in net long-term capital gain, or 42% of the total on taxable returns, $609 billion.

Within this group, the rate of return on portfolio income investments appears to be much lower than the rate of return on more active investments. For transactions conducted through a broker, where basis is reported on Form 1099-B or on other tax forms, total sales price of $14.8 billion exceeded basis of $10.9 billion, for a gain of $3.9 billion — an average investment return of 36%. For transactions with no basis reported by a third-party, the total sales price of $137 billion exceeded basis of $76 billion, for a gain of $61 billion — an investment return of 80%. Because the I.R.S. data does not include the relative holding periods of each type of transaction, we do not know with certainty that the rate of return is lower for portfolio income investments, but it seems likely. But because gains from the sale of founders' stock and other closely-held equity interests would not typically be reported on Form 1099-B, it seems a fair inference that the difference in the return, assuming it exists, is partly attributable to *alpha*.

Journalists' accounts. Journalists provide another source of data. The Forbes 400 is an annual list of the wealthiest Americans. The data is not entirely reliable, as it seems to be compiled based largely on public securities filings; it may omit a great deal of private wealth. The estimated wealth of Americans on the list ranges from $1.7 bil-

lion to $76 billion, with rankings varying from year to year depending mainly on the stock price of undiversified holdings.[36]

Figure 8: Founders' Stock

FORBES 400, SEPT. 2015				
	Name	**Wealth**	**Source**	**Type**
#1	Bill Gates	$76 B	Microsoft	Founder Stock
#2	Warren Buffett	$62 B	Berkshire Hathaway	Founder Stock
#3	Larry Ellison	$47.5 B	Oracle	Founder Stock
#4	Jeff Bezos	$47 B	Amazon.com	Founder Stock
#5	Charles Koch	$41 B	conglomerate	Passthrough Income
#5	David Koch	$41 B	conglomerate	Passthrough Income
#7	Mark Zuckerberg	$40.3 B	Facebook	Founder Stock
#8	Michael Bloomberg	$38.6 B	Bloomberg LP	Passthrough Income
#9	Jim Walton	$33.7 B	Wal-Mart	Founder Stock
#10	Larry Page	$33.3 B	Google	Founder Stock
#11	Sergey Brin	$32.6 B	Google	Founder Stock
#12	Alice Walton	$32 B	Wal-Mart	Founder Stock
#13	S. Robson Walton	$31.7 B	Wal-Mart	Founder Stock
#14	Christy Walton	$30.2 B	Wal-Mart	Founder Stock
#15	Sheldon Adelson	$26 B	casinos	Passthrough Income
#16	George Soros	$24.5 B	hedge funds	Carried Interest
#17	Phil Knight	$24.4 B	Nike	Founder Stock
#18	Forrest Mars, Jr.	$23.4 B	Mars	Founder Stock
#18	Jacqueline Mars	$23.4 B	Mars	Founder Stock
#18	John Mars	$23.4 B	Mars	Founder Stock
#21	Steve Ballmer	$21.6 B	Microsoft	Founder Stock
#22	Carl Icahn	$20.5 B	hedge funds	Carried Interest
#23	Michael Dell	$19.1 B	Dell	Founder Stock
#23	Laurene Powell Jobs	$19.1 B	Apple, Disney	Founder Stock
#25	Anne Cox Chambers	$18 B	Cox	Founder Stock

As shown in the Figure 8, the wealthiest Americans are mostly the founders of companies or their heirs.

What founders do with this wealth is difficult to track. Some stock is sold to fund current consumption or to provide diversifica-

[36] http://www.forbes.com/sites/luisakroll/2015/09/29/inside-the-2015-forbes-400-facts-and-figures-about-americas-wealthiest/

tion. Some is given away—in which case the founders' capital gain in transformed into a charitable deduction, and the charity's transferred capital gain becomes tax-exempt. The remainder is held until death and bequested to heirs and charitable organizations with a step up in basis.

My point here is simple one: there are large amounts of capital gains at the very top of the income spectrum, largely attributable to *alpha*, taxed at low capital gains rates or not at all.

C. Executive Compensation

Most executive compensation, other than carried interest, is taxed at ordinary rates. If an executive receives cash, the cash is taxed at ordinary rates when received. If an executive receives a stock award, the award is typically taxed at ordinary rates when the stock is received, unless the stock is restricted by vesting or performance conditions, in which case the award is taxed when those conditions are satisfied. Some executives choose to make an election, known as a §83(b) election, to recognize the value of a stock award at the time of receipt rather than vesting, in which case future appreciation in the value of the stock is taxed at capital gains rates. Most stock option awards are taxed at exercise at ordinary rates.

The majority of executive compensation is performance-based pay, where the size of the award is tied to the stock price or other measures of performance, such as sales, or the performance of the stock price relative to industry competitors. Most of this compensation is *alpha* income: compensation for labor efforts where the amount of compensation is tied to the performance of the company. It is often tax at ordinary rates, and not as capital gains, but it is still *alpha* income.

When executives hold on to stock after the initial recognition of income, it is unclear whether to thing of any future appreciation in the value of the stock as *alpha* income. In one common scenario, executives who receive stock options will opt for a "cashless hold," selling only as many shares as necessary to fund the exercise price and tax liability associated with the exercise. The remainder of the stock is held in the hopes of further appreciation at capital gains rates. On the one hand, the capital gains that may result look like *alpha* in the sense that the executive will eventually receive income based on his labor efforts. On the other hand, the executive has paid tax at exercise on the spread between the fair market value and exercise price,

and so—unlike founders' stock or carried interest—the stock represents an investment of after-tax dollars. For purposes of understanding inequality, it is probably better to think of these gains as *alpha* income rather than portfolio investment income. For purposes of capital gains policy, however, the fact that tax is paid at the time of receipt or vesting means that it is probably better to think of future appreciation in the value of the stock as similar to portfolio investment income.

D. Carried Interest and Investment Management Fees

IRS Data: The Fortunate 400

While data on the super-rich is sparse, the IRS sometimes provides statistics on taxpayers with the top 400 adjusted gross income numbers. For the most recent update in 2012, the cutoff for adjusted gross income was $139.6 million, up from $24.4 million in 1992. The top 400 individuals roughly tripled their share of national income over 20 years, from 0.52% to 1.48%.

A significant number of the top 400 are likely the founders of companies. But changes in the composition of income of the the top 400 also suggest that private equity and hedge fund managers now make up a significant part of the very top of the income distribution. In 1992, the top 400 earned 26% of income from salaries and wages (including stock awards), 7% from taxable interest, 6% from dividends, 36% from capital gains (33% long-term), 5% from Schedule C income, and 17% from Partnership and S Corporation net income. In 2012, the top 400 earned just 8% from salaries and wages and 4% from taxable interest, while earning 16% from dividends (including private equity dividend recapitalizations), 57% from the sale of capital assets (68% from long-term capital gains, including carried interest), 1% from Schedule C income, and 13% from partnership and S Corporation net income.

The decline in the relative proportion of salaries and increase in capital gains suggest that fewer CEOs make the top 400 today. The decline in the effective tax rate of the top 400 seems to confirm this trend. The median effective tax rate dropped from between 25 and 30% in 1992 to between 10 and 15% in 2012. 270 of the top 400 had an effective tax rate between 10 and 20%.

Other data from the top 400 suggest that a significant portion of the top 400 are fund managers. Partnership income for the top 400

peaked at $13 billion during the financial crisis — precisely when some hedge fund managers did extremely well from the "big short." Long-term capital gains peaked in 2007 ($57 billion) and 2012 ($52 billion), corresponding with peaks in the private equity market.

Media Accounts of the Top 400

How many of the top 400 are fund managers? According to Institutional Investor's Alpha magazine, the top 25 hedge fund managers would have made the list, earning at least $200 million in 2012, with a median of $350 million.[37] Perhaps another 25 or 50 made the top 400, depending on the distribution of returns.

In total, the top 25 hedge fund managers earned about $14 billion in 2012. It is unclear how much of this income was recognized immediately and how much was deferred in offshore vehicles. Nor is it clear how much was taxed at long-term capital gains rates. Some of the top funds are long-only funds or activist funds, both of which often generate long-term capital gains. Others use hedge fund reinsurance schemes to transform what would otherwise be ordinary income, blended rate income or short-term gains into long-term capital gains.

The story is similar in private equity, with top earners consistently clearing nine-figure incomes. In 2013, for example, nine founders of four large private equity firms took home more than $2.6 billion in carried interest and dividend income, or about $300 million each. In 2014, Stephen Schwarzman (Blackstone) earned $690 million, Leon Black (Apollo) earned $331 million, Henry Kravis (KKR) earned $220 million, George Roberts (KKR) earned $229 million, and each of the founders of Carlyle earned more than $200 million.[38]

The top 0.1%

Moving beyond the top 400 to the top tenth of the top one percent, carried interest seems to represent an even larger portion of top incomes. One way this is visible is the ratio of capital gains to capital losses. The year 2012 was a good year for the stock markets, but not a spectacular one. For all taxpayers, long-term capital gains outpaced long-term capital losses by about 2 to 1, with $637 billion in net long-

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37 http://www.institutionalinvestorsalpha.com/Article/3190499/The-Rich-List.html

38 http://www.reuters.com/article/2015/03/02/privateequity-ceoearnings-idUSL1N0W202C20150302

term capital gain against $379 billion in net long-term capital losses. For taxpayers who made more than $10 million, however, long-term capital gains outpace long-term capital losses by 40 to 1, with $256 billion in net long-term capital gains agains $6.2 billion in net long-term capital losses. This does not just reflect the fact that portfolios with winners are more likely to land someone an income over $10 million. Instead, it reflects the fact that carried interest is, by definition, incapable of loss—it is a share of profits.

Just $102 billion of the $256 billion in capital gains for the top 0.01% came from the sale of capital assets. $112 billion, by contrast, came from net long-term gain from partnerships and S Corporations, including carried interest. (Some fund managers hold carried interest through an S Corporation to avoid paying payroll taxes on management fee income.)

About two-thirds of the $112 billion in partnership long-term capital gains earned by the top 0.1% is carried interest. The SOI data breaks out partnership income by type of entity, and partnerships with a general partner that is itself organized as a partnership in the finance industry—a good proxy for private equity funds and hedge funds—allocated $69 billion of long-term capital gain to general partners.[39] Another $10-$15 billion represents carried interest from real estate partnerships.[40]

E. Dividends

Dividends for the top 0.1% surged to $12 billion in 2012. The trend at the top is not driven by portfolio income, however: S&P div-

[39] Total long-term capital gain in these partnerships was $351 billion. The GP's take, in other words, was almost exactly 20 percent of all long-term capital gains, equal to the typical carried interest agreement.

How carried interest is distributed within private equity firms is mostly opaque, but some inferences can be drawn from public securities filings. In 2012 Blackstone paid out $2.6 billion in compensation to its 1,780 employees, including 121 senior managing directors and 750 investment professionals. If each investment professional earned $1 million and each regular staff employee $200,000, there would be about $1.7 billion distributed among the senior MDs, or about $14 million to each senior MD. In practice, of course, the compensation would be more concentrated among certain senior or high-performing MDs.

[40] SOI 2012 partnership data.

idends have generally been rising, but 2012 was unexceptional and roughly the same as 2007 and 2008.[41]

The trend, rather, seems to be driven by private equity dividend recapitalizations, which surged to a new record in 2012, the last year for which tax data is available. In a dividend recap, a private equity-backed company borrows money in the "leveraged loan" market (loans that are syndicated out to other financial institutions) and uses the money to fund a special dividend to the private equity fund shareholders. By partially cashing out of the investment early, dividend recaps help keep up the internal rate of return. After a dividend recap, the portfolio company carried a higher debt-to-equity ratio, but the higher risk of failure is offset by the early cash in hand, as well as the tax benefits of higher interest deductions.

As I discussed in the introduction, the majority of capital provided to private equity comes from tax-exempt investors. Thus, when dividends are reported in the tax data, the dividends mostly represent the portion allocated to the individual fund managers and company management, not to individual portfolio investors in the fund.

F. Partnership Equity & Goodwill

Many founders of private equity and hedge fund management firms have sold partnership equity interests in recent years. The sale of a partnership interest is generally treated as a capital asset. Section 741 and 751 treat certain "hot assets"—assets that would give rise to ordinary income if held, like inventory and receivables—as giving rise to ordinary income when sold. Proposed legislation to change the tax treatment of carried interest would treat carried interest as a hot as-

[41] S&P Data — Date - Real Dividend
Dec 31, 2014 - 39.97
Dec 31, 2013- 35.73
Dec 31, 2012 - 32.38
Dec 31, 2011 - 27.86
Dec 31, 2010 - 24.68
Dec 31, 2009 - 24.69
Dec 31, 2008 - 32.13
Dec 31, 2007 - 31.42
Dec 31, 2006 - 29.34
Dec 31, 2005 - 26.86
Dec 31, 2004 - 24.31
Dec 31, 2003 - 22.45
Dec 31, 2002 - 21.14
Dec 31, 2001 - 21.20
Dec 31, 2000 - 22.25

set. Under current law, however, the sale of a partnership equity interest in a private equity firm gives rise to capital gain treatment.

The value of these partnerships is a reflection of the future streams of management fees and carried interest earned by the funds —for accounting purposes, this is mostly reflected as goodwill. The creation of goodwill is *alpha* income to the extent it is captured by the founders and senior managers of the firm.

G. Summary

In sum, *alpha* income represents most of the increase in top-end inequality in the United States, and a significant portion of that amount is reported as capital gains and taxed at the lower long-term capital gains rate. The main sources of such capital gains are from the sale of founders' stock, the sale of partnership equity, and from carried interest.

IV. ABOLISHING THE LABOR/CAPITAL INCOME DISTINCTION

Let us assume, for the sake of argument, that half of the capital gains income recognized by the top tenth of the top one percent is *alpha* income. How should that affect a normative assessment of the capital gains preference?

The capital gains preference stands on shaky footing as it is. The case is even weaker for *alpha* income. In this Part IV, I provide a normative theory for taxing capital income in Part A. Part B reviews the arguments for a capital gains preference, and how they fare with respect to *alpha* income. Part C addresses timing concerns. Part D explicitly incorporates the presence of imperfect political institutions and the special concern that Congress pays to small business.

A. A Normative Theory of Taxing Capital Income

A theory of taxing capital income is both a theory of taxing income (as opposed to consumption, endowment, or some other base) and a theory of taxing income from capital (and not just labor income) in particular. For purposes of this paper, however, I assume that income and not consumption is the ideal base for taxation. I discuss the implications of *alpha* income for the design of a consumption

tax below, but for purposes of keeping the exposition brief, I assume that income is the ideal tax base.

One could begin a theory of income tax from either a consequentialist or deontological perspective. In a consequentialist framework, there is a rich and controversial literature which may justify exemption of all capital income from taxation and taxing only labor, as a proxy for consumption, as an ideal base. As I explain below, my primary objection to this approach is in the design, which can have the perverse effect of exempting labor (and capital) from tax at the top end of the distribution.

Equality of opportunity. —But I also think it is important to articulate a normative theory of income taxation in non-consequentialist terms. In particular, equality of opportunity resonates more with the American public than consequentialist arguments, and equality of opportunity fits more easily with American ideals and institutions.

So the starting point is that inequality of outcomes is perfectly justified if each person has an equal opportunity to pursue economic goals. The quality of one's economic opportunities, however, is not easily observable by the government. It is easier to observe outcomes—especially income. And while the ex post distribution of income is an imperfect proxy for ex ante opportunity, it may be the best available proxy.

Perfect equality of opportunity is not possible, of course. But the more unequal the ex ante opportunities, the greater the justification for ex post redistribution.

One way to assess equality of opportunity is to consider the role of luck.[42] To the extent that economic income reflects variation in brute luck, as opposed to effort, a broad measure of economic income regardless of source provides a just basis for taxation. Taxing economic income is just, in other words, because economic income is not perfectly correlated with merit. If income were *purely* a matter of focused effort and willpower, for example, rather than partly a matter of luck and happenstance, then it might be better to choose a different tax base.

[42] Discuss differences between luck egalitarians and equality-of-opportunity egalitarians.

Luck plays a role. Economic income is highly correlated with parental income and the happenstance of one's upbringing. For example, in his work on social mobility, Gregory Clark found that 80% of the variation in income can be predicted simply by knowing one's parental income.[43] Of course, what one inherits from one's parents is not just genetic, but also the varied capability to navigate the academic, social, and economic world in order to take advantage of one's opportunities. Economic income is not simply a matter of brute luck, but it is a reasonable proxy for the quality of opportunities one has had access to.[44]

The correlation of income with parental income suggests that economic opportunity is not evenly distributed across the population. Government programs that increase equality of opportunity, such as public funding of education, should be financed by those who have benefited from the relative advantage of a good starting position. Economic income is a reasonably proxy for one's starting position.

Incentives matter. Of course, luck only explains part of the variation of income. One's choices about which opportunities to pursue matter. As does one's choice about how much effort to put in to a job, a business, or a career. Using ex post outcomes as a proxy for ex ante opportunities can obscure the role of effort, and as such can reduce the effort that one would exert.

Moreover, the logical extreme of an equal opportunity approach is an endowment tax. In addition to the difficult measurement problems, an endowment tax would conflict with important values of personal autonomy. Those with the best opportunities or highest endowment would have to go work on Wall Street just to pay the tax on their endowment.

Progressive income tax. So suppose that endowment and luck explain half of the variation in income, and effort explains half of the variation in income. So long as income tax rates remain below 50%,

[43] Gregory Clark, The Son Also Rises.

[44] Parental income might be a better proxy for ex ante inequality of opportunity. An income tax arguably undertaxes trust fund kids and overtaxes self-made entrepreneurs. But like an endowment tax, using parental income as the tax base would represent a greater government intrusion of autonomy and force all the children of wealthy parents to go into finance, removing their opportunities to do something more socially beneficial or personally rewarding.

one would not have to worry too much that the tax burden was unjust. There is a separate efficiency concern—a tax rate of 50% distorts the labor/leisure decision—but the result is not unjust.

The appropriate tax rate structure, of course, may vary depending on one's view of progressivity, distributive justice, and the size and role of government. Such normative claims about the rate structure are beyond the scope of this paper. But all that is required for present purposes is agreement that some amount of progressivity as measured by economic income is just.

Uniformity. —The next question is whether the rate of taxation on income should be uniform regardless of source (labor, capital, windfall, inheritance, etc.). Uniformity is generally desirable because one's obligation to help create a society of equal opportunity is generally not affected by the source of one's income. A teacher who earns $80,000 can be expected, at first approximation, to have the same obligation as the salesman who earns $80,000. A fund manager who makes $10 million from carried interest generally has the same obligation as the heir who makes $10 million from selling stock.

One is tempted to make value distinctions based on the source of income. Is a teacher not more socially valuable than a salesman? But such inquiries are unwise. It depends on the individual teacher and salesman in question. And on one's view of the value of teaching over commerce in general. And, more broadly, on one's conviction that the tax system is the appropriate vehicle through which to incorporate collective social values at a granular level. All else equal, source uniformity in taxation minimizes the role of government tax institutions and maximizes economic freedom.

There are three categories of arguments for non-uniformity: (1) efficiency-based arguments tied to income elasticity, (2) administrability arguments, and (3) arguments based on externalities or social costs.

Efficiency-based arguments for non-uniformity

The public finance literature provides the main argument in the literature for non-uniformity. In order to reduce deadweight loss and increase overall social welfare, the tax rate should vary inversely with the elasticity of the activity in question.[45] All taxes cause economic distortions, but if an activity is largely price inelastic, it is less sensi-

[45] Cite Ramsey, Atkinson Stiglitz, new papers by Saez, Gamage, Sanchirico, etc.

tive to taxes. Thus, when seeking to raise a given amount of tax revenue, the public finance literature generally teaches that we should vary the tax rate inversely with elasticity.

Historically, this argument for non-uniformity has carried particular force with respect to capital income. Capital income is generally more sensitive to tax rates than labor income, and thus in an open economy where capital is more mobile than labor, it is generally thought to be more efficient to tax capital at a lower rate than labor income.

Along similar lines, there is a concern that taxing capital income increases distortions on the savings/consumption margin. Taxing labor income causes a distortion on the labor/leisure margin. Taxing capital income causes an additional, second distortion on the savings/consumption margin. All else equal, one distortion is better than two.[46]

I find these arguments more appealing in theory than in practice. The argument for non-uniformity puts a lot of faith in the government's ability to distinguish between labor income and capital income. If an activity is placed in the wrong category, then deadweight loss increases, not decreases, compared to a uniform approach. For example, suppose we start with a uniform tax rate of 25%, and, for the sake of efficiency, move to a system where labor income is taxed at 45% and capital income at 5%. Assume that if all income is categorized accurately, deadweight loss is reduced because taxes causes fewer people to over-consume and under-save. But now assume that some labor income is mischaracterized as capital income and taxed at a low rate, and some capital income is mischaracterized as labor income and taxed at a high rate. The capital that is mischaracterized will flee that sector, creating an economic distortion.[47] And workers who can get a job in the mischaracterized sector will seek work there, creating another economic distortion. For example, a Harvard Business School graduate might opt for a job in private equity over a job at McKinsey. The efficiency costs of these new distortions can outweigh the efficiency savings that non-uniformity provides, depending on the rate of mischaracterization. Efficiency, in other words, depends not just on elasticity but also on the government's error rate.

[46] Kaplow vs. Gamage, Sanchirico.

[47] I can't think of an example where capital is mischaracterized as labor under current law. But this distortion would be analogous to the increased cost of new equity capital caused by the corporate income tax.

Tax lawyers are in the business of maximizing the government's error rate—finding ways to fit the economic activity that clients desire into the most advantageous tax treatment.[48] And the government is at an intrinsic disadvantage in this game because it must set out its rules—the definitions of income—in advance. The less uniformity, the more opportunities to find gaps and engage in regulatory arbitrage.

The error rate for mischaracterizing labor income as capital income is now very high, particularly at the top end of the income spectrum. It is not difficult to tie one's labor compensation to the value of a capital asset, and doing so is often enough to transform labor income into capital income for tax purposes. Uniformity would eliminate this economic distortion.

And of course there is more than efficiency at stake. Even if the government's error rate is low, and there are efficiency gains to taxing capital income at a lower rate, doing so undermines justice in an equality-of-opportunity normative framework. To the extent that individuals with privileged opportunities escape tax because their income is mischaracterized as capital income, there is an economic injury to everyone whose income is properly taxes, as well as a symbolic injury and a legitimate complaint about unfairness.

Administrability arguments for non-uniformity.

Some departures from the ideal tax base are justified by administrability concerns. Perhaps the most embedded in our current system is the realization doctrine and its many non-recognition siblings, like partnership formations and corporate reorganizations. Because of the difficulty in valuing assets, we often wait until income is realized before imposing tax liability. This creates non-uniformity between realized and unrealized income.

Another example is the exclusion of imputed income—such as the value of services provided to oneself or within one's family. If I stay home when my daughter is sick, I have greater ability to pay than a neighbor who must pay a babysitter when their child is home sick. But because of the difficulty of measuring the value of such services in the absence of a market-based transaction, and because of concerns about government intrusiveness into private realms, we general-

[48] Victor Fleischer, Regulatory Arbitrage, Texas L. Rev. (2010).

ly do not tax imputed income, creating non-uniformity between explicit and imputed income.

Do administrability concerns justify non-uniformity? Possibly with respect to timing—questions of realization and recognition—but not rate. The amount of income from a capital asset can usually be assessed when the asset is bought or sold. Valuation is more difficult at other times, and such measurement may be necessary to implement a tax on capital income. But we need not adopt a mark-to-market system in order to tax capital income effectively.

Tax rates do interact with timing concerns. As tax rates increase, the value of deferral increases. I address those concerns in my discussion of the lock-in effect below. Non-uniform rates might also be called for as a corrective to timing mistakes, as in Alan Auerbach's proposal for retrospective capital gains taxation. But as a general matter, measurement concerns do not affect the justification for uniform rates.

Pigovian arguments for non-uniformity

The government often lowers tax rates for activities thought to be socially beneficial and sometimes increases tax rates for activities thought to be socially harmful. I generally find Pigovian justifications for tax to be unpersuasive as a matter of institutional economics.[49] The case for Pigovian taxation depends on an assumption of uniform social costs across different firms or individuals—an assumption that is rarely true outside of the context of a carbon tax.[50]

A common argument for taxing capital income at a low rate or not at all is that investment in capital assets causes more economic growth. In other words, a low tax rate on capital income might encourage savings over consumption, lowering the cost of capital. Empirical evidence for this proposition is not robust, however.[51]

The argument is sometimes couched in terms of entrepreneurship. We provide a wide array of government tax subsidies oriented towards entrepreneurs and investors in small business and venture-backed companies. Yet there is precious little evidence that entrepre-

[49] Victor Fleischer, Curb Your Enthusiasm For Pigovian Taxes, Vand. L. Rev. (2015).

[50] Id.

[51] Summarize literature from Saez paper.

neurs and their investors are very sensitive to tax rates; the subsidy is mostly inframarginal.[52]

Moreover, to the extent that a low tax rate on capital income benefits the economy, those benefits must be balanced against the costs of (1) the government's error rate in mischaracterizing labor income as capital income, and (2) equity considerations when people with high capital income (as a proxy for unequal opportunity) pay tax at a low rate. In my view, the high rate of mischaracterization and the importance of equity considerations outweigh the weak empirical relationship between capital income taxes and economic growth.

Summary of Normative Theory

Economic income provides a good baseline for taxation because it is the best available proxy for ex ante equality of opportunity. Tax rates should generally be uniform, regardless of source, to minimize the social costs of tax planning behavior, to minimize the role of tax institutions in shaping social policy, and to maximize economic freedom.

B. A Review of the Arguments

Having established a prima facie case for taxing capital income, I can turn now to the classic arguments for the capital gains preference in particular. The most relevant arguments for a capital gains preference include the following:

Consumption, Not Income, Should be Taxed

Consumption tax advocates sometimes argue that because capital gains arise from saved income, a capital gains preference brings us closer to the ideal. Cunningham & Schenk noted that a consumption tax ideal provides no reason for favoring the sale of capital assets over other forms of income from savings. Moreover, the preference for capital assets over other assets distorts the allocation of resources.[53]

The phenomenon of *alpha* income further undermines this justification for the capital gains preference. An income tax with a capital gains preference resembles a "prepaid" consumption tax, i.e., an income tax with a partial exemption for income from savings. When

[52] Cite to Clingingsmith & Shane; Bruce.

[53] Cunningham & Schenk, supra note x, at 327.

labor income is mischaracterized as capital income, the consumption it funds goes untaxed. Suppose, in an attempt to approach a consumption tax ideal, we reduced the capital gains rate to zero. Because *alpha* income is taxed as capital gains instead of ordinary income, a founder or fund manager would face no tax at all on their labor income, and their consumption would go entirely untaxed.

By contrast, a postpaid consumption tax, such as a value-added tax, would avoid regressive consumption tax rates based on the source of labor income. It is entirely possible that a progressive, postpaid consumption tax would better satisfy the goal of advancing equality of opportunity. But so long as we tax income rather than consumption, a capital gains preference does not move us closer to a consumption tax ideal.

Double Taxation of Corporate Earnings

Defenders of the capital gains preference often argue that it is necessary to reduce the problem of double taxing corporate earnings. Cunningham & Schenk explained that a capital gains preference is a very poor second-best alternative to integration. For example, the capital gains preference exacerbates the incentive of corporate managers to retain earnings rather than distribute them. Moreover, if double taxation is the rationale, then the definition of a capital asset should be limited to stock in C Corporations.

The analysis is similar in light of *alpha* income. To the extent that *alpha* income is derived from the sale of stock in a C Corporation, and to the extent that shareholders, not employees, bear the burden of the corporate tax, it is correct that the recipients of *alpha* income indirectly bear some of the incidence of the corporate tax. Of course, it is also true that to the extent that salaried employees bear the burden of the corporate tax in the form of reduced wages, the employees are double-taxed. Yet employees of C Corporations receive no preferential rate on wage income. Why should shareholders but not employees avoid the burden of the corporate tax, even in a second best world?

Moreover, the assumption that capital gains have already been taxed at the corporate level has become a heroic assumption in the last twenty years. For passthrough entities, there is no entity-level tax, and passthrough entities now outnumber C Corporations by a wide margin.

The double tax justification for the capital gains preference fares only somewhat better in the technology industry. Apple, Google, Facebook, Air-BnB and other companies that have generated large gains for founders pay tax at a low rate thanks to transfer pricing, cost sharing agreements, and other tax planning techniques.

In sum, alpha income is inconsistently burdened by the corporate tax. Double taxation is a weak, though not completely spurious, justification. Obviously, to the extent that double taxation of corporate earnings is viewed as problematic, a dividend paid credit or other approach to corporate integration would be a superior second best alternative.

Inflation

Advocates for the capital gains preference often point out that part of the increase in the sales price of a capital asset reflects inflation rather than real economic gain. Cunningham & Schenk explained that the benefits of deferral, over time, comes to offset and eventually surpass the burden of inflationary gains. Moreover, because the capital gains preference applies to real gains and not just inflationary gains, "the historically designed capital gains preference is so rough as to provide no justice; in many cases it would exclude real gain and in almost all cases would account for inflation on a purely random basis."

Inflation is an even weaker justification for a preference for *alpha* income. Because the "investment" in the capital asset is made with pretax dollars in the form of foregone wages, the deferral benefit is larger and more than offsets the inflationary gains.

Risk

Because our tax system limits taxpayers' ability to use capital losses to offset ordinary income, it is sometimes argued that a preference is necessary to reduce a bias against risk-taking that an income tax would otherwise induce. Cunningham & Schenk explained that it is hardly clear that an income tax discourages risk-taking, and that even if it does, the definition of a capital asset is not well designed to remedy such a bias.

Alpha income is more heavily burdened by the income tax than portfolio income; one cannot costlessly scale up labor efforts or costlessly diversify away firm-specific risk. But I find the argument for

using the capital gains preference as a tax subsidy for entrepreneurial activity to be weak.

The strongest case for an entrepreneurial risk subsidy is set forth by Ron Gilson and David Schizer, along with William Gentry's contribution to this volume. Gilson & Schizer describe the entrepreneur's ability to take cheap founders' stock as compensation as a useful tax subsidy for entrepreneurship. Similarly, Gentry argues that the burden of taxation likely causes an undersupply of entrepreneurs.

I am unpersuaded. Tax is not a very good policy instrument for increasing the supply of entrepreneurs. Most of the benefit of the tax subsidy is inframarginal; every founder who succeeds benefits from the capital gains preference, even if they would have started a business in an environment with higher capital gains rates. Tax is not a first-order consideration for most entrepreneurs.

Nor is it clear that we have an undersupply of entrepreneurs generally. Rather, what people often mean is that there is an undersupply of qualified technology-focused entrepreneurs seeking venture capital. But tax is not constraining the supply. Rather, the supply of such entrepreneurs is constrained by the limited number of people with the leadership experience, technological expertise, finance and accounting skills, and human capital necessary to form a successful start-up.

Lock In Effect

The strongest argument for a capital gains preference for *alpha* income is an efficiency-based argument that the holders of appreciated assets will be more likely to hold on to those assets as tax rates rise. Lock-in both reduces revenue and creates an additional efficiency cost because the holders of appreciated assets may not be the most economically efficient owner of the assets.

Alpha makes the lock-in effect look somewhat less problematic compared to portfolio investors. On the one hand, founders and fund managers often do not control the timing of disposition in the same way that a portfolio investor does. *Alpha* income this tends to be less elastic than portfolio income. On the other hand, when an entrepreneur does control the timing of disposition and tax distorts the decision to sell, the efficiency cost from the misallocation of ownership may be larger than when portfolio investors hold on to shares.

Consider the effect of lock-in on the founders of a successful venture-backed company. Lock-in is not normally important. Venture capitalists exert a great deal of influence, through contract and otherwise, to control the timing of a sale of a portfolio company.[54] If the company is successful enough to go public, founders usually sell shares in an initial public offering or secondary offering in order to diversify their portfolio and reduce exposure to firm-specific risk. There is no empirical evidence showing a relationship between capital gains tax rates and the holding period of venture-backed founders. On the other hand, founders of highly successful companies like Facebook or Google often hold so much equity that it is not practical to sell their entire stake, and founders typically hold on to some shares so that their heirs will get a step up in basis at death. As tax rates increase, such tax-motivated planning activity can be expected to increase as well.

Lock-in may exert a greater effect on small and family-owned businesses. Without pressure from outside equity investors or the pressure of market timing, tax may become an important consideration.

C. Timing

Consistent with earlier literature, lock-in remains the most plausible argument for the capital gains preference. The efficiency cost of lock-in must be evaluated in light of *alpha* income, however, which somewhat weakens the concern. More importantly, *alpha* income changes the trade-off between equity and efficiency. Even if lock-in occurs, and imposes an efficiency cost, the fact that most of the benefit of the capital gains preference occurs at the top of the income distribution—and that some of this income is disguised labor income—

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[54] Lock-in has little effect on the fund managers. Because most investors in venture capital, private equity, and hedge funds are tax-exempt, the investors care only about maximizing pretax returns. In theory, agency costs could lead a fund manager to defer the sale of a portfolio company in order to defer the capital gains tax on carried interest. But tax is not a first-order consideration. First, the amount of carried interest depends on pretax returns, so any tax savings gained from deferral risks being swamped by a decline in pretax returns. Second, fund sponsors are engaged in fundraising for new funds while old funds are still active, and investors judge the quality of funds by looking at the internal rate of return. Even if deferral might bring a tax benefit, it risks depressing the fund's IRR. If anything, agency costs appear to inefficiency accelerate exits, not defer them. Finally, fund managers have a legal obligation to consider what is best for their investors, not themselves. While fund managers are known to disregard fiduciary obligations not infrequently, the legal obligation to maximize returns for the investors may also mitigate the lock-in effect.

changes the equity analysis. A capital gains preference makes it impossible to maintain progressivity across the income distribution.

The better response to lock-in is to make the disposition of a capital asset by gift or bequest a taxable event. Lock-in is caused by both a timing distortion (deferral) and a measurement distortion (the exemption of capital gains disposed of by gift or bequest, and the associated step-up in basis at death). The measurement distortion, not the timing distortion, is more important. The owners of appreciated assets are often willing to defer income in the hopes of avoiding tax altogether. They are rarely willing to defer income merely for the time value of money.[55]

There are other options. David Miller, for example, has argued for a mark-to-market regime for publicly-traded assets. I am skeptical, however, of the government's ability to police planning behavior. If publicly-traded stocks are marked-to-market, then surely it would be necessary to mark derivatives to market as well. That would be a good change in the law as well, I think, but even more may be required. For example, it might be necessary to mark-to-market illiquid classes of stock that are not publicly traded. Moreover, some founders would opt to keep a business private on the margins to avoid paying capital gains. Mark-to-market is certainly an idea worth pursuing, but many details need to be worked out.

Another option is Alan Auerbach's proposal for retrospective capital gains taxation. Under this approach, a deferral charge would be added to the tax calculation at the time of disposition. This approach, like mine, would require us to treat the disposition of a capital asset by gift or bequest as a taxable event.

If we assume, for the sake of argument, that disposition of a capital asset by gift or bequest is treated as a taxable event, then the advantage of retrospective capital gains taxation over a uniform rate structure is less obvious. Given the administrative challenges associated with retrospective capital gains tax and the administrative benefits of simply repealing the preference, it seems preferable to just treat income as income.

[55] See Treasury Estimates on White House Budget Proposal FY 2016 (showing large revenue increase from treating death as a realization event).

The hard part, then, is treating disposition by gift or bequest as a taxable event. That said, the primary challenge is political, not administrative.[56]

D. Imperfect Political Institutions

Congress is not a perfect political institution. It works with imperfect information provided primarily by lobbyists. Small business, in particular, tends to fare well. In part this is because of true political preferences; small business is thought to be important to the fabric of our system of entrepreneurial capitalism. Small business has proven to be an engine of social mobility for generations of immigrants.

In part, small business has fared well because it provides cover for big business. Section 1202, for example, provides exemption from capital gains tax for qualified small business stock. The exemption is limited to C Corporations, however, thereby excluding vast majority of small business owners. In effect, section 1202 is a tax subsidy for angel investors, venture capitalists, and a few lucky venture-backed entrepreneurs. Similarly, our generous rules for passthrough business taxation are usually publicly justified as helping small business, even though many finance, real estate and oil and gas firms that qualify as passthroughs are anything but small.

In my view, an ideal tax code drafted by a Congress acting purely in the public interest would contain no subsidies for small business. Once those assumptions are relaxed, it seems foolish to make perfect the enemy of the good. There are legitimate concerns about the efficiency costs associated with lock-in, particularly in the context of small, family-owned businesses. Treating disposition by gift or bequest as a taxable event would mitigate but not eliminate the lock-in effect.

To simplify the policy choices somewhat, imagine a trade-off between equity and efficiency. For middle-income taxpayers, abolishing the capital gains preference imposes a potential efficiency cost, especially for small business owners, but slightly improves horizontal and vertical equity. For top earners, taxing capital gains also imposes a potential efficiency cost, but vastly improves both horizontal equity and vertical equity. There are some plausible arguments for a capital gains preference for the middle class—arguments I do not find fully persuasive, but plausible. In light of equity goals, I do not find the

[56] Add graf on Nordic dual income taxes.

arguments plausible for top income earners. And so a limited capital gains preference may be the optimal second-best solution.

V. PROPOSAL

A. Repeal the Capital Gains Preference

Congress should abolish the capital gains preference and tax capital and labor income at a uniform rate. Doing so would reduce inequality at the very top, and it would cost little in terms of efficiency.

B. Revision of Section 1202

To mitigate the lock-in effect on small business owners, and to provide a politically-necessary subsidy for small business owners, Congress should modify Section 1202. Current section 1202 provides for the exclusion of up to $10 million of gains from the sale of qualified small business stock, limited to Subchapter C corporations. Section 1202 should be amended to allow the exclusion of income from the sale of common stock in a qualified small business, up to a lifetime limit of $1 million per household. The definition of a qualified small business should be expanded to include Subchapter S corporations as well as Subchapter C corporations.

This proposal may be able to garner more political support than a simple repeal of the capital gains preference. The owners of most small businesses have less than $1 million in unrealized appreciation, and those with more than $1 million would still enjoy lower effective tax rates. The burden of taxing gains in excess of $1 million would fall only on reasonably or very wealthy taxpayers.

It's possible, of course, that political preference will demand additional carve-outs beyond what I have proposed. If forced to make trade-offs, it is likely to be better policy to allow exceptions than to cede ground on the uniform rate structure.

For example, current law provides numerous retirement savings vehicles that allow for the deferral of income. Congress could make it easier for entrepreneurs and small business owners to hold assets in those vehicles, deferring income until retirement age (but taxing distributions at ordinary rates).

C. Disposition by Gift or Bequest as a Taxable Event

[It is essential that capital gains reform by accompanied by a provision treating disposition of an asset by gift or bequest as a taxable event. As effective tax rates on capital gains rise, tax planning will increase in search of a zero rate.]

VI. CONCLUSION

It is sometimes said that we cannot solve inequality by taxing the rich. That statement is only partly true. The effective rate of tax on the top 400 taxpayers is very close to the capital gains rate. Repealing the capital gains preference would raise about $x billion a year just from 400 taxpayers. It would raise about $x billion a year from the top 0.1%. Those taxpayers would all still be very rich, but slightly less so. And the revenue could be used to reduce payroll taxes or expand the EITC, thereby boosting the after-tax income at the low end. Or the revenue could be used to enhance access to higher education for poor and middle-income families.

If addressing inequality is the goal, then repealing the capital gains preference is far preferable than increasing the top ordinary income rate. The rich earn most of their income from *alpha*, and *alpha* is usually taxed as capital gains. The policy priorities of the Democratic party in recent years suggests that this is news to them. Raising the top ordinary income rate affects the top 2% of taxpayers, but not the top 0.1%. Indeed, by stirring up broader resentment towards high tax rates, raising the top ordinary income rate arguably benefits the top 0.1%, who might be happy to pay a higher tax on ordinary income if that is the cost of preserving a low tax rate on their much larger capital gains.

Capital gains policy is just one small part of the inequality debate. The tax system did not cause inequality. It cannot fix inequality—unless we were to impose confiscatory tax rates that would stifle economic growth. What the tax system can and should do is treat people fairly, with average tax rates rising with income. The tax system fails spectacularly at the very top end, where capital gains are concentrated.

TOP 50 - FORBES 400				
	Name	Wealth	Source	Type
#1	Bill Gates	$76 B	Microsoft	Founder Stock
#2	Warren Buffett	$62 B	Berkshire Hathaway	Founder Stock
#3	Larry Ellison	$47.5 B	Oracle	Founder Stock
#4	Jeff Bezos	$47 B	Amazon.com	Founder Stock
#5	Charles Koch	$41 B	diversified	
#5	David Koch	$41 B	diversified	
#7	Mark Zuckerberg	$40.3 B	Facebook	Founder Stock
#8	Michael Bloomberg	$38.6 B	Bloomberg LP	Partnership Equity
#9	Jim Walton	$33.7 B	Wal-Mart	Founder Stock
#10	Larry Page	$33.3 B	Google	Founder Stock
#11	Sergey Brin	$32.6 B	Google	Founder Stock
#12	Alice Walton	$32 B	Wal-Mart	Founder Stock
#13	S. Robson Walton	$31.7 B	Wal-Mart	Founder Stock
#14	Christy Walton	$30.2 B	Wal-Mart	Founder Stock
#15	Sheldon Adelson	$26 B	casinos	
#16	George Soros	$24.5 B	hedge funds	Carried Interest
#17	Phil Knight	$24.4 B	Nike	Founder Stock
#18	Forrest Mars, Jr.	$23.4 B	candy	Founder Stock
#18	Jacqueline Mars	$23.4 B	candy	Founder Stock
#18	John Mars	$23.4 B	candy	Founder Stock
#21	Steve Ballmer	$21.6 B	Microsoft	Founder Stock
#22	Carl Icahn	$20.5 B	investments	Carried Interest
#23	Michael Dell	$19.1 B	Dell	Founder Stock
#23	Laurene Powell Jobs	$19.1 B	Apple, Disney	Founder Stock
#25	Anne Cox Chambers	$18 B	media	
#26	Paul Allen	$17.8 B	Microsoft	Founder Stock
#27	Len Blavatnik	$17.7 B	diversified	
#28	Charles Ergen	$16.4 B	satellite TV	
#29	Ray Dalio	$15.3 B	hedge funds	Carried Interest
#30	Donald Bren	$15.2 B	real estate	
#31	Abigail Johnson	$14.2 B	money management	
#32	James Simons	$14 B	hedge funds	Carried Interest
#33	Thomas Peterffy	$13.5 B	discount brokerage	
#34	Elon Musk	$13.3 B	Tesla Motors	Founder Stock
#35	Patrick Soon-Shiong	$12.9 B	pharmaceuticals	
#36	Ronald Perelman	$12.5 B	leveraged buyouts	
#37	Steve Cohen	$12 B	hedge funds	Carried Interest
#38	Rupert Murdoch	$11.6 B	media	Founder Stock
#38	Stephen Schwarzman	$11.6 B	investments	Carried Interest
#38	David Tepper	$11.6 B	hedge funds	Carried Interest
#41	John Paulson	$11.4 B	hedge funds	Carried Interest
#42	Andrew Beal	$11 B	banks, real estate	
#43	Philip Anschutz	$10.9 B	investments	
#44	Charles Butt	$10.7 B	supermarkets	
#45	Donald Newhouse	$10.6 B	media	
#46	Samuel Newhouse, Jr.	$10.3 B	media	
#47	Jack Taylor	$10.1 B	Enterprise	Founder Stock

	Name	Wealth	Source	Type
#48	Eric Schmidt	$9.9 B	Google	Executive Pay
#49	John Menard, Jr.	$9.2 B	retail	
#50	Jim Kennedy	$9 B	media	