

Top income inequality and tax policy

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The strikingly high levels of income concentration at the top in the UK have drawn increasing attention in the public policy debate. The top 1% of adults received 15% of fiscal income in 2018–19. This is more than flows to the bottom 55% of adults combined, and is an increase from the 6% income share flowing to the top 1% in 1980. At the same time, the taxation of top incomes is in desperate need of reform. The way in which dividends, retained earnings and capital gains are taxed in the UK looks far from optimal. The concentration of top incomes and the need for reform of the way that income is taxed are common issues across many developed economies.

The article by [Isaac Delestre](#), [Wojciech Kopczuk](#), [Helen Miller](#) and [Kate Smith](#) provides a comprehensive assessment of top income measurement, current tax policy and key directions for reform. It is a remarkable source of information and ideas providing a valuable perspective on top income inequality and tax policy options. The three commentaries by [Owen Zidar](#), [Arun Advani](#) and [Andy Summers](#), and [Emmanuel Saez](#) and [Gabriel Zucman](#) add further depth and perspective, highlighting the key role of capital gains taxation and the role of wealth taxation. Taken together with the other contributions to the IFS Deaton Review, including those on the role of firms, labour markets, trade and geography, this material provides a unique new view of top income inequality and its drivers as well as insights into the range of policies available to address some of the key inequality concerns in the UK.

The [main article](#) begins by noting that while taxes on personal income are progressive on average in the UK, average tax rates are not always higher for those with higher incomes because they depend not only on the level of income that people have but also on the sources from which they get that income. Those who receive more of their income from capital are able to access tax rates considerably below those available to the majority of taxpayers. This is a particular issue when it comes to top incomes in the UK since the top 1%, especially the top 0.1%, are much more likely to get their income from active business ownership than those lower down in the income distribution. This business income typically comes either from partnerships (a form of self-employment) or from owner-managers of ‘closely held companies’. These differences in source of income matter hugely for tax rates and tax revenue as the average tax rate on wage earners in the top 1% is as high as 49%, but company owners are able to access a rate of just 27% on income taken in the form

of capital gains, which falls to 0% if the realization of gains is deferred until death.

The main analysis in the article is based on ‘fiscal income’, a broad measure that captures most income sources but notably excludes capital gains and untaxed incomes. Including taxable capital gains in the measurement of top 1% incomes is not straightforward, as realized gains are likely to be lumpy and untaxed gains, notably including those from main residences, are more evenly spread across the income distribution. However, when it comes to the tax reform of top incomes, capital gains taxation is a key issue because capital gains, including those from profits retained in businesses, flow disproportionately to the top 1%.

[Delestre et al.](#) make a strong case for aligning the tax rates on different forms of income, while reforming the tax base so that taxes on business income do not unduly discourage investment. A key counterargument for having lower rates on some forms of business incomes is that they encourage investment and innovation. However, as the [Mirrlees Review](#) pointed out, this argument mainly depends on taking the current tax base (the set of income subject to tax) as a given. In fact, the trade-off between higher tax rates and incentivizing innovation and investment could be largely avoided if the tax base were reformed so that, as far as possible, higher rates do not unduly discourage investment. Conceptually, this can be achieved by exempting the normal rate of return to saved or invested income. Rates can then be aligned, including removing the preferential rate of capital gains tax given to business owners and the forgiveness of capital gains tax at death. By reducing ‘escape routes’ for tax revenue, a reformed tax base that removed these distortions would also allow more revenue to be raised from high-income individuals, if desired.

One of the biggest challenges for tax reform and for the measurement of top incomes is the lack of (tax or survey) data on incomes that evade taxes. The authors point to evidence that suggests as much as 8% (12%) of the income flowing to the top 1% (0.1%) may go unrecorded as a result of undeclared holdings in tax havens. Measures of fiscal income also miss gifts and inheritances. The authors point to evidence that inheritances are twice as important relative to incomes for those born in the 1980s as for the generation born in the 1960s. Although income taxes will clearly affect how much wealth is accumulated and inherited, changes to inheritance tax could tackle this form of inequality much more directly.

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In his commentary, [Owen Zidar](#) first notes the striking similarities between the USA and the UK, especially in terms of the prominent role that business owners play at the top of the income distribution. The concentration of capital gains in the UK among the top 1% is also similar to the concentration of capital gains in the USA. Zidar notes that most individuals in the top 1% are active owner-managers and that their incomes often reflect disguised wages of private business owners. He finds that much more of the rise of top incomes in the USA is due to labour income rather than capital income.

Although top incomes include many business owners, [Zidar](#) also points to the many 'missing entrepreneurs' implied by an examination of who business owners are. That is, entrepreneurship rates are much lower for people from less advantaged family backgrounds. Assuming entrepreneurial talent is similar by race, gender and parental income, he points out that this implies there are many more people who would be entrepreneurs if opportunity were spread more widely in the USA. This clearly has implications for overall productivity growth and innovation.

Turning to tax reform, [Zidar](#) notes the general pattern of declining progressivity of the US tax system and relatively low levels of taxation at the top. He uses this to point to feasible policies that could increase revenues and tax progressivity. His focus is on the revenue potential from taxing capital gains, which, as we saw from the [main article](#), is going to be important for tax reform in the UK. Zidar argues that the revenue potential from increasing tax rates and broadening the tax base on capital gains may be substantially larger than previously thought.

In their commentary, [Arun Advani and Andy Summers](#) provide a timely and detailed analysis of measurement issues. They argue there is nothing immutable about the definition of fiscal income even though it has the singular benefit that it is relatively straightforward and uncontroversial to measure at the individual level when one has access to administrative tax data. Their focus is on the role of capital gains, of non-fiscal income and the role of entrants/immigrants in the top percentiles of income. They show that migrants make up a large and increasing proportion of top income shares in the UK. They are twice as prevalent in the top 0.01% as anywhere in the bottom 97% of the distribution, and the vast majority (90%) of the observed rise in the top 1% share over the past 20 years has accrued to migrants. Like [Delestre et al.](#), they note the difference between the headline tax rate and effective tax rate on income, and how it is driven by a combination of lower/nil rates of National Insurance on some sources of income, lower income tax rates on dividends and the use of various deductions and reliefs. Again like [Delestre et al.](#), they make the case for equalizing the treatment of capital gains and income and for aligning marginal tax rates across capital (and labour) income sources.

In terms of capital gains, [Advani and Summers](#) argue that treating gains more like income, with appropriate adjustments to the base and averaging provisions to account for lumpiness, would improve efficiency and equity (both horizontally and vertically) and raise substantial revenue. They point to three concerns about low rates on capital gains. First, using reduced rates of tax on capital gains is a relatively inefficient way to support risk taking. If support for risk taking is desired, ex ante support is likely to be more cost-effective than preferential tax treatment only after the gains have been made. Second, the reduced rate for capital gains is strongly regressive in practice. Around 92% of all taxable gains, by value, go to the top 1% ranked on total remuneration; 88% go to individuals with total gains exceeding £100 000. Third, these reduced rates distort how people structure their remuneration;

the authors point to research that shifting income from labour to gains is a major driver of the observed responsiveness of owner-managers to income tax rates. In other words, this feature of the tax system creates avoidance opportunities, which reduce the ability of policymakers to influence overall tax revenue by changing income tax rates.

They also argue that the reform of inheritance tax is key. They note that transfers of wealth (inheritances and gifts) are estimated to total approximately £127 billion per year in the UK, around 7% of GDP. There are completely unjustifiable rules on agriculture and business, and the authors suggest a capital acquisitions tax much as is implemented in Ireland and recommended in the Mirrlees Review. Taken together, reforms to capital gains tax and inheritance tax could raise more tax from the wealthy.

[Advani and Summers](#) also make the case for a one-off wealth tax, which they argue can reduce manipulation provided the valuation date is set before the date of announcement and that this date is also the relevant date for determining liability to wealth tax. These forestalling measures are not possible in the same way for an annual wealth tax. The authors do though emphasize the potential for an annual wealth tax starting at a high threshold, covering only a small proportion of the adult population. They argue that current theory and empirical evidence suggest that there is a principled economic case for a recurrent tax on wealth applied to those with very high levels of wealth. They conclude by noting that whether or not an annual wealth tax is brought in, it is not a substitute for fixing the problems with existing capital taxes.

In their commentary, [Emmanuel Saez and Gabriel Zucman](#) focus on tax evasion and wealth taxation. They note that the administrative environment for a wealth tax is very different now from that in the past. European wealth taxes were based on self-reported asset values. Today, tax authorities can leverage the information they receive from third parties (banks, brokers, pension funds, insurance companies, etc.). In principle, this information could be used to pre-populate wealth tax forms, reducing the need for self-reporting and thus the scope of under-reporting. The authors argue that tax evasion can be curtailed with proper information collection and the regulation of the suppliers of tax evasion services.

Like the other contributors, [Saez and Zucman](#) highlight capital gains, which they argue currently can escape taxation for decades and often forever, as the wealthy wait to sell their stock and other assets. To address this issue, they propose a one-off tax on the stock of unrealized capital gains of billionaires. All these unrealized capital gains could be deemed realized at a particular date, and these gains would be subject to the individual income tax but with payments spread over 10 years. The authors argue that such a tax on the stock of unrealized gains of billionaires would be a simple way to tax 'above-normal' returns and, as a one-off tax on the stock of unrealized capital gains, would raise substantial sums given the increase in billionaire wealth in recent years.

The reform of taxation of top incomes, including capital gains and inheritances, is long overdue. We have seen that much of the income in the top 1% is generated through business activities, which may be a source of investment and innovation thereby driving productivity growth. There has been debate about the extent to which the incomes of business owners reflect the returns to capital investments or entrepreneurial risk taking versus the return to labour effort. A large portion of UK closely held companies have no employees other than the owner and carry out little or no investment activity.

Nonetheless, given the stagnation of productivity growth in the UK, the key to policy reform is to generate revenue for redistribution and for public goods while not unduly taxing investment and innovation activities. The history of reforms to capital gains reflects this debate, with pressure on increasing rates to tax all income streams fairly against pressure to reduce rates to spur productivity. The result is a tax system of top incomes in which the average tax rate on wage earners in the top 1% is far higher than that on company owners, who face an effective tax rate of 0% if they take their income as capital gains and organize the realization of those gains to be deferred until death. These contributions to the IFS Deaton Review show how tax base reforms can address

the concerns over deterring risk taking and innovation, while allowing for alignment of tax rates across labour and business incomes. The contributions have also made the case for a more detailed examination of a wealth tax.

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