Piketty in America: A Tale of Two Literatures

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Law & Economics Colloquium, October 16, 2014

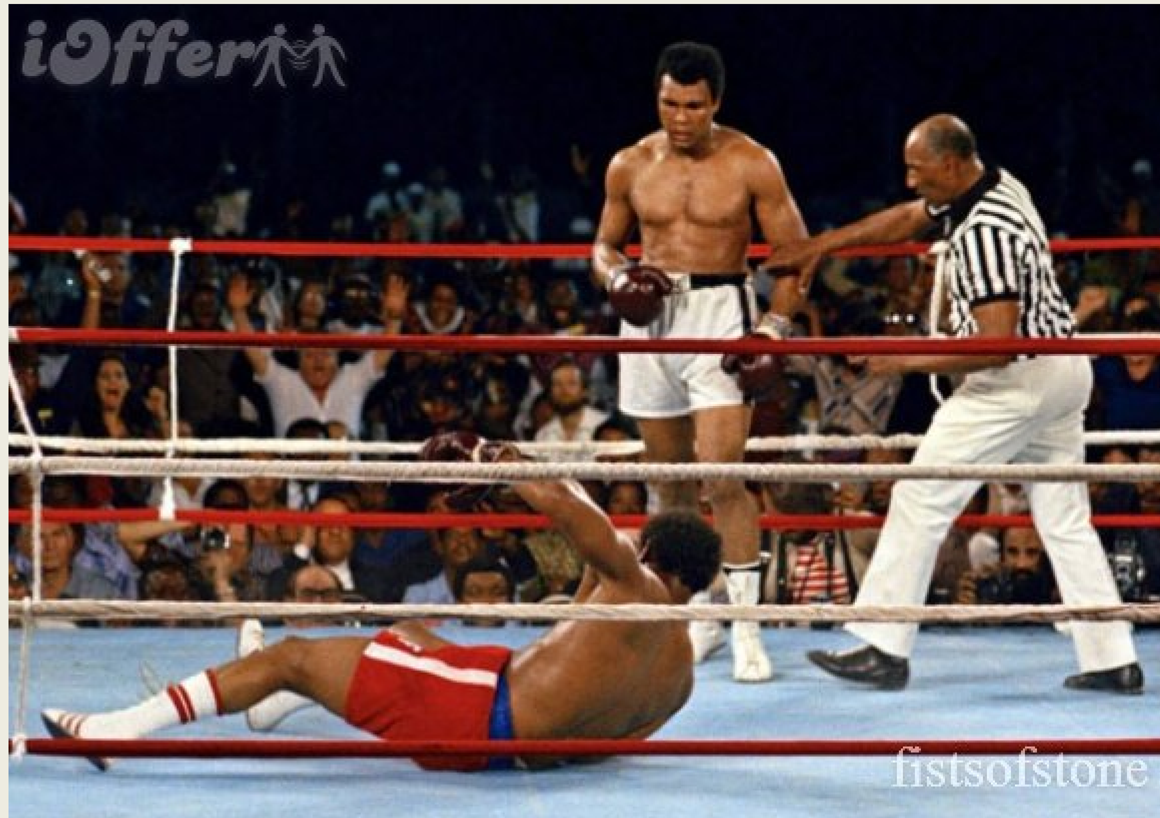
Capital in the 21st Century vs. the "Standard Tax Policy Literature"

Paper written with Joe Bankman for NYU-UCLA Tax Policy Symposium (attended by Piketty, who responded).

Central idea: there is a large gap between the assumptions & approaches in (a) Piketty, *Capital in the 21st Century*, & (b) standard literatures (OIT, fundamental tax reform, mainstream public & welfare economics, etc.).

We aim to explain / adjudicate the "dispute," ask how each might enrich or undermine the other, etc.

Some contests are resolved more definitively than others



Scoring the "Bout"

- The literature: internal analytical rigor not always matched by fit between models & the world.
  - Utility just from own consumption?
  - If book is correct about $r > g$, something important has been missed in the savings literature.
  - Political economy of academic scholarship?

- *Capital in the Twenty-First Century*: important basic empirical finding, but how best explain / respond to it?
  - Even under $r >$ g, nuance from the literature may affect policy implications.
  - If human capital at center stage, no first-order normative difference, but greatly changes the prescriptions.

- I'll address (1) "capital" vs. "saving," (2) decomposing *r*, (3) human capital, (4) wealth taxation vs. capital income taxation.

(1) “Capital” vs. “Saving”

What’s in the choice of a word? Perhaps a lot, e.g., when only one (“saving”) is a verbal noun, befitting an ex ante focus on decisions.

Tax policy literature: “capital” is mainly an adjective. (Capital income, capital asset, capital gain.)

“Human capital”: the exception that actually makes the point about where the literature stands.

Capital & labor not seen as distinct groups – it’s high-earners vs. low-earners – ability is the first-order distributional attribute.

Mirrlees doesn’t even have time or capital or savings!

Huge savings literature, but here it’s a taste (Fisher’s 3 brothers) or a stage (lifecycle model).

Vs. Piketty …

Why tax saving?

OIT et al has a strong lean against taxing savings: gratuitous distortion, not needed for progressivity.

To be sure, one still might tax it – e.g., as a tag of high ability, or to impede high-earners from camouflaging themselves as low-ability.

But if rising high-end inequality is driven by $r > g$ and has bad effects, a Pigovian case for taxing ... something.

Wealth without respect to *r*? *R*? Bequests?

Gifts & bequests in the literature

Note Simons' famous argument for double-taxing gifts, as they reflect double consumption (by both donor & recipient).

(Only exception to this is for pure accidental bequests, which can efficiently be expropriated.)

Kaplow: altruistic externalities may support "subsidy" relative to the Simons baseline.

But suppose high-end marginal utility is negligible or deemed so, & that high-end bequests have negative distributional externalities.

Then one may want to tax them at a high rate – e.g., revenue-maximizing or even beyond that?

(2) Decomposing *r*

In Piketty, *r* is unitary, measured ex post. (But if history allowed replays, how might 1815-1900 or 1914-1970 come out?)

The literature decomposes *r* into (a) normal risk-free return, (b) risk (any expected premium ex ante, actual outcome ex post), (c) expected inflation, & (d) inframarginal returns.

Income taxes, but not consumption taxes, aim to reach (a). But it may be quite low (and < *g*).

Both aim to exclude (c) and reach (d).

There is some question as to their capacity to reach (b). Investors can choose portfolios in light of the tax.

While graduated rates, loss limits, & incomplete capital markets may impede risk-taking, a realization-based regime can unduly reward it.

Human capital, part 1

- Importance of rising wage inequality, as distinct from $r > g$, in the recent U.S. story.
- 19th Century: heyday of the rentier?
- Or of the adventurer / arriviste?

Eugène de Rastignac

Human capital, part 2

- But perhaps we do see the subsequent literary decline of the rentier.

Bertie Wooster

Human capital, part 3

- Then there's the modern era to think about.

Leonardo DiCaprio as Jordan Belfort (or if you prefer, as himself)

"Ability" and distributive desert

- I like Piketty's critique of undue moralizing of "ability."
  - Abstract "ability" is as nonsensical a concept as abstract evolutionary "fitness;" both are relative to a given environment.
  - In evolution, no reason to think the "good guys" generally win or that the winners get there by helping everyone else.
  - True, evolution doesn't feature the "invisible hand," but this raises issues of efficiency, not moral desert.

- Efficiency: Piketty is right to question the link between high-end wages & marginal social productivity. BUT:
  - How important here is corporate governance? Note arm's length high-end wages (hedge fund managers, financial sector free agents, etc.)
  - Maybe better to focus on the gap between marginal *private* & *social* productivity? (Financial sector)

What if the main culprit is wage inequality, not $r > g$?

- Under $r > g$, it's relatively simple: tax r!
  - Although: exempt life cycle saving? Focus on bequests? Can / should we tax risk?

- If human capital / wages, a more complicated problem.
  - How reach it consistently? What other behavioral effects? What exactly are the harms caused by high-end inequality? (And is it the same for all high wages, wealth, etc.?)

Possible tax instruments include (1) wealth tax, (2) high-end income tax progressivity, (3) inheritance tax, (4) progressive consumption tax.

Each has its gaps & problems.

Wealth taxation

- Unconstitutional at the U.S. federal level?
  - Might be viewed as an unapportioned direct tax, prohibited by Article 1
  - Can one simulate it by taxing imputed returns & calling it an income tax?
  - Which side has 5 Supreme Court votes when the case goes up?

- True wealth tax, unlike a capital income tax where the risk-free rate is zero, can't be avoided through portfolio choice.

Big problems of valuation, liquidity, and planning – as shown by the closest existing taxes (state and local property taxes, estate taxes, capital appreciation under the income tax).

High-End Income Tax Progressivity

Diamond-Saez have called for 70% top rate (meant to be revenue-maximizing).

- Under existing income tax, richest may not have much income.
  - SEC filing shows that Larry Ellison pledged $250M Oracle shares for personal credit line.
  - The usual menu of possible changes: realization at death, eliminate *Woodsam*, mark-to-market for publicly traded assets, impute market returns generally, stronger anti-shelter rules, address carried interest, etc.

Huge problems if need entity-level taxation for income earned through corporations.

Estate or inheritance tax

Too irregular, lumpy, lagged, unpopular, and planning-prone?

Say we object, not just to high-end inequality, but to dynasties, lack of mobility across time, "unearned"/ "undeserved" success, etc.

To what extent do bequests address the problem?

"Human capital" transmission via good parenting may be benign; via genetics might be viewed as not involving unjust institutions.

But there are other mechanisms. E.g., unequal access to elite education that creates social connections.

Or consider what I call "rentrepeneurs." E.g., Paris Hilton, Chelsea Clinton, Tagg Romney.

Progressive consumption tax

Basic models are: (a) consumed income tax or CIT (all saving deducted, dissaving/borrowing included); (b) X-tax (VAT plus progressive wage subsidy).

In theory, can match progressivity of income tax. But high rates under CIT raise consumption smoothing issues. X-tax can't easily have top rate above the VAT rate.

Even if progressive enough, under $r > g$ they miss the ball, failing to address the negative distributional externality.

But if the problem is high-end wage inequality, should we fully credit the deferred liability as equivalent to paying more tax currently?

Progressive consumption tax, cont.

Under these c-tax models, in theory no benefit to the TP from indefinitely deferring the tax bill by not consuming yet.

And note that, in theory at least, we could treat high-end bequests as taxable consumption acts. (E.g., subject to a large exclusion amount.)

Taxing bequests is often thought at odds with the intertemporal neutrality logic of a consumption tax – but the Simons double-consumption point suggests not!

If bequests aren't taxed, does indefinite deferral mean that wealthy people aren't actually bearing tax burdens on unspent wealth?

NO if the tax is perpetual & unavoidable (value of $$ comes from potential to spend it) – but even apart from the optical problem there is an issue of option value if the tax rate could change.

Two further non-trivial issues

- We need to consider the efficiency costs of the tax.
- We also need a theory of the harms caused by high-end inequality.
  – Is it just low marginal utility of consumption at the top?
  – Negative hedonic externalities? (Relative consumption, status as a zero-sum contest)
  – Concentrated political power / rent-seeking?
  – Lost social cohesion & solidarity?
- These all may imply differing remedies.