Econ 230B – Graduate Public Economics

Progressive wealth taxation

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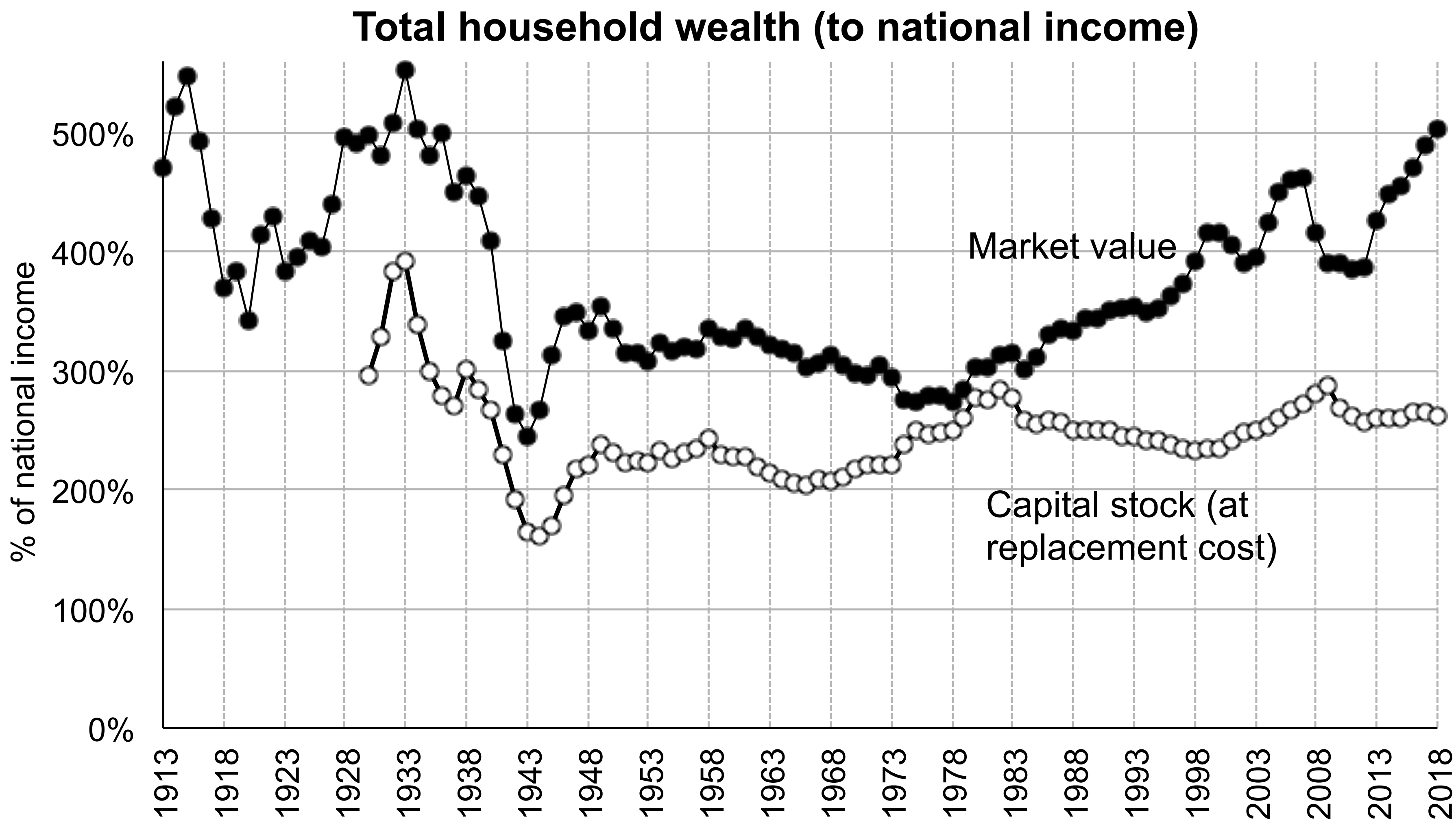
Roadmap

1. Aggregate wealth and its distribution
2. Models of the wealth distribution
3. Optimal wealth taxation

1 Aggregate wealth and its distribution

1.1 What is wealth?

- Wealth = market value of assets (corporate equities, business assets, real estate, interest-bearing assets...) net of all debts
- National wealth = private wealth + public wealth
- US private wealth = 5 times national income (up from 3 in 1980)
- Wealth reflects both capital stock (accumulated through savings) and price effects (reflecting organization of production and market power, eg, Greenwald et al. 2020)



This figure depicts the share of total household wealth relative to national income Source: Piketty, Saez, and Zucman (2018).

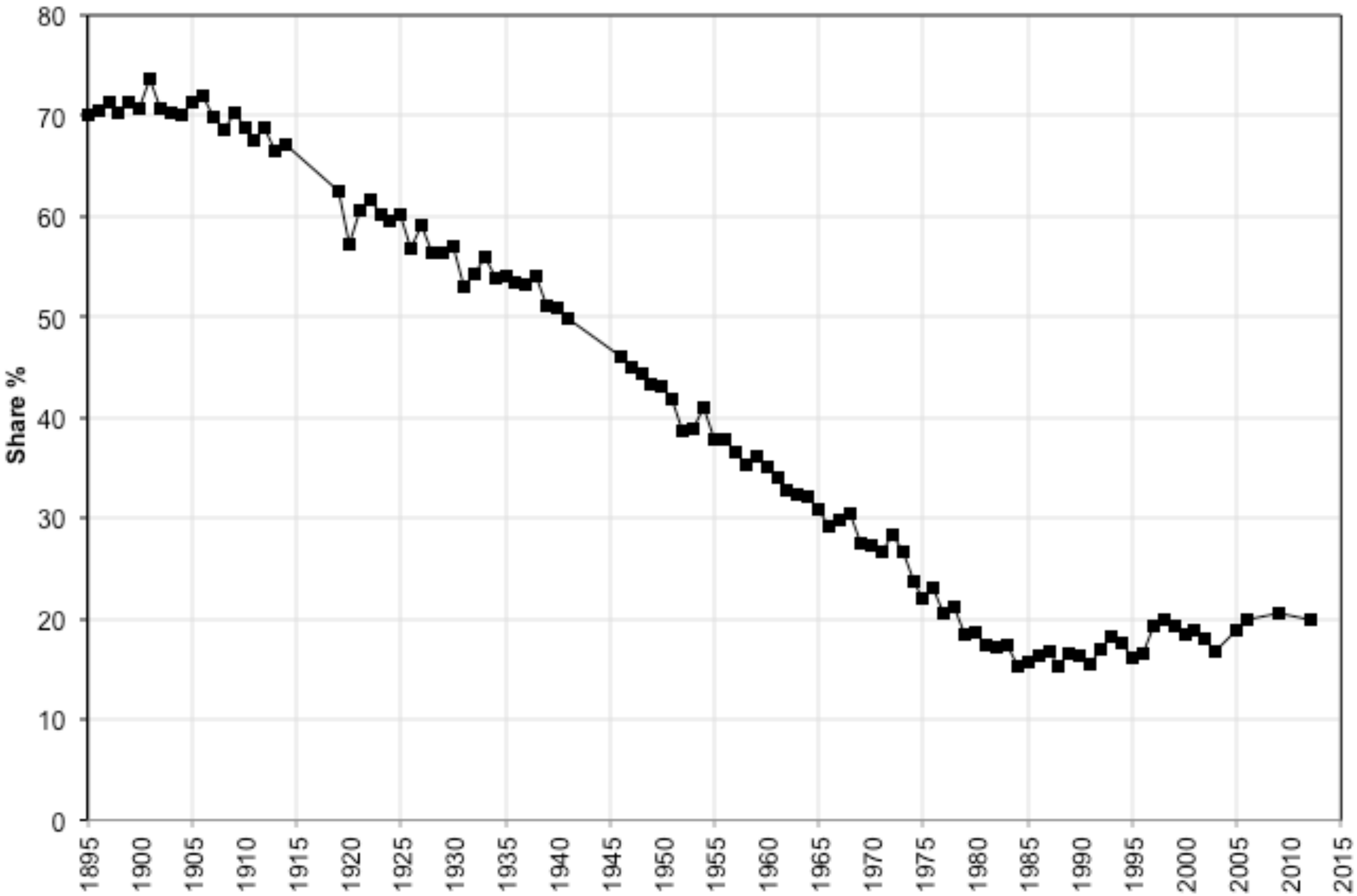
1.2 The distribution of wealth

Three key facts:

- Fact 1: Wealth is very unequally distributed, much more than labor income
- Fact 2: Wealth concentration tends to be particularly high in low-growth societies
- Fact 3: Wealth inequality has been rising in recent decades but there is a diversity of national trajectories

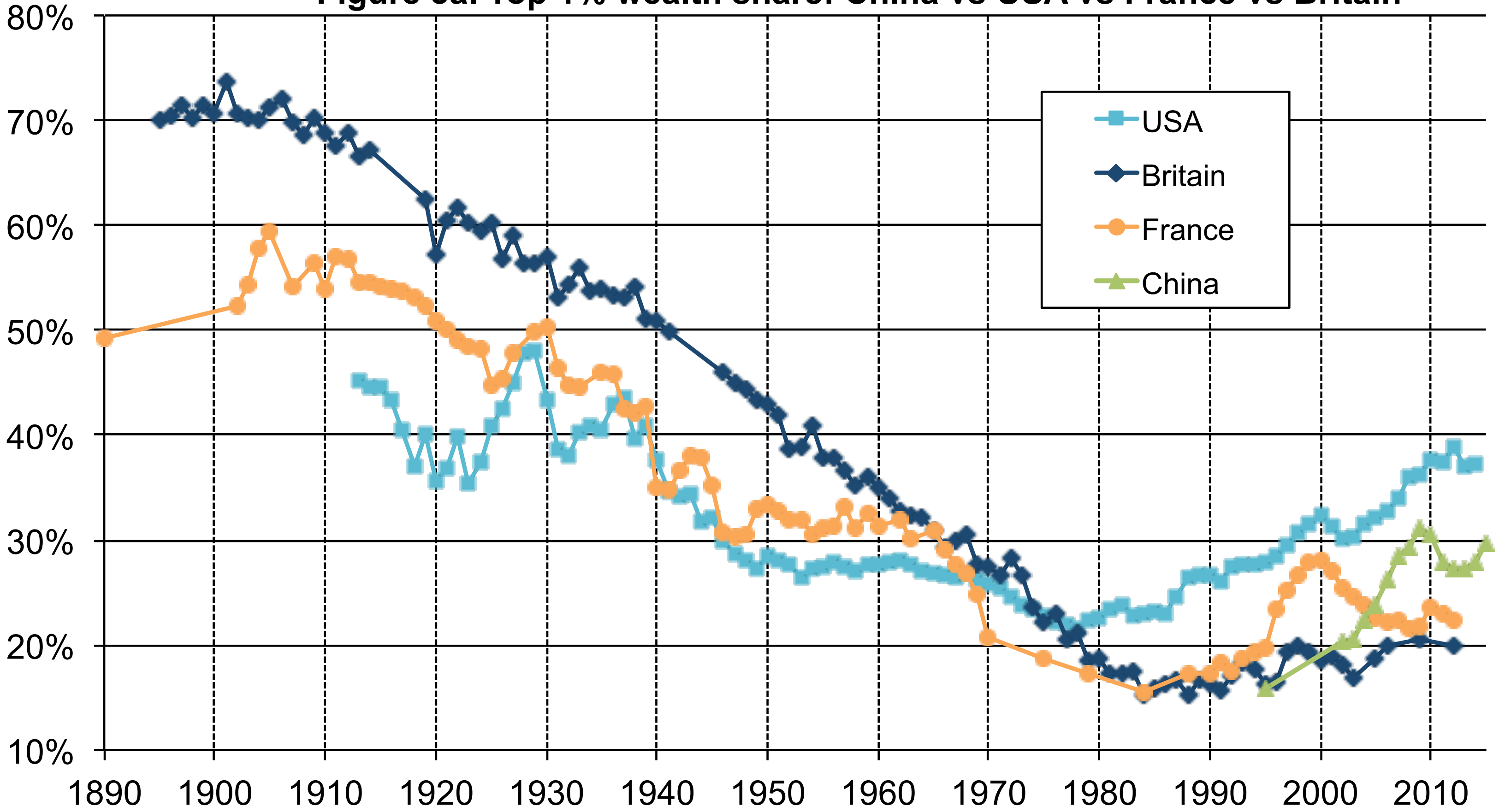
Source: Piketty, Saez and Zucman (2016).

Figure 1. Wealth share of top 1% in the UK 1895-2013



Source: Alvaredo, Atkinson and Morelli (2017).

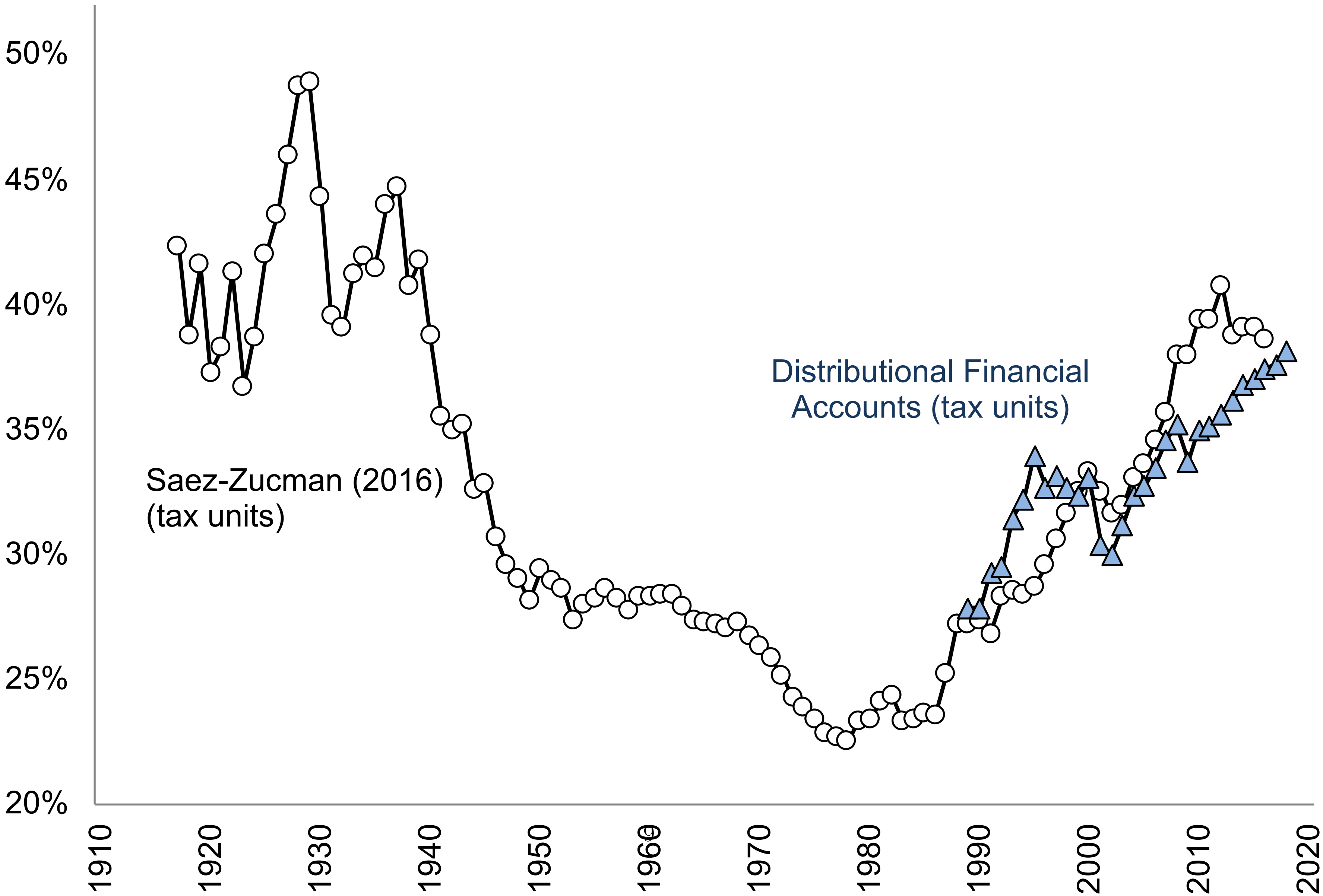
Figure 3a. Top 1% wealth share: China vs USA vs France vs Britain



Distribution of net personal wealth among adults. Corrected estimates (combining survey, fiscal, wealth and national accounts data). Equal-split-adults series (wealth of married couples divided by two). USA: Saez and Zucman (2016). Britain: Alvaredo, Atkinson and Morelli (2017). France: Garbinti, Goupille and Piketty (2016). China: Piketty, Yang and Zucman (2016).

Source: Alvaredo et al. (2017).

Top 1% wealth share



2 Models of the wealth distribution

2.1 Precautionary saving models

- General equilibrium models of wealth accumulation with non-insurable idiosyncratic risks

- Main form of risk: unemployment risk

- Other form of risk: fluctuation in earnings

- Widely used in macro to study the distribution of wealth and the effect of tax policies (see DeNardi & Fella 2017 for a survey)

Aiyagari (QJE 1994)

- Neoclassical growth model with a continuum of infinitely-lived, ex-ante identifical agents who max $U(c_0, c_1, ...) = E_0 \sum \beta^t u(c_t)$

- Idiosyncratic uninsurable shocks to endowment of efficiency units of labor follow Markov process $\pi(\epsilon', \epsilon) = Pr(\epsilon_{t+1} = \epsilon' | \epsilon_t = \epsilon)$

- Problem of each agent can be written in recursive form:

$$v(w, \epsilon) = \max_{c, w'} \left(u(c) + \beta \sum \pi(\epsilon', \epsilon) v(w', \epsilon') \right)$$

$$c + w' = (1 + r)w + v\epsilon \quad \text{and} \quad w' \geqslant -b$$

- Result 1: there exists a stationary equilibrium where the distribution of wealth is invariant and ergodic

- This is in contrast to a perfect market world (standard dynastic model) where any initial distribution of wealth is sustained forever

- Result 2: In contrast to Chamley-Judd, > 0 optimal capital taxation in such models (people save too much) (Aiyagari, JPE'95)

- Result 3: such a model does not generate much wealth inequality...

- Unless one chooses a sufficiently unrealistic income process (Castañeda et al., JPE'03). Even then, wealth not Pareto distrib.

2.2 Dynamic random shock models

- Consider dynamic equation for wealth z_i of the form

$$z_{t+1i} = \gamma_{ti} \cdot z_{ti} + \varepsilon_{ti}$$

- Where γ_{ti} are i.i.d. shocks with mean $0 < \gamma = E(\gamma_{ti}) < 1$
- ε_{ti} is a positive additive shock (possibly random)
- Then under a number of regularity assumptions, three key results:
  - The distribution of z_i converges to a steady state

- The steady-state distribution has a Pareto upper tail
- The Pareto coefficient a solves the following equation:

$$E(\gamma_{ti}^{a}) = 1$$

- The latest result was first shown by Champernowne (1953)
- The general study of these stochastic processes was rigorously done by Kesten (1973). See Gabaix (2009).
- Key intuition: cumulative multiplicative shocks lead to Pareto laws, but needs reflective barrier ε_{ti} to prevent process from diverging

Piketty-Zucman (HID 2015): Setup

- Discrete time $t = 0, 1, 2, ...$ (can be interpreted as one year or one generation)

- Stationary population $N_t = [0, 1]$ made of a continuum of agents of size one

- Aggregate and average variables are the same for wealth and national income: $W_t = w_t$ and $Y_t = y_t$

- Effective labor input $L_t = N_t \cdot h_t = N_0 \cdot (1 + g)^t$ grows at exogenous rate g

- Domestic output given by production function $Y_{dt} = F(K_t, L_t)$.

- Each individual $i \in [0,1]$ receives **same** labor income $y_{Lti} = y_{Lt}$ and has same rate of return $r_{ti} = r_t$

- End-of-period wealth in utility function (flexible: middle-ground between life-cycle and dynastic model)

$$V(c_{ti}, w_{t+1i}) = c_{ti}^{1-s_{ti}} w_{t+1i}^{s_{ti}}$$

- Where s_{ti} is wealth (or bequest) taste parameter

- Budget constraint: $c_{ti} + w_{t+1i} \leq y_{Lt} + (1 + r_t) \cdot w_{ti}$

- Random shocks = idiosyncratic variations in saving taste s_{ti} drawn from i.i.d. random process with mean $0 < s = E(s_{ti}) < 1$

- Cobb-Douglas utility implies consumption c_{ti} is a fraction $1 - s_{ti}$ of $y_{Lt} + (1 + r_t) \cdot w_{ti}$, the total resources (income+wealth) available

- Plugging this formula into the budget constraint yields following individual-level transition equation for wealth:

$$w_{t+1i} = s_{ti} \cdot [y_{Lt} + (1 + r_t) \cdot w_{ti}] \qquad (1)$$

Piketty-Zucman (2015): aggregate convergence

- At aggregate level, national income equals $y_t = y_{Lt} + r_t \cdot w_t$, hence

$$w_{t+1} = s \cdot [y_{Lt} + (1 + r_t) \cdot w_t] = s \cdot [y_t + w_t] \tag{2}$$

- Divide by $y_{t+1} \approx (1 + g) \cdot y_t$, denote $\alpha_t = r_t \cdot \beta_t$ the capital share, $(1 - \alpha_t) = y_{Lt}/y_t$ the labor share to obtain transition equation for the wealth-income ratio $\beta_t = w_t/y_t$

$$\beta_{t+1} = s \cdot \frac{1 - \alpha_t}{1 + g} + s \cdot \frac{1 + r_t}{1 + g} \cdot \beta_t = \frac{s}{1 + g} \cdot (1 + \beta_t) \tag{3}$$

- Solution to this dynamic equation? Two cases

- Open-economy case: world rate of return $r_t = r$ is given. β_t converges towards a finite limit β if and only if

$$\omega = s \cdot \frac{1+r}{1+g} < 1$$

- If $\omega > 1$, then $\beta_t \to \infty$. In the long run, the economy is no longer small, and world rate of return has to fall so that $\omega < 1$

- Closed-economy case: β_t always converges towards a finite limit because r adjusts (falls with β)

- Example: with a CES production function: $r = F_K = a \cdot \beta^{-1/\sigma}$

- Setting $\beta_{t+1} = \beta_t$ in equation 3, we have:

$$\beta_t \to \beta = s/(g + 1 - s) = \widetilde{s}/g$$

- where $\widetilde{s} = s(1 + \beta) - \beta$ is the steady-state saving rate expressed as a fraction of national income

- See Piketty & Zucman (2014 QJE) for models of β in the long-run (whatever the utility function, $\beta \to s/g$)

- So macro variables converge to a steady-state, what about the distribution of wealth?

Piketty-Zucman (2015): convergence of wealth distribution

- Denote $z_{ti} = w_{ti}/w_t$ normalized individual wealth, and divide both sides of equation 1 by $w_{t+1} \approx (1+g) \cdot w_t$

- In the long run the individual-level transition equation for normalized wealth can be written as follows:

$$z_{t+1i} = \frac{s_{ti}}{s} \cdot [(1-\omega) + \omega \cdot z_{ti}] \tag{4}$$

- (To see this, note that $y_{Lt} = (1-\alpha) \cdot y_t$, where $\alpha = r \cdot \beta = r \cdot s/(1+g-s)$ is the long-run capital share.)

Now apply Kesten (1973) theorem:

- Distribution $\psi_t(z)$ of relative wealth converges towards a unique steady-state distribution $\psi(z)$
- $\psi(z)$ has a Pareto upper tail
- Pareto exponent a is such that $E\left(\left(\frac{s_{ti}}{s} \cdot \omega\right)^a\right) = 1$

Example: binomial taste shocks

- $s_{ti} = s_0 = 0$ with probability $1 - p$ (consumption lovers)

- $s_{ti} = s_1 > 0$ with probability p (wealth lovers)

- Average saving taste $s = E(s_{ti}) = p \cdot s_1$

- If $s_{ti} = s_0 = 0$, then $z_{t+1i} = 0$: children with consumption-loving parents receive no bequests

- If $s_{ti} = s_1$, then $z_{t+1i} = \frac{s_1}{s} \cdot [(1 - \omega) + \omega \cdot z_{ti}]$: children with wealth-loving parents receive positive bequest growing at rate ω / p

By Kesten's (1973) theorem, $E\left(\left(\frac{s_{ti}}{s}\cdot\omega\right)^{a}\right) = (\omega/p)^{a}\cdot p = 1$, hence

$$a = \frac{\log(1/p)}{\log(\omega/p)} \tag{5}$$

$$b = \frac{a}{a-1} = \frac{\log(1/p)}{\log(1/\omega)}$$

- As $\omega = s\cdot(1+r)/(1+g)$ rises, Pareto coefficient a declines and inverted Pareto-Lorenz coefficient b rises: more inequality

- High ω means the multiplicative wealth inequality effect is large compared to the equalizing labor income effect

- In the extreme case where $\omega \to 1^-$ (for given $p < \omega$), $a \to 1^+$ and $b \to +\infty$ (infinite inequality)

- The same occurs as $p \to 0^+$ (for given $\omega > p$): an infinitely small group gets infinitely large random shocks

- Extreme concentration can also occur if taste parameter s_{ti} is higher on average for individuals with high initial wealth

- All models with multiplicative random shocks in the wealth accumulation process yield distributions with Pareto upper tails

- True whether shocks come from tastes or other factors

Stiglitz (Econometrica 1969)

- Shock is the rank of birth: primogeniture

- Generational growth g only comes from population growth n

- Each family has $1+n$ boys, $1+n$ girls

- Probability to be first-born son (= good shock) $p = 1/(1+n)$

- Plug this into eq. 5 for a in binomial random shock model:

$$a = \frac{log(1+n)}{log(s(1+r))}$$

Cowell (1998)

- Shock is the number of children

- This is more complicated because families with many children do not return to zero wealth (unless infinite number of children)

- No closed-formed solution for a which must solve:

$$\sum \frac{p_k \cdot k}{2} \left(\frac{2 \cdot \omega}{k} \right)^a = 1$$

- $p_k =$ fraction of parents who have k children ($k = 1, 2, 3...$), $\omega =$ average generational rate of wealth reproduction

Benhabib, Bisin and Zhu (Econometrica 2011)

- Shocks come from rates of return $\rightarrow$ same Kesten multiplicative random shock process $z_{t+1i} = \gamma_{ti} \cdot z_{ti} + \varepsilon_{ti}$ as with random saving

- Rich set up: finite life with inter-generational linkages; endogenous saving; capital income taxes vs. wealth taxes...

- Allow for correlation between γ_{ti} (persistence in rates of returns across generations) and γ_{ti} and ε_{ti} (high labor income earners can have high rates of returns)

- Capital taxes reduce inequality a lot

Calibration of random saving taste model: the role of $r - g$

- Interpret each period as lasting H years (with $H = 30$ years $=$ generation length)

- Let r and g denote instantaneous rates, then $1 + R = e^{rH} =$ generational rate of return; $1 + G = e^{gH} =$ generatl. growth rate

- Multiplicative factor ω can be rewritten

$$\omega = s \cdot \frac{1 + R}{1 + G} = s \cdot e^{(r-g)H}$$

- If $r - g$ rises from $r - g = 2\%$ to $r - g = 3\%$, then with $s = 20\%$

and $H = 30$ years, $\omega =$ rises from $\omega = 0.36$ to $\omega = 0.49$.

- For a given binomial shock structure $p = 10\%$, the resulting inverted Pareto coefficien from $b = 2.28$ to $b = 3.25$.
- This corresponds to a shift from moderate wealth inequality (top 1% wealth share around 20-30%) to very high wealth inequality (top 1% wealth share around 50-60%).
- Small changes in $r - g$ can make a huge difference for long-run wealth inequality

Intuition: why $r - g$ matters

- $r - g$ magnifies any initial wealth inequality

- Ex: if $g = 1$ and $r = 4\%$, then a person whose income only derives from wealth W (hence has income rW) needs to save only g/r=25% for her wealth to grow as fast as the economy

- With taxes in the model, r must be replaced by the after-tax rate of return $\overline{r} = (1 - \tau) \cdot r$

- Where τ is the equivalent comprehensive tax rate on capital income, including all taxes on both flows and stocks.

Level and changes in $r - g$ gap can contribute to explain:

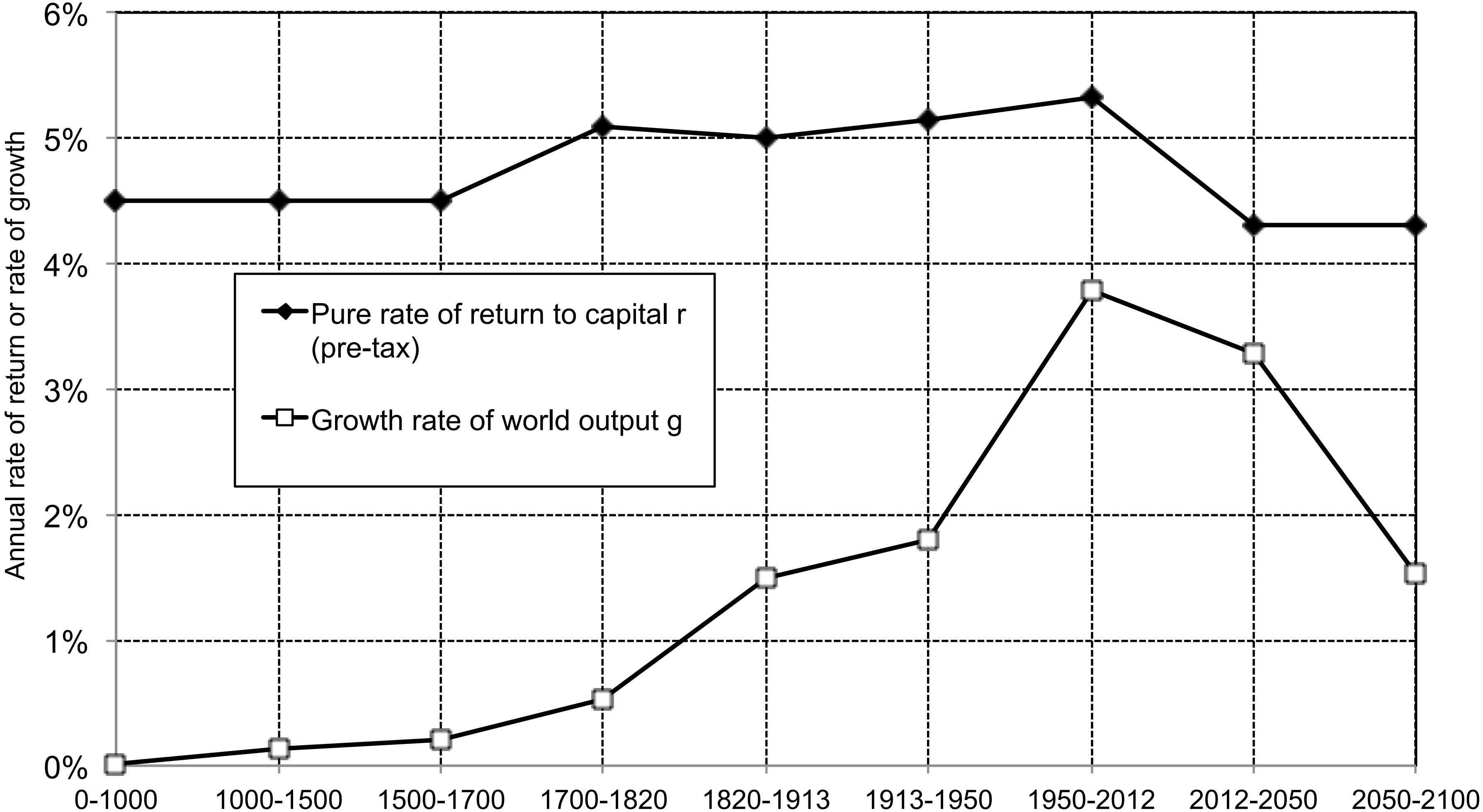
- Extreme wealth concentration in Europe in 19c and during most of human history (high $r - g$)

- Lower wealth inequality in the US in 19c (high g)

- Long-lasting decline of wealth concentration in 20c (low r due to shocks, high g)

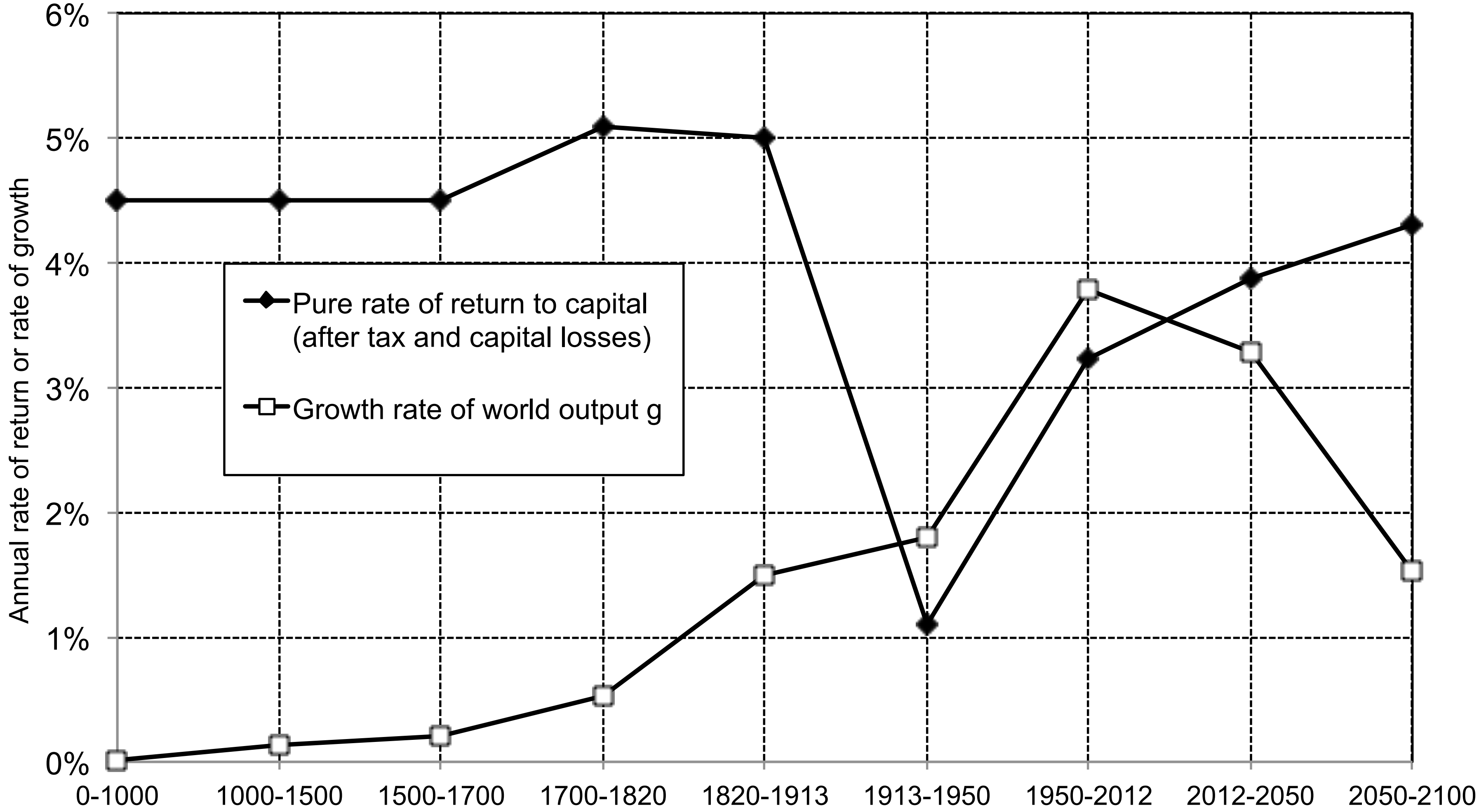
- Return of high wealth concentration since late 20c/early 21c (lowering of g, and rise of r, in particular due to tax competition)

Figure 10.9. Rate of return vs. growth rate at the world level, from Antiquity until 2100

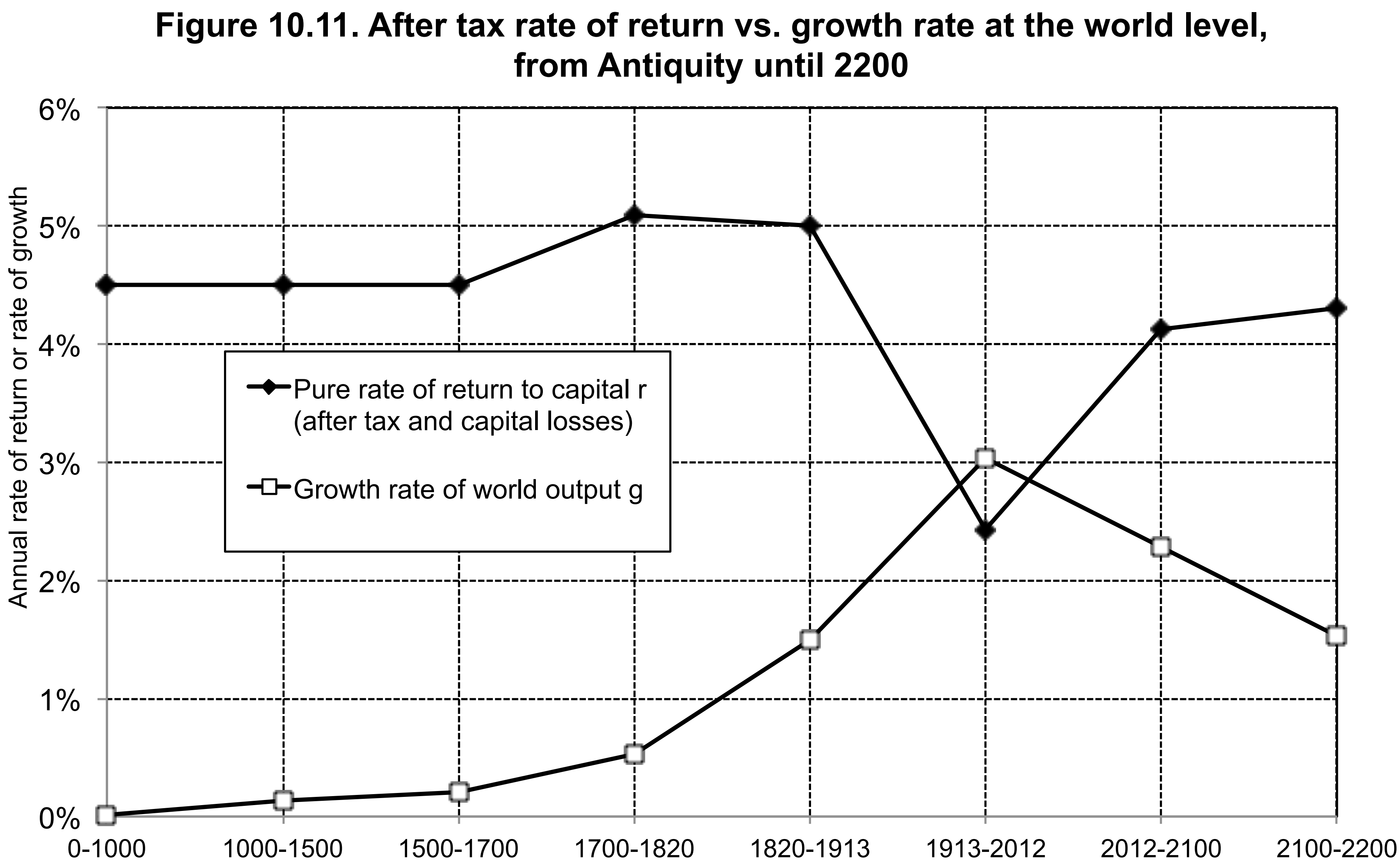


The rate of return to capital (pre-tax) has always been higher than the world growth rate, but the gap was reduced during the 20th century, and might widen again in the 21st century.
Sources and series: see piketty.pse.ens.fr/capital21c

Figure 10.10. After tax rate of return vs. growth rate at the world level, from Antiquity until 2100



The rate of return to capital (after tax and capital losses) fell below the growth rate during the 20th century, and may again surpass it in the 21st century. Sources and series : see piketty.pse.ens.fr/capital21c



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3 Progressive wealth taxation

- Progressive wealth taxation: annual tax on families' net worth

- Ex: Warren wealth tax proposal (2019): 2% above $50m exemption, 3% above $1bn

- Long history of wealth taxation in Europe. Switzerland, Norway, and Spain still have a wealth tax.

- Recent research on behavioral responses to wealth taxes: Seim (2017), Londono-Velez and Avila-Mahecha (2020), Bruhlart et al. (2019), Jakobsen et al. (2020)...

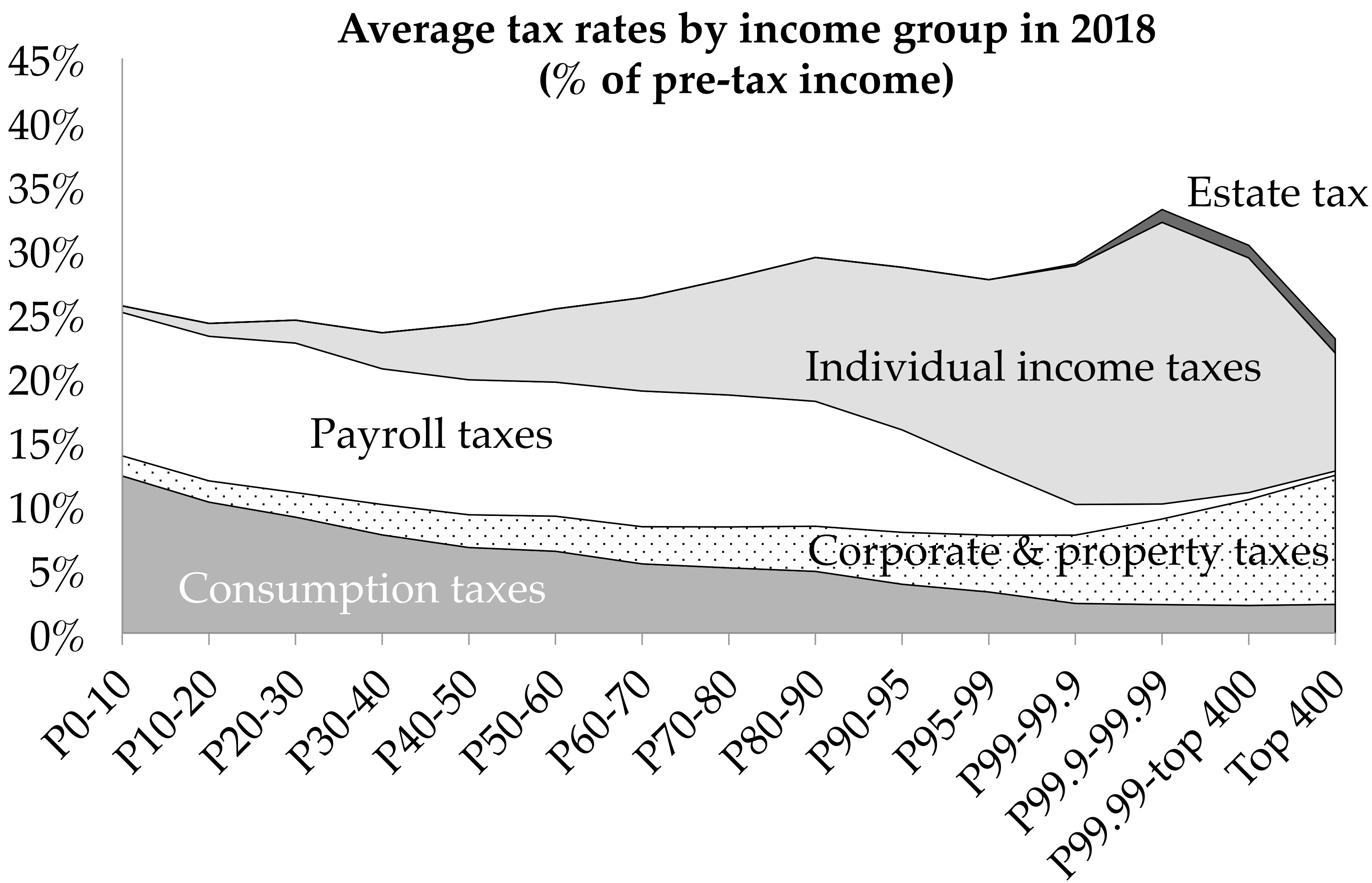
Rationales for a wealth tax

- Structurally low effective tax rates at the top because a lot of income is not taxable (Saez and Zucman, 2019)

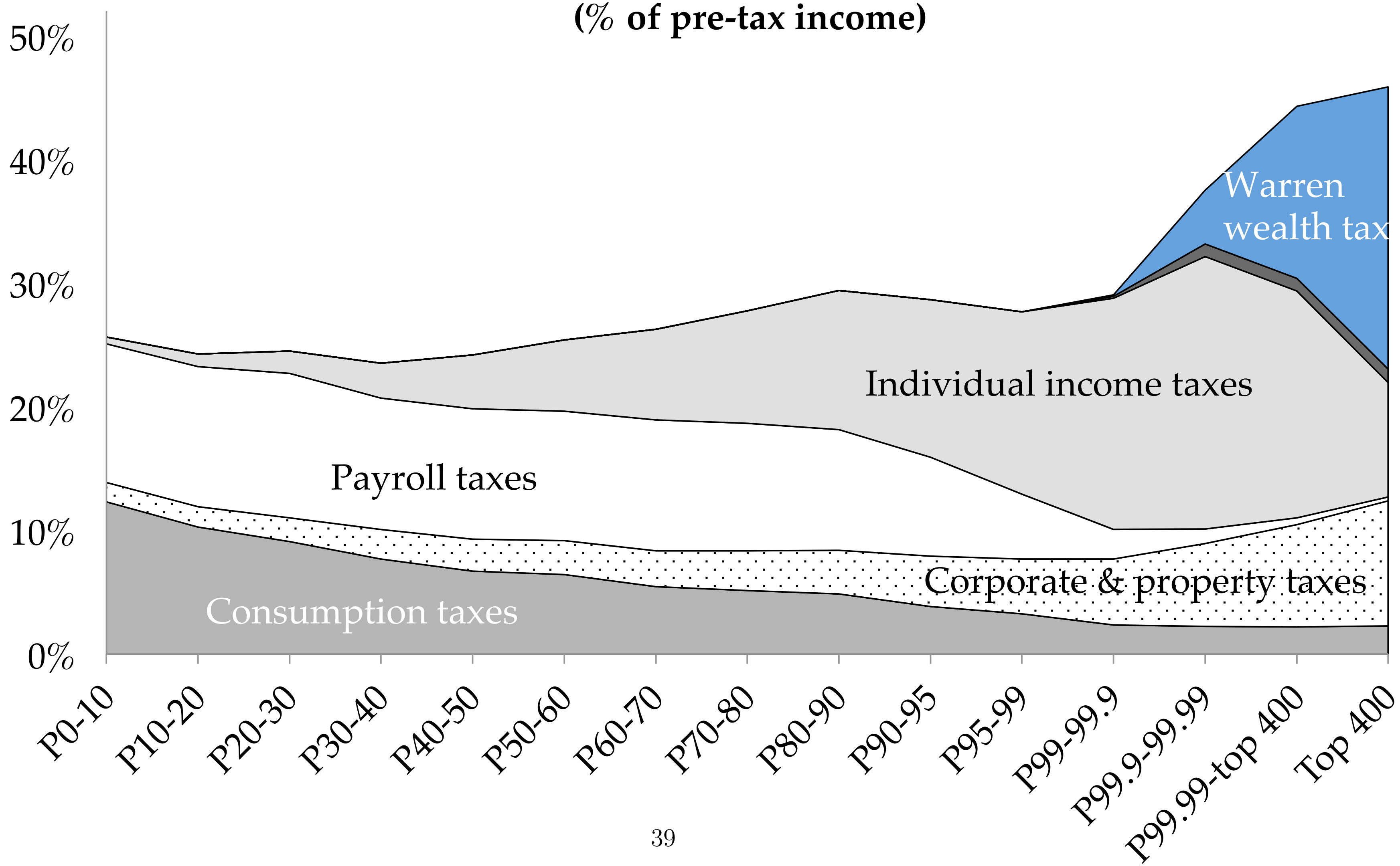
- Two-dimensional heterogeneity: wealth, taxable income $\rightarrow$ two instruments

- Consumption tax not a solution (saving rate $\rightarrow$ 100% at the top, so effective tax rate $\rightarrow$ 0)

- Negative externalities of wealth concentration (political capture, market power)


Average tax rates by income group in 2018
(% of pre-tax income)
45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
Estate tax
Individual income taxes
Payroll taxes
Corporate & property taxes
Consumption taxes
P0-10
P10-20
P20-30
P30-40
P40-50
P50-60
P60-70
P70-80
P80-90
P90-95
P95-99
P99-99.9
P99.9-99.99
P99.99-top 400
Top 400

Appendix Figure 7.2: Average tax rates by pre-tax income group (% of pre-tax income)



Economic effects of wealth taxation

- Well-enforced wealth tax reduces wealth concentration

- Capital stock: ambiguous effect. Reduction in saving from the wealthy could be compensated by higher public savings or higher middle class saving (Jakobsen et al. 2020)

- Innovation: No good empirical evidence. Wealth tax comes late. Early interventions (education / immigration / peers) might be more impactful.

- Giving: Wealth tax can accelerate giving to charities and heirs. Socially desirable as long as they are not "straws"

Key enforcement aspects

Lesson from European experience: wealth tax can work if

- Use a comprehensive tax base with no asset class exemption

- Use information reporting (publicly traded stocks, fixed claim assets, mutual+pension funds, real estate, and debts)

- Closely held stock ($\simeq$ 30% of top 0.1% wealth) toughest:

  – Small/medium: use valuation formula based on profits/capital stock/sales (as in Switzerland)

- Large: pay tax in stock and create missing market?

- Always value underlying assets when assets held through intermediaries (pension and mutual funds, trusts, businesses)

- Clear rules to assign shared assets (such as trusts)

Why did wealth tax fail in Europe?

- Tax competition (no EU wealth tax, unanimity rule within EU for tax issues)

- Offshore tax evasion (see lecture 6)

- Exemption threshold too low (around \$1m) creating hardship for illiquid millionaires $\rightarrow$ led to backlash and base erosion

- Reliance on self-assessment (making enforcement hard)

- In principle, all 3 weaknesses could be remedied (Saez and Zucman BPEA 2019)

Optimal billionaire taxation

- Basic assumption: wealth tax at average rate τ reduces billionaires wealth by $1-\tau$ after 1 year, $(1-\tau)^2$ after 2 years, ... $(1-\tau)^t$ after t years

- Elasticity e of wealth wrt to $1-\tau =$ number of years being billionaire. Revenue maximizing rate $\tau^* = \frac{1}{1+e}$

- Forbes 400 tracks billionaires since 1982

- On average US billionaires have been billionaires for 15 years on average $\rightarrow \tau^* =$ 6.25%

Old wealth vs. young wealth

- Top wealth life-cycle: a) explosive new wealth growth (Zuckerberg Facebook), b) lower growth of mature wealth (Gates Microsoft), c) inherited wealth (Walton family Walmart)

- Old wealth gets eroded most by permanent wealth tax; young explosive wealth not so much

- Illustration: how Forbes 400 would look like today if wealth tax had been in place since 1982

Long-Term Wealth Taxation and Top Wealth Holders

Top Wealth Holder	Source	Current 2018 wealth ($ billions)	With Warren wealth tax (3% above $1b) since 1982	With Sanders wealth tax (5% above $1b up to 8% above $10b)
1. Jeff Bezos	Amazon (founder)	160.0	86.8	43.0
2. Bill Gates	Microsoft (founder)	97.0	36.4	9.9
3. Warren Buffett	Berkshire Hathaway	88.3	29.6	8.2
4. Mark Zuckerberg	Facebook (founder)	61.0	44.2	28.6
5. Larry Ellison	Oracle (founder)	58.4	23.5	8.5
6. Larry Page	Google (founder)	53.8	35.3	19.5
7. David Koch	Koch industries	53.5	18.9	8.0
8. Charles Koch	Koch industries	53.5	18.9	8.0
9. Sergey Brin	Google (founder)	52.4	34.4	19.0
10. M. Bloomberg	Bloomberg LP (f.)	51.8	24.2	11.3
11. Jim Walton	Walmart (heir)	45.2	15.1	5.0
…				
Total top 15		942.5	433.9	195.7

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