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Friday April 10th 2009

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Resenting the rich

This house believes that the rich should pay higher taxes.

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Defending the proposition

Professor Thomas Piketty

Professor of Economics at the Paris School of Economics (PSE)

In his opening statement, Chris Edwards argues that higher taxes on the rich would lead to a huge fall in productive effort and an enormous destruction of real economic activity. Well, this claim is wrong.

Against the proposition

Mr Chris Edwards

Director of Tax Policy Studies, Cato Institute

In his opening statement for the tax debate sponsored by The Economist, Thomas Piketty argues that we should impose a very high tax rate of about 80 percent on the top income earners in society.

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The moderator's rebuttal remarks

Apr 10th 2009 | Mr Saugato Datta

To ask whether the rich *should* pay higher taxes is to pose a normative question, as one of our readers, b_frandsen, points out, saying that "at stake in the debate over higher taxes is the sanctity of property rights and the principle of freedom to dispose of one's resources as one chooses."

But philosophical positions can be informed by answers to positive questions about the effects and feasibility of higher taxation on the rich, which our speakers are addressing. Obviously, there isn't a direct mapping from one to the other. It is perfectly defensible to decide that higher taxes on the rich have no efficiency effects, and still decide that one opposes them on moral grounds. On the other hand, it also possible to conclude that the efficiency costs are large, but moral concerns about inequality still provide a basis for supporting the motion. For example, reader DEFkay says of higher taxation for incomes above $2m that "I think removing much of the incentive to earn more than that figure is a worthy trade for the amount of income it would generate for governments."

Leaving philosophical differences aside for the moment, our protagonists disagree on a number of positive issues too.

First, they disagree about who precisely "the rich" that the motion refers to are. Mr Piketty defines them as the very, very rich: the top 1% or perhaps 0.5% of the income distribution. Mr Edwards, on the other hand, is referring to a broader segment of the population: perhaps the top quintile or quartile.

But they are fundamentally in disagreement about how the incomes of those at the top of the income distribution relate to their productivity. As Mr Piketty put it in his opening statement, "For jobs that cannot be replicated a CEO, a CFO, or for that matter all high ranking executives—nobody has any idea what their marginal product might be." Mr Piketty is making what I think is a crucial, and provocative, point here: he is arguing that there is market failure in the way top compensation is decided. If that is true, it provides a rationale for higher taxation of the rich separate from concerns about inequality.

But Mr Edwards argues that while a trash collector's wage matches his contribution, a person in a high-end job doesn't get his full marginal product because he generates positive externalities for society. These differences between our speakers on the productivity-wage relationship at the top end leads them to different conclusions on the effect of increased tax rates on productivity are. Hence their opposing conclusions about the efficiency effects, through the elasticity of labour supply, on effort, output, etc.

Our first guest commentator, Edward Wolff of New York University, takes the desirability of taxation as a given, and argue that taxing the rich (more) will provide for more government expenditure, which he argues will reduce inequality not only through transfers to the poor, but also to the middle income, who together are

the main beneficiaries of such expenditure.

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His argument points to another issue that our speakers might want to address, which is mobility. Taxation, through higher public expenditure, can help to increase mobility (think spending on education and health). Reader DEFkay goes on to say that "not all the world's poor are "bums" as one reader so bluntly put it … perhaps in a world where true equality of opportunity existed we could justify leaving the "bums" to their lot. But funding the creation of that world is, for me, the main reason to increase taxes on the rich." But what we believe about the existing patterns of income and class mobility are clearly important in figuring out whether we need government intervention to change those patterns.

And reader srojak argues that we're on the wrong track, arguing about income when the discussion should be about wealth. Srojak says "Income has generally been used as a proxy for wealth, but this is an uncertain and confused connection." So should taxes on wealth, or consumption, be the focus of this discussion?

The proposition's rebuttal remarks

Apr 10th 2009 | Professor Thomas Piketty

In his opening statement, Chris Edwards argues that higher taxes on the rich would lead to a huge fall in productive effort and an enormous destruction of real economic activity. Well, this claim is wrong. It is based upon a misreading of the extensive empirical evidence on labour supply elasticity, and upon an extremely naïve model of how the very top end labour market really operates.

Referring to a study by Feldstein, Chris Edwards argues that "the elasticity of taxable income with respect to income tax rates is about 1, so that cutting the top rate from 40% to 30% would boost taxable income by about 16%". Chris Edwards goes on even further, claiming that every new $1 billion raised in federal income revenue "will destroy about $1.76 billion of activities in the private sector".

There are many problems with these claims. In his 1995 paper based upon the 1986 Tax Reform Act, Feldstein did indeed support the view that the top end elasticity of taxable income was equal or larger than 1. He then used his elasticity estimates to predict that President Clinton's 1993 decision to raise to the top marginal rate (from about 30% to about 40%) would result into a large fall in reported taxable income, and eventually a fall in total tax revenues.[1] The first problem is that this is not at all what happened. If we let aside a short-run shift in the timing of compensation (many bonuses were cashed right before the tax reform), there exists extensive empirical evidence showing that top reported incomes kept rising after 1993 approximately at the same pace as before 1993, and that the long run elasticity response to the 1993 tax reform was not significantly different from 0, and in any case much smaller than 1.[2]

In their authoritative survey on taxable income elasticities, based upon dozens of careful empirical studies, Emmanuel Saez, Joel Slemrod and Seth Gierz conclude: "The most reliable longer-run elasticity estimates range from 0.1 to 0.4, suggesting that the U.S. top marginal rate is far from the top of the Laffer curve".[3] These findings reflect a wide consensus among economists, and they ought to be taken seriously.

Next, and most importantly, available empirical evidence suggests that only a small fraction of these 0.1-0.4 consensus elasticity estimates has something to do with real labour supply and productive effort. In particular, it has long been shown that the bulk of the elasticity response for top incomes comes from income shifting between various tax bases. For instance, lower personal top tax rates might lead to a rise in top taxable incomes reported to the individual income tax, but this rise can be almost entirely offset by a corresponding decline in taxable profits reported to the corporate income tax.[4] Although this has attracted less attention by economists, and is harder to identify econometrically, the rise in top executive compensation could also be offset by a decline in the wage bill going to other workers in the company. In any case, the key point is that most of the—limited in size—behavioural response of top incomes to top tax rates seems to be due not to a real change in economic activity and output, but simply to a re-labelling of income outlays over various tax bases. Using the terminology introduced by Saez and his co-authors in their survey, the behavioural response of top incomes involves substantial tax externalities—which like all externalities have a tremendous impact on welfare and policy analysis.

This is really the critical point. According to the standard textbook model, an increase (or a decline) in the labour income of a given individual should be interpreted as a rise (or a fall) in his or her marginal product, i.e. his or her contribution to total economic output. That is, if Mr Smith's wage rises from $30,000 to $50,000, then it must be that Mr Smith has produced $20,000 of extra economic output. The beauty of the market system is precisely that the increase in Mr Smith's wage should in principle correspond to the creation of new economic value and well-being, and is not obtained at the expense of anybody else (i.e. even with fully selfish economic agents there is no externality on others that is not being internalised by the price system). This textbook model probably provides an (approximately) accurate description of 99% of the labour market. However it is extremely naïve—to say the least—to imagine that it adequately describes the pay determination process at the very top end of the labour market. Assume that the CEO of AIG or GM manages to get an increase in compensation, say a rise from a $5m to a $10m total annual compensation. It is truly heroic to conclude from this observation that his or her contribution to AIG or GM output has increased by $5m, and that the total output of AIG and GM has risen by that much. There is tremendous evidence showing that the invisible hand of the market simply does not work in this very peculiar segment of the labour market, and that top executives will keep setting their own pay to the highest possible levels (with no connection whatsoever with their marginal product, which nobody can properly estimate) as long as they are not prevented to do so. Historical evidence suggests that highly progressive taxation on very high incomes is the most efficient way to achieve this goal.

This brings me to my last point. The main objective of raising marginal tax rates on the rich is not to raise additional tax revenue, but rather to keep top compensation under control and to curb the grabbing hand. In fact, the proposal that I am making - introducing a 80% marginal tax rate on all annual incomes in excess of €1m, leaving the rest of the tax system unchanged—would probably raise limited additional tax revenue. First because it would apply to only a small fraction of the population—less than 0.5%. [This is fortunate: in the current recession context, it would be pretty silly to raise tax on substantial fractions of the population]. Next because the main effect of this 80% marginal rate would probably be to reduce drastically the incentive to take away more than €1m from one's company, so that the number of taxpayers in the €1m+ bracket would probably fall substantially. This is what happened during the 1932-1980 period, and available evidence suggests that this would actually a good thing. I.e. this would not correspond to a fall in real productive efforts and economic output, but rather to a redistribution of income flows. Maybe the right analogy is the following: one should think of taxing the rich pretty much in the same way as taxing pollution activities. In the case of pollution, a number of green tax advocates have argued that such a tax can deliver a so-called "double dividend": it can eradicate pollution, and at the same time raises substantial tax revenue. Unfortunately this is wrong: if they work effectively, green taxes won't raise much revenue—just like taxes on the very rich, to some extent. In other words, the debate that we are having right now about taxing the rich is not a debate about raising aggregate tax revenues or making the government bigger. The question as to whether the government should be bigger or not is a very interesting and complicated issue—and would require a thorough discussion of many different kinds of tax instruments and public spendings. The answer would probably be different for countries like the U.S. and countries like Sweden. As a matter of fact, I happen to be extremely sceptical about the government's ability to properly spend 50% of national income. But this is a completely different debate from the one we are having right now—and this should be the topic of another debate!

In his opening statement for the tax debate sponso[illegible] *The Economist*, Thomas Piketty argues that we should impose a very high tax rate of about 80 percent on the top income earners in society. The following rebuttal of this idea addresses Piketty's philosophy of income, and it discusses problems with his political, economic, and historical reasons for tax increases on high earners.

Piketty's Philosophy of income

Piketty's understanding of the nature of income is very European. He implies that there is a fixed income pie, such that any income that high earners receive must come at the expense of others. Because the share of income earned by the top 1 percent has increased, he says that there has been "an income *transfer* of about 14 points of national income" to the top group. But high earners did not take that money from other people, they generated it by their own efforts.

In a market economy, there is no central pile of money that is distributed out to the citizens. Each person produces value and earns income by voluntary exchange in a decentralised fashion. Compensation follows from people producing items of value to others. Of course there are exceptions, such as those high-earning CEOs who perform poorly, but it doesn't make economic sense to impose exorbitant tax rates because of the exceptions.

Those at the top end—the entrepreneurs, doctors, and others with unique skills—often generate benefits that are greater than their reward in compensation. One reason is that there is scope for innovation in top-end jobs like heart surgery that there isn't in lower-income jobs. The trash collector's wage matches his contribution, but when the surgeon invents a new medical technique, it can create long-lasting benefits for the rest of us that will only be partly reflected in compensation.

I have people like Apple's Steve Jobs in mind when I think about designing tax policy for the top 1%. But Piketty seems to think that those at the top end did not earn their compensation, rather their high pay came from amorphous forces such as "gains from globalisation." However, let's say Piketty is right, that the innovators behind firms like Apple just happened to be lucky that their products became global bestsellers. It still makes no sense to impose high taxes on them because those entrepreneurs are more likely to use the cash productively than the government. Indeed, from the beginning of Silicon Valley, wave after wave of millionaires have funded the next wave of business successes through angel financing and venture capital. Obviously, that would not have been possible under Piketty's 80% tax rate.

A final note on income is that Piketty's calculations on the rising income share of the top 1% are much less precise than he pretends. Piketty's work is based on income as reported on tax returns, but there have been huge changes in the American tax system since the 1970s that make measuring income over time very difficult. My colleague Alan Reynolds has tackled some of these problems with the Piketty data.[1] One issue is that the top federal income tax rate fell from 70% in the late 1970s to 35% today, with the result that high-income taxpayers are avoiding and evading taxes less, and reporting more income on their returns.

If you look at Piketty's data showing the share of income received by the top 1% since the 1970s, you will see sudden upward spikes after major tax rate cuts. That suggests that a portion of the income gains at the high end are not based on structural factors, such as globalisation as Piketty suggests, but are simply expected responses to changes in tax law. In a 2009 paper, Emmanuel Saez and co-authors confirmed that, noting:

> "It is striking to note that the share received by the top 1% of income recipients started to increase precisely after 1981—when marginal tax rates started to decline. The timing of the jump in the share of top incomes from 1986 to 1988 corresponds exactly to the sharp drop in the weighted average marginal tax rates from 45% to 29% after the Tax Reform Act of 1986. These correspondences in timing ... provide very compelling evidence that high incomes are indeed quite responsive to marginal tax rates." [2]

Piketty's Political Arguments

Mr. Piketty argues that if we don't impose very high taxes on the rich "there is a serious risk that citizens will ask for much more damaging, anti-market policies." *The Economist* debate proposition similarly suggests that we need to buy "social peace" by imposing high tax rates at the top. I think the reality is exactly the opposite. The more arbitrary and punitive government intervention becomes, the more that politicians and the public will get used to it, and the more likely that further punitive measures will be imposed. The government that persecutes certain people with 80% tax rates will find it much easier to expropriate the property of other groups it deems to be a menace. The more that politicians try to centrally plan the end goals for society, the less they will focus on making the general rules of government equal and fair.

Piketty's Economic Arguments

This is a strange statement by Piketty: "The idea that heavy taxes on very top incomes would entail huge economic distortions is purely ideological and is based on zero *empirical* evidence." I don't understand how a public finance specialist could say that, unless he is hiding behind the word "huge." Are the distortions "large" Mr. Piketty?

One mistake Piketty makes is to suggest that tax distortions are caused only by changes to labour supply. But the economic distortion caused by high tax rates is related to the total taxable income response, not just to changes in labor supply. Martin Feldstein, one the top public finance experts of recent decades, has stressed that point repeatedly. Feldstein's *empirical* work shows that the economic distortions caused by high marginal rates are large. Increases in marginal tax rates set into a motion a whole range of behavioral responses, all of which add to deadweight losses. Piketty's own co-author, Emmanuel Saez, has found that behavioural responses are substantially greater at the top end, indicating that the top tax rates are the most distortionary.[3]

In the United States, half of all business income is reported on individual returns, not corporate returns, and a lot of that business income is reported by people at the top end. If you raise individual income taxes at the top end, you hit a large amount of small business income. And *empirical* research has shown that small businesses are sensitive to income tax changes. A series of studies by economists Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen explored, for example, the effect of marginal income tax rates on small business hiring, investment, and growth.[4] They found substantial effects, such as that a five percentage point cut in marginal tax rates would cause a 10% increase in capital expenditures.

But Piketty doesn't mention entrepreneurial businesses. Instead, he repeatedly implies that the only people who earn top incomes are shady corporate executives, who operate a "crude skimming model" rather than earning their pay. Actually, the literature on executive compensation is mixed in its conclusions regarding the extent to which executive pay is based on market forces. Scholars Kevin Murphy and Jan Zabojnik, for example, argue that there are market reasons why CEO compensation has risen quickly in recent decades.[5] As in any market, the market for corporate executives makes mistakes that are corrected over time, which is something we cannot say about governments. These days, corporate executives operate in a very stressful and risky environment, and they are subject to very high firing rates—a much different climate, for example, than tenured university professors.

Piketty's Historical Arguments

Piketty thinks that "confiscatory marginal rates applied to the very high incomes of the 1932-80 period were a pretty good policy." That is quite a claim, but let me just note that the world has vastly changed since the mid-20th century. I co-authored a book last year, "Global Tax Revolution", which documented the worldwide movement to cut tax rates on skilled workers, entrepreneurs, and corporations since the 1970s.

During Piketty's golden era in the 20th century, most industrial countries had fixed exchange rates, which allowed them to seal their borders to capital flows and to keep tax rates high. But nations started floating their currencies in the 1970s and dismantling their exchange controls, with the result that cross-border capital flows have exploded. Virtually every advanced nation has responded with dramatic cuts to top rates on those taxes that have the most mobile bases. Even socialist Sweden recently abolished its wealth tax because it was scaring away too many productive people, such as Ingvar Kamprad, the founder of IKEA, who moved to Switzerland.

or add your view

High tax rates in the mid-20th century were not go[illegible] the economy then, but they would be a disastrous today. In recent years, Europe has seen the most intensive tax competition for skilled workers and bu[illegible]es anywhere in the world, so it is surprising that Piketty doesn't understand that.

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[1] www.cato.org/pub_display.php?pub_id=6880.

[2] www.econ.berkeley.edu/~saez/saez-slemrod-giertzJEL09elasticity.pdf. Thanks to Alan Reynolds for pointing out this study.

[3] Jonathan Gruber and Emmanuel Saez, "The Elasticity of Taxable Income: Evidence and Implications," National Bureau of Economic Research Working Paper 7512, January 2000.

[4] See the following National Bureau of Economic Research papers by Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen: "Entrepreneurs, Income Taxes, and Investment," NBER Working Paper 6374, January 1998; "Income Taxes and Entrepreneurs' Use of Labour," NBER Working Paper 6578, May 2000; and "Personal Income Taxes and the Growth of Small Firms," NBER Working Paper 7980, October 2000. See also William M. Gentry and R. Glenn Hubbard, "Success Taxes, Entrepreneurial Entry, and Innovation," NBER Working Paper no. 10551, June 2004.

[5] www-rcf.usc.edu/~kjmurphy/CEOTrends.pdf.

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The moderator writes:
"Reader DFrikay goes on to say that "not all the world [illegible] are "bums" as one reader so bluntly put it … perhaps in a world wher[illegible] equality of opportunity existed we could justify leaving the "bums" to their lot. But funding the creation of that world is, for me, the main reason to increase taxes on the rich."

The reader and the moderator fail to recognize that because the working and middle class in the West are "rich" by global standards, what this argument justifies is not limited to taxing Western rich and transferring the funds to Western middle and working class, but also taxing Western middle class and working class and transferring the funds to nonWestern poor.

Please accept the consequences of your logic and solicit votes on that proposition or please abandon the argument.

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cynic8 wrote:

Dear Sir,
The past 8 years have been with tax rates that favor the higher incomes. The new investment is down, unemployment is up, and there is no indication that the incomes of the rich and very rich have increased the GNP! When tax rates were higher, GNP was also. There is thought too be a 'Goldilocks' overall taxation of the country of 20% [so I have read]. If 90% of the population is earning less than $100,000 [guesstimate] how does one get to the Goldilocks number unless the 'graduated' tax structure goes substantially higher for the rich and ultra rich? AS Warren Buffet observed, there is something wrong when his secretary pays more in taxes than he does.
I add that the current tax structure is conducive to a return to the wealth structure of Dickens times. That destroys the work force on which the rich depend.

Recommended (3) Report abuse posted on 10/04/2009 16:18:25 pm

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Bernnie Gomez wrote:

Dear Sir,
The question we must ask ourselves is, are there enough rich citizens to tax in order to help the millions of poor citizens in the United States? Is this the long-term solution the United States wants to take to solve the problem, penalizing some of our rich citizens for being successful must they pay for the misfortune of others? We must realize that some of these rich taxpayers do work hard to get to were they are at in life thanks to hard work and sacrifices. Looking for other alternatives such as re-inventing the American economy, inviting various types of industries to come back to our country in order to create jobs for these poor and middle class citizens perhaps may be the solution. I believe taking away from the rich to give to the poor may be a temporary solution but not a long-term solution we may want to impose on our more successful citizens.
Bernardo Gomez, MBA

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JAJ wrote:

Dear Sir,
It is the policy of my country(Norway), and it works for us. JJ

Recommended (2) Report abuse posted on 10/04/2009 16:06:55 pm

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