Capital Folly

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"Carthago delenda est!" Carthage must be destroyed! The ancient historians tell us that Cato the Elder ended with this injunction in all his speeches to the Roman Senate, regardless of the subject. In our own times, Thomas Friedman could be writing his column in the Times on male pattern baldness, but you may be sure the solution will include a huge tax on gasoline.

Comes now Thomas Piketty, offering a sharply progressive annual tax on wealth as his silver bullet for all that ails us. Piketty sees many advantages to a wealth tax, but primarily he is animated by his desire to remedy current levels of income and wealth inequality.

After his lengthy analysis of historical inequality levels he urges draconian action on the basis of multi-decade extrapolations showing inequality levels growing without bound. For perspective, let's ask just how many economists correctly forecast the 2008 market meltdown even a few months before it occurred. Yet he wants a drastic remaking of the worldwide economy based on forty year forecasts. He also argues that the lower inequality of the twentieth century versus the eighteenth and nineteenth centuries primarily resulted from the capital destruction from wars, depressions and inflation. And we aren't going to have any of these in the twenty first century? Watched the news lately? What's your forecast?

His extrapolation that inequality has no natural limits in capitalism presumes a low growth economy, a high return on capital, and high savings rates of those returns on capital. In his singular focus on inequality, Piketty loses sight of the role of capital in the real world. Returns earned by capital must ultimately come from investment in real means of production. Today's world of complex and abstract financial instruments sometimes obscure this reality, but at the end of the chain of invested capital, that capital must be deployed in enabling real economic activity if it is to pay interest at all. If his scenario of huge pools of capital accumulating unproductively were correct, then elementary supply and demand balance would drop the rate of return and reduce the gains of its owners.

He argues that inequality is most powerfully propelled by the after-tax rate of return on capital exceeding the underlying economic growth rate. Yet In a recent survey of forty three leading economists by the University of Chicago, sixty three percent either disagreed or strongly disagreed with this proposition. Only two percent agreed with Piketty. In fact empirical evidence on the recent increase in wealth inequality shows that differences in income levels and savings rates produced the wealth inequality, yet Piketty regularly attributes it to inherited wealth and *rentier* billionaires.

The rise in capital's share of national income has been shown to be due primarily to housing capital and the rise in real estate prices. But here the "return on the capital" is almost entirely realized as living in the house! Thus for this large portion of capital his assertion that returns are largely saved just isn't supported by economic reality.

He sees a global tax on wealth as very straightforward to implement. It is anything but! Piketty offers a very simple execution: your bank, broker, and any other financial institution would simply report your holdings to the government electronically. Real property is already well identified, valued and assessed, so it can be readily included. The government would add up your wealth, apply the rate of tax based on the total and send you the bill.

If you think the current seventy thousand pages of IRS regulation are complicated, wait until you see what a wealth tax will require. The income tax is complicated because it is hard to define just what "income" means. "Wealth" raises even more questions. Let me indicate a few.

Whose wealth? Is it so easy to determine who has what? The Times recently ran an article reporting that among the most expensive Manhattan condos, something under thirty percent had clear individual owners. Most were well camouflaged behind multiple layers of LLCs, trusts, nominees and so on. Often these led back to third world political elites.

What constitutes "wealth"? University endowments? Medical research funders? The Clinton Foundation? Investment grade wine collections? Masterpiece art? You can be sure that any place money can be parked that is not included in the definition of taxable wealth will experience an influx of cash.

How do you value assets? What's that small or medium business worth? How do I value that multi-billion dollar private equity investment where there is no public market? How do I value resources still in the ground? Accountants value assets every day, but once there's real money at stake in taxes, valuing these many repositories of wealth will be endlessly argued and litigated.

Is all wealth to be treated identically? The IRS code is filled with distinctions on both income and deductions. All claim to advance the public welfare somehow or another. In some cases, they probably even do. In all cases they are put there and defended by raw financial and political interests. One can readily imagine that many categories of investment will be excluded on some basis. I can see Democrats arguing that investments in low-income housing, minority owned enterprises or solar energy should be given favorable treatment. Republicans will argue that oil and gas producing properties should be preferentially valued. Everyone will argue that owner-occupied housing shouldn't count. Care to forecast how "family farms" will be treated, even though the greatest bulk of farm subsidies are already paid to zip codes in Manhattan?

Does the fact that someone has wealth mean that they have the cash to pay a steep wealth tax? If I own a company, a wealth tax would require that I must now pay tax on its valuation every year. Unlike income tax, I must pay even in years when my operations lose money, unless the plan is to vary the valuation based on income – another administrative nightmare. I pay even when I am using my cash to expand operations and employment by investing further capital in the business. The first step to building wealth is to get an income. Does a wealth tax on companies creating jobs sound like a prescription to grow employment for those at the bottom?

The argument that a sharp, progressive wealth tax is in some sense fair does not withstand scrutiny. Hillman points out in his text *Public Finance and Public Policy*, "Wealth is past income that has been saved or invested. A wealth tax is therefore a retroactive tax on income. Introducing a wealth tax is thus inconsistent with the principle of the rule of law that laws not be retroactive."

Let me give another fairness problem. Consider two retired people, one retiree has a defined benefit pension, another is a retiree from a company with a defined contribution plan. The former has limited financial assets, but can live comfortably on his after tax monthly pension payments. The latter must live on the interest received from his IRA or 401k "wealth." But to last his lifetime, he will only be able to draw three or four percent annually from his assets and will already be paying income taxes on the interest and dividend income he lives on. Now if in addition to income taxes, Mr. IRA gets hit with an annual wealth tax of one percent (Piketty's suggested rate for assets over a million and half dollars), his annual "income" is reduced by a third, while leaving Mr. Pension untouched. This hardly passes the test of treating people in similar situations similarly. Well, you might say, we can value the pension payments as an annuity and add that to Mr. Pension's wealth. Oops, more IRS agents, now calculating annuity equivalents in addition to valuing wine cellars and Picasso prints. No wonder Due and Friedlaender in their book *Government Finance* say, "The net wealth tax in itself is a much more difficult tax to operate than the income tax, even if the two are used in conjunction with each other." (Due and Friedlaender, pg. 455)

Piketty's plan increases the share of the economy given to government, but who believes that government would be more effective stewards of that wealth than individuals and foundations? Which gives better value for the dollar, the Gates Foundation or USAID? He does not want to use the proceeds of a wealth tax to nationalize industries. But, if governments simply redistribute the proceeds, capital needed to improve productivity will instead be consumed. Economic growth will slow and fewer people will have good incomes, which is the first step towards building broader distribution of wealth. More activity will turn toward rent-seeking and political action to gain a share of the increased government largess rather than toward growing the economy.

I really don't spend my time envying those with more wealth and income than me, even though they are legion. But if you are much bothered by inequality of income or wealth, far more positive means could temper it. I won't elaborate on these, but will just mention several approaches. First, policy-makers should strive to get more people owning more capital, like individual retirement accounts. They could and should improve corporate governance regarding executive compensation, an area now totally out of hand. Most importantly, society should eliminate the economic rents regularly provided to the wealthy and politically connected both in the US and even more so, globally. Aggressively rooting out corruption, particularly among third world elites would go a long way towards reducing inequality and increasing economic growth for all.

Piketty regularly calls his proposal for a global wealth tax "utopian," but I would call the consequences of a wealth tax would create positively dystopian. Let's focus on growing the economy and broadening individuals' ability to build their own wealth across the income spectrum. What would be destroyed by Piketty's *idée fixe* of a global wealth tax is not Carthage, but economic growth.

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