Week 9: Explaining wealth inequality

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Remember, before any taxes are collected, all of the nation’s income is received by either workers or the owners of capital.

Everything that we produce is made using labor and capital.
Revision

Labor income is paid to workers.
   It is equal to the wages, salaries, and employment fringe benefits such as health insurance and pension benefits.

Capital income accrues to the owners of capital.
   It includes the profits earned by the owners of corporations (whether they are paid in dividends or reinvested), the interest paid to bondholders, the rents paid to landlords, and so on

By definition, every euro of income that does not go to labor goes to capital, and vice versa. Capital is taxed less and less, and labour more and more.
“That makes me smart”...

The outbreak of a tax-avoidance industry that obscures income and wealth.

The emergence of new legal-loopholes exploited by multinational companies.

The spiral of international tax competition that has led countries to cut their tax rates one after another.

Globalisation, tax shelters, tax havens, and financial opacity

These are not rational choices deliberated on and made by an informed citizenry.

The triumph of tax injustice undermines the social contract of democracy.
Capital income

Capital income has effectively become tax-free.

Capital is taxed less and less, and labour more and more.

Defenders will argue this is all perfectly legal. But it does not make it legitimate.

No profit or capital income shifting would be possible without the complicity of tax havens’ governments.

For these governments, the lower the rate, the higher the revenue!
5.1 THE COLLAPSE OF CAPITAL TAXATION
(Macroeconomic tax rates on labor and capital in the United States)

Notes: The figure depicts the evolution of the macroeconomic tax rates on capital income, labor income, and total income since 1915. Capital income and labor income add up to total national income. All federal, state, and local taxes are included and allocated to either capital or labor. Historically, the tax rate on capital was much higher than the tax rate on labor. This gap has shrunk a lot. In 2018, for the first time, the tax rate on labor is higher than on capital. Complete details at taxjusticenow.org.
Notes: The figure depicts the evolution of the macroeconomic tax rates on capital income and labor income since 1915. Capital income and labor income add up to total national income. All federal, state, and local taxes are included and allocated to either capital or labor. The figure also includes a series where employer sponsored health insurance is added to labor taxes. Health insurance costs create an increasing and now very large extra burden on labor. In 2018, when including health insurance, the tax rate on labor is about 40%, much higher than on capital. Complete details at taxjusticenow.org.
Wealth accumulation

Between 1985 and 2018, the global average corporate tax rate has fallen by more than half, from 49% to 24%.

Top one-percenters derive more than half of their income from capital, the top 0.1% more than two-thirds.

Reducing capital taxes, reduces taxation on the wealthy.

But surely less capital income tax means more corporate profits that a firm can invest in the economy?
5.3 THE UPSURGE IN US WEALTH INEQUALITY
(Top 1% and bottom 90% shares of total private US wealth)

Notes: The figure depicts the evolution of shares of total household wealth owned by the top 1% wealthiest adults and the bottom 90% poorest adults. Wealth includes all private assets owned directly or indirectly by households (including housing, pension funds, and all financial assets) net of all debt. Wealth within married couples is split equally. The top 1% wealth share has almost doubled from 20% in the late 1970s to almost 40% today. Meanwhile, the bottom 90% wealth share has collapsed from 40% to about 25%. Complete details at taxjusticenow.org.
Wealth taxes

Less capital taxation means that the wealthy—who derive most of their income from capital—can mechanically accumulate more wealth (i.e. R>G).

But the notion that capital taxation is particularly harmful is mainstream, and taught in UG economic textbooks.

The argument is that the most inelastic factor of production bears the burden of taxes, while the most elastic factor dodges them.

It’s the super-rich—most of whom own a lot of wealth but have little taxable income—for whom a wealth tax is essential.
Inheritance

Donald Trump…. and the political and economic power of inherited wealth.


Or is he a product of inherited wealth/power?

Is inheriting large amounts of wealth compatible with democracy?
Figure 11.11. Which fraction of a cohort receives in inheritance the equivalent of a lifetime labor income?

Fraction of each cohort receiving in inheritance at least the equivalent of the lifetime labor income received by bottom 50% labor earners (as a function of year of birth).

Within the cohorts born around 1970-1980, 12-14% of individuals receive in inheritance the equivalent of the lifetime labor income received by the bottom 50% less well paid workers. Sources and series: see piketty.pse.ens.fr/capital21c
Inheritance

The graph shows that for those born around 1970-1980, 12-15 percent of individuals will inherit the equivalent of what the bottom 50 percent of the population earn in a lifetime.

In a context of R>G inheritance will predominate over savings.

For economists the term 'rent' is generally used in a pejorative way and it is assumed to equal the lack of competition, particularly in the non-traded sector.

But historically 'rent' was a term that was used to describe any income that was earned from owning a capital asset.
Rent seeking

Inheritance is the logical consequence of capital accumulation in a slow growth economy.

Market and economic rationality have nothing to do with democratic rationality.

Democracy and social justice require specific institutions of their own, and these institutions cannot be justified or legitimated in terms of market competition.

When universal suffrage was instituted in the 19th century (and property-based voting abolished) it ended the legal domination of politics by the wealthy.

But it did not abolish the economic forces capable of producing a society of rentiers.
Global wealth inequality

Financial globalization and the inequality of \( R > G \) leads to a greater concentration of capital ownership.

This automatically contributes to a structural divergence in the ownership of capital, particularly at the very top of the distribution.

One way to observe this (the impact of the \( R > G \) inequality among the top centile) is to examine global wealth rankings (ranking of billionaires) and global wealth reports.

Both of these rankings illustrate that the rate of return on the large fortunes has grown faster than average wealth. See the latest Crédit Suisse report in the notes.
Global wealth

Global inequality of wealth in the early 2017 is comparable in magnitude to that observed in Europe in 1900-1910.

The top 0.1 percent own 20 percent of global wealth, the top 1 percent own 50 percent of global wealth and the top 10 percent own between 80-90 percent of wealth.

If the top 0.1 percent (4.5 million people) enjoy a 6 percent return on their wealth, while average global wealth grows at 2 percent a year, then after 30 years their share of global capital is likely to increase to 60 percent.

Do multi-billionaires run the world?
Sovereign wealth funds

Consider the case of sovereign wealth funds and petroleum states. The Norwegian sovereign wealth fund is worth about 700 billion. 60 percent of money earned from Norwegian oil was reinvested into the fund, while 40 percent went to government public services and expenses.

The financial reports of the next two biggest sovereign wealth funds, Abu Dhabi Investment Authority and Saudi Arabia, are more opaque.

Abu Dhabi boasts an average return of 7 percent, whilst Saudi Arabia is approximately 2-3 percent. This is because Saudi Arabia primarily invests in US Treasury bonds. But it is now diversity into Silicon Valley.

At a global level, sovereign wealth funds hold total investments that equal $5.3 trillion, of which $3.2 trillion belongs to petroleum exporting states. This is the same as the fortune of all the world's billionaires.
Petro states

As oil becomes more scare and its price increases, the inequality $R>G$ would imply that the share of global capital going to petro-states could reach 10-20 percent.

This would not bode well for democracy, as it implies growing economic dependence on oil-producing states.

The populations of petro states are often tiny, but their global investments are huge.

Can we imagine a democratic state blocking a sovereign wealth fund from buying up real estate in a country?
China/Asia

A large portion of the global capital stock is accumulating in Asia, particularly in China.

In borderless capital-markets, Chinese investment is causing some political tensions.

The big difference between China and the small Arab oil-producing states is that Asian populations are huge.

Most of the future investment in Asia is likely to be spent on their own domestic populations/infrastructure.

The total capital stock owned by European households is 70 trillion whereas the sovereign wealth fund in China is less than 3 trillion.

Rich countries are being taken over by domestic oligarchs not China.
Conclusion

Wealth in most western democratic countries is private and cannot be mobilized by governments for public purposes.

The EU cannot tax or mobilize the capital it generates within its member-states.

Small states compete with each other to reduce capital taxation at the very moment when demand for public expenditure is increasing.

Can the super-rich distort democracy, and if so, how? Should we care?

To overcome these contradictions, is a wealth tax necessary?