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Discussion

Comment on: "Income Inequality and Asset Prices under Redistributive Taxation" by Ľuboš Pástor and Pietro Veronesi

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1. Introduction

The question of how an optimal tax system should be designed has spawned an enormous literature and is still subject to heated debates (see, e.g., Mankiw et al., 2009 or Piketty and Saez, 2013 for extensive overviews). Models to tackle this question usually posit that the chosen tax system should maximize a social welfare function subject to a set of constraints while taking into account the individuals' responses to taxes and transfer payments. In standard models this results in a tradeoff between equality and efficiency: on the one hand, taxes and transfers lead to resources being distributed more equally and, thus, to an increase in social welfare. On the other hand, redistributive taxation may negatively affect the incentives of individuals to exert effort and create income in the first place, ultimately resulting in a reduction in efficiency.

While Pástor and Veronesi (2016) do not tackle the question of optimal taxation, it is still instructive to relate their setup to some of the basic insights in the existing literature. Pástor and Veronesi focus on the channels through which business ownership and financial markets can affect inequality through the lens of a simple general equilibrium model with heterogenous agents. Taxes are exogenously given and their sole purpose is redistribution. Ultimately though, a better understanding of the interaction between taxation, entrepreneurial activity and financial markets may be useful for tax policy making.

The research field of optimal income taxation originated with Mirrlees (1971) who approaches the question by recognizing that governments who want to redistribute from high to low skill types can (at best) observe wages but not the heterogenous skills. As a result, taxes and transfers depend on the observed wages instead of unobserved skills. The tax system must then be designed such that high skill types are provided with enough incentives to still exert a high level of effort and not mimic low skill types.

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While the Mirrlees model operates on the intensive margin, Diamond (1980) considers a tax system that operates on the extensive margin, i.e., where agents decide whether or not to participate in the labor market in the first place. He shows that a subsidy for work (or a negative marginal tax rate) may be optimal in certain cases.

What both approaches have in common is the underlying premise of a benevolent social planner. Mankiw (2013) challenges the utilitarian approach and makes a case for an alternative approach based on the principle that people should get what they deserve.[1] Such a shift in the political philosophy also results in a more nuanced view of inequality, i.e., it makes a difference whether the high earners are simply more productive or whether they are able to exploit the system by extracting rents without producing anything of value.

As a thought experiment, Mankiw (2013) starts with a utopian society where everybody earns the same until an entrepreneur has an idea for, and launches a new product. If the product turns out to be something that everybody wants to buy (Mankiw uses the iPod as an example) then the entrepreneur becomes very rich without making the rest of the society worse off. The question then is whether public policy should be altered as a reaction to the fact that inequality has just risen, i.e., whether the additional profits of the entrepreneur should be heavily taxed and redistributed. Mankiw notes that this cannot be tackled by relying solely on economic reasoning as the question is fundamentally of a philosophical nature.

In their paper, Pástor and Veronesi (2016) study the choice of agents to become either an entrepreneur (and be subject to redistributive taxation) or a pensioner (and be completely unproductive). The level of taxation then has an effect on the decision of agents to become either entrepreneurs or pensioners. The effects of different (flat) tax rates are analysed via comparative statics.

2. Financial markets, business ownership, and inequality

The model of Pástor and Veronesi features heterogenous agents that differ along two dimensions: skill and risk aversion. They optimally choose to become either “entrepreneurs” or “pensioners”. Entrepreneurs take risks and invest their endowed capital. Their skill level determines their productivity and, ultimately, the return to their investment which is taxed. Tax revenues are equally redistributed among the pensioners who choose not to invest and, thus, lose their endowed capital.

The model is very stylized on purpose and the authors are careful to highlight their channel of interest. Unlike most of the exhaustive literature on optimal taxation, their model does not feature wages. Instead, the agents earn business income, capital income and pensions that are exclusively financed through taxes. This allows Pástor and Veronesi to provide novel theoretical insights on how financial markets and business ownership can contribute to overall inequality.[2]

The simplicity and elegance of the set up also allows Pástor and Veronesi to solve for the equilibrium and obtain closed-form solutions for and a characterization of the equilibrium properties of asset prices. In particular, the asset pricing implications are novel and very interesting, linking tax rates to expected stock returns and stock price levels. Given that the participation in the stock market differs across the agents, the asset price patterns feed back into, and contribute to, income inequality.

While the lack of wages is a virtue in many respects, a more realistic model would allow for an extra choice: in addition to becoming either entrepreneurs or pensioners, agents could also select to become workers. As Pástor and Veronesi conjecture in the conclusion, there are reasons to believe that the main selection effects survive such an extension. However, it would be interesting to explore the labor market implications of such an extension in more detail. One can expect workers to be more skilled than pensioners (as in, e.g., Meltzer and Richard, 1981) and, depending on the idiosyncratic risk of wages (see, e.g., Borjas, 1999 for evidence that wages are less risky than entrepreneurial income), to be less risk averse.

Moreover, the existence of a “worker” category would most certainly have a positive effect on aggregate output compared to the model in the paper. In the current model, an increase in the tax rate unambiguously reduces output, even though productivity goes up. This happens because as the tax rate increases, more agents choose to become pensioners and their capital is immediately destroyed, thus leading to a reduction in aggregate output. Nevertheless, productivity increases at the same as the remaining entrepreneurs are more skilled on average. In a model that features workers, the “lost” capital could still be put to productive use, potentially leading to interesting interactions between taxes and aggregate output. In general, redistributive taxation can have a positive effect on aggregate output (see, e.g., Benabou, 2000).

A further, and even more ambitious extension would introduce a social planner who sets a tax rate or tax schedule to maximize a social welfare function, which would allow to properly relate the model to the extensive literature on optimal taxation referred to previously.

Even though the contribution of the paper is mainly theoretical, Pástor and Veronesi check whether the empirical evidence is consistent with the predictions of the model. What is important to note in this context is that while the analysis remains very basic, the evidence is interpreted through the lens of a general equilibrium model. Thus, even though it is not possible to claim causality from an empirical point of view, the model provides strong guidance on how to interpret the correlations found in the data. Overall, the data is surprisingly consistent with the predictions of the model with respect to the relationship between taxes and inequality, productivity, and stock returns and prices, respectively.

[1] See also Mankiw (2010).

[2] While wage income is still the predominant source of income, Kacperczyk et al. (2015) for example provide empirical evidence on the growing importance of non-wage income, especially for households that participate in financial markets.