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Economic inequality and optimal redistribution: A theoretical and empirical analysis

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Abstract

This research applies the innovative *els* model to estimate optimal redistribution as implemented through progressive income taxation, a "social safety net" represented by guaranteed minimum consumption, and allocation of total tax revenues between provision of a pure public good and financing guaranteed minimum consumption. In addition to the two traditional primary factors of production provided by the household to the economy (labor l and saving s), the *els* model adds a third primary factor: capital management effort e. The principal empirical basis for the model consists of estimates of capital wealth distribution and labor income distribution from the 2010 Survey of Consumer Finances. General insights are gained into the overall relationship between economic inequality and optimal redistribution, as well as specific insights into the effect of various economic parameters on this relationship.

JEL classification: H21; D58

Keywords: Labor income; Capital wealth; Taxation; Welfare entitlements; Computable general equilibrium

1. Introduction

Over the last few decades, a number of economists and socio-political analysts have expressed concern over the high and increasing level of economic inequality: Atkinson (1972), Thurow (1975), Levy (1987), Packard (1989), Winnick (1989), Dagum and Zenga (1990), Maxwell (1990), Inhaber and Carroll (1991), Levy and Michel (1991), Toshiyuki (1991), Osberg (1991), Frank and

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Cook (1995), Wolff (1995), Yunker (1997), Keister (2000), Arrow, Bowles, and Durlauf (2000), Smith (2001), Welch (2001), Bartels (2008), Rycroft (2009), Kennickell (2009). A notable contribution to this literature was recently added by the Nobel prize-winning economist Joseph E. Stiglitz: *The Price of Inequality: How Today's Divided Society Endangers Our Future* (2012). Stiglitz's book was on the *New York Times* bestseller list for several months, but as far as commercial success and general recognition is concerned, Thomas Piketty's *Capital in the Twenty-First Century* (2013) is perhaps even more impressive.

Thomas Piketty's treatise is essentially an elaborate, sustained protest against the social policies, especially taxation policies, that are seemingly responsible for a trend toward a form of "patrimonial capitalism" under which economic inequality would be on a par with that of the pre-modern and early industrial periods. According to Piketty, at this point the best hope for avoiding "patrimonial capitalism" is to return rates of taxation to the mid-twentieth century levels that were customary prior to the political pendulum's radical rightward swing during the 1970s and 1980s. The scope of Stiglitz's book is broader, but he also argues for increases in the progressivity of the tax system, as well as for strengthening the social welfare system. It is too soon to say whether the unusual amount of interest in the Stiglitz and Piketty books will translate into significant changes in professional attitudes, political realities, and public policy.

The principal focus in the professional literature at the present time seems to be on taxation of capital income and/or capital wealth. This seems appropriate in that capital income and wealth are far more unequally distributed than labor income. Moreover, capital income is less persuasively justified as "earned" than labor income. The significant role of inheritance and chance in the generation of capital wealth inequality (on which inequality in capital income heavily depends) weakens the case that this inequality is justified by considerations of economic efficiency and/or equity. Characteristic of the literature is the controversy over taxation of such capital income components as dividends, interest and capital gains. It had long been a staple principle among some economists that taxation of this type of income is especially harmful because it deters the saving and investment on which future progress depend. The proposition was given a formal rationale in the independent work of Chamley (1986, 2001) and Judd (1985, 1999). However, the proposition has been challenged on the basis that it is dependent on implausibly strong assumptions (e.g., infinite lifespans, perfect capital markets), and that when some or all of these assumptions are relaxed a plausible case for capital income taxation emerges: Aiyagari (1995), Golosov, Kocherlakota, and Tsyvinski (2003), Cagetti and De Nardi (2009), Kocherlakota (2005), Piketty and Saez (2012). That these alternative models may be more realistic is suggested by the fact that many nations actually do tax capital income.

To the extent that high and increasing economic inequality is perceived to be a serious problem, as Piketty and many others do, one possible solution is a more aggressive redistribution policy. This possibility has been, and is being, actively studied in the professional literature. For example, a substantial literature has emerged in recent years on the Basic Income Guarantee (BIG): Van Parijs (1991, 1992, 2004), Bowles (1992), Van Der Veen (1998), Widerquist (2001), Clark (2002), Garfinkel, Huang, and Naidich (2003), Bryan (2005), Mitchell and Watts (2005), Handler and Babcock (2006), Widerquist, Lewis, and Pressman (2005), Caputo (2008, 2012), Boettke and Martin (2011), Murray and Pateman (2012), Widerquist (2013), Yunker (2013).

Implicit in these various literatures is the widely accepted principle that economic inequality provides a justification for public intervention in the economy through redistributive tax and welfare policy, and the greater the degree of economic inequality, the greater the optimal level of redistribution policy. The present contribution, which has its roots in the optimal taxation literature,