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The Meaning of Capital in the Twenty-First
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Abstract

America is on a path towards a level of both wealth and income inequality unparalleled in recorded history. Thomas Piketty's *Capital in the Twenty-First Century* summarizes and conveys the work of Piketty and many co-authors, over many decades, looking at the structure of income and wealth inequality across many nations and centuries. This review essay builds on Piketty's ambitions as well as his data, in order to put forth a better solution: one that accepts and even embraces the facts of unequal ownership of capital, but changes the social meaning of those facts to avoid the social harms that follow from unfettered private party capitalism. A progressive spending tax does not simply take capital away from the wealthy. It allows the rich to keep and manage their wealth, as they have shown the ability and temperament to do so. But it curtails their ability to spend their capital on themselves and their luxurious wants. The social distinction of holding wealth can continue; the progressive spending tax makes this state of affairs work to the common utility.

The Meaning of Capital in the Twenty- First Century

Capital in the Twenty-First Century. By Thomas Piketty. Translated by Arthur Goldhammer. Cambridge, Mass: The Belknap Press of Harvard University Press. 2014. Pp. vii, 685.

Edward J. McCaffery¹

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America is on a path towards a level of both wealth and income inequality unparalleled in recorded history. Thomas Piketty is a distinguished Professor of Economics at the Paris School of Economics. He has written an impressive, monumental book laying out the facts, recently translated into English, and making surprising and sustained appearances on all forms of best-seller lists.² *Capital in the Twenty-First Century* (“21st Century Capital”) summarizes and conveys the work of Piketty and many co-authors, over many decades, looking at the structure of income and wealth inequality across many nations and centuries. The main lesson to emerge is that both income and wealth are unequal and getting worse. The situation in America and other advanced democracies in the 21st Century is approaching the extreme levels of *Belle Epoque* France³ which, for those a bit fuzzy in their knowledge of modern eras, means *circa* 1900. The great wars of the twentieth century wiped out vast stocks of capital and hence equalized matters to an extent. Inequality began increasing again after World War II, during a “catch up” phase of economic growth, and has spiked up considerably, especially in the United States, since around 1980, the year that Ronald Reagan was elected president.⁴ Piketty, like an Old Testament prophet, is here to warn us of this trajectory, and to get us to repent and reform our ways before it is too late.

² Jia Lynn Yang, *Here’s an Unlikely Bestseller: A 700-Page Book on 21st Century Economics*, THE WASHINGTON POST (Apr. 22, 2014), <https://www.washingtonpost.com/news/wonk/wp/2014/04/22/heres-an-unlikely-bestseller-a-700-page-book-on-21st-century-economics/>.

³ The Belle Epoque (French for “Beautiful Age”) is conventionally dated from 1871, the end of the Franco-Prussian War, to 1914, the dawn of World War I; a time period roughly convergent with the “Gilded Age” (a term coined by Mark Twain) in America. See <http://europeanhistory.about.com/od/france/a/belleepoque.htm> (last visited Feb. 27, 2016).

⁴ THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* 294-96 (The Belknap Press of Harvard University Press, 2014).

So much, so good. A simple way to summarize Piketty's voluminous data – which, in fact, overflows beyond the nearly 700 pages of the book, into technical online appendixes and scores of related scholarly publications⁵ -- is that there will be poor always, and there will be rich always. The question for a normative social and political theory is what to do about these damn facts. Karl Marx, whose *Capital*⁶ is in many ways an important precursor to Piketty, thought that capitalism would lead to its own demise. The communist revolutions that followed in Marx's wake addressed the problem of unequal private wealth by purporting to take all wealth into the public sphere: "from each according to his ability, to each according to his needs!" in the standard Marxist slogan.⁷ That did not turn out so well. Piketty, being a thoroughly modern sort of scholar, advocates what he takes as a thoroughly modern solution: Tax the rich. Piketty repeatedly calls for, though he also notes the difficulties of ever obtaining, a global tax on capital,⁸ and he also supports a far more steeply progressive income tax than America has today.

Piketty's proposals turn out not to be the best answers to the best understanding of the problems of economic inequality. In this review essay, I aim to build on Piketty's ambitions as well as his data, in order to put forth a better solution: one that accepts and even embraces the *facts* of unequal ownership of capital, but changes the social *meaning* of those facts to

⁵ See generally THOMAS PIKETTY, TECHNICAL APPENDIX OF THE BOOK: CAPITAL IN THE 21ST CENTURY (Harvard University Press, March 2014); Thomas Piketty, *About Capital in the Twenty-First Century*, 105(5) AM. ECON. REV. 48-53 (2015).

⁶ KARL MARX, CAPITAL: VOLUME 1 (Friedrich Engels, 1867).

⁷ Letter from Karl Marx to the Social Democratic Workers' Party of Germany, *Critique of the Gotha Program*, May 5, 1867 available at https://www.marxists.org/archive/marx/works/download/Marx_Critque_of_the_Gotha_Programme.pdf.

⁸ See PIKETTY, *supra* at 676: Index entry for "global tax on capital."

avoid the social harms that follow from unfettered private party capitalism, as we now know it. We begin with Piketty's facts.

1. Piketty's Facts

21st Century Capital is itself a composite of scholarly work that Piketty, alone and with many co-authors, has produced over many years. At its core is a detailed presentation of statistics about the holdings and concentration of wealth, or capital, and income across many countries and over extensive time periods. The longest-running data comes from England and France, where Piketty is able to go back to 1700, or even earlier; by the 20th Century, America along with Germany, Japan, various Nordic countries, China, and others begin to appear. The basic story, with important variations, is that wealth and income are both unequally distributed. Inequality by many measures peaked around 1900, the *Belle Epoque* period in France, declined dramatically in the first half of the 20th Century, and has been on the rise ever after, especially since roughly 1980. Extending trend lines paints a worrisome picture of what lies ahead.

This quick summary leaves out a vast amount of detail and color. *21st Century Capital* is a dense, rich book, notwithstanding that Piketty (and his translator) write beautifully – it is a clear presentation of complex data and ideas, with plenty of interesting asides, on life, law, literature, contemporary and historical events, and more. I give here but a quick tour of this intricate whole.

The book is divided into four main Parts. There is first a brief “Introduction,” which Piketty opens with a quotation from the Declaration of the Rights of Man, 1789: “Social distinctions

can be based only on the common utility.”⁹ Piketty goes on to stress, as he often does, the importance of detailed statistical analysis, across cultures and long stretches of time, in order to better understand the nature of capital, wealth, income, and ownership. Piketty also introduces some of his theoretical apparatus, including the “fundamental force for divergence,” which obtains when r , the rate of return on capital, exceeds g , the growth rate, or

$$r > g$$

in simple form.¹⁰

Next comes Part One, “Income and Capital.” This Part, comprising two chapters and some seventy pages of text, sets out key definitions. Piketty emphasizes the important concept that growth, g in the book’s shorthand algebra, cannot be very high in equilibrium. Growth consists of two components, a demographic one (growth in population), and a productivity one (growth in per capita output). The two combined explain g : total national income, which we commonly refer to as GDP (gross domestic product).¹¹ GDP grows both because there are more people, or “capita” to contribute to it, and because each person, or “caput,” on average, becomes more productive. Piketty shows that, for most of world history – from 0 to 1700, to be precise – g was a mere 0.1%, due almost solely to an equivalent level of modest population growth (i.e., productivity growth was essentially 0). From 1913 to 2012, in contrast, g has been 3.0%, consisting of 1.4% population growth and 1.6% productivity

⁹ *Id.* at 1.

¹⁰ *Id.* at 25-27.

¹¹ Piketty’s “national income” is slightly different from the more commonly used (in the U.S., at least) GDP, but the difference is not material for this essay. *See Id.* at 43-45.

growth.¹² Piketty shows that the low growth of the first seventeen centuries of the Christian era is the norm, and more or less a necessity – due to the miracle of compounding, in essence, even very small growth rates would lead to extreme overpopulation (and unrealistic productivity gains) over vast stretches of time. Thus Piketty expects population growth to slow, to near 0 later in the 21st Century, and for productivity growth (which Piketty calls “growth in per capita output”) to revert to historical means: “The key point is that there is no historical example of a country at the world technological frontier whose growth in per capita output exceeded 1.5 percent over a lengthy period of time.”¹³

These seemingly dry details are important for many reasons. During a time of high growth, inequality is muted as the store of capital is spread over a growing population base, and as labor output becomes more productive and hence wages ought to rise. Citizens everywhere are pleased with their rising material well-being: workers are getting raises. When growth slows, in contrast, so does this overall rise and sense of dynamism. At the same time, *old* money becomes more important and entrenched – heirs can live off dynastic fortunes while doing little, creating the conditions for a “patrimonial capitalism” that Piketty fears. It is easier for $r > g$ to obtain when g is low after all; low g means that the working classes struggle to hold steady while the high r means that the capitalist or propertied classes get richer without having to exert much effort to do so.

¹² *Id.* at Table 2.1, p. 73 (and passim).

¹³ *Id.* at 93. Piketty goes on to assume, with some reluctance, a productivity growth rate of 1.2% going forward, after noting that economists such as Robert Gordon assume a lower one, of 0.5%. *Id.* at 94-95.

Part Two, “The Dynamics of the Capital/Income Ratio,” weighs in at four chapters and just over one hundred and thirty pages of text. Once more, there is a vast amount of detail. Piketty’s primary focus here is β , the Greek letter beta, which he uses for the national capital level, and which he presents as a multiplier of national income. Drawing once more on impressive data sets from Britain and France in particular, Piketty can go back to 1700 and tell a tale of Europe. With some minor variations, β stayed at 700% -- seven times national income – in both Britain and France, from 1700 until roughly 1914, the dawn of World War I.¹⁴ Capital then crashed, with the capital stock falling by more than half, to less than 300% of national income by mid-Century. From then, and especially after 1970, the capital level has been ascending back to its *Belle Epoque* levels, now approaching 600%.¹⁵ Germany shows a roughly parallel trajectory. America, which was still emerging as a world power during the *Belle Epoque* and which has had a higher demographic growth rate throughout this period – and, importantly, which was far less devastated by the great wars of the 20th Century – shows both a lower overall β and a suppressed bottom to its “U-shaped curve.” Still, the United States peaked with a β of 500% just before the Great Depression hit, after which the level fell to under 400%, and has been trending up since the end of World War II.¹⁶ There are many other interesting observations in Part Two. Most capital (some 95%) is private (“[t]o a first approximation, public assets and liabilities, and a fortiori the difference between the two, have generally represented very limited amounts compared with the enormous mass of private wealth”)¹⁷ in almost all states. Most capital is also domestic –

¹⁴ *Id.* at 116-117.

¹⁵ *Id.* at 116-17 n.13.

¹⁶ *Id.* at 165.

¹⁷ *Id.* at 126.

foreign holdings *in* a country tend to roughly equal foreign holdings *from* a country (in-bound investments roughly equal out-bound ones). Piketty also describes the metamorphosis of capital away from land and towards financial assets; interestingly, a sea-change in the composition of capital has had little effect on the broad facts of its ownership, distribution, and control.

Finally, Part Two turns to the capital-labor split, looking to the share of national income paid over to capital. This follows from the “first fundamental law of capitalism:”¹⁸

$$\alpha = r \times \beta,$$

where α , the Greek letter alpha, is the share of national income paid over to capital, r is (again) the rate of return on capital, and β is (again) the capital stock. For those readers getting a bit dizzy with the algebra (which I shall review more slowly in the next Section), note that this “fundamental law” is, as Piketty himself knows and states full well, merely an accounting identity, a matter of definition. Recall that β , the capital stock, is itself a function of national income: a β of 600% means total national savings are six times national income. R is the real rate of return (taking out inflation), on average. This then leaves α , which is the share of national income that has to be paid over to capital. If r is 5%, as it often is, then the capital stock, which is 600% of (or 6 times) national income, must – by definition – be paid

¹⁸ *Id.* at 52. For those keeping score at home, Piketty’s “second fundamental law of capitalism,” namely that $\beta = s/g$, where s is the savings rate. *Id.* at 166-168. This means that the capital stock is equal to the savings rate divided by the growth rate. Unlike the “first fundamental law” discussed in the text, however, the second fundamental law is not a simple accounting identity, necessarily true – it depends on some assumptions being made. In any event, this second law is far less important to ours (or Piketty’s) analysis; the main point to be made is that the capital stock can increase, possibly quite dramatically, with a constant savings rate and a low growth rate; the fundamental force for divergence, $r > g$, is also helped by a low growth rate, g , and the two factors interact, because any savings out of the “excess” r , where $r > g$, counts for savings that is driving up β .

5% x 600%, or 30%, *of the national income each year*. This is, again, because the 600% means “600% of national income”; taking 5% of “600% of national income” leads to “30% of national income.” And, since the sum must be 100%, and capital and labor are the two great factors of production, a capital share, α , of 30% means – again by definition – a labor share of 70%. Of all the dollars earned in a country in any given year, under the above facts, 30 percent gets paid out to capitalists for the use of their capital, and 70 percent gets paid over to workers for their labor.

Once more, Piketty gives a vast amount of detail about capital’s share of national income, cross-culturally and historically; once again, the story is that this metric has bottomed out and is on the rise. Thus the capital share exceeded 40% in both Britain and France in the 19th Century, initially fell in the 20th Century to where it was “between 15 percent and 25 percent of national income in rich countries in 1970,” and has been on the uptick ever since, to where it is now “between 25 and 30 percent.”¹⁹

All this sets the stage for Part Three, the heart of the book, weighing in at six chapters and two hundred and thirty pages of text, “The Structure of Inequality.” This is the Part of the book that has drawn the most attention from popular commentators, for it clearly communicates some startling trends and statistics. At the start, Piketty sets out three tables showing inequality of labor, capital, and total income, respectively, “across time and space.” He heads his columns “Low” “Medium,” “High” and “Very High” inequality. For labor income, these columns mean Scandinavia in the 1970s-80s, Europe in 2010, the United States in 2010, and, with a question mark, the United States in 2030. Tellingly, for “low inequality” of

¹⁹ *Id.* at 200-201, 222 Fig 6.5.

capital ownership, Piketty must posit a “never observed . . . ideal society,” as even Scandinavia in the 1970s-80s featured a top 10% owning 50% of the nation’s capital. In part to normalize across currencies and other national variations, Piketty presents his data most commonly in the form of deciles and centiles – what does the top 10% own? Top 1%?²⁰ These figures, for labor/capital, and low/medium/high/very high levels of inequality, are reflected in the table below:

	Low Inequality Sweden in 1970s/Nowhere		Medium Inequality Scandinavia 1970s-80s		High Inequality U.S. 2010		Very High Inequality <i>Belle Epoque</i> _Europe US 2030?	
	Labor	Capital	Labor	Capital	Labor	Capital	Labor	Capital
Top 1%	5	10	7	20	12	35	17	50
Top 10%	20	30	25	50	35	70	45	90

Table One: Labor and Capital Shares of Top 1 and 10% of Populations

In words, a “low” inequality state would have a top 10% earning 20% of the labor income (2x its weighted average) and 30% of the national capital (3x). America in 2010 had a top 10% that earned 35% of labor income (3.5x) and owned 70% of the wealth (7x). Trend-lines according to Piketty suggest that, by 2030, the top 10% of American earners will earn 45% of the nation’s labor income (4.5x) and own 90% of the wealth (9x). Looking at the “top 1%,” as we often do, this centile gets 12% (12x) of the labor income in the U.S. today and owns 35% (35x) of the national wealth; by 2030, Piketty predicts, without changes, these levels

²⁰ *Id.* at 247-48.

will rise to 17% (17x) and 50% (50x). To round things out, the lowest 50% of the capital-owning distribution owns about 5% of any nation's wealth (a 0.10 weighted average), just about anywhere, anytime.²¹

The vast bulk of Part Three plays out these gory facts, with many literary references to Balzac, Jane Austin, and others thrown in for illustrative color. Historically, Piketty shows how we moved from the very unequal *Belle Epoque* period, where the high concentrations of capital ownership enabled a class of rentiers to live off of capital, inherited or otherwise, and conditions made it difficult for mere laborers to enter this capitalist Garden of Eden. The Great Wars and other shocks levelled capital, and so facilitated a rebuilding and rethinking of capitalism: post War, a stronger (bigger) social state emerged, and a prolonged "catch-up" phase supported demographic and productivity growth. Meanwhile, the fall in capital meant that labor had a bigger share of a growing pie; an era of "managers" dawned, the working classes earned greater rewards. Yet starting sometime around 1970, and certainly by 1980, things changed, most dramatically in the United States but in other developed countries as well. "Super-salaries" started to be observed; inequality of labor incomes spiked up. Piketty is more than willing to go on an extended aside debunking neo-classical economics theory here, making the case that the outsized incomes afforded to the "winners" have little to do with their marginal productivity.²² At the same time, capital stocks are returning to *Belle Epoque* levels, and are unequally held – fueling both great inequality and a return to a rentier class. This is a new era of "patrimonial capitalism," and Piketty does not like it.²³

²¹ *Id.* at 247-249.

²² *Id.* at 330-333 ("The Illusion of Marginal Productivity") *passim*.

²³ *Id.* at 339-343.

Part Four, “Regulating Capital in the Twenty-First Century” completes the book, but for a very brief conclusion. This Part feels like a descent from the mountaintop, coming in at four chapters and just under one hundred pages of text. Here Piketty looks for solutions to the problems intimated by his extensive data. The chapter titles more or less tell the story: Chapter 13, “A Social State for the Twenty-First Century,” Chapter 14, “Rethinking the Progressive Income Tax,” Chapter 15, “A Global Tax on Capital,” and Chapter 16, “The Question of Public Debt.”

Piketty is a thoroughly modern sort of scholar and man. He likes the social state that emerged in the midst of the 20th Century, and he sees it as a general force for good, and for taking the edge off some of the harsher aspects of unfettered capitalism. Then there is necessarily the question of how to pay for it – and hence the question of national debts of various sorts ripples throughout this Part. With cameo appearances of ideas such as simply renouncing the debt, or using inflation – printing money – as a tool for both paying down debt and redistributing wealth (inflation, or at least unanticipated inflation, helps borrowers and hurts lenders, at least initially), Piketty then turns to what he clearly sees as the best ideas. First is shoring up the progressive income tax, which Piketty lauds as a great American invention that helped make the 20th Century more kind and gentle, when it comes to income and wealth distribution at least, then its immediate neighboring centuries. But Piketty is naïve in lauding the U.S. income tax of the immediate post War era, as we shall see, and he

might as well take a seat waiting for Godot as he awaits a return to the kind of steeply progressive rates for which he yearns.²⁴

Next comes the showpiece recommendation, the global tax on capital, which Piketty praises and anticipates throughout *21st Century Capital*, although he often simply states its unrealism (“A global tax on capital is a utopian idea. It is hard to imagine the nations of the world agreeing on any such thing anytime soon.”).²⁵ Here, at the end of the day, Piketty presses the case for his pet proposal further, realism be damned, with some good thoughts on partial-implementation strategies. A few words on the public debt – Piketty thinks we should just tax private capital, perhaps with a one-time hit, to pay this down -- round out the volume. We are left to ponder our collective fate, especially if we cannot quite pull the trigger on any of Piketty’s proposals.

2. Piketty’s Dynamics

A little bit of economics theory goes a long way, and Piketty has been highly praised for keeping his theory delightfully readable and relevant. I have set out most of the main points in the prior Section. This Section underscores the basic economics ideas and their relevance to the central normative tasks at hand. There are two key principles, what Piketty calls the “first fundamental law of capitalism”²⁶ and “the fundamental force for divergence.”²⁷

²⁴ See Edward J. McCaffery and James R. Hines, Jr., *The Last Best Hope for Progressivity in Tax*, 83 S. CAL. L. REV. 1031 (2010).

²⁵ PIKETTY, *supra* at 515.

²⁶ *Id.* at 52.

²⁷ *Id.* at 25. I have discussed the “second fundamental of capitalism,” which I take as less central to the analysis here (and less of a law), in note --, *supra*.

The first fundamental law of capitalism, as stated above, is:

$$\alpha = r \times \beta,$$

where α is the share of national income going to pay for capital, leaving the rest to pay for labor. This share is increasing in both r , the real rate of return (net of inflation), and β , the national capital stock. Just as Piketty spends some time debunking the naïve belief that wages always reflect the marginal productivity of labor (such that wages, however high or unequal, are always “fair” or “earned” in some sense, reflecting the impersonal, neutral valuations of market processes), he also discusses and dismisses another lazy theory, or assumption, of much modern neoclassical economics: the “Cobb-Douglas production function.”²⁸ A “production function” states how readily the two great factors of production, labor and capital, may substitute for each other. Cobb-Douglas simply states that this substitutability ratio is 1:1. What this would mean, for Piketty’s first fundamental law, is that α would be constant – when β increases, r falls in perfect lockstep, so that the product $r \times \beta$ holds constant. This is a happy theory, consistent with the Marxist idea (assumption?) that “too much capital kills the return on capital.”²⁹ Cobb-Douglas would mean that Piketty’s problem – of too much capital, too unevenly held – would cure itself, over time, or at least not systematically worsen.

Alas, we get no such luck. Here is one of the many and highly significant benefits of Piketty’s astonishingly thorough empiricism: Cobb-Douglas does not hold. Over time and across nations, α has varied significantly, from a high of over 40% in the *Belle Epoque*, to a low of

²⁸ *Id.* at 217-223.

²⁹ *Id.* at 215.

20% or less in the mid-20th Century.³⁰ Since 1975 or so, the capital share has been on the rise, approaching 30% in developed countries. This is all wildly inconsistent with the simple Cobb-Douglas story. Piketty argues, persuasively, that looking forward and over time, the elasticity of substitution between capital and labor is likely to be greater than one, meaning that an increasing β will lead to a higher α , and less to be paid over to labor.³¹

This leads to some important real-world points. One, the simple Marxist story, that “the principle of infinite accumulation” will lead to a falling rate of return and ultimately the death of capitalism, will not obtain. Two, if α , the share of national income paid over to capital, is *the* problem, or a major part of the problem, then strategies that tax capital, β , *even if they do little more than reduce β without producing significant revenues for the state* can make sense. As Piketty puts it: “The primary purpose of the capital tax is not to finance the social state but to regulate capitalism. The goal is first to stop the indefinite increase of inequality of wealth, and second to impose effective regulation on the financial and banking system in order to avoid crises.”³² I pick up this point below.

Second, the key relationship to which Piketty frequently draws attention is between the rate of return on capital, r , and the growth rate, g . This is the “fundamental force for divergence.” By “divergence,” Piketty means a growing apart, a higher degree of inequality, here of capital holdings vis a vis labor’s share of the social pie, over time. Growth has both a demographic component and a productive one. When populations are increasing, such as in America during the 19th century, g is high, and g is also high with productivity gains, which also

³⁰ *Id.* at 200-201.

³¹ *Id.* at 220-223

³² *Id.* at 518.

obtained during the industrial revolution of the 19th century and throughout the 20th century. In a stable, advanced economy, however, both components of g level out. Population growth slows, to close to 0, and productivity gains also diminish. One of the many benefits of the long sweep of time in play in *21st Century Capital* is that matters that might seem surprising, even inaccurate, over short periods of time become obvious and even necessary over time. High growth is simply not sustainable.

Then there is r , the rate of return on capital. Piketty is especially and recurrently concerned with the situation that obtains when $r > g$, that is, when the rate of return on capital exceeds the rate of growth. This is, in short, a situation that favors “old” money or wealth over new. Piketty never breaks out a separate, systematic discussion of what exactly is wrong with this state of patrimonial capitalism, in political, philosophical, economic, or moral theoretic terms. Instead, Piketty uses literature, most extensively Vautrin’s lecture to Rastignac in *Pere Goriot*,³³ to make the point that a society where $r > g$ obtains, over long periods, has a host of problems, beginning with perverse incentive and demoralization effects. In *Pere Goriot* Vautrin explains to Rastignac that going to law school (of all things) is an economically foolish decision, and that he would do much better by marrying well, that is, into the capitalist class.³⁴ Piketty also uses Jane Austen to make the same point – marrying for money is the only ticket out of a life of limited possibilities and constant stress.

Piketty seems mainly concerned with the appearances and impropriety of a “rentier class” that can live off capital without working by the sweat of their brows. This obtains because,

³³ HONORE DE BALZAC, *LE PERE GORIOT* (Revue de Paris, 1835).

³⁴ PIKETTY, *supra* at 238-240.

with $r > g$, wealth is building up faster than the overall economy is growing (by definition), and wealth-holders can maintain their standard of living, and their capital stock, without ever working: by simply reinvesting g , the wealth-holder's capital stays constant against growth, and he or she can spend the excess r . This situation can go on indefinitely. With an increasing β , the capital stock, and the failure of Cobb-Douglas to hold, the share of national income that is going to capital is increasing, and the share that is going to labor is decreasing, even as low g itself is dampening wage growth. In sum, capital is taking over, eating up value that would otherwise be going to labor, which is shrinking in its share of the pie. This is "patrimonial capitalism," as Piketty calls it, in contrast, say, to entrepreneurial capitalism (or "old" money as opposed to "new" money.) In the world of patrimonial capitalism, where $r > g$, wealth seems perpetual and dynastic, and inheritance looms large. β is increasing in this age of capital, leading to a greater share of national income being paid over to capital – even as capital ownership is becoming more unequal. This is all evident in Table One. The bottom-line story is we are re-entering a *Belle Epoque* like period, in which a comparative handful of capitalists can live very well, indeed, without ever troubling to actually work, and the rest of us, dependent on labor income, are left to fight it out over an ever-shrinking pie.

This is where we are, with capital in the 21st Century.

3. Piketty's Problem?

Enough of the math and Greek letters. What is the reality of Piketty's story?

Piketty's world of capital in the 21st century – our world – is a world where the rich get richer, explosively and dynamically so, without doing anything much at all. Large financial accounts

grow larger each year, increasing beyond all reasonable spending needs. Labor's share of the social pie is, by logical necessity, shrinking, even as growth is slowing. Work is hard and does not yield the benefits of simply, passively, owning capital. Raises are low. Soon, there will not be much point in going to law school. This is where Piketty sees things heading, to an unhappy place where we all plot to marry well and work little, and we wait around for some great war or other social cataclysm to reset the dynamics and bring back hope. In sum, for most of us, life is pretty far from *belle*.

For all of Piketty's understandable pride in producing a detailed, comprehensive picture of capital and income in many countries today, and over vast stretches of time, the casual reader might think that not much is new, here. A few minutes spent watching television, trying to keep up with the Kardashians or trying to understand contemporary business or politics, brings home the reality that the few today have much, and the rest of us do not. The question – *before* we get to the question of what to do about it – is what, exactly, is wrong with this situation?

There is much to be said for laying out normative premises first and, in the tradition of Hume, starting with a normative conception of the self.³⁵ Piketty's view of human nature is not fully stipulated. This turns out to matter. To Piketty, the problem seems to be the *fact* of unequal wealth and income. Pushing a bit harder, and spending time with Balzac and Austen, we can see that Piketty is bothered by rentiers – individuals making money from economic rents, that is, off capital, with little or no work effort. Piketty distinguishes rentiers from those who “earn” income, although he is not happy with outsized salaries, either – which he suggests

³⁵ See DAVID HUME, A TREATISE OF HUMAN NATURE (1738-40).

are not fully “earned,” certainly not in the neo-classical economic sense of being rewards for the marginal productivity of labor. Here is where we get to the rub: The “social distinctions” afforded to the rentier class can not be justified by the “common utility.”³⁶ Balzac and Austin show the various problems that befall a society of patrimonial capitalism, of incentives (why try honest labor?), demoralization, and more. In a society dominated by capital, it seems pointless to work. Rather than ending with capital eating its own profits, as Marx would have it, Piketty’s world ends with labor simply quitting, and everyone trying to marry someone in the top 1%, which will eventually have all the wealth. That is what happens with Piketty’s data and dynamics, unchecked. We are left waiting for some great war or other social conflagration to whack down the stock of capital. That is a strange and sad Godot on which to pin our human hopes.

But with Piketty’s facts, and his sense of the problem, waiting for a war is indeed a perfectly logical solution. Recall that Piketty finds that Cobb-Douglas does not hold, as a fact of the matter, across time and cultures. This means that, under the first fundamental law, $\alpha = r \times \beta$, the share of income paid over to capital, α , will fall with a falling capital stock, β . The rate of return, r , will increase, but not by enough to offset the fall in capital. This *necessarily* means that simply destroying capital – by wars, taxes, or any other port in the storm – will increase the share of national income going to labor, and hence, relatively, promote equality, dynamism, and hope: Rastignac can go to law school, after all. Piketty does not stress this logic, but he is aware of it, and it explains why he does not much rely on his pet recommendation for a global tax on capital to do what most people think taxes are supposed

³⁶ PIKETTY at 1, quoting *The Declaration of the Rights of Man and of the Citizen*, (1789).

to do – raise revenue. If Piketty’s tax “simply” reduced the stock of capital, β , Piketty’s main concerns over a rentier class and patrimonial capitalism would be addressed. Interestingly, there would still be unequal ownership of wealth or capital – a perhaps universal social fact – but the magnitude of such capital will have diminished. So an idea is to tax capital and simply throw the money away, as preferable to having to wait for a war: tax policy as peace initiative, in short.

Well, we can say, good luck with that. Aside from other, seemingly insurmountable problems with getting a global tax on capital up and running,³⁷ the logic of destroying capital to better the world runs deeply counter-intuitive to the American mind, such that the people might actually opt to wait for the wars to come instead of agreeing to a new tax on capital. America, after all, was founded on a war waged in part against tax increases. There is however a way out of this seeming political dead-end. It starts with thinking through the “problem” with Piketty’s facts more thoroughly.

Return to the human side of the facts. Piketty’s data shows clearly what we all know at some level: Some people and families have large amounts of capital while most have none. We can put aside the centuries-long debate about whether this state of affairs is “earned” or not, just as we have gotten beyond “fault” in much of our analysis of tort law.³⁸ Instead let us try simply to understand the facts of the matter. This focus allows us to see another critical aspect of reality. Some people become rich. And *some* of these rich people pass on their wealth to their heirs. People who bequeath wealth have done more than merely having

³⁷ See *Infra* Section 5.

³⁸ See generally Anthony J. Sebok, *Symposium: Responsibility and Blame: Psychological and Legal Perspectives: The Fall and Rise of Blame in American Tort Law*, 68 BROOKLYN L. REV. 1031 (2003).

earned or gotten lucky in obtaining capital. They have done more than simply invested their wealth well. They have also *not* spent “their” capital. They are frugal capitalists rather than spendthrift aristocrats, in language borrowed from John Rawls.³⁹ This turns out to make a major difference. We are not all equal when it comes to our savings propensities. People are heterogeneous. Some of us are spenders. Others are savers. It takes saving, across generations, and – what is, necessarily, the same thing -- forbearance from consumption to create the capital stock.

Is there a way to make the “social distinctions” that come from owning capital work to the “common utility”? There is. We can redesign the tax system not to take capital away from its individual owners, but to change what it is that these private owners can do with their wealth. In this way, we would change the meaning of capital, allowing the wealthy to keep their cake while limiting their ability to eat it too. But before we can get to tax as cure, we must confront an embarrassing reality: the United States tax system, as is, is a significant *cause* of Piketty’s problems.

4. Labor, Capital, and Tax Planning 101

Piketty lauds America’s progressive income tax policies of the 1970s’s: “It is also important to note the rise of progressive taxes in the twentieth century, that is, of taxes that imposed higher rates on top incomes and especially top capital incomes (at least until 1970-1980), along with estate taxes on the largest estates.”⁴⁰ Piketty is wrong. The facts are that even in the 1970s, high income-earners were rather easily able to avoid high marginal tax rates. The

³⁹ See *infra* Section 8.

⁴⁰ PIKETTY at 374.

situation obtained until the Ronald Reagan reforms of the 1980s, when rates came down and the base was broadened -- as primarily a labor tax.⁴¹

In fact, the United States has long used the *appearance* of high marginal tax rates on the rich to mask the reality of burdensome labor taxes on the not-rich. When Franklin Roosevelt helped institute a 79% bracket in 1936, for example, only John D. Rockefeller was in it.⁴² The payroll tax, which applies to the first dollar of labor earnings and falls off precipitously around \$118,000,⁴³ has risen to being a close second to the income tax as a source of federal revenue.⁴⁴ Taxes on capital income have been easily avoidable for the entire century of modern income taxation in America, as we shall explore below.⁴⁵ The estate tax has always been a “voluntary” tax, all the more so now.⁴⁶ To give a quick and current example, the casino magnate Sheldon Adelson transferred \$7.9 *billion* to his heirs, altogether tax-free, under the current “progressive” estate tax.⁴⁷

Piketty’s lack of familiarity with the real-world of contemporary tax planning makes his celebration of past tax policy hollow and his recommendations for the future doomed. Even a quick consideration of the United States tax system shows that it is, in essence, a highly

⁴¹ Edward J. McCaffery, *Taxing Wealth Seriously* (forthcoming 2016).

⁴² *Id.*

⁴³ Becky Hendriksen, What is FICA? 3 Things you Need to Know, PAYCHECK CITY (Oct. 13, 2014), <https://www.paycheckcity.com/pages/article.php?page=what-is-FICA> (the Medicare tax continues however, uncapped, at 2.9%).

⁴⁴ McCaffery, *supra*.

⁴⁵ *Id.*

⁴⁶ See generally George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 (1977); Edward J. McCaffery, *A Voluntary Tax? Revisited*, 93 NAT’L TAX ASS’N PROC. 268 (2001); Edward J. McCaffery, *Distracted from Distraction by Distraction: Reimagining Estate Tax Reform*, 40 PEPP. L. REV. 1235 (2013).

⁴⁷ Zachary R. Mider, *Accidental Tax Break Saves Wealthiest Americans \$100 Billion*, BLOOMBERG BUSINESS (Dec. 16, 2013), <http://www.bloomberg.com/news/articles/2013-12-17/accidental-tax-break-saves-wealthiest-americans-100-billion>.

burdensome wage tax that leaves capital essentially off the social hook. This means that the United States tax system, throughout the entire 20th century and beyond, has been *adding* to, not subtracting from, the benefits of capital and the burdens of labor. Not only is labor getting a shrinking piece of a more-slowly growing pie, but it is also seeing its tax burdens increase, while capital continues to be able to lower, defer, and even altogether avoid taxes. In sum, tax gives Rastignac even more reason to drop out of law school to try and marry well.⁴⁸ I have developed this theme elsewhere, including at book length, so I will do so only quickly here, leaving the vast amount of details aside.⁴⁹ Fortunately if curiously one can explain this critical point quickly and simply enough.

Three features built deeply into the fabric of the U.S. income tax—and rarely seriously questioned by legislators—conspire to make the tax into a virtual wage tax, where any taxation on capital is largely voluntary. These features are outlined as the following three steps, what I have called Tax Planning 101:

- Buy
- Borrow
- Die

Step One’s “Buy” derives from the realization requirement from, among other sources, the celebrated 1920 U.S. Supreme Court case of *Eisner v. Macomber*, 252 U.S. 189, which held that the change in value of an existing asset is not income until and unless the gain is realized

⁴⁸ See Michael Simkovic, *The Knowledge Tax*, 82 U. CHI. L. REV. 1981 (2015). See also *Taxing Wealth Seriously*, *supra*.

⁴⁹ EDWARD J. MCCAFFERY FAIR NOT FLAT: HOW TO MAKE THE TAX SYSTEM BETTER AND SIMPLER (University of Chicago Press, 2002); Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807 (2005).

through a sale or other disposition. By buying assets that rise in value without triggering taxable gains—real estate works pretty well here, as do non-dividend paying stocks — one gets to grow wealthy without taxation.

How does one spend the kind of unrealized appreciation that following Step One generates? Borrow. When you borrow, there is no change in your net worth, no income: the cash borrowed is offset by the liability to repay the debt. Under today's income tax, you can even borrow against your unrealized appreciation from an asset and spend away, tax-free.⁵⁰ This gets us to one side of the deep problem that Tax Planning 101 poses today: The rentier class can spend away without facing any tax.

The final step in Tax Planning 101, as in life, is to die. The built-in gain, or the difference between the fair market value of an asset and its tax basis, which had been allowed to grow untaxed under the realization requirement of Step One, disappears on death, Step Three. If Jane bought stock for \$1,000, she would have basis in the stock of \$1,000.⁵¹ As the stock rose in value, to say \$5,000, Jane's basis would stay at \$1,000. The difference between the fair market value, \$5,000, and Jane's basis, \$1,000 – that is, \$4,000 – would not be taxable, under the realization requirement, until and unless Jane sold or otherwise disposed of the stock.⁵² Jane would be holding the stock with a built-in gain of \$4,000. The point of Step Three, die, is that this built-in gain goes away on death. The heirs take an asset with a “stepped-up” basis equal to its fair market value; Jane's children would get stock worth \$5,000 with a basis of

⁵⁰ *Woodsam Assocs., Inc. v. Commissioner*, 198 F.2d 357 (2d Cir. 1952). See also James E. McWhinney, *Home-Equity Loans: What you Need to Know*, INVESTOPEDIA, <http://www.investopedia.com/articles/pf/05/041305.asp> (last visited Feb. 27, 2016).

⁵¹ IRC Sec. 1011.

⁵² IRC Sec. 1001.

\$5,000.⁵³ This provision has been called the “Angel of Death” benefit.⁵⁴ The kids can inherit the asset, sell it, and pay off their mother’s debts—all tax-free. The circle is complete.⁵⁵

That is it. By buying capital assets that appreciate without producing taxable dividends, borrowing to finance present consumption, and continuing the game straight onto death, the rich can avoid taxes. Warren Buffet, Bill Gates and countless others among the rich and famous have figured this all out, perfectly well.⁵⁶ Tax Planning 101 avoids all federal taxes. It avoids the income tax because of the three doctrines just noted. It avoids the increasingly important social security or payroll tax system by the simple expedient of never actually working. It avoids the estate tax because that is a net tax, on assets minus liabilities held at death. If Tax Planning 101 is taken to its limits, there is no net estate. Tax Planning 101 means no taxes, notwithstanding a comfortable lifestyle for those with the assets in hand to play it. Those, that is, who live off of capital: rentiers.

Tax Planning 101 turns on a simple buy-and-hold strategy that many capitalists follow in any event, and which Piketty’s dynamics suggest is a perfectly fine way to get rich and richer. By using debt, Tax Planning 101 can become a roadmap to a life of tax-free, luxurious living. At

⁵³ IRC Sec. 1014.

⁵⁴ Michael Kinsley, *Eight Reasons Not to Cut the Capital-Gains Tax*, SLATE (Feb. 23, 1997), http://www.slate.com/articles/briefing/articles/1997/02/eight_reasons_not_to_cut_the_capitalgains_tax.html.

⁵⁵ Under the strange political tale of the gift and estate tax, there was, briefly, no estate tax and a carryover basis regime in place for the single year, 2010. The carryover basis component of this law was especially unpopular. When Congress and President Obama finally decided to clarify the situation for at least the two years 2011–2012, they gave taxpayers an option, retroactively, to use stepped-up basis for 2010. This parallels a story from Jimmy Carter’s presidency in the 1970s. Congress voted to replace stepped-up basis with carryover basis on death, but the law never took effect, and was retroactively repealed under President Reagan. Stepped-up basis on death, like the other planks in Tax Planning 101—and like the home mortgage interest and other personal deductions discussed—appears to have attained the status of a “sacred cow” in tax.

⁵⁶ *Taxing Wealth Seriously*, *supra*.

the same time, for those capitalists not bent on spending all their wealth and dying broke, wealth can be transferred easily enough -- recall Adelson's \$7.9 billion tax-free transfer -- such that later generations can start life with a healthy spoonful of capital, which can easily be held and invested in a low or no-tax manner. This is what is occurring with the hundreds of billions of dollars in "Dynasty Trusts" now roaming the American landscape, in places like South Dakota, free even from any worry about hoary doctrines such as the Rule Against Perpetuities.⁵⁷ In sum, tax provides a roadmap for, not a hindrance to, the rentiers' *belle* life.

Tax Planning 101 is not a glib witticism, let alone a joke. It is the key to capital's bearing little or no tax. There is plenty of evidence that the wealthy follow its principles. Warren Buffet certainly does.⁵⁸ If large numbers of wealthy Americans do not, by and large, follow Tax Planning 101, something is dangerously wrong with the principal assumptions of rational choice social theory. Why would any wealthy capitalist or rentier willingly pay excessive taxes? Why would various advisors and financial intermediaries not crop up to give the advice, for a fee? Certainly, financial products such as cash value life insurance follow the blueprint.⁵⁹ Americans borrowing against their home equity, or taking out margin loans on stock, do too.

Perhaps most importantly, the mere existence of Tax Planning 101 constrains major aspects of the tax system, especially the capital gains rate. *Macomber's* realization requirement creates a "lock-in" effect, whereby wealthy capitalists have an incentive to hold onto their

⁵⁷ Robert H. Sitkoff and Max M. Shazenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L.J. 356 (2005).

⁵⁸ Edward J. McCaffery, *The Buffet Rule is Going Nowhere*, CNN (Apr. 16, 2012), <http://www.cnn.com/2012/04/16/opinion/mccaffery-buffett-rule/>.

⁵⁹ *Cash Value Life Insurance*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/cash-value-life-insurance.asp> (last visited, Feb. 27, 2016).

assets with their built-in gains until death, given the “angel of death” benefit that lies right at the gravesite. If rates on realization events got too high, far fewer sales would transpire. This would hurt the entire economy, which wants assets to flow to their highest and best use and users. Given that capital can avoid *all* taxes easily enough, the taxes that do apply to capital must be kept modest. And so they are, and have been, for a century and counting.

All these factors conspire to generate little tax revenue from capital, at precisely a time when capital is growing more powerful, as Piketty shows. At the same time, governments keep needing ever-more revenues. As governments at all levels keep spending, with or without cash in hand, tax reform transpires under conditions of fiscal crises, leading to the quickest, easiest solutions to the revenue need.⁶⁰ Wage taxes, which are technically easy to raise and collect, ride in at the eleventh hour to keep the lights on in government buildings.⁶¹ Labor, carrying a heavy burden around its neck, finds it hard to cross over onto the capital side of life. When wage-earners do save, as in “tax-favored” pension plans and individual retirement accounts (IRAs),⁶² the tax laws make sure that taxes still get paid, at ordinary income rates: instead of the “angel of death” visiting wage-earners who die with pension plans in tow, the tax collector comes, citing the “income in respect of a decedent” provision of the Internal Revenue Code.⁶³ Meanwhile the capital side can perpetuate itself, not only because $r > g$, but also because capital bears little if any tax, especially on the deathbed.

The point of understanding these basic facts from tax runs deeper than critiquing Piketty for not knowing more about tax law today. By not understanding how simple it is for capitalists

⁶⁰ *Taxing Wealth Seriously, supra.*

⁶¹ *Id.*

⁶² IRC Sec. 401 et seq, 408.

⁶³ IRC Sec. 691.

in America to avoid tax, and for celebrating the progressive U.S. income tax, Piketty simply misses the deeper point that the way things are in America – see Table One – is, in part, a direct result of consciously chosen tax policies.⁶⁴ “If democracy is someday to regain control of capitalism, it must start by recognizing that the concrete institutions in which democracy and capitalism are embodied need to be reinvented again and again,” Piketty tells us.⁶⁵ There is no more important “concrete institution” embodying capitalism today than the tax system. Tax as it is in America today is part of the problem, not of the solution. We must reinvent tax, to redefine capital.

5. Problems with Piketty’s Proposals

Piketty sees the need for change, of course, but his particular efforts at reinventing tax fall far short of any actionable mark. It is a frequent theme of the reviews of *21st Century Capital* that Piketty’s two major taxing recommendations, for a steeper progressive income tax and a global tax on capital, are not going to happen.⁶⁶ The phenomenon is overdetermined, as hinted at above. This Section briefly considers a few of the reasons why Piketty’s proposals are unlikely to be the real-world answer to any pressing question.

One, history is not on Piketty’s side. Although America has had the *appearance* of progressive income taxes, the reality has never lived up to its promise. Tax Planning 101 has been in existence for nearly a century, unchecked. The United States has never been serious about taxing wealth directly, and it would be hard to change the deeply ingrained habits now. So

⁶⁴ See David Singh Grewal, *The Laws of Capitalism*, 128 HARV. L. REV. 626 (2014).

⁶⁵ PIKETTY, *supra* at 570

⁶⁶ Grewal, *supra* at 664; James Kwak, *Reducing Inequality with a Retrospective Tax on Capital*, 25 CORNELL J.L. & PUB. POL’Y 191, 198-200 (2015).

too with a meaningful estate tax: we have never had one, and the trends have been moving against getting one for decades. When George Cooper published his study of tax planning under the “voluntary” estate tax in 1972, a time of low exemption levels and high marginal rates under the tax, he used the DuPont family as an example of tax-free wealth transfer.⁶⁷ Today, when the tax only applies to the top 0.3% of wealth-holders, we have Adelson and his \$7.9 billion transfer to suggest it remains voluntary even at the apex of capital. Rentiers abound, and they are not accustomed to paying tax.

Two, Piketty’s ideas are not practical. The global tax on capital is unrealistic absent global coordination, as Piketty notes, and it is hard to see a solution to this problem anytime soon:⁶⁸an inability to coordinate internationally has badly weakened the U.S. corporate income tax, a far smaller effort than a direct tax on all capital would be.⁶⁹ Even if there were a way to get the world’s nations together on a common project, taxing static piles of capital is problematic. Where is the property? Who is the “owner”? What are the values? These problems have haunted capital taxation for centuries.

As for progressive income taxes, the high marginal tax rates of the post World War II period produced massive complexity but little real taxation of wealth. As with his case for a global tax on capital, Piketty and others sometimes suggest that a progressive income tax could serve goals *other than* to raise revenue, as by checking “greed.”⁷⁰ But raising revenue is the most pressing practical need of any government, such that designing complicated taxes that

⁶⁷ Cooper, *supra*.

⁶⁸ Grewal, *supra* at 664; Kwak, *supra* at 198.

⁶⁹ Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2001).

⁷⁰ PIKETTY, *supra* at 345. see also Thomas Piketty & Emmanuel Saez, *How Progressive is the U.S. Federal Tax System? A Historical and International Perspective*, 21(1) J. ECON. PERSPECTIVES 3 (2007).

do not add dollars to the fisc seems like a nonstarter in today's political climate: who has the time for the task? It is practically easy to tax wages, where employers report the earnings on forms sent into the government, W-2s, in contrast to attempting to tax the mere possession of capital. America raises taxes only in times of crisis, when it has to. But in a time of crisis, there is no time but for the quick fix. Labor, not capital, provides the easy target.

Three, Piketty's proposals are economically unwise. The theory of optimal income taxation, developed by the British Nobel Laureate James Mirrlees in the 1970s, lays out the efficiency case for declining, not increasing, marginal tax rates on upper incomes.⁷¹ The idea is that high tax rates at the "top" of the income distribution raise little revenue, because there are so few taxpayers there, and yet these high marginal tax rates could lead upper-income wage-earners to quit working or at least to work harder to shelter their incomes from the government.⁷² It is "optimal" instead to raise tax rates *infra*-marginally, on the middle class, of whom there are many, and who have fewer options not to work or to recharacterize their earnings; the rich pay these taxes, too, but not on their margin for decision-making. The economics case for lower rates on the high earners was popularized by Martin Feldstein, Arthur Laffer, and others, and has become a fixture of American tax policy since the Reagan years: a strategy of lowering rates and broadening the base as a wage tax.⁷³

⁷¹ See J. A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38(2) REV. ECON. STUD. 175 (2008). See also McCaffery & Hines, *supra*.

⁷² *Id.* See also Emmanuel Saez, et al., *The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review*, 50 J. ECON. LIT. 3 (2012).

⁷³ Martin Feldstein, *The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act*, 103(3) J. POL. ECON. 551 (1995); Arthur Laffer, *The Laffer Curve: Past, Present, and Future*, HERITAGE (June 1, 2004), <http://www.heritage.org/research/reports/2004/06/the-laffer-curve-past-present-and-future>.

The global tax on capital fares no better as a matter of economics theory. Attacking the capital stock could lead to various forms of capital flight, less capital, and a higher r , which will benefit the “super wealthy,” perhaps at the cost of the “wealthy,” and likely will do little to help the poor. Piketty is naïve in thinking that a one-time tax on capital can pay off public debts⁷⁴ -- a more realistic political economy suggests that democratic governments are inclined towards deficits, enacting salient spending programs, never cutting them, and avoiding salient taxes.⁷⁵ A government would be sorely tempted to repeat its “one-time” tax on capital, having created the apparatus to do so. Capital might well treat the “one time,” “modest” wealth tax with skepticism, viewing it as but a first step on a path towards confiscation. This understandable fear would trigger flight if not revolt.

Four, in part for all the reasons just discussed -- which work together, in constant feedback loops -- there is no political gain to be had from Piketty’s proposals. The ideas will not raise much revenue, as Piketty himself concedes, yet they will offend a capitalist class whom American politicians, in constant thirst for campaign funds, desperately need to support them. The people do not understand tax well enough to support a grassroots movement to effect the technical changes needed to bring about the reforms. Politicians can appease the people’s thirst to do something about taxing the rich, such as it is, with modest and mainly meaningless proposals.⁷⁶ The pattern of pairing symbolic taxes on the rich with real taxes on

⁷⁴ PIKETTY at 360.

⁷⁵ Edward J. McCaffery and Jonathon Baron, *Thinking About Tax*, Psychol., 12 PUB. POL’Y & LAW 106 (2006).

⁷⁶ *Taxing Wealth Seriously*, *supra*.

labor traces back at least to Franklin Roosevelt.⁷⁷ Even Bernie Sanders has fallen prey to its spell.⁷⁸

Five, and finally, there might still be reason to push ahead with Piketty's proposals if there were no better option to waiting for the wars to come. But there is indeed a better way -- the progressive spending tax, as anticipated above and explained next.

6. A Better Answer to a Better Sense of the Problem

Once we have a better sense of Piketty's problem, we can consider better answers to it. It is not the unequal ownership of capital, alone, that is what is wrong with the state of capital in the twenty-first century. Unequal wealth emerges from Piketty's reams of data as a universal fact, across time and cultures. It is rather the real or possible *uses* for the unequal capital holdings that pose risks to the wider society. Spending by the rentier class creates the demoralization effects felt by Rastignac and the multitudes of wage-earners. The shift in focus from looking at the facts of wealth or its sources to looking at its uses affects a Copernican shift in our thinking about tax. It leads to a recommendation for a progressive spending tax, one that falls on the private act of consumption and not the mixed private/public act of accumulation.

Piketty discusses the idea of a progressive spending tax rather quickly, with a citation to the usual suspect, Nicolas Kaldor, a prominent British economist in the post World War II

⁷⁷ *Id.*

⁷⁸ *Making the Wealthy, Wall Street, and Large Corporations Pay their Fair Share*, BERNIE SANDERS 2016 (detailing Bernie's plans to raise tax rates on the laboring class while not getting at capital very effectively).

period.⁷⁹ Kaldor himself unfortunately backed off the idea.⁸⁰ It was picked up in an American law and tax policy context by the Harvard Professor William D. Andrews.⁸¹ The idea of a progressive spending tax has featured in several policy proposals. Most prominently, it was one of two options considered in an influential U.S. Treasury publication from 1977, *Blueprints for Basic Tax Reform*, largely authored by the late David Bradford. *Blueprints* provided many of the details for the great Reagan reforms of the 1980s, which chose the *other* path forward, that of shoring up the income tax as a wage tax, broadening its base, and lowering its rates. A progressive spending tax was even put on the floor of the U.S. Congress, in the Nunn-Domenici USA (for “unlimited savings accounts”) Tax plan in the 1980s.⁸² Alas, the concept of a progressive spending tax has languished in a sea of misunderstandings, including the (incorrect) ideas that consumption taxes exempt the yield to capital, are regressive, cannot be progressive, and are impractical.⁸³

Piketty’s powerful book gives reason to rethink all this. A progressive spending tax responds to the problems of capital in the 21st century, not by simply taking capital away from the wealthy individuals who now, largely, own it, but by changing the meaning of “private” capital. These points follow from a rather simple statement of the basic idea.

⁷⁹ NICHOLAS KALDOR, *AN EXPENDITURE TAX* (Allen & Unwin, 1955); PIKETTY at 494, 634 n. 1, 638 n. 35.

⁸⁰ See Nicholas Kaldor, *Commentary on William D. Andrews*, in Joseph Pechman, editor, *WHAT SHOULD BE TAXED, INCOME OR EXPENDITURE?* (Brookings 1980).

⁸¹ William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87(6) *HARV. L. REV.* 1113 (1974).

⁸² LAURENCE S. SEIDMAN, *THE USA TAX: A PROGRESSIVE CONSUMPTION TAX* (The MIT Press, 1997).

⁸³ FAIR NOT FLAT, *supra*; *New Understanding of Tax, supra*.

The concept of a progressive spending tax can be understood with another basic accounting identity, the Haig-Simons definition, which holds that Income equals Consumption plus Savings, or

$$I = C + S.^{84}$$

This is, like Piketty's first fundamental law of capital, a matter of definitions. The Haig-Simons definition maintains, quite simply, that sources equal uses, inputs equal outputs, or that all wealth (Income) is either spent (Consumption) or not (Savings.) But as with Piketty's dynamic principles, simple truths can emerge from simple relations. Thus, most to the point, a consistent consumption or spending tax can be had by a simple rearrangement:

$$C = I - S.$$

In other words, a "consumed income" or spending tax can be had by toting up all sources of income, just as we do now, and systematically subtracting all savings. A progressive spending tax does not operate like a sales tax, levied at the cash register: there will be annual tax returns reporting the overall level of spending, and tax rates will be based on that level, with rates potentially going far higher than they are today under the income tax.⁸⁵

A progressive spending tax must pick up debt or borrowing as an input: if this were not done, taxpayers could "save" with one hand and borrow with the other.⁸⁶ Debt that is used to save or invest would be a wash: the inclusion of debt offset by the deduction for savings. Debt that

⁸⁴ EDWARD J. MCCAFFERY, *INCOME TAX LAW* 7 (Oxford University Press, 2012).

⁸⁵ McCaffery & Hines, *supra*. Note also that "luxury taxes" in major league sports work this way. McCaffery, *What Sports Can Teach Us: Lessons from the Luxury Tax*, 135 *TAX NOTES* 1646 (2012).

⁸⁶ SEIDMAN, *supra*.

is used to finance consumption, however, will be taxed, and under the progressive rate system. It may sound strange to tax debt, but this is what all spending taxes do: when you pay for a good using a credit card, you still must pay the sales tax, which you do not pay again when you pay off the card's balance.

Not only is a progressive spending tax a feasible, attractive idea for tax reform, but it also captures a good deal of how the "income" tax works in the United States. Think of traditional individual retirement accounts (IRAs) or other forms of retirement savings.⁸⁷ Amounts placed into these accounts lead to deductions, and so are not taxed currently. Nor is the rise in value of the accounts. Only when sums are withdrawn to be spent is the tax levied. In the case of a consistent progressive spending tax, this mechanism can work straight through death: the tax-favored accounts can be passed on, tax free, to heirs, who will be taxed when *they* spend, at rate levels calibrated to *their* spending levels. The progressive spending tax shuts down Tax Planning 101 by attacking the "borrow" step; citizens can hold their wealth, but their attempts to use it, directly or indirectly (via debt) will be taxed.

We can call the unlimited savings accounts at the core of the progressive spending tax model Trust Accounts, to help make some wider points. Imagine that Rastignac has managed to work and earn enough to start saving. He puts money into his Trust Account, presently tax free. The sums invested grow, at r , unreduced by present taxation. Rastignac can make prudent investment decisions, and buy and sell particular assets, all without fear of tax. He pays tax only when, if and as he withdraws from his Trust Account to spend, or borrows

⁸⁷ IRC Sec. 408

against it -- much the same thing as withdrawing, given the fungibility of money.⁸⁸ Imagine that Rastignac's Trust Account grew to \$10 million, a level just above the net worth of the top 1% of American wealth-holders, on average.⁸⁹ Rastignac can continue to manage these funds. He can pass them on to others. But if he goes to spend some of the resources, he will face the progressive tax rates.

Suppose, to sharpen the understanding, the tax rate schedule was set such that a 90% bracket, as America had for decades starting with World War II,⁹⁰ took effect after \$1 million of spending. Rastignac has already spent \$1 million living the rentier life. He now wants to take a \$1 million trip. He can do so, but only at the cost of withdrawing his entire \$10 million: \$9 million would go to the government, under the progressive spending tax (90% of \$10 million), leaving him with \$1 million to party. All of this could be backed up with third-party reporting and withholding, from the financial intermediaries serving to manage the Account. Special provisions could allow for lower rates on certain forms of spending, as for medical, educational, or philanthropic purposes. These details can be left aside here, for "democratic deliberation," as Piketty often invokes, to fill in. The point for now is that a progressive spending tax is a promising reinvention of a concrete institution of capitalism, one that reacts

⁸⁸ Imagine that Rastignac has \$10 million in his Trust Account. He wants to spend \$1 million. Whether he withdraws \$1 million from the Account, directly, or borrows \$1 million and spends it all instead, his net worth will be at \$9 million.

⁸⁹ Joseph Hines, *It Takes Nearly \$8 Million to Join the Wealthiest One Percent*, DEMOS (Sep. 19, 2014), <http://www.demos.org/blog/9/19/14/it-takes-nearly-8-million-join-wealthiest-one-percent>; *The top 1% Net Worth Amounts by Age*, FINANCIAL SAMURAI, <http://www.financialsamurai.com/top-one-percent-net-worth-amounts-by-age/> (last visited Feb. 28, 2016) (the number has fluctuated around \$8 million in recent years). See also *Taxing Wealth Seriously*, *supra*.

⁹⁰ *Taxing Wealth Seriously*, *supra*.

to Piketty's facts in a different and perhaps counter-intuitive way, but one that also holds out hope of checking the rentier class before the wars come.

7. A Note on Realism

Time for a pause. It might seem as if this essay has led to a battle of utopias, a bait and switch trick. Piketty sees a problem with the radical maldistribution of income and wealth. This essay agrees. Piketty's solution is to tax, which seems logical enough. But this essay argues that Piketty's precise tax proposals, for a more steeply progressive income tax and for a brand new global tax on capital, are unrealistic. Then the essay rolls out an alternative tax proposal, for a progressive spending tax, which seems equally unrealistic. What's up? There are compelling answers, on both the practical and theoretical levels, to this perfectly good question.

One, a progressive spending tax is far more realistic than Piketty's proposals. It turns on cash flows, which can be measured and traced, as opposed to static piles of wealth, which can be hidden and disguised. The lower rate-bracket levels of a progressive spending tax can be met with a simple sales or value-added tax, such that only the high spenders need fill out forms.⁹¹ A progressive spending tax is not economically unwise in the way that a progressive income tax is, because a spending tax does not necessarily deter the productive activities of work or savings, attacking rather the private-regarding act of luxury spending.⁹² A progressive spending tax could raise revenue: the tax base, which would shrink from the

⁹¹ FAIR NOT FLAT, *supra*. Michael J. Graetz *100 Million Unnecessary Returns: A Fresh Start for the US Tax System*, 112 YALE L.J. 261 (2002-03).

⁹² McCaffery and Hines, *supra*.

unlimited deduction for savings (much of which is out of the base, today, in any event), would increase with the inclusion of debt-financed consumption and the repeal of any capital gains preference, which would not be needed under a progressive spending tax, as there is no “lock-in” effect inside the Trust Accounts. The main practical difficulty in implementing a progressive spending tax is including borrowing within the tax base. There is no point denying that this will be a challenge, but it seems far easier to tax resources as they are being used, and converted into cash for spending, rather than attempting to tax unspent wealth. Along with the complications of taxing debt, a progressive spending tax would simplify vast stretches of tax, including all of the rules about basis, realization and capital gains, and the estate tax.

Two and perhaps more important, on the level of theory, a progressive spending tax comports with a realistic normative conception of human nature, and so swims with the tides, not against them. Machiavelli told us that “nature has endowed men with industry and avarice, it takes laws to make them good;” the task of Adam Smith was to take the avarice of the “butcher, the baker and the brewer” and turn them into forces for good. Piketty’s data helps to demonstrate that at least some people want to save for intergenerational reasons. This is what they do in dynasty trusts among other devices. Under Piketty’s view of the problem, dynasty trusts are bad, providing largely tax-free fruits to nourish rentiers. But under the light of our new understanding, dynasty trusts actually form a model of what to do. These trusts are set up to preserve stores of capital, for a long time, *without private use*. Professional trustees must manage the wealth. Withdrawals are taxed.

This is what the progressive spending tax does. Thus it is not swimming upstream to implement the plan on a wide social scale. The very existence of dynasty trusts shows that many wealthy people are motivated to leave wealth to their heirs, but to set this wealth up to be prudently managed and used. Thus, for example, common “spendthrift” clauses prevent beneficiaries from alienating and using the full value of their interests.⁹³ The Trust Accounts under the progressive spending tax work just this way, as a matter of law, of the “concrete institution” of tax. Rastignac can have “his” wealth, to manage and control, but he cannot use it, on his personal pleasures, without paying a hefty tax for the privilege. He can pass the wealth on to his descendants, limited in just the same way -- the heirs cannot spend profligately, or their Uncle Sam will get the bulk of the wealth. Just as Adam Smith’s genius lay in allowing the butcher, baker, and brewer to do what they want to do, anyway, a progressive spending tax can allow the rich to build and pass on dynastic fortunes. But no individual will be able to live large without paying large taxes. The social distinction of owning capital will be tethered to the common utility.

8. A 20th Century Conversation

The themes of this essay arose in an implicit conversation between two leading thinkers of the 20th century. The important British economist and political financier John Maynard Keynes, in a passage cited by the American political philosopher John Rawls, saw that a “frugal aristocracy” was essential to England’s power and success throughout the 19th

⁹³ Mainsail Family Trust, Spendthrift Trusts, GFS Private Wealth (Nov. 20, 2015), <http://www.gfsprivatewealth.com/trust-resources/spendthrift-trusts/>.

century and into the *Belle Epoque* period. The interchange between the two prominent intellectuals sheds light on much of the argument here. In Rawls's text:

Keynes remarks, for example, that the immense accumulations of capital built up before the First World War could never have come about in a society in which wealth was equally divided. Society in the nineteenth century, he says, was arranged so as to place the increased income in the hands of those least likely to consume it. The new rich were not brought up to large expenditures and preferred to the enjoyments of immediate consumption the power which investment gave. *It was precisely the inequality of the distribution of wealth which made possible the rapid build-up of capital and the more or less steady improvement in the general standard of living of everyone.* (emphasis supplied)⁹⁴

Keynes's underlying point brings together two important themes. One is the idea that the rich are especially good savers, because they are less likely to consume than the not-rich. Keynes emphasizes the "inequality of the distribution of wealth" as being a central element in this happy state of affairs: by giving the rich more than they need, society gets more savings.

Two, Keynes sees that social norms or individual preferences were essential to the fact of the unequal distributions of wealth leading to "immense accumulations of capital." "*The new rich were not brought up to large expenditures and preferred to the enjoyments of immediate consumption the power which investment gave.*"

There is no denying that, under the "concrete institutions of democracy and capitalism" as they were in England and America at the turn of the 20th century, the rich had the right to consume all that they owned, under an absolute understanding of property ascendant since

⁹⁴ JOHN RAWLS, A THEORY OF JUSTICE 298-99 (Harvard University Press, 1971), citing JOHN MEYNARD KEYNES, THE ECONOMIC CONSEQUENCES OF THE PEACE (New York: Harcourt, Brace and Howe, Inc., 1920).

at least the eighteenth century.⁹⁵ But there is also the fact that enough of these rich refrained from “immediate consumption” such that “immense accumulations of capital” could be built up--accumulations that were essential to Anglo-American victories in both World Wars, the Marshall plan following World War II, and so on. This is both a matter of social norms and individual preferences, as Keynes implies, and a function of the structure of society: as the new rich were, indeed, new, markets and opportunities for them to exploit their consumptive abilities might have lagged. For whatever reason it came into being and persisted, having a wealthy class of nonspenders benefited all.

Rawls is predictably troubled by this state of affairs, although he does not deny the facts of the matter. This is as we would expect of a liberal political theorist--at least one who has not seen the possibilities of a reinvented concrete institution, the progressive spending tax.

Rawls goes on to respond to Keynes’s central points:

If the rich had spent their new wealth on themselves, such a regime would have been rejected as intolerable. Certainly there are more efficient and just ways of raising the level of well-being and culture than that Keynes describes. *It is only in special circumstances, including the frugality of the capitalist class as opposed to the self-indulgence of the aristocracy, that a society should obtain investment funds by endowing the rich with more than they feel they can decently spend on themselves.* (emphasis supplied).⁹⁶

This exchange between two leading political thinkers, in the United States and United Kingdom, perfectly illustrates the case for a progressive spending tax. Keynes sees unequal distributions of wealth without private use as key to social progress. Rawls does not deny this, but finds it precarious to rely on norms and amorphous social duties to keep the rich

⁹⁵ EDWARD J. MCCAFFERY, A NEW UNDERSTANDING OF PROPERTY: THE CASE AGAINST WASTE (forthcoming 2016).

⁹⁶ RAWLS, *supra* at 299.

from turning selfish. Rawls's strong and bare statement that "[i]f the rich has spent their new wealth on themselves, such a regime would have been rejected as intolerable" states Piketty's case against rentiers simply and unequivocally. Rawls has no doubt that there would be something greatly wrong with allowing the rich to spend all of their wealth on themselves.

Rawls then considers but rejects Keynes' central insight, that allowing the rich to have more than they need can be a good thing because it leads to greater capital accumulation. The critical point is that Rawls sees the "frugality of the capitalist class" as a mere fortuity. He is reluctant to grant the "rich more than they can decently spend on themselves" out of the obvious fear that this frugality will soon turn into the "self-indulgence of the aristocracy"--a fear that Thorsten Veblen shared and that contemporary works such as Robert Frank's *Luxury Fever* caution may be increasingly well-founded.⁹⁷ It is this fear that we are addressing here. Rawls also assumes, without noting any specifics, that "certainly there are more efficient and just ways of raising the level of well-being and culture." But are there? Are there better ways of having social capital than allowing private savings to be managed by the rich? If we give the capital to governments or the not-rich, they will spend it. History and common sense well illustrate that. What else is to be done?

Under the current concrete institutions of tax and property, Rawls is without question correct to have his fears: there is no legal means to prevent the self-indulgence of the aristocracy. Keynes and like-minded capitalists can only counter such fears with the hope that things will not become as they, legally, can become. They rely, that is, on hope and

⁹⁷ VEBLEN, FRANK. ROBERT H. FRANK, *LUXURY FEVER: WEIGHING THE COST OF EXCESS* (Princeton University Press 2010); THORSTEN VEBLEN, *THE THEORY OF THE LEISURE CLASS* (Macmillan, 1899).

prayer: weak tools for a large and pluralistic modern society. It is, of course, democratic capitalist society that generates the large sums of nominally private wealth for its affluent members in the first place. We do not want to throw the benefits of private property overboard. Things work reasonably well as long as the resulting rich act with noblesse oblige, a sense of natural duties, and continue to work hard and save well. But what if they do not? One task of a reasonable society is to rein in the potentially “intolerable” social situation that can obtain from these large private accumulations of wealth, without sacrificing the benefits of productivity or capital in the process--without, that is, cutting off our nose to spite our face. A progressive spending tax does this.

9. Towards a New Meaning of Capital

Something is wrong in America and other advanced capitalist states today. There is a great deal of capital, highly unequally held. Piketty shows us that we are in a dynamic where all this is getting worse. The rich are getting richer. Workers are not. Piketty uses a wide sweep of history to suggest that this situation cannot persist, and grow worse, indefinitely. Wars of some sort will come to whack down the capital stock if we do not get ahead of the curve and do something to prevent the apocalypse from coming.

Piketty leaves his problems on the doorstep of tax, which he finds to have provided some light to help address them in the 20th century. But the U.S. tax system, for its entire history, has only added to these problems. America has a burdensome wage tax, with little or no tax on capital. This adds to the *belle* life of the rentier class, while keeping workers in a decidedly non-*belle* state of having to constantly work to avoid falling even farther behind.

It is time, past time, to reinvent the concrete institution of tax. A progressive spending tax does not simply take capital away from the wealthy. It allows the rich to keep and manage their wealth, as they have shown the ability and temperament to do so. But it curtails their ability to spend their capital on themselves and their luxurious wants. The social distinctions of holding wealth can continue, but they must work to the common utility. The progressive spending tax assures that result.

We should be thinking about changing the meaning of capital before events far out of our control solve the problems of wealth inequality for us.