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COMMENT ON

PROF PIKETTY'S “R” IS GREATER THAN “G” THEORY IN PIKETTY’S BOOK
CAPITAL IN THE TWENTY-FIRST CENTURY.

A HYPO BY PROF THOMPSON ILLUSTRATING (1) THE IMPACT OF
ECONOMIC INEQUALITY, AND (2) THE NEED FOR BOTH (a) A
PROGRESSIVE INCOME TAX, AND (b) A PROGRESSIVE WEALTH TAX TO
REVERSE GROWING INEQUALITY

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1. Assume that there are two people in Country X: Capitalist, and Entrepreneur.

2. Capitalist has $100M, which is the only money in Country X.

3. Entrepreneur has a great idea for building and selling a Widget, which will costs
$100M in payments to third parties who are not in Country X, and Entrepreneur
expects to sell the Widget to someone outside of Country X for $108M.

4. Entrepreneur approaches Capitalist for a $100M loan, which Capitalist, after
reviewing Entrepreneur’s business plan, makes to Entrepreneur.

5. Entrepreneur uses the loan efficiently and builds the Widget for a costs of $100M,
which is paid to workers and providers of materials who are outside of Country X.

6. Entrepreneur then sells the Widget for $108M to Purchaser, who is located outside
of Country X.

7. Entrepreneur uses the $108M from the sale to pay to Capitalist the principal of the
loan, which is $100M, plus the $5M in interest. Consequently, Entrepreneur has
$3M left over, which is his profit, or the growth in the economy.

8. Note that Entrepreneur has done well for herself because she has gone from having
zero wealth before the transaction to $3M in wealth after the transaction. So, it is a
positive transaction from the perspective of Entrepreneur. Also, it is a positive
transaction from the perspective of Capitalist.

9. From the perspective of the whole economy of Country X, when the dust settles
before any taxes or consumption, Capitalist has grown his capital to $105M, and
Entrepreneur has grown her capital by the $3M earnings.

10. Thus, the return of capital (r) of $5M has exceeded the earnings of Entrepreneur or
growth (e) in the economy of $3M.
11. As long as in repeat transactions the 5% return of the Capitalist exceeds the Entrepreneur’s profit, which is the growth in the economy, the Entrepreneur can never catch up in wealth, and there will be a growing inequality in wealth.

12. It should be noted the growing inequality in wealth could be slowed by a significantly progressive income tax that taxed the Capitalist’s interest of $5M at a higher rate than the tax on the Entrepreneur’s $3M of earnings. And, the growing inequality could easily be reversed by a small wealth tax of, for example, 2% of wealth above a certain limit, such as $10M of wealth.

13. As a general matter, assuming that (1) the benefit from the expenditures of the tax revenues was realized proportionately by Capitalist and Entrepreneur, and (2) both Capitalist and Entrepreneur saved all of their after-tax earnings, to reverse the growing inequality in wealth, the combined income and wealth taxes on Capitalist would have to be greater than the after tax earnings of Entrepreneur. In such case, in time, Entrepreneur’s capital would grow to the same size of the capital of Capitalist.

14. This hypo shows the importance of wealth taxes in addressing the inequality in Country X. The job cannot be done with progressive income taxes only.

Sam’s comment: The most important thing the hypo says to me is that in order to get serious about inequality in the US, it is absolutely necessary to make the Federal Estate and Gift taxes, which are wealth taxes, much more robust and less susceptible to abuse. Even though I am a tax lawyer and strong supporter of a progressive income tax, only after thinking about this inequality problem have I appreciated the necessity for an effective Federal Estate and Gift tax to help close the wealth gap.