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Public Capital in the 21st Century

Giacomo Corneo

Giacomo Corneo is Professor of Public Finance and Social Policy at the Free University of Berlin. Previously he taught at ENPC in Paris, the University of Bonn, and the University of Osnabrück. Since 2004, he has been managing editor of the *Journal of Economics*. He also serves as associate editor of the *International Review of Economics*. Furthermore, he is a Research Fellow of CEPR in London, CESifo in Munich, and IZA in Bonn.

ABSTRACT

The increase of income and wealth concentration threatens the European project of a good society. Capital taxation alone cannot stop this process, but a combination of moderately higher capital taxes and a novel role of public capital will do. The governance of public capital requires carefully designed institutions: a sovereign wealth fund and a special public investment agency called Federal Shareholder.

INTRODUCTION

Real, participatory democracy, a dynamic and pluralistic market economy and a fair and generous social welfare system: these are the three cornerstones for building the good society desired by the great majority of the population. But today this ambitious social project hangs in the balance. As a result of the growing concentration of economic power, the capitalistic logic of the dominance of money is now starting to seep through from economics into politics and morality. Democracy is gradually degenerating into plutocracy, the market economy into a gambling casino, and the welfare state into a poorhouse. No wonder reformers are increasingly asking themselves how this encroachment of capitalistic power can be curbed.

The recent book by the French economist Thomas Piketty *"Capital in the 21st Century",* has had a major impact on the current debate and excited a great deal of interest. In order to break the mechanisms that lead to an increasing concentration of incomes and wealth, he argues the need for aggressive action on the fiscal policy front. His prescription: the taxes on capital should be increased to a level where the gap between the after-tax return on capital and GDP growth rate is closed.

However, a tax-based reform strategy of this kind is problematic for a number of reasons. For one thing, nobody wins elections by promising massive tax increases – even if these taxes are payable only by the very rich. For another thing, high taxes on capital are ineffective in the absence of international coordination, because capital can simply move to another country with lower rates of tax. The supporters of higher taxes on capital in Europe have been trying for many years to bring about coordination, but so far without success. And admirable as their efforts are, we should not delude ourselves that they are likely to succeed any time soon.

There is an even more fundamental objection to Piketty's plan: even if the political conditions for the implementation of his proposed tax offensive were met, it is doubtful whether it would have the desired economic impact. The problem lies in the scale of the tax increases that would be required. Given a return on capital of 6% and a growth rate of 1.2%, the tax rate on the return on capital would have to be around 80% in order to achieve the results envisaged by Piketty. Under a progressive taxation system the rates of tax for very wealthy taxpayers would be even higher. But such high rates of tax are likely to have such a disincentive effect on investment and entrepreneurial initiative that technology development and productivity growth would suffer badly in consequence. And this in turn would put the general prosperity of our society at risk.

THE ROLE OF PUBLIC CAPITAL

If taxes on capital are not the answer, it does not mean that we have to roll over and accept the economic divide within society. Instead logic suggests the following conclusion: the desired redistribution of wealth needs to happen before the taxman takes his cut, i.e. when the capital income is distributed. In other words, the shortcomings of taxes on capital are an argument for developing a new role for the public ownership of capital. The income from public capital could be divided equally among all citizens through a social dividend, which would help to counteract the increasing concentration of income. And unlike massive tax increases, enhancing the status of public ownership has the potential to unlock positive emotions, foster an ethos of solidarity and attract broad political support.

So how would that work?

Let us start with the formation of public capital. Public capital can be accumulated by the state in the form of equities acquired through market transactions. The state should finance its stock purchases by issuing government bonds. In the case of a solvent state like Germany, financing costs are very low, so that only a small part of

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the income from the stocks would be needed to cover them. If for example the rate of return on equities is 6 - 9% and the interest paid on government bonds is 1 - 1.5%, one-sixth of that rate of return is sufficient to cover the government's refinancing costs. The rest of it should then be prioritized for paying down the debt incurred to purchase the equities. After fifteen years or so the new borrowing for the formation of public capital would have been repaid, and the polity would have collective ownership of debt-free assets in the form of worldwide-diversified stocks.

The equities in public ownership would then effectively be a collective capital investment by the citizens. Because of the opportunities for diversification and the fact that any taxes on capital would be collected by the state, this investment would over the long term yield an above-average return on capital for the state. This would mean that even those who have no private means of their own would share in the highest capital returns, since every citizen is an equal shareholder, through the state, in state-owned investments.

SOVEREIGN WEALTH FUND

In the initial phase, responsibility for managing public capital should rest entirely with a sovereign wealth fund (SWF). There are at present over fifty SWFs worldwide, i.e. state-owned financial vehicles that manage public funds. Generally speaking they operate like passive investors or collective rentiers, which seek to secure high rates of return by making appropriate portfolio decisions, without assuming control of business enterprises.

Setting up a SWF would require a suitable institutional framework, such as the one adopted for the Norwegian SWF "Government Pension Fund – Global". Notable aspects of the Norwegian arrangement are its high degree of transparency and conspicuous political independence.

The market value of Norway's SWF is currently around 170% of the country's GDP. Even if the return on capital is rather less than average, a fund of this magnitude is able to make a substantial contribution to the national budget. Indeed, substantially less than the total return on capital has normally been transferred to the public purse hitherto, with the result that the Norwegian SWF has grown strongly over the years.

The proposed SWF should invest most of its capital in a diversified international share portfolio. Its task would be to maximize long-term returns, which would then be allocated to the national budget. It is important to understand the scale of the effects that can be achieved. If for example the value of the SWF amounts to only 50% of GDP, and equity returns equal 9%, the long-term boost to state income is equivalent to 4.5% of GDP. That represents nearly the whole of Germany's public spending on education. This shows that a sovereign wealth fund can be an effective instrument of redistribution. Through the socialization of the equity risk premium it can take over part of the (re)distributive function of the taxation system. In this way the aim of limiting inequality can be achieved without imposing the punitive rates of tax that result from the application of Piketty's prescription.

FEDERAL SHAREHOLDER

The establishment of such a state investment fund would only be the first step in a program aimed at curbing the excessive power of capitalism. The central argument for preventing a high concentration of wealth is the danger that the political system could degenerate into a plutocracy. Large corporations and banks, and the lobbies that represent them, are the key instruments used by members of the moneyed elite to coordinate their endeavours and foster their interests in the political arena. If the state were only to own a few shares in these corporations but not exercise any power of control, the excessive influence of the moneyed elite on political decision-making would go largely unchecked.

A strategy for rejuvenating democracy therefore needs to incorporate a second stage in which the body politic challenges the capitalists on their own ground in order to contest their control over big business. Looking ahead, this contest could initiate a transition to a form of market socialism – an economic system in which all the large corporations and banks are embedded in a public-democratic governance while private-capitalistic initiative is limited to small and medium-sized enterprises.

An essential requirement for ensuring fair competition between public-democratic and private-capitalistic enterprises is the creation of an institution that will motivate the management of public-democratic enterprises to achieve the best possible business outcomes. I have coined the term *Bundesaktionär* ["Federal Shareholder"] to refer to this public investment agency (Corneo, 2014).

Initially the Federal Shareholder would control a small number of large corporations. It would own a majority capital share (fixed at, say, 75%) in these companies. These shares would be frozen in state ownership, and under the terms of the law on stock corporations the public investment agency would exercise a controlling and monitoring function on the supervisory boards of these companies through its own personnel. Dividend payouts would go to the state, which could use them to fund a social dividend.

The public investment agency would be tasked with a clear objective: to maximize the long-term profitability of the corporations under its control, and with it the long-term profit income of the state. In pursuing this objective it should remain completely independent of the government of the day – in much the same way as the *Bundesbank* in Germany is independent of the federal government. The political independence of the public investment agency would be guaranteed by constitutional norms.

Such an institution would require well-trained specialist personnel capable of devising their own solutions to problems they encounter in the course of carrying out their duties. It should aim to be a centre of excellence for issues of corporate governance, investment analysis, financing

THERE IS QUITE A GOOD CHANCE THAT A MIXED OR WHOLLY PUBLIC-DEMOCRATIC FORM OF GOVERNANCE FOR LARGE CORPORATIONS AND BANKS WILL ULTIMATELY TURN OUT TO BE THE BEST and risk management. It should offer its staff interesting long-term career prospects and foster a sense of belonging and of mission.

Private ownership of a minority share (e.g. 25%) in the public-democratic corporations has an important part to play in creating an effective incentive structure. Since private-sector stakeholders are free to buy and sell shares in the public-democratic corporations, the share price would reflect the market view of how well the management of these enterprises is performing. Rather as with today's share option schemes, the information contained in the movement of share prices can be used to encourage managers to pursue profit maximization. Furthermore, associations of private shareholders would constitute influential interest groups which could put pressure on the managements of the public corporations to operate as profitably as possible.

A duty of transparency on the part of the public investment agency would ensure that its employees did indeed perform their proper function and maximize the long-term profitability of the public-democratic corporations. Under the supervision of an existing authority (e.g. the *Bundesbank* or Federal Ministry of Finance) the public investment agency would publish the financial results of the companies under its control and the relevant benchmark groups of companies. A portion of the remuneration paid to its staff would be performance-related, i.e. dependent on the relative performance of the companies under their control.

To ensure that the maximization of company profits is good for the economy as a whole, it should not be pursued at the expense of the company employees or consumers or to the detriment of the environment; it should be the result of increased production efficiency and successful product innovations. The regulations designed to safeguard employees, consumers and the environment therefore need to be rigorously formulated and strictly observed, which calls for further transparency. In addition, the public-democratic corporations should seek to revive the role of worker participation and foster a sense of solidarity among their employees. The level of worker participation in capitalistic enterprises is inefficiently low, and greater worker involvement could increase productivity. Public ownership would encourage employees to identify more closely with the companies they work for, and opening up new opportunities for employees to have a say in the running of the business would ultimately push up both wages and corporate profits.

We cannot know today how well such public-democratic corporations would function in comparison with capitalistic enterprises. We should therefore not tie ourselves down at this stage to a specific ownership structure for large corporations and banks, but allow it to emerge as the result of a collective learning process extending over a number of years. Once the Federal Shareholder has been established and the first corporations placed under its control, a market-driven selection process will follow. Given a level playing field where both forms of governance (democratic and capitalistic) can compete openly on even terms, their relative efficiency will lead in time to an optimized ownership structure. The more profitable sector will expand and the other will shrink, until the most efficient distribution is arrived at. In the course of this process the better-managed companies will be more profitable, and the higher returns they offer will mean that their shares are more in demand; consequently more capital will flow into the better-managed companies, and their market share will grow.

Capitalistic enterprises are not as efficient as the guardians of the status quo would like to believe: sometimes they are run by incompetent heirs, occasionally they are raided by their own managers and they are reluctant to give their employees a say in the running of the business. So there is quite a good chance that a mixed or wholly public-democratic form of governance for large corporations and banks will ultimately turn out to be the best.

CONCLUSION

The belief that public ownership of capital could become a mainstay of the new European model for the 21st century is by no means far-fetched. Such an evolution would not present major difficulties for countries with a high financial standing like Germany. Unlike the strategy proposed by Piketty for high taxes on capital, any single country can go it alone, embarking on the formation of public capital in its own time – and thereby reducing inequality within its own borders. For EU countries, of course, care must be taken that such a strategy is consistent with existing public-debt rules. And while international coordination is not necessary, the creation of a sovereign wealth fund for the Eurozone might be a promising way to strengthen the sustainability of public finances.

Finally, it should be noted that enhancing the status of public ownership presupposes a new respect for the values of democracy and public service. In societies where democracy is eroded by lobbyism and political bribery, and those who serve the state are demotivated and lacking in competence, public capital would be a recipe for economic disaster. So if the strategy outlined above is to succeed, measures must be put in place to ensure greater transparency, a greater degree of direct civic participation and more efficiency in the conduct of public affairs.

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