

Policy Uncertainty and Rent Seeking by Firms and CEOs: Implications for Efficiency and Optimal Tax Rates

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Abstract

We posit that rent seeking is a largely neglected cost of policy uncertainty. We build on the insights of William Baumol (1990), who contends that entrepreneurship can be not only productive, but also unproductive or even destructive. We argue that policy uncertainty increases the expected returns from rent seeking and thus yields more of this unproductive or destructive entrepreneurship. We develop a model and empirically test the hypothesis that CEOs, and the firms that they manage, respond to tax policy uncertainty by increasing their political contributions and lobbying expenditures. We view uncertainty as a signal that politicians are receptive to policy changes. With little policy uncertainty, higher returns may be sought from investing in productive activities. However, when government is receptive to policy changes, the returns from rent seeking (through lobbying, Political Action Committees, etc.) may be more appealing.

Our work also has implications for tax policy. Piketty, Saez and Stantcheva (forthcoming) show that optimal tax rates depend heavily on both the responsiveness of top incomes to taxes *and* to the avenues by which they respond. We look at the implications of uncertainty and rent seeking on optimal tax rates. We argue that, to the extent that rent seeking targets tax preferences, higher marginal tax rates will raise incentives for rent seeking, increasing the excess burden from taxation. However, to the extent that rent seeking targets government policies not tied to taxes, our results are in line with the Piketty, Saez and Stantcheva bargaining model, which shows that a higher optimal top tax rate discourages rent seeking. Thus, the responsiveness of rent seeking to policy uncertainty, as well as the relative responsiveness of rent seeking targeting tax versus non-tax policies, independent of uncertainty, both have important implications for optimal taxation.