Econ 133 – Global Inequality and Growth

Optimal capital taxation

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What we've learned so far:

- There has been dramatic changes in top tax rates over time

- Two key principles of optimal labor income taxation:

  – Don't tax what is elastic

  – The more inequality, the higher the optimal labor income tax rate at the top

What we're going to learn in this lecture:

- Why tax capital?

- Theories of optimal capital taxation

- How high and progressive should capital taxes be?

1 Why tax capital?

- Distribution of capital income much more unequal than labor

- Capital is back: rising wealth/income ratios, rising capital shares

- Capital income inequality is due to differences in savings behavior but also inheritances received

$\rightarrow$ Equity suggests it should be taxed more than labor

But capital accumulation is useful if capital makes workers more productive

$\rightarrow$ Efficiency cost of capital taxation might be high

- Capital accumulation might be sensitive to the net-of-tax return

- But uncertainty on how elastic capital supply is

In practice, it is difficult to tax capital with capital mobility and little international coordination

- Easy to book corporate profits in low-tax countries

- Easy to evade personal taxes if no coordination

$\rightarrow$ Here we assume closed economy (or perfect international coordination). Will be relaxed in next lecture

2 Theories of optimal capital taxation

- If inequality entirely came from labor income, it would be useless to tax K

- But in practice inheritance plays a big role

- And it is not easy to separate L from K income flows

$\rightarrow$ These are the two key reasons why capital should be taxed

2.1 Fuzzy frontier between capital and labor

Main situations where the K/L frontier is fuzzy:

- Business owners can decide how much they get paid in wages vs. dividends

- Freelancers (journalists, consultants...) and self-employed (doctors, lawyers, etc.) can incorporate

Vast empirical evidence on how differential tax treatment can induce shifting:

- Finnish dual income tax system: taxes separately K income at preferred rates since 1993 $\rightarrow$ people report more K income

- Carried interest in the US for hedge fund and private equity fund managers $\rightarrow$ people report capital gains instead of wages

The higher the shifting elasticity, the closer the tax rates on labor and capital income should be

- Extreme case where government cannot distinguish at all between labor and capital income

- Govt observes only $wl + rK \Rightarrow$ Only option is to have identical marginal tax rates on labor and capital

- In practice, this seems to be an important consideration when designing income tax systems, especially for top incomes

2.2 Meritocratic arguments

- Most normative theories of distributive justice put a strong emphasis on individual merit $\rightarrow$ tax bequests

- But individuals value the possibility of leaving a bequest to their children $\rightarrow$ don't tax bequests

$\rightarrow$ Interesting trade-off

Piketty-Saez (2013) simplified optimal inheritance tax model:

- Meritocratic Rawlsian criterion: maximize welfare of those receiving no inheritances

- **Optimal inheritance tax rate:**

$$\tau_B = \frac{1 - \bar{b}}{1 + e_B}$$

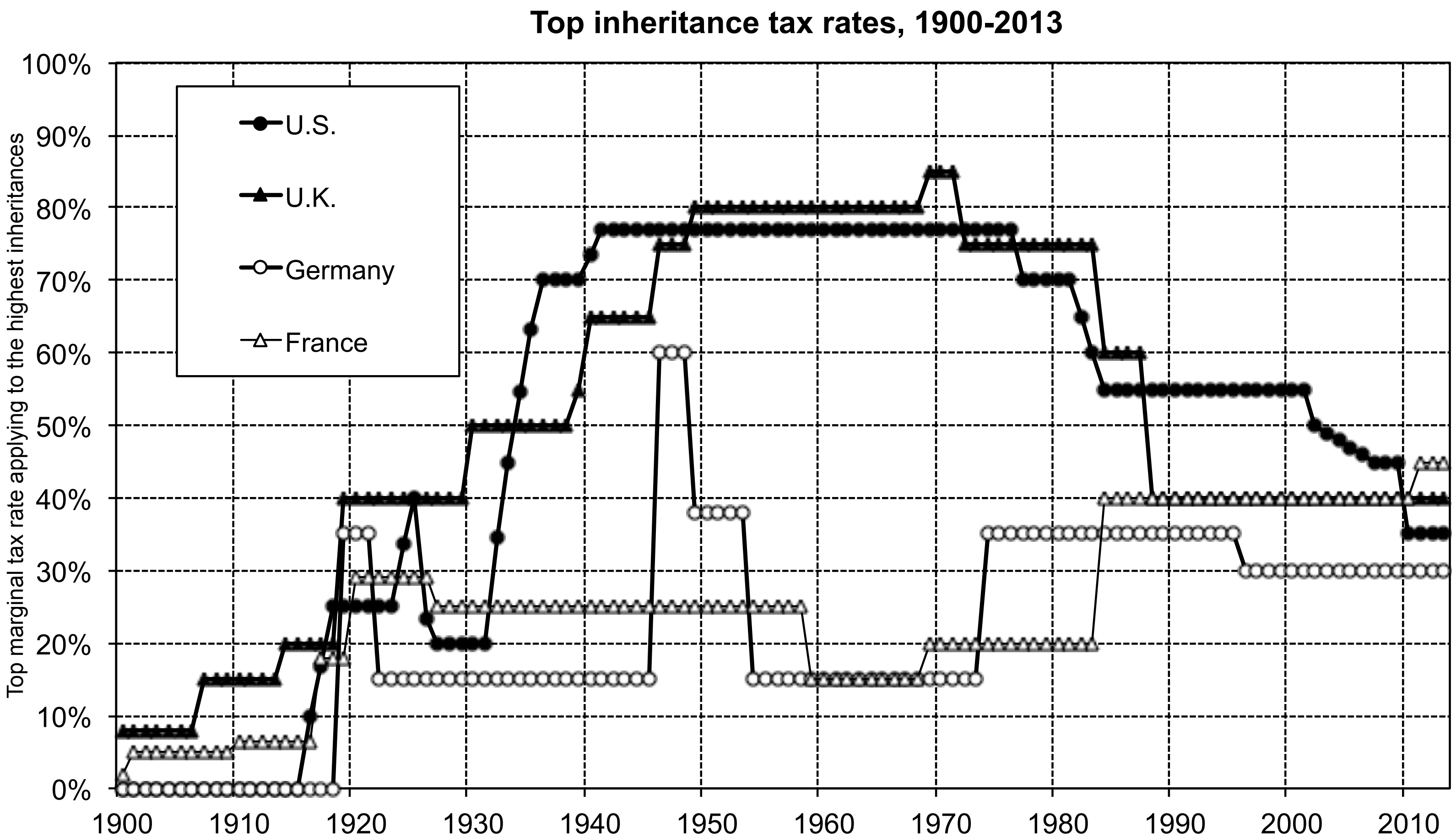
with $e_B =$ elasticity of aggregate bequests and $\bar{b} =$ relative bequest left by zero-bequest receivers

Key insights:

- Optimal $\tau_B < 1/(1+e_B)$ revenue maximizing rate because zero-receivers care about bequests they leave

- $\tau_B = 0$ if $\bar{b} = 1$ (i.e, zero-receivers leave as much bequest as average)

- If bequests are quantitatively important, highly concentrated, and low wealth mobility then $\bar{b} << 1 \rightarrow$ high τ_B



The top marginal tax rate of the inheritance tax (applying to the highest inheritances) in the U.S. dropped from 70% in 1980 to 35% in 2013. Sources and series: see piketty.pse.ens.fr/capital21c.

Everything else equal, countries with big macroeconomic bequest flows should tax bequests:

A — More than countries with small bequest flows

B — Less than countries with small bequest flows

C — As much as countries with small bequest flows

D — More than labor income

2.3 The proper way to tax billionaire: a wealth tax?

Income flow can be difficult to observe for top wealth holders:

- Capital income retained in holding companies, trusts, etc., can create large gap between economic and taxable income

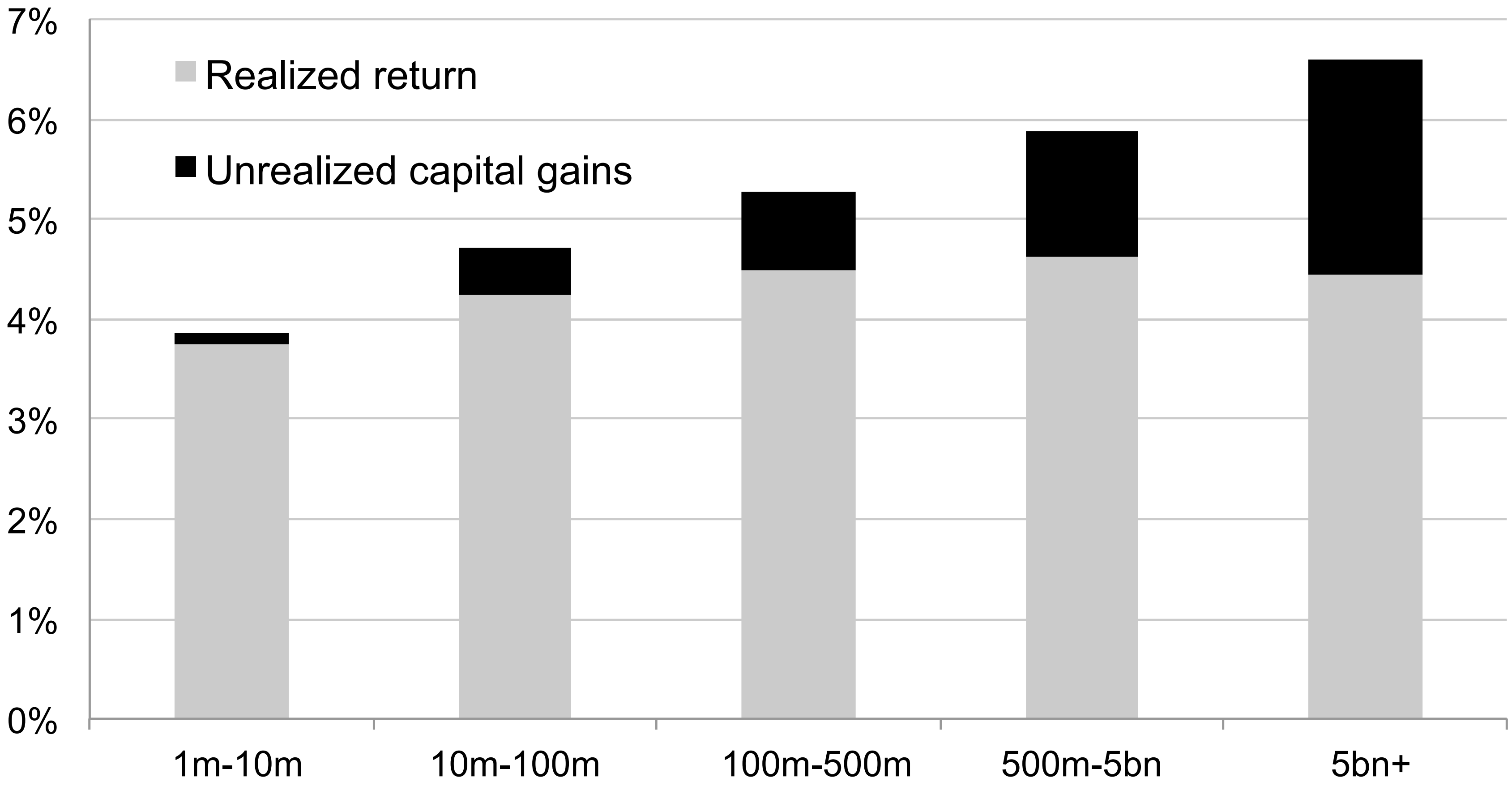
- On the contrary W_{ti} is well defined

The lower the elasticity of the rate of return $\tilde{R}(e_{ti})$ with respect to the tax rate, the higher the optimal wealth tax rate on billionaires

- Some evidence suggests $\tilde{R}(e_{ti})$ may largely be determined by initial wealth

- Above a certain threshold, high fortunes tend to grow fast, whatever their source

Figure C4: Return on foundation wealth, 1990-2010 average
Returns including realized & unrealized gains



3 Summary

- Two mains reasons for taxing capital:
  1. Meritocratic reasons
  2. Imperfect observability of labor vs. capital flows

- A wealth tax might be the right way to tax billionaires

References

Piketty, Thomas and Emmanuel Saez "A theory of optimal inheritance taxation", *Econometrica*, 2013 (web)

Diamond, Peter and Emmanuel Saez "The case for a progressive tax: from basic research to policy recommendations", *Journal of Economic Perspectives* 2011 (web)