

# **Econ 230B – Graduate Public Economics**

## **Capital taxation over time and across countries**

Gabriel Zucman

[zucman@berkeley.edu](mailto:zucman@berkeley.edu)

# Roadmap

1. What are capital taxes?
2. Who pays capital taxes?
3. Inheritance and its taxation in the long run

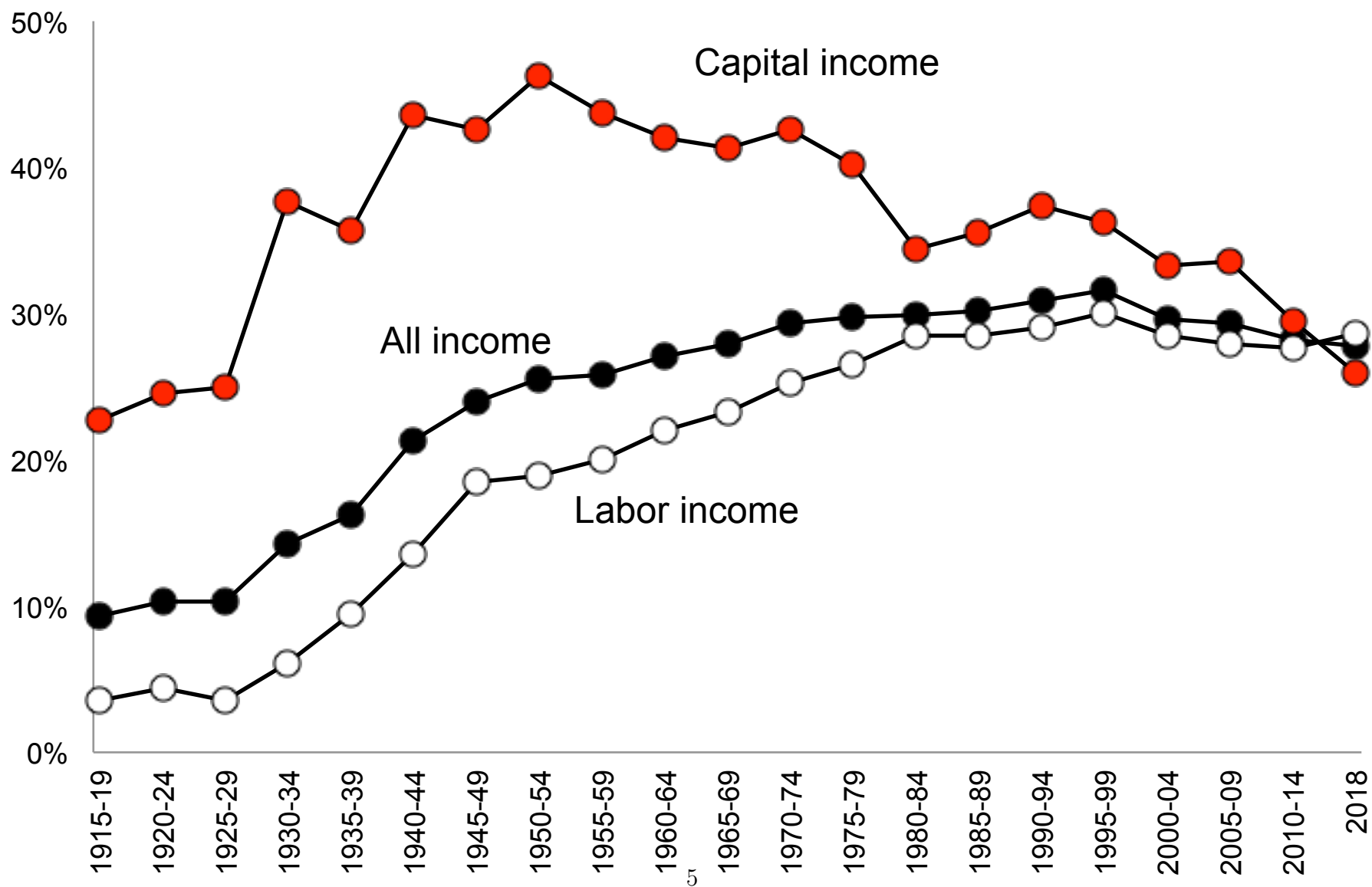
# 1 What are capital taxes?

- Taxes on the stock of capital: one-off taxes (inheritance, estates, gifts) vs. annual taxes (property, wealth)
- Taxes on the flow of capital income: corporate level (corporate profits) vs. individual level (dividends, interest, rents, capital gains)
- Capital taxes  $T_k$  account for a sizable but falling share of government revenue
- In the US:  $T_k$  about 25% of government revenue

## Macro capital tax rates (2018)

- In the U.S., macro capital tax rate  $\tau_K = T_K/Y_K \approx 25\%$
- Capital taxes  $T_K = 25\%$  of total tax revenue  $T$  and  $T \approx 30\%$  of total national income  $Y \rightarrow T_K = 7.5\%$  of  $Y$
- Capital income  $Y_K = 30\%$  of  $Y$  (capital/income ratio  $\beta = K/Y \approx 500\%$ ,  $r \approx 6\%$ ,  $\alpha = r \cdot \beta = 30\%$ )  $\rightarrow \tau_K \approx 25\%$
- Capital tax rate  $\tau_K$  declining over time (as in many other countries)

# Macro tax rates on labor and capital income in the US



## The structure of capital taxes in the US (Zucman JEP'14, updated to 2018)

In the US, total capital taxes can be decomposed into three categories of roughly equal importance:

- Corporate tax = 1.5% of  $Y$  (around 10% of a 15% tax base)
- Annual property taxes = 3% of  $Y$  (around 1% of a 300% tax base)
- Personal taxes on capital income = 2.8% of  $Y$  (around 30% of a  $15\% \times 60\% = 9\%$  tax base) + estates = 0.2% of  $Y$  (around 2% of a 10% tax base)

## Taxing flows vs. taxing stocks

- If rate of return  $r$  is the same for all individuals and assets, then flow and stock capital taxes are equivalent
- Ex: If  $r = 5\%$ , it is equivalent to tax capital stock at  $\tau_K = 1\%$  per year or to tax capital income flow at  $t_K = 20\%$  per year
- In practice returns differ; individual  $i$  prefers stock taxes if  $r_i > r$
- Key argument in favor of taxes on stock rather than on flow: they put incentives to get a high return on capital (Allais, 1966, 1977)
- See Guvenen et al. (2017) for recent analysis

## 2 Who pays capital taxes?

- Are capital taxes really paid by capital owners or shifted to labor?
- Key distinction: residence vs. source capital taxes
  - Residence: capital tax based on residence of owner of capital (or location of headquarter for firms) → not easy to avoid
  - Source: Capital income tax based on location of capital → incidence shifted to labor if capital is mobile
  - Most individual income tax systems are residence based (with credits for taxes paid abroad); most corp. taxes are source based



## The incidence of labor vs. capital taxes

- Consider  $Y = F(K, L) = Y_K + Y_L$  and a tax  $\tau_K$  on capital income  $Y_K$  and tax  $\tau_L$  on labor income  $Y_L$
- Is  $\tau_K$  paid by  $K$  and  $\tau_L$  paid by  $L$ ? Depends on:
  - The elasticity of capital supply  $e_K = d\log K / d\log((1 - \tau_K)r)$
  - The elasticity of labor supply  $e_L = d\log L / d\log((1 - \tau_L)v)$
  - The elasticity of substitution between  $K$  &  $L$   $\sigma = \frac{d\log(K/L)}{d\log(v/r)}$   
(determines the elasticities of demand for  $K$  &  $L$ )

## Tax incidence with linear production

- Simplest case: linear production  $Y = rK + vL$  ( $\sigma \rightarrow \infty$ )
- $r$  = fixed marginal product of capital;  $v$  = fixed marginal product of labor
- Labor demand is infinitely elastic at rate  $v \rightarrow$  whatever  $e_L$ , labor pays labor taxes  $\tau_L$
- Capital demand is infinitely elastic at rate  $r \rightarrow$  whatever  $e_K$ , capital pays capital tax  $\tau_K$
- The factor markets are like 2 separate markets with no interaction

## Tax incidence with Cobb-Douglas production

- With  $Y = K^\alpha L^{1-\alpha}$ , the two factor markets interact and part of labor taxes are shifted to capital and vice versa
- Ex: Consider a small increase from  $\tau_L$  to  $\tau_L + d\tau$ , then

$$\frac{dv}{v} = \frac{\alpha e_L}{1 + \alpha e_L + (1 - \alpha)e_K} \cdot \frac{d\tau}{1 - \tau_L}$$

$$\frac{dr}{r} = \frac{-(1 - \alpha)e_L}{1 + \alpha e_L + (1 - \alpha)e_K} \cdot \frac{d\tau}{1 - \tau_L}$$

- If  $e_L = 0$  then labor bear full burden of  $\tau_L$ ; if  $e_L \rightarrow \infty$  then wage adjusts and  $\tau_L$  entirely shifted to K. Vice versa for  $\tau_K \rightarrow \tau_K + d\tau$

## Tax incidence with general production function

- With CES production, same conclusion as Cobb-Douglas except  $\sigma$  enters the formulas. See Sachs et al. (2016) for a general analysis.
- $\tau_K$  borne by capital if  $e_K$  small relative to  $\sigma$
- $\tau_K$  shifted to labor if  $e_K$  large relative to  $e_L$  and  $\sigma$
- For residence-based K tax,  $e_K$  possibly quite small: can only avoid tax by changing residency or reducing saving
- For source-based K tax,  $e_K$  can be higher, especially in small open economies

## Incidence of the corporate tax

**Case 1:** Open economy with fully mobile capital and source taxation

- Local GDP:  $wL + rK = F(K, L) = L \cdot F(K/L, 1) = L \cdot f(k)$   
where  $k = K/L$  is capital stock per worker
- Net-of-tax rate of return fixed by the international rate  $r^*$  so that

$$(1 - \tau_c)F_K(K, L) = (1 - \tau_c)f'(k) = r^*$$

- As  $wL + r^*K = F(K, L)$ , wage  $w = F_L(K, L) = f(k) - r^* \cdot k$   
falls with  $\tau_c \rightarrow$  corporate tax  $\tau_C$  is fully borne by labor

## Case 2: Capital not mobile internationally but mobile within country

- Then net return to corporate capital needs to equal return to non-corporate capital → all capital affected by  $\tau_C$  (Harberger 1962)
- Unless little capital market integration (e.g., limited substitution between real estate and business capital)
- Small countries more likely to be in case 1, while big countries more like in case 2?
- But limited empirical evidence, because hard to find large quasi-experimental variation in  $\tau_C$  and good control groups

## Fuest, Peichl & Siegloch (2016): municipal corporate tax incidence in Germany

- Municipalities  $\approx$  small open economies where incidence likely to be on labor
- Use 20-year panel of data on 10,000 German municipalities' tax rates linked to administrative matched employer-employee data
- Find about half of the tax shifted to workers
- Effect not through  $K$  accumulation but bargaining: workers lose part of rents generated by the firm when  $\tau_C$  rises.

### Case 3: Capital not even perfectly mobile within country:

- Many firms depend on local amenities (pool of workers, other firms)
- Apple or Google could not costlessly move away from Silicon Valley  
→ firm owners bear more of the corporate tax burden
- Suarez-Serrato and Zidar (2016) develop spatial equilibrium model with firms; estimate incidence and structural elasticities
- Find that firm owners bear roughly 40% of the incidence, while workers and landowners bear 30-35% and 25-30%, respectively



## The incidence of the property tax

**View 1:** the property tax is mostly a capital tax like the corporate tax

- Property tax in community  $i$  is  $\tau_i = \bar{\tau} + \epsilon_i$  with  $\bar{\tau}$  national average property tax rate and  $\epsilon_i$  local deviation (Mieszkowski, 1972)
- Harberger model  $\rightarrow \bar{\tau}$  tax on all forms of capital
- $\epsilon_i$  residual either shifted to prices or immobile factors (labor, land)
- Raising property taxes nationally is progressive, but locally can be regressive

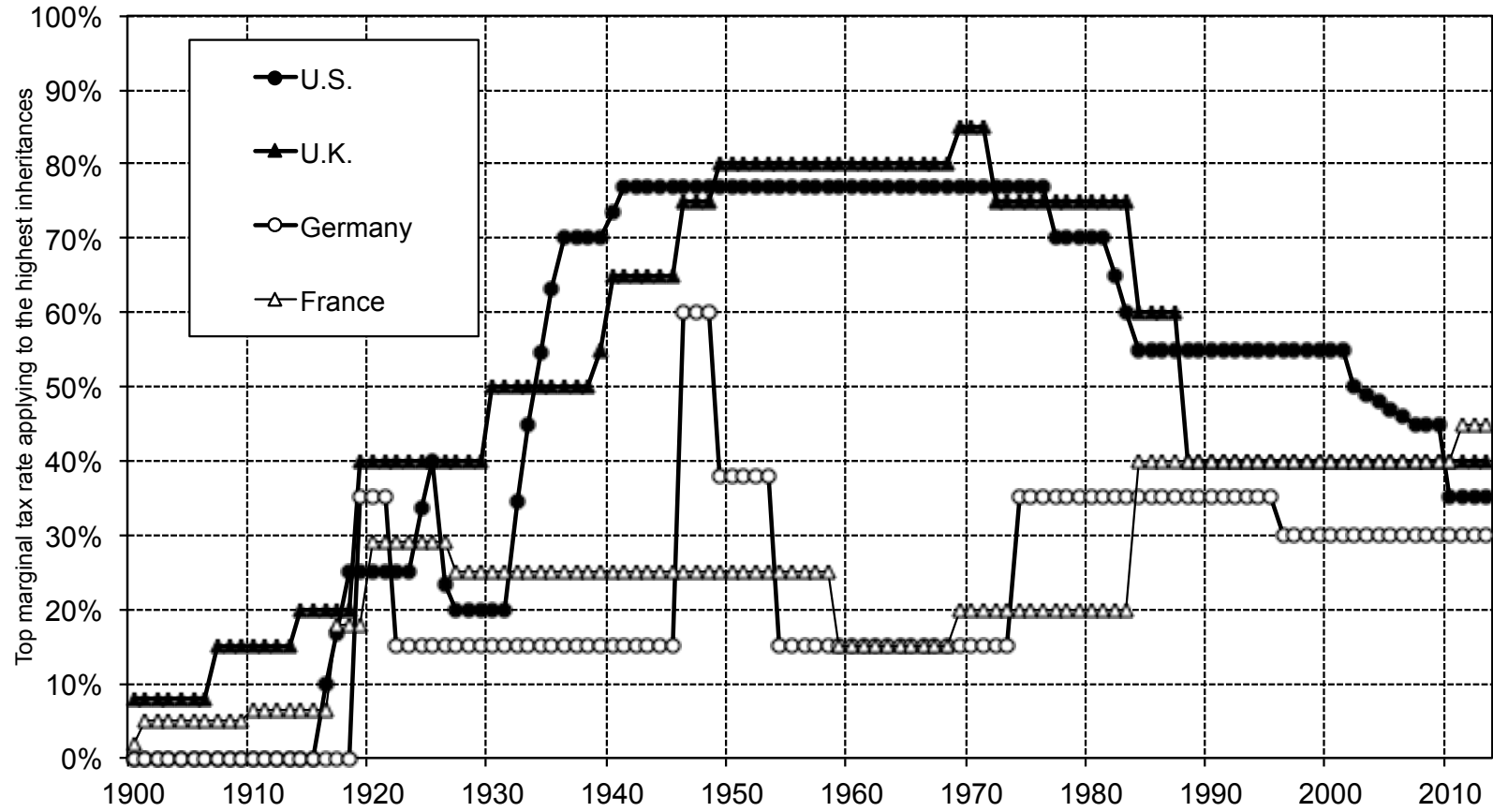
**View 2:** the property tax is not really a tax (“benefit view”)

- Property taxes finance local public goods
- Mobile taxpayers would not live in a jurisdiction that charges a tax higher than value of its local public goods: Tiebout (1956)
- Local property tax is a price paid for those local goods (it’s like a fee paid to a gated community for the community’s pool)
- Problem: taxpayers probably not as mobile as Tiebout assumes; part of property taxes do not fund local public goods (e.g., part goes to State)

### 3 Inheritance and its taxation

- Estate / inheritance taxes: smaller (in terms of revenue) than other capital taxes
- But more progressive than other capital taxes → critical role for inequality
- Big increase in inheritance taxation after mass-mobilization wars (Scheve and Stasavage, 2012, 2016)
- Important differences across countries in implementation and top rates

### Top inheritance tax rates, 1900-2013



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](http://piketty.pse.ens.fr/capital21c).

Source: Piketty (2014).

## Why tax inheritances?

- Most normative theories of distributive justice put a strong emphasis on individual merit → tax bequests
- But individuals value the possibility of leaving a bequest to their children → don't tax bequests
- Less bequest (and capital) taxation means more labor taxation (for given government spending)

→ Interesting trade-offs studied by Piketty and Saez (Econometrica 2013)

## Piketty and Saez (Econometrica 2013)

- Measure one of individuals, who are both bequests receivers and bequest leavers (in ergodic general equilibrium)
- Linear tax  $\tau_B$  on bequests funds lumpsum grant  $E$
- Life-time budget constraint:  $c_i + b_i = R(1 - \tau_B)b_i^r + y_{Li} + E$
- with  $c_i$  consumption,  $b_i$  bequests left,  $y_{Li}$  inelastic labor income,  $b_i^r$  pre-tax bequests received,  $R = 1 + r$  generational rate of return
- Individual  $i$  has utility  $V^i(c, \underline{b})$  with  $\underline{b} = R(1 - \tau_B)b$  is net-of-tax

bequests left and solves

$$\max_{b_i} V^i(y_{Li} + E + R(1 - \tau_B)b_i^r - b_i, Rb_i(1 - \tau_B)) \Rightarrow V_c^i = R(1 - \tau_B)V_{\underline{b}}^i$$

- Gov B.C.:  $E = \tau_B b$  with  $b$  aggregate (=average) bequests; solves:

$$\max_{\tau_B} \int_i \omega_i V^i(y_{Li} + \tau_B b + R(1 - \tau_B)b_i^r - b_i, Rb_i(1 - \tau_B))$$

- with  $\omega_i \geq 0$  Pareto weights
- Meritocratic Rawlsian criterion: maximize welfare of those receiving no inheritances with uniform social marginal welfare weight  $\omega_i V_c^i$  among zero-receivers

## Optimal inheritance tax rate:

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

- With  $e_B$ : elasticity of aggregate bequests, and  $\bar{b} = E[b_i | b_i^r = 0] / b$  relative bequest left by zero-receivers
1. Optimal  $\tau_B < 1/(1 + e_B)$  revenue maximizing rate because zero-receivers care about bequests they leave
  2.  $\tau_B = 0$  if  $\bar{b} = 1$  (i.e, zero-receivers leave as much bequest as avg)
  3. If bequests are quantitatively important, highly concentrated, and low wealth mobility then  $\bar{b} \ll 1$



## The inheritance flow

- Key parameter to think about inheritance and its taxation:  $b$
- How big is the flow of wealth transmitted at death every year in a country?
- There are 2 ways to measure this flow:
  - Fiscal flow: use tax data on inheritances / estates
  - Economic flow, using the following accounting equation:

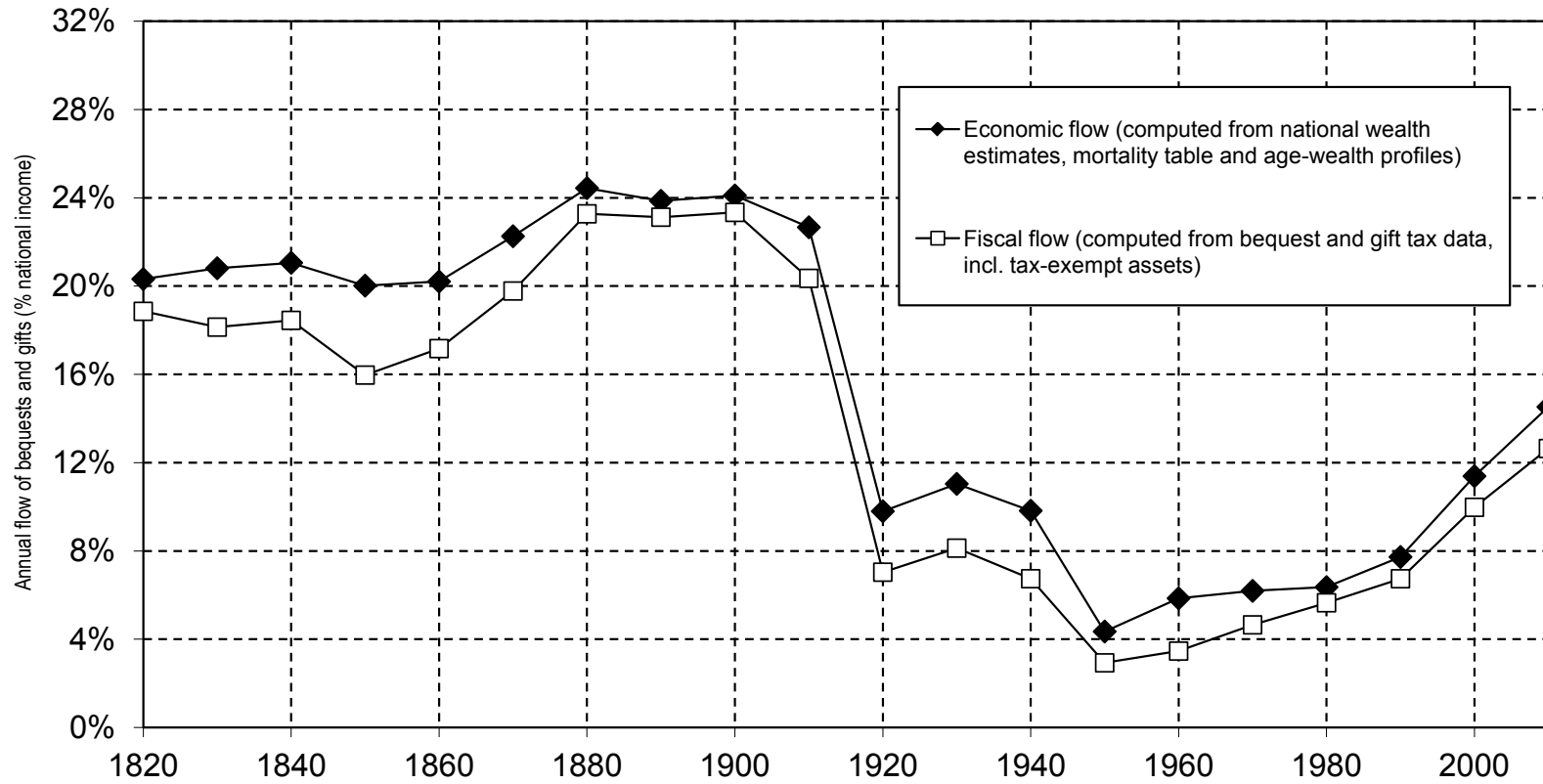
$$b_t = (1 + v_t) \cdot \mu_t \cdot m_t \cdot \beta_t$$

- Where:  $m_t$  = mortality rate (number of adult decedents divided by total adult population)
- $\mu_t$  = ratio between average adult wealth at death and average adult wealth for the entire population
- $v_t = V_t/B_t$  = estimate of the gift/bequest flow ratio
- $\beta_t$  = private wealth / national income ratio
- Gap between the fiscal and economic flows can be interpreted as capturing tax evasion and other measurement errors

## Piketty (QJE 2011)

- Estimates bequest flow  $b$  in France, country where inheritance tax data are exceptionally good
- $b$  has followed a spectacular U-shaped pattern over the 20th century.
- $b$  was relatively stable around 20–25% of national income throughout the 1820–1910 period (with a slight upward trend)
- Then divided by a factor of 5–6 between 1910 and the 1950s, and multiplied by a factor of 3–4 between the 1950s and the 2000s

**Figure 4.1. The annual inheritance flow as a fraction of national income, France 1820-2010**



The annual inheritance flow was about 20-25% of national income during the 19th century and until 1914; it then fell to less than 5% in the 1950s, and returned to about 15% in 2010.

Source: Piketty (2011).

## The share of inherited wealth in total wealth

- What is the fraction of total wealth  $W$  that is self-made vs. comes from inheritances?
- Most natural way to define the share of inherited wealth in aggregate wealth is to cumulate past inheritance flows

$$W_{Bt} = \int_{s \leq t} B_s \cdot ds$$

- Pb 1: key to include in this sum not only past bequest flows  $B_s$  (wealth transmissions at death) but also inter vivos gift flows

- Pb 2: One should only take into account fraction of inheritance flows  $B_{st} \leq B_s$  received at time  $s$  by individuals still alive at time  $t$
- Requires very detailed individual-level information
- Standard simplifying assumption: cumulate the full inheritance flows observed the previous  $H$  years, where  $H =$  generation length
- Pb 3 (key): inheritances produce flow returns!
- So past inheritance flows need to be upgraded

## Kotlikoff-Summers (1981) vs. Modigliani (1986)

- Modigliani (1986, 1988) chooses zero capitalization.

$$W_{Bt}^M = \int_{t-30 \leq s \leq t} B_s^* \cdot ds$$

- Assume fixed inheritance flow-national income ratio  $b_y = B_s^*/Y_s$ , growth rate  $g$  (so that  $Y_t = Y_s \cdot e^{g(t-s)}$ ), generation length  $H$ , and aggregate private wealth-national income ratio  $\beta = W_t/Y_t$ .
- Steady-state stock of inherited wealth relative to national income  $W_{Bt}^M/Y_t$  and share of inherited wealth  $\varphi_t^M = W_{Bt}^M/W_t$  given by:

$$W_{Bt}^M / Y_t = \frac{1}{Y_t} \int_{t-30 \leq s \leq t} B_s^* \cdot ds = \frac{1 - e^{-gH}}{g} \cdot b_y$$

$$\varphi_t^M = W_{Bt}^M / W_t = \frac{1 - e^{-gH}}{g} \cdot \frac{b_y}{\beta}$$

- Kotlikoff and Summers (1981, 1988): full capitalization

$$W_{Bt}^{KS} / Y_t = \frac{1}{Y_t} \int_{t-30 \leq s \leq t} e^{r(t-s)} \cdot B_s^* \cdot ds = \frac{e^{(r-g)H} - 1}{r - g} \cdot b_y$$



$$\varphi_t^{KS} = W_{Bt}^{KS} / W_t = \frac{e^{(r-g)H} - 1}{r - g} \cdot \frac{b_y}{\beta}$$

- If growth rates and rates of return are negligible then both definitions coincide:  $\varphi_t^M = \varphi_t^{KS} = Hb_y/\beta$
- If  $g$  and  $r - g$  are significantly different from zero, the two definitions can lead to widely different conclusions
- Ex: with  $g = 2\%$ ,  $r = 4\%$  and  $H = 30$ , for a given inheritance flow  $b_y = 10\%$  and aggregate wealth-income ratio  $\beta = 400\%$ ,  $\varphi_t^M = 56\%$  and  $\varphi_t^{KS} = 103\%$ .

## Piketty et al. (EHH, 2014)

Wealth accumulation process always involves two different kinds of people and wealth trajectories

- Inheritors: people whose assets are worth less than the capitalized value of the wealth they inherited (over time they consume more than their labor income)
- Severs: people whose assets are worth more than the capitalized value of the wealth they inherited (they consume less than their labor income)

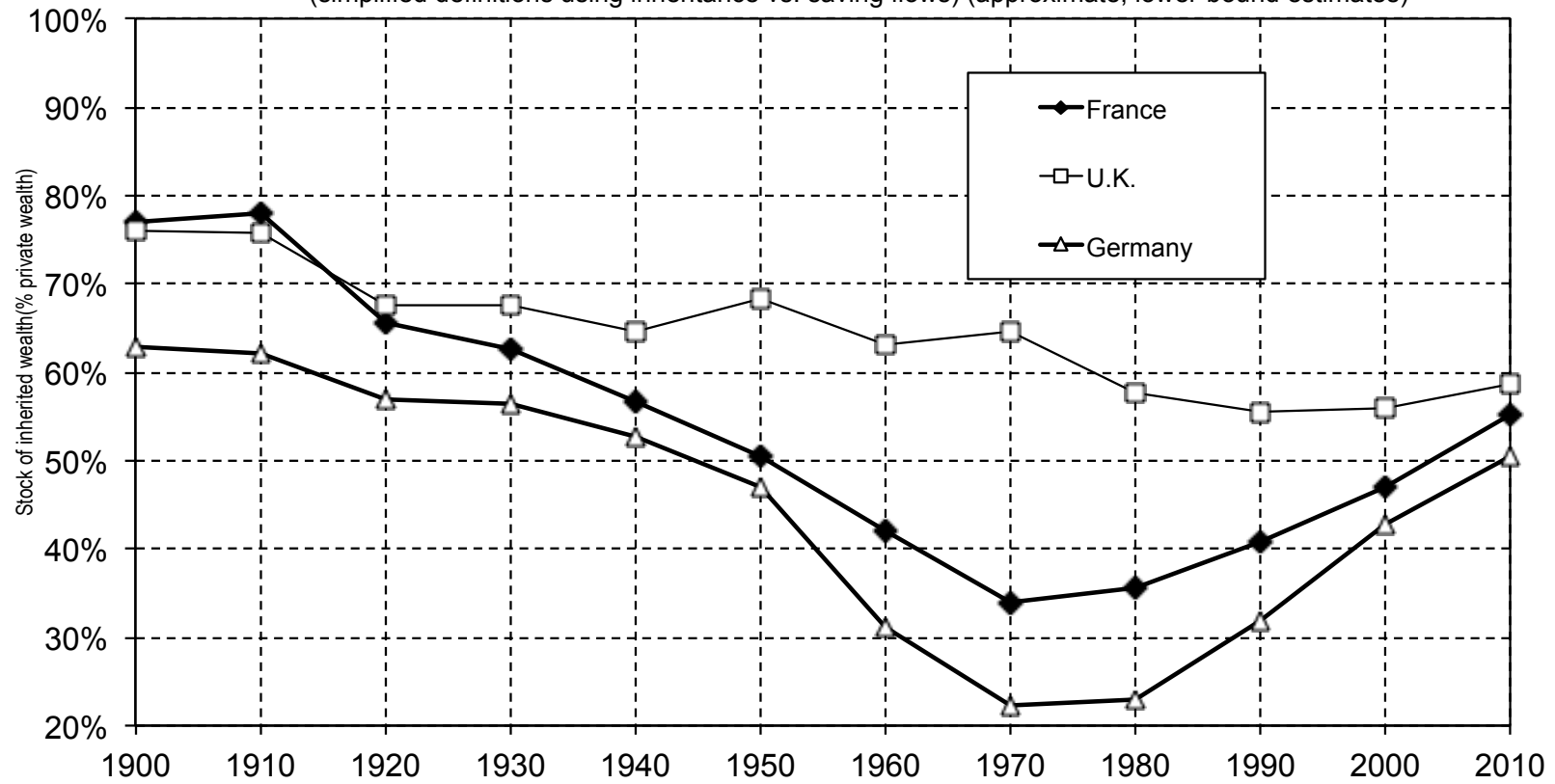
- Aggregate inherited wealth can then be defined as the sum of inheritors' wealth plus the inherited fraction of savers' wealth
- Self-made wealth is then equal to the non-inherited fraction of savers' wealth.
- By construction, inherited and self-made wealth are less than 100% and sum to aggregate wealth,
- Downside of this definition: more demanding in terms of data availability. Requires micro data.

## Estimates of the share of inherited wealth in total wealth

- Burgeoning literature attempts to estimate  $b$  and  $\varphi$  (Alvaredo et al., 2017; Atkinson, 2013; Ohlsson et al. 2016)
- In Europe,  $b_t$  and  $\varphi_t$  have also followed a U-shaped pattern over the past century
- Less marked in the United States
- Data limitations, however, make it difficult at this stage to make precise comparisons between countries

**Figure 4.6. The inheritance stock in Europe 1900-2010**

(simplified definitions using inheritance vs. saving flows) (approximate, lower-bound estimates)

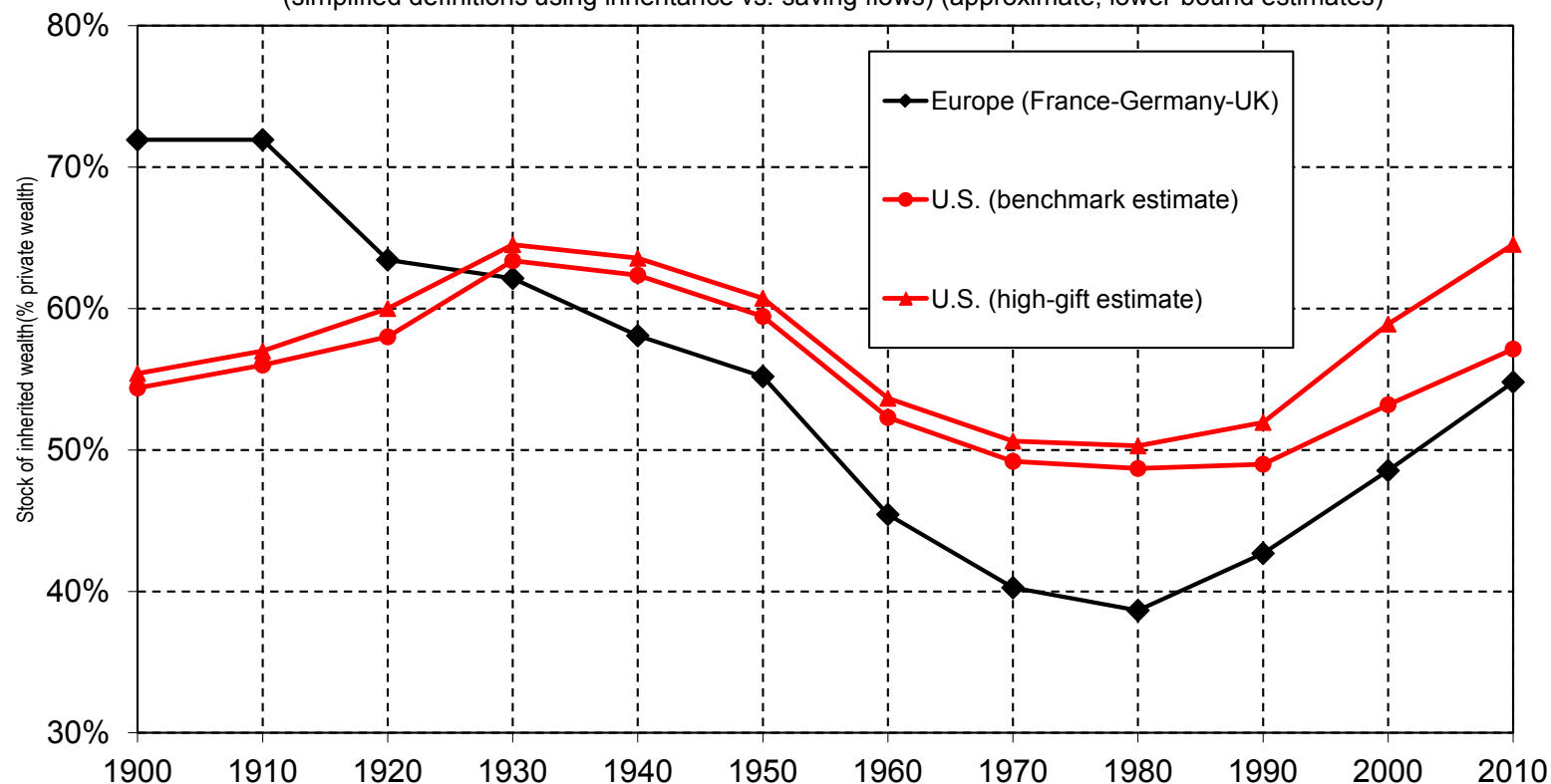


The inheritance share in aggregate wealth accumulation follows a U-shaped curve in France and Germany (and to a more limited extent in the U.K. and Germany). It is possible that gifts are under-estimated in the U.K. at the end of the period.

Source: Piketty and Zucman (2015).

**Figure 1. The share of inherited wealth. Europe and the U.S. 1900-2010**

(simplified definitions using inheritance vs. saving flows) (approximate, lower-bound estimates)



The inheritance share in aggregate wealth accumulation was over 70% in Europe in 1900-1910. It fell abruptly following 1914-1945 shocks, down to 40% in 1970-1980 period. It is back to about 50-60% in 2000-2010 and rising. The U.S. pattern also appears to be U-shaped, but less marked, and with significant uncertainty regarding recent trends, due to data limitations.

Source: Alvaredo, Garbinti and Piketty (2015)

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