Global Inequality & Growth:

Optimal capital taxation

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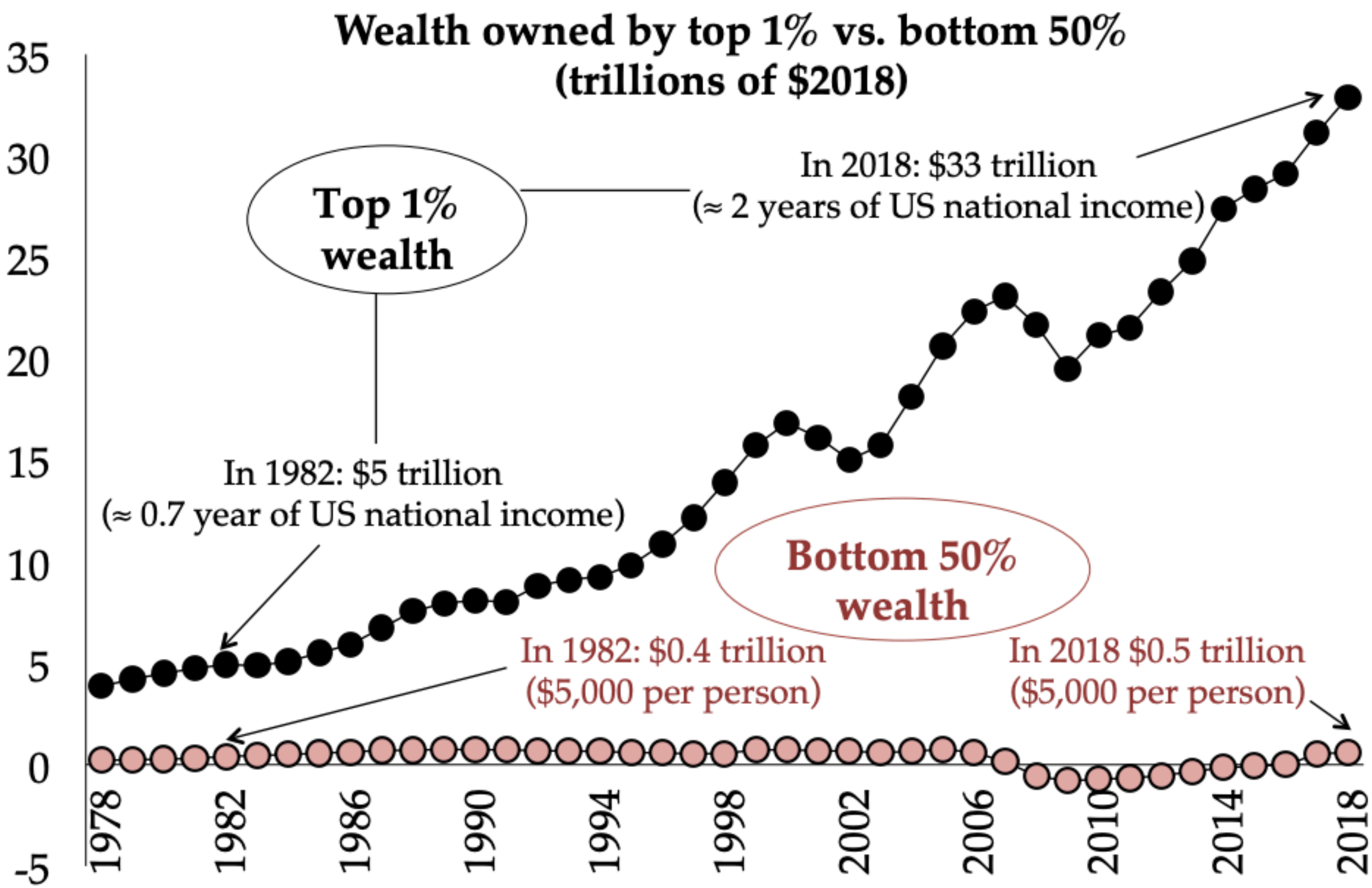
Last topic:

- There has been dramatic changes in top labor income tax rates over time
- When determining tax policy, there is a trade-off between equity and efficiency
- Two key principles of optimal taxation: 1. Don't tax what is elastic 2. The more inequality, the higher the optimal tax rate at the top

This lecture: optimal taxation of capital



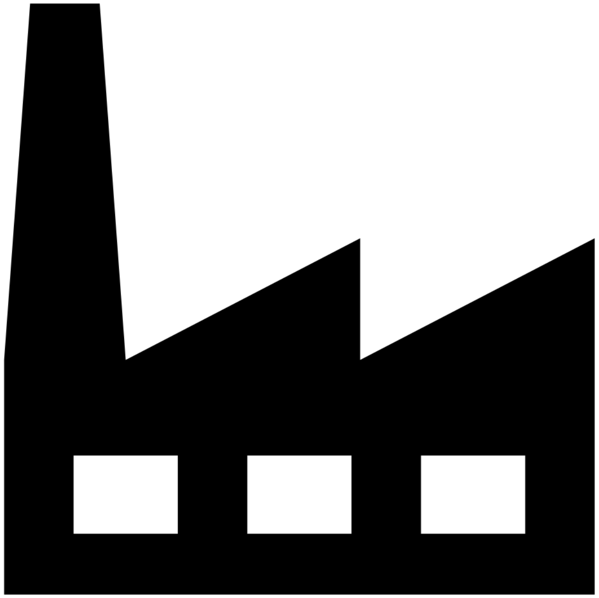
Roadmap: optimal taxation

Optimal labor income taxation

Optimal capital income taxation

Beyond income taxation

Optimal capital income taxation



What is capital income?

Income generated by owning an asset

- Assets = all non-financial (housing, land…) and financial assets (equities, bonds, bank deposits…)

Income consists of profits, rents and interest

- Profits
  - Retained earnings (saved in business)
  - Dividends (paid out to owner/shareholder)
- Rents on e.g. housing
- Interest income

Why tax capital income?

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Why *not* tax capital income?

?

Why tax capital?

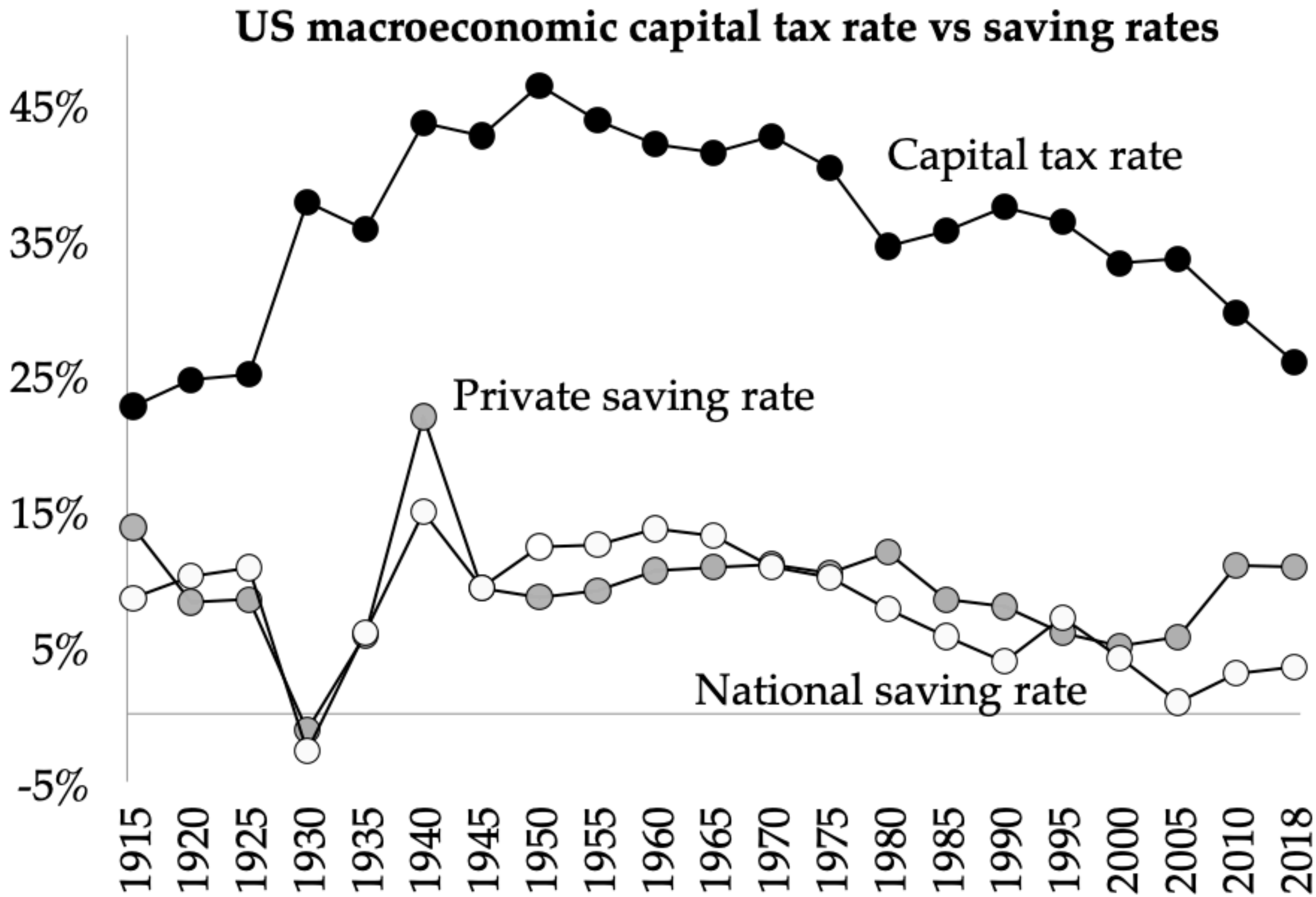
- Distribution of capital income much more unequal than labor
- Capital is back: rising wealth/income ratios, rising capital shares
- Capital income inequality is due to differences in savings behavior but also inheritances received

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

Why *not* tax capital income?

- Capital accumulation is useful if capital makes workers more productive

→ If capital income taxation impacts capital accumulation
efficiency cost of capital taxation might be high



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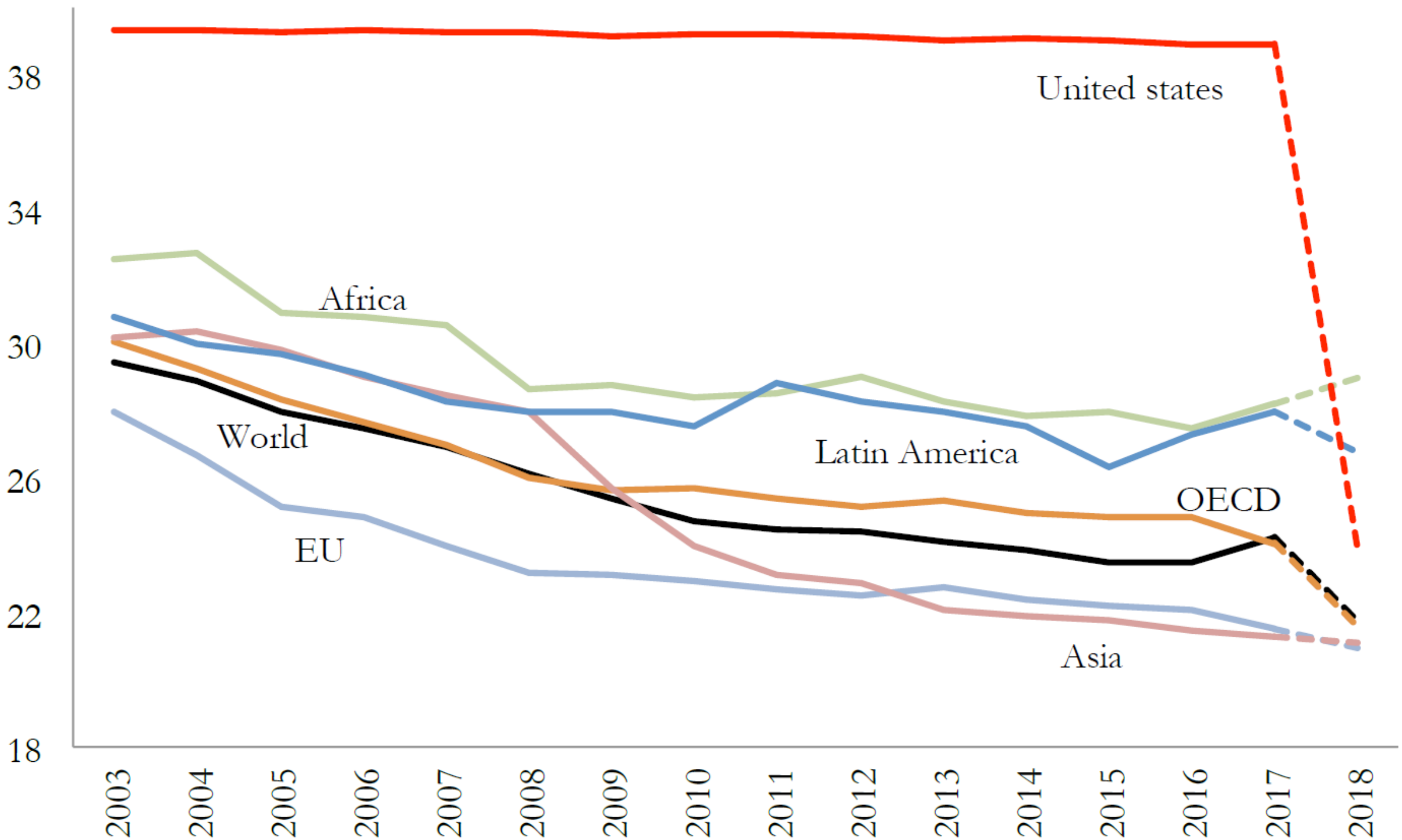
Capital income tax avoidance – key obstacle

- 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 → Here we assume closed economy (or perfect international coordination). Will be relaxed in next lecture

Global corporate tax rates (%)



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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 → These are the two key reasons why capital should be taxed

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

Profits or hidden wages?

FIGURE V

Profit Effects of Owner Deaths and Retirements

- Smith et al., The Quarterly Journal of Economics (2019), 1–72. doi:10.1093/qje/qjz020.

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 → people report more K income
- Carried interest in the US for hedge fund and private equity fund managers → people report capital gains instead of wages
- The higher the shifting elasticity, the closer the tax rates on labor and capital income should be

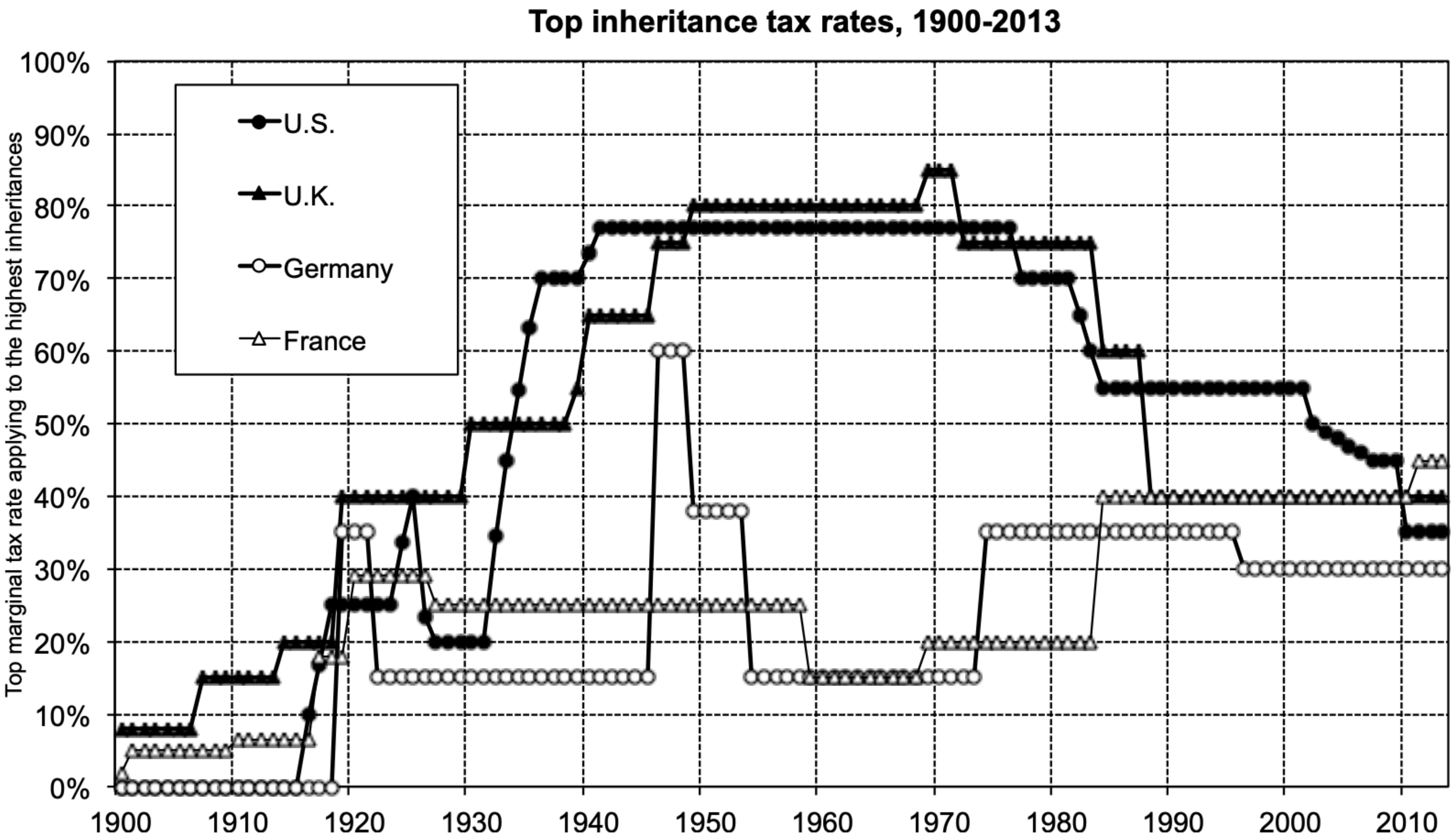
Extreme case where government cannot distinguish at all between labor and capital income

- 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

Meritocratic arguments of capital taxation

- Most normative theories of distributive justice put a strong emphasis on individual merit $\longrightarrow$ tax bequests
- But individuals value the possibility of leaving a bequest to their children $\longrightarrow$ don't tax bequests

$\longrightarrow$ Interesting trade-off



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.

Beyond income taxation: a wealth tax

Why tax wealth instead of income?

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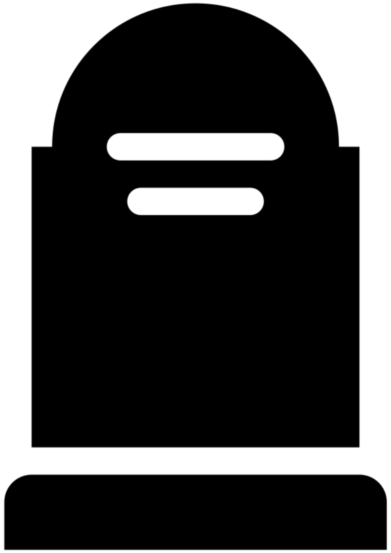
Two existing wealth taxes



Beyond income taxation: a wealth tax

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

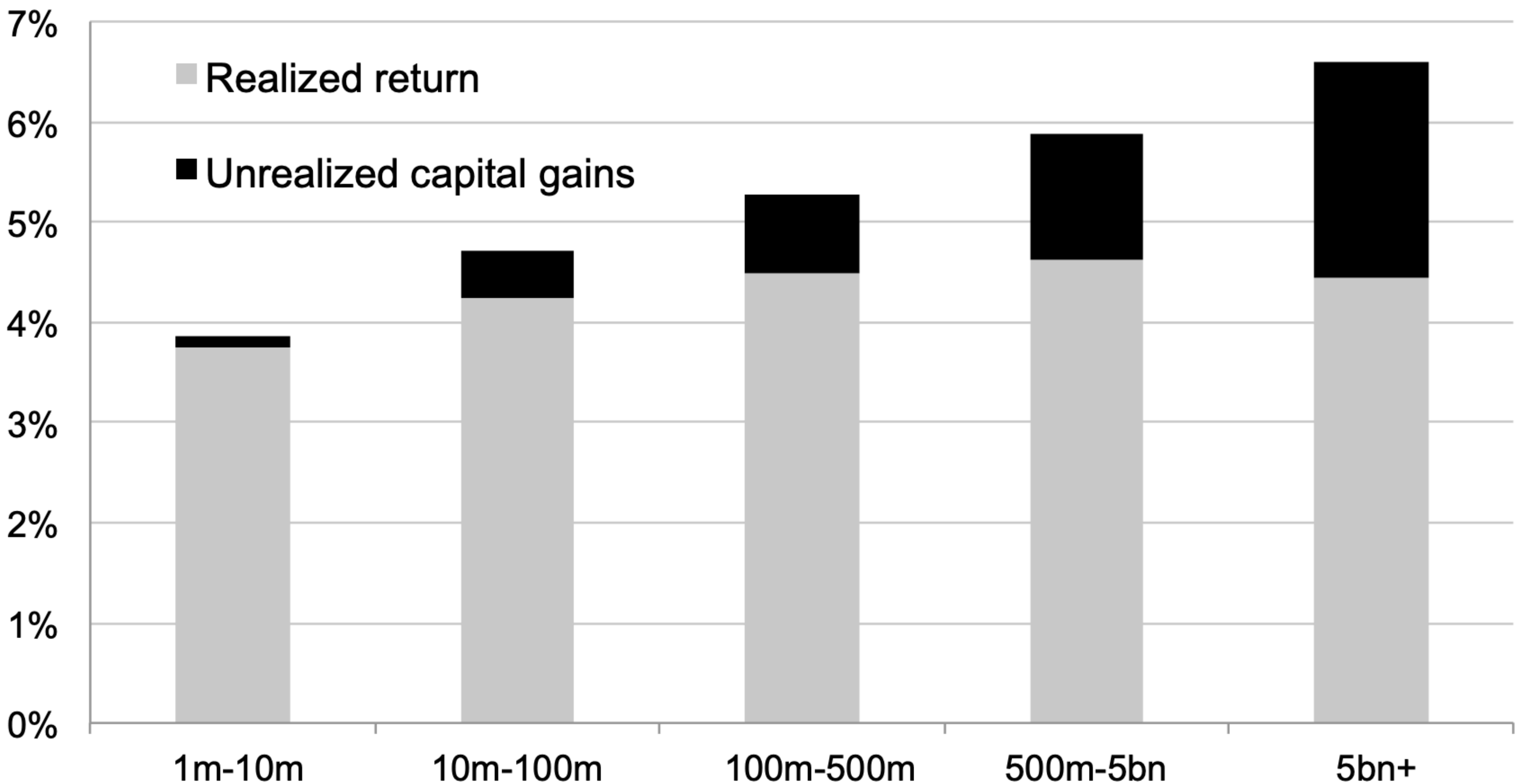
- Capital income retained in holding companies, trusts, etc., can create large gap between economic and taxable income
- On the contrary wealth is well defined

$\Rightarrow$ Wealth tax may be efficient

Alternative: redefine taxable income to economic income

$\Rightarrow$ Wealth tax may not be required

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



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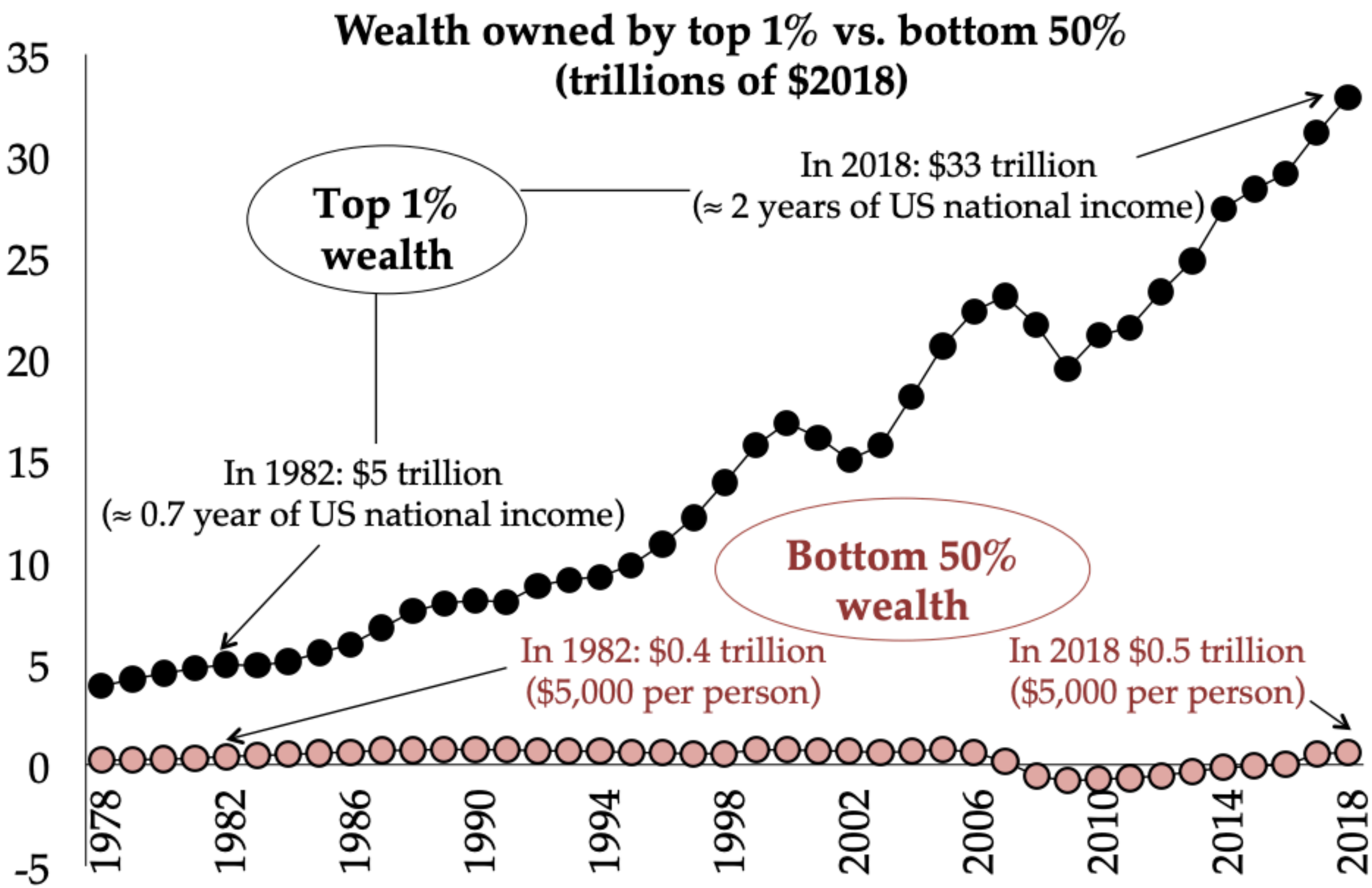
When does economic inequality ⇒ political ineq.



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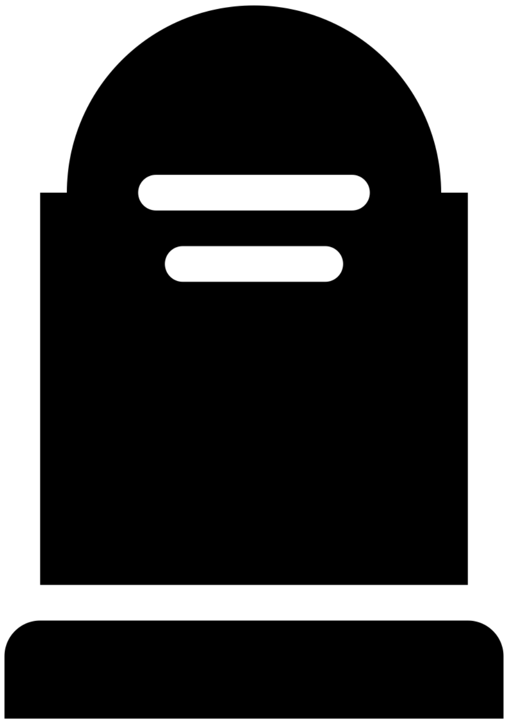
Wealth tax: a way to tax inheritance?



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, when
  1. capital income is difficult to observe
  2. concentration of wealth implies a concentration of power
  3. wealth is in large the result of inheritance