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Capital income taxation, wealth distribution and borrowing constraints

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Abstract

The theorem of zero taxation of capital income is reexamined and is shown to hinge critically on the assumptions of a long horizon and perfect markets for the inter-temporal allocation of resources. The theorem does not hold when borrowing constraints prevent individuals from insuring against idiosyncratic shocks and have a precautionary motive for savings. Structural assumptions are made such that with no taxation, aggregate savings are socially ‘excessive’ in the long-run, i.e. the rate of return is smaller than the discount rate. Sufficient conditions for a Pareto efficient taxation or subsidization of capital in the long-run depend on the correlation between individuals’ consumption and savings. A subsidy may be efficient when individuals’ incomes follow a predictable pattern of life-cycles with no negative bequest. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

The debate on capital income taxation becomes sometimes confused when the public finance view is neglected. This approach emphasizes that the tax on capital is a tax on future consumption (Feldstein, 1978). The flow of capital income is not a base like labor income which could be an opportunity for taxation. The efficiency cost of the tax is caused solely by the wedge on the prices of future consumptions. In a welfare analysis the tax impact on savings or accumulated capital is irrelevant.

Simple accounting shows that a permanent tax on capital at a constant rate creates the same distortion as an ad valorem tax on future consumption at an increasing rate which tends to infinity! It is well known that the structure of efficient taxation depends heavily on the structure of preferences. Standard studies on capital taxation generate indeterminate results because they assume a finite horizon. When the horizon is infinite, the impact of the ever widening tax wedge imposes the convergence of the efficient tax rate to zero (Chamley, 1980; Chamley, 1986)¹. This result holds even when individuals have different initial endowments and seems to put in doubt the usefulness of the capital income tax for redistribution.

However, the zero tax result rests critically on the possibilities of shifting consumption between any future periods through perfect capital markets. This assumption is not satisfied in any relevant model of income distribution which should incorporate random incomes with borrowing constraints. The purpose of this paper is to reexamine the redistributive role of capital income taxation in such economies.

The issue of the relation between capital accumulation and taxation has been raised again by Aiyagari (1993), who takes the view that the level of capital in the long-run is 'too high' socially because individuals who face a credit constraint save for possible bad draws in the future lotteries of their labor income. In the steady state of the economy the rate of return on capital is smaller than the discount rate. A tax on capital income would reduce capital accumulation and be socially desirable. This intuitive argument is disproved here. The model presented in this paper is structural and generates a level of capital income that is 'too high', in the sense of Aiyagari, and for the same reason: individuals use private capital accumulation to smoothen their consumption path even when the rate of return is lower than the rate of time preference. It will be shown that the impact of capital income taxation is in general ambiguous: whether an anticipated future capital income tax is Pareto efficient depends on the random properties of the labor income.

In the present study, the operating mechanism of the capital income tax is the standard motive for insurance when markets are incomplete. (Previous studies of fiscal policies with uncertainty and incomplete markets include: Eaton and Rosen, 1980; Hellwig, 1980; Mirrlees, 1990). The tax on capital income (positive or negative) may redistribute income from the 'rich' to the poor, i.e. from individuals with a relatively low marginal utility of consumption to their contemporaries who have a relatively high marginal utility of consumption. These marginal utilities may have a positive or a negative correlation with the level of an individual's savings. When the correlation is positive (negative) the optimal tax rate is positive (negative). Both cases are found in the structural models presented here which

¹The tax rate is not zero when some incidence falls on pure profits (Correia, 1996). See also Atkeson et al., 1999. For an analysis with endogenous growth, see Chamley, 1992.

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