Bob Hall's Discussion of "Use It or Lose It: Efficiency Gains from Wealth Taxation" by Guvenen, Kambourov, Kuruscu, Ocampo, and Chen

Which tax base is better?

$$\pi(a, z) + ra$$

or

$$\pi(a, z) + (1 + r)a$$

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A wealth tax wins because its improvement in efficiency outweighs its tendency to increase the dispersion of wealth

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The modeling of wealth managers is novel and exciting—they acquire physical capital and make highly specialized intermediate products that are enormously profitable; some managers are much better at doing this than others.

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That's realistic for high-tech, but not for the economy as a whole

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Some start in the fast-lane H state, where their productivities are their birth levels raised to the power 5

Each year, they face a hazard of 5 percent of dropping to their birth productivities

After that, they face a hazard of 3 percent of losing all of their productivity for the rest of their lives

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More on productivity

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The resulting distribution of wealth has a Pareto tail, but is somewhat less unequal than in US data

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Relation to the literature on capital taxation

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Here, most of the income arises from extreme market power

And, the Ak technology does not have a clean separation between labor and capital

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Diamond-Mirrlees, *AER* (1971a)

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Unless a tax on an intermediate product leaves the economy on its production frontier, the tax is undesirable in the sense that a tax system that does not tax intermediate goods is dominant

.

Diamond and Saez, *JEP*, footnote 14

The aggregate efficiency theorem in Diamond and Mirrlees (1971) is sometimes cited as support for not taxing capital income. Taxes on transactions between households and firms (that do not vary with the particular firm) do not interfere with production efficiency. While taxing all capital income of households will generally change the level of savings, and so investment, it does not move the economy inside the production possibility frontier. Thus, the aggregate efficiency theorem, that the optimum is on the production frontier, has no direct implications relative to taxing the capital income of households.

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Diamond and Saez's case for taxation of capital income

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2. Households face borrowing constraints; the constrained households hold no capital; there is sorting of a low-consumption group, so capital taxation permits lower taxes on their earnings

3. The literature on the inverse Euler equation recommends rising consumption taxes in later years of the life cycle, which is accomplished by positive taxes on capital income

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The income confusion problem

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The businesses are owner-managed, so this is an indication of a source of income that is predominantly return to the owners' efforts

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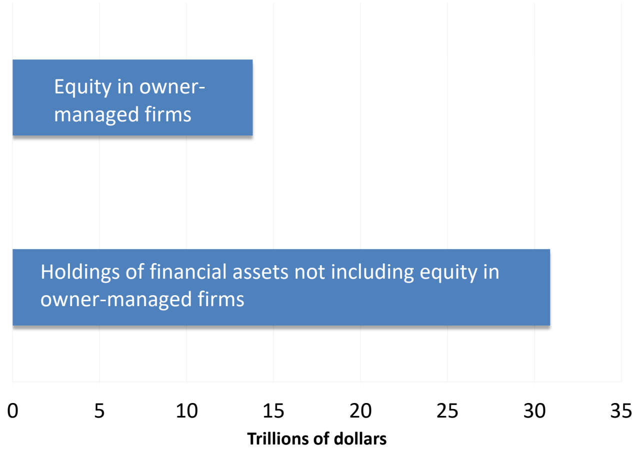
The unexpected importance of entities with large components of labor income, SCF, 2013



The difference between a capital income tax and a wealth tax

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To equalize after-tax returns at the level r,

$$\tau_a = \frac{\tau_k}{1 - \tau_k} r$$

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This paper has enough new features to make a wealth tax far superior

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The "capital tax" in 4(a) bears on the flow of profit $\pi(a, z)$ and on wealth, ra; the first term is very different from any normal concept of capital income

The "wealth tax" in 4(b) bears on the same measures, but puts much higher weight $1 + ra$ on wealth, so it is more like a capital income tax

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Thinking about this paper has shifted me toward the view that treating all business income as labor income may not be such a bad idea, but I don't see any role for wealth taxation

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