Preferences, incentives matter for capital tax levels, study finds

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(Phys.org)—Against the backdrop of a nation obsessed with the debate on taxes, Cornell assistant professor of economics Maxim Troshkin and colleagues have completed a study that could help determine the ideal capital tax policy by showing why current theories result in particular levels and types of taxes.

Capital income is essentially about the trade-off between consumption today and consumption tomorrow, explains Troshkin, because it's income that comes from savings rather than a paycheck. His paper, forthcoming in the *Journal of Public Economics*, explores a prominent justification for taxing capital income: In an efficient tax system, goods preferred by the most productive individuals ought to be taxed. While economists have long used this reasoning as one justification for capital taxation, it has not been well understood at what levels and to what degree it may increase overall economic welfare.

Using various social welfare models and National Longitudinal Survey of Youth data, Troshkin found that an optimal policy would have generally moderate levels of capital income taxation and that in all cases the overall economic welfare gains from introducing optimal capital income taxes are small.

Taxing capital income may be efficient, explains Troshkin, because the data show that more productive people are also more patient. "We know that people have different preferences about consuming today versus consuming tomorrow. More productive people turn out to put a higher weight on their expected future consumption than do less productive people, which translates into their saving more."

But while people differ widely in their productivity, how they differ regarding savings behavior is not as significant as the differences in the incomes their productivity earns them, says Troshkin. This results in moderate levels of capital taxes being ideal.

The study's results are surprising, says Troshkin, because models based on different justifications for capital taxation (e.g., the dynamics of productivities) usually produce quite high optimal tax rates, at least for top earners. "Before this study we didn't know what tax levels were justified by differences in preferences and whether that can make a significant difference in terms of overall economic welfare," says Troshkin.

An argument often offered in favor of keeping capital tax rates low or at zero is that it provides an incentive to invest or save more. Troshkin's study stresses that one important goal of taxing savings or capital is to provide incentives to highly productive individuals to convert their high abilities into high incomes. According to Troshkin, "This sort of distinction between the ability to produce and the actual output or income is missing in the more popular discussion of tax policy." His study offers an important way to better inform that discussion.

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