Efficiency Gains from Wealth Taxation

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This paper studies the quantitative implications of wealth taxation (as opposed to capital income taxation) in an incomplete markets model with return rate heterogeneity across individuals. The key source of heterogeneity comes from the fact that some individuals have better entrepreneurial skills than others, allowing them to obtain a higher return on their wealth. In this environment, consider a flat-rate wealth tax. This will shift the after-tax return distribution downward, which has two effects. First, entrepreneurs at the left tail of the productivity distribution now have an even more negative return, causing their wealth to shrink (faster) over time, in turn increasing the share of aggregate wealth owned and operated by the more skilled entrepreneurs. This reallocation increases aggregate productivity. Second, and at the same time, because such a wealth tax is regressive, it increases wealth (and welfare) inequality in the population.

To provide a quantitative assessment of these different effects and the optimal level of wealth taxation, we build and simulate an overlapping generations model with individual-specific returns on capital and idiosyncratic shocks to labor income. Entrepreneurial ability (or rate of return) is allowed to vary both within a generation and across generations (from father to son). In this environment, the children of very successful entrepreneurs will inherit large amounts of wealth but may not be able to work that capital as efficiently. By taxing all wealth at the same rate, the society can weed out these low-productivity children from those with better uses of capital. Clearly, if capital markets were efficient, wealth would be put at its most productive use without taxes, simply by high productivity individuals

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renting capital from those with low returns. In this sense, incomplete markets is essential to the analysis in this paper. The key exercise we conduct is to consider an economy calibrated to the US data and implement a revenue-neutral tax reform that replaces capital income taxes with linear wealth taxes. Our results so far indicate that this reform can have large welfare gains through increased efficiency.