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Should We Tax Capital Income?

If we did not care about equity, designing an optimal tax system would be easy. We would only care about efficiency and a tax is more efficient if it cannot be avoided by changing one's behavior. Hence, we would just have a lump-sum tax: each and every individual would pay the same nominal amount, regardless of income, age, number of dependents, employment status, and whether the taxpayer is an individual, small or medium-sized enterprise, or multinational. Such a tax cannot be avoided (except by migrating perhaps).

However, since we do care about fairness, we have to live with the fact that tax systems around the world are complex and cause significant distortions by discouraging people's incentives to work, save, and invest. The costs of these distortions need to be carefully weighed against the benefits of greater equality. Taxes on capital income have been singled out as being particularly disruptive. Should we therefore stop taxing this income source? Not so fast!

Indeed, a large number of economic models suggest that, among taxes, those on capital income are the most distortionary, followed by personal income taxes, payroll taxes, and the VAT being most efficient. Taxes on wages discourage labor effort. Similarly, a VAT also reduces work incentives. After all, at least according to economists, labor has no intrinsic value for the laborer, but generates income, which we consume now or at some point in the future. By taxing consumption, why would we work as hard? However, the key difference with a wage tax is that the VAT also notionally taxes a person's savings, or, alternatively formulated, the fruit of one's past labor. After all, savings have to be consumed at some point (possibly by our dependents). This feature of the VAT distinguishes it from a pure payroll tax and makes it more efficient. Put differently, the VAT has a broader tax base (and, as an aside, secures revenue for the government throughout the process of production, which distinguishes it from a sales tax).

So what about taxes on capital gains and corporate profits? These are particularly disruptive in many models as they reduce the incentives to save and invest. The key difference with reducing the amount of labor supplied in the economy (as with the wage tax and, to a lesser extent, the VAT) is that lower investment reduces the available capital stock and therefore the economy's growth rate permanently, while lower labor supply has only a one-off effect, reducing output only in the year in which it is introduced (or increased). Since personal income is generally a combination of income from wages and capital gains, its distortions are in between the corporate income and wage tax.

According to the ranking above, we can improve the performance of the economy by substituting capital income with indirect taxes or, second-best, personal income taxes.

Indeed, close at home, in the Philippines there are proposals to reduce the corporate income tax and instead to rely more heavily on the VAT.

Although efficient, this may hurt equity despite the fact that the VAT notionally taxes the stock of savings, affecting the rich (and elder) consumers proportionally more. I say may, because it depends on how one defines an individual's welfare: if it is defined as income then a flat-rate VAT is regressive. Instead, if welfare depends on consumption, then the VAT is neutral in terms of distributional implications. Furthermore, certain goods that are consumed by the poor could have a reduced VAT rate or be exempted altogether, making the tax reform above more progressive, although this causes administrative and compliance difficulties and should generally be avoided. As a general rule, they key advantage of the VAT is that it raises revenue in an efficient manner and that any distributional concerns are best addressed by other tax or spending instruments.

Some prominent economists (including a few Nobel laureates) and pundits go even a step further and suggest that capital income should not be taxed at all: you levy a one-time tax on the existing capital stock (which would be lump-sum, since there is nothing the firms could do about it, the capital is there already after all), and then exempt new investment. Some studies even argue that this would not only be efficient, but also fair: corporate income taxes reduce investment, imply less capital per worker, make labor less efficient, and reduce wages. Hence, it is the workers that ultimately pay the price!

However, these more extreme conclusions are often derived in models with very specific assumptions, including that everyone is rational, has perfect information, and that markets work frictionless. In more realistic models, a case can quickly be made that we need taxes on capital income: the channels above remain valid, but are to some extent offset by other considerations. For example, once we include human capital in the analysis, taxes on wages quickly become more distortionary as they reduce incentives for schooling, thereby permanently reducing productivity and the growth rate of the economy.

There are other reasons why the argument for zero capital taxes does not hold in reality. Time inconsistency is one argument. Another is that financial markets are not perfect and a large part of the population often cannot borrow. This leads to excessive savings for the economy as a whole. A capital income tax essentially redistributes from people that save too much to people that cannot borrow and mitigates the financial market friction.

Thus, there is a good case for positive capital income taxes and any tax reform should carefully consider the interaction between the distortions created by different taxes and other market frictions and its distributional implications. This makes a review of the optimal mix between direct and indirect taxation a challenging task. For some countries it is easier: they have little choice. Indeed, in economies facing rapid population aging, it makes sense to shift towards higher indirect taxes as the labor force is shrinking (retirees also pay the VAT and excises thereby preventing a gradual erosion of the tax base).

This illustrates a general point. It is generally more efficient to expand the tax base rather than tinker with individual tax rates. In this regard, strengthening tax compliance and reforming tax incentives are the way to go for the Philippines before considering a comprehensive tax reform. Not only is this more efficient, it is fairer as well by creating a level-playing field for all taxpayers.

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