Bridging the Gap between Tax Policy Evaluation and Optimal Tax Analysis: Taxing the Rich

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- We who study public economics pride ourselves on connecting empirical findings to policy evaluation, and doing our best to ensure that policy evaluation is based on a rigorous framework.
- Of course, the price of rigorous modeling is the use of stylized models. There is always a tradeoff between rigor and capturing the key elements of a setting.
- Today I want to illustrate this tension in the setting of taxing the rich.

Taxing the Rich

- Stimulated by the perception of growing inequality and stagnation of living standards at the lower income ranges, taxing the rich is at the forefront of current tax policy debate in many countries.
- In the U.S., two leading candidates for the Democratic Party's presidential nomination have proposed a stiff annual wealth tax, rising as high as 8% for billionaires.
- In 2010, the U.S. introduced legislation to constrain tax evasion using foreign accounts—FATCA—and more than 100 countries have committed to the automatic exchange of information standard.

A Generic Concern with Optimal Tax Analysis

- What is the appropriate social welfare function (SWF)?
- This is ***not*** an economics question.
- Much recent analysis dispenses with this, finding conditions for Pareto undominated tax systems. The idea is that, whatever your (Paretian) SWF, you wouldn't want to be on the wrong side of the Laffer curve.
- This provides upper bounds on the top tax rates that would maximize a SWF in which the marginal social weight on the superrich is ***zero.***
- A zero weight is scary, but not much different than an Atkinson SWF ($W = \Sigma(1/v)U^v$) with $v=-2$. The relative marginal weight of someone with $100 million of income to someone with $10,000 of income is one ***trillionth***.

Optimal Tax Analysis and the Rich

Today I will discuss three reasons why optimal tax analysis of the rich might be special:

1. They, or their productivity, might be fundamentally different from others in some relevant respects.
2. Evasion and avoidance responses may be especially important.
3. Capital gains, and their tax treatment, loom large.

1. The Rich Might Be Different

They Might Be Superstars

- Relatively small differences in ability or effort are amplified by other factors, such as technology or globalization, leading to dramatic differences in productivity and, ultimately, pay. Movie stars, CEOs, etc.
- How does this affect how to optimally tax them?
- Since the phenomenon leads to greater inequality, it may seem to increase optimal progressivity, i.e., higher tax rates at the top.
- But it also increases the behavioral earnings response to any tax change, as e.g. a CEO anticipates being matched with a better job, with better pay, and this further amplifies the incentive for effort.
- It runs out that the formulae are unchanged, but the sufficient statistics are endogenous to superstar effects.

There Might Be Spillovers

- Do some top incomes reflect rent-seeking—i.e., the pursuit of personal enrichment by enlarging one's slice of the existing economic pie rather than by increasing the size of that pie?
- If so, the optimal policy is to levy a "corrective" Pigouvian tax equal to the marginal social damage.
- Some have argued that CEOs, financial sector workers, and lawyers fit this description.
- But how can we measure the extent of rent-seeking, and how can we target even sector- or profession-specific taxes?

More on Spillovers

- For optimal tax, one also needs to know at whose expense "overpaid" individuals are benefiting. E.g., is CEO compensation at the expense of low-skill workers or of other CEOs?
- Another kind of externality arises from "positional" concerns, where individuals gain utility from their ***rank*** in the income or wealth distribution, and fail to internalize that increasing their income makes others less happy.
- Do the rich suffer from lack of self-control re workaholism, thus suggesting a tax to correct this ***internality***?

2. The Rich Evade More

Do the Rich Evade?

- Old conventional wisdom: “the rich avoid, and the poor evade.”
- New conventional wisdom: “the rich avoid, and the rich evade.”
- Note, though, that evasion, including evasion of the rich, is difficult to measure—(research) creativity is rewarded— and so its determinants are difficult to credibly identify.
- In recent years, new (largely administrative) data and new methods have allowed us to learn much more than a decade ago, in part by focusing on “traces” of evasion.

Yes, the Rich Evade

- Based on random audit data, Johns and Slemrod (2010) concluded that in the U.S. the ratio of aggregate misreported income to true income generally increases with income.
- Leaks from HSBC Bank in Switzerland and the "Panama Papers" have recently allowed researchers to gain insights into tax evasion by the richest.
- Alstadsæter et al. (2019) link data from these leaks to administrative data from Norway, Sweden and Denmark, and conclude that the top 0.01% evaded about 30% of the income and wealth taxes they owe.
- Moreover, 95% of these foreign account holders did not report the existence of the account on their tax forms.
- Are these results generalizable?

Surprise! We Can Do RCTs in Tax

- When it first became clear that RCTS were becoming the “gold standard” of identification, I despaired.
- I was, though, overreacting, because RCTS about the impact of tax enforcement treatments have proliferated in recent years. See my recent survey in the *Journal of Economic Literature*.

Optimal Tax Insights

- As Slemrod and Kopczuk (2002) point out, the elasticity of taxable income (or any tax base) is not a structural parameter.
- E.g., the rich will be less responsive to a tax rate increase, the broader and less plastic is the tax base, and the more effective is the enforcement of tax evasion.
- This suggests that proposals to raise rates should be accompanied by calls for a broader base and better enforcement.
- Keen and Slemrod (2017) show how the optimal tax rate structure should be determined simultaneously with the optimal setting of these other aspects of tax systems.

The Politicians Apparently Agree

- Both prominent U.S. wealth tax proposals include expanded IRS resources.
- Warren proposes a minimum audit rate for taxpayers subject to the wealth tax, and systematic third-party reporting that builds on FATCA. Sanders advocates a 100 percent audit rate for all billionaires.
- Both candidates also advocate stiff exit taxes, up to Sanders' 60% exit tax for those with wealth exceeding $1 billion.
- They both advocate a very broad base, including all assets and, e.g., all trusts (Sanders would tax the grantor.) This is broader than any previous wealth tax.

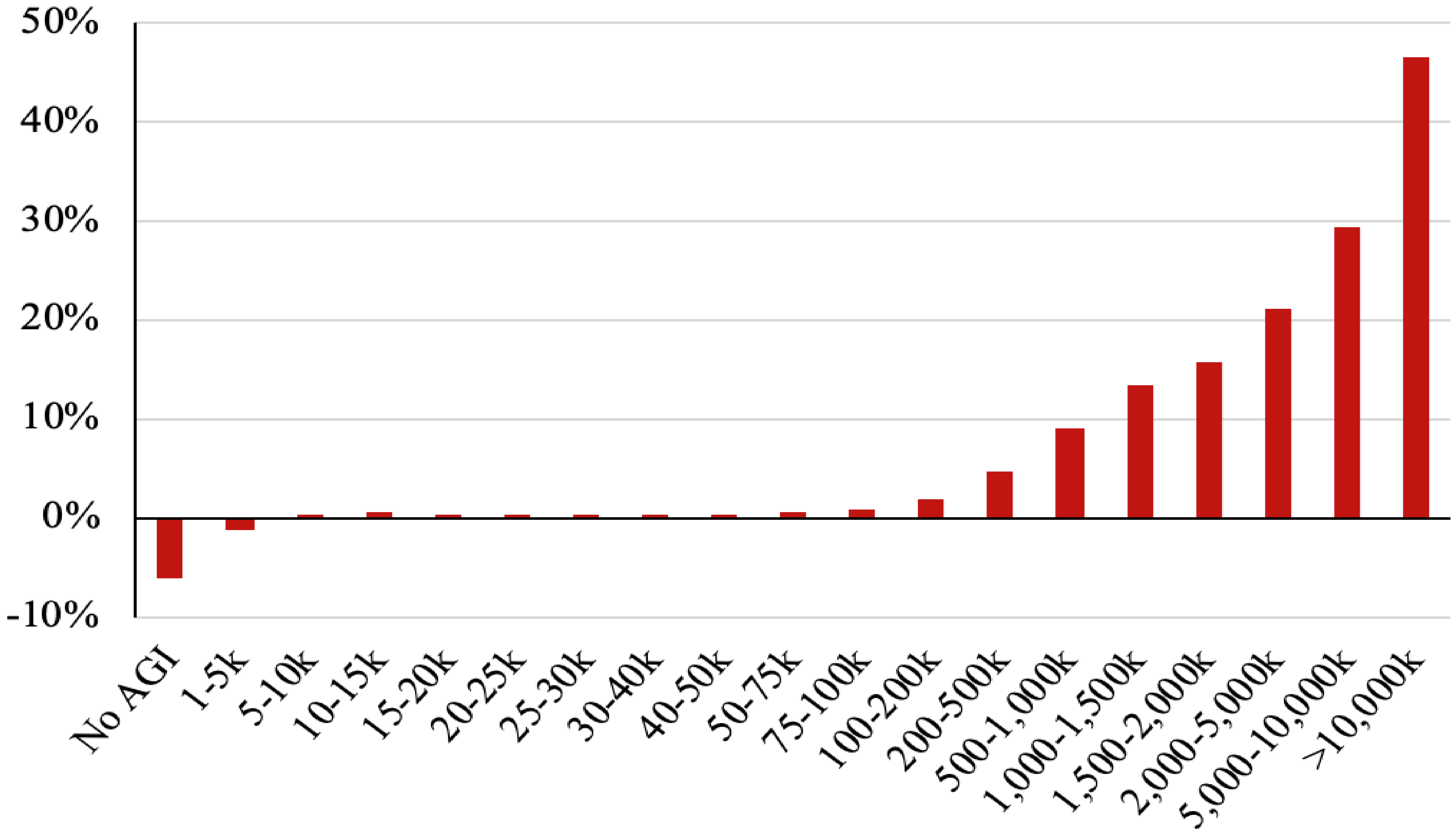
3. Capital Gains Matter a Lot to the Rich

Capital Gains and Optimal Taxation

- Neither Diamond-Mirrlees nor Mirrlees mention the term.
- No country treats capital gains as Haig and Simons said an ideal income tax would, by taxing real gains as they accrue.
- Many countries don't tax them at all.
- If they do, they tax nominal gains on a realization basis, often with a preferential tax rate. In the US, in addition there is a step-up in the tax basis upon death, so all unrealized gains accrued during a lifetime are excused from tax.

Capital Gains Are (Mostly) For the Rich

- IRS data shows that in tax year 2014 realized capital gains represented 60% of total AGI for the 400 highest-AGI Americans.
- Those with AGI over $10 million report net capital gains corresponding to 46% of their AGI, whereas it is a negligible fraction for those earning less than $200,000.
- Of course, the preponderance of capital gains among the rich is in part because of their preferential tax treatment.


50%
40%
30%
20%
10%
0%
-10%
No AGI
1-5k
5-10k
10-15k
15-20k
20-25k
25-30k
30-40k
40-50k
50-75k
75-100k
100-200k
200-500k
500-1,000k
1,000-1,500k
1,500-2,000k
2,000-5,000k
5,000-10,000k
>10,000k

The Lock-In Effect of of Capital Gains

- The traditional behavioral response is known as the lock-in effect: how realizations (sales) respond to the tax rate.
- The higher the rate of tax, the greater the incentive to postpone the sale, and best of all to postpone sale completely during one's lifetime.
- The empirical evidence suggests that the rate of realization, and therefore the tax collected, can be quite responsive to the tax rate.
- But, it is important to note, the elasticity certainly depends on the system in place, crucially the realization basis of tax and the step-up rules. It would be much lower under an accrual-base system.

The Plasticity of Capital Gains Income

- The other behavioral response concerns the conversion of ordinary income into capital gains--the *plasticity* of taxable income.
- Examples: collapsible corporations, founders' stock, "carried interest."
- The post-IPO gain Facebook shares is taxed as capital gains.
- Note that the behavioral responses here depend very little, if at all, on "tastes," such as labor-leisure preferences, and depend instead on the "technology" of taxation.
- Note also that such conversion is relatively easy in technology activities.

Conclusions

The Role of Economists in Policy Evaluation

- The role of experts in policymaking is under attack in many countries. Taxation of the rich is an excellent example of an issue where input from experts (like us) can be crucial.
- We should concentrate on estimating consequences, and silo our conclusions from value judgments.
- E.g., what is the magnitude and nature of rent-seeking, and evasion; what have been the effects of FATCA and AEoI?
- Practical, implementation issues matter, too, e.g., feasible ways to measure wealth and to tax capital gains.

Case Study: U.S. Wealth Tax Proposals

- We should admit to incomplete knowledge when appropriate (it will pay off in the long run.)
- The U.S. wealth tax proposals feature historically unprecedented rates and base breadth, making extrapolation especially difficult.
- This implies that the lessons from past wealth tax failures do not necessarily apply.
- But it also means that it is very difficult to be confident about its consequences.

References

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