Revisiting Tax on Top Income

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Discussed by Johannes Fleck

– Winners, Losers and Policy Reforms after the Euro Crisis –
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The European debt crisis and tax changes

Changes in cyclically adjusted categories of revenue for the euro area aggregate

(percentage of potential GDP)

- average of 2003-05 - start of consolidation
- start of consolidation - 2013
- 2013-15
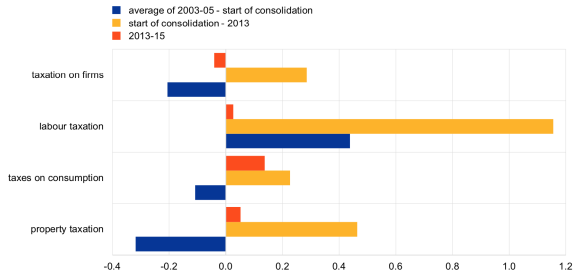
Start of consolidation: 2009   *(ECB, 2017)*

- ▶ Increasing (labor) taxes was part of Euro Area fiscal consolidation
- ▶ Additional fiscal adjustments are waiting for the Europeans...

- ▶ Time for a (re)assessment:
  - ▶ What were the effects of the recent tax changes?
  - ▶ How to design future revenue increases?

The paper in a nutshell (1/2)

1. Model: incomplete markets with heterogenous agents
   - Agents are risk averse and value consumption and leisure
   - Agents have corporate and entrepreneurial abilities (y_t, θ_t)
   - Two generations and life cycle
       - Young decide to work in one of two sectors

       C: $F(K_t^c, L_t^c) = A(K_t^c)^\alpha (L_t^c)^{1-\alpha}$

       E: $f(k_t, n_t) = \theta_t \left(k_t^\gamma (l_t + n_t)^{1-\gamma} \right)^\nu$

       - Entrepreneurs can continue to work or may retire once old
       - Corporate workers have to retire in old age
       - Old who have to exit the model re-enter as young
   - Government's parametric tax function

$$T_t(Y_t) = \begin{cases} (1 - \lambda Y_t^{-\tau})Y_t + \tau_t^{bal}Y_t + \tau_t^k r_t a_t & \text{if } Y_t < Y_H \\ (1 - \lambda Y_H^{-\tau})Y_H + \tau_t^{bal}Y_H + \tau_t^k r_t a_t + \tau_H(Y_t - Y_H) & \text{if } Y_t > Y_H \end{cases}$$

   where Y_H is the top 1% income threshold

The paper in a nutshell (2/2)

2. Calibrate model to match data – income and savings in particular
   - Strategy: adjust transition matrices for abilities $\pi(y'|y)$ and $\pi(\theta'|\theta)$ and their grid point values ('superstars')

3. **Effects of changing the tax code?** $\rightarrow$ Policy experiments I to IV

Objective	$\Delta\,\tau$ (Overall progressivity)	$\Delta\,\tau_H$ (Marginal rate top 1%)
Maximize Revenue	I	II
Maximize Welfare	III	IV

   - Revenues comprise federal, state and local and corporate taxes
   - Welfare is measured in consumption equivalent terms

Contribution

- Tractable model fitting empirical earnings and savings well

- Relative to the baseline
  - <u>Revenue maximization</u>: increase top 1% marginal tax more effective; *'fewer distortions because smaller number of entrepreneurs affected'*
  - <u>Welfare maximization</u>: increase overall progressivity more effective; *'wealth share of top 1% same, top 10% decreases, below increases'*

- Comparisons to similar studies
  - Badel and Huggett (2015)
  - Guner, Lopez-Daneri and Ventura (2016)
  - Kindermann and Krueger (2017)

My first two comments and suggestions

1. The paper explores a policy question but motivation is scarce
   - $\rightarrow$ Extend non-technical description or focus on a specific story
     - ▶ Does it relate to the current debate on US tax reform?
     - ▶ Can it speak to the issue of entrepreneurial mobility?

2. Some of the model assumptions would benefit from additional details
   - $\rightarrow$ Provide empirical support or show results are robust
     - ▶ Only entrepreneurs allowed to borrow
     - ▶ Returns independent of portfolio size and composition (and activity)

My last comment and three related suggestions

3. Go further in characterizing model properties and results

   1. → Discuss transitions: can they change your results (or not)?
      - In general, changing 'tax mix' can have different distributional consequences along the adjustment path towards steady state

   2. → Further decompose tax reform effect on steady state allocations
      - Variance of agent's after-tax income and cost of insurance via labor and asset market not invariant to reform

   3. → Elaborate on elasticities (labor and capital supply, activity)
      - Sharpens the comparison to papers such as KK 2017; e.g. persistence of their highest earning state much lower
      - Helps to determine the trade-offs related to changing the tax system; key to understand *why* tax rates are optimal for a given objective

Thanks for your attention