On the Optimality of Progressive Income Redistribution

Bakis, Kaymak, and Poschke (BKP)

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The Context

Quantitative tax papers under incomplete markets: DH (2004), CK (2006), CKK (2009), HSV (2013)

- Progressive taxes can serve as partial substitute for missing insurance markets if people face uninsurable labor income risk.
- Increasing progressivity of income taxes has redistribution and insurance benefits.
- Also creates efficiency loss due to distorting labor supply and capital accumulation.
- CK (2006) finds that the optimal tax system that arises from this trade-off is **slightly less progressive** than the current U.S. system.

What does BKM do?

- Observation: (Altruistic) people also face descendants' earnings risk (even harder to insure!).
- BKM replaces life-cycle elements of CK (2006) with intergenerational elements, and asks the same question:

Q: What is the optimal progressivity of the income tax code?

Details of the analysis

- Non-overlapping generations model where each generation is alive for one period.
- Altruistic people face intergenerational labor income risk (modeled by an intergenerational earnings matrix).
- Insurance available only via risk-free non-negative bequests.
- Government taxes **total** income, y, with the tax function:

$$T(y) = y - \lambda y^{1-\tau}.$$

- Calibrate the model under current taxes.
- Optimal tax problem: pick λ and τ to max *average* welfare s.t. government budget.

Results

- Steady state optimal taxes are **regressive**: average taxes decrease from 42% to 15% as income increases. Striking!
- Optimal taxes including transition are **mildly more progressive than current U.S. system.**
- Why different? Redistribution and insurance more important during transition and capital accumulation more important for the steady state.

Discussion of Results

- Why BKP steady state optimal taxes so different from CK (and status quo)?
- I suspect different results are due to life-cycle elements disregarded in BKP because:

  In appendix, BKP add (partially) life-cycle wage risk, and find that optimal taxes are much less regressive (closer to CK)!
- Their taxes might get closer to CK if they also take into account age-profile of earnings (as CK does).

Suggestions

- Bequest and labor income are taxed together in their main model.
- Not true in the actual U.S. tax code.
- Also, creating a confusion about what they are after.
- I suggest separate them and focus on either one of the following:

  Q.1. Effects of intergenerational earnings risk on the optimal progressivity of labor income taxes,

  OR

  Q.2. Optimal progressivity of bequest taxes.

Suggestions

- If Q.1., the do CK with altruism and intergenerational wage risk.
- Keep bequest taxes at their current levels.
- Tell us how much their results about progressivity is altered.

Suggestions

- If Q.2., then keep the benchmark model.
- Add human capital accumulation for children.
- Keeping income taxes as they are, what is the optimal progressivity of bequest taxes?

A general comment

- Tax function is nice because it is flexible, easy to work with, and can replicate the current average tax rates.
- Might be OK in a positive analysis.
- But, 'optimal' tax analysis with fixed functional form is problematic because it is not clear why we should restrict model government to choose within this parametric family given that is not the case in real life.