Taxing High-Income Individuals: Should We Aim for the Peak of the Laffer Curve?

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Overview

For the last 30 years, a widespread academic & political consensus has held that tax rates on individuals should be (a) low and relatively flat, and (b) far below the Laffer curve peak (i.e., the revenue maximizing rate).

In my view, this consensus can no longer be viewed as correct.

There is a strong case that, at the top of the income distribution, rates should be highly graduated, & approximately revenue-maximizing.

This partly reflects the staggering increase in wealth concentration at the top, occurring in many countries over the last 30+ years.

But it also reflects changed analysis of the relevant issues.

Optimal income taxation (OIT) & the case for “flattish” rates

OIT: fiscal system should transfer $$ from high-ability to low-ability due to declining marginal utility, subject to incentive issues.

In effect, the income tax provides ability insurance (& addresses under-diversification of human capital).

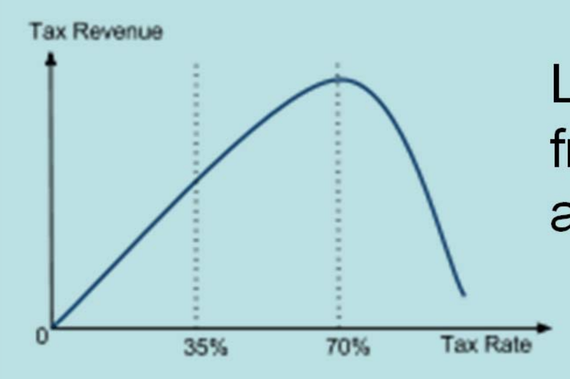
As a response to market failure (from adverse selection), the case for it is much like that for addressing externalities, which, e.g., Hayek supported.

OIT is generally thought to suggest “flattish” rates, because lower-tier rates are inframarginal for everyone who’s sufficiently higher-up.

E.g., the tax rate at $20 K (or $100K) of income raises lots of revenue from high-income people for whom it has *no* effect on their marginal incentives.

Note also the case for a zero rate at the very top.

The Laffer Curve & tax rates at the top



Laffer Curve depicts revenue raised as tax rate climbs from 0 to 100%. Recent work suggests it may peak at about 70% in the U.S. for labor income.

Standard view: never exceed the revenue-maximizing rate (i.e., right of the peak), since then the taxpayers lose AND the fisc loses.

And indeed, never be close to the peak, since the ratio of deadweight loss to revenue raised keeps rising as you move rightwards.

But both this view & the OIT conclusion about flattish rates (& zero at the top) rest on 2 key assumptions that are standard in public economics:

(1) Utility is derived from own consumption only (no positional considerations or other relevant externalities);
(2) Non-satiation.

Problems with the standard assumptions

Non-satiation: Do we really believe that billionaires, with far more $$ than they will ever spend, are still deriving marginal utility from an extra $?

If not, then we have a case for the revenue-maximizing rate.

And if we are unsure what rate this is, opposite errors (too high or too low) may be equally socially costly.

The same consideration does not apply at lower income levels, even for people who are well above the median.

Hence, satiation may support significant rate graduation at the top.

Note that behavioral factors or other motivations (e.g., keeping score) may help reconcile satiation with high-earners' tax-responsiveness.

High-end wealth concentration and positional externalities

The standard public economics assumption that utility comes purely from own consumption is clearly incorrect – we are social beings who care about relative position.

One implication: if there are both positional & non-positional goods, higher tax on the former (like a pollution tax).

If market consumption is positional relative to leisure, this suggests applying higher (whether or not more graduated) income tax rates.

But "expenditure cascades," rippling down from the top, would support also having higher rates at the top.

Not limited here to people above the "satiation" point – indeed, the point is to affect consumption choices.

Here, the optimal rate could be above the Laffer Curve peak.

Other externalities from high-end income concentration

Increasing wealth at the top may yield some positive externalities (e.g., spillovers from high-end medical or other consumer innovation).

But the externalities are negative insofar as there is zero-sum competition between people & groups for status, power, influence, etc.

Are some Western countries at risk of becoming plutocracies, in which the super-rich control politics and only their preferences matter? (See, e.g., Bartels, UNEQUAL DEMOCRACY, 2008.)

Consider the U.S. & U.K. (non)-responses to massive unemployment post-2008 – unthinkable in earlier political eras, & arguably reflecting shifts in the relative political importance of financial elites as opposed to workers.

(Although continental Europe has responded similarly.)

Concern about this problem could potentially support higher than revenue-maximizing rates in a purely welfare-based framework.

High rates at the top as indirect regulation

At least in some countries such as the U.S. & U.K., high-end income concentration is driven in large part by the rise of the financial sector & of executive compensation.

In both cases, this may reflect incentives that are economically destructive.

"Heads-I-win, tails-you-lose" bets & exploiting "Muppets" in the financial sector; looting & short-termism in corporate governance.

In both realms, direct regulation could be better-targeted than a general increase in high-end tax rates.

But absent adequate direct regulation, these concerns might significantly affect the overall assessment of high-end rates.

Once again, a Pigovian argument, not limited to revenue-maximization.

Summing up

For some decades, a widespread academic & political consensus has held that high-end rates should not be very high.

The academic case for this consensus has greatly weakened recently.

Too early to tell whether politics will follow suit (although it did when the prior consensus arose in the 1970s & 1980s).

Plutocracy can be self-reinforcing, as its causation is partly political (not just economic and technological). And its consequences can be dire, as social cohesion weakens and "extractive elites" hijack economic policy (see, e.g., Acemoglu & Robinson, WHY NATIONS FAIL, 2012).

While this is a much bigger topic than just high-end tax rates, they can be part of the attempted response.