It is best to tax true incomes from capital

By: Kevin Spiritus

The treatment of capital incomes in the Dutch tax system is exceptional among industrialized countries. The Dutch tax code disregards true incomes from capital. Instead, it assigns a fictional rate of return to the wealth holdings of its residents, and it taxes the resulting amounts. Our research shows that the Dutch tax system inflicts considerable damage to the economy.

When the Dutch government introduced the current tax code in 2001, it faced fierce opposition from economists. The main objections against the reform stem from the fact that not all individuals earn the same rates of return from their savings and that rates of return vary considerably over time. However, little research existed to further substantiate the objections against the tax reform.

A rich empirical international literature has since emerged, showing that large differences exist between the rates of return earned by different households, for a myriad of reasons. One important reason is that there are large differences in financial literacy. Many individuals do not know how to compare financial services, how much risk to take or how to balance their portfolio. Furthermore, there are no financial instruments that allow diversifying the risk from owner-occupied housing or from a family business. This creates large differences in outcomes between households. Moreover, some financial services are only accessible to the very rich, and some individuals have access to exclusive information about high yielding investments. Finally, some investors have the necessary skills that allow them to obtain higher returns for the same amount of wealth and risk.

Our research takes to heart this new body of evidence. We study the consequences for the optimal taxation of capital. We assume that the government aims to collect a given amount of revenue to finance its activities. In doing so, it cares about the distributive effects of the tax system: the government aims to levy higher taxes from those with a higher ability to pay. Finally, the government wants to accomplish its goals at a minimal cost to the economy. Keeping the objectives of the government in mind, we find several reasons why taxing fictional capital incomes is a bad idea.

First, by ignoring information about the true capital incomes, the government becomes ineffective at redistributing from individuals with a high ability to earn money to those who have a lower ability. By taxing true capital incomes, the government can reduce the tax on labor income, reducing the overall economic losses caused by the tax system.

Second, differences between individuals are often caused by luck. Some people are luckier than others. By redistributing true capital incomes, the government effectively insures the households against bad outcomes. Empirical research shows that a tax system that taxes true capital incomes, induces owners to invest more in their own companies, especially if investors are also compensated for the losses they make.

A third, related reason to tax actual capital incomes, is that the economy fluctuates over time. If the government taxes fictional capital incomes, then households pay the same amount of taxes on their wealth holdings, regardless of whether the economy is doing well or badly. If taxes remain high when the economy shrinks, this further constrains the purchasing power of the households, further deepening the recession. A tax on effective capital incomes automatically stabilizes the economy, as tax liabilities automatically decrease when the times get rough, and tax liabilities automatically increase as the economy heats up. Especially today, when the European Central Bank struggles to stabilize the economy, it is important that the government implements automatic stabilizers. The government can spread the risk over time by borrowing in the financial markets.

A final reason to tax effective capital incomes, is that not all differences between households are caused by mere luck or effort. Some companies obtain high profits because they have market power. Dutch families increasingly pay prices that are too high, the benefits of which accrue to shareholders. A government that cares about redistribution should redistribute these income differences.

Our research thus clearly shows that the tax system should not ignore differences in the rates of return, regardless of whether they stem from luck, skill or market power. Moreover, part of the income that households obtain from their savings, is a reward for their patience, for not immediately consuming all their income. A tax on this part of capital income is in fact a postponed tax on their labor income, and as such discourages individuals from working. It is more efficient to directly tax labor income, because taxing the part of capital income that rewards patience, also discourages people from saving.

It is thus better to levy a low tax, or even no tax at all, on a common rate of return that is a reward for patience, but to tax more strongly differences in returns between individuals, for reasons of efficient redistribution, insurance and stabilization of the economy. In conclusion, the Dutch tax system does the exact opposite of what it should be doing.

BIO:

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