Capital Income Taxation with Portfolio Choice*

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July 7, 2020

Abstract

This paper analyzes redistributional and macroeconomic effects of differential taxation of financial assets with a different risk levels. The redistributive effect stems from the fact that various households hold portfolios with a starkly different risk levels. In particular, poor households primarily save in safe assets, while rich households often invest a substantially higher share of their wealth in (risky) equity. At the same time, equity and safe assets are often taxed at different rates in many tax codes. This is primarily because investments in equity (which are relatively riskier) are taxed both as corporate and personal income, unlike debt, which is tax deductible for corporations. This paper firstly builds a simple theoretical two-period model which shows that the optimal tax wedge between risky and safe assets is increasing in the underlying wealth inequality. Furthermore, I build a quantitative model with a continuum of heterogeneous agents, parsimonious life-cycle, borrowing constraint, aggregate shocks and uninsurable idiosyncratic shocks, in which the government raises revenue by using linear taxes on risky and safe assets. Simulations of quantitative models shows that elimination of differential asset taxation leads to a welfare loss equivalent to a 0.3% permanent reduction in consumption. I find that the optimal tax wedge between taxes on equity and debt is higher than the one in the U.S. tax code.

Keywords: Portfolio Choice, Optimal Taxation, Redistribution

JEL Codes: E62, G11, G32, H21, H23

*I am grateful for financial support from the ADEMU project "A Dynamic Economic and Monetary Union", funded by the European Union's Horizon 2020 Program under grant agreement No 649396, and from Charles University GA UK, under project No. 344217. I am thankful to Byeongju Jeong, Jesús Fernández-Villaverde, Marek Kapička, Marios Karabarbounis, Dirk Krueger, Felix Kübler, Benjamin Moll, José-Víctor Ríos-Rull, Florian Scheuer, Petr Sedlaček, Veronika Selezneva and Ctirad Slavík for useful discussions and comments.

†CERGE-EI is a joint workplace of Charles University and the Economics Institute of the Czech Academy of Sciences, Politickych veznu 7, 111 21 Prague, Czech Republic.