

Should We Tax Capital Income or Wealth?*

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Abstract

We study optimal capital income and wealth taxation in an economy that reproduces the importance of private businesses for output and inequality. If entrepreneurs are subject to collateral constraints, they face heterogeneous rates of return, which generate a meaningful distinction between capital income and wealth taxation. We find that taxing capital income is preferable to taxing wealth because the efficiency gains from wealth taxation are swamped by the redistributive benefits of taxing the profits of richer entrepreneurs. Consequently, the gains from taxing wealth are modest. This conclusion is robust to the planner's preference for redistribution and allowing for non-linear taxes.

Keywords: inequality, redistribution, tax policy, entrepreneurship.

JEL classifications: E2, E6, H2.

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1 Introduction

Private businesses are an important determinant of both real economic activity and inequality in the United States. They account for 40% of all output and, even though private pass-through business owners represent only 12% of households, they hold nearly half of all wealth and a third of all income.

An important characteristic of private businesses is that rigid ownership rules make them reliant on internal saving and collateralized borrowing (Dyrda and Pugsley, 2018), leading them to face potentially heterogeneous rates of return (Quadrini, 2000, Cagetti and De Nardi, 2006). As Guvenen et al. (2019) point out in a recent influential paper, rate of return heterogeneity generates an important distinction between capital income and wealth taxation. Taxing capital income, which includes the profits of private business owners, distorts their incentives to accumulate wealth, amplifying the heterogeneity in rates of return and the ensuing production inefficiencies.

Our goal in this paper is to characterize optimal tax policy in an environment with heterogeneous private businesses that reproduces their importance for economic activity and inequality. We calculate the optimal tax on labor income, capital income, and wealth, taking into account the transition dynamics after reforms. Optimal policy balances the tradeoff between production efficiency, which calls for increasing the wealth share of productive business owners, and redistribution, which requires the opposite. Taxing capital income, which includes the profits of wealthy business owners, achieves substantial redistribution. Taxing wealth increases the wealth share of private business owners and improves allocative efficiency.

We find that taxing capital income is preferable to taxing wealth if the planner is restricted to only using one of these two instruments. Intuitively, because the wealth share of entrepreneurs is so high in the data, the redistributive motive dominates efficiency considerations. A planner who can use all tax instruments sets the wealth tax close to zero and achieves only small incremental welfare gains from introducing a wealth tax.

The economy we study consists of households who work in a competitive labor market. A fraction of them can also run a private business. Households face idiosyncratic shocks to their labor market efficiency and their entrepreneurial ability and can partially insure against these shocks by saving in capital, corporate stocks or government bonds. Private business owners compete alongside publicly owned firms. While private firms face a collateral constraint, as in Buera et al. (2011), corporate firms have unlimited access to external finance.

Given our focus on the distributional consequences of tax reforms, we require that the

model reproduces the distribution of wealth and income in the data, both for workers and entrepreneurs, as well as the relative size of the private business sector. Our calibration implies relatively small losses from misallocation, consistent with the findings of [Midrigan and Xu \(2014\)](#), reflecting, in part, that corporate firms are unconstrained and that entrepreneurial ability is persistent so productive entrepreneurs eventually overcome borrowing constraints.

The tax reforms we consider are once-and-for-all unanticipated changes in the tax on labor income, capital income and wealth. The government uses the tax revenue to finance government spending and lump-sum transfers. We focus on a utilitarian social welfare function and flat taxes, but show that our results are robust to considering alternative preferences for redistribution and allowing for non-linear taxes. A utilitarian planner restricted to only taxing labor and capital income finds it optimal to tax capital income at a higher rate than labor income and increases consumption equivalent welfare by 9.5%, greatly benefiting workers at the expense of entrepreneurs. The planner achieves much smaller gains, of only 5.6%, if it were allowed to only tax labor income and wealth. Thus, a capital income tax is preferable to a wealth tax, despite the misallocation losses it entails. Moreover, when the planner can tax both capital income and wealth, it sets the wealth tax equal to approximately zero and thus achieves modest gains from introducing a wealth tax.

Related Work. Our result that a capital income tax is preferable to a wealth tax stands in contrast to that of [Güvener et al. \(2019\)](#). There are a number of differences between the settings we study. In our economy, private business owners co-exist with unconstrained corporate firms and operate a technology that uses both capital and labor. In theirs, all production is done by private businesses that only use capital to produce. These two features imply that in our model the losses from misallocation are much smaller. In addition, we target the large wealth and income shares of private business owners, and allow for lump-sum transfers. These features generate a strong motive for redistribution.¹ Finally, we characterize optimal policy taking transition dynamics into account. [Güvener et al. \(2019\)](#), in contrast, maximize long-run steady-state welfare.² Also related is the work of [Imrohoroglu et al. \(2018\)](#) and [Brüggemann \(2021\)](#), who study optimal top income taxation in an economy with entrepreneurs. In contrast to their work, we allow for differential taxes on capital and labor income, as well as on wealth.

¹See [Boar and Midrigan \(2022\)](#) for a discussion of the role of lump-sum transfers in shaping optimal policy in an environment without entrepreneurs.

²See also [Meh \(2005\)](#), [Boar and Knowles \(2022\)](#) and [Güvener et al. \(2022\)](#), who also study tax policy in economies with private business owners without taking into account transition dynamics.

2 Model

The economy is inhabited by a continuum of households that differ in their labor market ability. In addition, a fraction ψ of them are also endowed with entrepreneurial ability and can run a private business. This latter group of households, who we refer to as entrepreneurs, produce a homogeneous good alongside perfectly diversified corporate firms. There is no aggregate uncertainty.

2.1 Households

Households choose consumption c_t and hours worked h_t to maximize life-time utility

$$V = \max \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t \left(\frac{c_t^{1-\theta}}{1-\theta} - \frac{h_t^{1+\gamma}}{1+\gamma} \right), \quad (1)$$

The income i_t of households is equal to

$$i_t = W_t e_t h_t + r_{t-1} a_t + \pi_t(a_t, z_t).$$

Labor income $W_t e_t h_t$ depends on the equilibrium wage W_t and idiosyncratic ability e_t . Asset income $r_{t-1} a_t$ depends on wealth holdings a_t and the equilibrium return r_t . Wealth is the sum of holdings of government bonds, physical capital and shares in corporate firms. Absent aggregate uncertainty, the return on all these assets is equal, so we only need to keep track of total household wealth. Profits $\pi_t(a_t, z_t)$, earned only by entrepreneurs, depend on idiosyncratic entrepreneurial ability z_t and wealth due to a collateral constraint. We assume that households cannot borrow, so $a_{t+1} \geq 0$.

The budget constraint of households in the initial steady state is

$$(1 + \tau_s) c_t + a_{t+1} = i_t - T(i_t) + a_t,$$

where, as in the United States, both capital and labor income are subject to income taxes, and where τ_s is a consumption tax. We assume a HSV tax function $T(i_t) = i_t - (1 - \tau) \frac{i_t^{1-\xi}}{1-\xi} - \iota_t$ that also includes a lump-sum transfer ι_t . The parameter τ determines the average level of marginal income taxes and ξ governs their slope. In our optimal policy experiments, we allow the government to tax labor and capital income, as well as wealth.

Entrepreneurs. Entrepreneurs produce using a decreasing returns to scale technology

$$y_t = z_t^{1-\eta} (k_t^\alpha l_t^{1-\alpha})^\eta,$$

where η determines the managerial span-of-control, α the elasticity of capital in production, and entrepreneurial ability z_t is iid across firms and follows a Markov process with transition probability $F_z(z_{t+1}|z_t)$.

Entrepreneurial profits are equal to

$$\pi_t = y_t - W_t l_t - R_t k_t,$$

where R_t is the rental rate of capital. Entrepreneurs face a collateral constraint which limits the capital used in production to a multiple $\lambda \geq 1$ of their wealth

$$k_t \leq \lambda a_t.$$

The return to wealth for entrepreneurs is equal to

$$r_{t-1} + \frac{\partial \pi_t(a_t, z_t)}{\partial a_t} = r_{t-1} + \lambda \mu_t(a_t, z_t),$$

where $\mu_t(a_t, z_t)$ is the multiplier on the collateral constraint. The model therefore features heterogeneity in rates of return to saving, which [Benhabib et al. \(2011\)](#) argue are key determinants of top wealth inequality. Intuitively, poor but efficient entrepreneurs are more constrained and therefore have a higher return to saving. As [Güvener et al. \(2019\)](#) point out, heterogeneity in rates of returns creates an important distinction between capital income and wealth taxation.

2.2 Corporate firms

We assume that corporate firms operate the same technology as entrepreneurs. There are three key distinctions between corporate and entrepreneurial firms. First, the ownership of corporate firms is fully diversified. Second, corporate firms face no collateral constraints. Third, corporate profits are subject to double taxation. Specifically, corporate income is first taxed at a corporate tax rate τ_c and then the dividends issued by corporate firms are taxed as personal income.

Without loss of generality, we assume that all corporate firms have the same productivity z^c . They exit with exogenous probability φ and their mass evolves endogenously according to

$$N_{t+1} = (1 - \varphi)(N_t + \nu_t),$$

where ν_t is the mass of new entrants, determined in equilibrium by the free-entry condition

$$F_t \geq Q_t.$$

Here, F_t is the cost of creating a new firm and Q_t is the price of a claim to a firm, given by

$$Q_t = \frac{1 - \varphi}{1 + r_t} [Q_{t+1} + (1 - \tau_c) \pi_{t+1}],$$

where π_{t+1} are the profits of the representative firm.

We follow [Gutierrez et al. \(2019\)](#) in assuming that entry costs increase with the mass of entrants, so that entry responds inelastically to changes in the environment. Specifically, we assume that

$$F_t = \bar{F} \nu_t^\varepsilon,$$

where ε determines the elasticity of firm entry to changes in firm profitability and \bar{F} determines the average level of the entry costs. The elasticity of firm entry ε has implications for the comovement of stock prices and entry rates. If $\varepsilon = 0$, stock prices are constant, and all adjustment is in the entry margin, as in [Hopenhayn \(1992\)](#). As ε increases, entry rates respond less, and the stock price responds more to a given shock.

2.3 Government

The government issues debt B_t . It finances the debt service $r_{t-1}B_t$ and exogenous government spending G using tax revenue T_t . The budget constraint of the government is

$$(1 + r_{t-1}) B_t + G = B_{t+1} + T_t.$$

2.4 Aggregation

Output is used for consumption, investment and government spending, so the aggregate resource constraint is

$$Y_t = C_t + X_t + G,$$

where

$$Y_t \equiv \int_{\text{entr}} y_{it} di + N_t y_t^c$$

is total output, y_{it} is the output of entrepreneur i , y_t^c is the output of a corporate firm, and X_t is investment in physical capital and in new firms

$$X_t = K_{t+1} - (1 - \delta) K_t + F_t \nu_t.$$

Collateral constraints on entrepreneurs introduce two distortions. First, they generate dispersion in the marginal product of capital across producers, generating misallocation and

reducing TFP. Second, they depress the aggregate capital-output ratio. To see the impact on misallocation, we note that aggregating individual producers' choices allows us to write an aggregate production function

$$Y_t = Z_t (K_t^\alpha L_t^{1-\alpha})^\eta,$$

where K_t and L_t denote aggregate capital and labor. Aggregate productivity Z_t is equal to

$$Z_t = \left(\int_{\text{entr}} z_{it} \phi_{it}^{-\frac{\alpha\eta}{1-\eta}} di + N_t z^c \right)^{1-(1-\alpha)\eta} \left(\int_{\text{entr}} z_{it} \phi_{it}^{-\frac{1-(1-\alpha)\eta}{1-\eta}} di + N_t z^c \right)^{-\alpha\eta},$$

where $\phi_{it} = 1 + \mu_{it}/R_t$ is the capital wedge induced by the collateral constraint. Absent collateral constraints, $\phi_{it} = 1$, and aggregate productivity increases to

$$Z_t^* = \left(\int_{\text{entr}} z_{it} di + N_t z^c \right)^{1-\eta}.$$

To see that collateral constraints also depress the capital-output ratio and act as a tax on capital, we note that aggregating individual capital choices across firms gives

$$\alpha\eta \frac{Y_t}{K_t} = R_t \bar{\phi}_t,$$

where the aggregate capital wedge $\bar{\phi}_t = \frac{1}{K_t} \left(\int_{\text{entr}} \phi_{it} k_{it} di + N_t k_t^c \right)$ is a weighted average of the individual capital wedges.

The equilibrium in this economy is characterized by sequences $\{r_t, W_t\}$ which satisfy asset and labor market clearing. The market clearing condition for assets equates the savings of households to overall amount of capital, government debt and value of corporate stocks

$$\int a_{t+1}(a, e, z) dn_t(a, e, z) = K_{t+1} + B_{t+1} + Q_t(N_t + \nu_t),$$

where $n_t(a, e, z)$ is the distribution of households over individual states. The labor market clearing condition is

$$\int e h_t(a, e, z) dn_t(a, e, z) = L_t.$$

Lastly, no-arbitrage implies that $R_t = r_{t-1} + \delta$.

3 Parameterization

We assume that the economy is in the steady state in 2013 and target moments for that year. A period in the model is one year.

Assigned Parameters. We set the relative risk aversion $\theta = 1$, the Frisch elasticity of labor supply $\gamma = 2$, the depreciation rate of capital $\delta = 0.06$, and the capital elasticity $\alpha = 1/3$, all common choices in the literature. We set the stock of government debt to 100% of GDP, the value in 2013. We set the exit rate of corporations $\varphi = 0.04$, to match that exiting firms account for approximately 4% of employment and the elasticity of entry rates equal to $\varepsilon = 1.5$, the estimate of [Gutierrez et al. \(2019\)](#) who exploit the comovement between industry-level entry rates and stock prices to pin down this parameter. We set $\tau_s = 0.065$ and $\tau_c = 0.36$ and assume that unexpected capital gains generated from the tax reforms are taxed at a rate $\tau_k = 0.20$, consistent with the US tax code. We use the estimates of the income tax function from [Boar and Midrigan \(2022\)](#), who calibrate $\tau = 0.26$, $\xi = 0.05$ and $\iota = 0.17$ of the mean household income (or approximately \$14,000) to match the relationship between pre- and post-tax income in the CBO data. These values imply that the marginal income tax paid by the median household is 27% and that paid by a household at the 95th percentile of the income distribution is 35%. Panel B of Table 1 summarizes these choices.

Calibrated Parameters. We follow [Castaneda et al. \(2003\)](#) in assuming a fat tailed process for labor market ability to allow the model to better match the tails of the income and wealth distribution. In particular, ability can be in a normal state, where it evolves according to an AR(1) process with autocorrelation ρ_e and standard deviation of Gaussian innovations σ_e , or a super-star state where it is \bar{e} times higher than the average. Households enter the super-star state with probability p and remain there with probability q . Entrepreneurial ability follows an AR(1) process with persistence ρ_z and standard deviation σ_z .

We choose the parameters governing the process for labor market and entrepreneurial ability, the fraction of entrepreneurs, the discount factor, the collateral constraint and the span-of-control parameter to match the moments listed in Panel A of the Table 1. We target the wealth-to-income ratio and moments characterizing overall wealth and income inequality, the fraction of entrepreneurs, their wealth and income shares, the fraction of entrepreneurs in the top 0.1% and 1% wealth brackets, and the Gini coefficients of the wealth and income distributions for entrepreneurs and workers separately. All these statistics are computed using the 2013 SCF. In addition, we target the sales share of corporations reported by [Dyrda and Pugsley \(2018\)](#) and the 0.35 size-weighted average debt-to-capital ratio for entrepreneurs reported by [Crouzet and Mehrotra \(2017\)](#) and [Zetlin-Jones and Shourideh \(2017\)](#).

As Panel A of Table 1 shows, the model successfully reproduces all these statistics. In the model, as in the data, the wealth-to-income ratio is equal to 6.5. Even though only 12% of

households are entrepreneurs, they hold a large share of aggregate wealth and income (44% and 28%) and account for the majority of the households at the top of the wealth distribution. Both wealth and income are unequally distributed, not only across all households but also within the group of workers and entrepreneurs, as shown by the Gini coefficients as well as the top wealth and income shares. The debt to capital ratio is equal to 0.34 and corporate firms account for 63% of all sales.

Panel B of Table 1 reports the calibrated parameters. The discount factor is $\beta = 0.969$. The persistence of labor ability in the normal state is 0.981 and the standard deviation of innovations is $\sigma_e = 0.198$. Households enter the super star state, where ability is $\bar{e} = 474$ larger than the average, with probability $p = 2.1\text{e-}6$ and stay there with probability $q = 0.985$. The persistence of entrepreneurial ability is 0.961 and the standard deviation of innovations is $\sigma_z = 0.696$. The estimated maximum leverage ratio is $\lambda = 2.3$ and the span-of-control is $\eta = 0.78$.

Intuitively, the discount factor is pinned down by the overall wealth-to-income ratio, while the parameters of the labor and entrepreneurial ability process are pinned down by moments of wealth and income inequality. The maximum leverage ratio is pinned down by the debt to capital ratio and the relative productivity of corporate firms by their sales share. Finally, the span-of-control parameter determines the relative share of payments to labor versus profits, and is therefore pinned down by the income and wealth share of entrepreneurs.

We briefly discuss the model's implications for the severity of financial constraints. We note that the capital-weighted fraction of constrained entrepreneurs is equal to 43%, reflecting the relatively low value of the leverage ratio λ of 2.3 necessary to match the debt-to-capital ratio of entrepreneurs in the data. Nevertheless, our model predicts relatively small overall losses from misallocation, of 1.3%, similar to those in [Midrigan and Xu \(2014\)](#), partly reflecting that corporate firms are unconstrained and partly that entrepreneurial ability is persistent so productive entrepreneurs grow out of their borrowing constraints. The capital wedge $\bar{\phi}$ induced by collateral constraints depresses the capital-output ratio of entrepreneurial firms by 17% and the aggregate capital-output ratio by 6%.

4 Results

To compute optimal policy, we need to take a stand on the social welfare objective of the planner. We start by computing a measure of consumption-equivalent welfare for each household

Table 1: Parameterization

A. Moments Used in Calibration

	Data	Model
Wealth to income ratio	6.6	6.5
Percentage entrepreneurs	11.7	11.7
Wealth share of entrepreneurs	0.46	0.44
Income share of entrepreneurs	0.31	0.28
Fraction entrepr., top 0.1% wealth	0.66	0.65
Fraction entrepr., top 1% wealth	0.70	0.80
Gini wealth, all hhs	0.85	0.87
Gini income, all hhs	0.64	0.66
Gini wealth, entrepr.	0.78	0.78
Gini income, entrepr.	0.68	0.68
Gini wealth, workers	0.81	0.87
Gini income, workers	0.58	0.62
Wealth share top 0.1%	0.22	0.17
Wealth share top 1%	0.35	0.37
Income share top 0.1%	0.14	0.12
Income share top 1%	0.22	0.22
Average debt to capital ratio	0.35	0.34
Sales share of corporate firms	0.63	0.63

B. Parameter Values

<i>Assigned</i>			<i>Calibrated</i>		
θ	1	CRRA	β	0.969	discount factor
γ	2	inverse Frisch elasticity	ψ	0.117	share of entrepreneurs
α	1/3	capital elasticity	ρ_z	0.961	AR(1) z
δ	0.06	depreciation rate	σ_z	0.696	std. dev. z shocks
B	1	government debt to GDP	ρ_e	0.981	AR(1) e
τ_c	0.36	corporate profits tax	σ_e	0.198	std. dev. e shocks
τ_k	0.20	capital gains tax	p	2.1e-6	prob. enter super-star state
φ	0.04	exit rate, corporations	q	0.985	prob. stay super-star state
ε	1.5	elasticity of entry rate	\bar{e}	474.0	ability super-star state, rel. to mean
τ	0.26	average marg tax	λ	2.303	leverage constraint
ξ	0.05	slope marg tax	η	0.784	span of control
ι	0.17	lump-sum transfer to income	z	2.63	productivity corporate firms

i using

$$V_i = \sum_{t=0}^{\infty} \beta^t \frac{\omega_i^{1-\theta}}{1-\theta},$$

where V_i is the lifetime utility of the household, defined in equation (1). We aggregate individual welfare according to

$$\left(\int_i \omega_i^{1-\Delta} di \right)^{\frac{1}{1-\Delta}},$$

where $\Delta \geq 0$ is a parameter that determines the planner's preference for redistribution. In particular, if $\Delta = 0$, the planner seeks to maximize average welfare (Benabou, 2002). If $\Delta = \theta$, then the social welfare function recovers the preference of a Utilitarian planner. In the limit, as $\Delta \rightarrow \infty$ the objective is that of a Rawlsian planner.

Our optimal policy exercise considers one-time, unanticipated, and permanent changes in the tax parameters. We assume that government debt and the consumption tax are constant and adjust the lump-sum transfer ι_t to balance the government budget at each date during the transition.

For most of our analysis we assume the planner is restricted to using flat taxes on labor income, capital income, and/or wealth. As we discuss below, the gains from non-linear taxation are small, confirming the results of Boar and Midrigan (2022) even in this richer setting. Letting τ_l , τ_k and τ_a denote the flat labor income, capital income and wealth tax, respectively, the budget constraint of a household is

$$(1 + \tau_s) c_t + a_{t+1} = (1 - \tau_l) W_t e_t h_t + (1 - \tau_k) (r_{t-1} a_t + \pi_t(a_t, z_t)) + (1 - \tau_a) a_t.$$

Given this specification, allowing the government to tax capital income as well as wealth implicitly allows it to tax returns to entrepreneurial activity at a different rate than returns to labor market activity and risk-free saving. This is in contrast to the status quo in the US and in our benchmark model, in which all these activities are taxed at a uniform rate.

4.1 Optimal Policy

We next report the optimal policies chosen by a utilitarian planner and the associated welfare gains. To understand the relative merits of capital income and wealth taxation we proceed incrementally. We first allow the government to tax capital and labor income only, and set $\tau_a = 0$. We then consider the case in which the government can only tax labor income and wealth, and impose $\tau_k = 0$. Finally, we consider the unrestricted case in which the government can use all three tax instruments.

The first column of Table 2 shows that when the wealth tax is restricted to zero, the planner taxes capital income at 65.6%, a rate higher than the 53.2% rate on labor income. This result is in contrast to Boar and Midrigan (2022), who find that in an economy without entrepreneurs it is optimal to tax capital income at a lower rate than labor income. Optimal policy increases utilitarian welfare by 9.5%, primarily reflecting gains concentrated in the bottom third of the welfare distribution. For these households utilitarian welfare increases by 32.2%. Households in the middle of the distribution benefit as well, albeit to a lesser extent (8.8%), while households at the top lose 8.8%. Recall that all these numbers are in consumption-equivalent units. We also note that taxing capital income greatly benefits workers whose utilitarian welfare increases by 12.2%, at the expense of entrepreneurs whose welfare falls by 8.7%.

The second column of the table shows that when the capital income tax is instead restricted to zero, the planner taxes wealth at 4.3% and utilitarian welfare only increases by 5.6%. Relative to the policy that taxes capital income, all terciles of the initial welfare distribution are faring worse. For example, the bottom third of the distribution gains only 26.6% and the middle third gains only 4.2%. Since under this reform the planner no longer taxes entrepreneurial income, entrepreneurs experience welfare gains of 3.6%. However, workers experience smaller welfare gains, of only 5.9%. These results reflect that a wealth tax is much less redistributive compared to a capital income tax. Since entrepreneurs earn, on average, more income than workers, a policy that does not tax entrepreneurial income does not achieve enough redistribution.

Lastly, the third column of Table 2 reports the consequence of allowing the government to simultaneously tax capital income and wealth. The optimal wealth tax is equal to zero, even though we did not impose any restrictions on its sign. Consequently, there are no welfare gains from introducing a wealth tax provided capital and labor income taxes are chosen optimally. As we show below, depending on the preference for redistribution embedded in the social welfare function, it might be optimal to tax or subsidize wealth accumulation, but the welfare consequences of introducing a wealth tax are relatively small.

To further illustrate the equity-efficiency tradeoff entailed by capital income and wealth taxes, the top row of Figure 1 shows the transition dynamics of output Y_t , the losses from misallocation Z_t/Z_t^* , and the aggregate capital wedge $\bar{\phi}_t$ upon implementing the optimal capital income tax and wealth tax reforms in isolation. The bottom row plots the transition dynamics of the wealth share of entrepreneurs and the Gini coefficients of the wealth and

Table 2: Optimal Policy, Utilitarian Planner

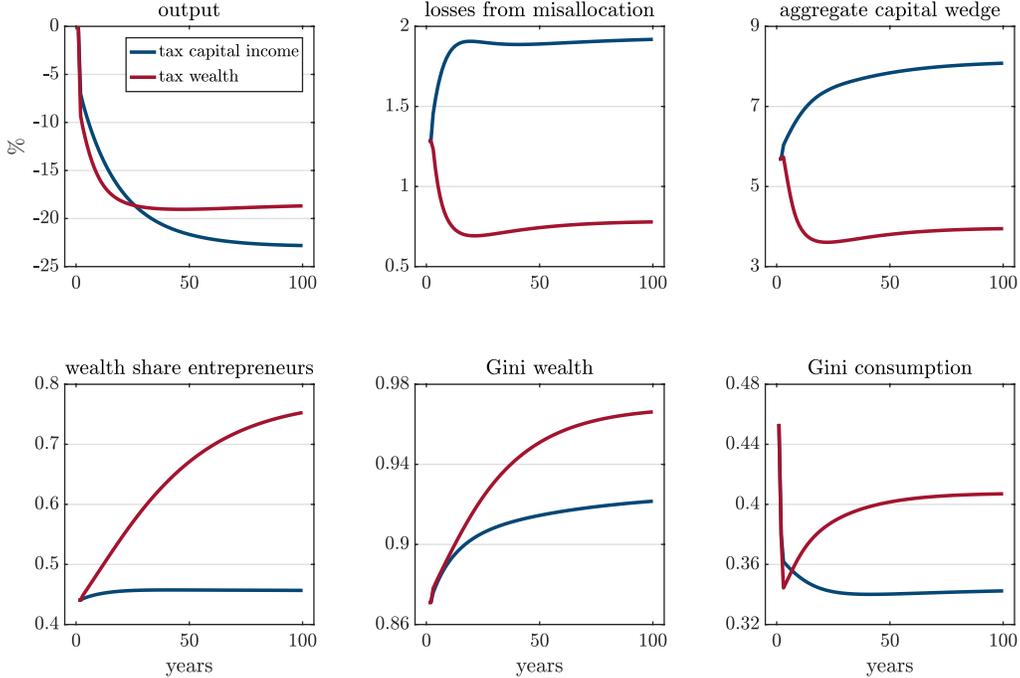
	Tax capital income	Tax wealth	Tax capital income and wealth
A. Tax Schedule			
labor income tax	53.2	55.6	53.2
capital income tax	65.6	—	65.6
wealth tax	—	4.3	0.0
B. Welfare Change			
utilitarian welfare	9.5	5.6	9.5
bottom 1/3	32.2	26.6	32.2
middle 1/3	8.8	4.2	8.8
top 1/3	-8.8	-10.8	-8.8
workers	12.2	5.9	12.2
entrepreneurs	-8.7	3.6	-8.7

consumption distributions.

We note that output falls substantially under both reforms, because of the distortions in the labor and savings choices induced by higher taxes, but output falls more when we tax capital income. The differential response of output reflects that under capital income taxes financial frictions become more severe. First, the losses from misallocation increase, as shown in the middle panel. Second, the aggregate capital wedge increases as well, resulting in a decline in the capital-output ratio. Intuitively, a capital income tax disproportionately affects productive entrepreneurs' ability to save and grow out of the borrowing constraints. In contrast, a wealth tax improves allocative efficiency, nearly halving the losses from misallocation, and also reduces the aggregate capital wedge. These findings corroborate the insight of [Güvener et al. \(2019\)](#), who point out that a wealth tax may improve allocative efficiency by reducing the relative tax burden of productive entrepreneurs.

However, since these misallocation losses are relatively small to begin with, the efficiency gains from wealth taxation are swamped by its redistributive consequences. As the second row of the figure shows, an optimally chosen wealth tax increases the wealth share of entrepreneurs from 44% in the initial steady state to 75% in the new one. This leads to a higher increase in wealth inequality relative to what a capital income tax reform achieves, and a smaller decline in consumption inequality. Interestingly, wealth inequality increases under

Figure 1: Effect of Capital Income and Wealth Taxes



both reforms because they increase lump-sum transfers and reduce the incentives to work and save of the poor. This suggests that measures of wealth inequality do not necessarily capture inequality in welfare, which decreases under both reforms.

Overall, we conclude that a capital income tax is preferred to a wealth tax. This result differs from [Güvenen et al. \(2019\)](#), who argue that a wealth tax is preferable to taxing capital income. Our analysis deviates from theirs along a number of dimensions. In contrast to [Güvenen et al. \(2019\)](#), in our framework entrepreneurs co-exist with unconstrained corporate firms and operate a technology that uses both capital and labor. Our losses from misallocation are therefore much smaller than in their setting (1.3% vs. 20%). In addition, we target the large wealth and income concentration in the hands of entrepreneurs, allow for lump-sum transfers, and conduct optimal policy taking transition dynamics into account. Though there is much debate about how large are the losses from misallocation induced by financial frictions,³ our insight applies more broadly: one cannot evaluate the relative merits of wealth and capital income taxation without factoring in their distributional implications.

³See [Boar et al. \(2022\)](#) who argue that commonly used measures of dispersion in accounting returns to wealth or in capital-output ratios greatly overstate the degree of misallocation implied by financial frictions.

Table 3: Optimal Policy, Alternative Social Welfare Functions

	Tax capital income	Tax wealth	Tax capital income and wealth
A. Maximize Average Welfare			
labor income tax	47.1	50.3	48.5
capital income tax	49.0	—	63.6
wealth tax	—	1.5	−1.0
average welfare	1.7	−0.4	2.0
B. Maximize Rawlsian Welfare			
labor income tax	72.8	74.6	72.6
capital income tax	72.4	—	63.3
wealth tax	—	6.6	1.1
rawlsian welfare	74.1	67.5	74.6

4.2 Alternative Social Welfare Functions

We next gauge the robustness of our results to alternative social welfare functions. Table 3 summarizes the optimal tax schedules and the implied welfare gains for a planner who seeks to maximize average welfare ($\Delta = 0$) and a planner who seeks to maximize the welfare of the poorest agent ($\Delta = \infty$).

We find that, irrespective of the preference for redistribution, a capital income tax is preferable to a wealth tax. A planner who seeks to maximize average welfare and can only tax capital income in addition to labor income is able to increase average welfare by 1.7%. In contrast, if this planner can only tax wealth in addition to labor income, optimal policy reduces average welfare relative to the status quo by 0.4%. Moreover, even when the planner can tax both capital income and wealth, the marginal welfare gains from introducing a wealth tax are small. The optimally chosen wealth tax is equal to -1% and generates welfare gains of 2%, only slightly larger than the 1.7% that can be attained without subsidizing wealth. We draw a similar conclusion for a Rawlsian planner. This planner sets the wealth tax to 1.1% and is able to increase the welfare of the poorest household by 74.6%, very similar to the 74.1% increase it can achieve without a wealth tax. Not surprisingly, the stronger the planner’s preference for redistribution the larger are tax rates on labor income, capital income and wealth.

4.3 Non-linear Taxes

We next show that our conclusion that a capital income tax is preferred to a wealth tax and that the marginal gains of introducing a wealth tax are small is robust to allowing for non-linear income and wealth taxes. We assume that the government taxes labor income $W_t e_t h_t$, capital income $ra_t + \pi_t$ and wealth a_t using tax schedules of the HSV form $T_s(y) = y - (1 - \tau_s) \frac{y^{1-\xi_s}}{1-\xi_s}$, where y represents the base subject to taxation and $s \in \{l, k, a\}$. As earlier, τ_s governs the average level of taxes and ξ_s governs the slope of the tax schedule.

Because tax parameters are not easily interpretable on their own, Figure 2 depicts the optimal marginal labor income, capital income and wealth tax schedules as a function of their respective tax base. As earlier, we consider three experiments in which the government only taxes labor and capital income, labor income and wealth and all three simultaneously. The figure also reports the welfare gains from each of these optimal reforms.

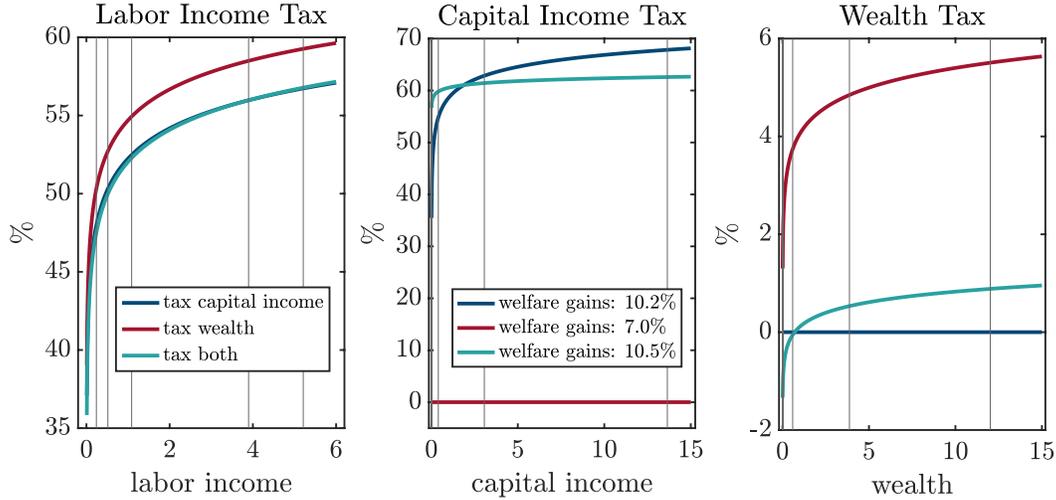
We make three observations. First, optimal marginal income and wealth taxes are upward sloping, reflecting the large inequality in the economy. Second, in line with our baseline results, taxing capital income yields higher welfare gains than taxing wealth (10.2% vs. 7%). Moreover, when the planner can tax both capital income and wealth the optimal wealth tax is relatively low and the incremental gains from introducing the wealth tax are small as well (10.5% vs. 10.2%). Third, allowing for non-linear marginal taxes generates only small additional welfare gains compared to the flat tax schedule reported in Table 2, a point that echoes the findings of [Boar and Midrigan \(2022\)](#) in an economy without entrepreneurs.

5 Conclusion

When private business owners are financially constrained, they differ in their returns to saving. As pointed out by [Güvener et al. \(2019\)](#), this heterogeneity in rates of return implies a non-trivial distinction between capital income and wealth taxation. This paper characterizes the optimal tax on capital income and wealth in an economy with private businesses that reproduces the degree of inequality observed in the U.S., as well as the large income and wealth shares of private business owners.

We find that capital income taxation is preferred to wealth taxation if the government is restricted to taxing only one of these in isolation. This is because the redistribution motive dominates the efficiency gains from increasing the wealth share of private business owners. When the planner is able to tax both capital income and wealth, the incremental gains from

Figure 2: Nonlinear Taxes



Notes: The lines represent the optimal marginal taxes on labor income, capital income and wealth. Vertical bars represent the 25th, 50th, 75th, 95th and 99th percentiles of the income and wealth distributions in the initial steady state. The x-axes report income (wealth) relative to mean income (wealth) in the initial steady-state.. The legend in the second panel reports the welfare gains from each experiment.

wealth taxation are small and the optimal wealth tax is close to zero. This result is robust to the planner’s preference for redistribution, as well as to allowing for non-linear income and wealth taxes.

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