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COMPREHENSIVE INCOME TAX, IMPERFECT LABOR MARKETS AND OPTIMAL REDISTRIBUTIVE POLICY

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Comprehensive income tax, imperfect labor markets and optimal redistributive policy

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Abstract

The tax reforms occurred during the eighties in most industrialized countries were mainly guided by a shift toward a less pervasive Welfare State. In general, these reforms reduced the progressivity of the income taxation system, given the growing concern about the efficiency costs of such redistributive taxation policies. However, since the last decade, considering the so called "skilled-biased technological change" - and the consequent increase in wage (income) inequality - governments in charge are now paying more attention to the welfare effects of redistributive policies. The present paper concentrates on two problems. We first look at a characteristic of income taxes in most developed countries often neglected in previous studies, and we evaluate the welfare effects of redistributive policies when labor income tax differs from a capital income tax. In particular, given that capital incomes are more unequally distributed than labor incomes, a progressive labor income tax and a proportional capital income tax is compared here with a comprehensive income taxation policy. We then consider alternative tools available for redistribution to governments, looking in particular at social expenditures (considered both as cash and in-kind transfers).

The theoretical evaluation of relative costs and benefits of redistributive policies is not new in the literature. For instance, Benabou [2002] presents a dynamic heterogeneous agent model with endogenous effort and missing credit and insurance markets. He considers two alternative policies, a progressive income tax and progressive education finance. The costs of these policies derive from the distortions in agents' labor supply and/or savings decisions. Consumption taxes and investment subsidies are introduced to correct for the distortions in the savings decisions. Therefore saving is restored to its optimal level. The benefits of these policies are expressed in terms of higher insurance against the risk of negative shocks and lower credit constraints, which do not allow certain investment. Benabou shows that in order to achieve a higher growth rate, an education finance redistributive policy always dominates income tax progressivity and transfers. The intuition behind this result is that the former policy implies smaller distortions to agents' effort; the opposite holds from an insurance point of view.

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The current analysis differs from the contribution by Benabou in several respects. Firstly, we focus on the welfare effects of redistributive policies in the presence of unemployment. We will attempt to take into account the governments' concern about the increase in wage (income) inequality due to a higher "skilled-biased" labor demand. Secondly, we contribute also to the debate on whether capital should be taxed differently (at a lower rate) from labor. As shown by Koskela and Schob [2002], in the presence of unemployment the standard textbook result according to which internationally mobile capital should be taxed at a lower rate does not hold. In their static model of imperfect labor markets, it is optimal to tax more heavily capital income than labor income. The present paper will evaluate whether this result holds true by comparing the optimal taxation structures and the level of public expenditure in presence of a progressive labor income taxation system and a proportional capital income tax and those derived in presence of a comprehensive taxation system.

In our theoretical analysis, we model the individuals' behavior as depending on the wealth distribution. The presence of a distortionary income taxation system and of an imperfect labor market introduce some conflicting effects according to which the welfare impact of a redistributive policy financed by an increase in tax progressivity is ambiguous. A similar result can be found in Benabou [1996] where greater redistribution leads to two conflicting effects: on the one hand, it disincentives the individuals' human capital investment rate; on the other hand, it relaxes the credit constraints faced by the poor and - given the assumption of decreasing returns to investments - allows the poor to earn a higher return. According to Benabou, the growth maximizing tax rate depends on the degree of pre-tax inequality. In our model the presence of a higher (wealth) income inequality due to the skilled bias technological change implies a shift toward a higher redistribution (e.g. an increase in the marginal tax rate faced by the high skilled workers). However, this taxation policy may increase the skilled-unskilled wage gap given the higher wage pressure that arises.

The aim of our analysis is to define the optimal Government's redistributive policy. The costs and benefits of alternative redistributive policies are evaluated also numerically by means of some microsimulation exercises using data for Italy. We exploit results by Atkinson (1970) and Shorrocks (1983), and define the optimal policy by considering the Lorenz dominance approach. In order to take into account the fact that governments redistribute resources also by directly providing services, differently from previous microsimulations, we consider also in-kind transfers together with cash transfers. We show how income distribution change when considering, besides the redistributive aspects of taxes, the redistribution operated through expenditures. This appears to be important also to evaluate the recent proposal of the Italian Government that - given the planned switch towards a less progressive labour income tax and the international constraints on public deficits - will probably cut also social expenditures.

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