Taxes on Capital Income

\[ \tau_r \]

The Tax on Wage Income

The impact of a short run wage tax

The Demand and Supply of Loans

Is there a comparable \( \tau_r \)?

The Demand and Supply of Loans

If we tax capital income at \( \tau_r \), equilibrium will move

The Demand and Supply of Loans

If we tax capital
The higher rate that borrowers pay means less investment
The Demand and Supply of Loans

And there is an efficiency loss

\[ r_1 \]
\[ r_0 \]
\[ (1 - \tau_r) r_1 \]

The Problem

\[ \tau^* = \frac{\tau_w + \tau_s}{1 + \tau_s} \]

Is there a comparable formula for \( \tau_r \)?

How We Tax Interest Income

- Corporate Profits Tax
- Taxes on Dividends
- Taxes on Capital Gains
- Interest Income

But It Gets Worse

- Sally puts money every year into an IRA. The contributions come from her wage income and are shielded from \( \tau_w \).
- When she retires, the account is worth $1,000,000. She begins to make (taxable) withdrawals. What is \( \tau_w \)? \( \tau_r \)?

The Solution

\[ \tau_r = f(\tau_1, \tau_2, \tau_3, \tau_4, \ldots) \]
Our Scenario

• Suppose
  – The tax rate on dividends is lowered
  – Capital gains taxes are lowered
  – IRA plans are liberalized

Taxes on Capital Income

Our Scenario

• Suppose
  – The tax rate on dividends is lowered
  – Capital gains taxes are lowered
  – IRA plans are liberalized
• Each effectively lowers $\tau_r$

Taxes on Capital Income

There is More

• In fact, there are other effects.
  – Companies sometimes repurchase stock rather than pay dividends; there are tax advantages. These are so-called back-door dividends.
  – A lower tax on dividends, reduces the incentive for back door dividends, and may lead to more dividends and reduced stock repurchases.

Taxes on Capital Income

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• In fact, there are other effects.
  – Companies sometimes repurchase stock rather than pay dividends; there are tax advantages. These are so-called back-door dividends.
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But this is just too much detail for this course.

Taxes on Capital Income

Our Agenda

• Suppose we want to analyze a reduction in dividend taxes.

Taxes on Capital Income

Our Agenda

• Suppose we want to analyze a reduction in dividend taxes.
  • We will treat it as a reduction in $\tau_r$
Our Agenda

• Suppose we want to analyze a reduction in dividend taxes.
• We will treat it as a reduction in $\tau_r$
• We ignore the impact on stock repurchases

End

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