Optimal Labor Income Taxation[*]

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September 2012 (comments welcome)

Abstract

This handbook chapter reviews recent developments in the theory of optimal labor income taxation. We emphasize connections between theory and empirical work that were initially lacking from optimal income tax theory. First, we provide historical and international background on labor income taxation and means-tested transfers. Second, we present the simple model of optimal linear taxation. Third, we consider optimal nonlinear income taxation with particular emphasis on the optimal top tax rate and the optimal profile of means-tested transfers. Fourth, we consider various extensions of the standard model including tax avoidance and income shifting, international migration, models with rent-seeking, relative income concerns, the treatment of couples and children, and non-cash transfers. Finally, we discuss limitations of the standard utilitarian approach and briefly review alternatives. In all cases, we use the simplest possible models and show how optimal tax formulas can be derived and expressed in terms of sufficient statistics that include social marginal welfare weights capturing society's value for redistribution, behavioral elasticities capturing the efficiency costs of taxation, as well as parameters of the earnings distribution. We also emphasize connections between actual practice and the predictions from theory, and in particular the limitations of both theory and empirical work in settling the political debate on optimal labor income taxation and transfers.

Keywords
optimal taxation, behavioral responses to taxation, means-tested transfers

JEL classification: H21

Table 1. Public spending in OECD countries (2000-2010, percent of GDP)

	US	Germany	France	UK	Total OECD
	(1)	(2)	(3)	(4)	(5)
Total public spending	**35.4%**	**44.1%**	**51.0%**	**42.1%**	**38.7%**
Social public spending	**22.4%**	**30.6%**	**34.3%**	**26.2%**	**25.1%**
Education	4.7%	4.4%	5.2%	4.8%	4.9%
Health	7.7%	7.8%	7.1%	6.1%	5.6%
Pensions	6.0%	10.1%	12.2%	4.8%	6.5%
Income support to working age	2.7%	3.9%	4.8%	4.9%	4.4%
Other social public spending	1.3%	4.4%	5.1%	5.7%	3.7%
Other public spending	**13.0%**	**13.5%**	**16.7%**	**15.9%**	**13.6%**

Notes and sources: OECD Economic Outlook 2012, Annex Tables 25-31; Adema et al., 2011, Table 1.2; Education at a Glance, OECD 2011, Table B4.1. Total public spendings include all government outlays (except net debt interest payments). Other social public spending include social services to the elderly and the disabled, family services, housing and other social policy areas (see Adema et al., 2011, p.21). We report 2000-2010 averages so as to smooth business cycle variations. Note that tax to GDP ratios are a little bit lower than spending to GDP ratios for two reasons: (a) governments typically run budget deficits (which can be large, around 5-8 GDP points during recessions), (b) governments get revenue from non-tax sources (such as user fees, profits from government owned firms, etc.).