Taxation of Top Incomes and Tax Avoidance
Alessandro Di Nola¹, Georgi Kocharkov², Almuth Scholl¹, Anna-Maria Tkhir³, Haomin Wang¹
¹University of Konstanz ²Deutsche Bundesbank ³Goethe University Frankfurt

Motivation
• Recent increase in concentration of income at the top led to proposals to significantly raise the top marginal income tax rate (Diamond and Saez, 2011). However, elasticity of taxable income (ETI) is high at the top (Mertens and Gela, 2014).
• Many top earners are business owners: 40% of the top 1% income is business income.
• Entrepreneurs can (1) report income as wage or profit to lower tax liability (2) choose pass-through business to avoid the double taxation on C-corporations.

<table>
<thead>
<tr>
<th>Income Types</th>
<th>Wage only</th>
<th>Wage and Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Access to Capital</td>
<td>Difficult</td>
<td>Easy</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>Minimal</td>
<td>Medium</td>
</tr>
<tr>
<td>Tax on Profit</td>
<td>Income Tax</td>
<td>Corp + Dividend Tax</td>
</tr>
<tr>
<td>Prevalence</td>
<td>67%</td>
<td>24%</td>
</tr>
</tbody>
</table>

Research Questions
• How does tax avoidance affect tax revenue and productive efficiency?
• What are the aggregate and distributional consequences of an increase in the top marginal tax rate and in tax progressivity in the presence of tax avoidance?

Heterogeneous-Agent Model
• Agents have different working and entrepreneurial abilities (\(z\), \(d\)) and asset levels (\(o\)).
• Occupational choice: Worker or Entrepreneur.
• Entrepreneurs choose to be sole proprietors, S-corps, or C-corps.
• S- and C-corp owners choose to declare fraction \(o\) of income as wage and the rest as profit.

Reform 1: Eliminating Tax Avoidance
We consider two counterfactual scenarios:
1. No intensive margin of tax avoidance: S-corps are subject to the same tax treatment as sole-prop., and C-corps cannot report labor income.
2. No tax avoidance on any margin: All entrepreneurs are subject to the same tax treatment as sole-prop., i.e. pay income and payroll taxes.

Reform 2: Increasing Tax Progressivity
We consider a revenue-neutral increase in income tax progressivity under:
1. the benchmark economy with tax avoidance, and
2. the no-tax-avoidance economy (scenario 2), where all businesses pay income taxes.

### References