

Econ 131
Spring 2019
Emmanuel Saez

Problem Set 2

DUE DATE: April 3

Student Name:

Student ID:

GSI Name:

- **You must submit your solutions using this template.**
- **Although you may work in groups**, each student must submit individual sets of solutions. You must note the names other students that you worked with. Write their names here:

1. Essay

Read the following recent New York Times article discussing the consequences of the 2018 Trump corporate tax cut. Write a short essay [the essay has to fit in the page below] discussing what we learn from this article about the incidence of the corporate tax cut in light of what we discussed in class. Do you find the empirical facts laid out in the article conclusive? (Why or why not?).

NY Times link:

<https://nyti.ms/2DjpHXJ>

(d) Evidence from the Israeli Kibbutz implies that redistribution does not hurt people's incentives to work.

(e) If wealth comes primarily from life-cycle savings, there should be no tax on capital income.

(f) Tax havens lower taxes on the rich.

3. Capital Income and Savings Taxation

Consider a 2 period model where individuals earn labor income $Y = 200$ from working in period 1 and do not work in period 2 (retirement). Individuals choose how much to consume in each period. Savings in period 1 earn an interest rate $r = 25\%$. Let C_1 denote consumption in period 1 and C_2 denote consumption in period 2. Suppose that individuals have a utility function $U = \ln C_1 + \ln C_2$.

- (a) Set up the individual's lifetime utility maximization problem and solve for the optimal C_1 , C_2 , and S in an economy without taxes.

Now assume that a comprehensive income tax $\tau = 20\%$ is imposed on both labor and savings income.

(b) Find the optimal C_1 , C_2 , and S .

(c) Compare the ratio of consumption C_2/C_1 in (a) and (b). Does the comprehensive income tax distort consumption choices?

(d) How much revenue does the government collect from each individual under the comprehensive income tax system?

Suppose now that the government is considering switching to a system where only the labor income is taxed.

(e) Find the labor income tax τ_L that would raise as much revenue as is collected under the comprehensive income tax system.

(f) Find the optimal C_1 , C_2 , and S .

(g) Compare the ratio of consumption C_2/C_1 in (a) and (f). Does the Labor income tax distort consumption choices?

Consider now that individuals have the opportunity of shifting half of their labor income into savings income.

(h) How much revenue would be collected from each individual under the labor income taxation system?

(i) Under this scenario which tax system would collect more revenue? Explain.