Optimal Capital Income Taxation in the Presence of Private Donations to a Public Good

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Abstract

We investigate optimal nonlinear labor and capital income taxation joint with taxes on the contribution good in an overlapping generation setting, when individuals can contribute to a public good. We show that when individuals can contribute to a public good—even if additive and separable preference between consumption and labor supply is assumed and individuals differ only in earning abilities—marginal capital income tax rates for low-income earners are not zero, indicating that the Atkinson-Stiglitz theorem does not hold. The point is that heterogeneous tastes for private consumptions endogenously occur. Here, two types of indirect taxes, capital income taxes and taxes on private donations, are useful in a complementary tax policy in mitigating the incentives for high-income earners to mimic low-income earners. In addition, we derive the formula for optimal tax treatment of a public good, which is expressed in terms of the Pigouvian effect, and the effect on the incentive compatibility constraint.

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