

Discussion of "Market Power and Income Taxation" by L. Kaplow and "Generalized Compensation Principle" by A. Tsyvinski and N. Werquin

Antoine Ferey
Ecole Polytechnique, CREST

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Market Power and Income Taxation

- **Question:** Does market power interact with income taxation?
 - Do the induced rents affect optimal income taxation problem?
 - Do redistributive concerns affect market power regulations?
- **Set-up:** Non-linear income tax $T(y)$ with aggregate profits Π
 - Heterogeneous earnings ability $w \leftrightarrow y$
 - Multiple goods sold with markup $p_i = c_i + \mu_i$
 - Profit ownership as a function of income $\theta(y)$

⇒ Atkinson, Stiglitz (1976) economy where μ_i replaces t_i

Paper & Take-Away

1. Provide **equivalence result**

- If markups are proportional $\frac{\mu_i}{p_i} \equiv \lambda_i = \lambda$, the economy E is equivalent to economy \hat{E} without markups

$$\hat{T}(y) = (1 - \lambda)T(y) + \lambda y - (1 - \lambda)\theta(y)\Pi$$

2. Consider **changes in markups with compensating tax reform**

- Marginal decrease in markup μ_i with a compensating tax reform is Pareto-improving if and only if markup is high $\lambda_i > \bar{\lambda}_{-i}$

3. Robust to markups covering real resource costs, up to adjustments in ability distribution and above inequality

⇒ **Redistribution and market regulation can be separated**

1. Equivalence: redistribution problem is independent of profits
2. Compensation: market regulation guided by total surplus test

Discussion

- Simple and elegant contribution on very topical issue
 - Important benchmark, yet many open questions
- Simplicity requires a number of assumptions
 - Separable preferences
 - One-dimensional heterogeneity
 - Implicit **unconstrained ability to tax profits** (profit taxes?)
- Natural extension: **commodity taxes** $p_i = c_i + \mu_i + t_i$
 - Uniform commodity taxes to reduce relative distortions?
 - Higher commodity taxes on more competitive sectors?
 - Is reducing market power then always beneficial?
- Exogenous markups and market power: impact of endogenous market structure and **general equilibrium** effects?

Generalized Compensation Principle

- **Question:** Is it possible to design a tax reform that compensates the welfare impacts of an arbitrary economic disruption?
 - Wage disruption: technological change or immigration inflow
- **Set-up:** General equilibrium setting with distortionary taxes
 - Endogenous wages w_i
 - Heterogeneous earnings ability θ_i [labor supply]
 - General production function \mathcal{F} [labor demand]
 - Non-linear income tax $T(y)$
- **Difficulty:** Infinitely many feedback effects
 - Disruption \implies 1st compensation \implies 2nd compensation ...

Paper & Take-Away

1. Compensation in **partial equilibrium** in simple model
 - No feedback, first compensation adjusts average tax rates
 - Associated changes in marginal tax rates yields impact on budget
2. Compensation in **general equilibrium** in simple model
 - Fixed-point solves jointly for all average and marginal tax rates
 - System of *Integro-Differential Algebraic Equations* (IDAE)
3. Compensation in general equilibrium in **general model**
 - General utility function, extensive margin of labor supply
 - General production function with capital and capital income taxes

⇒ **Always possible to compensate economic disruptions**

- Paper characterizes compensation and its budget impact

4. Application: compensation of **automation** in US and Germany

Discussion

- Major contribution to **General Equilibrium Public Finance**
 - Why now? Recent mathematical tools (2006 IDAE textbook)
 - Amazingly crafted: very technical and yet very intuitive
- General model relaxes all assumptions but
 - Competitive labor and goods market
 - One-dimensional heterogeneity
 - Marginal economic disruptions
- Minor clarification: properties of $\hat{T}(y)$ and $\hat{T}'(y)$?
 - Is continuity of $\hat{T}(y)$ and $\hat{T}'(y)$ ensured in compensation?

Big Picture: Compensating Variation Approach

- Compensating variation is an **interesting approach**
 - Constructive: full closed-form analytical solutions
 - Policy-relevant: based on actual distributions and elasticities
- Compensating variation **orthogonal to gov't objective**
 - Characterizes how compensation can be done and its cost
- Can be applied to tackle many questions involving redistribution without relying on any particular social welfare function
 - Market regulation, labor market policies, political economy ...