

# On Optimal Taxation in the Presence of *Non-Capitalist* Households.

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## Abstract

In this paper, I examine optimal taxation in a Neoclassical framework in which a fraction of households do not accumulate capital, herein referred to as *non-capitalists*. In particular, I compare optimal tax setting in a standard model without the so-called *non-capitalists* to one that features both category of households. I find that, first, the standard results in the literature supporting zero capital income taxation is sub-optimal once we account for these *non-capitalist* households. Specifically, the optimal capital income tax rate is not only negative, but falls with the share of *non-capitalist* households. Secondly, volatility in the labor income tax rate is contingent on whether we have consumption taxes or not. The labor income tax rate is optimally non-constant once we account for consumption taxes, irrespective of whether there are *non-capitalists* present or not. This result is also contrary to the widely publicized findings in tax literature regarding smoothness of labor income taxes. Moreover, optimality requires that we design tax policy in favor of more consumption taxes relative to capital and labor income taxes when the fraction of *non-capitalist* households is larger. This is due to the potentially lower crowding out effects of consumption taxes on capital as opposed to that of income taxes.

**JEL codes:** E12, E62, F41, H63

**Keywords:** optimal taxation, tax smoothing, capital accumulation.