

Taxing Capital Income to Consolidate – An Incomplete Markets Perspective

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Abstract

This paper studies tax-based vs. expenditure-based fiscal consolidation in a Heterogeneous Agent New Keynesian (HANK) model that features a portfolio choice between liquid government debt and less liquid capital. Fiscal consolidations, i.e. a reduction of government debt over an extended period of time, crowd-in capital in the medium run. This is independent of whether the fiscal consolidation is financed through government expenditure cuts or labor tax and/or capital tax hikes. Government expenditure cuts and, even to a stronger extent, labor tax hikes are recessionary in the short run, while an increase in capital taxation is expansionary at all horizons, despite being strongly recessionary under complete markets. Key to this result is that, when asset markets are incomplete, the precautionary savings motive substantially reduces the interest rate elasticity of savings in comparison to complete markets and introduces household liquidity as an additional motive for building up capital.