

The taxation of labour vs. capital income: A focus on high earners

August 2023

Recent years have seen growing interest in differences between labour and capital income taxation. New stylised effective tax rates show that governments almost always tax the capital income individuals receive more favourably than wage income. But that is only part of the story, because governments also usually tax labour and capital income at the firm level. After accounting for firm-level taxes, capital is still taxed more favourably than labour in many OECD countries, but in others, the reverse is true.

Interest in the taxation of labour and capital income is growing

Many governments tax labour and capital income differently, in line with prevailing theoretical views that capital should be taxed more favourably than labour. But recent academic findings have challenged these views, with some studies supporting better alignment of the tax treatment of capital and labour. The concentration of capital income among high income earners and concerns about inequality also are driving greater interest in the topic.

Governments tax individuals' capital income more favourably than labour income, benefitting high earners

In most countries, when looking at taxes payable by individuals at hypothetical high income levels¹ (including personal income taxes and employee social security contributions), stylised effective tax rates (ETRs) reveal that dividends or capital gains from shares are taxed more favourably than wage income (Figure 1). Reasons include that capital income may be taxed under a separate tax rate schedule (e.g. at lower flat rates), may be exempt from tax or employee social security contributions, or attract special tax credits. This preferential tax treatment of capital income generally benefits high income earners who earn a greater share of their income from capital sources. In some countries, the gap between ETRs on labour and capital income also rises with income – the higher the income level, the more preferential the tax treatment of capital income compared to labour income.

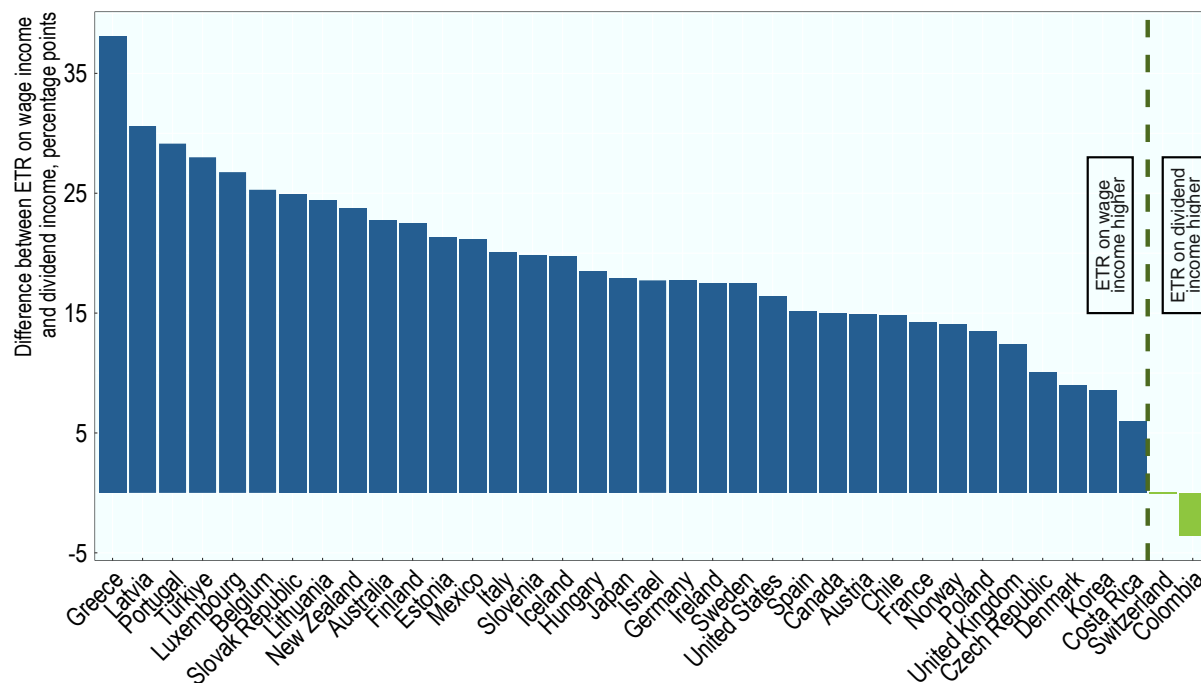
Stylised effective tax rates (ETRs) draw on country tax rules to measure tax due on a given level of income. They show the percentage of income that is payable in tax. They incorporate all features of tax systems that affect final tax payable (e.g. tax rates, deductions, exemptions, credits) in one indicator, making it possible to compare effective rates across income levels and countries.

These rates contrast with backward-looking ETRs that draw on data (e.g. tax administration microdata) to measure actual taxes paid.

¹ The figure shows income levels equal to five times the average wage, which represent different shares of the population in different countries and may in some represent only a very small share of total taxpayers.

Figure 1. Comparing taxes paid at the individual level shows that dividends are almost always taxed more favourably than wages at high income levels

Difference in ETR, individual earning five times the average wage, 2021



Note: The chart shows the difference in ETRs payable on wage and dividend income, for a hypothetical individual earning five times the average wage. The taxes refer to individual-level taxes, and do not include taxes payable at the firm level. In some countries, individuals pay SSCs on labour income and not dividend income, driving large differences in ETRs at the individual level. However, SSCs can confer entitlement to social benefits (e.g. pension income or unemployment insurance) that are not available to individuals earning non-wage income. In some countries, the gap in ETRs for wage and dividend income at five times the average wage is significantly higher than at lower income levels (e.g. Greece, Israel, Sweden). The results rely on hypothetical incomes calculated as multiples of average wages, and do not show effective tax rates across the actual income distribution.

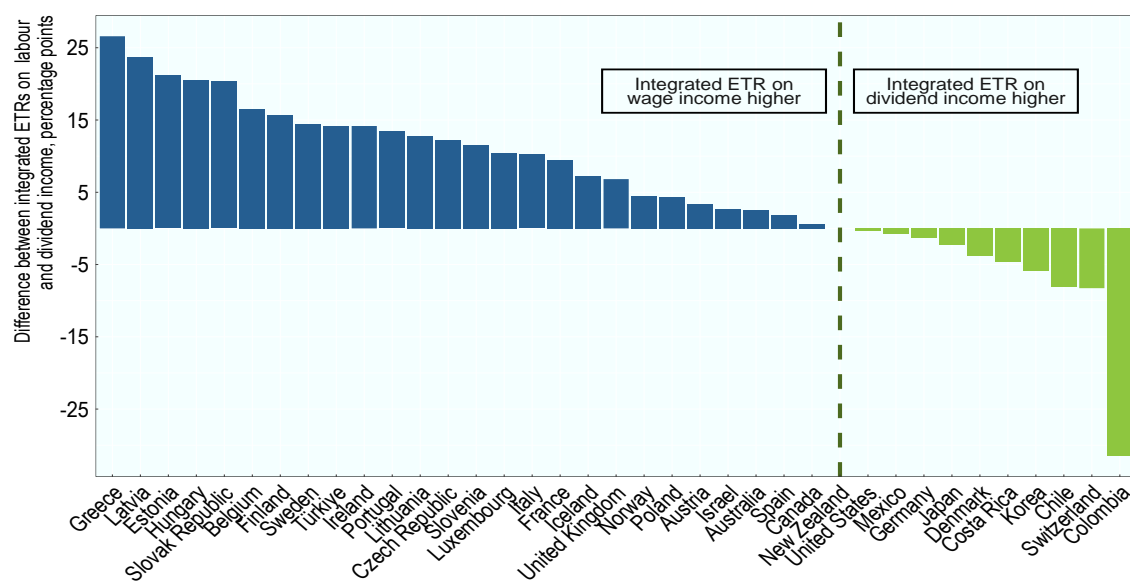
Source: OECD Secretariat calculations

The gap between labour and capital income taxation tends to be smaller when accounting for taxes paid by firms

Governments also levy firm-level taxes on labour and capital income. Firm-level taxes on profits (corporate income tax) are often higher than firm-level taxes on wages (employer social security contributions and payroll taxes), adding to the total tax burden on capital relatively more than on labour. Even after accounting for the combined effect of these firm-level taxes and taxes paid by individuals on wage and dividend income, the tax treatment of dividend income is more favourable than that of labour income in many OECD countries (Figure 2). But the gap between the two is generally smaller than when considering only taxes paid by individuals. However, for some countries and income levels, the opposite result is evident – wage income is tax-preferred after accounting for firm-level taxes.

Figure 2. Combining taxes paid by individuals and firms shows dividends are taxed more favourably than wages at high income levels in many, but not all, countries

Difference in integrated ETRs when total labour cost or shareholder profits are five times the average wage.



Note: The chart shows the difference in integrated ETRs payable on wage and dividend income. Integrated ETRs refer to the total of individual-level and firm-level taxes as a percentage of total labour costs or pre-tax distributed profits. Calculations assume companies pay the domestic top statutory CIT rate. In some countries, individuals pay SSCs on labour income and not dividend income, driving large differences in ETRs at the individual level. However, SSCs can confer entitlement to social benefits (e.g. pension income or unemployment insurance) that are not available to individuals earning non-wage income. In some countries, the gap in integrated ETRs for wages and dividends at five times the average wage is significantly higher than at lower multiples of average wage (e.g. Greece, Israel, Sweden). The results rely on hypothetical incomes calculated as multiples of average wages, and do not show effective tax rates across the actual income distribution.

Source: OECD Secretariat calculations.

The differential tax treatment of labour and capital income affects the efficiency and equity of tax systems

The results show that capital income is tax-preferred compared to labour income in many OECD countries, affecting the equity and efficiency of tax systems. Different ETRs for capital income and labour income reduce horizontal equity, since taxpayers earning the same income from different sources are taxed differently. Capital income is concentrated at the top of the distribution, so high earners benefit disproportionately from preferential capital income tax treatment, reducing vertical equity. Differential tax treatment between labour and capital income can also create distortions that may reduce the efficiency of tax systems. Balancing these implications with other policy objectives such as promoting savings and investment is a key challenge for policy makers.

This work highlights the need for further analysis

Differential tax treatment between labour and capital income can open the door to strategies to minimise tax, including income shifting, capital gains deferral and the strategic timing of income realisation. Upcoming OECD work will delve further into how individuals, particularly those with higher incomes, use such strategies to minimise the taxes they pay. Future work will also consider the pros and cons of different tax policy options that governments may consider to enhance the efficiency and equity of their personal income tax systems.

Source: Hourani, D., B. Millar-Powell, S. Perret, A. Ramm (2023), "The taxation of labour vs. capital income: A focus on high earners", OECD Taxation Working Papers, No. 65, OECD Publishing, Paris, <https://doi.org/10.1787/04f8d936-en>.

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