

# THE ECONOMICS OF TAXATION

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# Overview

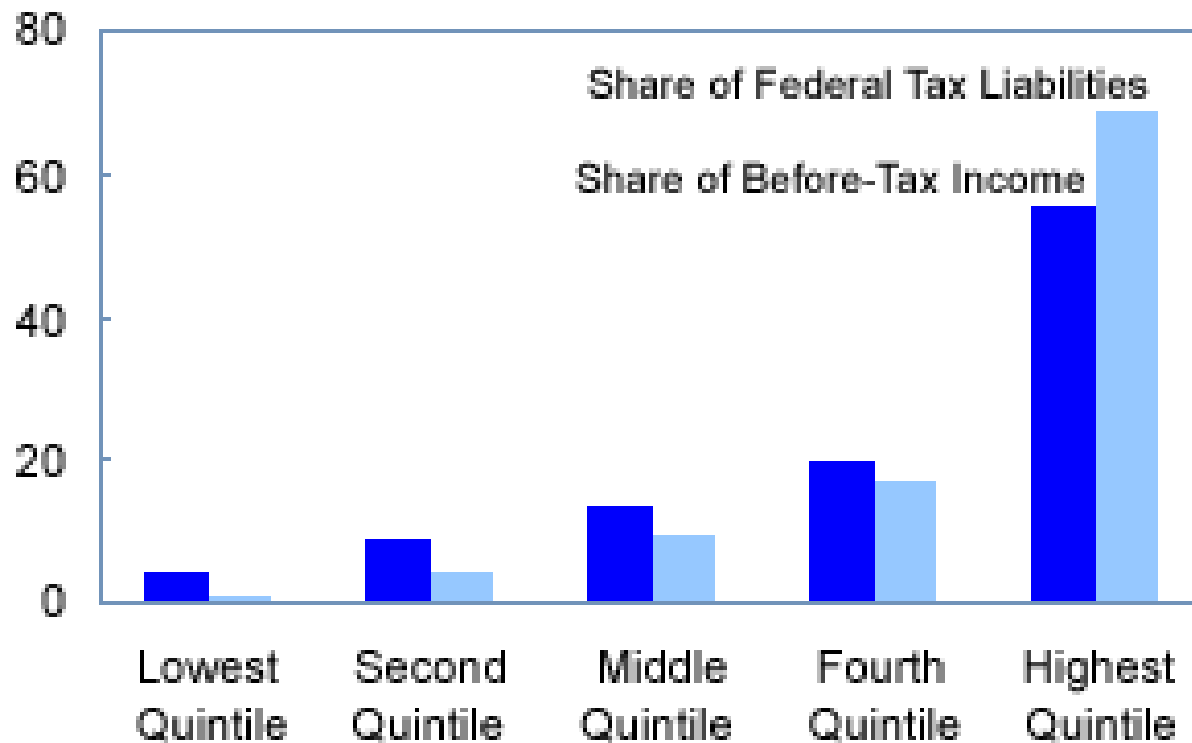
1. “Holding revenue constant”
2. Who pays federal taxes?
3. Taxes and the Poor: *High rates discourage work.*
4. Taxes and the Rich: *They are crafty.*
5. Taxes on Capital: *A strong result.*
6. The Laffer Curve: *Not Relevant (now).*

# “Holding Revenue Constant”

- Sensible debates about taxes start here.
- Today’s government has to be paid for via:
  - ▣ Present Taxes
  - ▣ Future Taxes (borrowing)
  - ▣ Printing money (important in Zimbabwe, not important in U.S.)
- So when comparing tax regimes, we’ll stick to options that bring in the same amount of money.

# Who pays federal taxes? (1)

Share of Total Before-Tax Income and  
Total Federal Tax Liabilities (2005)



Source: CBO

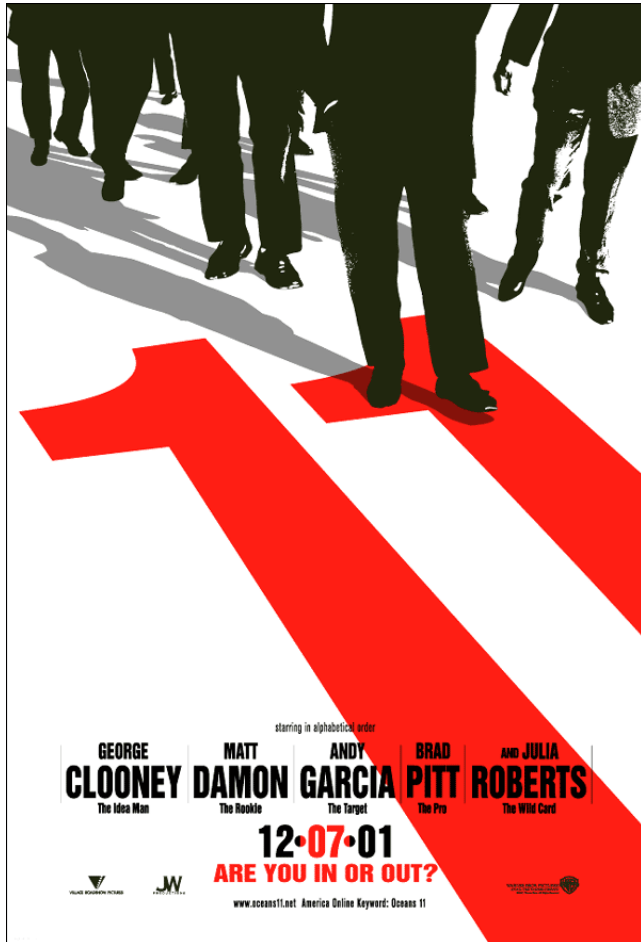
# Who pays federal taxes? (2)

Year	Lowest Quintile	Second Quintile	Middle Quintile	Fourth Quintile	Highest Quintile			Top 10%	Top 5%	Top 1%
<b>Average Pre-Tax Income for All Households, by Household Income Category, 2005</b>										
2005	15,900	37,400	58,500	85,200	231,300			339,100	520,200	1,558,500
<b>Tax Rates, All Federal Taxes, percent</b>										
2005	4.3	9.9	14.2	17.4	25.5			27.4	28.9	31.2
<b>Total Federal Taxes paid, dollars</b>										
2005	684	3,703	8,307	14,825	58,982			92,913	150,338	486,252

Source: Congressional Budget Office.

Notes: Income equals pretax cash income plus all in-kind benefits (Medicare, Medicaid, food stamps, school lunches and breakfasts, etc.).

# Labor Supply: The Big Question



The decision to work vs. staying home

The decision to retire 2 years earlier

The decision to hide out in grad school

The decision to work as a waiter (hard-to-tax tips) or a restaurant manager (taxable salary)

Not a question of  
“10 hours more” vs. “10 hours less”

# Earned Income Tax Credit: An important experiment

- “Behavioral Responses to Taxes”  
(Eissa and Hoynes, MIT Press, 2006)
- EITC: A big anti-poverty, pro-work program.
  - ▣ 22 million families, >\$1500 per family in 2004.
- Example: 40% wage subsidy to 2-child families.
  - ▣ If taxes influence behavior, we should see it here.

# Testing EITC: A little science

- How do we see if EITC changes labor supply?
- A: Your bosses help a lot!
  - ▣ Big expansions or shrinkages in EITC:
    - Watch the same/similar people over years, see if they start or stop working
  - ▣ Compare statistically similar young women with 0 kids (no or little EITC), with 1 kid (medium credit), or with two kids (highest credit)
    - Who works? (*Or really, who works above the table*)



# EITC: Does it make people work?

- Eissa and Hoynes' summary of many EITC studies:
  - 10% more take-home pay >> 7% to 12% more workers
  - Gross oversimplification:
    - 10% rise in after-tax wages >> 10% more workers. **1 for 1.**
  - If work pays, people work.
  
  - *If work doesn't pay....*
  
  
  - EITC has little effect on hours *among workers*:
    - *It's "in or out."*

*(Further info: Hotz and Scholz, NBER 2003)*

# How average people respond to tax changes

- Survey of labor economists:

Married Women (MW) respond more than men

- MW: 10% rise in take-home wage → 5% more hours

- Men: 10% rise in take-home wage → 1% more hours

- Low-earners respond more:

- about 2X these numbers

- and high-earners respond *less*.

Source: Fuchs, Poterba, Kreuger (1997, J. Econ Lit).

- *Note: Nobel Laureate Edward Prescott sees **10x bigger** responses*

**Social forces at work?**

# Taxes and the Rich:

## Taxable Income Games

- And now, some hand-waving:
  - ▣ For the rich, it's not just "in or out."
  - ▣ There's investing in real estate (low tax) vs. corporate profits (high double tax) vs. wage labor (high tax) vs. capital gains (low tax) vs. volunteering to build your spouse's reputation vs.....
  - ▣ There's taking an easy job (low wage, low stress) vs. taking a harder job (high wage, high stress)
  - ▣ There's this year (low tax) vs. next year (high tax)
  - ▣ Little of this involves "hours of work."

# How much do the rich change their “taxable income” when taxes change?

- Martin Feldstein (Harvard, former NBER chief)
  - 2 for 1
  - 1% rise in take-home fraction → 2% rise in income
- Gruber (MIT) & Saez (Harvard)
  - 0.6 for 1: Quite a bit smaller.
  - 1% rise in take-home fraction → 0.6% rise in income
- Goolsbee (Chicago): Looking at 1993 tax increase
  - 1 for 1 in short run (end-of-year tax games)
  - 0.1 in long run (they work and work)

# How we split the income pie

- 2/3 of US income: Wages/Salaries
- 1/3: Capital income/Interest/Rent/Profit
- True across time and countries
  - A surprise!

# Taxing Capital Income in Theory

- A shockingly robust result: Taxing capital income is generally a bad idea.  
(Chamley/Judd result (1986/1985))  
(In general, includes corporate income taxes, interest and profit taxes, and capital gains taxes. IRAs and 401K's get us closer to zero tax.)
- Key point: Capital tax causes lower wages in long run.
- Future-minded workers would vote to tax themselves, not capital.

# Really? How?

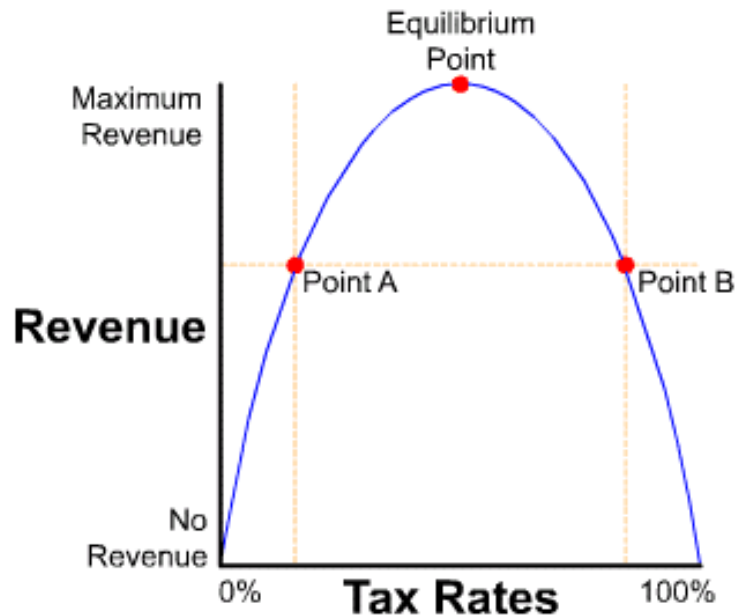
- Higher tax on capital → Lower long-term saving  
→ fewer machines to tax  
(An obvious point)
- The subtle point: Fewer machines → workers produce less →  
Lower wages
- Even if you take all capital tax revenue and gave it to workers,  
workers would vote against capital tax.

# Taxes, Capital, and Growth

- Survey of top tax economists:
  - ▣ Shift to pure consumption tax
  - ▣ Examples: National sales tax, USA tax, or full expensing income tax
  
  - ▣ avg. answer: 0.2% faster growth → unnoticeable
    - 10% richer in long run
  
  - ▣ optimists: 0.5% faster growth →
    - Probably noticeable → 25% richer in long run



# Time for the Laffer Curve?



- Laffer, *Time*, 12/7/07: “I've never said all tax cuts pay for themselves. I never even said Reagan's tax cuts would pay for themselves.”
- Brad DeLong, Berkeley & Clinton Treasury: “[R]educing the top tax rate from 70% to 50% is probably a revenue gainer and surely not much of a loser.”

# Conclusion

- Good *economic* debates on taxes hold spending constant. *“How should we raise this money?”*  
(see Alan Auerbach, Berkeley, for more)
- Our tax system is progressive. *“Enough?”*
- ‘Whether to work’ more important than ‘how much to work.’ *“Early retirement sounds good....”*
- But not for the rich—they do nuance.  
*“And maybe for the rest of us: Is college worth it?”*
- Capital taxation: Bad in theory.  
*“But I’ll sell this rare t-shirt for \$100K....”*