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).*
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)

Source: CBO
Who pays federal taxes? (2)

Average Pre-Tax Income for All Households, by Household Income Category, 2005

<table>
<thead>
<tr>
<th>Year</th>
<th>Lowest Quintile</th>
<th>Second Quintile</th>
<th>Middle Quintile</th>
<th>Fourth Quintile</th>
<th>Highest Quintile</th>
<th>Top 10%</th>
<th>Top 5%</th>
<th>Top 1%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>15,900</td>
<td>37,400</td>
<td>58,500</td>
<td>85,200</td>
<td>231,300</td>
<td>339,100</td>
<td>520,200</td>
<td>1,558,500</td>
</tr>
</tbody>
</table>

Tax Rates, All Federal Taxes, percent

<table>
<thead>
<tr>
<th>Year</th>
<th>Low</th>
<th>Sec</th>
<th>Mid</th>
<th>Fourth</th>
<th>Highest</th>
<th>Top 10%</th>
<th>Top 5%</th>
<th>Top 1%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>4.3</td>
<td>9.9</td>
<td>14.2</td>
<td>17.4</td>
<td>25.5</td>
<td>27.4</td>
<td>28.9</td>
<td>31.2</td>
</tr>
</tbody>
</table>

Total Federal Taxes paid, dollars

<table>
<thead>
<tr>
<th>Year</th>
<th>Low</th>
<th>Sec</th>
<th>Mid</th>
<th>Fourth</th>
<th>Highest</th>
<th>Top 10%</th>
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<th>Top 1%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>684</td>
<td>3,703</td>
<td>8,307</td>
<td>14,825</td>
<td>58,982</td>
<td>92,913</td>
<td>150,338</td>
<td>486,252</td>
</tr>
</tbody>
</table>

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 $\rightarrow$ 2% rise in income

- Gruber (MIT) & Saez (Harvard)
  - 0.6 for 1: Quite a bit smaller.
  - 1% rise in take-home fraction $\rightarrow$ 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!
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 $\rightarrow$ Lower long-term saving $\rightarrow$ fewer machines to tax
  (An obvious point)

- The subtle point: Fewer machines $\rightarrow$ workers produce less $\rightarrow$ Lower wages

- Even if you take all capital tax revenue and gave it to workers, workers would vote against capital tax.
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...."