# Are Americans overtaxed?

Lane Kenworthy

Fall 2011

# *Outline*

How heavily are we taxed?

Do taxes hurt the economy?

What's the best way to increase taxes?

# How heavily are we taxed?

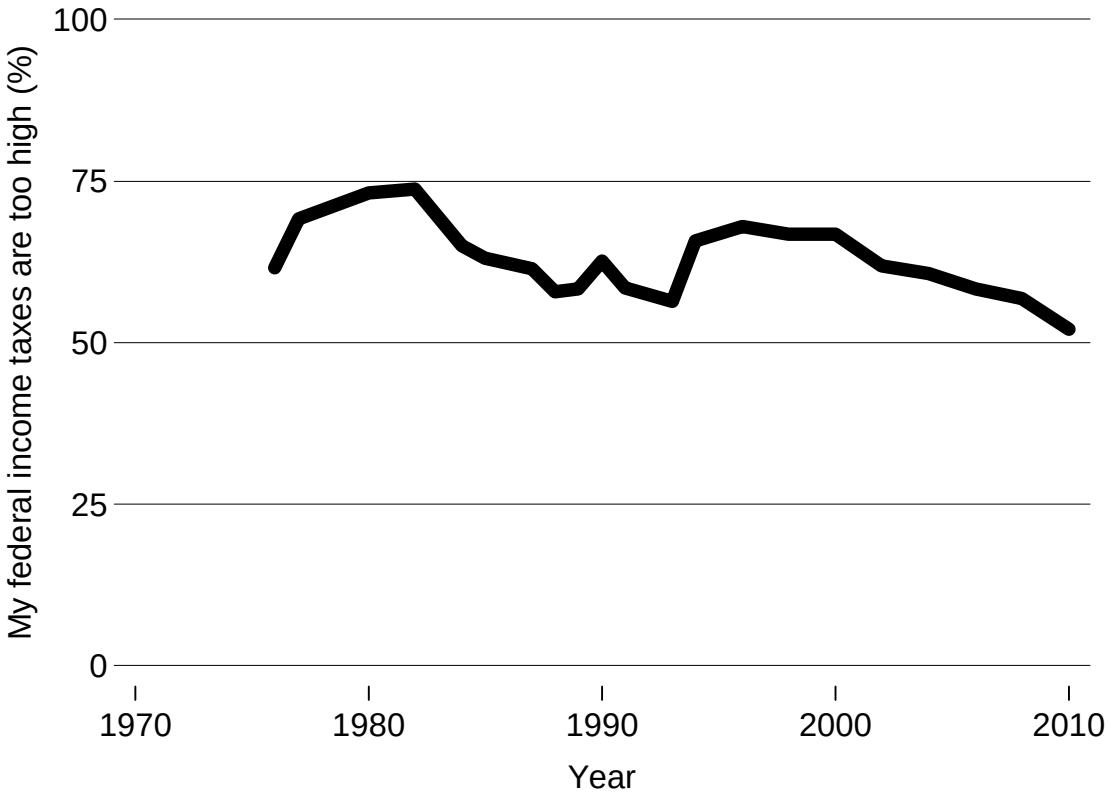
IRS
cra

DON'T TAX
ME BRO!!
RIP
NOV 08
TAX
AEROPOSTALE
CALIFORNIA

...BUT WHO WANTS THAT?
NO TAXES
NO GOVERNMENT
JUST ME
"TAXES ARE THE PRICE WE PAY FOR CIVILIZED SOCIETY."
-JUSTICE OLIVER WENDELL HOLMES
BEN SARGENT

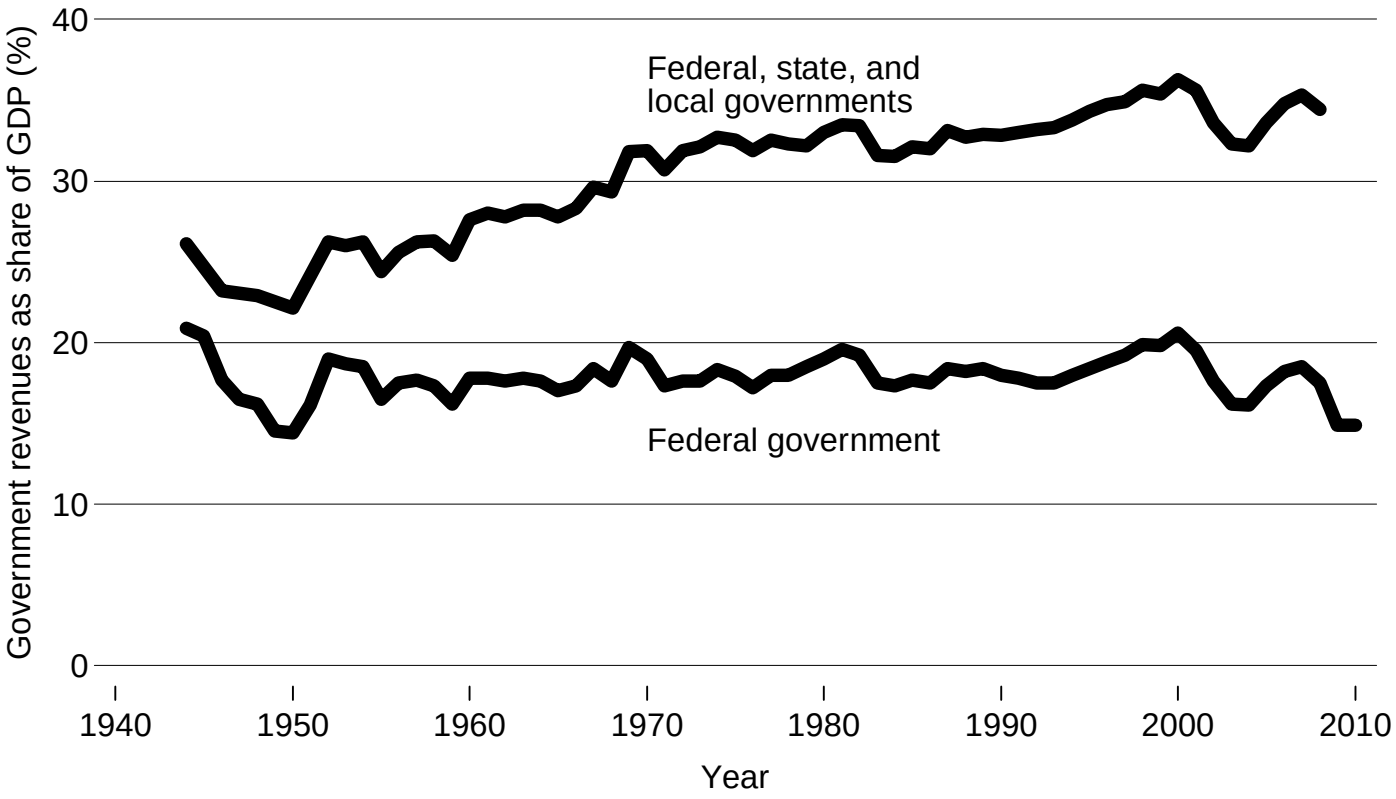
*"No, thanks—I'm a libertarian."*

# How heavily are we taxed?




Question: "Do you consider the amount of federal income tax which you have to pay as too high, about right, or too low?" Data source: General Social Survey, variable = tax, sda.berkeley.edu/archive.htm.

# How heavily are we taxed?



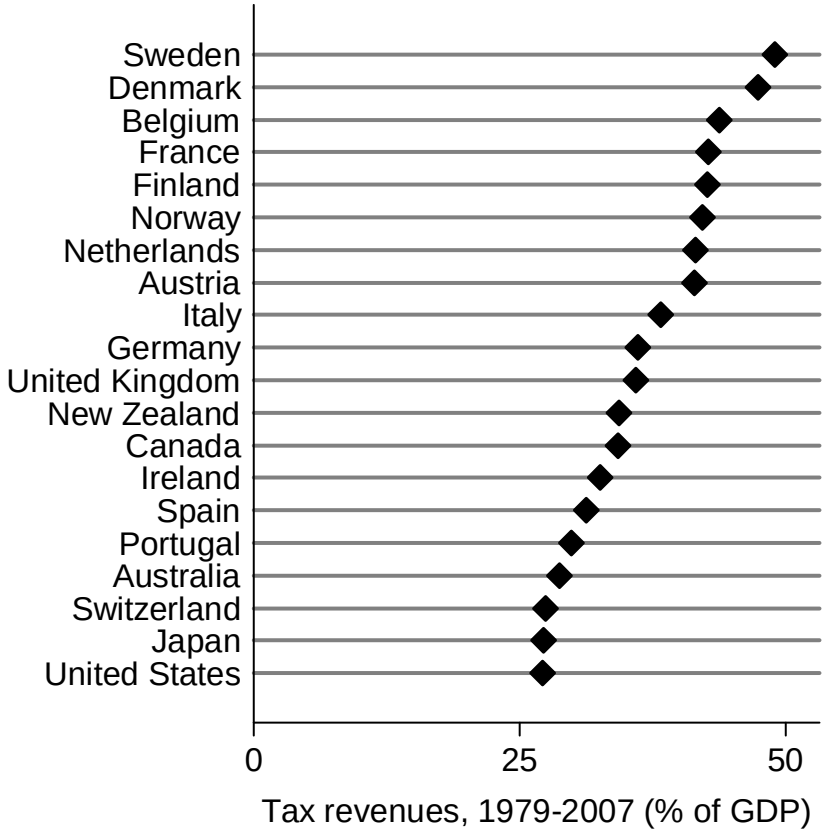

Government revenues as a share of GDP. Most, but not all, government revenues are from taxes. Data source: *Economic Report of the President*, tables B-78 and B-86.

# *How heavily are we taxed?*

What share of our incomes do we pay in taxes?

Around 30% on average

# How heavily are we taxed?




Tax revenues as a share of GDP, averaged over 1979 to 2007. Data source: OECD.

# Do taxes hurt the economy?

## *"If you eat less, you'll be healthier"*

This seems compelling

There's a simple logic and fundamental truth underlying it

# *"If you eat less, you'll be healthier"*

The underlying notion is of a *tradeoff*

- Eating is necessary
- But too much eating is harmful

A similar argument is often made about taxes

- We need some taxation
- But too much is harmful; it jeopardizes the health of the economy
- There is a tradeoff, in this view, between taxes and economic health

"Noteworthy for its clarity, logic, candor and unequivocal stand on political implications." —THE NEW YORK TIMES BOOK REVIEW

# Free to Choose

## A PERSONAL STATEMENT

THE CLASSIC INQUIRY INTO THE RELATIONSHIP BETWEEN FREEDOM AND ECONOMICS


Milton Friedman

*Winner of the Nobel Prize*

*and* Rose Friedman

# *Do taxes hurt the economy?*

"Government is not the solution to our problem. Government *is* the problem."

– U.S. president, 1981

# *Do taxes hurt the economy?*

It isn't only conservatives

ARTHUR M. OKUN

# EQUALITY AND EFFICIENCY

## The Big Tradeoff

THE BROOKINGS INSTITUTION
WASHINGTON, D.C.

# *Do taxes hurt the economy?*

"The era of big government is over."

– U.S. president, 1996

## *"If you eat less, you'll be healthier"*

It seems compelling, but it's too simplistic

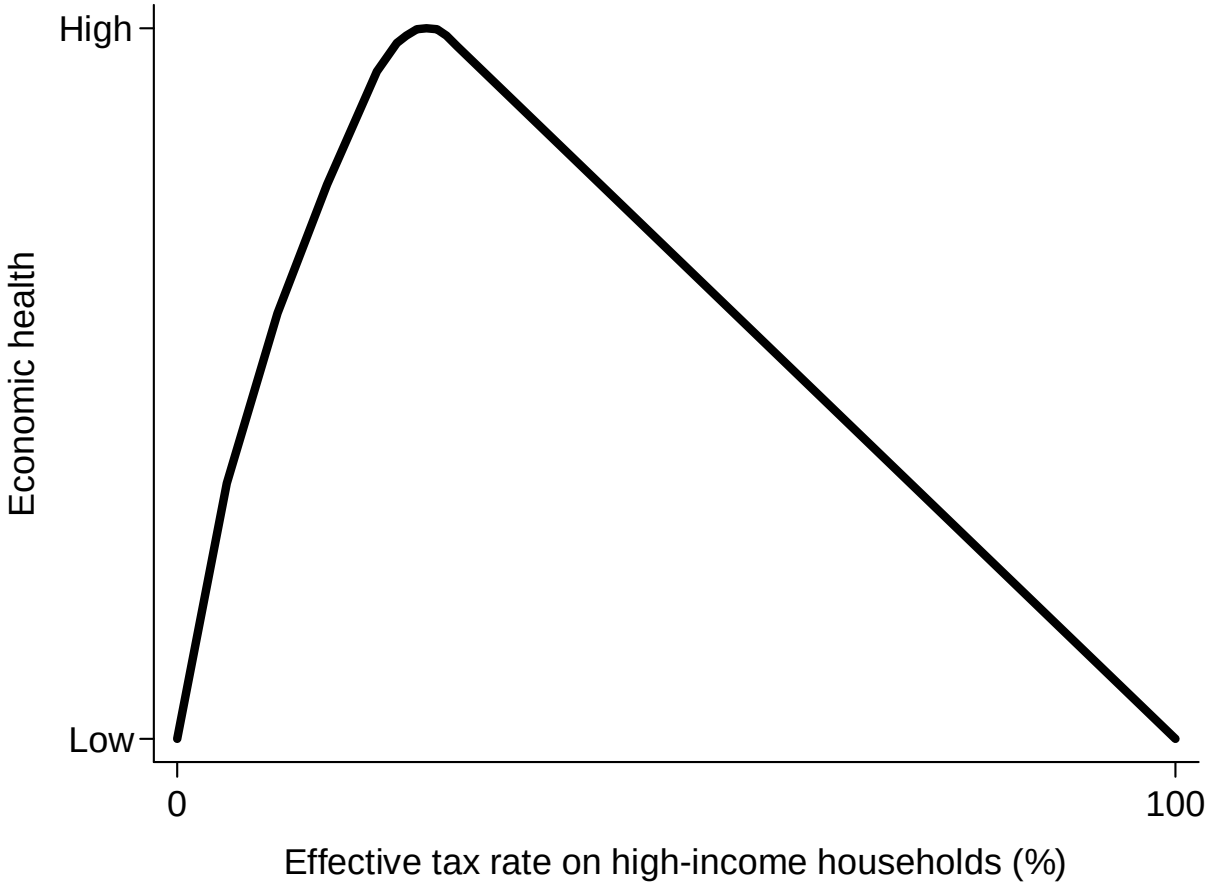
Whether it's accurate depends on

- How much you're currently eating
- Your individual characteristics: height, metabolism, amount of exercise
- The quality of the calories

## *The tradeoff view*

Taxes are thought to hurt the economy by reducing the financial incentive to work hard, save and invest, start new businesses

# *The tradeoff view*




"Economic health" refers to economic growth, employment, competitiveness.

# *Opposing considerations*

High taxes and generous government transfers and services might *increase* economic health

- The impact of financial incentives on investment and work effort is ambiguous
- Consumption
- Fairness and motivation

# *The nature and severity of the tradeoff*

It's certainly true that at some point higher taxes reduce economic health

But the key questions are:

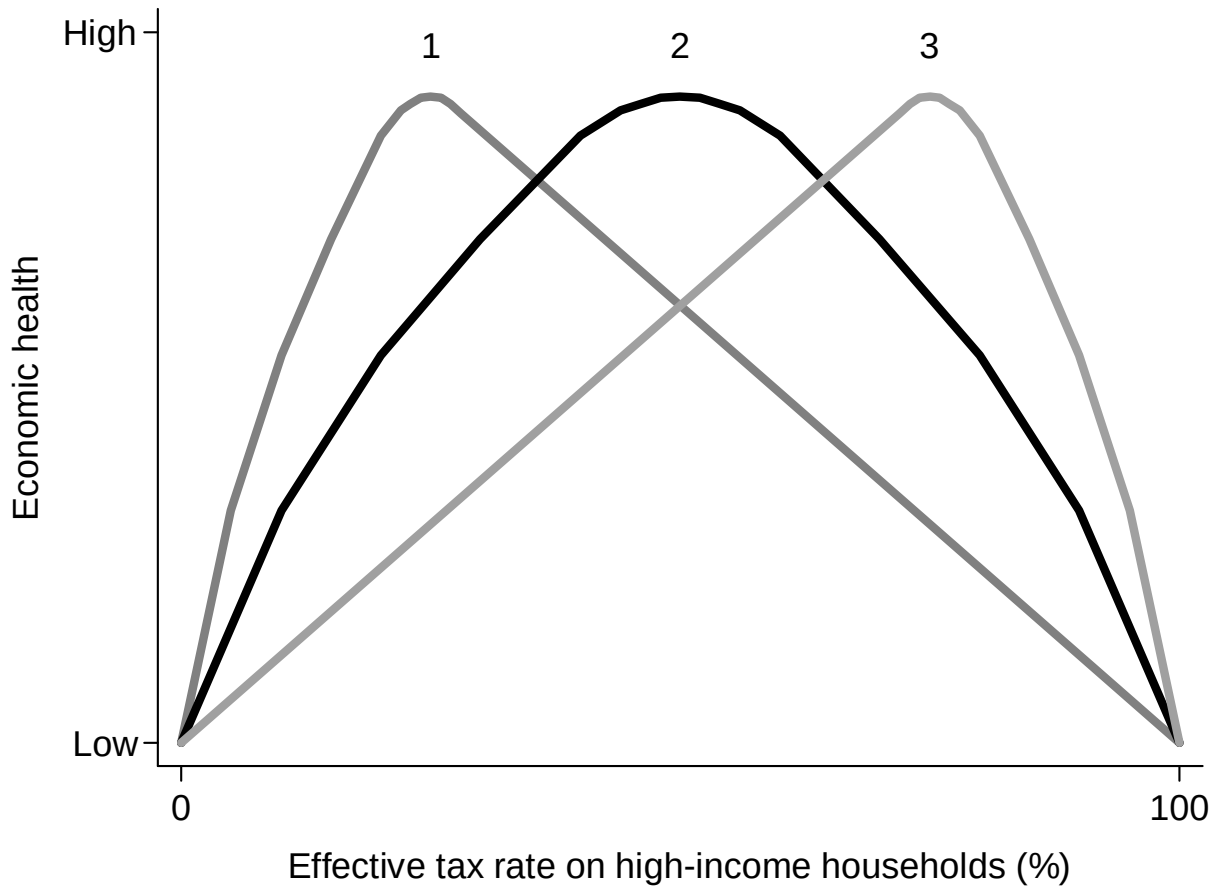
Where is the tipping point?

What's the magnitude of the effect?

We need the answers in order to determine where we currently are in relation to the tipping point and what the cost/benefit would be of changing taxes

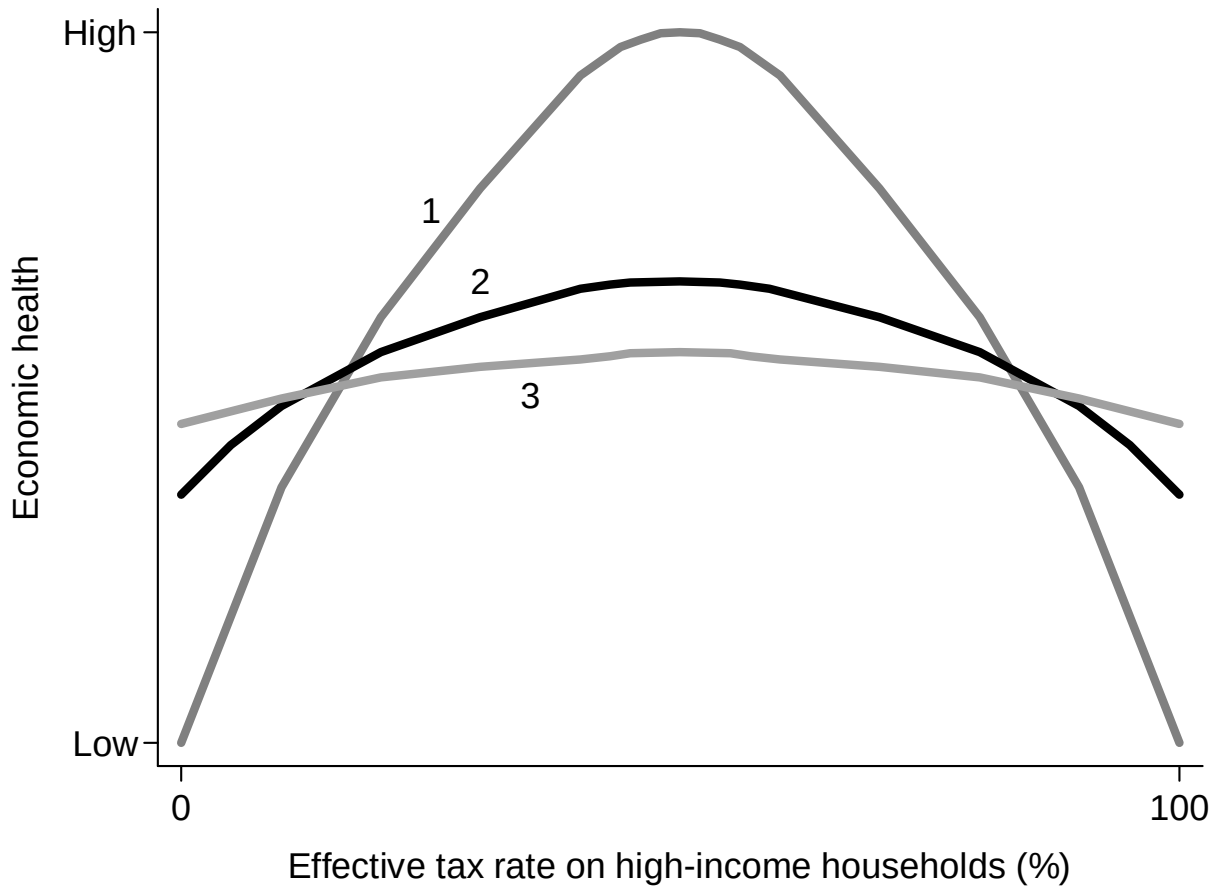
These questions can only be answered empirically

# *Where is the tipping point?*




"Economic health" refers to economic growth, employment, competitiveness.

# *What's the magnitude of the effect?*




"Economic health" refers to economic growth, employment, competitiveness.

## *How can we assess this hypothesis?*

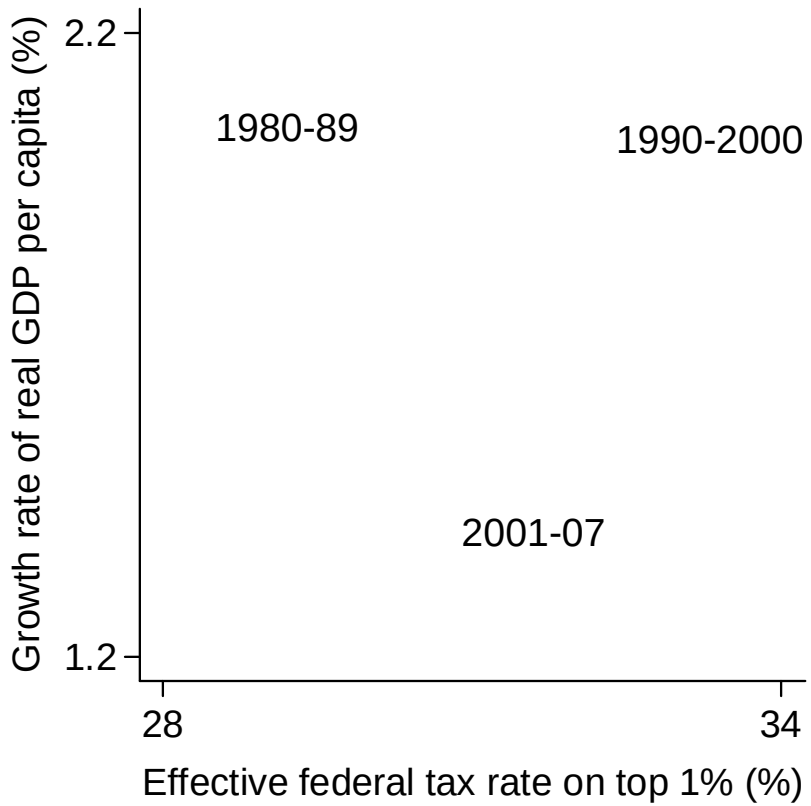
Compare

1. Within the United States over time
2. Across countries at a given point in time
3. Change over time across countries

The third strategy is the best. It's the closest we can get to an experiment

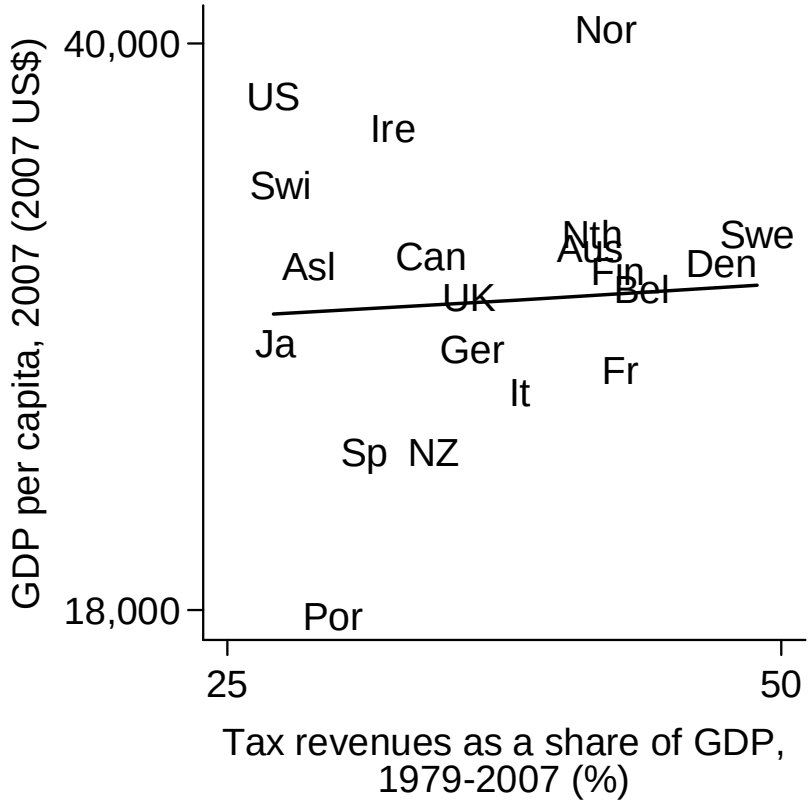
But there's not much variation across the countries in changes in taxation, so we resort to the first and second strategies

# United States: economic growth



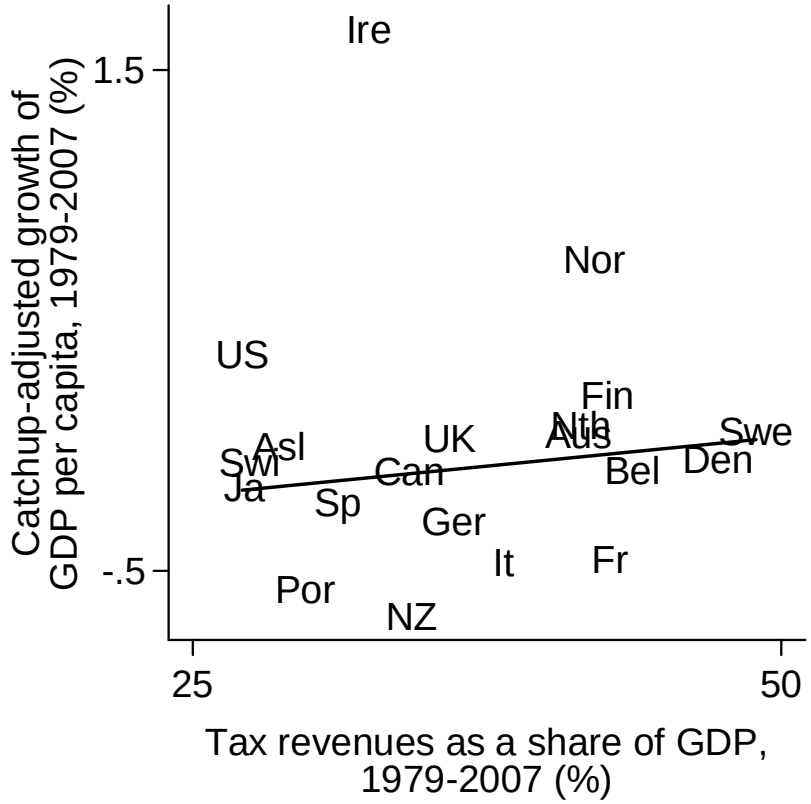

Economic growth by taxation, United States, 1979-2007 business cycles. Data sources: Bureau of Economic Analysis; Congressional Budget Office.

# 20 affluent countries: economic growth



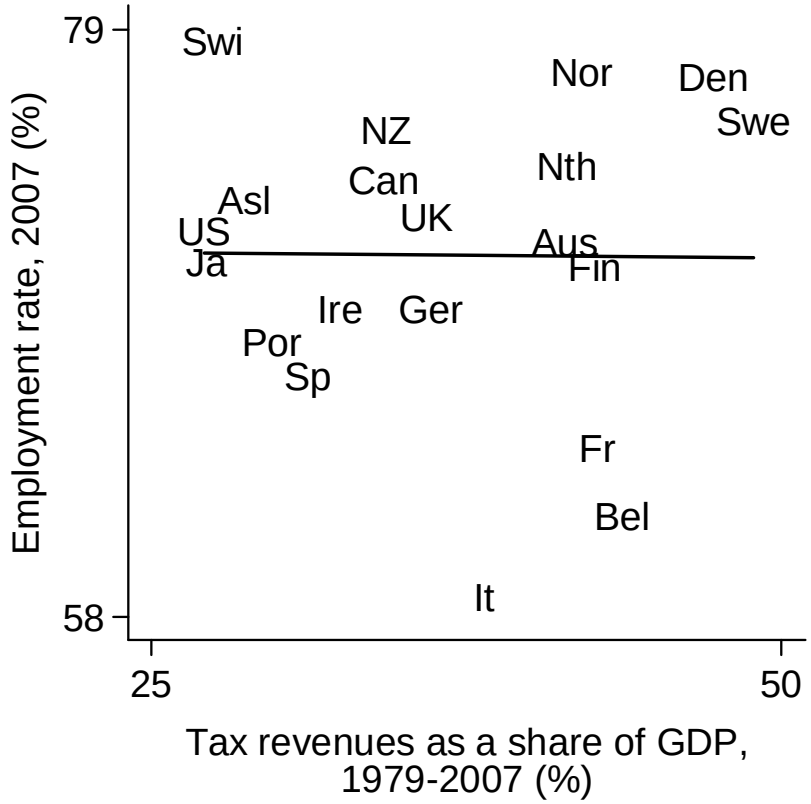

GDP per capita in 2007 by taxes 1979-2007, 20 countries. Regression line is calculated with Norway excluded. Data source: OECD.

# 20 affluent countries: economic growth



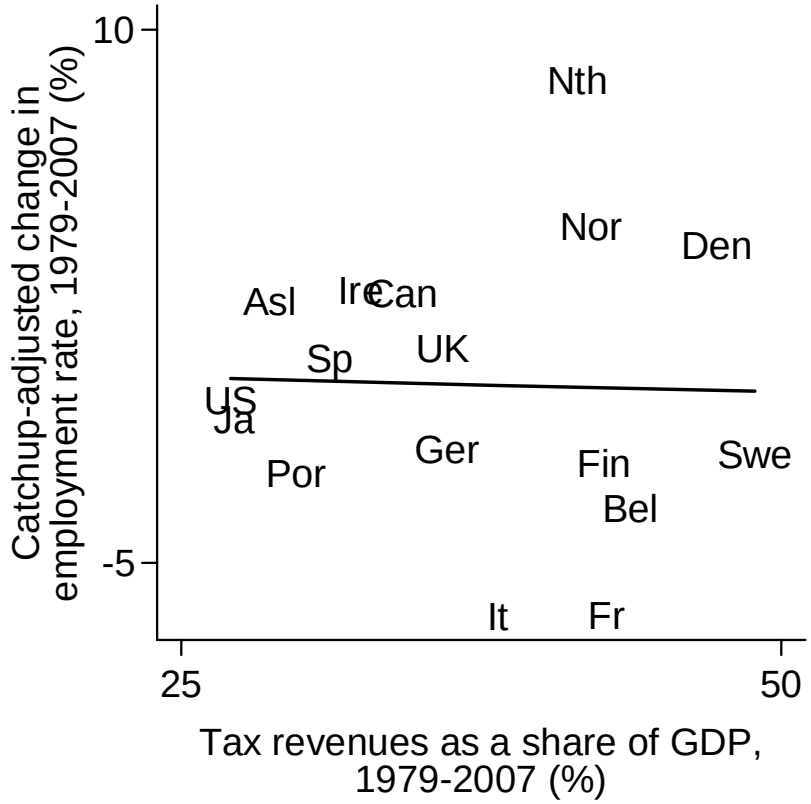

Growth rate of GDP per capita adjusted for catch-up effects by taxes, 20 countries, 1979-2007. "Catchup-adjusted" = adjusted for initial level of GDP per capita. Regression line is calculated with Ireland excluded. Data source: OECD.

# *20 affluent countries: employment*



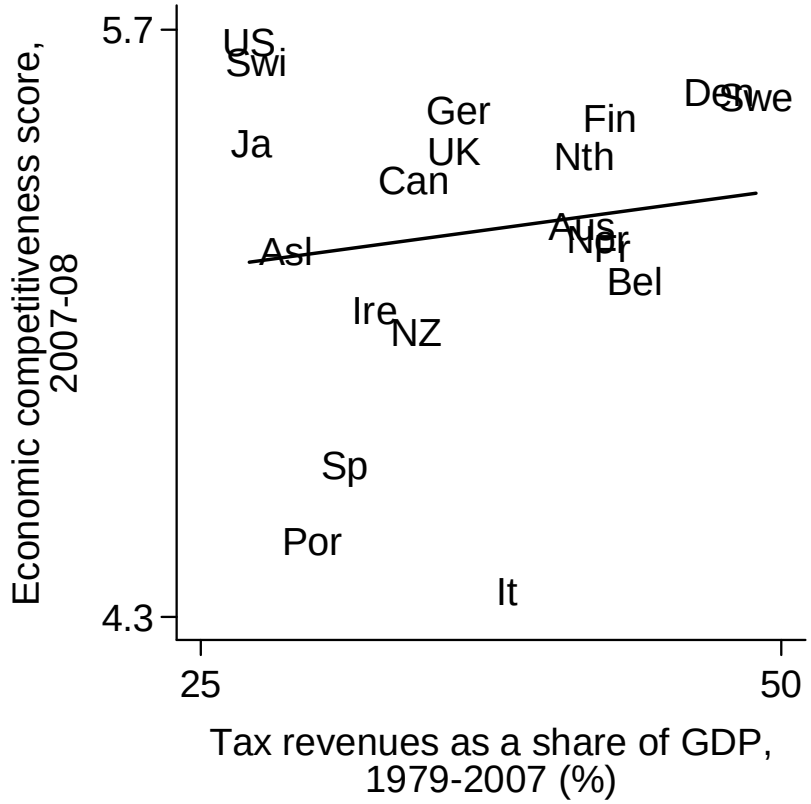

Employment rate in 2007 by taxes 1979-2007, 20 countries. Data source: OECD.

# 20 affluent countries: employment




Change in employment adjusted for catch-up effects by taxes, 20 countries, 1979-2007.
"Catchup-adjusted" = adjusted for initial employment level. Data source: OECD.

# 20 affluent countries: "competitiveness"




Economic competitiveness score in 2007-08 by taxes 1979-2007, 20 countries. Data sources: OECD; World Economic Forum.

# *Do taxes hurt the economy?*

There's no indication that the United States has reached or passed the tipping point

# What's the best way to increase taxes?

# *Why increase tax revenues?*

To fund an increase in government transfers and services

- Expanded EITC and income maintenance programs
- Health care
- Early education
- Other services (schools, transportation, etc.)
- Maintenance and improvement of infrastructure and public spaces

To shore up funding of Medicare

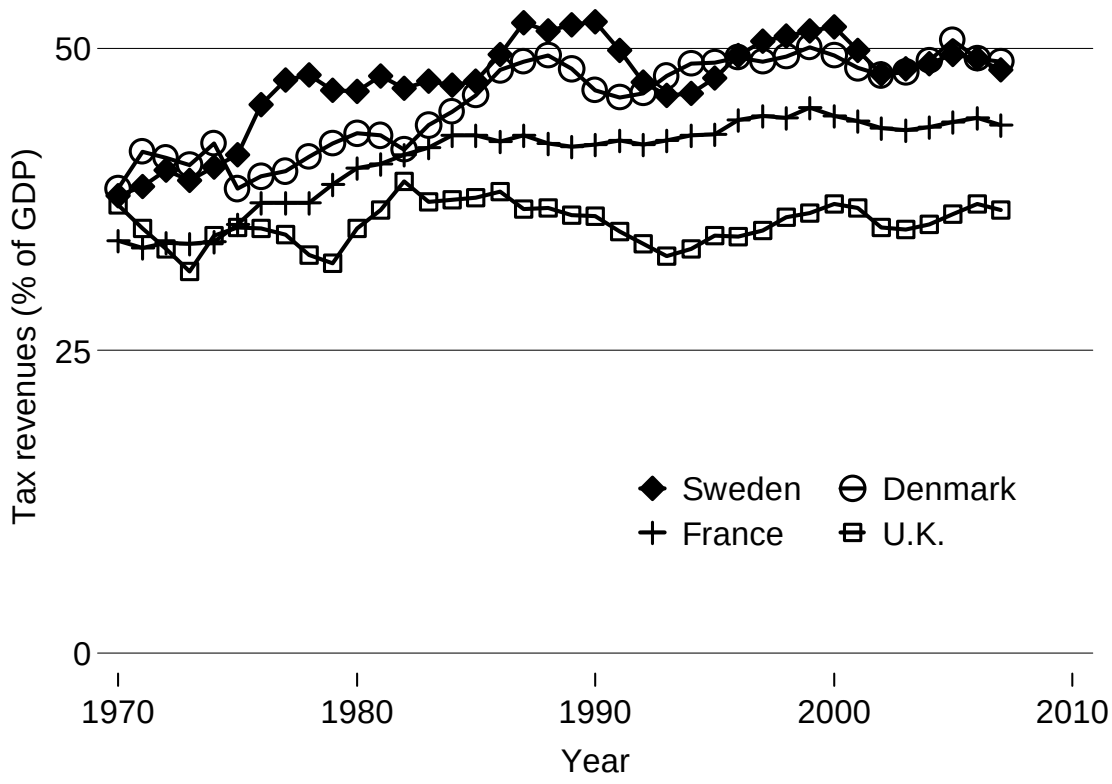
To reduce the budget deficit

## *What's the best way to increase taxes?*

Now that firms and individuals are able to shift assets to virtually any country they want, is heavy taxation still feasible?

So far, the evidence for affluent countries suggests yes

# What's the best way to increase taxes?




Tax revenues as a share of GDP in four moderate- and high-tax countries, 1970-2007. Data source: OECD.

# *What's the best way to increase taxes?*

One view favors making the richest bear the burden of a tax increase

- As a presidential candidate, Barack Obama pledged not to increase taxes on the bottom 95% of households — roughly, those with incomes less than $250,000
- As president, he's continued with this approach

# *What's the best way to increase taxes?*

There's a rationale to focusing on the richest

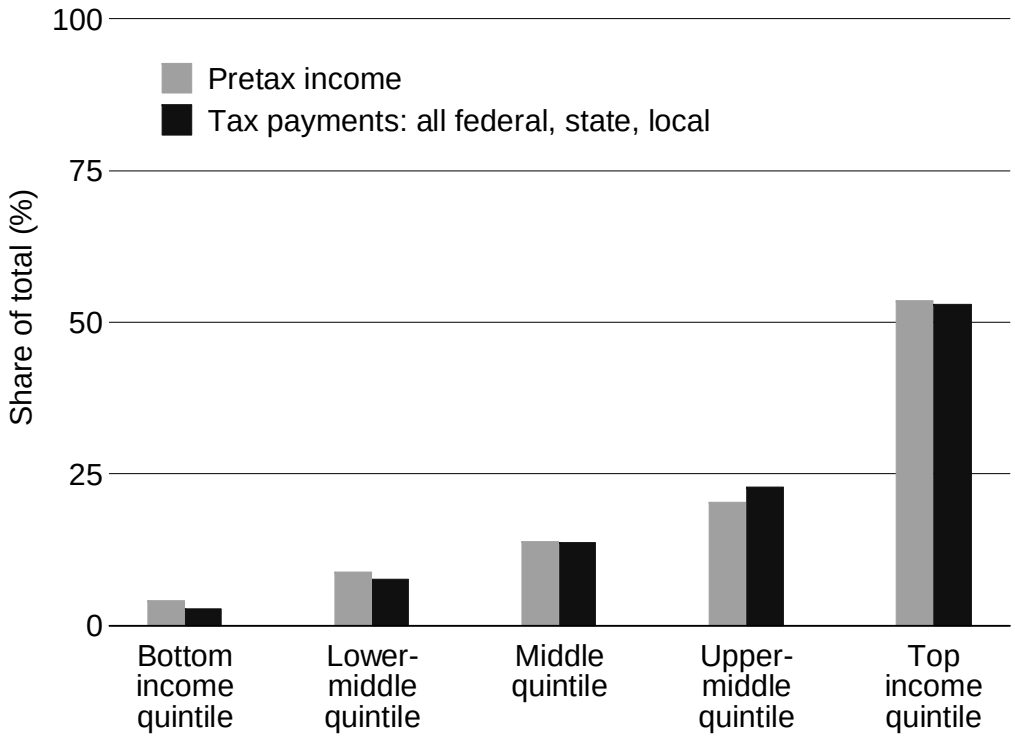
- The logic of progressive taxation: The rich should pay a larger share of their income in taxes because they can afford to
- The top 1%'s share of pretax income has increased over time, so they can now afford to pay a larger share of it in taxes

# *What's the best way to increase taxes?*

Currently our tax system is roughly proportional

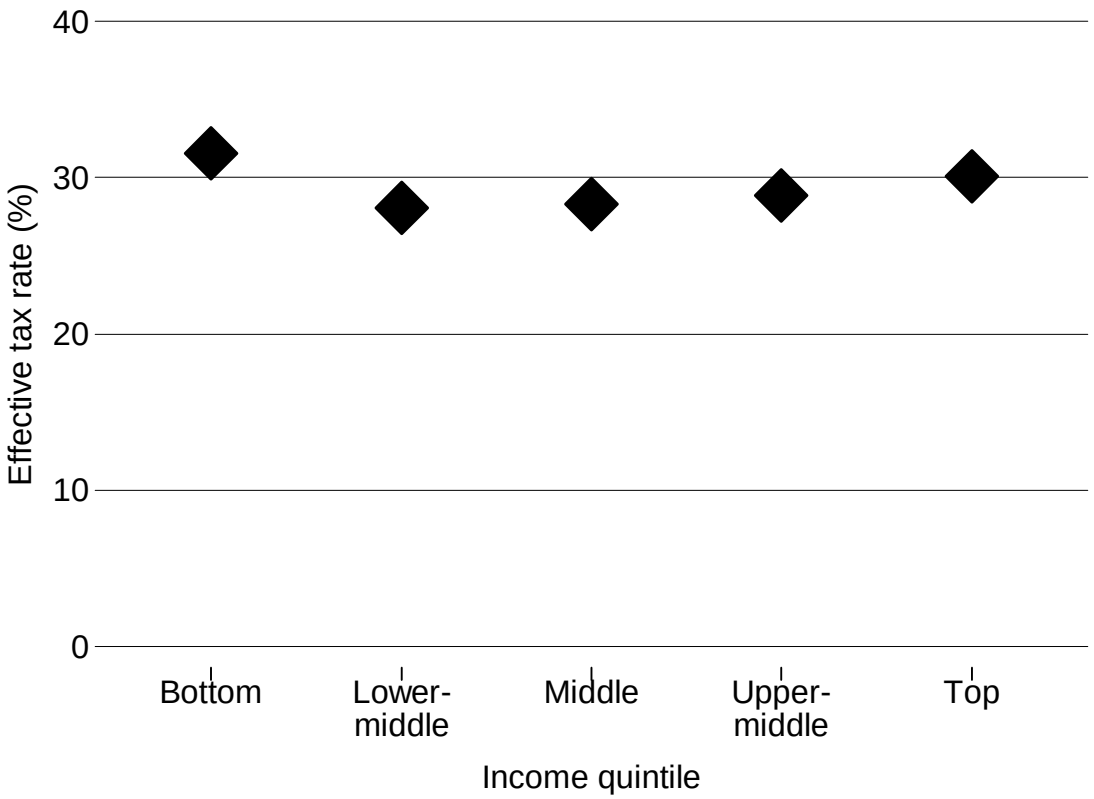
- The federal income tax is progressive, but that progressivity is offset by the regressive payroll tax and regressive state and local sales taxes

# What's the best way to increase taxes?




The data are for 2004. Data sources: Congressional Budget Office, www.cbo.gov/doc.cfm?index=8885; Andrew Chamberlain et al., "Who Pays America's Tax Burden, and Who Gets the Most Government Spending?" Tax Foundation, 2007.

# What's the best way to increase taxes?




Effective tax rates in 2004, with income measured as pretransfer-pretax income. Data source: Andrew Chamberlain et al., "Who Pays America's Tax Burden, and Who Gets the Most Government Spending?" Tax Foundation, 2007.

# *What's the best way to increase taxes?*

But it will be difficult to raise enough revenue solely by "soaking the rich"

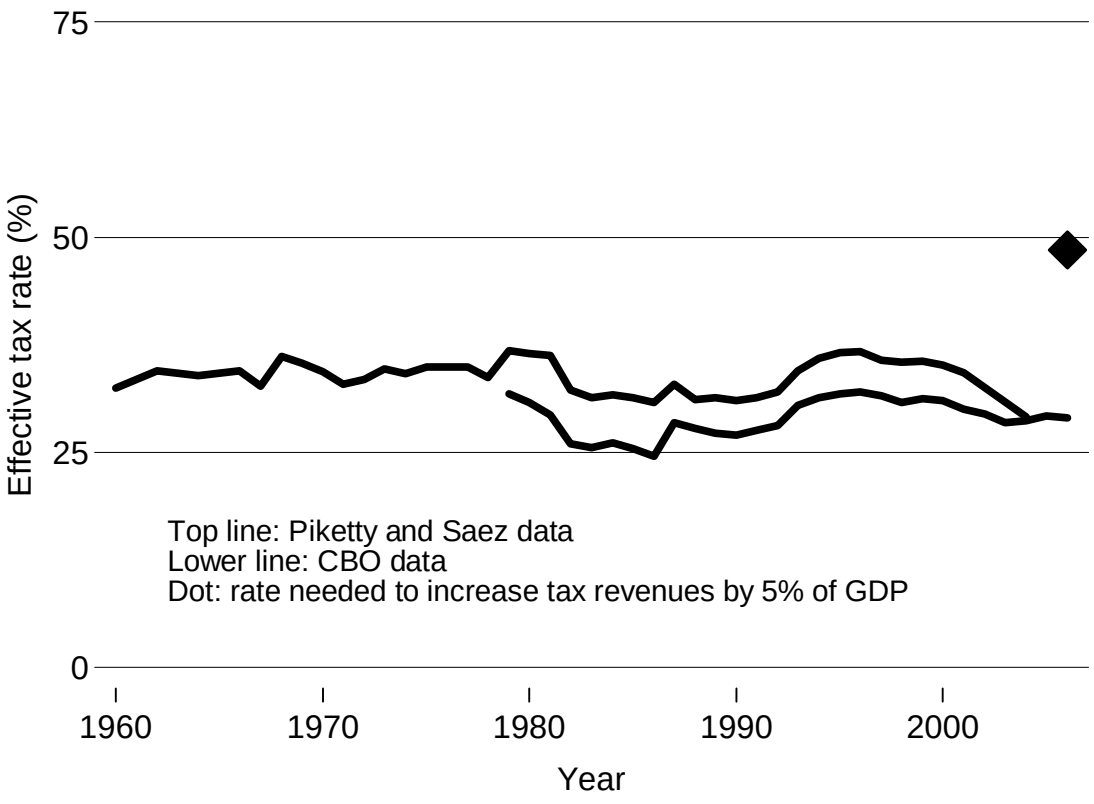
# *What's the best way to increase taxes?*

Suppose we want to increase tax revenues' share of GDP by 5 percentage points

- This would increase government revenues by about $700 billion per year
- We'd still be at the low end in taxation among affluent countries

To do that by raising taxes only on the top 5% of households (about 6 million households), we'd have to increase the effective tax rate on that group by 20 percentage points

# What's the best way to increase taxes?




Actual (lines) and hypothetical (dot) effective federal tax rate on the top 5% of households. Data sources: Piketty and Saez, elsa.berkeley.edu/~saez/jep-results-standalone.xls, table A3; CBO, www.cbo.gov/publications/collections/taxdistribution.cfm.

# *What's the best way to increase taxes?*

An alternative approach

- New national consumption tax (≈5%), with a rebate to reduce its regressivity
- Higher effective income tax rate on the top 5%
- Reduction or elimination of some upper-middle-class tax deductions, such as the homeowner mortgage interest deduction
- Small tax on financial transactions ("Tobin tax")

# *What's the best way to increase taxes?*

How much revenue would this raise?

A 5% consumption tax (VAT): about $400 billion

Increase the effective income tax rate on the top 5% of households by 5 percentage points: about $175 billion

Eliminate the homeowner tax subsidy: about $160 billion

0.25% tax on financial transactions: about $100 billion

Total: approximately $835 billion (6% of GDP)

# *What's the best way to increase taxes?*

The new consumption tax is the most controversial of these proposals

- Many on the left dislike it because it's regressive
- Many on the right dislike it because they worry it will enable a big increase in taxation
- But there are exceptions

# THE NEW AMERICAN ECONOMY

## THE FAILURE OF REAGANOMICS AND A NEW WAY FORWARD

BRUCE BARTLETT

*NEW YORK TIMES* BESTSELLING AUTHOR OF *IMPOSTOR*

# THE TYRANNY OF DEAD IDEAS

## LETTING GO OF THE OLD WAYS OF THINKING TO UNLEASH A NEW PROSPERITY

MATT MILLER

AUTHOR OF THE TWO PERCENT SOLUTION

# *What's the best way to increase taxes?*

Wouldn't this sharply reduce the progressivity of the tax system?

No: the other changes would largely or entirely offset the regressivity of a new consumption tax

- Higher effective rate on the top 5%, including new rates for the top 1%, 0.1%, and 0.01%
- The homeowner tax subsidy mainly benefits the top income quintile
- A financial transaction tax would affect few below the top quintile

# *What's the best way to increase taxes?*

How do other countries do it?

- In all rich nations, the tax system is roughly proportional
- Ours is slightly more progressive than others

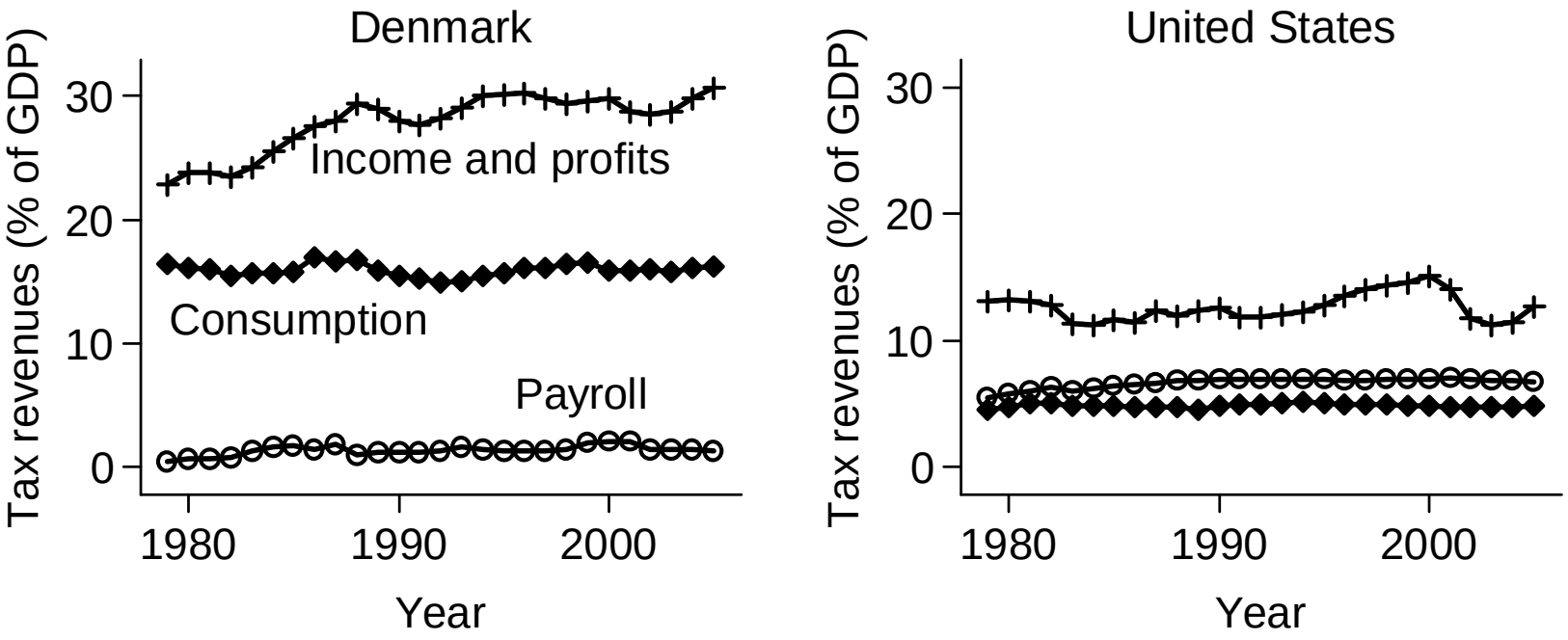
# *What's the best way to increase taxes?*

How do other countries do it?

Denmark: heavy overall taxation, progressive income tax, low payroll tax, high consumption tax

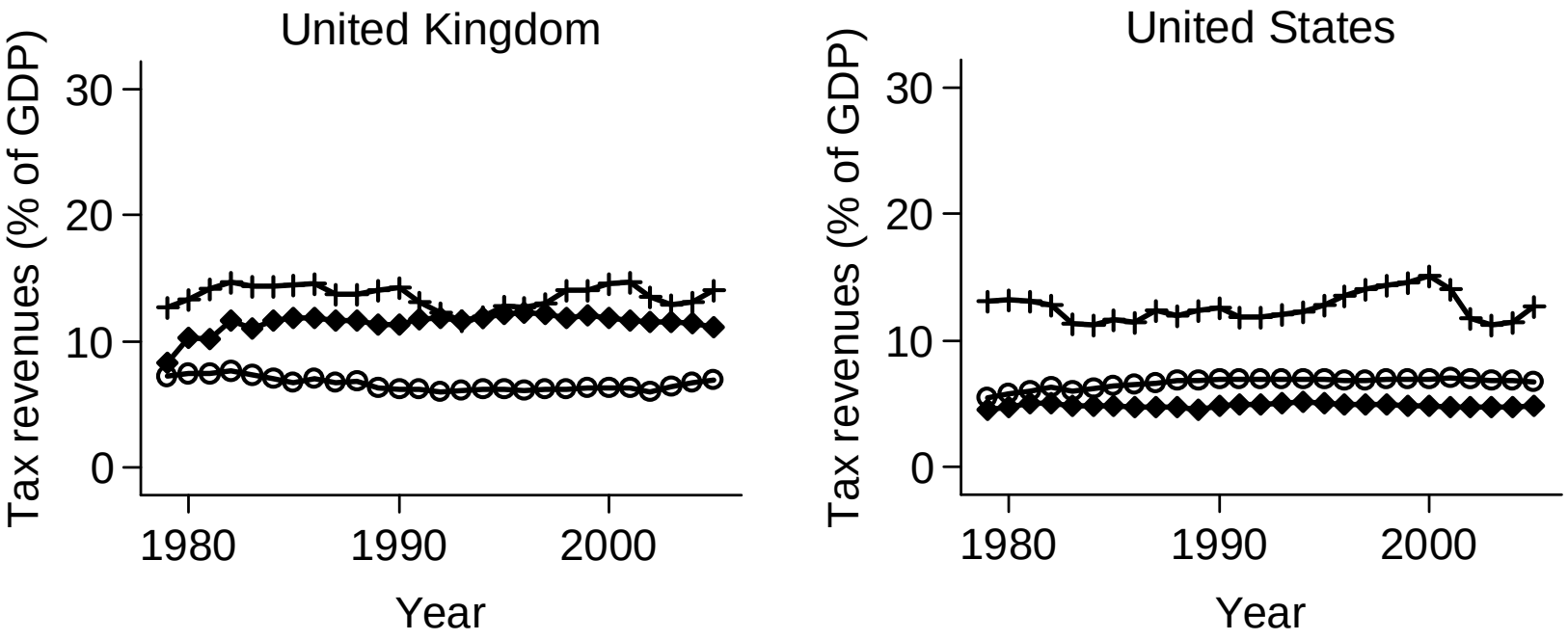
United Kingdom: similar to the United States but with higher consumption tax

# *What's the best way to increase taxes?*




+ = taxes on income and profits; o = social security contributions and payroll taxes; ♦ = taxes on consumption (goods and services). Tax revenues as a share of GDP. Data source: OECD.

# What's the best way to increase taxes?




+ = taxes on income and profits; o = social security contributions and payroll taxes; ♦ = taxes on consumption (goods and services). Tax revenues as a share of GDP. Data source: OECD.

# Summary

# *Summary*

How heavily are we taxed?

- Around 30% of GDP
- Much less than in other affluent nations

Do taxes hurt the economy?

- At some point, yes
- But there's no evidence we've reached that point

What's the best way to increase taxes?

- It'll be hard to raise revenues by a lot if we focus solely on the rich