The Disadvantages of High Marginal Tax Rates

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Testimony before the Senate Budget Committee

April 8, 2014

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Chair Murray, Ranking Member Sessions, Members of the Senate Budget Committee, I am honored to be invited to testify before you today on the subject of the effects of high taxes on GDP growth

Currently I am a senior fellow and director of Economics21 at the Manhattan Institute for Policy Research. I am author or editor of several books, including *Women's Figures: An Illustrated Guide to the Economic Progress of Women in America,* (AEI Press, 2012), and *Overcoming Barriers to Entrepreneurship in the United States* (Rowman and Littlefield, 2008). From February 2003 until April 2005 I was chief economist at the U.S. Department of Labor.

The State of America's Economy

The Great Recession ended in June 2009, but, almost five years later, America still has not recovered. America's real gross domestic product grew by 1.9 percent in 2013, which was not enough to generate a sufficient number of jobs to raise nonfarm payroll employment to prerecession levels. The unemployment figures for March 2014, released on April 4, show an economy that is still sputtering along. The unemployment rate was 6.7 percent, and would have been higher if it were not for the labor force participation rate, which stood at 63.2 percent, equivalent to 1978 levels, before millions of women marched into the labor force in the 1980s.

The 6.7 percent overall unemployment rate masks other groups within the economy that are doing far worse. The African American unemployment rate is 12 percent. The teen unemployment rate is even higher, at 21 percent, and the African American teen unemployment rate is 36 percent.[1]

It is most troubling that although economic activity and jobs are the first priority for most Americans, America's tax policy has the effect of reducing economic activity. High taxes drive out both businesses and residents. High tax rates are not just confined to high-income earners. Low-income Americans face high tax rates when their incomes rise so that they phase out of different entitlement programs.

Disincentives of High Marginal Tax Rates

Taxes matter. If they did not matter, America could double them and buy everyone a Prius. Taxes affect individual and business decisions. States with high

[1] Bureau of Labor Statistics, "Employment Situation Report," April 4, 2014.

taxes, such as New York and California, see that their residents migrate to low-tax states, such as Texas and Florida. Countries with high tax rates find they are unsustainable because capital is global and shifts to more hospitable environments.

Many eminent economics professors have shown that lowering individual and corporate income taxes is the key to increasing incentives for Americans to work and for businesses to invest.

Professors Jonathan Gruber of MIT and Emmanuel Saez of the University of California (Berkeley) have found that people at the upper end of the income distribution are highly responsive to changes in tax rates, more so than those at the middle and lower end. Their research shows that lowering top tax rates in France would encourage upper-income earners to work more.[2]

Nobel laureate economist Edward Prescott found that in the 1970s the labor supply of France, Germany, and the United Kingdom exceeded that of the United States. In the 1990s, Americans worked much more than Europeans. Controlling for other factors, he discovered that when tax rates of European countries and the United States were comparable, their labor supplies were comparable as well. Prescott concluded that the difference in the marginal tax rate accounts for the predominance of the differences at points in time and the large change in relative labor supply over time.[3]

The tax system should be designed so that "when an individual works more and produces more output, the individual gets to consume a larger fraction of the increased output." Prescott finds that the elasticity of labor supply with respect to income is nearly three, and that "the large labor supply elasticity means that as populations age, promises of payments to the current and future old cannot be financed by increasing tax rates." He goes on to advocate for mandating that people save for retirement, arguing that such a requirement is "not a tax and does not reduce labor supply."

Similarly, Professors William Gentry of Williams College and Glenn Hubbard of Columbia University found that higher marginal tax rates discourage entrepreneurship.[4] Entrepreneurship involves risk-taking, and people are less willing to take risks when the rewards will be taxed away. A five-percentage-

[2] Gruber, Jon and Emmanuel Saez, "The Elasticity of Taxable Income : Evidence and Implications," *Journal of Public Economics*, 2002.
[3] Prescott, Edward C., "Why Do Americans Work So Much More Than Europeans?," Federal Reserve Bank of Minneapolis, 2003.
[4] Gentry, William and Glenn Hubbard, "'Success Taxes,' Entrepreneurial Entry, and Innovation," National Bureau of Economic Research, 2005.

point reduction in tax progressivity would increase the entry rate into entrepreneurship by 25 percent. The increase in taxes in America in 1993, they found, lowered the probability of people becoming self-employed by 20 percent. The ensuing period of high growth and low unemployment could have been even better.

Princeton University professor Harvey Rosen wrote that on the basis of tax return data for sole proprietors from before and after the Tax Reform of 1986, the probability of purchasing capital assets goes down when a sole proprietor's marginal tax rate goes up. A five percentage point increase in marginal tax rates would reduce the proportion of entrepreneurs who make new capital investments by 10.4 percent, and decrease average investment expenditures by 9.9 percent.[5]

Professors Christina and David Romer, in a 2010 article in the *American Economic Review*, concluded that "a tax increase of 1 percent of GDP reduces output over the next three years by nearly three percent." Romer and Romer say the effect is highly statistically significant. Furthermore, the effect is larger and more significant than if they had examined all legislated tax changes rather than just the ones they determined to be legitimate. The effect on output was smaller after 1980 than prior. The maximum output decline from 1950-1980 was 4.3 percent after 7 quarters, compared to a 3.1 percent decline after 8 quarters in 1980-2007.[6]

The Romers believe that most studies examining the effect of taxes on output suffer from an omitted variable bias. Many tax changes do not occur through legislation, but through changes in the economy, such as increases in the overall level of income, stock prices, or inflation. In order to fix this bias, the authors examine the narrative rhetoric surrounding legislated tax changes to determine which tax changes should be used as legitimate observations to measure the effect on macroeconomics.

Using the narrative record for these tax changes, Romer and Romer categorized tax changes by their motivations. The authors estimate that a deficit-driven tax increase would actually increase GDP growth, but by no more than 2.5 percent. Romer and Romer also examine which components of GDP are affected most by tax increases. A tax increase of one percent of GDP decreased personal consumption expenditures by 2.55 percent, with expenditures on durables accounting for a large portion of the drop. Gross private domestic investment fell 11.2 percent in response to a one percent of GDP tax increase.

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[5] Carroll, Robert, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen, "Entrepreneurs, Income Taxes and Investment," *National Bureau of Economic Research*, 1998.

[6] Romer, Christina D. and David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based On A New Measure of Fiscal Shocks," *American Economic Review*, 2010.

Writing in 2006, Harvard Professor Martin Feldstein concluded that a typical wage earner ($40,000 a year) pays a combined income and payroll tax rate of 45 percent, with sales taxes pushing the rate above 50 percent.[7]

Using the NBER Taxsim calculator, Feldstein simulated tax reform that would raise all individual marginal tax rates (except capital gains) by one percent. The resulting static estimate showed revenue increased by $7.5 billion. Using modest assumptions for a behavioral response (compensated elasticity of .4 and an income effect of .15) Feldstein found that the aforementioned tax reform would decrease taxable income by $6.6 billion and only increase tax revenue by $4.6 billion. Deadweight loss from the tax reform is calculated to be $3.5 billion. "This implies that financing additional government spending by an across the board rise in all marginal tax rates would make the cost per dollar of government spending equal to $1.76."

Feldstein concluded that all government estimates of tax reform should take into account that actual revenue was only 57 percent of static revenue, and that deadweight loss was 75 cents per dollar of revenue.

Taxation and Inequality

One objection to reducing taxes is that lower taxes lead to more inequality, and inequality decreases economic growth. A recent IMF report concluded that inequality decreases economic growth, and suggested raising taxes to counteract inequality.[8]

The idea that inequality limits a country's economic growth is on the verge of becoming conventional wisdom. But, despite the latest International Monetary Fund report, no one has proved the negative macroeconomic effects of inequality.

Entitled "Fiscal Policy and Income Inequality," the IMF report states that "there is growing evidence that high income inequality can be detrimental to achieving macroeconomic stability and growth."

Here are three common errors in the attempt to prove that inequality slows growth.

Error 1: Use of Pre-Tax, Pre-Transfer Income to Measure Inequality.
Throughout the report, the IMF uses the concept of "market income" to measure

[7] Feldstein, Martin, "The Effect of Taxes on Efficiency and Growth," National Bureau of Economic Research, March 2006.
[8] Sanjeev Gupta et al., "Fiscal Policy and Income Inequality," International Monetary Fund, January 2014.

inequality. Market income is defined as income before taxes are paid to the government, and before transfers from the government to low-income individuals.

This concept of income is far removed from reality. The top five percent paid 57 percent of all federal individual income taxes in 2011, the latest year data are available. The top half of earners paid 97 percent of these taxes. The bottom half of earners paid 3 percent. They received back a substantial share of the 97 percent paid by the top half for programs including Medicaid, food stamps, the earned income tax credit, housing vouchers, and unemployment insurance.

Data from the non-partisan Tax Foundation show that families in the bottom fifth of income earners receive over $5 in government sending for every $1 they pay in combined federal, state, and local taxes. Families in the middle fifth of incomes receive $1.50 for each dollar they pay and those in the top fifth receive only 30 cents for every dollar they pay.[9]

The idea that inequality can be measured by income irrespective of taxes and transfers makes little sense.

Yet the IMF report states that "the share of market income captured by the richest 10 percent surged from around 30 percent in 1980 to 48 percent by 2012, while the share of the richest 1 percent increased from 8 percent to 19 percent."

Mismeasurement of income is not the only flaw: many changes occurred between 1980 and 2012. The Tax Reform Act of 1986 lowered tax rates on individuals relative to corporations, and so more businesses filed as individuals. This meant that individuals appeared to earn more after 1986, even though the assets were just transferred from the corporate side to the individual side of the tax code.

Women streamed into the workforce in the 1980s. By 2012, most families in the top fifth of the income distribution had two earners, not one. These data are shown in Table 1.

Census data in Table 2 show that men and women living alone are most likely to be in the lowest-income quintiles. Some 46 percent of women living alone were in the bottom quintile in 2012, and 72 percent of women living alone were in the bottom two quintiles. Only 3 percent of women living alone were in the top

[9] Prante, Gerald and Scott Hodge, "The Distribution of Tax and Spending Policies in the United States," Tax Foundation, November 2013.

quintile. The trends are similar for men. Some 60 percent of men living alone were in the bottom two quintiles, and only 7 percent were in the top quintile.

In contrast, married couples are more likely to be in the top quintiles. Some 32 percent of married couples were in the top quintile, and 58 percent were in the top two quintiles.

Between 1980 and 2012, the share of taxes paid by top earners increased, and the share paid by low-income earners declined. At the same time, transfers to low-income Americans went up.

Cornell University economists Richard Burkhauser and Philip Armour, together with Jeff Larrimore of the Joint Committee on Taxation, accounted for these factors in a paper published last year by the National Bureau of Economic Research. Rather than an increase in inequality over time, they concluded that the share of income of the top five percent declined between 1989 and 2007.[10]

I calculate spending on a per-person basis in order to produce comparable measures. These data are converted into 2012 dollars using the Bureau of Labor Statistics Consumer Price Index for all urban centers. It is important to compute spending on a per-person basis because the number of persons in a household varies by quintile. For a given level of income, a family is better off with fewer people.

Table 3 shows that the average annual spending for a household in the lowest quintile in 2012 was $13,032 per person. In contrast, the average spending for a household in the top quintile was $32,054 per person.

On a per-person basis, the new Department of Labor numbers show that in 2012, households in the top fifth of the income distribution spent 2.5 times the amount spent by the bottom quintile, as can be seen in Table 3. That was the same as 25 years ago. There is no increase in inequality. In addition, the overall level of inequality is remarkably small. A person moving from the bottom quintile to the top quintile can expect to increase spending by only 146 percent.

Error 2: More Inequality Leads to Lower Mobility. The result that more inequality leads to less economic mobility, cited in the IMF report, comes from a graph by Princeton University professor Alan Krueger, former chair of President Obama's Council of Economic Advisers. The graph, called "The Great Gatsby Curve," purported to show that countries with more inequality had lower

[10] Armour, Philip, Richard V. Burkhauser, and Jeff Larrimore, "Levels and Trends in United States Income and Its Distribution A Crosswalk from Market Income Towards a Comprehensive Haig-Simons Income Approach," National Bureau of Economic Research, 2013.

intergenerational economic mobility. The logical conclusion of such a graph was that inequality is actually preventing people from getting ahead.

Just one problem: as with Error 1, more sophisticated data lead to different results. In "The Collapse of the Great Gatsby Curve," my Manhattan Institute colleague Scott Winship showed that the Great Gatsby curve reversed itself when economists used better measures of inequality, the Luxembourg Income Study inequality estimates.[11] Data from University of Ottawa professor Miles Corak on the United States, Canada, and Sweden suggest that more inequality is associated with higher mobility, not less mobility.[12]

Winship's findings echo those of Harvard University economist Raj Chetty, who found little association between the share of income of the top one percent and mobility, either in the United States or between different countries.[13]

Error 3: Tax Increases Lead to Higher Economic Growth. The IMF report suggests many ways that taxes can be raised on upper-income individuals in order to increase economic growth. The theory is that the poor spend a larger share of their income than the rich, so raising taxes on the rich and redistributing these funds to the poor raises growth.

However, spending by upper-income consumers creates local employment, at least in the United States. Labor Department data show that the top fifth of income earners was responsible for 52 percent of all spending on personal household services, and 56 percent of spending on fees and admission to entertainment.[14] Services and entertainment are local businesses that employ low-wage workers. Taxing top earners will result in lower spending on these categories, and less domestic employment.

In contrast, the lowest fifth of income earners spend more on apparel, footwear, and nondurables, which are more likely to be imported. A substantial percentage of goods purchased at big box stores, where low-income individuals tend to shop, are made overseas.

Conclusion

[11] Winship, Scott and Donald Schneider, "The Collapse of the Great Gatsby Curve," Economics21 at the Manhattan Institute. February 3, 2014.
[12] Corak, Miles, Matthew J. Lindquist, and Bhashkar Mazumder, "A Comparison of Upward and Downward Intergenerational Mobility in Canada, Sweden and the United States," March, 2014.
[13] Chetty, Jar, Nathaniel Hendren, Patrick Kline, and Emmanuel Saez, "Where is the Land of Opportunity? The Geography of Intergenerational Mobility in the United States," National Bureau of Economic Research. 2014.
[14] Bureau of Labor Statistics, "2012 Consumer Expenditure Survey," September, 2013.

Many people try to justify increases in taxation by saying that they will reduce inequality, and hence increase economic growth. Academic studies on taxation and GDP growth show that this is not true. Much of the concern about inequality is caused by problems of measurement and changes in demographic patterns over the past quarter-century. Government data on spending patterns show remarkable stability over the past 25 years and, if anything, a narrowing rather than an expansion of inequality.

If transfers of income from one group to another succeeded in creating economic growth, the fastest-growing countries would be those with the highest top tax rates. Empirical observation shows that the reverse is true. America needs economic growth and jobs, and a simpler, lower tax system is the best way to achieve it.

Tables

Table 1: 2012 Consumer Units by Income Quintile

	Lowest 20 percent	Second 20 percent	Third 20 percent	Fourth 20 percent	Highest 20 percent
Number of persons in consumer unit	1.7	2.2	2.5	2.8	3.1
Earners	0.5	0.9	1.3	1.7	2
Homeowner	39	54	64	75	89
With mortgage	11	23	37	54	68
Without mortgage	28	31	27	21	11
Renter	61	46	36	25	11

Source: U.S. Department of Labor, Bureau of Labor Statistics, Consumer Expenditure Survey, September 2013.

Table 2: Percentage of Households within Each Income Quintile by Type of Household, 2012

Type of Household	Lowest 20 percent	Second 20 percent	Third 20 percent	Fourth 20 percent	Highest 20 percent	Top 5 percent
Family households	12.2	17.7	20.5	23.5	26.1	6.6
Married-couple families	7.0	14.8	19.9	26.3	32.1	8.4
Male householder, nsp	16.9	23.3	25.8	19.6	14.4	2.7
Female householder, nsp	30.2	26.6	20.9	14.5	7.8	1.3
Nonfamily households	35.2	24.5	19.0	13.1	8.2	1.9
Male living alone	34.3	26.0	20.6	12.4	6.8	1.7
Female living alone	45.7	26.0	16.5	8.5	3.4	0.7

Note: nsp denotes no spouse present.

Source: U.S. Census Bureau, Annual Social and Economic Supplement, 2013 (Table HINC-05. Percent Distribution of Households, by Selected Characteristics within Income Quintile and Top 5 Percent in 2012).

Table 3: Annual Expenditures by Income Quintile 2012

Real Expenditure per Person by Income Quintile, Selected Years 1987-2012, 2012 Dollars

	1987	**1992**	**1997**	**2002**	**2007**	**2012**
Lowest 20 percent	11,626	11,495	12,722	14,309	13,334	13,032
Second 20 percent	14,410	14,325	14,652	15,744	15,678	14,833
Middle 20 percent	16,874	17,395	17,994	18,827	18,801	17,202
Fourth 20 percent	20,631	20,368	21,135	22,986	21,873	21,421
Top 20 percent	29,350	30,608	30,825	31,586	33,479	32,054
5:1 ratio	2.52	2.66	2.42	2.21	2.51	2.46

Source: Manhattan Institute Calculations, and U.S. Department of Labor, Bureau of Labor Statistics, *Consumer Expenditure Survey 1987-2012.*