

# The Consequences of Taxation

Arpit Gupta | July 9, 2010

America is substantially wealthier than many European countries. For instance, America's per capita income was over \$45,000 in 2007, while Germany's weighed in at just over \$34,000. If Germany were an American state, its per capital level would sit in between South Carolina and Oklahoma. For an even more stark comparison, Greece's per capital income level is lower than every American state.

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A number of economists – among them Ed Prescott – have argued that higher European taxes play a large role in determining this outcome. During the 1970s, Western Europeans worked more than Americans. Now, Americans work 50% more than Europeans. This argues against durable cultural differences as an explanation for greater American employment, and points to recent policy changes.

The rise of female employment in American two-earner households, for instance, appears related to the passage of the 1986 tax reform law. While European countries are quite diverse, as a group they offer higher taxes and so more disincentives to work. Prescott argues that the “multiplier” of economic losses as a result of higher taxes is substantial.

Other economists, among them Alberto Alesina and Edward Glaeser, credit this difference to other policies. The multipliers Prescott uses come from macro data that uses information about taxation and employment across numerous countries to determine

the disincentives caused by higher taxes. Alesina's team argues that these estimates are inconsistent with “micro” multipliers that use information from individual firms and find much smaller negative impacts of taxes.

Instead, Alesina argues that alternate policies, such as unionization and labor market regulations, are responsible. As more Europeans lowered their work hours, it became more convenient to take time off and spend it with others on vacation. Perhaps workers on both sides of the Atlantic prefer to work less; but Europeans have managed to better coordinate common vacations with coworkers and relatives.

Ultimately, a review of these two research strands still leaves the key question unanswered – why do the negative impact of taxes appear much larger at the national level than the firm level?

A clever resolution is suggested by a set of papers by Raj Chetty, an economist at Harvard. Chetty points out that the micro estimates rely on instantaneous adjustment to higher tax rates, and typically focus on short durations after law changes. However, a variety of factors may combine to make the behavior responses to tax cuts a more long-run effect. People face costs in switching jobs or entering the job force. They may simply be unaware of tax changes or lazy. Any of these plausible frictions are compatible with large long-term effects of tax cuts that are difficult to capture in micro data.

This distinction is important, because policymakers are generally interested in the economy-wide and durable impacts of tax increases, rather than their short-term impacts. Macro estimates, which use



economy-wide data, may be better suited to answer this question.

In a separate paper, Chetty and coauthors develop new techniques to capture broader responses to taxation while looking at firm-level data in Denmark. They are able to obtain a set of estimates that suggest that the work disincentives of taxes, properly computed, are closer to the higher macro estimates (though lower than some estimates Prescott prefers). These figures would suggest that a sizable portion of the Europe-America income difference can be accounted for by differences in marginal tax rates.

Sadly, public discussion of this issue has been far more simplistic. The Obama Administration and other progressives have argued that because growth was high in the '90s and '50s; the higher tax rates of those periods can be revisited with few consequences. This coarse argument relies on decade-level generalizations, and ignores the difficulty of isolating the effects of tax cuts from the noise of other economic activity.

So, what does the best academic work conclude about the effects of taxes during these periods? The research finds large work disincentives of taxes, and suggests that growth in the '90s and '50s happened *despite* higher taxes, and that higher taxes now would have real costs.

This narrative about the consequences of taxation is worth keeping in mind as the U.S. faces a higher tax regime in the coming years. The cumulative impacts of Obamacare, repeal of the Bush tax cuts, and the new (future) taxes required to pay for the current deficits will have large economic consequences. Put simply, if we want higher levels of government spending, we will need higher levels of taxes, and accept lower economic growth.