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'Taxes Are Much Higher Than You Think'

By Veronique de Rugy - December 12, 2012

Noble Prize winner Ed Prescott and UCLA economist Lee A. Ohanian have a piece in the *Wall Street Journal* today warning us of the impact of increasing taxes further in high-income earners. For one thing, they argue, taxes are already much higher than we think.

> Taking into account all taxes on earnings and consumer spending—including federal, state and local income taxes, Social Security and Medicare payroll taxes, excise taxes, and state and local sales taxes—Edward Prescott has shown (especially in the Quarterly Review of the Federal Reserve Bank of Minneapolis, 2004) that the U.S. average marginal effective tax rate is around 40%. This means that if the average worker earns $100 from additional output, he will be able to consume only an additional $60.

Also, as Andrew Stuttaford noted, taxes are also scheduled to go up anyway. He quotes AEI's Alan Viard:

> In the debate over the looming fiscal cliff, U.S. President Barack Obama often plays down any adverse economic impact from letting the 2001 and 2003 tax cuts expire for high-income Americans, claiming that the top tax rates would merely return to where they were during the Clinton years. Unfortunately, the president's claim is incorrect because he ignores the impending arrival of the unearned income Medicare contribution tax, which will further raise tax rates on income from saving.
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> Scheduled to take effect on Jan. 1, the tax, which was adopted as part of the 2010 health-care law, is a 3.8 percent levy on interest, dividends, capital gains and passive business income received by taxpayers with incomes exceeding $200,000 (or $250,000 for couples).
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> Because the new tax was added to the health-care law late in the process without congressional hearings, it received little attention at the time. With only a few weeks left before it takes effect, it remains largely unknown.

Moreover, Prescott and Ohanian outline one of the channels by which raising tax rates will significantly reduce U.S. economic activity:

> High tax rates—on both labor income and consumption—reduce the incentive to work by making consumption more expensive relative to leisure, for example. The incentive to produce goods for the market is particularly depressed when tax revenue is returned to households either as government transfers or transfers-in-kind—such as public schooling, police and fire protection, food stamps, and health care—that substitute for private consumption.

This is one of the key findings behind Prescott's paper "Why Do Americans Work So Much More Than Europeans?" Before you say, or think, "duh, that's an easy question," read this great explanation of the Prescott "big idea" by economist Garett Jones at George Mason University. It boils down to this: In the absence of a welfare state, it would be hard to predict the impact of higher taxes. But a generous welfare state reduces the feeling of being poorer due to higher taxes, and along with it the need to work more to compensate for the loss of income. As a result, people work less. (Professor Casey Mulligan of the University of Chicago has some path-breaking research on this problem, summarized here by the Cato Institute's Dan Mitchell.)

We are left with a pretty grim outlook. Even on paper, the soak-the-rich proposals currently on the table (from both the Republicans and the Democrats) will do little to address the U.S. deficit, and will probably exacerbate the spending problem. But it will be worse than it looks because as Prescott and Ohanian explain people will, over time, reduce the number of hours of work. When people work less, the government collects less revenue, or at least less revenue than projected by static estimates. In other words, we end up with fewer hours being worked, lower growth, less tax revenue, and are still looking at a budget crisis.

It is unfortunate that instead of focusing on the real fiscal cliff this country is facing — a structural spending problem driven by growth in programs like Social Security, Medicare, and Medicaid — the president and Congress have decided to focus on whether to raise revenue by increasing tax rates or capping deductions. The economic damage from the deal will be non-trivial and the savings resulting from it will be close to zero.

It is time for conservatives to realize that they will gain nothing by agreeing to a deal that only increases taxes on the rich, especially without serious entitlement reform. As such, their offer should be this: Implement true reform of Social Security, Medicare, and Medicaid, or jump off the cliff.