



# Positive and normative judgments implicit in U.S. tax policy, and the costs of unequal growth and recessions<sup>☆</sup>



Benjamin B. Lockwood<sup>a</sup>, Matthew Weinzierl<sup>b,\*</sup>

<sup>a</sup> Harvard University, USA

<sup>b</sup> Harvard Business School and NBER, Soldiers Field Road, Boston, MA 02163, USA

## ARTICLE INFO

### Article history:

Received 10 August 2015

Received in revised form

14 October 2015

Accepted 19 October 2015

Available online 2 November 2015

### Keywords:

Income taxation

Optimal taxation

Inverse optimum

## ABSTRACT

Calculating the welfare implications of changes to economic policy or shocks requires economists to decide on a normative criterion. One approach is to elicit the relevant moral criteria from real-world policy choices, converting a normative decision into a positive inference, as in the recent surge of “inverse-optimum” research. We find that capitalizing on the potential of this approach is not as straightforward as we might hope. We perform the inverse-optimum inference on U.S. tax policy from 1979 through 2010 and argue that the results either undermine the normative relevance of the approach or challenge conventional assumptions upon which economists routinely rely when performing welfare evaluations.

© 2015 Elsevier B.V. All rights reserved.

## 1. Introduction

Economists are put in an awkward position when asked to calculate the welfare consequences of changes to economic policy or of shocks to the economy: we are asked to act as moral philosophers. Though we have largely converged on a standard approach to that task—i.e., by using a generalized form of utilitarianism—we have left room for a wide range of normative perspectives within that approach. For example, in optimal tax models we have tried to remain agnostic about the values of the so-called marginal social welfare weights that determine the value of transferring resources across individuals (see Saez, 2001). Choosing a more specific normative perspective, for example choosing the values of the marginal social welfare weights, remains an uncertain and basically unwelcome task.

When the researcher's goal is to produce specific tax policy recommendations or quantitatively characterize optimal policy, however, choosing a more specific normative perspective cannot be avoided. In those cases, optimal tax analysts from Mirrlees (1971, p. 201) to Saez (2001, p. 223) and beyond have typically assumed that the objective of policy is to maximize the simple sum of individuals' utility, or well-being, levels, where individual utility is a concave function of after-tax income (i.e., in which the marginal utility of a dollar decreases with income, approaching zero as income grows very large). When economists make such assumptions, they implicitly take a strong moral philosophical position.

<sup>☆</sup> This paper was prepared for the April 2015 Carnegie Rochester NYU Conference on Public Policy. We are grateful to Stefanie Stantcheva for her discussion and comments on the paper, to Sevin Yeltekin for valuable editing advice, and to participants at the conference for helpful discussions. Thanks also to Alex Gelber, Andreas Peichl, and Danny Yagan for in-depth comments, and to Nathan Hendren, Louis Kaplow, Greg Mankiw, Joel Slemrod, Glen Weyl, and participants at the NBER Public Economics Program meeting for insightful discussions.

\* Corresponding author. Tel.: + 617 495 6697.

E-mail addresses: [lockwood@fas.harvard.edu](mailto:lockwood@fas.harvard.edu) (B.B. Lockwood), [mweinzierl@hbs.edu](mailto:mweinzierl@hbs.edu) (M. Weinzierl).

An alternative approach is to take our normative cues from society, eliciting the relevant moral criteria from real-world policy choices.<sup>1</sup> Progress along these lines has been facilitated by the recent “inverse-optimum” research that, following Bourguignon and Spadaro (2012), uses analytical results from optimal tax theory and assumptions on economic parameters to infer the marginal social welfare weights (MSWWs) currently prevailing in a number of developed economies.<sup>2</sup> While that literature has largely refrained from using the inferred weights for welfare evaluation, the potential for doing so is clear. For example, related work by Hendren (2014) uses a similar inference exercise to calculate the implicit welfare costs of rising inequality in the modern United States given mainstream estimates of the distortionary costs of taxation. In principle, these inference exercises would allow us to convert the selection of a normative perspective into an empirical question, exempting economists from some difficult choices. Along the way, they would allow us to characterize the conditions under which the conventional specification of the policy objective (i.e., utilitarian with diminishing marginal utility of income) is and is not consistent with the objective that appears to be hold sway—if only implicitly—in reality.

In this paper, we find that this “revealed preference” approach yields results that demand an explanation. The problems start when we extend the previous literature by performing the inverse-optimum inference analysis intertemporally, using official data on U.S. income distributions and standard theoretical conditions on optimal marginal tax rates to infer the combinations of positive and normative judgments implicit in U.S. tax policy from just after the Tax Reform Act of 1986 (TRA86) through 2010. We find that tax rates are consistently (for more than two decades) much lower on high earners, and to a lesser extent middle-income earners, than what is recommended by the conventional optimal policy analyses described above.

The interpretative challenge posed by the surprisingly low marginal tax rates on high incomes takes the form of a trilemma in which at most two of the following conditions can hold: the inverse-optimum exercise yields normatively-relevant results on MSWWs (e.g., they broadly reflect the public will despite flaws in the political system); society's perceived size of the distortionary cost of taxation (the elasticity of taxable income, or ETI) lies within conventional ranges; and society's true pattern of MSWWs is consistent with conventionally-assumed principles (e.g., where the highest earners receive minimal marginal weight). In other words, the results from 1987 through 2010 either undermine the normative relevance of this inference exercise or challenge conventional assumptions upon which economists routinely rely when performing welfare evaluations.

The interpretive challenge deepens when we extend the analysis to policy prior to TRA86. The inferred normative and positive judgments for much of the 1970s and early 1980s are substantially different from those for later years, with either the perceived distortionary costs of taxation or the MSWWs on high earners appearing to be much lower prior to TRA86 than after. If these results accurately capture the desired shift in tax policy over these two decades, the trilemma described above worsens. Specifically, in that case welfare analyses using the results of the inverse-optimum exercise are sensitive to the year for which it is performed, and to use those results we would have to accept not only unconventional values for some key assumptions (i.e., in the 1987–2010 period) but also changes in these values over time. Alternatively, one might argue that the purpose of TRA86 was to reform aspects of the tax code that poorly implemented society's normative and positive judgments, which themselves were largely stable over time. In that case, the challenge posed by the original trilemma extends across approximately the last 40 years, not 25, of modern U.S. tax policy. Even more puzzling results appear if we extend our analysis back to the early twentieth century (where our data are more limited).

Addressing the interpretive challenge posed by our results is, we argue, a prerequisite to fulfilling the promise of this empirical approach to normative questions and, more generally, an important task for economists interested in welfare analysis. If the policymaking process is so deeply flawed that a policy as widely-debated, familiar, and controversial as the progressivity of the income tax fails to usefully aggregate the public's policy preferences, there is little hope for using such inference exercises to uncover society's underlying normative priorities. If the prevailing income tax is, instead, consistent with the public's priorities and beliefs, these exercises provide a rigorous, transparent way to check conventional assumptions against reality. In particular, while the conventional optimal tax model simplifies reality in a number of ways, it distills the essence of the tax policy problem into a few key, general parameters—indeed its influence is due to its remarkable ability to do so.

<sup>1</sup> See Saez and Stantcheva (2015), Weinzierl (2014a,b) for analyses that look for underlying principles that inform the inferred marginal social welfare weights.

<sup>2</sup> Bourguignon and Spadaro (2012) estimate the MSWWs for France in 1995 and find that they are negative on high earners unless the labor supply elasticity is small, similar to our findings in U.S. for the early 1980s. Spadaro et al. (2012) estimate and compare average MSWWs on five income-earning groups for 26 European countries, finding substantial variation across them. Olivier Bargain et al. (2013, 2014a,b) include the United States (as well as European countries) in their analyses. In Bargain et al. (2013), they study how tax policy has affected inequality in the United States from 1979 to 2007 and find partisan effects on policy consistent with the trends we show below. In Bargain et al. (2014a,b) they examine 2005 U.S. policy and data, estimate the relevant labor supply elasticities, and calculate implicit MSWWs that are quite flat across the income distribution relative to many European countries, consistent with our findings for the same time period if elasticities of taxable income are perceived to be small. Floris Zoutman et al. (2013,2015) analyze in detail the Dutch tax system and proposals for it by Dutch political parties to infer prevailing and preferred MSWWs in the Netherlands. In Zoutman et al. (2013) they find that top MSWWs are negative unless the elasticity of labor supply is small, consistent with the Bourguignon and Spadaro results for France and ours for the United States. In Zoutman et al. (2015) they show (among other things) that the tax proposals by Dutch political parties have the same feature. Other related works include Mera (1969), Moreh (1981), Kopczuk et al. (2005), Christiansen and Jansen (1978), Pirttilä and Uusitalo (2010), Bargain and Keane (2010), Stern (1977), Amiel et al. (1999), and Pflingsten and Schneider (1994).

Download English Version:

<https://daneshyari.com/en/article/7368513>

Download Persian Version:

<https://daneshyari.com/article/7368513>

[Daneshyari.com](https://daneshyari.com)