

The Daily Dish

Tax Policy 101

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Eakinomics: Tax Policy 101

The headline in the *Financial Times* read, "White House says capital gains tax rise will hit only richest 0.3%," and I lost my mind. I admit, and long-time Eakinomics readers are well aware, that it does not take very much to drive me over the edge. But this is terrible economic analysis. Literally an F coming from a place like the White House. So, I said so on Twitter (perhaps not my finest moment) and the haters began to hate. Let me explain.

From a tax policy perspective, there are two main questions about a tax: (1) How distortionary is the tax – how much does it change economic decision-making and thus re-shape the economy – and (2) Who really pays the tax – who bears the ultimate economic burden of the tax? The first is often referred to as the deadweight loss of the tax and the latter as the economic incidence of the tax.

Knowing that the capital gains tax increase is targeted on only 0.3 percent of individuals does not tell you anything about the answer to either question.

To understand the first question, you need to know how much of the capital gains are taxed. If the 0.3 percent own 0.3 percent of the capital gains, there is likely to be very little aggregate change in the accumulation of capital, the improvement in productivity, or the rise in real wages. But if the 0.3 percent of individuals own 100 percent of the capital gains, then this is potentially a very big impact on the incentive to save and invest (especially because the all-in rate, including the increase in taxation at death, is 67 percent). So, what matters is the fraction of accumulated gains that the affected taxpayers will hold.

Dear White House, what is that number?

As it turns out, that is also the key to the second question. If the tax affects a tiny amount of overall gains and does not change the aggregate patterns of saving and investment, then the

taxpayers sending in the checks are also bearing the burden. But if the prospect of these taxes causes individuals to shift away from saving and investment in high-return activities that generate gains, then they will be able to legally avoid more taxes. But as they shift, they reduce the capital and innovation in those activities, diminish productivity growth, and reduce the real wages of workers. Those reduced wages represent the burden of the tax, which has been "shifted" from the 0.3 percent to the working class.

This White House claim is not the only notable episode of this kind of mistaken argumentation. In our research on the wealth taxes of Senators Sanders and Warren, Gordon Gray and I found that workers would ultimately bear a majority (60 percent) of the burden of the wealth taxes – even though only a "handful" of the affluent would be targeted. Why? That handful was targeted precisely because they own a large fraction of the investible capital, and the wealth taxes are a draconian tax on the annual return to that capital. What matters is the amount of economic activity that is taxed, not the number of people.

A White House should be able to provide the information needed to actually evaluate its policy proposals. The fraction of taxpayers is not that information.