The Daily Dish

A Guide to the Tax-Hike Debate

DOUGLAS HOLTZ-EAKIN | OCTOBER 27, 2020

Eakinomics: A Guide to the Tax-Hike Debate

One of the most high-profile policy promises in the 2020 cycle is Joe Biden's plan to raise taxes by roughly $2.8 trillion, with the taxes targeted on those making more than $400,000. The key elements of the plan are a higher individual income tax rate, higher dividend and capital gains tax rates, imposing the Social Security payroll tax on labor income above $400,000, and raising corporation income taxes.

One rationale for such a change is to use the resulting funds for programs that are focused on low-income individuals. In effect, this tax hike makes the overall tax-transfer system more progressive and seeks to reduce the overall income inequality in the United States. From a conceptual perspective, if individuals were simply born with a fixed earning power, then it would make sense to use the tax-transfer system to offset any rise in the inequality of these fixed endowments.

Of course, earning power is not fixed at birth. In particular, overall earnings are influenced by the frequency and amount of work. To the extent that raising taxes induces less participation and work, this is an efficiency cost that argues for a less aggressive increase in taxes to lean against rising inequality. I think it is safe to say that the consensus on the liberal side of the policy aisle is that higher taxes have no real impact on the labor supply of upper-income Americans, and thus there is no reason to mitigate tax hikes out of concern for the growth consequences.

One more layer down, conditional on the amount of labor supplied, the productivity of that labor will depend upon the quantity and quality of the technologies, equipment, and other capital that is available to workers. Higher taxes reduce the return to saving and investment, and thus diminish the accumulation of capital, reduce the growth of productivity and real wages, and thus are less desirable for combatting inequality as a result. It is precisely this channel that underlies AAF's analysis of the (draconianly progressive) Sanders and Warren wealth taxes. Because over the long haul workers wages fall by $0.63 for every dollar of wealth tax, it is undesirable to lean heavily on this redistribution.

There is a similar channel, however, that is often overlooked in the inequality debate: human capital. Just as taxes defer the accumulation of tangible capital, they can also deter the accumulation of human capital – education, experience, and skills that result in higher wages. This channel is featured in a new paper from Jonathan Heathcote, Kjetil Toresletten, and Giovanni Violante entitled How Should Tax Progressivity Respond to Rising Income Inequality?

In the words of the authors, "In this paper, we challenge on two levels the traditional narrative on inequality and redistribution. First, we argue that the tax and transfer system has not in fact become less progressive over time. On the contrary, we argue that the amount of redistribution embedded in the tax and transfer system has been rather stable on net between 1980 and 2016. Second, we argue that the appropriate policy to address rising inequality depends on why income inequality is going up."

In short, the authors carefully calibrate the sources of rising inequality, separating out the portion that is a result of rising returns to human capital. What does it tell us about the right tax-based response to increased inequality? “When we model both the rise in returns to skills and the increase in residual wage dispersion, counteracting forces emerge in the optimal taxation problem. We conclude that progressivity should have remained roughly stable over time.”

Some think that rising inequality makes a more sharply progressive income tax system a no-brainer. But a careful consideration of all the economic impacts suggests that considerable caution is in order.