November 6, 2008

Saving and taxes

I hope you will excuse me for trading in a bit of old news, but I've been thinking about a post by Greg Mankiw from last week. Titled "My Personal Work Incentives," the item takes published details of the McCain and Obama tax proposals. The essence of the post was to point out how these details impact the return to working for higher-income individuals, assuming that a marginal dollar earned is a marginal dollar saved (for the children, of course):

> "Let t1 be the combined income and payroll tax rate, t2 be the corporate tax rate, t3 be the dividend and capital gains tax rate, and t4 be the estate tax rate. And let r be the before-tax rate of return on corporate capital. Then one dollar I earn today will yield my kids:
>
> (1-t1){[1+r(1-t2)(1-t3)]^T}(1-t4).
>
> "For my illustrative calculations, let me take r to be 10 percent and my remaining life expectancy T to be 35 years…
>
> "Under the McCain plan, t1=.35, t2=.25, t3=.15, and t4=.15. In this case, a dollar earned today yields my kids $4.81. That is, even under the low-tax McCain plan, my incentive to work is cut by 83 percent compared to the situation without taxes.
>
> "Under the Obama plan, t1=.43, t2=.35, t3=.2, and t4=.45. In this case, a dollar earned today yields my kids $1.85. That is, Obama's proposed tax hikes reduce my incentive to work by 62 percent compared to the McCain plan and by 93 percent compared to the no-tax scenario."

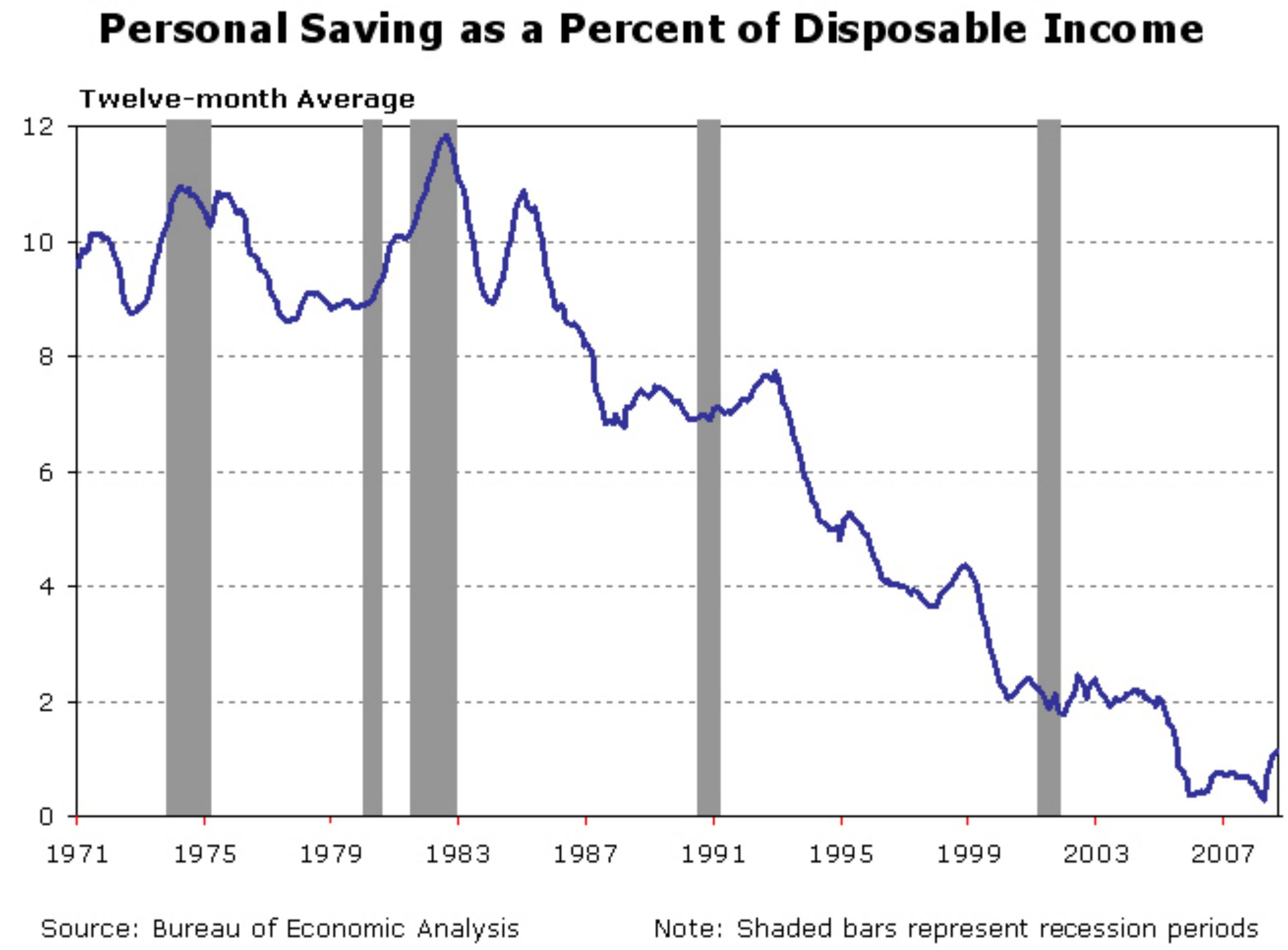
Since the election is over, I trust that fact will keep the focus on the essential economic point, which is that tax policy does indeed affect incentives.

Which brings me to my point. Using Mankiw's interest rate assumption, the present value of McCain's $4.81 is $0.17 (which is implied directly by the 83 percent marginal tax rate). The comparable figure for Obama's $1.85 is $0.07.

Mankiw's point is that these sorts of numbers would substantially change his incentives to work. If the whole point is to leave a little nest egg for the kids, that is surely true, but there is another choice.

Here is another possibility: Suppose I forgo provisioning for the children altogether and simply consume that extra dollar of income. That way I avoid the corporate tax, dividend and capital gain tax, and the estate tax altogether. Under the McCain plan I get to enjoy $0.65 worth of extra consumption, or $0.57 worth under the Obama plan. I would have to value my children's consumption an awful lot to trade $0.65 (or $0.57) of my own for $0.17 (or $0.07) of theirs.

As I think about this example, I am naturally drawn to the fact that savings rates in the United States are, in an historical context, pretty darn low.



There are almost certainly multiple reasons for the pattern shown in this chart. It would be tough to make the case that tax policy is the only culprit, but it would be equally tough to argue that it is irrelevant.

The distortion on saving from capital-income taxation could be eliminated, of course, by simply eliminating taxes on saving, but doing so would have exactly the sort of distributional consequences that account for a good deal of difference in the Obama and McCain tax plans in the first place. My training as an economist gives me no special expertise in determining how to value the trade-off between “fairness” and efficiency—and beware of any economist who pretends otherwise. But as you contemplate the distortions presented by your favorite tax proposal—a required step in any complete analysis—you might consider putting disincentives to save fairly high up on the list.

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