CTJ Citizens for Tax Justice

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Will Taxes Make Former Bush Adviser Greg Mankiw Work Less?

Real People Don't Work Less When Their Taxes Go Up. What Does Mankiw Really Want?

On Sunday, October 10, Harvard professor Greg Mankiw wrote an op-ed for the *New York Times* arguing that if taxes go up, he'll work less.[1] Mankiw was the chief economic adviser to President Bush, whose administration oversaw a period when median incomes not only stagnated but actually *fell* for the first time since the government started keeping track,[2] and left us in the deepest recession since the 1930s.

Mankiw was a champion of the Bush tax cuts and apparently thinks they should be extended for all taxpayers. President Obama, on the other hand, wants to extend the Bush tax cuts fully for everyone except the top 2 percent of income earners. The top two tax brackets will revert from 33 and 35 percent back to the pre-Bush levels of 36 and 39.6 percent. The brackets will be adjusted slightly so that no married couples with adjusted gross income (AGI) less than $250,000 will be included in the top two brackets. (And taxpayers in the top two brackets will still benefit from the extension of the cuts in the lower brackets because the top brackets only apply to their income *over* $250,000). Mankiw acknowledges he earns enough to lose a portion of his Bush tax cut under President Obama's proposal. So for every additional dollar he earns (over $250,000), his federal income tax will be 3 cents higher or, at most, 4.6 cents higher, than it would be if the tax cuts were fully made permanent even for the rich.

Mankiw says he doesn't like taxes on wages, because he thinks they discourage people from working. He also doesn't like taxes on investment income or wealth — he says they discourage both work and savings. As a result, he's not a fan of the corporate tax or the estate tax either. Which pretty much leaves him with two alternatives: no government or a consumption tax like a sales tax or a VAT, which is paid by everyone, including workers and investors, based on what they spend.[3] Such a tax would, of course, be much tougher on the vast majority of us, but much lighter on wealthy investors.[4]

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[1] N. Gregory Mankiw, "I Can Afford Higher Taxes. But They'll Make Me Work Less." New York Times, October 10, 2010. http://www.nytimes.com/2010/10/10/business/economy/10view.html
[2] David Leonhardt, "For Many, A Boom That Wasn't," New York Times, April 9, 2008. http://www.nytimes.com/2008/04/09/business/09leonhardt.html
[3] For his support of a VAT, see "Thoughts about the Fiscal Commission," Greg Mankiw's Blog, February 17, 2010, and "The Value-Added Tax," October 14, 2009. http://gregmankiw.blogspot.com
[4] See, for example, Institute on Taxation and Economic Policy, "The Effects of Replacing Most Federal Taxes with a National Sales Tax, A State-by-State Distributional Analysis," September 2004. www.itepnet.org/pdf/sale0904.pdf

Mankiw's Sad Tale (As He Tells It)

Here's the short version of Mankiw's argument. Say an editor asks him to write an article, for which he'll be paid $1,000. After federal and state income and payroll taxes, Mankiw, who apparently is among the half of a percent of Americans in the top income tax bracket, will have $523 left to invest. If he put that in a stock investment earning 8 percent a year, he claims that personal and corporate income taxes will cut his rate of return to only 4 percent. After 30 years, that $523 will grow to about $1,700, but, he predicts, estate taxes will eat up $700, resulting in only $1,000 to be left to his kids.

If there were no taxes (an absurd comparison), he would have $10,000 after 30 years which, he argues, means that he has a 90 percent tax rate! On the other hand, he says, if the Bush tax cuts were made permanent (including repeal of the estate tax), there would be about $2,000 to leave to his kids after 30 years (an 80 percent tax rate under Mankiw's analysis). All of this means that Mankiw won't have much incentive to take that $1,000 assignment if the tax cuts are not fully extended for the rich, he says.

We take exception to both Mankiw's calculations and his theory of how taxes affect behavior.

The Basic Economics: Mankiw Tells Only Half the Story (or Less)

Higher taxes have two possible effects under standard economic theory — an income effect and/or a substitution effect.

An income effect assumes that you have an income goal, such as making enough to feed your family. If your income rises (from lower taxes, higher wages, a higher interest rate or whatever), you will work less, but if your income falls (higher taxes, lower interest rate, etc.), you will work more.

The substitution effect, on the other hand, assumes that if after-tax wages go down, then people will substitute personal leisure for work because work is less attractive. Opponents of taxes argue that because of the substitution effect, tax increases, which allow you to keep less of the income you earn from working, will cause you to choose personal leisure over work.

Unfortunately for the anti-tax ideologues, history supports a strong income effect, but not much, if any, substitution effect. Specifically, as wages rose over the last century, hours worked went down virtually in lock step.

Nonetheless, Mankiw argues that the substitution effect is the dominant effect that taxes have on *his* behavior. At least that's what he tells us at first. He admits he's a lucky guy and has no real wants — he's got all he needs and has no desire for anything more. Because, if he had an income goal that was not already met, like sending his kids to college, his behavior would be dominated by the income effect and he would be expected to work MORE if taxes go up.

But if all this is true, why would he accept any more assignments at all? Is he just a compulsive wealth acquirer without any particular goal? Well, he says, he would like to pass on a little to his kids to help with down payments on their homes or send their own kids to college. So it seems he has an income goal after all. If he wants to leave a nest egg for his kids, and higher taxes threaten his ability to do that, it's reasonable for us to conclude that he'll take on a few *more* writing assignments in response to higher taxes. (Of course, he won't have to work a lot more, because we're talking about a difference in taxes of less than 5 cents on the dollar.)

Economists can argue about whether the income effect or the substitution effect is more important in determining behavior, but, as explained above, history suggests that the income effect is more important. Perhaps both exist for different people in different circumstances. For Americans not lucky enough to be in the top one or two percent, we bet they are mostly driven by income goals.[5] Really, how many of us base job decisions on our marginal tax rates?[6]

Mankiw's Outrageous Marginal Tax Rate

Mankiw argues that if the Obama tax plan is enacted, his effective marginal tax rate will be about 90 percent. This is so intellectually dishonest, it's amazing he had the chutzpah to publish it.

In fact, his marginal tax rate is nowhere near 90 percent. There's a host of problems with his analysis and several good criticisms have already been written.[7] Among his many inaccuracies, Mankiw assumes tax on his annual investment income at the highest tax rate even though most taxes on investment income can be eliminated, indefinitely deferred, or paid at the much-lower capital gains tax rate, and the effective corporate tax rate in the U.S. is much closer to 20 percent than the statutory 35 percent rate that Mankiw uses.[8]

Exaggerating the Effect of Taxes

If President Obama's plan to let most of the Bush tax cuts on the wealthy expire is enacted, Mankiw, assuming he really is in the top income-tax bracket, will have $523 to invest after taxes compared to $569. This difference doesn't quite pack the drama that Mankiw is looking for. So his argument largely revolves around how much wealth he will have after 30 years if he saves whatever income he's allowed to keep after taxes.

Using a 30-year horizon to calculate the effect of taxes greatly exaggerates the effect of a small marginal increase. Any amount of money seems more important if you think about it in terms of what amount it might grow to if it's invested for 30 years. And, logically, any decrease in that

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[5] See Stan Collender, "Taxed More and Work Less? Barry Ritholtz Slices Up Greg Mankiw," http://capitalgainsandgames.com/blog/stan-collender/2001/taxed-more-and-work-less-barry-ritholtz-slices-greg-mankiw?

[6] Barry Ritholtz, "10 Questions for Greg Mankiw," http://www.ritholtz.com/blog/2010/10/10-questions-for-greg-mankiw

[7] Michael Kinsley, "Rich Professors Doth Protest Too Much," Politico, October 19, 2010. http://www.politico.com/news/stories/1010/43772.html . John Schmitt, "Three-card Mankiw," http://noapparentmotive.org/blog/2010/10/12/three-card-mankiw-2

[8] The only thing that's really relevant is that the top federal individual income tax rate is going up by about 5 percentage points. In addition, starting in 2013, the Medicare tax will increase by 0.9% to help fund health reform and the Medicare tax will be extended to certain kinds of investment income.

amount will seem more important from the same 30-year time horizon. Basically, Mankiw is talking about the effects of compounding rates of return over time. He's right that an 8 percent rate of return delivers a lot more than a 4 percent rate of return over 30 years. But taxes, or lack thereof, are only one factor in rates of return. The health of the overall economy, which of course depends largely on a strong, well-run government, is much more important.

In addition, a big chunk of the taxes that Mankiw claim's he'll have to pay on his wealth reflects the estate tax at its highest rate. That falsely assumes Congress will do nothing to address the estate tax and that Mankiw will leave an estate well over the large amount that is exempt from estate tax.

Mankiw says that the estate tax will take another $700 of what he's accumulated when it's passed on to his kids (unless he's really lucky and dies this year while the estate tax rate is 0 percent). He explains that the estate tax will have a rate of "55 percent next year, but Congress may reduce it a bit." The Obama proposal is to make permanent the 2009 rates of 45 percent. He confuses (deliberately, because we're sure he understands the difference) the marginal and effective rates. He doesn't take into account that the first $7 million he and his wife leave to the kids is completely free of estate tax under President Obama's proposal. In fact, recent IRS data show that the effective rate paid by those few estates that actually owe estate tax is only about 20 percent.[9]

What Do Taxes (and the Government) Contribute to Mankiw's Wealth?

Mankiw's op-ed tells us how all of the federal and state taxes take a piece of that $1,000 he'll earn. But what he doesn't tell you is how the government supports his ability to earn it. He doesn't mention the state and federal court systems that enforce his employment contracts. Or the infrastructure like roads and air traffic systems that enable him to get to his speaking gigs. Or the law enforcement and military that protect the assets he's accumulated.

When the government uses Mankiw's taxes to pay unemployment benefits or invest in transportation projects, most of the funds end up in the hands of workers who immediately turn around and spend it, buying goods and services, stimulating the economy, and helping to make it possible for the corporation he's invested in to pay that 8 percent dividend.

Maybe Mankiw's long-term rate of return has something to do with how the government is run. Over the last 20 years, the average rate of return on a typical investment portfolio has been about 5.5 percent (before tax). During the Clinton administration, that average return was almost 9 percent, so even *after tax*, the return was well above the 20-year pretax average. Contrast that with the 8 years of the Bush administration, when the pretax return on investments in the stock market was essentially zero. So even with Bush's lower tax rates, Mankiw's portfolio was much worse off under Bush than it was under Clinton. Which illustrates how economic policies (good or bad) are a lot more important than taxes.

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[9] Citizens for Tax Justice, "State-by-State Estate Tax Figures: Number of Deaths Resulting in Estate Tax Liability Continues to Drop," October 19, 2010. http://www.ctj.org/pdf/estatetax2010.pdf

The Part Economics Doesn't Explain

In his op-ed, Mankiw concludes that if tax rates go up a little on the rich, then high-income taxpayers will choose to work less and the rest of us will suffer from the loss of their services. But that's true only if those high earners are more likely to trade income for additional leisure time. And it ignores one very powerful motivator for working, especially for folks who have plenty of income. For most workers, a sense of achievement is the most important factor in job satisfaction — more important than salary, working conditions, or opportunities for advancement. A venture capitalist testifying before the House Ways and Means Committee (in favor of a tax increase!) said he loved his work, "the rewarding collaboration between the limited partners … the venture capitalist … and the entrepreneur who brings an idea and a fire in his or her belly …. I would not stop doing it because my tax rate [increased]."[10]

[10] William D. Stanfill testimony before the House Ways and Means Committee, Hearing on Fair and Equitable Tax Policy for America's Working Families, September 6, 2007. http://waysandmeans.house.gov/Hearings/Testimony.aspx?TID=1821