

MERCATUS RESEARCH

TAX GIMMICKS

Antony Davies and Devin Bowen



MERCATUS CENTER
George Mason University

Bridging the gap between academic ideas and real-world problems

ABOUT THE MERCATUS CENTER AT GEORGE MASON UNIVERSITY

THE MERCATUS CENTER at George Mason University is the world's premier university source for market-oriented ideas—bridging the gap between academic ideas and real-world problems.

A university-based research center, Mercatus advances knowledge about how markets work to improve people's lives by training graduate students, conducting research, and applying economics to offer solutions to society's most pressing problems.

Our mission is to generate knowledge and understanding of the institutions that affect the freedom to prosper and to find sustainable solutions that overcome the barriers preventing individuals from living free, prosperous, and peaceful lives.

Founded in 1980, the Mercatus Center is located on George Mason University's Arlington campus.

www.mercatus.org

Copyright © 2012 by Antony Davies
and the Mercatus Center at George Mason University

Mercatus Center
George Mason University
3351 North Fairfax Drive, 4th Floor
Arlington, VA 22201-4433
(703) 993-4930
mercatus.org

Release date: October 11, 2012

ABOUT THE AUTHOR

ANTHONY DAVIES is associate professor of economics at Duquesne University and a Mercatus Center-affiliated senior scholar. His primary research interests include forecasting and rational expectations, consumer behavior, international economics, and mathematical economics.

Davies' research has appeared in the *Journal of Econometrics*, the *Journal of Consumer Psychology*, the *Journal of Economic Psychology*, the *International Journal of Forecasting*, *Clinical Cancer Research*, *Applied Economics*, the *Journal of Socioeconomics*, and *Analysis of Panels and Limited Dependent Variable Models* (published by Cambridge University Press). His popular press writings have appeared in *BizEd*, *World & I*, *Religion and Liberty*, and the *International Journal on World Peace*.

DEVIN BOWEN is an MA fellow at the Mercatus Center at George Mason University.

ABSTRACT

POLITICIANS EMPLOY GIMMICKS to hide tax increases from voters. In this paper, we discuss four types of gimmicks. Legislative gimmicks use the wording of the tax law to hide who is being taxed or how much they are being taxed. Economic gimmicks use economic forces to hide who is being taxed and by how much. Communication gimmicks are ways of communicating tax legislation to voters so as to hide the effect or circumstances of tax legislation. Perceptual gimmicks use the voters' psychologies against them so as to encourage the voter not to be aware of the tax.

JEL code: H2

To get elected, politicians must please voters, and one thing that tends to greatly displease voters is higher taxes. But since government needs tax revenues to pay for government spending, politicians are often forced to vote for higher taxes. To minimize the effect of the increased taxes on their election prospects, politicians employ gimmicks to hide the taxes. In this paper, we discuss four types of gimmicks. Legislative gimmicks use the wording of the tax law to hide who is being taxed or how much they are being taxed. Economic gimmicks use economic forces to hide who is being taxed and by how much. Communication gimmicks are ways of explaining tax legislation to voters so as to hide the effect or circumstances of tax legislation. Perceptual gimmicks use the voters' psychologies against them to discourage awareness of the tax. Since politicians employ these gimmicks for the purpose of hiding taxes, let us refer to them generically as tax gimmicks.

Politicians rely, at least in part, on special interest groups to fund their campaigns. In 2011, special interests donated almost three-quarters of a billion dollars to political candidates and parties. In addition, lobbyists spent more than \$3 billion lobbying Congress and federal agencies.¹ The better hidden is a tax, the better able are politicians to manipulate that tax to benefit favored interests while hiding the manipulation from the voters. The result is often a cycle wherein the lobbyist funds the politician's campaign, the politician promises the voter more spending but no new taxes, the politician uses gimmicks to hide the taxes that are needed to pay for the spending and, in the process, crafts the hidden taxes to benefit the lobbyists who, in turn, pay for the politician's next campaign. In short, gimmicks can be used to hide taxes, and, the more hidden the taxes are, the easier it is to raise them.² The easier it is to raise taxes, the more valuable lobbying efforts become.

1. Special interest and lobbying data come from the Center for Responsive Politics at <http://www.opensecrets.org/orgs/list.php?order=A> and are based on data from the Senate Office of Public Records.
2. Amy Finkelstein, "E-ZTax: Tax Salience and Tax Rates" (NBER Working Paper No. 12924, Cambridge, MA, February 2007), <http://www.nber.org/papers/w12924>; Arno Riedel, "Behavioral and Experimental Economics Do Inform Public Policy," *Public Finance Analysis* 66, no. 1 (2010): 65–95, http://www.personeel.unimaas.nl/a.riedel/pdf/BehExpEconPublicPolicy_final.pdf.

TEMPORARY TAXES

CALLING TAXES (OR tax cuts) “temporary” is a perceptual gimmick. In the midst of a crisis, people will usually put up with a new tax if the tax is directed at addressing the crisis. Politicians may overcome any opposition to the tax by promising that the tax will be temporary. Voters perceive they are getting the best of both worlds: the government will have the money it needs to address the crisis and, when the crisis is over, the tax will vanish. The problem is that when the crisis ebbs, so too do people’s attentions. If the politician has crafted the legislation to his or her advantage, the tax will not disappear automatically but will require further legislative action. No politician can then be blamed for having made the tax permanent because it becomes permanent through *inaction*. What is more usual, however, is that legislatures will extend the sunset deadline—not making the tax permanent, just stretching the definition of “temporary”—several times until the people forget what it was like not to have the tax. At that point, officially making the tax permanent is not perceived by voters as raising taxes so much as codifying the status quo. A few examples of temporary taxes that became permanent are as follows:

The Johnstown Flood Tax. Following the devastating 1936 flood that wiped out most of Johnstown, Pennsylvania, the state enacted a 10 percent temporary tax on alcohol sold throughout the state. The tax was intended as a short-term measure to fund the cleanup of Johnstown and to provide aid to flood victims. Starting in the 1940s, the tax revenue was diverted to the state’s general fund.³ Although Johnstown had long since recovered from the flood, the tax not only continued to be renewed, but was made permanent in 1951 and then increased to 18 percent in 1968. Efforts to repeal the tax in 2001 and 2003 failed, and, today, the tax generates \$200 million a year in revenue.

The property damage due to the 1936 flood was estimated to be over \$40 million, or around \$600 million in today’s dollars.⁴ At \$200 million in revenue per year, the tax has paid for the 1936 flood damage more than 25 times over. In support of keeping the tax, state Senator John Wozniak has argued that the tax should serve as a “rainy day fund” that provides relief in case of natural disasters.⁵ However, the tax revenue is not set aside for natural disasters, but goes into the general fund, where the money can be used for other

3. Johnstown Area Heritage Association, “Johnstown Flood Museum: The Compelling Story of the 1889 Disaster,” <http://www.jaha.org/FloodMuseum/1936.html>.

4. Ibid.

5. “Use Flood Tax for Rainy Days,” *Altoona Mirror*, October 9, 2011, <http://www.altoonamirror.com/page/content.detail/id/554305/Use-flood-tax-for-rainy-days.html?nav=728>.

purposes until the next natural disaster comes along. At that point, politicians will likely argue for another temporary tax to raise money to deal with the disaster.

Various sales and excise taxes. North Carolina instituted a temporary 3 percent sales tax in 1933.⁶ The tax became permanent in 1939 and is currently 5.75 percent. Ohio instituted a temporary 5 percent sales tax effective January–June 1981. The tax became permanent in November 1981.⁷ In 1982, Wisconsin enacted a temporary increase in its sales tax from 4 percent to 5 percent. The state made the increase permanent in 1983.⁸ In 1991, California increased its sales tax by 1.25 percentage points. Of this increase, 0.5 percentage points were to be temporary. Prior to the tax expiring, Proposition 172 made the additional 0.5 percentage point increase permanent.⁹ In 1898, Congress passed the Revenue to Meet War Expenditures Act, which imposed a temporary 3 percent excise tax on telephone service to help pay for the Spanish-American War. As telephones were a luxury at the time, this tax was considered a tax on the rich. The Spanish-American War lasted for about 110 days, but the tax continues more than 110 years later, although courts recently pared it back significantly due to a discrepancy between what the law specified should be taxed and what was actually being taxed.¹⁰

INCOME TAX WITHHOLDING

PRIOR TO 1943, the few Americans who paid income taxes wrote a check to the government once a year for the entire amount owed. It was not until Congress passed the Current Tax Payment Act of 1943 that employers withheld taxes from employees' paychecks. This act achieved two things. First, it effectively made all employers IRS agents charged with collecting income taxes owed by their employees and turning those taxes over to the IRS. Second, via a perceptual gimmick, the act hid

6. Cindy Avrette, *Key Events in NC State and Local Tax History* (Raleigh: North Carolina General Assembly, February 2, 2011), <http://www.ncleg.net/documentsites/committees/senatefinance2011/Meeting%20Documents/02-02-2011/Key%20Events%20in%20NC%20Tax%20History.pdf>.
7. Department of Taxation, Revenue Accounting Division, "Sales and Use Tax," http://www.tax.ohio.gov/divisions/communications/publications/annual_reports/2005_Annual_Report/sale_and_use_tax.pdf.
8. Joseph Kreye, *Governing Wisconsin: Wisconsin Taxes* (Madison: Wisconsin Legislative Reference Bureau, May 2007), http://www.legis.wisconsin.gov/lrb/gw/gw_22.pdf.
9. Sarah Olsen, *Proposition 172: How Did It Affect Spending for Public Safety?* (Sacramento: Legislative Analyst's Office, June 9, 1994), http://www.lao.ca.gov/1994/proposition_172.pdf.
10. Internal Revenue Service (IRS), "Internal Revenue Bulletin 2006-50: Communications Excise Tax; Toll Telephone Service," June 19, 2006, <http://www.irs.gov/pub/irs-drop/n-06-50.pdf>.

the income taxes by ensuring that employees would never actually take possession of the money they owed to the IRS. From that time forward, employees would think of their wages as the after-tax amount on their paychecks rather than the pre-tax amount from which the employer withheld taxes. Consumer psychologists have since identified a phenomenon that plays an important role in this gimmick: the endowment effect.¹¹ The endowment effect is the tendency for people to place a higher value on a thing when they own the thing and a lower value on the same thing when they do not own that thing. For example, because of the endowment effect, a taxpayer would feel worse about receiving a \$1,000 paycheck and then having to pay \$100 in tax than he would about receiving a \$900 paycheck from which a \$100 tax had already been withheld. Because of this psychological phenomenon, politicians can make a tax appear less onerous to taxpayers simply by altering how the tax is collected.

In 2009, American taxpayers had \$827 billion withheld from their federal paychecks out of a total income tax liability of \$911 billion. Assuming that state and local taxes are withheld at the same rate, American taxpayers never see 91 percent of the income taxes they pay because the taxes are deducted before they receive their paychecks.¹² These figures do not include payroll (Social Security and Medicare) taxes, which, with minor exceptions, are also withheld by employers. Including these taxes, almost all of the taxes individuals pay to the federal government are hidden from full view. These hidden taxes comprise 40 percent of all the revenue the federal government collects.

One can argue that tax withholding benefits taxpayers. Taxpayers who find it difficult to save money from their paychecks could find themselves in a financial bind come tax season when they are required to pay a large lump sum to the government. However, we do not need the federal government to mandate withholding for all taxpayers. If some taxpayers do derive value from withholding, entrepreneurs would find a way to leverage that value to earn a profit for themselves while simultaneously fulfilling the taxpayers' need for withholding. For example, banks might offer a service wherein they automatically deduct money from a customer's direct-deposited paycheck and hold the money in a savings account in the person's name. When the customer files his tax return, the bank would release the money to the customer or even directly to the government on the customer's behalf.

In fact, banks currently offer services exactly like this. One example is the Christmas Club account wherein banks automatically withdraw a fixed sum from a member's checking account and deposit the amount in a savings account which is later turned over to the customer for Christmas shopping. Banks offer a similar service for home insurance premiums and property taxes—in fact, many mortgage

11. This effect is also known as *divestiture aversion*.

12. IRS, *Statistics of Income*, Tax Stats, table 2, 2009, <http://www.irs.gov/pub/irs-soi/09in02ar.xls>.

lenders require that borrowers have such an arrangement, called an “escrow” or “impound” account, with their mortgage servicers.

The important difference between government mandated withholding and these examples of voluntary withholding is that, in the latter cases, individuals choose whether to engage in the withholding scheme. One can argue that the person who voluntarily has his taxes withheld is as subject to the endowment effect as is the person whose tax withholdings are mandated. The difference is that when the government mandates that taxes be withheld, it is relying on the endowment effect to help hide the amount of tax the person is paying.

STATUTORY VERSUS ECONOMIC TAXES

EMPLOYER-PAID TAXES, INCLUDING the portion of Social Security and Medicare taxes that employers pay on behalf of their employees, are economic gimmicks. Like withheld taxes, the employee never sees employer-paid taxes. Unlike withheld taxes, employer-paid taxes are accompanied by the fiction that it is the employer, not the worker, who is paying the tax. The economic gimmick revolves around the distinction between the *statutory burden* of a tax (from whom does the government collect the tax money?) and the *economic burden* of a tax (whose money is the government collecting?). The government can only establish the statutory burden of a tax; what really matters is the economic burden. If the statutory burden reflects who the government intends to pay a tax, the economic burden reflects who actually pays the tax.

A mental exercise is useful for illustrating the difference. Suppose that a worker, given his skill, education, and work ethic, can contribute \$15 per hour to an employer’s revenue. As long as the employer can hire the worker for less than \$15 per hour, the employer will do so because the additional revenue that the worker contributes will be at least as great as the cost of employing the worker. If the cost of employing the worker rises above \$15 per hour, the firm will not hire the worker because the cost of employing the worker will exceed the worker’s value to the firm.

Firms compete for workers by offering higher wages. The more competition there is, the closer to \$15 per hour the wage will go. Let’s suppose that the labor market is highly competitive and that there is no tax on labor. The wage rate will be \$15 per hour: the firm pays \$15 per hour for labor and the worker receives \$15 per hour for labor. Now suppose that the government imposes an employer-paid tax of \$4 per hour on labor. The statutory burden of the tax falls on the employer; for each hour of labor the firm hires, the firm must pay the government \$4. How will the firm respond? As before, the firm will hire the worker so long as the cost of employing the worker does not exceed \$15 per hour. That means that competition among employers will drive the wage to \$11 per hour. At \$11 per hour, the worker costs the firm \$15 per hour (\$11 for labor plus \$4 in tax).

Prior to the tax, the worker cost the firm \$15 per hour and the worker received

\$15 per hour. After the tax, the worker still cost the firm \$15 per hour, but the worker only received \$11 per hour. The economic burden of the tax is on the worker. That is, the government collected the tax from the firm, but the money belonged to the worker. The moral of this story is that employer-paid taxes are not really “employer-paid.” Rather, employers reduce the wages they pay employees so as to recoup at least some of the tax’s cost.

Empirical studies confirm that at least part of the economic burden of “employer-paid” taxes falls on employees, though market conditions influence the degree to which employers and employees share the burden.¹³ Regardless of market conditions, even the portion of the “employer-paid” tax that is truly paid by the employer ultimately ends up coming out of people’s pockets. When a business pays a tax, the money must come from one (or a combination) of three places: reduced wages, higher prices, or reduced profits. We have seen an example of the firm paying for a tax through reduced wages. Alternatively, the firm can pass the tax on to consumers in the form of higher prices. Finally, the firm can pass the tax on to the firm’s owners in the form of reduced profits. In all three cases, individuals—either workers, customers, or investors—pay for the tax.

Since a firm pays out a portion of its profits to the firm’s owners as dividends and keeps a portion of its profits as retained earnings, one could argue that a firm that makes enough of a profit could pay for the tax out of its retained earnings and avoid reducing employees’ wages, raising the price of a good, or reducing the dividends paid to investors. The problem with this argument is that if the firm pays for the tax out of its profits, the firm’s value declines because the firm has less money than it had before the tax. The decline in the firm’s value reduces the value of the investors’ ownership in the firm. When an owner goes to sell some of his ownership in the company (for example, by selling shares of stock in the firm), he receives less money for his shares than he would have had the firm’s value not declined. Thus, once again investors pay the tax, only in the form of reduced capital gains rather than reduced dividends.

Employer-paid taxes are a gimmick because politicians can make use of the difference between the statutory burden and the economic burden of a tax to claim that they are taxing one group of people while actually taxing another. The difference between the statutory and economic burdens of a tax does not just apply to employer-paid taxes, either.¹⁴ For example, in the 1990s, George H. W. Bush signed into law a luxury tax on yachts, furs, and expensive cars and jewelry. The tax was

13. Jonathan Gruber, “The Incidence of Payroll Taxation: Evidence from Chile,” *Journal of Labor Economics* 15, no. 3, part 2 (1997): S72–S101; Bertil Holmlund, “Payroll Taxes and Wage Inflation: The Swedish Experience,” *Scandinavian Journal of Economics* 85, no. 1 (1983): 1–15; John Brittain, *The Payroll Tax for Social Security* (Washington, DC: The Brookings Institution, 1971); Ossi Korkeamäki and Roope Uusitalo, “Employment and Wage Effects of a Payroll Tax Cut: Evidence from a Regional Experiment,” *International Tax and Public Finance* 16, no. 6 (2009): 753–772.
14. Raymond J. Ring, “Consumers’ Share and Producers’ Share of the General Sales Tax,” *National Tax Journal* 52, no. 1 (1999): 79–90.

advertised as a tax on the rich because it applied to consumer goods that rich people were more likely to buy than were poor and middle-class people. In fact, firms responded by dropping the prices of their luxury products so as to largely offset the tax that was tacked on to the price tag. The lower prices reduced the firms' profits, and the firms, in turn, passed on some of the tax burden to employees and suppliers in the form of layoffs and reduced orders. In 1990, the Joint Committee on Taxation estimated that the luxury tax on yachts would generate \$53 million in revenue. Due in part to the reduction in sales caused by the tax, however, it generated less than \$33 million.¹⁵ The airplane tax fared similarly, generating less than one-tenth of the predicted revenue. Who paid for these taxes? More than 300 workers lost their jobs in jewelry manufacturing and almost 1,500 workers lost their jobs in aircraft manufacturing as the affected firms scaled back or went out of business entirely. Those 1,800 people (plus a few thousand more in the boat manufacturing industry) paid for the tax in the form of lost jobs when the industries passed the tax on to employees and suppliers in the form of reduced employment and orders.¹⁶

Similarly, corporate taxes are an economic gimmick because corporate taxes are paid by people, not corporations. When the government taxes a corporation, there are only three ways for the firm to pay the tax. The corporation can raise the price of its product, thereby passing the tax on to consumers. The corporation can pay its workers less, thereby passing the tax on to its employees. The corporation can also pay the tax out of its profits, thereby passing the tax on to its stockholders. A fourth option is for the corporation to reduce the prices it pays to its suppliers. But this option merely passes the tax on to another corporation that faces the same three options. In the end, corporate taxes are ultimately paid either by customers, workers, stockholders, or a combination of the three.¹⁷

COMPLEX TAXES

COMPLEX TAXES ARE a legislative gimmick wherein the intricacy of a tax law prevents taxpayers from determining the effect of a change in the law. According to the National Society of Accountants, the average cost to prepare a nonitemized income tax return was \$130 in 2011.¹⁸ The IRS states that in 2009, 57 percent of taxpayers paid a tax professional to prepare their tax returns.¹⁹ While one might expect high-income taxpayers to pay a professional—75 percent of those earning \$200,000 or more did—one would not expect it of lower-income taxpayers since their tax returns

15. Daniel Mitchell, *How to Measure the Revenue Impact of Changes in Tax Rates*, Backgrounder no. 1090 (Washington, DC: Heritage Foundation, August 9, 1996).

16. Walter E. Williams, "Ignorance, Stupidity, or Connivance?" *Townhall*, August 10, 2011.

17. The corporation could borrow to pay the tax. But since loans must be repaid, borrowing merely delays the choice of which of the three groups will ultimately pay the tax.

18. National Society of Accountants, "NSA Survey Finds Tax Preparation Fees Stable," news release, August 3, 2011, <http://tinyurl.com/cmxfnqf>.

19. IRS, *Statistics of Income*, Tax Stats, table 2.

tend to be much simpler to prepare. However, 56 percent of those reporting an adjusted gross income less than \$50,000 paid a tax professional to complete their returns. That a majority of lower-income people pay a professional to complete a supposedly simple nonitemized return attests to the complexity of the tax code.

One form of complexity comes from deductions, exemptions, and credits. Deductions and exemptions reduce taxable income and allow Congress to alter the amount of taxes it collects by changing the definition of what is being taxed. Exemptions reduce taxable income based on the number of people in the household. Deductions reduce taxable income based on the taxpayer's spending habits (e.g., how much he gives to charity, how much he drives his car for business purposes, etc.). If a taxpayer's marginal tax rate is 20 percent, then an additional \$1 in deductions or exemptions reduces the person's tax bill by $\$1 \times 20\% = \0.20 . Deductions and exemptions do not reduce taxes dollar for dollar because they impact *taxable income*, not *taxes due*.

Unlike deductions and exemptions, tax credits reduce the tax bill dollar for dollar; each \$1 tax credit lessens the amount of tax owed by \$1. One of the more popular tax credits is the Earned Income Tax Credit (EITC), a refundable tax credit for low to moderate-income households.²⁰ As of 2011, more than 26 million taxpayers received an average of \$2,240 from this credit.²¹ The credit applies even if the taxpayer has no taxable income. For example, in 2011, a single-parent household that earned \$15,000, had three children, and took the standard deductions received \$8,500 in tax deductions and \$14,800 in exemptions. This household owed no tax because the household's income (\$15,000) was more than offset by the deductions and exemptions. Although the household owed no income tax, it received a tax refund because the tax law gave it \$7,500 in tax credits (of which the EITC contributed about \$5,700). Therefore, in addition to paying no income taxes, the household received a check from the government for \$7,500.

A complex tax code presents two opportunities for politicians. First, the more complex the tax code is, the harder it is for the average taxpayer to anticipate the effects of proposed changes in tax law and to know whether a given politician's proposals are in the taxpayer's best interest. For example, with a complex tax code, politicians can claim to be lowering taxes when, in fact, they are raising them. Consider a couple in 2011 who each earned \$70,000. Under 2011 tax law, if the couple did not marry and took the standard deductions and exemptions, they would have paid a

20. "Non-refundable" tax credits reduce the taxpayer's tax liability. If the non-refundable tax credit is greater than the person's tax liability, the person owes no tax and receives no tax refund. "Refundable" tax credits are like payments from the IRS to the person. If the refundable tax credit is greater than the person's tax liability, the person receives a check for the difference from the IRS.

21. IRS, "EITC Statistics," <http://www.eitc.irs.gov/central/eitcstats>. The allowed EITC varies based on income, filing status, and number of qualifying children. For 2011, the maximum possible EITC was \$5,751.

combined \$24,400 in taxes.²² If they married and filed jointly, they would still pay \$24,400. But, if they married and filed separately, they would pay \$31,100. Now, suppose a candidate promises that, if elected, he will reduce the marginal tax rate that the couple pays by 2 percent and he will pay for this tax cut by reducing the standard deduction by \$1,000. Will this change in tax policy lower the couple's taxes? Without doing some rather involved calculations, it is unclear. On the one hand, the couple would be paying a lower marginal tax rate. On the other hand, \$1,000 more of their incomes will be subject to taxation. Further, by how much they are better or worse off depends on whether they remain single or marry and, if they marry, whether they file their tax returns jointly or separately.

To attract fiscal conservatives, the politician can say that he will cut taxes by 2 percent. To attract deficit hawks, the politician can say that he will pay for the tax cut by reducing deductions and exemptions. Consider this example from 2011:

Sen. Pat Toomey, R-PA [suggested] limiting the tax breaks enjoyed by people who itemize their deductions, in exchange for lower overall tax rates for families at every income level . . . The one-third of taxpayers who itemize their deductions might find themselves paying more.²³

The second problem with a complex tax code is that Congress can easily raise taxes without people realizing it. For example, when you buy a share of stock at a low price and then sell it later at a higher price, you must pay capital gains tax on the profit you make. But if you buy a share of stock at a high price and sell it later at a lower price, you do not necessarily get to deduct the losses from your taxes. Whether capital losses can offset capital gains depends on how large the losses are and the "carryover rules" that allow you to spread the claimed losses over several years. Congress could effectively raise taxes by reducing the maximum years over which you are allowed to carry losses. Even if the media reported such an esoteric tweak to the tax law, most taxpayers would not understand what the tweak meant and would be unaware that Congress had raised taxes. Politicians could claim that they did not raise taxes, but that they merely reduced the maximum number of carryover years.

Tax code complexity also encourages special interest groups to lobby politicians for tweaks to the tax code that benefit one group at the expense of its consumers or its competitors. Years of special interests lobbying Congress to approve numerous

22. Tax Foundation, "U.S. Federal Individual Income Tax Rates History, 1913–2011 (Nominal and Inflation-Adjusted Brackets)," <http://www.taxfoundation.org/taxdata/show/151.html>.

23. Stephen Ohlemacher, "A GOP Debt Plan Would Hit Some Popular Tax Breaks," *Bloomberg Businessweek*, November 17, 2011, <http://www.businessweek.com/ap/financialnews/D9R2S8U00.htm>.

tax deductions to encourage people to buy their products has contributed to the labyrinthine tax code we now have. For 2011, taxpayers could count as deductions 10 percent of the cost of adding insulation to their houses (not counting labor costs and up to a maximum of \$500), 30 percent of the cost of solar electric systems (including labor costs and with no maximum),²⁴ and 100 percent of the cost of classroom materials (up to \$250 and provided you are a primary or secondary school teacher).²⁵ These are just three examples found among a tax code that spans more than 50,000 pages and encompasses more than 500 individual IRS forms.²⁶ The structure of the tax code encourages special interests to lobby politicians to hide special favors among the complexities.

MARGINAL AND AVERAGE TAXES

THE DISTINCTION BETWEEN marginal and average tax rates is a communication gimmick that politicians use to hide the effect of tax policies. In 2011, Warren Buffett announced that he was taxed at a lower rate (17.4 percent on income) than his secretary (35.8 percent on income).²⁷ This announcement culminated in the president singling out the secretary, Debbie Bosanek, in his 2012 State of the Union address, and to a proposal (informally known as the “Buffett Rule”) to impose an alternative minimum tax of 30 percent on people earning over \$1 million.²⁸ Buffett has publicly supported the rule, saying that he disagrees with the rich paying less in federal taxes (proportional to their incomes) than the middle class. The rhetoric has engendered voter support for policies that increase taxes on the rich.

The gimmick here is the confusion of marginal and average tax rates. The marginal tax rate is the fraction of an *additional* dollar of income the person must pay in tax. The average tax rate is the fraction of income a person has *already* earned that the person must pay in tax. Marginal tax rates look forward and so are relevant when discussing people’s motivations to work more or to work less. Average tax rates look backward and are relevant when discussing how much in taxes people have paid. For example, consider a hypothetical case in which the government taxes all income up to \$50,000 at 10 percent and all income over \$50,000 at 100 percent. Suppose a worker earns \$50,000. At \$50,000, the worker owes $10\% \times \$50,000 = \$5,000$ in taxes. The worker’s average tax rate is $\$5,000 / \$50,000 = 10\%$. Suppose that the

24. IRS, “Home Energy Credits Still Available for 2011,” <http://www.irs.gov/newsroom/article/0,,id=249922,00.html>.

25. IRS, *1040 Instructions 2011*, <http://www.irs.gov/pub/irs-pdf/i1040.pdf>.

26. Chris Edwards, *10 Outrageous Facts About the Income Tax* (Washington, DC: Cato Institute, April 15, 2003), http://www.cato.org/pub_display.php?pub_id=3063.

27. Warren Buffett, “Stop Coddling the Super-Rich,” *New York Times*, August 14, 2011, http://www.nytimes.com/2011/08/15/opinion/stop-coddling-the-super-rich.html?_r=1.

28. “Debbie Bosanek: Why Is Warren Buffett’s Secretary Invited to the 2012 State of the Union?” *International Business Times*, January 24, 2012, <http://www.ibtimes.com/articles/287018/20120124/warren-buffett-state-union-debbie-bosanek.htm>.

worker is offered a \$10,000 raise that will require him to work more hours. Will the worker accept the raise? If the worker were to take the raise, he would earn \$60,000 and pay $10\% \times \$50,000 + 100\% \times \$10,000 = \$15,000$ in taxes, and his average tax rate would be $\$15,000 / \$60,000 = 25\%$. By accepting the raise, the worker would increase his average tax rate from 10 percent to 25 percent. But this increase in the average tax rate has no bearing on the worker's decision to accept the raise. What matters to the worker is that his *marginal* tax rate is 100 percent. At a 100 percent marginal tax rate, each additional dollar he earns will be entirely taxed away, making the raise meaningless.

At the heart of the Buffett Rule's gimmick are both a blurring of the distinction between marginal and average tax rates and confusion about the statutory versus economic burden of corporate income tax. People, like Buffett, who earn most of their income from investments pay lower marginal income tax rates than do people who earn most of their income from labor because investment income is not subject to payroll taxes. Furthermore, the marginal tax rate on investment income is usually 15 percent, whereas the marginal tax rate on labor ranges from around 18 percent for lower income workers to over 35 percent for higher income workers.²⁹ Only under a flat tax with no deductions and exemptions are marginal and average tax rates the same. As soon as you introduce progressive (or regressive) taxes or deductions and exemptions, marginal rates no longer measure how much tax you are paying. In our complicated tax system, marginal rates measure the tax you will pay on the *next* dollar of income you will earn. Marginal tax rates tell us nothing about how much tax you are paying in total.

The reason that income from investments is taxed at a lower marginal rate is because the income has already been taxed once.

Currently, corporate profits are generally subject to "double taxation," whereby firm profits are taxed first at the corporate level and then again at the individual level. . . . One of the reasons why we currently have a lower tax rate for individuals on capital gains is to account for the fact that capital gain income received by an individual was first taxed at the corporate level, up to 35 percent. Hence, if a corporation first pays the maximum statutory tax rate of 35 percent on each \$1 of profit, leaving \$0.65 of retained profit to either be distributed as a dividend or realized as capital gain, then

29. This includes income and payroll taxes.

30. Jason J. Fichtner, "Increasing America's Competitiveness by Lowering the Corporate Tax Rate and Simplifying the Tax Code," testimony before the United States Senate Committee on Finance, January 31, 2012, <http://www.finance.senate.gov/imo/media/doc/Fichtner%20Testimony%20SFC%20Tax%20Extenders.pdf>.

combining the individual's 15 percent tax rate yields a combined tax rate of 44.75 percent.³⁰

While the statutory burden of the income tax is split between the corporation (when it pays tax on its profits) and the person receiving investment income (when the person pays income tax), the economic burden falls on the person receiving the investment income. This is because each additional dollar of tax a corporation pays reduces the corporation's after-tax profit by one dollar. After-tax profits end up in the pockets of investors either directly (as dividends) or indirectly (as capital gains). Either way, the economic burden falls on the investor.

Depending on family and filing status, the median income earner pays a marginal tax rate of around 30 percent for all federal taxes combined.³¹ Let's assume that the typical person in the top 1 percent of income earners obtains most of his income from investments and so pays a statutory marginal tax rate of around 15 percent. Relying on statutory marginal tax rates leads us to the erroneous conclusion that the median person is taxed at twice the rate of the rich person. According to the Congressional Budget Office, in 2009 (the last year for which data are currently available) the top 1 percent of households (by income) paid an average federal income tax rate of 21.0 percent compared to 1.3 percent for the median household³² If we add all federal taxes, including the share of the person's investment income tax that is paid by corporations in the form of corporate income tax, the top 1 percent of households paid an average tax rate of 28.9 percent versus 11.1 percent for the median household. It is disingenuous to point to differences in marginal tax rates and claim them as evidence that the middle class pays more tax than the rich. In fact, differences in how much people pay are measured by *average* rates, not marginal rates, and differences in average rates tell the opposite story.

In 2010, Warren Buffett paid almost \$7 million in federal taxes, or 17 percent of his taxable income.³³ In 2010, Buffett's company, Berkshire Hathaway, incurred income tax expenses of \$5.6 billion on earnings of \$19.1 billion,³⁴ meaning that Berkshire Hathaway paid an average tax rate of 29 percent. Berkshire Hathaway's average tax rate matters because most of Buffett's income comes from his ownership

31. Federal taxes principally include income tax (applied to income from labor, rent, investments, gifts, or any other source), social security tax, and medicare tax.

32. Congressional Budget Office, "The Distribution of Household Income and Federal Taxes, 2008 and 2009," Table 2, July 2012, <http://www.cbo.gov/sites/default/files/cbofiles/attachments/43373-06-11-HouseholdIncomeandFedTaxes.pdf>.

33. Warren Buffett, "Stop Coddling the Super-Rich," *New York Times*, August 14, 2011, http://www.nytimes.com/2011/08/15/opinion/stop-coddling-the-super-rich.html?_r=1. Buffett had \$62 million in adjusted gross income, but gave a large portion to charity, thereby reducing his taxable income. Robert A. Green, "How Buffett Saves Billions on His Tax Return," *Forbes.com*, August 17, 2011, <http://www.forbes.com/sites/greatspeculations/2011/08/17/how-buffett-saves-billions-on-his-tax-return/>.

34. Berkshire Hathaway, Inc., "Consolidated Statements of Earnings," *2010 Annual Report*, <http://www.berkshirehathaway.com/2010ar/2010ar.pdf>, 31.

of Berkshire Hathaway stock. Suppose that Berkshire Hathaway earns \$1 of additional income for Warren Buffett and that dollar is taxed at 29 percent, leaving \$0.71. The \$0.71 is passed on to Warren Buffett and becomes his income. Buffett paid an average of 17 percent on his income, which reduces the \$0.71 to \$0.59. In other words, if there were no income taxes, Buffett would have received \$1 in income. Because of income taxes, Buffett receives only \$0.59 in income. In the end, Buffett (and Berkshire Hathaway on Buffett's behalf) pays 41 percent of his income in taxes. The 17 percent that Buffett claims is only that portion of Buffett's income tax that he paid on his own behalf.

Inflation as a Legislative Gimmick

SINCE 1947, ANNUAL consumer inflation in the United States has ranged from a high of almost 14 percent to a low of -1 percent and has averaged 3.7 percent. By not crafting legislation to account for inflation, politicians can use inflation to raise taxes. Table 1 shows the federal income tax brackets for 2012 for a single taxpayer.

TABLE 1. FEDERAL INCOME TAX BRACKETS FOR SINGLE TAXPAYERS, 2012

Income between this . . .	and this	. . . is taxed at this marginal rate.
\$0	\$8,700	10%
\$8,700	\$35,350	15%
\$35,350	\$85,650	25%
\$85,650	\$178,650	28%
\$178,650	\$388,350	33%
\$388,350		35%

Source: Internal Revenue Service, *2012 Tax Rate Schedules*, <http://www.irs.gov/pub/irs-pdf/f1040es.pdf>, 6.

According to this table, a worker with an adjusted gross income of \$35,000 pays 10 percent on the first \$8,700 he earns and 15 percent on the next \$26,300 for a total tax of \$4,815. Suppose that from 2012 to 2013, inflation is 4 percent and the worker earns a cost of living adjustment to compensate for inflation. In 2013, he will have an adjusted gross income of \$36,400. If Congress does not adjust the tax brackets to account for the inflation, in 2013, the worker will pay 10 percent on the first \$8,700, 15 percent on the next \$26,300, and 25 percent on the remaining \$1,400 for a total tax of \$5,165.³⁵

Ignoring taxes, the worker is no better off in 2013 than he was in 2012 because inflation cancels out the effect of his cost of living adjustment. But look at what happens to the amount of taxes the worker is paying. In 2012, he pays \$4,815 in taxes on \$35,000 in income for an average tax rate of 13.8 percent. In 2013, he pays \$5,165 in taxes on \$36,400 in income for an average tax rate of 14.2 percent. Even though the

35. These figures account for federal income taxes only; they do not include payroll taxes.

raise made him no better off, the worker's cost of living increase pushed him into a higher tax bracket and so increased his average tax rate.

Inflation also affects capital gains taxes, though in a different way. Suppose you bought stock in 1980 for \$1,000 and sold it in 2011 for \$2,700. Under the law, you would have earned a capital gain of \$1,700 on which you would pay 15 percent tax, or \$255. But, because of inflation, \$2,700 in 2011 buys the same amount of stuff (on average) as \$1,000 did in 1980. The result is that you gained nothing, yet paid \$255 in tax.

Since 1986, personal income tax brackets have been indexed for inflation, thereby removing this legislative gimmick from personal income taxes. Other tax brackets, like those that apply to the alternative minimum tax (AMT) and to the new Medicare tax on unearned income, are not indexed for inflation. For example, the AMT, instituted in the 1960s, was written to apply to a few hundred of the highest income taxpayers. Because the AMT was not indexed for inflation, the tax now hits millions of households annually. What makes this legislative gimmick so powerful is that it enables Congress to raise taxes by doing nothing whatsoever.

INFLATION AS AN ECONOMIC GIMMICK

NON-ECONOMISTS TYPICALLY DO not think of inflation as a tax. It is, in fact, a most dangerous economic gimmick because the average voter regards inflation as part of the economic landscape, like recessions and expansions, rather than what it truly is: a means for the government to obtain money at the taxpayer's expense. The government (actually, the Federal Reserve) can create inflation by expanding the money supply, which has the same effect on taxpayers as if the government had increased taxes.

As a central bank, the Federal Reserve can arbitrarily alter the money supply, thereby creating inflation almost at will. Noneconomists (and economists at the Fed) typically use the phrase "cut interest rates." But cutting interest rates and increasing the money supply are synonymous. Think of the money supply as a car's accelerator pedal and the interest rate as the speedometer. When we want to go faster, we do not think in terms of pushing the accelerator an extra half-inch to the floor. Instead, we think about pushing the accelerator down far enough to get the speedometer up to the speed we want. The accelerator is the lever we push and the speedometer is the metric we monitor. When the Federal Reserve conducts monetary policy, the money supply is the lever it pushes and the interest rate is the metric it monitors.

But increasing the money supply not only causes interest rates to fall, it also causes prices to rise. Think of the average price level as the number of dollars in the economy divided by the number of goods and services. When the number of

36. This explanation assumes, for simplicity, that the velocity of money remains constant.

dollars rises faster than the number of goods and services, the price level rises.³⁶ The way the Federal Reserve typically increases the money supply is by purchasing Treasury bills. Treasury bills are debt issued by the federal government. The government prints and sells Treasury bills to investors to raise money to pay for deficit spending. When the Federal Reserve buys Treasury bills from the government, it “prints” new money and hands the money over to the government in exchange for the Treasury bills. Prices do not yet rise because the new money has not yet entered into circulation. Therefore, as the government starts to spend this new money, it buys goods and services at today’s prices. After the government buys the goods and services, the people and businesses that received the new money turn around and spend the money elsewhere. It is at this point that the new money begins to flow throughout the economy. As the new money flows throughout the economy, prices start to rise because the money supply has grown. Other things held constant, prices will eventually rise by an amount proportional to the increase in the money supply. For example, suppose the amount of new money was 1 percent of the money supply. As the government spends the new money, the government acquires goods and services at current (low) prices. But as the new money circulates throughout the economy, prices eventually rise by 1 percent. This price increase makes the value of everyone’s money decline. In other words, by injecting new money into the economy, the government effectively taxed everyone by reducing the value of their dollars by 1 percent.

As an analogy, consider frequent flyer miles. Frequent flyer miles are valuable to travelers only if there are airline seats available on which to use the frequent flyer miles. Suppose that an airline typically sets aside 10 percent of its seats for purchase by frequent flyer miles. If the total number of seats available on any given day equals the total number of seats travelers want to purchase with frequent flyer miles, then travelers will have no trouble redeeming their frequent flyer miles for seats. Let’s suppose that, given the ease of redemption, travelers value the frequent flyer miles at \$0.02 per mile. The frequent flyer miles are analogous to the money supply and the available seats are analogous to the goods and services an economy produces. Now, imagine that the airline prints an additional 100 million frequent flyer miles and offers these for sale to travelers. Travelers are willing to pay \$0.02 per mile and so they pay the airline \$2 million and receive 100 million miles. But, because the number of seats available for purchase has not changed, when travelers go to use the new miles, they find that it is much harder to find seats that they can purchase with the miles. Because it is now harder to redeem the miles, travelers value the miles at only \$0.01 per mile. Notice what happened: When the airline sold the miles, they were worth \$2 million, but when the miles got into circulation and travelers found that they could not get seats, the value dropped to \$1 million. In effect, the airline just made \$1 million off the customers by selling them, for \$2 million, miles that were only worth \$1 million.

In the same way, the value of the dollar declines when new money is placed in

circulation. The government benefits because it uses the new money to buy things before the inflation occurs. Everyone else loses because the new money eventually creates inflation and the inflation decreases the value of the money that people have. By creating inflation, the government takes away the value of people's money and uses that value for itself.

Unexpected inflation also hurts savers by reducing the value of their savings and benefits borrowers by reducing the value of the money they must pay back. Suppose that inflation is 0 percent and that a person borrows \$1,000 in 2000 and agrees to pay back the \$1,000 principal plus another \$500 in interest in 2010.³⁷ If, immediately after signing the terms of the loan, inflation rises from 0 percent to 5 percent and remains there for 10 years, then the \$1,000 the borrower pays back in 2010 is worth the equivalent of only \$921 in terms of 2000 prices. In other words, the unexpected inflation enabled the borrower of \$1,000 to pay back the equivalent of only \$921 in purchasing power.

Unexpected inflation occurs when the Federal Reserve alters the money supply without warning.³⁸ The Fed typically increases the money supply by purchasing government securities (such as Treasury bills) on the open market and decreases the money supply by selling securities. A central bank is said to “print money” or “monetize the debt” when it purchases government securities not for the purpose of maintaining price stability but for the purpose of funding government spending. Figure 1 shows securities held by the Federal Reserve as a fraction of total federal debt. From 1988 through 2007, the Federal Reserve held a relatively constant 8 percent of government debt. By 2011, this figure had more than doubled to almost 17 percent. The dramatic increase in government debt held by the Federal Reserve suggests that the Federal Reserve has been monetizing a portion of the debt.

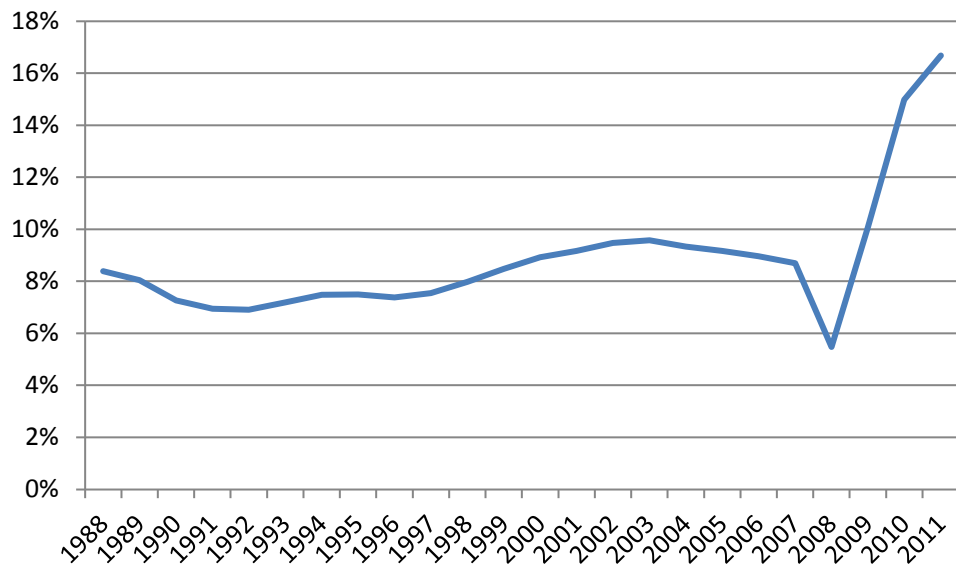
Debt monetization is the equivalent of taxing savers and handing the proceeds to borrowers. The net effect is to provide money to the government in exchange for creating unexpected inflation. The tax comes in the form of reducing the purchasing power of people's savings. Inflation is perhaps the most insidious of gimmicks. It is difficult for people to avoid, the general public tends to regard inflation as a random economic event rather than a tax that results directly from central bank actions, and it occurs without any official legislative action to raise taxes.

CONCLUSION

THIS PAPER HAS examined four gimmicks that politicians use to hide the taxes they

37. This type of loan, called a *zero coupon bond*, bundles all the interest payments into a single lump sum payment that is made when the loan is repaid. Treasury bills and some Treasury bonds are zero coupon bonds. Inflation affects all bonds and loans in a similar fashion. Zero coupon bonds merely provide the least complicated example.

38. Milton Friedman gave his famous quote, “Inflation is always and everywhere a monetary phenomenon,” at the Wincott Memorial Lecture in London on September 16, 1970.

FIGURE 1. SECURITIES HELD BY THE FEDERAL RESERVE AS A FRACTION OF TOTAL FEDERAL DEBT, 1988–2011

Source: Federal Reserve Bank of St. Louis, "Reserve Bank Credit: Securities Held Outright (WSECOUT)," FRED Economic Data, <http://www.research.stlouisfed.org/fred2/series/WSECOUT>; Moody's Analytics, <http://www.freelunch.com>.

levy. Some gimmicks portray a new tax as a temporary response to a crisis, but then fail to deliver its promised repeal. Some gimmicks hide taxes by playing on the psychological tendency for people to be less aware of taxes that are removed from their wages before they see them than of taxes that they pay explicitly from their already-received wages. Some gimmicks rely on the complexity of economic forces or on the complexity of tax law to disguise who is actually paying the tax and how much the tax truly is. Moreover, the distinction between marginal and average tax rates can obscure how much people are being taxed. Finally, inflation as a gimmick allows government to tax us without our knowledge and without Congress taking any action at all.