pay not only for transfer payments to the poor but also for government spending of all types—military, police, road building, and schools. We then consider transfers, such as welfare and health care payments to the poor and social security payments to the elderly. After we examine how various features of the tax and transfer system affect incentives, we examine the actual distribution of income and discuss how it has been affected by the tax and transfer system in the United States.

The Tax System

We begin by considering the tax system. The first part of our analysis is descriptive, looking at the different types of taxes used in the United States. Then we move into a more analytical mode, and review the efficiency and distributional implications of the tax system. Finally, we draw on these analytical findings to look at some policy proposals for reforming the tax system and discuss their merits.

The major types of taxes that exist in the United States are the personal income tax on people’s total income, the payroll tax on wage and salary income, the corporate income tax on corporate profit income, excise/sales taxes on goods and services purchased, estate and gift taxes on inheritances and gifts from one person to another, and tariffs, which are taxes on goods imported into the country. In addition, many local governments raise revenue through property taxes.

As shown in Figure 14-1, the personal income tax and the payroll tax are by far the largest sources of tax revenue for the federal government. Together they account for about 80 percent of federal tax revenue. Hence, we focus most of our attention on these two taxes in the following discussion.

The Personal Income Tax

The personal income tax is a tax on all the income an individual or household receives, including wage and salary income, interest and dividend income, income from a small business, rents on property, royalties, and capital gains. (A capital gain is the increase in the value of an asset like a corporate stock. When the asset is sold, the capital gain—equal to the difference between the original purchase price and the selling price of the asset—is treated as income and is taxed.) The personal income tax was introduced in 1917 in the United States, soon after the ratification of the Sixteenth Amendment to the U.S. Constitution, which authorized income taxes. Most states have now followed the federal government and have enacted a personal income tax at the state level; we focus our attention on the personal income tax collected by the federal government.

Computing the Personal Income Tax

To explain the economic effects of the personal income tax, we must examine how
the amount of tax a household owes is determined. The amount of tax owed by a household depends on the tax rate and the amount of taxable income. **Taxable income** is defined as a household’s income minus certain exemptions and deductions. An **exemption** is a dollar amount that can be subtracted from income for each person in the household. **Deductions** are other expenditure items actually incurred—such as interest payments on a home mortgage, charitable contributions, and moving expenses—that can be subtracted from income before taxes are assessed.

Consider, for example, the Lee family, which has four members: a wife, a husband, and two children. Suppose the Lees can subtract $3,650 as a personal exemption for each of the four people in the family, for a total of $14,600, and are entitled to a deduction of $11,400. Thus, they can subtract a total of $26,000 ($14,600 + $11,400) from their income. Suppose that the husband and wife together earn a total income of $80,000. Then their taxable income is $54,000 ($80,000 - $26,000).

Now let us see how we combine taxable income with the tax rate to compute the tax. Figure 14-2 shows two different tax rate schedules from the IRS 1040 form (throughout this chapter, the examples use the tax law as of 2010). The tax rate schedule labeled “Schedule X” in the figure is for a taxpayer who is single; the tax rate schedule labeled “Schedule Y-1” is for two married taxpayers who are paying their taxes together. The first two columns give a range for taxable income, or the “amount on Form 1040, line 37.” The next two columns tell how to compute the tax. The percentages in the tax rate schedule are the tax rates.

Look first at Schedule Y-1: The 10 percent tax rate in the schedule applies to all taxable income up to $16,750, at which point any additional income up to $68,000 is taxed at 15 percent. After this income level, the tax rate rises to 25 percent for any additional income up to $137,300, and then to 28 percent for any additional income up to $209,250. Above this, the tax rate is 33 percent. The marginal tax rate is the tax rate on the most recently earned dollar of income.
at 15 percent. Any additional income over $68,000 but less than $137,300 is taxed at 25 percent, and so on for tax rates of 28 percent, 33 percent, and 35 percent. Each of the rows in these schedules corresponds to a different tax rate; the range of taxable income in each row is called a tax bracket.

As an example, let us compute the Lees' tax. Recall that their taxable income is $54,000. They are married and filing jointly, so we look at Schedule Y-1. We go to the second line because $54,000 is between $16,750 and $68,000. In other words, the Lees are in the 15 percent tax bracket. We find that they must pay $1,675 plus 15 percent of the amount their income is over $16,750—that is, plus $5,587.50. Thus, the amount of tax they must pay is $1,675 + $5,587.50 = $7,262.50.

The Marginal Tax Rate

Now consider what happens when the Lees' income changes. Suppose that one of the Lees decides to earn more income by working more hours and the Lees' income rises by $5,000. Thus, their taxable income rises from $54,000 to $59,000. Now what is their tax? Again looking at Schedule Y-1, we see that the tax is $1,565 + 0.15 × ($59,000 − $16,750) = $8,012.50. Thus, the Lees' tax has increased from $7,262.50 to $8,012.50, or by $750, as their income rose by $5,000. Observe that the tax rose by exactly 15 percent of the increase in income.

The amount by which taxes change when an individual's income changes is the marginal tax rate. It is defined as the change in total tax divided by the change in income. In examining how the Lees compute their tax, we have discovered that their marginal tax rate is 15 percent. In other words, when their income increased, their taxes rose by 15 percent of the increase in income. As long as they stay within the 15 percent tax bracket, their marginal tax rate is 15 percent.

Observe that the marginal tax rate depends on one's income. The marginal rate varies from 10 percent for low incomes up to 35 percent for very high incomes. Suppose that one of the Lees did not work and that their taxable income was $15,000 rather than $54,000. Then they would be in the 10 percent bracket, and their marginal tax rate would be 10 percent.

In contrast to the marginal tax rate, the average tax rate is the total tax paid divided by the total taxable income. For example, the Lees' average tax rate before we considered changes in their income was (7,262.5/54,000) = 0.134, or 13.4 percent, which is lower than the 15 percent marginal tax rate. In other words, the Lees pay 13.4 percent of their total taxable income in taxes but must pay 15 percent of any additional income in taxes. The average tax rate is less than the marginal tax rate because the Lees pay only 10 percent on the first $16,750 of taxable income.

Economists feel that the marginal rate is important for assessing the effects of taxes on individual behavior. Their reasoning can be illustrated with the Lees again. Suppose that the Lees' marginal tax rate was 10 percent rather than 15 percent. Then, if one of the Lees decided to work an additional half day a week, the family would be able to keep $0.90 of each extra dollar earned, sending $0.10 to the government. But with a marginal tax rate of 15 percent, the Lees could keep only $0.85 on the dollar. If the marginal tax rate for the Lees was 35 percent, then they could keep only $0.65 of each dollar earned. To take the example to an even greater extreme, suppose the marginal rate was 91 percent, which was the highest marginal rate before President Kennedy proposed reducing tax rates. Then, for each extra dollar earned, one could keep only $0.09. Clearly, the marginal tax rate is going to influence people's choices about how much to work if they have a choice. The marginal tax rate has a significant effect on what people gain from working additional hours. This is why economists stress the marginal tax rate rather than the average tax rate when they look at the impact of the personal income tax on people's behavior.

Figure 14-3 provides a visual perspective on marginal tax rates. It plots the marginal tax rate from IRS Schedule Y-1 in Figure 14-2; the marginal tax rate is on the vertical axis, and the taxable income is on the horizontal axis. Observe how the marginal tax rate rises with income.
progressive tax
a tax for which the amount of an individual’s taxes rises as a proportion of income as the person’s income increases.

regressive tax
a tax for which the amount of an individual’s taxes falls as a proportion of income as the person’s income increases.

proportional tax
a tax for which the amount of an individual’s taxes as a percentage of income is constant as the person’s income rises.

flat tax
a tax system in which a marginal tax rate for all levels of taxable income is constant.

A tax is progressive if the amount of the tax as a percentage of income rises as income increases. If the marginal tax rate rises with income—in which case people with higher incomes pay a larger percentage of their income in taxes—then the tax is progressive. A tax is regressive if the amount of the tax as a percentage of income falls as income rises. An income tax would be regressive if the marginal tax rate declined as income rose, or if people with high incomes could use deductions or other schemes to reduce the tax they paid to a smaller percentage of income than people with lower incomes paid. A tax is proportional if the amount of the tax as a percentage of income is constant as income rises.

Zero Tax on Low Incomes In assessing how progressive the income tax is, remember that the taxes are based on taxable income, which is less than the income a household actually receives. Taxable income can be zero even if a household’s income is greater than zero. For example, if the Lee family earned only $26,000 for the year, then their taxable income would be zero, because $26,000 equals the sum of their exemptions and deductions. In general, the personal income tax is zero for household incomes up to the sum of the exemptions and deductions.

A flat tax occurs when the marginal tax rates are constant for all levels of taxable income, in which case the line in Figure 14-3 would become flat. Even a flat rate tax system would have a degree of progressivity: The tax paid would rise as a percentage of income from zero (for workers below the sum of exemptions and deductions) to a positive amount as income rises.

Marginal Tax Rates
As an example, the marginal tax rates from the IRS tax rate schedule Y-1 are plotted. The marginal tax rate is the change in the amount of tax paid for an extra dollar earned. The marginal tax rate increases with income. Each step takes the taxpayer to a higher tax bracket. Thus, higher-income people have a higher marginal tax rate than lower-income people. Under a flat tax, the marginal tax rate would be constant for all taxable income levels.

Figure 14-3

The Payroll Tax
The payroll tax is a tax on the wages and salaries of individuals; the payroll tax goes to finance social security benefits, Medicare, and unemployment insurance. Employers submit payroll taxes to the government. For example, the Lees’ employers must submit 15.3 percent of the Lees’ wage and salary income to the federal government. Thus, the payroll tax on the Lees’ wage and salary income of $80,000 would be $12,240 (that is, 0.153 × $80,000), more than 50 percent higher than the total that the Lees would pay in personal income taxes.

The tax law says that half of the 15.3 percent payroll tax is to be paid by the worker and half is to be paid by the employer. Thus, the Lees would be notified of only half of the payroll tax, or $6,120, even though their employer sent $12,240 to the government. If a person is self-employed—a business consultant, say, or a freelance editor—then the person pays the full 15.3 percent, because a self-employed person is both the employee and the employer. One of the

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Chapter 14 Taxes, Transfers, and Income Distribution
The most important things to understand about the payroll tax is that, as we will soon prove, its economic effects do not depend on who is legally required to pay what share of the tax; only the total 15.3 percent matters.

**Other Taxes**

All other federal taxes together amount to a little over one-fifth of total revenue. Corporate income taxes are taxes on the accounting profits of corporations. As of 2011, the corporate tax rate ranges from 15 percent to 38 percent, depending on the level of earnings.

Excise taxes are taxes on goods that are paid when the goods are purchased. The federal government taxes several specific items, including gasoline, tobacco, beer, wine, and hard liquor. A sales tax is a type of excise tax that applies to total expenditures on a broad group of goods. For example, if your expenditures on many different goods at a retail store total $100 and the sales tax rate is 5 percent, then you pay $5 in sales tax. There is no national sales tax in the United States, but sales taxes are a major source of revenue for many state and local governments.

The federal government also raises revenue by imposing tariffs on goods as they enter the United States. Until the Sixteenth Amendment was ratified and the personal income tax was introduced, tariffs were the major source of revenue for the U.S. government. Now revenue from tariffs is a minor portion of total revenue.

Local governments rely heavily on property taxes—taxes on residential homes and business real estate—to raise revenue. Recall that income taxes—both personal and corporate—are used at the state level to raise revenue for state governments.

**The Effects of Taxes**

The purpose of most of these taxes is to raise revenue, but taxes can have significant effects on people’s behavior. To examine these effects, let us start with a tax we looked at before in Chapter 7: a tax on a good or service.

The Effect of a Tax on a Good  
Recall that a tax on a good adds the amount of the tax to the marginal cost of the seller of the good. For example, a tax of $1 on a gallon of gasoline will shift the supply curve up by the amount of the tax, a result shown in Figure 7-9 on page 179. Once the supply curve shifts as a result of the tax, equilibrium price and quantity also will change. The ultimate impact on price and quantity will depend on the price elasticities of supply and demand.

The four panels of Figure 14-4 are designed to enable us to show how the price elasticity of demand and the price elasticity of supply determine the impact of the tax. In each of the figure’s four panels, the supply curve shifts up because of a tax of the same amount, shown by the green arrow to the left of each vertical axis. As a result of the tax, in each of the four panels, the equilibrium price rises and the equilibrium quantity falls. The decline in the equilibrium quantity creates a loss of consumer surplus plus producer surplus, which we call the deadweight loss from the tax. The size of the deadweight loss and the relative size of the impact on the price and the quantity are different in each panel of Figure 14-4 because the supply curve and the demand curve have different price elasticities.

A key point illustrated in Figure 14-4 is that when the price elasticity of demand or the price elasticity of supply is very low, the deadweight loss from the tax is small. This deadweight loss is shown in the two graphs in the left part of Figure 14-4, which have either a low elasticity of demand (top left) or a low elasticity of supply (bottom left). In either case, the deadweight loss is small compared with that in the graphs at the right, which have higher elasticities.

The intuitive reason why low elasticities result in small deadweight losses is that the quantity of the good does not change very much when the price changes. Recall that a
How Elasticities Determine the Effects of Taxes

(1) **Deadweight loss effects:** When price elasticities are low, as in the left graphs, the deadweight loss is small and the change in equilibrium quantity is small. When price elasticities are high, as in the right graphs, the deadweight loss is large and the change in equilibrium quantity is large.

(2) **Tax incidence and price effects:** When the price elasticity of demand is low or the price elasticity of supply is high, the tax is largely passed on to the consumer in the form of higher prices. In contrast, when the price elasticity of demand is high or the price elasticity of supply is low, the burden of the tax falls on the producer because the price changes little.
low price elasticity of demand means that quantity demanded is not very sensitive to a change in the price, as, for example, in the case of a good like salt, which has few substitutes. A low elasticity of supply means that only a small change occurs in the quantity supplied when the price changes. Thus, in the case of low elasticities, only a small difference exists between the efficient quantity of production and the quantity of production with the tax. There is little loss of efficiency. On the other hand, when the price elasticity of demand or the price elasticity of supply is very high, the deadweight loss from the tax will be relatively large. In this case, changes in price have big effects on either the quantity demanded or the quantity supplied, and the deadweight loss is large.

The price elasticities of supply and demand also affect how much the price changes in response to a tax. If the price rises by a large amount, then the tax is passed on to buyers in the form of higher prices, and the burden of the tax falls more on buyers. If the price rises little or not at all, then the seller absorbs the burden of the tax, and most of the tax is not passed on to buyers. Tax incidence refers to who actually bears the burden of the tax, the buyers or the sellers.

The graphs in Figure 14-4 suggest the general principle that the smaller the price elasticity of demand and the larger the price elasticity of supply, the greater the rise in the price. The opposite will be true if the elasticity of demand is large and the elasticity of supply is small—that is, the impact of the tax will raise the price by only a little.

This tells us that taxing a good like cigarettes, with a low elasticity of demand, will result in the buyers of cigarettes bearing the tax. The seller will be able to pass the tax on to the buyers in the form of higher prices. In contrast, taxing a good like land, which has a low elasticity of supply, will not affect the price very much. The supplier of the land will not be able to pass on the tax to the consumers in the form of higher prices and will bear the burden of the tax.

**Effects of the Personal Income Tax** We can apply the results of this analysis to the personal income tax. The personal income tax is a tax on labor income (wages and salaries) as well as on capital income (interest, dividends, small business profits). Labor income, however, is by far the larger share of most people’s income: For all 1040 forms filed, wages and salaries account for more than 75 percent of total income. Thus, we model the personal income tax as a tax on labor income.

The analysis of the personal income tax is illustrated in Figure 14-5. Because the personal income tax is a tax on labor income, we need a model of the labor market to examine the effects of the tax. Figure 14-5 shows a labor demand curve and a labor supply curve. The wage paid to the worker is on the vertical axis, and the quantity of labor is on the horizontal axis. Figure 14-5 shows that the personal income tax shifts the labor supply curve up. The size of the upward shift depends on the marginal tax rate because the income received from work would be reduced by the marginal tax. If the person was in the 15 percent bracket, the income received from working would be $0.85 for each extra dollar earned working. Thus, to supply exactly the same quantity as without the tax, people require a higher wage. Because the wage paid to the worker is on the vertical axis, the labor supply curve shifts up to show this.

As the labor supply curve shifts up, the equilibrium quantity of labor declines. Thus, we predict that an income tax will reduce the amount of work. The reduced amount of work will cause a deadweight loss just like that caused by the tax on a commodity. The size of the decline in hours of work will depend on the labor supply and labor demand elasticities. The higher the labor supply elasticity, the greater the reduction in the quantity of labor supplied in response to the personal income tax.

Economists disagree about the size of the labor supply elasticity. One thing that is certain is that the elasticity is different for different people. For example, the labor supply elasticity appears to be quite high for second earners in a two-earner family such as the
If elasticity is high, a high marginal tax rate can reduce hours of work and thereby income. But if the labor supply curve has a low elasticity, it has little effect on hours of work.

**The Effect of a Payroll Tax**

We can use the same type of labor market diagram to analyze a payroll tax, as shown in Figure 14-6. Clearly, the payroll tax is a tax on labor in that it applies to wages and salaries. In the case of the payroll tax, however, we need to consider that both the employer and the employee pay this tax, as required by law. Figure 14-6 handles the two cases.

Suppose that the wage before the tax is $10 per hour and that the payroll tax is 10 percent, or $1 per hour. The case in which the employee pays the tax is shown on the right of Figure 14-6. This picture looks much like Figure 14-5. The labor supply curve shifts up by the amount of the tax ($1) because the worker now has to pay a tax to the government for each hour worked. In other words, the worker will supply the same amount of work when the wage is $11 and the tax is $1 as when the wage is $10 and the tax is zero.

When the labor supply curve shifts up, the equilibrium quantity of labor employed declines (see the right-hand panel of Figure 14-6). Observe that, because of the lower supply of labor, the wage paid by the employer rises. The aftertax wage—that is, the wage less the tax—declines, however, because the increase in the wage is less than the tax increase.

The case in which the employer pays the tax is shown in the left graph of Figure 14-6. In this case, the labor demand curve shifts down by the amount of the tax ($1) because the firm has to pay an additional $1 for each hour of work. When the labor demand curve shifts down, the equilibrium quantity of labor employed declines and the wage falls. Observe that the impact of the payroll tax is the same in both cases: A new equilibrium emerges in the labor market with a lower wage and a lower quantity of labor.
Thus, a payroll tax has both an employment-reduction effect and a wage-reduction effect. As with any tax, the size of the quantity change and the price (wage) change depends on the supply and demand elasticities. If we apply the results from Figure 14-4, we know that when the labor supply elasticity is low and the labor demand elasticity is high, the reduction in employment will be small, but the wage will fall by a large amount. If the labor supply elasticity is high and the labor demand elasticity is low, however, the employment effect will be large, but the wage effect will be small.

**The Effect of a Payroll Tax**

If a payroll tax is paid by the employer, the labor demand curve shifts down by the amount of the tax because the firm’s labor costs increase by the amount of the tax. Thus, the quantity of labor employed declines, as does the wage paid to the worker (shown on the left). A payroll tax paid by the employee (shown on the right) causes the labor supply curve to rise by the amount of the tax, but the effects on aftertax wages received by the worker and the quantity of work are the same as when the employer pays.
The Possibility of a Perverse Effect on Tax Revenue

Tax revenue received by the government is equal to the tax rate times the amount that is subject to the tax. For example, in the case of a gasoline tax, the tax revenue is the tax per gallon times the number of gallons sold. As the tax rate increases, the amount subject to the tax will fall because the higher price resulting from the tax reduces the quantity demanded. If the quantity demanded falls sharply enough, then tax revenue actually could fall when the tax rate is increased.

The same possibility arises in the case of taxes on labor, either the payroll tax or the personal income tax. In the case of the payroll tax or the personal income tax for a worker, tax revenue is equal to the tax rate times the wage and salary income. As the tax rate rises, the amount of income subject to tax may fall if labor supply declines. Thus, in principle, it is possible that a higher tax rate could result in reduced tax revenue. For example, consider the high marginal tax rates shown in Table 14-1: 50 percent, 75 percent, and 90 percent. If labor supply declines with a higher tax rate, as assumed in the table, then tax revenue first increases as the tax rate goes from 50 to 75 percent but then declines as the tax rate goes from 75 to 90 percent.

The general relationship between tax rates and tax revenue is illustrated in Figure 14-7. As in the example of Table 14-1, tax revenue first rises and then falls as the tax rate increases. Figure 14-7 can apply to any tax on anything. At the two extremes of zero percent tax rate and 100 percent tax rate, tax revenue is zero. What happens between these two extremes depends on the elasticities. This relationship between the tax rate and tax revenue, frequently called the Laffer curve, has long been known to economists. It implies that if the tax rate is so high that we are on the downward-sloping part of the curve, then reducing the tax rate may increase tax revenue. Economists debate greatly, however, about the tax rate at which the curve bends around. Few economists believe that the curve bends at a rate that is as low as 35 percent, the current top marginal rate in the United States.

Other factors that influence tax revenue, especially when marginal tax rates get very high, are tax avoidance and tax evasion. Tax avoidance means finding legal ways to reduce taxes, such as buying a home rather than renting to have a deduction for interest payments on a mortgage. Tax evasion is an illegal means of reducing one’s tax. For example, at high tax rates, people may avoid reporting income. Workers are tempted not to report tips. Or people resort to barter, which is difficult for the government to track.

**Figure 14-7**

The Tax Rate and Tax Revenue

As the tax rate increases from low levels, tax revenue rises. At some point, however, the high tax rate reduces the quantity of the item that is taxed and encourages so much tax avoidance that the amount of tax revenue declines. This curve is frequently called the Laffer curve. The particular tax rate at which the curve bends depends on the price elasticity of the item being taxed and is a subject of great debate among economists.

**Table 14-1**

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<tbody>
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The Tax Rate and Tax Revenue

As the tax rate increases from low levels, tax revenue rises. At some point, however, the high tax rate reduces the quantity of the item that is taxed and encourages so much tax avoidance that the amount of tax revenue declines. This curve is frequently called the Laffer curve. The particular tax rate at which the curve bends depends on the price elasticity of the item being taxed and is a subject of great debate among economists.

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**Figure 14-7**

The Tax Rate and Tax Revenue

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<td>$10/hour</td>
<td>2,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>0.75</td>
<td>$10/hour</td>
<td>1,500</td>
<td>$11,250</td>
</tr>
<tr>
<td>0.90</td>
<td>$10/hour</td>
<td>500</td>
<td>$4,500</td>
</tr>
</tbody>
</table>
down. For example, an employer may “pay” a little extra to a truck driver by allowing free use of the truck on weekends for fishing trips.

**Tax Policy and the Trade-off between Efficiency and Equality**

We have observed in our analysis of each tax that the equilibrium quantity of the item taxed declines when the tax rate rises. This is where the inefficiency of the tax comes from. If the tax rate is very high, or the elasticities are very high, the inefficiency can be so severe that it could thwart one of the purposes of raising the taxes: that is, to provide income support to increase the well-being of the least well-off in the society. This is because a reduction in the quantity of labor supplied or goods produced could be so great that society would have less total income, and thus less support would go to the poor even if they received a larger share of total income. In other words, a trade-off exists between equality and efficiency. If one raises taxes too high for the purpose of making the income distribution more equal, the total amount of income may decline. In that event, there will be less available to redistribute.

Given these considerations, how should the tax system—the combination of all the taxes in society—be designed or improved? First, to reduce deadweight loss to a minimum, the ideal tax system should tax items with small price elasticities of supply and demand rather than items with large elasticities. We know that the deadweight loss is small when elasticities are small. The optimal tax system would inversely relate tax rates to the elasticities.

Second, the ideal tax system would try to keep the marginal tax rates low and the amount that is subject to tax high. For example, we saw that deductions reduce the amount subject to personal income tax by lowering taxable income. Some deductions are put in the tax system to encourage certain activities: A deduction for research expenses may encourage firms to fund research, for example. The more deductions there are, however, the higher the tax rate has to be to get the same tax revenue. Economists use the term broadening the tax base to describe an increase in the amount of income subject to taxation by limiting or eliminating deductions and exemptions. With a broader tax base, a lower marginal tax rate can generate the same amount of revenue; the lower marginal tax rate has the additional advantage of reducing the inefficiency of the tax. Most tax reform efforts have involved trying to broaden the tax base while lowering marginal tax rates. This was the idea behind the tax reform efforts in the 1960s under President Kennedy and in the 1980s under President Reagan. In the early 2000s, the marginal tax rates on all taxpayers were reduced substantially. Because many new deductions, exemptions, and credits also were introduced, however, the tax base was not broadened.

Third, the ideal tax system should be as simple and as fair as possible. If a tax system is not simple, then valuable resources—people’s time, computers, and so on—must be devoted to paying and processing taxes. A tax system is seen as unfair if it is regressive. Another view of fairness frequently used is the ability-to-pay principle; this view is that those with greater income should pay more in taxes than those with less income. The tax system also is viewed as unfair if people with the same incomes are taxed at different rates. For example, in the U.S. tax system, a married couple with each making $80,000 a year pays a higher tax than an unmarried couple with exactly the same income. Some view this system as unfair.
Transfer Payments

Transfer payments, payments made by the government to an individual that are not in exchange for goods or services, have important implications for the alleviation of poverty and the distribution of income in the United States. Transfer payments can be either in cash or in kind, such as vouchers that can be used to buy food or housing.

The United States has two types of government transfer payments: means-tested transfers, which depend on the income (the means) of the recipient and focus on helping poor people, and social insurance transfers, which do not depend on the income of the recipient.

Means-Tested Transfer Programs

Means-tested transfer payments are made to millions of people in the United States each year. The major programs are listed in Table 14-2.

The 1996 federal welfare law (called the Personal Responsibility and Work Opportunity Reconciliation Act, or PRWORA) created the Temporary Assistance to Needy Families (TANF) program, replacing the Aid to Families with Dependent Children (AFDC) program, which was what people typically referred to as “welfare” in the United States. TANF is a transfer program that provides cash payments to eligible poor families with children. The federal government provides grants to the states, which then decide which poor families are eligible. Unlike AFDC, TANF assistance is limited in duration (the program has a five-year lifetime limit) and requires that recipients work a certain number of hours per week.