

Tag, You're It. Maybe.

The Politics and Economics of Taxation

Thirty years ago, in an attempt to raise revenue and implicitly stick it to rich folks, Congress enacted a tax on certain perceived luxury items such as jewelry, yachts, and expensive cars. But lo and behold, it didn't take long for the wealthy to find other attractive amusements that weren't subject to the levy, while workers in boat factories and automobile plants—let's call them the middle class—suddenly found themselves out of work when the demand for what they produced dropped. Thus economics—lower case t—trumped politics.

"Tax incidence" is economic jargon for who actually ends up bearing the burden of a tax; generally it turns on which party can more easily find an alternative good, activity or location. Whether it be cigarettes, gasoline, bottled water, sugary drinks, income, wealth, or corporate profits, who pays will not be determined by politics but by economics.

BY ALLEN R. SANDERSON

A complementary economic term is "elasticity." Elasticity is a measure of the ease with which firms or families can adapt to a change in price or income—or the imposition of a tax. Who ultimately pays the tax does not depend on who writes the check; what does matter is which party has the lowest elasticity.

When we enacted FICA (Federal Insurance Contributions Act, the program that funds Social Security and Medicare), Congress intended that this "payroll tax" be split evenly between employer and employee, half coming from the firm's revenues and the other half deducted from employees' wages. But Congress's intention is irrelevant, and independent of whether the initial pin-the-tail-on-the-donkey assignment was on workers, firms or shared between them. Subsequent economic analysis indicates that almost all of the burden of this tax is borne by workers—in the form of lower wages. The forces of supply and demand in labor markets will determine who ultimately bears the burden. (The same principle is at play when it comes to mandatory health insurance. The incidence is likely to be similar to our experience with FICA.)

In 1996 Major League Baseball initiated a "competitive balance tax"—aka a "luxury tax"—on high payroll franchises. Teams that exceeded the cap—\$206 million for the 2019 season—paid a percentage of every salary dollar over the threshold. But to what

extent do the Red Sox and Cubs pay that tax, and to what extent is it actually borne by their fans or players. Economics, not the Commissioner of Baseball, determines that.

The same argument prevails when it comes to the opposite of a tax—a subsidy. Think generous subventions for water for agricultural use in California or federal grants for 20-year-olds in college. Who ultimately benefits and who loses? With regard to higher education, the evidence suggests that students net about a third of the award; two-thirds is captured by the institution in the former of higher tuition.

In a recent newspaper article on the impact of rising commodity prices, McDonald's said that it will likely "increase its prices to offset some, but not necessarily all, of these cost increases." The firm is neither the good guy nor the bad guy here. How much of any cost increase is passed along to consumers or absorbed by the seller depends entirely—economic jargon again—on "the elasticities of demand and supply." (Any "Fight for Fifteen" minimum-wage increase will be paid for by other fast-food workers, customers, the franchise owner, investors and some—former—workers who will lose their jobs to higher-skilled workers or automation.)

Move to—capital T this time—President Trump's decision to slap tariffs on certain Chinese products. "Who pays?" The American consumer because this 25 percent tax on imports will be tacked onto prices? Or absorbed by U.S. sellers who have to reduce the prices of what they sell to compete with substitute goods? Or Chinese manufacturers who have to lower their initial prices of what they ship to us? (Or no one with transshipments from China to Vietnam and then to the U.S.) It will not depend on a presidential tweet or desideratum.

With City Hall and Springfield bringing forth various schemes to replenish their coffers, they too are subject to the laws of economics. Can I buy something across state lines or jurisdictions, or even move to more hospitable economic climes? (It is harder for cigarette manufacturers and oil companies to avoid federal taxes than state duties. The same is true for individuals.)

My late colleague and Nobel laureate George Stigler was fond of noting that politicians assume that all elasticities of demand and supply are zero. That is, imposing a tax will not alter anyone's behavior when it comes to buying a product, offering goods for sale, or working more—or fewer—hours. Economists and savvy citizens likely know better. □