Soaked

Taxes are already much higher than most people realize. By Edward C. Prescott and Lee E. Ohanian.

President Obama argued that his re-election gave him a mandate to raise taxes on high earners. But tax rates are already high—much higher than is commonly understood—and increasing them will probably further depress the economy, especially by affecting the number of hours Americans work.

Taking into account all taxes on earnings and consumer spending—including federal, state, and local income taxes, Social Security and Medicare payroll taxes, excise taxes, and state and local sales taxes—Edward Prescott has shown (especially in the *Quarterly Review* of the Federal Reserve Bank of Minneapolis, 2004) that the U.S. average marginal effective tax rate is around 40 percent. This means that if the average worker earns $100 from additional output, he will be able to consume only an additional $60.

Research by others (including Lee Ohanian, Andrea Raffo, and Richard Rogerson in the *Journal of Monetary Economics*, 2008, and Edward Prescott in the *American Economic Review*, 2002) indicates that raising tax rates further will significantly reduce U.S. economic activity and by implication will increase tax revenues only a little.

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High tax rates—on both labor income and consumption—reduce the incentive to work by making consumption more expensive relative to leisure, for example. The incentive to produce goods for the market is particularly depressed when tax revenue is returned to households either as government transfers or transfers-in-kind—such as public schooling, police and fire protection, food stamps, and health care—that substitute for private consumption.

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In the 1950s, when European tax rates were low, many Western Europeans, including the French and the Germans, worked more hours per capita than did Americans. Over time, tax rates that affect earnings and consumption rose substantially in much of Western Europe. Over the decades, these have accounted for much of the nearly 30 percent decline in work hours in several European countries—to 1,000 hours per adult per year today from around 1,400 in the 1950s.

Changes in tax rates are also important in accounting for the increase in the number of hours worked in the Netherlands in the late 1980s, after the enactment of lower marginal income-tax rates.

In Japan, the tax rate on earnings and consumption is about the same as it is in the United States, and the average Japanese worker in 2007 (the last nonrecession year) worked 1,363 hours—or about the same as the 1,336 worked by the average American.

All this has major implications for the United States. Consider California, which recently enacted higher rates of income and sales tax. The top California income-tax rate will be 13.3 percent, and the top sales-tax rate in some areas may rise as high as 10 percent. Combine these state taxes with a top combined federal rate of 44 percent, plus federal excise taxes, and the combined marginal tax rate for the highest California earners is likely to be around 60 percent—as high as in France, Germany, and Italy.

Higher labor-income and consumption taxes also have consequences for entrepreneurship and risk-taking. A key factor driving U.S. economic growth has been the remarkable impact of entrepreneurs such as Bill Gates of Microsoft, Steve Jobs of Apple, Fred Smith of FedEx, and others who took substantial risk to implement new ideas, directly and indirectly creating new economic sectors and millions of new jobs.

Entrepreneurship is much lower in Europe, suggesting that high tax rates and poorly designed regulation discourage new business creation. The *Economist* reports that between 1976 and 2007 only one continental European startup, Norway's Renewable Energy Corporation, achieved a level of success comparable to that of Microsoft, Apple, and other U.S. giants, making the *Financial Times* Index of the world's five hundred largest companies.

U.S. growth is currently weak, and overall output is 13.5 percent lower than what it would have been had we continued on the pre-2008 trend.

The economy now faces two serious risks: the risk of higher marginal tax rates that will depress the number of hours of work, and the risk of continuing policies such as Dodd-Frank, bailouts, and subsidies to specific industries and technologies that depress productivity growth by protecting inefficient producers and restricting the flow of resources to the most productive users.

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If these two risks are realized, the United States will face a much more serious problem than a recession this year. It will face a permanent and growing decline in relative living standards.

These risks loom as the level of U.S. economic activity gradually moves closer to that of the 1930s, when for a decade during the Great Depression output per working-age person declined by nearly 25 percent relative to trend. Considering GDP growth, the U.S. economy is continuing to sink relative to its historical trend.

We have lost more than three years of growth since 2007, and our underachievement will continue unless pro-productivity policies are adopted and marginal tax rates are stabilized or lowered to prevent a decrease in work effort across the board. That means lifting crushing regulatory burdens such as those imposed by Dodd-Frank, and it means reforming immigration policies so that we can substantially increase our base of entrepreneurs by attracting the best and brightest creators from other countries.

Economic growth requires new ideas and new businesses, which in turn require a large group of talented young workers willing to take on the considerable risk of starting a business. This requires undoing the impediments that stand in the way of creating new economic activity—and increasing the after-tax returns to succeeding.