

I Can Afford Higher Taxes. But They'll Make Me Work Less.

By N. GREGORY MANKIWI

AN important issue dividing the political parties is whether to raise taxes on those earning more than \$250,000 a year. Democrats say these taxpayers can afford to chip in a bit more. Republicans say raising taxes on those who already face the highest marginal tax rates will hurt the economy.

So I thought it might be useful to do a case study on one of these high-income taxpayers. Fortunately, I have one handy: me.

As a professor at Harvard and the author of some popular textbooks, I am comfortably in the income range that would be hit by this tax increase. I have been thinking — narcissistically, to be sure — about how higher taxes would affect me. Maybe these thoughts can shed some light on some of the broader policy issues.

First, I have to acknowledge that the Democrats are right about one thing: I can afford to pay more in taxes. My income is not in the same league as superstar actors and hedge fund managers, but I have been very lucky nonetheless. Unlike many other Americans, I don't have trouble making ends meet.

Indeed, I could go so far as to say I am almost completely sated. One reason is that I don't aspire for much more than a typical upper-middle-

class lifestyle. I don't fly around on a private jet. I have little desire to own a yacht or a Ferrari. I own only one home, in which I have lived since 1987. Paying an extra few percent in taxes wouldn't create a lot of hardship.

Nonetheless, as Republicans emphasize, taxes influence the decisions I make. I am regularly offered opportunities to earn extra money. It could be by talking to a business group, consulting on a legal case, giving a guest lecture, teaching summer school or writing an article. I turn down most but accept a few.

And I acknowledge that my motives in taking on extra work are partly mercenary. I don't want to move to a bigger house or buy that Ferrari, but I hope to put some money aside for my three children. They will never lead lives of leisure, but I hope they won't have to struggle to find down payments to buy their own homes or to send their kids to college.

Suppose that some editor offered me \$1,000 to write an article. If there were no taxes of any kind, this \$1,000 of income would translate into \$1,000 in extra saving. If I invested it in the stock of a company that earned, say, 8 percent a year on its capital, then 30 years from now, when I pass on, my children would inherit about \$10,000. That is simply the miracle of compounding.

Now let's put taxes into the calculus. First, assuming that the Bush tax cuts expire, I would pay 39.6 percent in federal income taxes on that extra income. Beyond that, the phaseout of deductions adds 1.2 percentage points to my effective marginal tax rate. I also pay Medicare tax, which the recent health care bill is raising to 3.8 percent, starting in 2013. And in Massachusetts, I pay 5.3 percent in state income taxes, part of which I get

back as a federal deduction. Putting all those taxes together, that \$1,000 of pretax income becomes only \$523 of saving.

And that saving no longer earns 8 percent. First, the corporation in which I have invested pays a 35 percent corporate tax on its earnings. So I get only 5.2 percent in dividends and capital gains. Then, on that income, I pay taxes at the federal and state level. As a result, I earn about 4 percent after taxes, and the \$523 in saving grows to \$1,700 after 30 years.

Then, when my children inherit the money, the estate tax will kick in. The marginal estate tax rate is scheduled to go as high as 55 percent next year, but Congress may reduce it a bit. Most likely, when that \$1,700 enters my estate, my kids will get, at most, \$1,000 of it.

HERE'S the bottom line: Without any taxes, accepting that editor's assignment would have yielded my children an extra \$10,000. With taxes, it yields only \$1,000. In effect, once the entire tax system is taken into account, my family's marginal tax rate is about 90 percent. Is it any wonder that I turn down most of the money-making opportunities I am offered?

By contrast, without the tax increases advocated by the Obama administration, the numbers would look quite different. I would face a lower income tax rate, a lower Medicare tax rate, and no deduction phaseout or estate tax. Taking that writing assignment would yield my kids about \$2,000. I would have twice the incentive to keep working.

Now you might not care if I supply less of my services to the marketplace — although, because you are reading this article, you are one

of my customers. But I bet there are some high-income taxpayers whose services you enjoy.

Maybe you are looking forward to a particular actor's next movie or a particular novelist's next book. Perhaps you wish that your favorite singer would have a concert near where you live. Or, someday, you may need treatment from a highly trained surgeon, or your child may need braces from the local orthodontist. Like me, these individuals respond to incentives. (Indeed, some studies report that high-income taxpayers are particularly responsive to taxes.) As they face higher tax rates, their services will be in shorter supply.

Reasonable people can disagree about whether and how much the government should redistribute income. And, to be sure, the looming budget deficits require hard choices about spending and taxes. But don't let anyone fool you into thinking that when the government taxes the rich, only the rich bear the burden.