JOINT ECONOMIC COMMITTEE

JIM SAXTON, CHAIRMAN

RESEARCH REPORT #109-5
April 27, 2005

A BRIEF EXPLANATION OF THE ECONOMIC BURDEN IMPOSED BY FEDERAL TAXES

Economic theory gives policymakers solid support for resisting tax increases and preferring spending reductions as a method of reducing the federal deficit.

Taxes impose two main burdens on the economy. The first is that the mere act of collecting taxes imposes significant transaction costs, which increase with the complexity of tax laws. Individuals must either take the time and effort needed to understand the law or they must pay others to prepare the forms for them. In addition, the government must enforce the tax laws in order to reduce incentives to cheat.

This transaction cost depends on the type of tax and its complexity. In a survey of research on compliance costs Joel Slemrod and Jon Bakija estimated that Americans spent about $110 billion complying with and enforcing federal income taxes in 2003, or about 10 percent of income tax receipts that year.[1] Mere reductions in the size of current taxes may not significantly reduce this burden, but tax simplification will.

The second burden is even greater. In a free market economy driven by voluntary exchanges, economic activity is usually engaged in because it benefits both the buyer and the seller of a product or service. By raising the cost of engaging in such activity, taxes deter economic activity and thus reduce the benefit that would otherwise occur.

In a normal market, supply and demand balance at the market price. For the sake of simplicity, let us assume that for $3 per unit suppliers will deliver 300 units of a certain good and that, at that price, buyers are willing to purchase exactly the same amount. Supply and demand thus equal each other; there is neither a surplus nor a shortage.

What happens when the government taxes producers $1 on every unit sold? Now producers will be less willing to supply the good, since for every unit they sell, they will have to pay a tax. The next time buyers come to purchase 300 units, they will find that the price has risen by the amount of the tax, to $4.

But at $4, consumers are not willing to buy 300 units. By raising the price sellers charge, the government has ensured that fewer goods will be sold. The exact amount of both the increase in market price and the reduction in units sold will depend upon how responsive supply and demand are to changes in the price of the good.

Several points are worth mentioning. First, the total social gains from selling extra units of the good are gone forever. These gains existed because the value of each unit to buyers was higher than the market price, otherwise they would not have purchased the unit. Similarly, sellers preferred to receive the market price than not sell the good. Since the tax reduces the number of units for which these trades are made, it also reduces the total value that buyers and sellers receive from trading. This loss is often called the **deadweight loss** imposed by the tax.

[1]Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate over Taxes*, 3rd Ed. (Cambridge MA: MIT Press, 2004), p. 160.

Second, even though the tax is paid entirely by producers, consumers will bear part of both the tax and the deadweight burden. For one thing, consumers will have to pay a higher price on all of the units that they do buy. In addition, consumers will lose the benefit from the units that they would have bought had the price not risen.

Third, the exact amount of the burden and its distribution between producers and consumers will depend on how sensitive supply and demand are to changes in the price of the good. If demand is sensitive to changes in price, the total economic burden imposed by the tax will be large and consumers will bear a bigger portion of it.

Finally, the total burden usually rises sharply as the tax increases. For example, doubling the tax more than doubles the economic cost associated with the reduced economic activity that it causes. In a free market people do not always have to engage in activity that the government taxes and, if they do so, they will try to pass as much of the tax as they can on to others.

How significant is the deadweight burden in real life? In general the burden of the tax depends on the degree to which it deters desirable economic behavior. Where the tax is levied on an activity that causes social harm, such as pollution or illegal activity, taxes can increase overall welfare because they reduce the amount of the activity people engage in. However, most federal sales, income, excise, and payroll taxes fall on general economic activity that makes people better off: working, saving, and investment. Discouraging these activities reduces economic welfare.

Estimating the total size of the burden including secondary and tertiary effects is quite difficult. An earlier survey of the literature by this Committee found that the midpoint of empirical estimates was around 40 cents for every additional dollar of taxes raised.[2]

Of course, the burden of these taxes can be partially offset by the benefit created when the government spends the tax revenue. If the above estimate is correct, however, any new spending program must create additional benefits of at least 50 cents just to break even from the combination of transaction costs and deadweight loss imposed by the additional tax.

Since a great deal of government spending consists of merely transferring money from one person to another rather than making society as a whole better off, restraining growth in this spending is much preferable to increasing taxes.

Tax reform can also reduce the deadweight loss of taxes. To accomplish this policymakers should ensure that taxes:

- Cost as little as possible for the government and individuals to calculate.
- Apply low marginal tax rates to a broad base of economic activity.

For further information please see the following Joint Economic Committee studies by visiting the JEC website www.house.gov/jec, or contacting the JEC at (202) 226-3234.

- *How Competitive is the U.S. Tax System?* (April 2004)
- *Near-Term Stimulus and Long-term Growth* (May 2003)
- *Federal Tax Policy, Near-Term Stimulus and Long-Term Growth* (March 2003)
- *Tax Reduction and Economic Welfare* (April 1999)
- *Some Underlying Principles of Tax Policy* (September 1998)

[2] Richard K. Vedder and Lowell E. Gallaway, *Tax Reduction and Economic Welfare,* Prepared for the Joint Economic Committee, April 1999, p. 6.