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AND THE COSTS OF UNEQUAL GROWTH AND RECESSIONS

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Working Paper 21927
<http://www.nber.org/papers/w21927>

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, MA 02138
January 2016

This paper was prepared for the April 2015 Carnegie Rochester NYU Conference on Public Policy. We are grateful to Stefanie Stantcheva for her discussion and comments on the paper, to Sevin Yeltekin for valuable editing advice, and to participants at the conference for helpful discussions. Thanks also to Alex Gelber, Andreas Peichl, and Danny Yagan for in-depth comments, and to Nathan Hendren, Louis Kaplow, Greg Mankiw, Joel Slemrod, Glen Weyl, and participants at the NBER Public Economics Program meeting for insightful discussions. The views expressed herein are those of the authors and do not necessarily reflect the views of the National Bureau of Economic Research.

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NBER Working Paper No. 21927

January 2016

JEL No. D63,E32,H21

ABSTRACT

Calculating the welfare implications of changes to economic policy or shocks requires economists to decide on a normative criterion. One approach is to elicit the relevant moral criteria from real-world policy choices, converting a normative decision into a positive inference, as in the recent surge of "inverse-optimum" research. We find that capitalizing on the potential of this approach is not as straightforward as we might hope. We perform the inverse-optimum inference on U.S. tax policy from 1979 through 2010 and argue that the results either undermine the normative relevance of the approach or challenge conventional assumptions upon which economists routinely rely when performing welfare evaluations.

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Introduction

Economists are put in an awkward position when asked to calculate the welfare consequences of changes to economic policy or of shocks to the economy: we are asked to act as moral philosophers. Though we have largely converged on a standard approach to that task—i.e., by using a generalized form of utilitarianism—we have left room for a wide range of normative perspectives within that approach. For example, in optimal tax models we have tried to remain agnostic about the values of the so-called marginal social welfare weights that determine the value of transferring resources across individuals (see Emmanuel Saez, 2001). Choosing a more specific normative perspective, for example choosing the values of the marginal social welfare weights, remains an uncertain and basically unwelcome task.

When the researcher’s goal is to produce specific tax policy recommendations or quantitatively characterize optimal policy, however, choosing a more specific normative perspective cannot be avoided. In those cases, optimal tax analysts from Mirrlees (1971, p. 201) to Saez (2001, p. 223) and beyond have typically assumed that the objective of policy is to maximize the simple sum of individuals’ utility, or well-being, levels, where individual utility is a concave function of after-tax income (i.e., in which the marginal utility of a dollar decreases with income, approaching zero as income grows very large). When economists make such assumptions, they implicitly take a strong moral philosophical position.

An alternative approach is to take our normative cues from society, eliciting the relevant moral criteria from real-world policy choices.¹ Progress along these lines has been facilitated by the recent “inverse-optimum” research that, following François Bourguignon and Amedeo Spadaro (2012), uses analytical results from optimal tax theory and assumptions on economic parameters to infer the marginal social welfare weights (MSWWs) currently prevailing in a number of developed economies.² While that literature has largely refrained from using the inferred weights for welfare evaluation, the potential for doing so is clear. For example, related work by Nathan Hendren (2014) uses a similar inference exercise to calculate the implicit welfare costs of rising inequality in the modern United States, given mainstream estimates of the distortionary costs of taxation. In principle, these inference exercises would allow us to convert the selection of a normative perspective into an empirical question, exempting economists from some difficult choices. Along the way, they would allow us to characterize the conditions under which the conventional specification of the policy objective (i.e., utilitarian with diminishing marginal utility of income) is and is not consistent with the objective that appears to be hold sway—if only implicitly—in reality.

In this paper, we find that this “revealed preference” approach yields results that demand an explanation. The problems start when we extend the previous literature by performing the inverse-optimum inference analysis intertemporally, using official data on U.S. income distributions and standard theoretical conditions on optimal marginal tax rates to infer the combinations of positive and normative judgments implicit in U.S. tax policy from just after the Tax Reform Act of 1986 (TRA86) through 2010. We find that tax rates are consistently (for more than two decades) much lower on high earners, and to a lesser extent middle-income earners, than what is recommended by the conventional optimal policy analyses described above.

The interpretative challenge posed by the surprisingly low marginal tax rates on high incomes takes the form of a trilemma in which at most two of the following conditions can hold: the inverse-optimum exercise

¹See Saez and Stantcheva (2015), Weinzierl (2014a), and Weinzierl (2014b) for analyses that look for underlying principles that inform the inferred marginal social welfare weights.

²François Bourguignon and Amedeo Spadaro (2012) estimate the MSWWs for France in 1995 and find that they are negative on high earners unless the labor supply elasticity is small, similar to our findings in U.S. for the early 1980s. Amedeo Spadaro, Lucia Mangiacavchi, and Luca Piccoli (2012) estimate and compare average MSWWs on five income-earning groups for 26 European countries, finding substantial variation across them. Olivier Bargain, Mathias Dolls, Dirk Neumann, Andreas Peichl, and Sebastian Siegloch (2013; 2014a; 2014b) include the United States (as well as European countries) in their analyses. In Bargain et al. (2013), they study how tax policy has affected inequality in the United States from 1979–2007 and find partisan effects on policy consistent with the trends we show below. In Bargain et al. (2014a) and Bargain et al. (2014b) they examine 2005 U.S. policy and data, estimate the relevant labor supply elasticities, and calculate implicit MSWWs that are quite flat across the income distribution relative to many European countries, consistent with our findings for the same time period if elasticities of taxable income are perceived to be small. Floris Zoutman, Bas Jacobs, and Egbert L.W. Jongen (2013a; 2013b) analyze in detail the Dutch tax system and proposals for it by Dutch political parties to infer prevailing and preferred MSWWs in the Netherlands. In Zoutman et al. (2013a) they find that top MSWWs are negative unless the elasticity of labor supply is small, consistent with the Bourguignon and Spadaro results for France and ours for the United States. In Zoutman et al. (2013b) they show (among other things) that the tax proposals by Dutch political parties have the same feature. Other related works include Mera (1969), Moreh (1981), Kopczuk et al. (2005), Christiansen and Jansen (1978), Pirttilä and Uusitalo (2010), Bargain and Keane (2010), Stern (1977), Amiel et al. (1999), and Pflingsten and Schneider (1994).

yields normatively-relevant results on MSWWs (e.g., they broadly reflect the public will despite flaws in the political system); society’s perceived size of the distortionary cost of taxation (the elasticity of taxable income, or ETI) lies within conventional ranges; and society’s true pattern of MSWWs is consistent with conventionally-assumed principles (e.g., where the highest earners receive minimal marginal weight). In other words, the results from 1987 through 2010 either undermine the normative relevance of this inference exercise or challenge conventional assumptions upon which economists routinely rely when performing welfare evaluations.

The interpretive challenge deepens when we extend the analysis to policy prior to TRA86. The inferred normative and positive judgments for much of the 1970s and early 1980s are substantially different from those for later years, with either the perceived distortionary costs of taxation or the MSWWs on high earners appearing to be much lower prior to TRA86 than after. If these results accurately capture the desired shift in tax policy over these two decades, the trilemma described above worsens. Specifically, in that case welfare analyses using the results of the inverse-optimum exercise are sensitive to the year for which it is performed, and to use those results we would have to accept not only unconventional values for some key assumptions (i.e., in the 1987-2010 period) but also changes in these values over time. Alternatively, one might argue that the purpose of TRA86 was to reform aspects of the tax code that poorly implemented society’s normative and positive judgments, which themselves were largely stable over time. In that case, the challenge posed by the original trilemma extends across approximately the last 40 years, not 25, of modern U.S. tax policy. Even more puzzling results appear if we extend our analysis back to the early twentieth century (where our data are more limited).

Addressing the interpretive challenge posed by our results is, we argue, a prerequisite to fulfilling the promise of this empirical approach to normative questions and, more generally, an important task for economists interested in welfare analysis. If the policymaking process is so deeply flawed that a policy as widely-debated, familiar, and controversial as the progressivity of the income tax fails to usefully aggregate the public’s policy preferences, there is little hope for using such inference exercises to uncover society’s underlying normative priorities. If the prevailing income tax is, instead, consistent with the public’s priorities and beliefs, these exercises provide a rigorous, transparent way to check conventional assumptions against reality. In particular, while the conventional optimal tax model simplifies reality in a number of ways, it distills the essence of the tax policy problem into a few key, general parameters—indeed its influence is due to its remarkable ability to do so.

Understanding the specific ways in which the parameters of this model implied by existing policy diverge from conventional assumptions forces us to re-examine those assumptions. While we may have good reasons and solid evidence to support our assumptions, we may also learn something from the persistent results of public deliberation on taxation. With regard to assumptions on “positive” parameters such as the ETI, public perception may capture, for example, long-run aspects of individuals’ responses to taxation that empirical research is incapable of isolating, but which should be incorporated when designing tax policy. And for normative parameters such as the MSWWs, it is at least possible—though by no means certain—that public judgments may reflect priorities that merit more weight than they receive in current moral and political philosophical reasoning. Economists’ traditional humility with regard to such issues suggests, to us at least, that these possibilities are worth our consideration.

To demonstrate both the potential for, and complications with, using the inverse-optimum exercise to inform welfare calculations, we apply our results to two prominent features of the U.S. economy over the three decades from 1980 to 2010. First, we calculate the welfare cost of the inequality in income growth over that period, using the normative judgments implied by policy after TRA86 and conventional values for the perceived ETI. We estimate that this cost was equivalent to 4.3 percent of total economic growth in our baseline specification (with robustness checks yielding estimates between 1% and 10%). These results may seem remarkably small relative to what public discourse on the topic would imply, but they reflect the pattern of MSWWs inferred from recent tax policy in which an extra dollar of disposable income for a high earner is worth dramatically more in welfare terms than is commonly assumed in optimal policy analyses. Larger estimates for the cost of unequal growth obtain if we assume that the perceived ETI took an unconventionally large value or that the inferred MSWWs fail to reflect society’s true normative judgments, thereby illustrating the trilemma noted above.³ Similarly, we can illustrate the instability problem (potentially) introduced by

³This discussion is consistent with the point-in-time inverse-optimum calculations of Peter Diamond and Emmanuel Saez (2011), who note that conventional MSWWs imply that “The current [U.S. top marginal tax] rate, $\tau = 42.5$ percent, would

policy prior to TRA86 by showing that the estimated costs of unequal growth are three times as large when we use inferred MSWWs from that earlier period. Second, in what we believe is a novel application of this approach, we calculate the welfare costs of business cycles during this period and show that the concentration of some recent recessions on top earners means that the inferred pattern of MSWWs matters substantially for welfare calculations.

Identifying the solution to the interpretive challenge posed by our inverse-optimum results is difficult, as we cannot observe directly the societal judgments that we would need to determine which leg of the trilemma to abandon. As a first step, we present suggestive empirical evidence—both existing and new—on perceived ETIs and MSWWs.

On ETIs, unfortunately we have found no evidence on the level perceived by the public, though some imperfect data suggests fluctuations in the perceived incentive costs of taxation over the latter part of this period that qualitatively fit with policy. Academic research over this period consistently found that the average ETI was small. Larger estimates for high earners that were obtained during the 1990s were later attributed to taxpayer responses that should not be included in the “steady state” ETI used for welfare analysis, so the potentially appealing explanation of our inference results that (perceived) ETIs rise with income appears to have limited support. Finally, official government estimates of the ETI were small and stable throughout the period. In sum, although we cannot rule out this explanation, we find no evidence that perceived ETIs, even for high earners, took the unconventionally large values required to explain our inference results.

If a higher-than-expected perceived ETI is not the solution, our choice comes down to whether the inferred MSWWs on high earners were larger than expected over this period because policy failed to reflect society’s true normative judgments (which fit with conventional assumptions) or because society’s true normative judgments were at odds with conventional assumptions. To study this choice, we show evidence that a minority of public opinion survey respondents believe that public officials or policy are interested in or influenced by the concerns of the average citizen and that a substantial majority of Americans consistently say they want high earners to pay more in taxes. These data appear to support the hypothesis that implicit top MSWWs are biased upward, thereby suggesting that the results of inverse-optimum exercises have limited normative applicability. However, we present new survey evidence that these results may be sensitive to the information provided to survey respondents, preventing us from ruling out the possibility that the normative preferences implicit in prevailing policy are accurate representations of society’s normative judgments.

As this discussion makes clear, existing data are simply insufficient to identify the true explanation for our results. Given the different explanations’ substantial implications for policy design and evaluation, this indeterminacy means that a main lesson of this paper is that better data on the perceived costs and benefits of redistribution will be essential for progress along the revealed preference approach to normative policy analysis.

Fortunately, not all of our contributions in this paper are negative. We help develop the inverse-optimum literature in three ways. First, our focus on intertemporal analysis allows us to test the stability of the inferred positive and normative judgments required to explain policy, the importance of which is made clear by the instability we find when we extend our scope before 1986. Second, as part of trying to explain these puzzling features, our paper also emphasizes the importance for policy inversion exercises of the *perceived* distortionary costs of taxation (note that it could be voters, policymakers, or both whose perceptions are being inferred). Third, as far as we are aware, the application of this approach to the costs of recessions is new to this paper. Finally, our paper’s novel survey evidence contributes to two active literatures: one in economics on stated preferences toward redistribution (as in Ilyana Kuziemko et al. (2015)) and one in political science on the potential link between economic and political inequality in the modern United States (as in Larry Bartels (2008) and Martin Gilens (2012)). The correct interpretation of our findings depends in part on how well policy over this period represents Americans’ true redistributive preferences, and our new survey results demonstrate the sensitivity of evidence on these preferences to the information that is made salient to survey respondents.

The paper is structured as follows. In Section 1 we describe the theory and data behind our inverse-optimum exercise. We then perform that exercise for U.S. tax policy from 1979 through 2010, deriving and discussing the combinations of MSWWs and ETIs implied by that policy and pointing out the interpretive

be optimal only if the elasticity e were extremely high, equal to 0.9. [...ftnt:] Alternatively, if the elasticity is $e = 0.25$, then $\tau = 42.5$ percent is optimal only if the marginal consumption of very high-income earners is highly valued, with $g = 0.72$.”

challenge these results pose. For reference, in an online appendix we extend the inference of top-income MSWWs and ETIs back to 1920 using more limited evidence. Section 2 applies the inference results of Section 1 to compute the revealed preference costs of rising inequality and recessions over the last three decades in the United States. In Section 3 we frame the interpretive challenge as the trilemma discussed above, and we examine suggestive evidence pertaining to MSWWs and ETIs as a first step toward finding a solution. Section 4 concludes.

1 Positive and normative judgments in U.S. tax policy

In this section we show how the Diamond (1998) and Saez (2001) formula for optimal marginal tax rates can be used to infer combinations of the perceived costs and benefits of redistributive taxation underlying modern U.S. tax policy. In that famous formula, these perceived costs and benefits depend on specific quantities, namely the elasticity of taxable income (ETI) and the pattern of marginal social welfare weights (MSWWs). We then describe the data we use for the inference exercise. Finally, we present our results on the possible patterns of the ETI and MSWWs that can explain the evolution of U.S. tax policy since 1979.

1.1 Inverting the optimal marginal tax rate formula

As described in Bourguignon and Spadaro (2012), the inversion exercise is best understood as the dual of the standard Mirrlees (1971) optimal taxation problem. We follow their example and focus on the special case of no income effects, a concave social welfare function, and a uniform ETI, as considered in Diamond (1998). (Income effects typically raise optimal marginal tax rates, especially at high incomes—see, for example, Saez (2001), Table 1 and Figure 5. Including them in our analysis would therefore be likely to amplify the departures from conventional assumptions required to explain the evolution of policy.) In this case the first-order condition for optimal marginal tax rates takes a particularly simple and transparent form. We use the version of that expression derived in Saez (2001), written as a function of observable earnings y , the earnings distribution $F(y)$, with assumed density $f(y)$, and the elasticity of taxable income ε :

$$\frac{T'(y)}{1 - T'(y)} = \frac{1 - F(y)}{\varepsilon y f(y)} \int_y^\infty \frac{1 - g(z)}{1 - F(z)} dF(z). \quad (1)$$

This is analogous to expression (4) in Bourguignon and Spadaro, though by using Saez’s expression we avoid the need to back out the underlying skill distribution.⁴

In this expression, $g(y)$ denotes the MSWW of an individual earning y , which we will use to characterize the implicit social preference for redistribution, i.e., the social welfare function.⁵ In other words, $g(y)$ is the social welfare generated by a marginal increase in consumption for an agent earning y , expressed in terms of public funds. By construction, $\int_0^\infty g(z)f(z)dz = 1$ under the optimal tax policy; the planner is indifferent between a marginal dollar of public funds and a dollar equally distributed across the population. Thus a value of $g(y') = 0.5$, for example, indicates that the planner is indifferent between an evenly distributed \$0.50 of income and a rise in consumption of one dollar for an agent earning y' .

The standard Mirrlees approach specifies an individual utility function and social welfare function and solves for the tax function that satisfies (1); here we invert that approach, taking the observed tax function as given and solving for the social welfare function that would rationalize it (see Bourguignon and Spadaro for a thorough discussion of the conditions under which this inversion is possible). To implement this inversion,

⁴A technical point: in the formula from Saez (2001), $f(y)$ denotes the “virtual” earnings density—that which would obtain if the tax code were linearized around $T(y)$ —rather than the observed density. This complication is due to the fact that if the income tax is nonlinear, a tax perturbation generates an earnings adjustment to a new point with a different marginal tax rate, causing an additional earnings adjustment, and so on. As noted in Jacquet et al. (2013), if the ETI is defined to include this circularity, then the true income density can be used in (1). In any case, this distinction is important only if individuals optimize their earnings with respect to a highly nonlinear tax schedule, and the absence of pronounced bunching at most “kink points” in the US tax schedule (Saez, 2010) suggests this is unlikely to be the case in practice, and so we use the income distribution directly for our calculations. An alternative approach, followed by Bourguignon and Spadaro, is to assume a specific utility function and infer an underlying ability distribution based on observable earnings.

⁵Strictly speaking, MSWWs correspond to the derivative of the full social welfare function, but because the intercept of the social welfare function is immaterial, these weights are sufficient statistics for redistributive preferences.

we rearrange (1) to write:

$$\int_y^\infty \frac{g(z)}{1 - F(y)} dF(z) = 1 - \frac{T'(y)}{1 - T'(y)} \frac{\varepsilon y f(y)}{1 - F(y)}. \quad (2)$$

Given the observed tax code, a calibrated income distribution, and an assumed ETI the right side of this equation can be computed as a function of income. Differentiating (2) with respect to y yields

$$g(y) = - \left(\frac{1}{f(y)} \right) \frac{d}{dy} \left[1 - F(y) - \frac{T'(y)}{1 - T'(y)} (\varepsilon y f(y)) \right], \quad (3)$$

where the expression in brackets can be computed using numerical differentiation. This provides an estimate of the MSWW $g(y)$ as a function of income.

Importantly, in all of these expressions the elasticity ε is written as a constant, but in fact it need not be. For example, if the elasticity varies with income, we might replace the constant ε with $\varepsilon(y)$, so that the results above apply when using the local elasticity of taxable income at each income y .

1.2 Concerns about model misspecification

The optimal tax model on which this inversion exercise is based is clearly a stark simplification of reality, raising concerns that we may make incorrect inferences of the component factors.

One possible misspecification is that the model focuses entirely on the intensive labor supply margin (the question of how much to work), while ignoring the extensive margin (the question of *whether* to work). Although extensive margin elasticities have important implications for optimal tax design (Saez, 2002), we view our approach as a useful simplification for two reasons. First, the extensive margin is particularly important for low incomes, while our analysis focuses primarily on MSWWs on high incomes.⁶ Second, representing the perceived distortionary costs of taxation through a single parameter simplifies and facilitates the derivation and exposition of our results. Provided that we view the intensive ETI as a proxy for the overall perceived distortionary costs of taxation, we believe our results would be similar in a richer model incorporating other margins of adjustment.

Another possible misspecification is that the model we use is static, while the implications of dynamic factors (such as financial and human capital accumulation) for optimal taxation have received much attention in recent years.⁷ As with the extensive margin, to the extent that these factors primarily affect the distortionary costs of taxation, our use of a single parameter to capture perceptions of those costs is flexible enough to (at least roughly) accommodate them. In fact, one appealing aspect of using the static model for the inverse-optimum exercise is that it distills the wide range of factors potentially determining optimal taxation into just a few parameters. In addition, while the theoretical benefits of a tax system that takes into account earnings histories, age, and other complications may be large, actual policy design thus far is arguably better described by the simpler static Mirrleesian model.⁸

By using the static optimal tax model, we also do not explicitly separate the tax treatment of labor and capital income, and our exclusion of capital income may generate concerns about our results, particularly at the top of the income distribution. The precise implications of this exclusion depend on which possible rationale for capital taxation is included in the model—e.g., ability-related preference heterogeneity—a debate which is beyond the scope of this paper. That said, to the extent that capital income taxation represents an additional burden on earnings, excluding it would slightly bias up our inferred MSWWs on high incomes. On the other hand, to the extent that capital income represents the compensation of human capital which, in the static optimal tax model we use, ought to be included in labor income, our exclusion of capital income taxation is likely to substantially bias down the MSWWs implied by policy. Although a richer dynamic model of taxation is beyond the scope of this paper, we view the extension of these methods to the dynamic context as an promising area for additional research. At the same time, even the simpler

⁶Consistent with this, Bourguignon and Spadaro (2012) demonstrate that incorporating an extensive margin yields qualitatively similar results, particularly at the top, and Hendren (2014) ignores the extensive margin for those with incomes above EITC eligibility cutoffs.

⁷The relevant literature is usually said to start with Golosov, Kocherlakota, and Tsyvinski (2003). See Stantcheva (2014) for a recent examination of human capital in the model.

⁸See Golosov, Kocherlakota, and Tsyvinski (2003), Farhi and Werning (2007), Weinzierl (2011), and Best and Kleven (2014).

static framework in this paper presents serious informational challenges for the successful implementation of the inverse optimum approach, and these challenges are likely to be even more daunting in a dynamic context.

A different concern is that we do not treat all aspects of the model symmetrically. That is, we allow two sets of parameters—MSWWs and ETIs—to adjust and thereby explain our inference results, but in principle the other ingredients of the model may also play a role. In particular, voters may misperceive the income distribution or the existing tax system. Uncertainty over these two factors ought to be less, as their true values are easily discovered and not up for serious debate, but future work could explore their impact on our findings.

Finally, one may worry that the results of the inverse-optimum exercise are not useful because policy in the real world is not—of course—made by a single representative agent reasoning through a Mirrleesian optimal tax model. For example, politics surely impact tax policy, but politics have no place in the standard optimal tax framework. Perhaps it is misleading to study policy that is “contaminated” by these factors in the real world in the hopes of learning about the normatively optimal policy in an ideal one. Three considerations make us confident that the exercise in this paper is useful despite these concerns.

First, tax policy is a topic of frequent, repeated, and prominent debate, especially in the United States. This is especially true of the income tax and, within the income tax, the top marginal tax rate, which is often a major issue in presidential elections, for example. The likelihood of its broad distributional characteristics being set to serve narrow interests rather than to reflect the will of the public is thus arguably low, and we might plausibly hope to learn something about society’s true preferences from the policy that comes out of such a public debate.

Second, to the extent that one rejects this argument and believes the public’s will is not reflected in tax policy, our inferred MSWWs and ETIs are still useful. They can be regarded as implicit, in the sense that they are the weights that *would* give rise to the observed tax schedule if a policy maker favoring these weights and assuming those elasticities had freely selected a tax schedule. If such a decisive policy maker is believed to exist—for example, a self-interested pivotal voter, or a particular Congressional committee—then our results should be regarded as the revealed judgments of that entity and are useful as a measure of how much that entity is able to shift policy from what we may believe are more representative views. In fact, we discuss evidence on whether policy appears to be biased relative to the public’s preferences in Section 3.

Third, and perhaps most important, the results of the inverse-optimum exercise translate the potentially complicated mix of factors behind real-world tax policy into the simple, formal primitives that determine optimal tax policy in the Mirrleesian approach that dominates modern research. In that way, deviations of the inferred values from conventional assumptions provide a quantitative appraisal of the considerations outside the scope of the conventional analysis that are relevant to policy makers⁹ or to the decision process. In other words, when we find that MSWWs or ETIs implied by policy deviate substantially from conventional values, we provide a target at which researchers may aim their preferred, more nuanced models of policymaking and at which activists or policymakers concerned about deviations from what they regard as the appropriate values for these parameters can direct their reform efforts.¹⁰

1.3 Data

As described above, the estimation procedure for MSWWs depends on the distribution of market income (before taxes and transfers), $F(y)$, and the schedule of marginal tax rates $T'(y)$. To compute welfare costs of economic changes, these MSWWs are then applied to disposable income (after taxes and transfers). We obtain these data from two sources—the U.S. Congressional Budget Office (CBO) for market and disposable income, and the National Bureau of Economic Research’s TAXSIM utility for the marginal tax rate schedule.

Income distribution Since 1979 the CBO has produced annual data describing the distribution of market and disposable incomes across U.S. households.¹¹ These data consists of average market and disposable

⁹For instance, Smith (1776) famously recommended a “simple” tax system, a feature neglected by modern theory. Saez and Stantcheva (2015), Weinzierl (2014a), and Weinzierl (2014b) explore other unconventional normative priorities.

¹⁰We thank Stefanie Stantcheva for prompting this discussion.

¹¹We use the term “disposable income” to indicate income after *federal* taxes and transfers. This implicitly assumes property taxes and other local taxes are a component of consumption—see the online appendix for further discussion of such taxes.

income levels for households in eight quantiles, partitioned by percentiles 20, 40, 60, 80, 90, 95, and 99. Throughout the paper, all real figures are given in 2010 U.S. dollars as computed using the Personal Consumption Expenditures price index from the U.S. Bureau of Economic Analysis.

The CBO data's coarse level of aggregation creates two limitations for our purposes. First, we are unable to infer variation in MSWWs within quantiles reported by CBO. This is particularly relevant for the bottom four quantiles, which each represent 20% of the population. Mitigating this concern, much of our analysis will focus on MSWWs of high earners, where the smaller buckets provide a finer picture of the distribution. Second, we are unable to account for variation in marginal tax rates within the quantiles reported by the CBO. Rather, we will feed the average income levels from each quantile into NBER's TAXSIM utility to obtain marginal tax rate estimates, effectively treating each bucket as a representative agent, weighted by its population share. Although we do not believe these shortcomings qualitatively affect the nature of our results, universal data (such as that used by Hendren (2014)) surely provide a more precise measure of the distribution.

Nevertheless, in two respects the CBO data are particularly well-suited for the purposes of this paper. First, to compute the costs of unequal growth and recessions as we do in Section 2, we need to apply MSWWs to changes in disposable (post-tax) income. The CBO data are intended to provide a consistent and carefully-constructed measure of this income, combining internal U.S. Treasury tax return data with data from the Consumer Population Survey (CPS) of the U.S. Census Bureau. As the CBO argues in its documentation, combining these data sources is important because tax records exclude people who do not file federal tax returns as well as information on some government cash transfers and in-kind benefits that are captured by the CPS, while CPS data are sparse at the upper end of the income distribution relative to tax return data.

Second, the CBO data occupy a prominent place in public debates over taxation and the distribution of income in the United States.¹² This paper seeks to infer the combination of positive and normative judgments from existing policy, so using an official data source that is (and has been) salient for policymakers over the last several decades is arguably preferable to using more precise data that was less visible to them.

To compute the MSWWs, we include all market income other than capital gains in our analysis. Thus, we include dividend income and other capital income. In part, this choice is guided by the policy treatment of this income: capital gains are generally taxed separately from other forms of personal income in the United States, so it is natural to exclude them.¹³ In any case, our basic results remain the same if capital gains are included in market income.

The process for backing out MSWWs described above requires a continuous income distribution. We calibrate a Pareto lognormal distribution to the eight moments reported in the CBO data each year. This parametric form, introduced in Colombi (1990), fits observed income distributions quite well, both in the middle of the distribution and in the top tail (see Reed and Jorgensen (2004)). The distribution has a Pareto upper tail, the importance of which for computing optimal income taxes is highlighted in Saez (2001) and Diamond and Saez (2011). The Pareto-lognormal distribution is characterized by three parameters, one of which is the Pareto parameter for the distribution toward which the Pareto-lognormal converges in the upper tail. We constrain this parameter to equal the Pareto parameter implied by data reported in Piketty and Saez (2007), which is based on tax returns and thus should represent the top tail of the distribution well. We calibrate the remaining two parameters to minimize the squared errors between the observed means within the quantiles reported by CBO and the means within those quantiles predicted by our calibration. The Pareto-lognormal distributions (plotted graphically against the empirical distributions in the online appendix) somewhat underestimate incomes in the center of the distribution while overestimating incomes at the very bottom. Nevertheless we view this approach as a good approximation given the sparse nature of the CBO data; in particular, since the optimal top tax rate depends only on the ETI, the top limiting MSWW, and the Pareto parameter (see Saez (2001)), our use of the Piketty and Saez Pareto parameter estimates ensures that our computed top welfare weights approach those under the true income distribution.

¹²For one recent example, the CBO's report on the distributional impact of tax expenditures in May 2013 presented the data in exactly the same form as the data we use in this paper. That CBO report was widely covered in the press and referred to by policymakers, such as the House Ways and Means ranking member Sander Levin, (see <http://democrats.waysandmeans.house.gov/press-release/levin-statement-cbo-report-distribution-tax-expenditures>)

¹³We also use this definition of income to increase comparability to the well-known data on the concentration of income produced by Piketty and Saez (2007), as they also compute series excluding capital gains. See the online appendix for a comparison of their findings with the income concentrations at top percentiles in CBO data.

Our calibrated distributions also capture the well-known rise in inequality over this period, as evident in the implied Lorenz curves, also plotted in the online appendix.

Marginal tax rate schedule We use the NBER’s TAXSIM tool to obtain marginal tax rates on earned income at each of the CBO’s reported income levels from 1979 through 2010. We obtain the marginal tax rate on taxpayer earnings by assigning all of the household’s income to the taxpayer in a joint-filing household with two adults of working age, two dependents under the age of 17, and no state tax liability or capital gains. We construct a piecewise-constant marginal tax schedule from the TAXSIM marginal tax rates reported for a fine grid of incomes between \$1 and \$10 million. The resulting tax schedules, plotted graphically in the online appendix, exhibit substantial negative marginal tax rates at the bottom of the income distribution, driven by the Earned Income Tax Credit, and top marginal tax rates between 28% and 50%. We discuss the changes due to TRA86 below when interpreting the results of the inference exercise.

Focusing on federal income tax rates ignores a number of important components of the tax system, including the phase-out of certain transfers and in-kind benefits such as SNAP (food stamps) and housing vouchers, and state and local taxes. This simplification allows us to make better comparisons across time, for which we lack fine-grained data on transfers and local tax policies. Nevertheless, we present alternative calibrations in the online appendix to demonstrate that our main findings are likely robust to these considerations.

1.4 Results: Implicit MSWWs and perceived ETIs

Using the theory and data described in the preceding subsections, we can compute the combinations of MSWWs and perceived ETIs implicit in U.S. tax policy for each year from 1979 through 2010.

We will repeatedly compare the implicit MSWWs to those that are implied by conventional social welfare functions (such as in Diamond (1998) or Saez (2001)). By “conventional” we have in mind two features: MSWWs are everywhere nonnegative, and MSWWs approach zero toward the top of the income distribution. These two features arise from the intuitively plausible and commonly-imposed assumptions that society’s preferences respect the Pareto principle (i.e., non-negative weight is given to an increase in any person’s consumption, all else the same) and that the marginal social welfare of income is decreasing (which may be due to diminishing marginal utility at the individual level or a social judgment). Diamond and Saez (2011) give a standard illustration of the latter feature: “For example, if the social value of utility is logarithmic in consumption, then social marginal welfare weights are inversely proportional to consumption. In that case, the social marginal utility at the \$1,364,000 average income of the top 1 percent in 2007 (Piketty and Saez, 2003) is only 3.9 percent of the social marginal utility of the median family, with income \$52,700 (U.S. Census Bureau, 2009).”

Similarly, we will compare the implicit ETIs to the “conventional” levels of the elasticity of labor supply or, as available, the elasticity of taxable income estimated in the empirical labor literature. The Congressional Budget Office (2012) reviews that literature and finds “substitution elasticities [of labor supply] for the total population that range from 0.1 to 0.3.” Consistent with this judgment, the survey article by Saez, Slemrod, and Giertz (2012) concludes “While there are no truly convincing estimates of the long-run elasticity [of taxable income], the best available estimates range from 0.12 to 0.40...[and]...there is no compelling evidence to date of *real* economic responses to tax rates... at the top of the income distribution.”

In what follows, we characterize the general features of the schedule of the MSWWs and ETIs consistent with tax policy over the period for which we have data. We begin by showing the MSWW schedules consistent with policy over time assuming the ETI equals 0.3, a conventional value. Figure 1 shows the averages of these MSWWs within each of the eight CBO income groups for 1980, 1990, 2000, and 2010.¹⁴ In addition, the

¹⁴To generate this figure, we begin by computing the right side of (2), which represents the average MSWW above a given level of income (called “S weights” in Bourguignon and Spadaro (2012)) and which we denote with the function $S(y) = \int_y^\infty g(z)dF(z)/(1 - F(y))$. For the interested reader, we show $S(y)$ for 1980, 1990, 2000, and 2010 in the online appendix. We then differentiate $S(y)$ to compute the MSWW schedule $g(y)$ as given in equation (3). Since these weights represent the marginal social value of consumption, they are properly viewed as a function of real, disposable income, and thus are plotted against income after federal taxes and transfers, as reported by the CBO. As with market income, only average disposable income is reported within each quantile, so we plot the average MSWWs within each market income quantile against reported average disposable income within that quantile. For the lowest quintile, we average MSWWs over the values of y such that $0.01 \leq F(y) \leq 0.2$, to avoid numerical issues from MSWWs approaching infinity as y approaches zero.

dashed line plots MSWWs for a conventional logarithmic utilitarian benchmark, equal to $1/c$ (normalized to sum to one across the population). Consistent with conventional assumptions, these implicit MSWWs are generally positive and decreasing with income.

The first feature of these results we highlight is the consistent, unconventionally flat pattern of MSWWs in 1990, 2000, and 2010. In particular, the MSWWs on the highest one percent of earners are above 0.6 in all three of these years (relative to an average of 1.0 for the entire population), while conventionally they would be assumed to be very small. Similarly, MSWWs are nearly identical for all earners up to and including those at the 80th percentile, while conventional assumptions would have the MSWW at \$60,000 be only one third of that at \$20,000.

Figure 1 also shows a marked increase in the average MSWW for high earners between 1980 and 1990, corresponding to the dramatic reduction in the top marginal tax rate on earned income (from 50% to 28%) in TRA86.¹⁵ It is unclear, however, whether this large inferred impact of TRA86 truly captures a shift in judgments over this period. Instead, judgments prior to TRA86 may have closely resembled those we infer from policy after the reforms if TRA86’s reforms simply improved the design of policy so that society’s true, and stable, underlying judgments were better reflected in policy.¹⁶ In this paper, we simply point out the potentially deeper puzzles posed by extending the analysis to years before TRA86 and focus most of our analysis on our results after 1987.

The role of the assumed ETI in these results is examined further in Figure 2, which plots average MSWWs for 1980 and 2010 for ETIs ranging from 0.1 to 0.6. This figure shows that a larger perceived ETI reduces the inferred MSWWs at the top of the income distribution, as a given tax rate must reflect less weight on high earners if the efficiency costs of taxing them are perceived to be greater. In principle, ETIs that are perceived to rise with income could therefore resolve the inference puzzle we identify. They would have to rise quickly, however: the estimated top MSWW remains greater than 0.4 for an ETI of 0.6 in 2010. As suggested in the Saez et al., (2012) quotation above, the case for such large welfare-relevant elasticities at high incomes is unsettled at best. Moreover, larger ETIs make the apparent shift in high-income MSWWs corresponding to TRA86 especially dramatic and imply that the 1980 tax schedule was not Pareto efficient. In contrast, small values for the ETI reduce the apparent jump in average MSWWs on high incomes from TRA86, but at the cost of these post-1986 weights being even further above conventional levels.

As noted in the Introduction and discussed below in Section 3, these lessons pose an interpretive challenge. Does society—i.e., voters, policymakers, or both—believe that the distortionary costs of taxation are large enough so that the implied MSWWs at high incomes shrink to the values implied by standard social welfare functions? If not, are the unconventionally flat MSWW schedules accurate reflections of society’s normative judgments, or do they reflect a biased political process that favors high-earners? Before addressing that challenge in more detail, however, we explore how the results of this inverse-optimum exercise can be used to make welfare evaluations of two prominent policy issues.

2 Applications: costs of inequality and recessions

Ordinarily, welfare calculations of changes to policy or the economy are controversial because they are sensitive to the modeler’s assumptions about the social preferences for redistribution (i.e., the social welfare function). MSWWs inferred from policy are in principle able to provide a more objective basis for comparison, and in this section we use our results from above to measure of the welfare consequences of changes in the policy-inclusive (after taxes and transfers) distribution of income due to unequal growth and recessions in the United States since 1979. We show that these calculations reflect the unconventional nature of the results from Section 1 and are sensitive to how we resolve the interpretive challenge those results pose. These findings thereby warn against reliance on any single such welfare calculation and make clear the imperative

¹⁵As shown in the online appendix, if we extend our analysis back to the early 20th century the variation in implied high-income MSWWs (or perceived ETIs) is enormous.

¹⁶Clarifying the meaning of the inference results in this period is difficult because of the many possible methods for translating the complicated real-world U.S. tax system into the single tax function of earnings required by the model. For example, TRA86 included substantial base-broadening reforms, likely because of a perception that the effective marginal tax rate on high earners prior to this reform was lower than the 50 percent statutory rate. But some of this broadening may not have affected marginal earnings choices of high-income taxpayers (e.g. changes to retirement savings deductibility) so that TRA86 would have lowered the effective marginal distortion on them. Moreover, TRA86 included increases in the taxation of corporate and capital income, but the proper way to incorporate those sources income into this static inverse-optimum exercise is uncertain.

of better evidence on society’s preferences and beliefs about the fundamental parameters that enter into policy evaluation.

2.1 Costs of rising inequality

From 1979 to 2010, U.S. disposable income has grown by an average 1.5% annually. But as is well-known, income growth has been highly concentrated among high earning households. Figure 3 provides a graphical view of this evolution, plotting average income after federal taxes and transfers for the eight quantiles reported by the CBO. In this section, we use revealed social preferences from various years to compute the implied welfare costs of that unequal growth.

We compute the cost of rising inequality by asking a simple question: How much economic growth would be willingly sacrificed in order to prevent rising inequality? Answering this question requires a means of trading off gains to households with differing income levels, and for this we use the MSWW schedules derived in the previous section.

To implement our procedure, we weight changes in average disposable income within each of the eight CBO quantiles by a set of corresponding MSWWs from Section 1.4.¹⁷ Letting $\{g^i\}_{i=1}^8$ denote the vector of welfare weights across quantiles $i = 1 \dots 8$, and c_t^i the mean disposable income of quantile i in year t , then the change in welfare from year m to n , denoted $\Delta W_{m,n}|\{g^i\}_{i=1}^8$ is

$$\Delta W_{m,n}|\{g^i\}_{i=1}^8 = \sum_i (c_n^i - c_m^i) g^i f(y^i). \quad (4)$$

Next we calculate the counterfactual change in welfare $\Delta \tilde{W}_{m,n}(\rho)$ that would result from a given equally-distributed annual growth rate ρ from years m to n under a given vector of MSWWs:

$$\Delta \tilde{W}_{m,n}(\rho)|\{g^i\}_{i=1}^8 = \sum_i (c_m^i(1 + \rho)^{n-m} - c_m^i) g^i f(y^i). \quad (5)$$

By solving for the ρ such that $\Delta \tilde{W}_{m,n}(\rho) = \Delta W_{m,n}$, we can compute the constant-inequality growth rate that would yield the same gain in social welfare as that experienced in reality. Note that this definition of “equally distributed growth” holds the growth rate of disposable income constant across quantiles, which would result in constant values for many metrics of income inequality, including inter-quantile spreads and the Gini index.

The difference between the actual aggregate growth rate and ρ , as a share of the former, is our measure of the costs of unequal growth. Table 1 shows these costs using MSWWs computed in 1980, 1990, 2000, and 2010 for four values of the ETI.

As Table 1 shows, it turns out that these costs are strongly dependent on the vector of MSWWs and, therefore, on the explanation one adopts for U.S. tax policy. This exercise therefore illustrates the challenge to researchers interested in using this positive approach to welfare evaluation.

Perhaps the most striking feature of the results in Table 1 is how small are the estimated costs of unequal growth when we use MSWWs after TRA86 and conventional values for the ETI. For an ETI of 0.3, the results suggest that Americans in 2010 would have sacrificed only 4.3% of average growth over the last three decades to have had that growth be equal across the income distribution. Of course, this estimate reflects the flat MSWWs inferred above, in that those weights value the unequal growth actually experienced in the United States nearly as highly as equal growth at the same rate. To get a sense for how unconventional this estimate is, consider that the same ETI assumption implies a cost three times as large if we use the more redistributive MSWWs inferred from policy 1980 (though even those give substantially more weight to high-earners than conventionally assumed). Note that the large difference between the costs using 1980

¹⁷This calculation is a linear approximation, in that it holds fixed the welfare weight on each quantile even as the disposable incomes change. If changes in disposable incomes are large, this approximation may introduce bias. Yet three considerations lead us to believe this approach is reasonable even in this context. First, the computed MSWWs are quite flat over the bottom 80% of incomes, and at the very top, so that the possible bias is limited to approximately 15 percent of the income distribution where MSWWs decline sharply. Second, if weights are attached to *relative* income, as assumed in Hendren (2014), then this calculation is correct even for large changes in income. This possibility appears consistent with Figure 1: the post-TRA86 schedules appear to “shift right” over the period 1990–2010. Third, we also compute the costs of inequality using MSWWs updated continuously (by linear interpolation) as disposable incomes adjust, and the results are similar to those in Table 1.

and 2010 weights suggests another challenge in the use of inverse-optimum results: namely, being confident that one has used the right year for inference. Additionally, if MSWWs evolve over time, these calculations would need to take their evolution into account, creating an additional source of possible uncertainty.

We obtain larger estimates for the costs of inequality if we increase the perceived ETI: Table 1 suggests that doubling the ETI roughly doubles the estimated costs. If large values for the perceived ETI are deemed implausible, however, then the unconventionally flat MSWWs—and the low estimated costs of unequal growth—must be either accepted or explained away.

Before moving on to our second application of this approach, we discuss how our calculations of the cost of unequal growth compare to the important work of Hendren (2014), who estimates that adjusting for unequal increases in incomes since 1980 would offset 15–20% of growth. First, the conceptual motivation behind Hendren’s approach is different, leading him to focus on unequal changes in income *levels* rather than unequal rates of income growth.¹⁸ In the context of rising inequality, Hendren’s approach computes the number of dollars by which every individual’s disposable income would have risen if all economic gains had been equally distributed—in dollar terms—over the period between 1980–2010. Under this definition, equally distributed gains *reduce* inequality as measured by interquantile spreads or the Gini index. Our definition measures the cost of rising inequality relative to equally distributed income growth, which holds measured inequality constant. A second reason our approach differs from Hendren’s is that we use different data—income estimates by CBO, rather than the universe of tax returns. Reassuringly, in a calculation designed to replicate Hendren’s, using 2010 MSWWs (and an ETI of 0.3) to weight the pre-tax gains in levels to each CBO quantile since 1980, we find an inequality cost of 15% compared to Hendren’s estimate of 15–20%. The similarity of these estimates suggests that the coarseness of our data is not of primary importance to our results.

2.2 Costs of unequal distribution of recessions

A similar methodology can produce estimates of the cost of the unequal policy-inclusive distribution of business cycle downturns. These computations have important implications both for stabilization policy and economic research. If the economic costs of business cycles are small, as suggested by Lucas (2003), then efforts to understand and further mitigate them may be less necessary than if they are large. These calculations also provide a way to compare the severity of recessions in welfare-relevant terms. In particular, we are interested in quantifying the welfare costs from the unequal incidence of recessions, which are not captured by the representative agent approach employed by Lucas.

We start by calculating, for four recessions between 1979 and 2010, the loss in social welfare under a given set of MSWWs, relative to a counterfactual in which no recession occurred. A graphical representation of this smoothing method at the aggregate level is shown in Figure 4. We perform this smoothing for the income path within each of the eight CBO quantiles. We then weight the lost income in recessions (relative to the counterfactual) by each quantile’s MSWW to compute the welfare loss of recessions. Formally, we calculate the social welfare cost of those lower incomes using the MSWW vector $\{g^i\}_{i=1}^8$ during, say, the 2001–2003 recession, as:

$$\Delta \tilde{W}_m | \{g^i\}_{i=1}^8 = \sum_{m=2001}^{2003} \sum_i (\tilde{c}_m^i - c_m^i) g^i f(y_m^i), \quad (6)$$

where c_m^i and \tilde{c}_m^i denote the actual and counterfactual (non-recession) disposable incomes for individual i in year m . We dub $\Delta \tilde{W}_m | \{g^i\}_{i=1}^8$ the “equally distributed equivalent loss”. Since the g_i weights integrate to one, this is equal to the equally-distributed reduction in incomes which would generate the same welfare cost as the the unequally distributed recession which actually occurred.

¹⁸Hendren’s approach is motivated by the classic Kaldor-Hicks compensation principle, which holds that one environment dominates another if the “winners” in the former could hypothetically compensate the “losers”, leaving everyone better off. Hendren proposes an intuitive revision: since actually implementing such transfers through, say, reforms to the income tax would have distortionary effects, those distortions should be included when making welfare comparisons. This can be accomplished by weighting surplus to each individual by an “inequality deflator”, representing the distortionary cost of transferring a dollar from the population at large to a specific point in the income distribution. This inequality deflator turns out to be isomorphic to $g(y)$ if a social welfare function is assumed to exist (though an innovation of Hendren’s work is its applicability in contexts without a rationalizing social welfare function).

In Table 2, we show these costs for four recessionary periods using MSWWs from 1980 and 2010. All of these calculations assume an ETI of 0.3. One feature of these results stands out: the equally-distributed shock is smaller than the actual (unequal) recessionary shock in all four of these recent recessions. This is driven by the fact that reductions in disposable (not necessarily market) income during these recessions are concentrated on high earners. For example, as can be seen from Figure 3, the CBO reports that disposable income did not fall at all during the Great Recession for the two lowest quintiles. Since MSWWs from all years place a lower weight on individuals at the top of the income distribution than at the bottom, they imply a lower welfare cost of recessions than the average income loss, which places full weight on the large losses of top earners. Related, note that the 2010 MSWWs imply a much greater cost for the Great Recession than the 1980 weights because the former give much more weight to the losses suffered by high earners.

3 A trilemma and evidence on possible resolutions

In this section, we will use the values of high-income MSWWs as a way to summarize the interpretive challenge posed by our results from Section 1.¹⁹ Denote by g_t^* the average MSWW on the top one percent of income-earners in year t , corresponding to the right-most point on the average MSWW schedules in Figures 1 and 2. Formally, let y_t^* be the 99th percentile of market income in year t , so that $F_t(y_t^*) = 0.99$, then $g_t^* = \int_{y_t^*}^{\infty} g_t(z) dF_t(z) / 0.01$.

Figure 5 makes clear the negative relationship between g^* and the perceived ETI required to explain the U.S. data for any one year. Intuitively, a larger g^* means less willingness to redistribute from high earners and thus exerts downward pressure on high-income marginal tax rates, while a lower perceived ETI means less concern for the distortionary cost of redistribution and thus exerts an offsetting upward pressure on high-income marginal tax rates.

This figure also shows that our results are inconsistent with having three potentially appealing conditions hold simultaneously, a situation we label a trilemma. Those conditions are: 1) the inverse-optimum exercise yields normatively-relevant results on MSWWs; 2) society’s perceived ETI lies within conventional ranges; and 3) society’s true pattern of MSWWs is consistent with conventionally-assumed principles. To see why at most two of these conditions can hold at a time, start with assuming that the first and second hold and examine figure 5. Condition 2 restricts us to the left-hand-side of the figure, at an ETI no greater than 0.4, while Condition 1 means that the normatively-relevant MSWWs are given by the intersection of the chosen ETI with the lines explaining tax policy in a given year. In that case, MSWWs are either always much greater than conventionally assumed or, if the pre-TRA86 results are taken at face value, are also highly unstable over this time period. Therefore, condition 3 does not hold. Next, assume that conditions 1 and 3 hold, so that we are restricted to where the lines explaining tax policy cross positive values of g^* near zero. In this case, the perceived ETI range from around 1.0 to above 1.4, well above the conventional ranges described in Section 1 and in violation of condition 2. Finally, if conditions 2 and 3 hold we are restricted to a region of figure 5 that does not intersect any of the lines explaining policy since TRA86. In other words, the MSWWs inferred from policy must not reflect the true (conventional) MSWWs that condition 3 assumes to hold, so the inverse-optimum exercise does not yield normatively-relevant information and condition 1 cannot hold.

Ideally, we could use evidence on perceived ETIs and the public’s normative preferences to resolve this trilemma. We now turn to an attempt at this approach.

3.1 Suggestive evidence on possible explanations

In this section we present some suggestive evidence related to the trilemma described above. We emphasize that this evidence is far from conclusive and that we view this effort as a preliminary examination upon which we hope future work, with better data, will be able to build. In particular, a clear lesson from this section’s analysis is that more data, especially over time, on the perceived costs and benefits of redistributive taxation would be invaluable to researchers interested in the questions we ask in this paper. We believe both that obtaining such data is feasible and that doing so will require careful survey design. Our new survey evidence on attitudes toward current levels of redistribution illustrates, we hope, both of those beliefs.

¹⁹We do not discuss in detail the flat MSWWs through the fourth quintile, though that is a promising topic for further study.

3.1.1 Evidence on perceived ETIs

We begin by focusing on whether a plausible explanation for U.S. tax policy over the last several decades is that the public perceives the ETI, in particular of high earners, to be larger than is conventionally assumed.²⁰ Because the data are limited, we draw on three sources of evidence: popular opinion, academic research, and official government estimates. In sum, though we cannot rule out this explanation, we find no strong evidence in support of it.

First, for public opinion, we look for direct survey evidence on popular perceptions of the incentive effects of taxation. The World Values Survey provides what little, highly-imperfect evidence we have found on changes to public perceptions. It asked respondents in the U.S. for their views on a 10-point scale ranging from “1: Incomes should be made more equal” to “10: We need larger income differences as incentives.” The evolution of responses (plotted in the online appendix) is qualitatively consistent with the evolution of ETIs that would be consistent with policy over this period (also plotted in the appendix), first declining between 1990 and 1995, then rising slightly until 2006 before slightly declining again. Of course, the main shortcoming of these data is that they cannot tell us whether the high *levels* of the ETIs required to explain recent tax policy are consistent with the public’s perceptions.

Second, we turn to the extensive academic literature estimating the true incentive effects of taxation, with the implicit idea that public perceptions may track professional opinion. In particular, we focus on surveys of this literature by the CBO (1996), Blundell and MaCurdy (1999), Keane (2011), and Chetty (2012)²¹ to gauge the estimated compensated elasticity of taxable income (or labor supply, as available) of prime-aged men over time.²² We include estimates of the elasticities of both taxable income and labor supply because the latter was the main empirical target for researchers during the early years of our sample.²³

These data, plotted in Figure 6, show that estimates of the distortionary costs of taxation are quite stable over this period. Focusing on the survey articles (solid circles), the apparent consensus in early years that elasticities were quite low appears still to hold today. One possibility raised by the data in Figure 6 relates to the estimated elasticities for top incomes, shown as “x” symbols in the figure, which arose relatively recently. Lawrence Lindsey (1987) provided an influential analysis of the effects of top marginal tax rate reductions in the 1981 tax reform, estimating large ETIs—above 1.5—around the time of the 1986 tax reform. Such high estimates were found for the 1986 reforms in the well-known analysis of Feldstein (1995). These large estimates of high-earner elasticities were followed by smaller estimates (0.4 to 0.6) in subsequent work that took into account intertemporal shifting of incomes among high earners (Goolsbee, 2000) and econometric concerns (Gruber and Saez, 2002).²⁴ In fact, Goolsbee (1999) argued that the empirical results from the 1990s (based on 1980s tax reforms) were aberrations, as similar analyses applied to other periods’ tax changes yielded much smaller elasticity estimates.

Summarizing the evidence, CBO (2012) writes: “There is little compelling evidence that high-income taxpayers have substantially higher elasticities with respect to their labor input than lower-income taxpayers. Higher estimates of the elasticity of broad income among high-income taxpayers appear to reflect their greater ability to time their income rather than greater changes in their labor supply.”

Finally, we consider a third source of data on perceived elasticities: official estimates likely to inform policymakers’ beliefs. The Congressional Budget Office is the U.S. government’s official provider of budgetary and economic analyses for debates over legislation. We obtained several CBO reports that summarized its

²⁰In the online appendix, we discuss and find no evidence for a possibility not directly related to ETIs, namely that the perceived importance of complementarities across workers in the spirit of Stiglitz (1982) increased over this period.

²¹For the Chetty (2012) mean, we use his calculation of the mean for his Panels A and B of Table 1, which includes hours and taxable income elasticity estimates. We do not adjust for the optimization frictions that are the focus of his important paper, so as to maintain consistency with how the other surveys’ evidence is presented. He reports a value of 0.33 when that adjustment is made, bringing him closer to Keane’s (2011) estimate.

²²Excluding estimates for female elasticities means that we ignore the dramatic increased participation of women in the workforce and the subsequent decline in their elasticity: see Heim (2007) and Blau and Kahn (2007). Another survey of the literature, showing consistent results, is Bargain and Peichl (2013).

²³While the ETI includes margins of adjustment in addition to labor supply, the most recent surveys of the literature suggest that the quantitative difference is very small between the portions of these elasticities representing lost economic activity, rather than temporary shifts or strategic reporting of economic activity. See the Saez et al. (2012) summary in section 1.3, and see Chetty (2009) for a discussion of the components of the ETI.

²⁴Diamond and Saez (2011) comment on the latter of these as follows: “The paper Gruber and Saez (2002) is often cited for its substantial taxable income elasticity estimate ($e = 0.57$) at the top of the distribution. However, its authors also found a small elasticity ($e = 0.17$) for income before any deductions, even at the top of the distribution.”

view of the literature on the responses of economic activity to taxation.²⁵ The first was “An Analysis of the Roth-Kemp Tax Cut Proposal” from 1978, which estimates a labor supply elasticity of 0.1 to 0.3 (it is unclear whether this was an uncompensated or compensated elasticity). Second, the CBO’s analysis of TRA-86 references Hausman (1985) as providing evidence of secondary-earner responsiveness to tax changes but downplays the response of labor supply to the reform overall. The CBO’s 1994 analysis of President Bill Clinton’s health insurance proposal favors an elasticity of 0.1 to 0.2. In the 1996 survey paper cited above, the CBO stated the range 0.2 to 0.4 from its reading of the literature. In 2012, the CBO reported that it had revised down that range to 0.1 to 0.3. Thus the CBO appears to have used roughly the same range for this elasticity since 1978.

3.2 Evidence on MSWWs

If perceived ETIs are assumed to have been at conventional levels, the trilemma implies that the inferred MSWWs on high earners are larger than conventionally assumed over this period either because policy failed to reflect society’s true (conventional) normative judgments or because society’s true normative judgments were at odds with conventional assumptions. In principle, we can disentangle these options by using data on the extent to which the public agrees with the prevailing progressivity of tax policy.²⁶

First, we consider survey evidence on the perceived representativeness of the political process, as captured by the share of respondents agreeing with two relevant statements in the General Social Survey: “Public officials are interested in the problems of the average man” and “The average citizen has considerable influence on politics.” The most striking feature of these responses (plotted graphically in the online appendix) is that only approximately 35% of respondents believes, and has believed since 1977, that the political process reflects the interests of average citizens. This finding is broadly consistent with related work in the political science literature: Gilens (2012) and Gilens and Page (2014) present evidence that the influence of high earners does not appear to have risen relative to others over this time period but that policy is consistently and substantially more responsive to opinions of high-earners than to median-income constituents.²⁷

Pew survey results over the most recent decade of this period tell a broadly consistent story.²⁸ In 1997 and 2010, respondents were asked which of a number of groups—including “poor people”, “the middle class”, and “business leaders”—get “too much”, the “right amount”, or “too little attention” from government. Over that period, the share reporting that business leaders get too much attention fell slightly from 50% to 45%, while the share believing the poor get too much attention rose from 10% to 17%. A stable share reported that the middle class gets too much attention; yet the share reporting that the middle gets too little attention rose from 54% to 66%. These results provide further evidence that the level of representativeness is perceived to be persistently low.

For evidence more directly relevant to tax policy, we turn to survey evidence from Gallup. This question asks the respondent to compare the current state of tax policy with his or her ideal, a suitable question for gauging whether a biased political system is neglecting popular opinion. Specifically, respondents were asked in various years from 1992 through 2014 whether “upper income people” pay “too much”, “too little,” or their “fair share” in taxes. The results are plotted in Figure 7.²⁹

These Gallup data support the interpretation that the political system is failing to accurately reflect most Americans’ (lower) preferred top MSWWs. In this figure, the share of respondents who say that upper-income people are paying too little is a substantial majority throughout the period 1992 to 2014.³⁰

²⁵Thanks to Ed Harris of the CBO for his guidance toward the relevant documents.

²⁶While we do not explore alternative determinants of MSWWs in this paper, Lockwood and Weinzierl (2015) explore the role of beliefs on preference heterogeneity in setting MSWWs. We examine survey evidence about evolving preference heterogeneity, which does not appear to resolve the trilemma, in the appendix.

²⁷A side note: data from the General Social Survey presented in an earlier version of this paper shows highly stable preferences for redistribution over time in the United States. Unfortunately, those data do not quantify the implicit MSWWs of respondents nor do they indicate the level of agreement with current policy. Contemporaneous research by Kuziemko and Washington (2014) has documented in detail the overall stability of redistributive preferences among Americans over this period, though they also highlight important variation in trends across demographic groups. One finding of particular relevance is that redistributive preferences have risen among the young but fallen among those over 65 years of age over this period.

²⁸See <http://www.people-press.org/files/legacy-pdf/606.pdf>.

²⁹For underlying data, see

<http://www.gallup.com/poll/182426/americans-say-low-income-earners-pay-taxes.aspx>.

³⁰Changes to this share in response to policy changes are as would be expected. For example, the increase in top marginal

Note that, as with the previous evidence, these data do not suggest a worsening of the dissatisfaction with policy.

One concern with any survey evidence, such as Gallup’s, is its robustness to changing the framing or information that is salient to the respondents. In particular, it is unclear in this case what a respondent to Gallup’s survey knows about the current tax burden of “upper-income people.” As research using survey-based evidence on policy preferences has developed, increasing attention has been paid to the effects of information on expressed beliefs. For example, Kuziemko et al. (2015) is an important recent study exploring how responsive reported preferences for redistribution (through income or estate taxes) are to the presentation of information.

We explore this uncertainty by generating novel survey evidence in which we vary the information made salient to respondents. In addition to helping sort out the explanation for high top MSWWs, we hope that this evidence will be more broadly useful in the effort to understand Americans’ redistributive preferences.

The details are as follows. Using Amazon’s “Mechanical Turk” service (MTurk), we randomize 200 respondents across four information treatments. All treatment groups face the same welcome and permissions screens. The control group (#1) is simply asked the same questions as in the Gallup survey (except that we use the term “households” instead of “people,” for consistency with data we present the other groups). The remaining three groups are also asked the same question, but are first presented with an informational treatment. Group #2 is shown the distribution of pre-tax and -transfer income across household quintiles from the CBO. Group #3 is shown the distribution of federal income tax payments for each quintile. And Group #4 is shown both distributions before being asked the Gallup questions. (These informational figures are reproduced in the online appendix.)

Table 3 shows the distribution of responses to the Gallup question on upper-income people (households, in our survey). The MTurk data are reweighted to match the self-professed political affiliations in Gallup’s results. (Absent this reweighting, the results would be affected by the greater share of MTurk respondents self-identifying as “Liberal” or “Left-leaning” relative to Gallup respondents.) The raw data are reported in the online appendix.

The table shows substantial sensitivity of respondents’ preferences to information. Perhaps surprisingly, information on the concentration of income reduces the share of respondents believing that upper-income households pay too little. Most important for our purposes is the sharp decline in the share saying that upper-income households pay too little in taxes when the distribution of federal tax payments is provided (even if that information is combined with information on income shares). This finding suggests that the mismatch between policy and voter preferences may be smaller than the raw Gallup data indicated.

The sensitivity of preferences apparent in Table 3 is, in a sense, disappointing. If preferences had been unchanged across treatments, we would have strong evidence that most Americans robustly wish that taxes were more progressive and, in terms of what is at stake in this paper, that the large top MSWWs we inferred from policy are likely due to a political process that fails to reflect those wishes. Instead, a fundamental uncertainty remains: is policy not more progressive because most Americans are satisfied with policy as it is, or because they do not have the political influence to change it?

4 Conclusion

The recent surge of so-called inverse-optimum research seeks to use data on prevailing policy to infer society’s normative preferences; in this paper we extend that exercise across time to explain U.S. tax policy from 1979 to 2010. We characterize the set of positive and normative judgments that are implied by the joint evolution of tax policy and the income distribution over this period and, for reference, back to 1920. Our main finding is that policy after the Tax Reform Act of 1986 has consistently implied less redistributive preferences or higher perceived distortionary costs of taxation than are conventionally assumed to apply. If we look to results for policies prior to 1986, we add to the puzzle that implied societal judgments may have been highly unstable over time. We apply our results to estimates of the welfare costs of unequal growth and recessions in the United States over this period, demonstrating both the potential for using the results of the inverse-optimum approach to make welfare evaluations and the difficult questions raised by doing so with recent

tax rates in 1993 appears to match precisely the timing of a drop in the share of respondents who believe the rich pay too little in the Gallup data. The reverse happens after the 2001 and 2003 tax cuts lowered top rates on high earners.

U.S. tax policy.

These results leave economists with a difficult choice: either give up the inverse optimum exercise as a normative guide or revise conventional assumptions about the parameters of the benchmark model of optimal taxation. This paper attempts to determine which of these choices is best supported by the limited relevant data, drawing on public opinion surveys, academic research, official government estimates, and our own novel survey evidence. At first blush it appears that the best empirical case can be made for the possibility that policy is sub-optimal; that bias in the political system makes policy depart systematically from society's true preferences, undermining the normative relevance of this inverse-optimum approach. That evidence, however, appears not to be robust to minor interventions in survey design, as we demonstrate, so that tax policy may not in fact diverge dramatically from what the public wishes it were. This finding may be unsurprising, given that income taxes are one of the most prominent economic policy issues in U.S. politics and the top marginal tax rate is a particularly salient policy parameter. In the end, a candid appraisal of the available evidence is that it is, unfortunately, inconclusive as to the true explanation for our results.

What, then, can we learn from this exercise? We do not believe that the right lesson is that the standard optimal tax model is too simple to capture the complex reality of policymaking. In fact, the simplicity of the model is its great strength in this setting, in that it allows us to distill the myriad of factors influencing optimal taxation into just a few key parameters. The dominance of the Mirrleesian model is due, in no small part, to its ability to succinctly capture the central components of the tax policy problem.

Instead, we interpret our results as providing a strong impetus for optimal tax theorists, and economists doing welfare analysis more generally, to gather new, probably unconventional evidence on the key positive and normative ingredients of their models and, depending on the results, reconsider their conventional assumptions on them.

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Tables and Figures

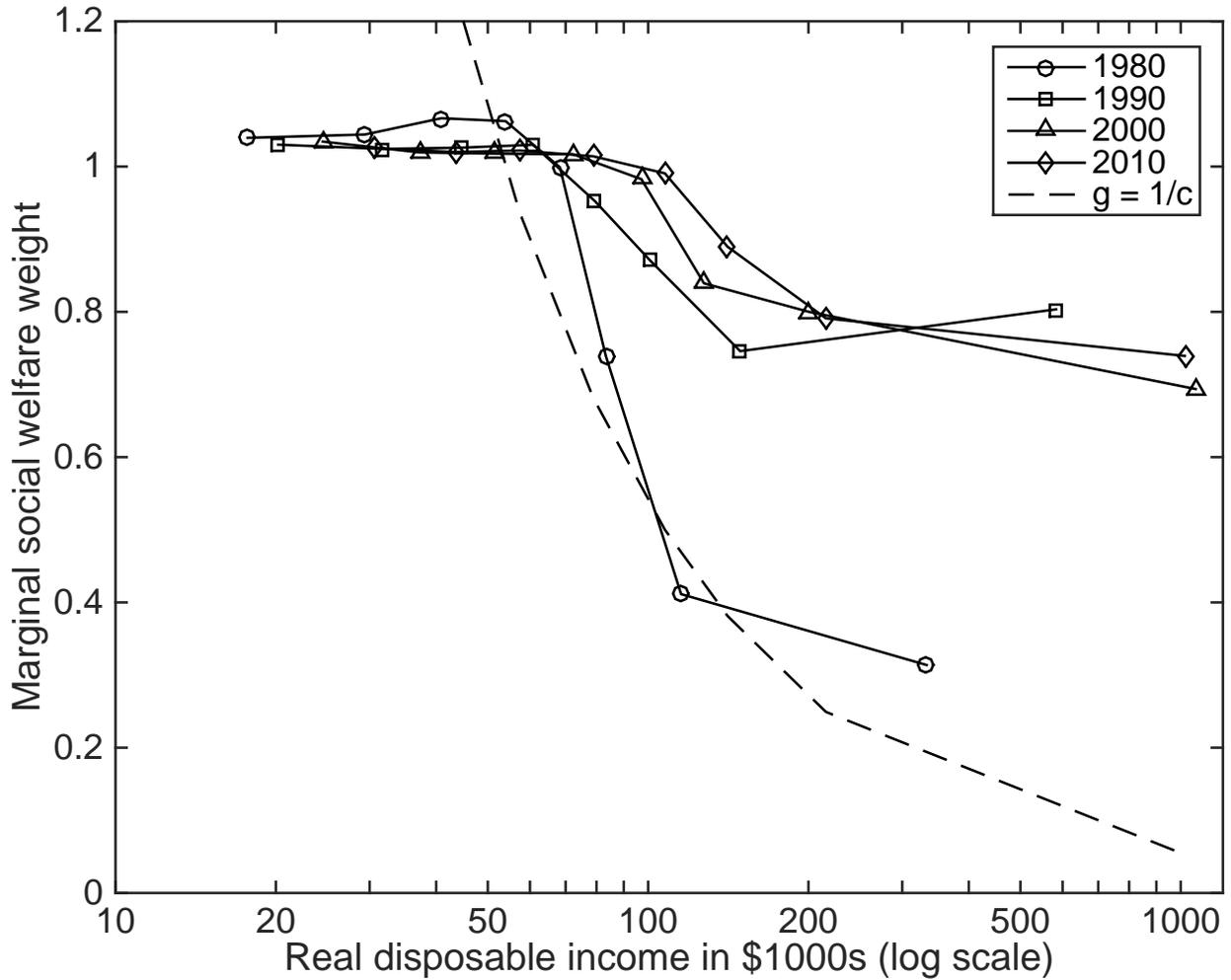


Figure 1: Average MSWWs, plotted against disposable income in 1980, 1990, 2000, and 2010. Points represent the average MSWWs within eight partitions of the market income distribution as reported by CBO, bounded by the following percentiles: 20, 40, 60, 80, 90, 95, 99. These averages are plotted against average income after federal taxes and transfers within each partition, in real 2010 dollars. Weights are computed assuming an elasticity of taxable income of 0.3. The dashed line shows a benchmark “conventional utilitarian” case with weights equal to $1/c$ (then normalized), where c is the vector of disposable incomes within each quantile in 2010.

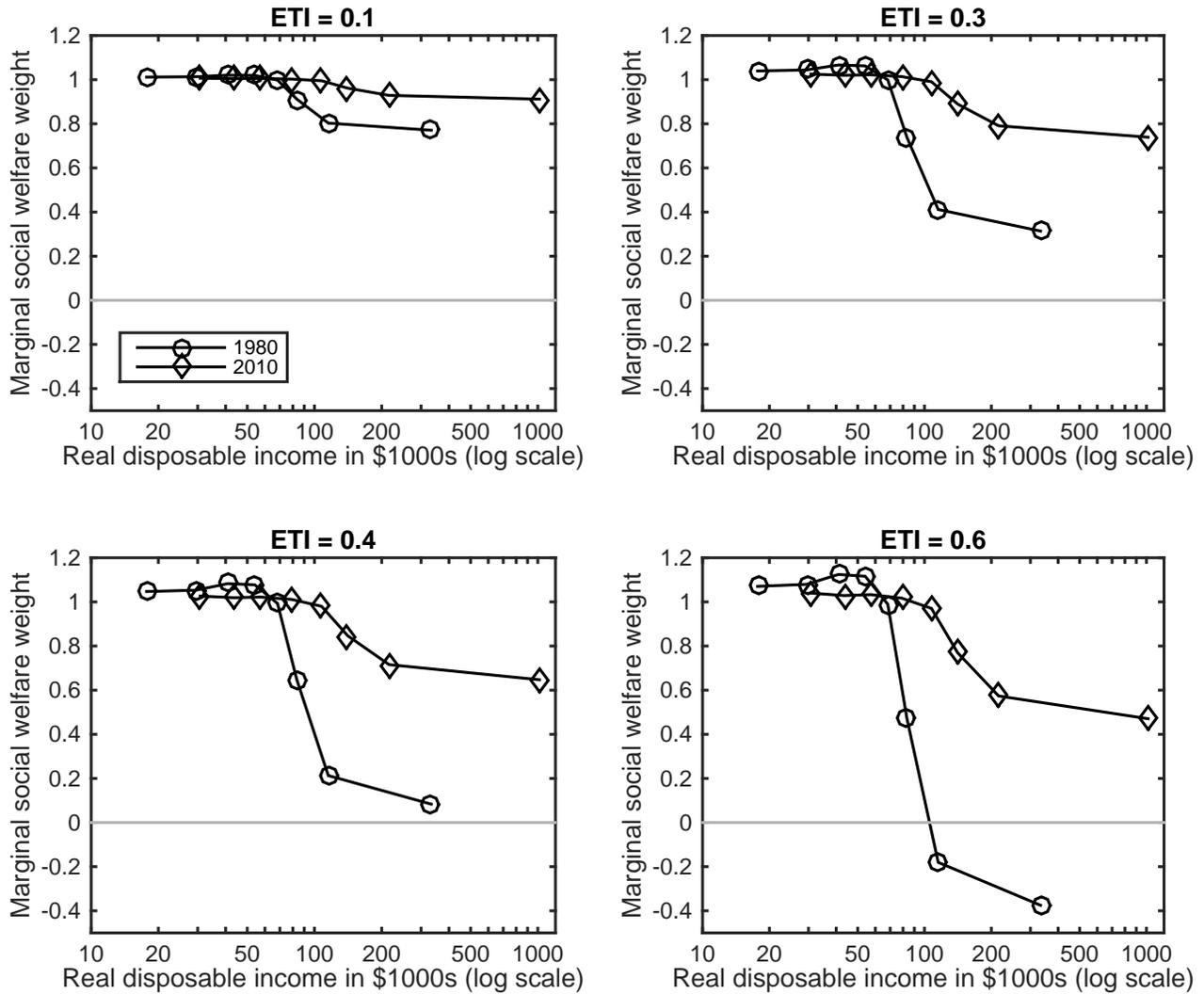


Figure 2: Average MSWWs in 1980 and 2000 for a range of elasticity assumptions, plotted against income after federal taxes and transfers within each partition, in real 2010 dollars.

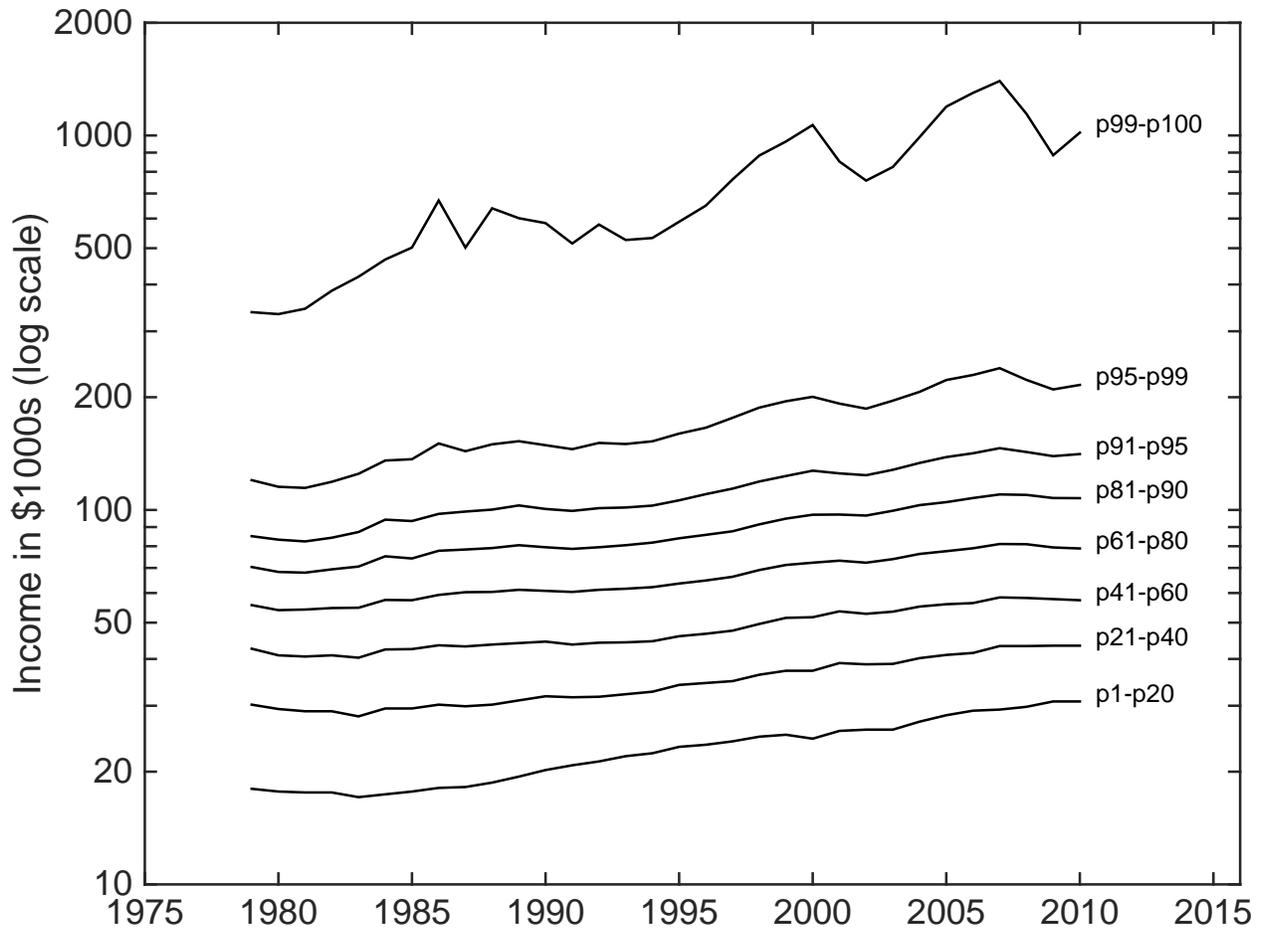


Figure 3: Growth in inequality of disposable income, 1979–2010. Each line represents the evolution of average income after federal taxes and transfers within eight quantiles of market income, as reported by CBO. Income is plotted on the vertical axis in log scale. The top percentile exhibits the strongest positive trend, reflecting rising inequality.

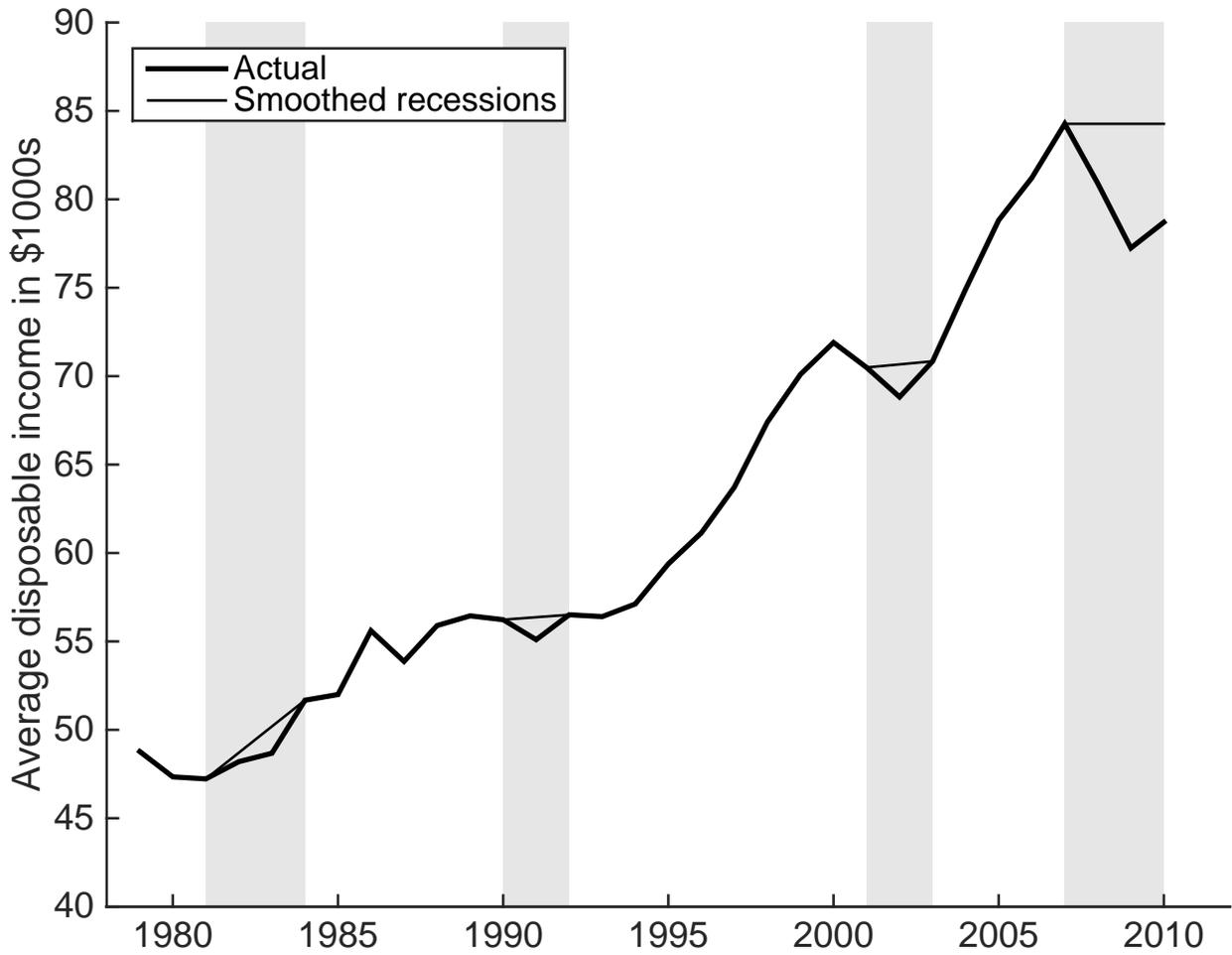


Figure 4: Recessions between 1979 and 2013. The bold line plots average income after federal taxes and transfers; recessionary periods are shaded. To compute welfare under a counterfactual without a recession in each case, we connect a straight line between the income levels at the beginning and end of each recession, as shown above. Because CBO data is only available through 2010, at which time income was still substantially lower than the pre-recession peak in 2007, in that case we simply extrapolate a flat level of mean income. (Income is reported in real 2010 dollars.)

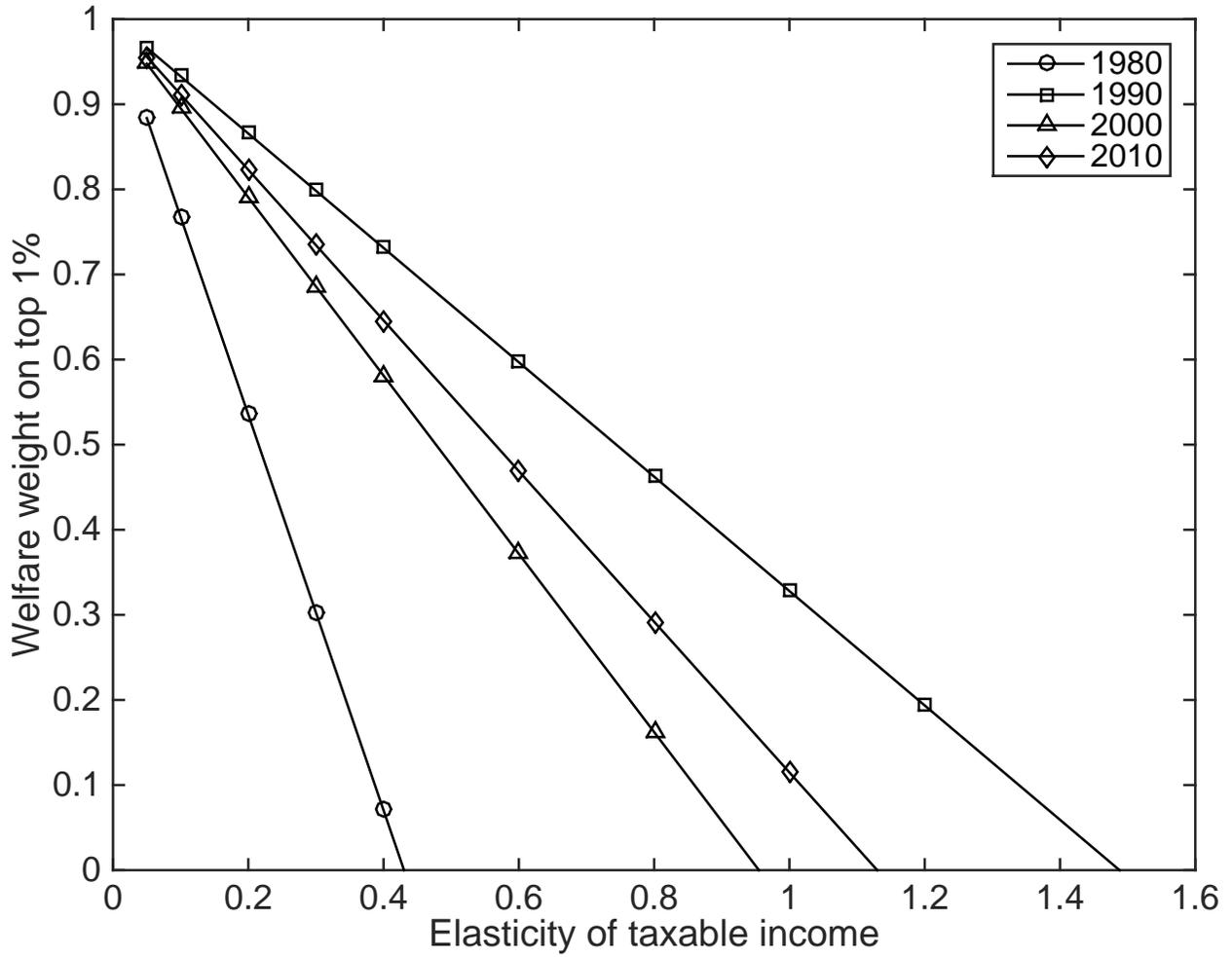


Figure 5: The implicit welfare weight attributed to the top 1% of earners under various elasticities of taxable income for years 1980, 1990, 2000, and 2010.

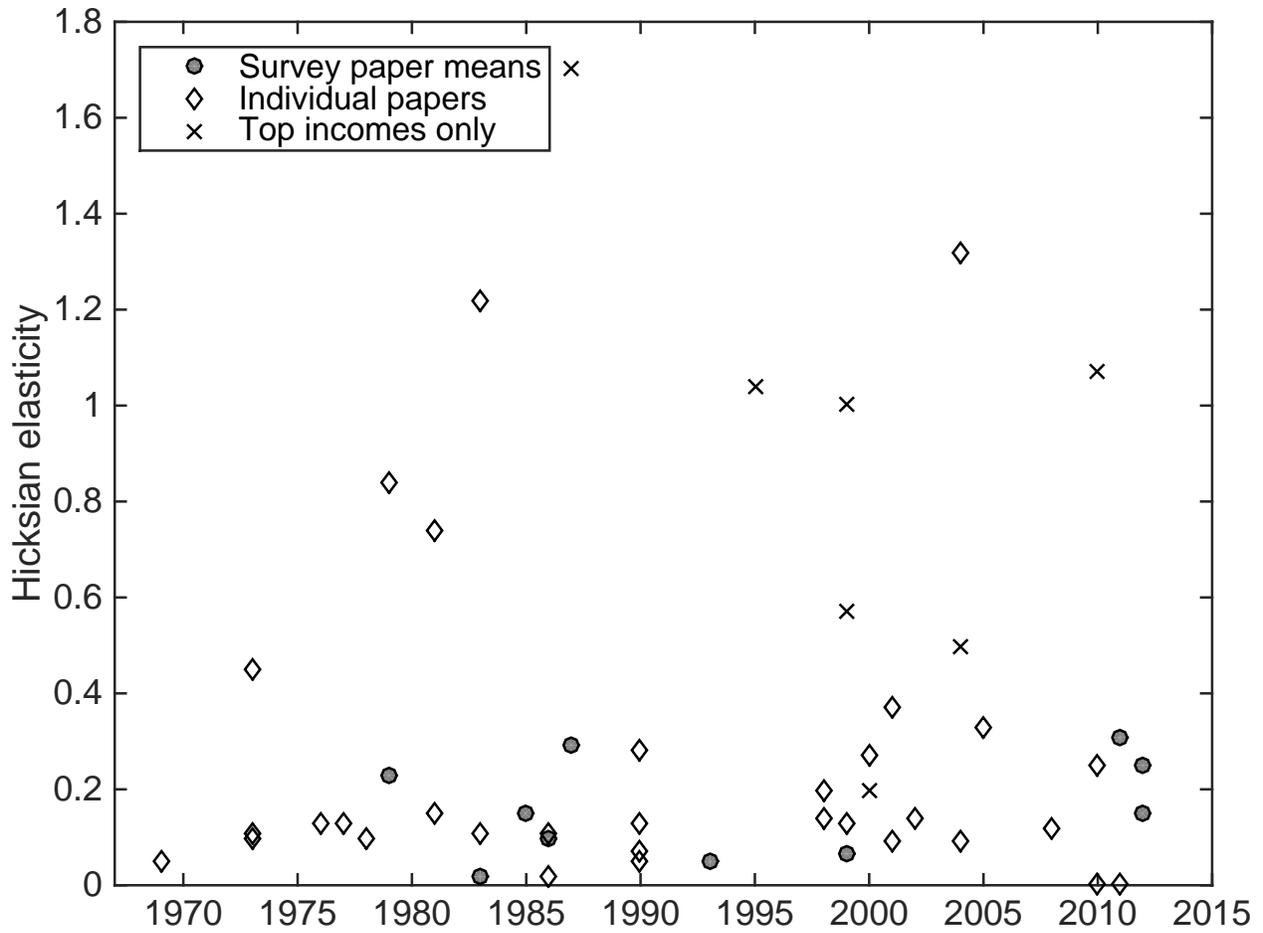


Figure 6: Elasticity estimates in the economics literature over time, drawn from the CBO's (1996) report, which gives the mean labor supply estimates from nine literature reviews spanning 1979 through 1993, along with the point estimates from the papers reviewed in Blundell and MaCurdy (1999), Keane (2011), Saez et al. (2012), and Chetty (2012).

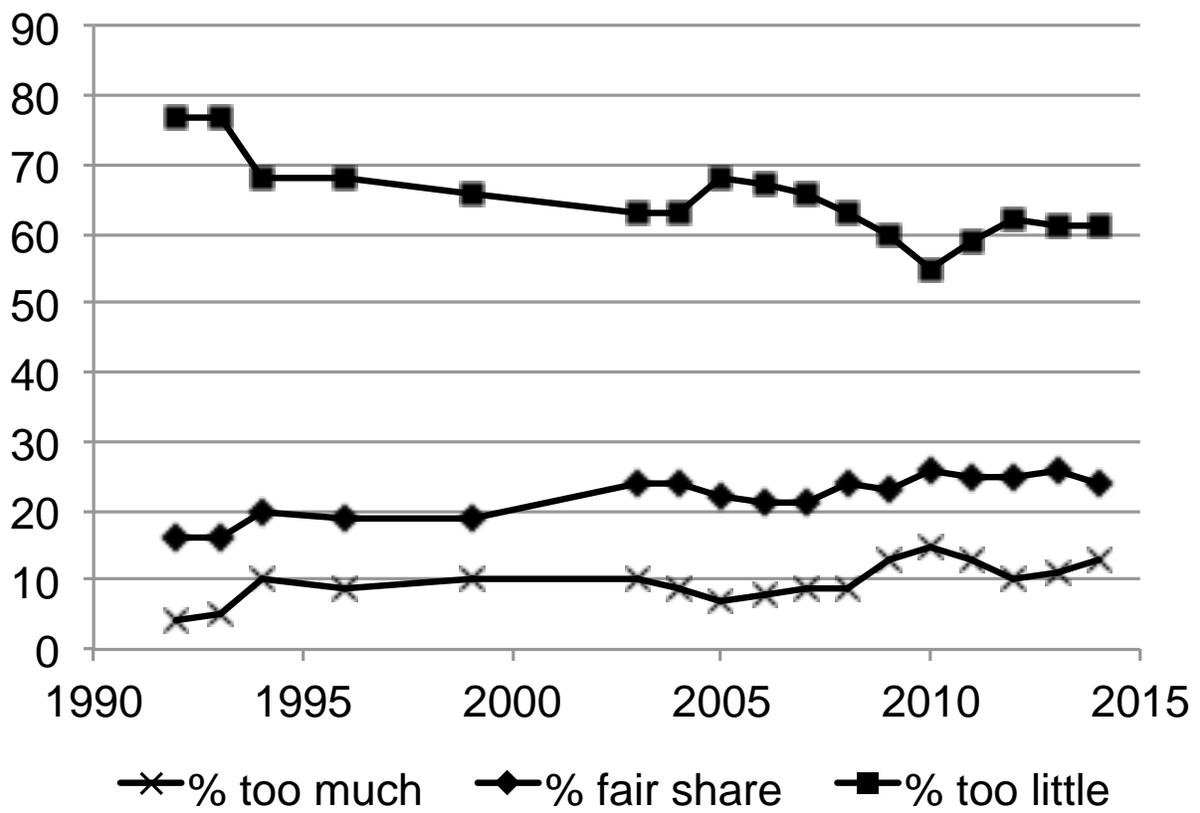


Figure 7: Share of Gallup respondents believing upper-income people pay their “fair share”, “too much”, or “too little” in federal taxes.

Cost of Rising Inequality, 1979–2010				
	ETI			
	0.1	0.3	0.4	0.6
1980 MSWWs	3.8%	12.5%	17.6%	29.2%
	(\$1420)	(\$4560)	(\$6300)	(\$10,220)
1990 MSWWs	1.2%	3.6%	4.9%	7.7%
	(\$430)	(\$1340)	(\$1810)	(\$2810)
2000 MSWWs	1.6%	4.9%	6.7%	10.5%
	(\$580)	(\$1800)	(\$2450)	(\$3830)
2010 MSWWs	1.4%	4.3%	5.8%	9.1%
	(\$510)	(\$1580)	(\$2140)	(\$3310)

Table 1: Cost of rising inequality, 1979–2010. This table shows the share of realized growth which would be willingly sacrificed to preserve 1979 level of inequality in disposable income, using MSWWs implicit in the tax code as computed in 1980, 1990, 2000, and 2010, for a range of elasticities of taxable income. Figures in parentheses represent the corresponding reduction in average income per capita, in 2010 dollars.

Cost of Unequal Distribution of Recessions, 1979–2010			
Recession	Average change in disposable income	Equally-distributed equivalent loss	
		1980 MSWWs	2010 MSWWs
1981–1984	–4.3% (\$2022)	–3.9% (\$1826)	–4.1% (\$1933)
1990–1992	–2.3% (\$1271)	–1.2% (\$702)	–1.9% (\$1050)
2001–2003	–2.6% (\$1844)	–1.6% (\$1098)	–2.2% (\$1552)
2007–2010	–12.3% (\$10,400)	–4.6% (\$3915)	–9.4% (\$7909)

Table 2: Cost of recessions, 1979–2010. The first column shows the share of annual pre-recession disposable income lost over the course of a recession. The second and third columns show the equally-distributed reduction in income which would generate the same welfare cost, using 1980 and 2010 MSWWs, again as a share of pre-recession income, as well as in dollar terms. These results assume an elasticity of taxable income equal to 0.3.

	Upper-income households pay...			Obs
	too little	fair share	too much	
Gallup results (2014)	61%	24%	13%	1026
MTurk treatments				
1. No information (control group)	71%	22%	7%	51
2. Income shares	59%	29%	12%	54
3. Tax shares	34%	40%	26%	39
4. Both income and tax shares	48%	28%	24%	52

Table 3: MTurk survey results by treatment, reweighted to match Gallup political composition.