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Journal of Public Economics 88 (2004) 1567–1588

JOURNAL OF
PUBLIC
ECONOMICS

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The incidence of personal income taxation: evidence from the tax reform act of 1986

Jeffrey D. Kubik *

Department of Economics, 426 Eggers Hall, Syracuse University, Syracuse, NY 13244, USA

Received 21 October 2000; received in revised form 13 August 2002; accepted 4 September 2002

Abstract

This paper studies the short-run incidence of personal income taxation in the US by examining how the wage structure shifted after the Tax Reform Act of 1986. I calculate the marginal tax rate for the median worker of each occupation during the 1980s to determine the professions whose workers were most affected by the tax change. When controlling for trends over time in the wage structure by occupation, I find that individuals in occupations that experienced large decreases in their median marginal tax rates received lower pre-tax wages after 1986 as the number of workers and the hours worked in those professions increased. The results suggest that consideration of the wage effects of tax reforms is important when using these reforms to identify behavioral parameters and evaluating their distributional consequences.

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Keywords: Personal income taxation; Tax Reform Act

1. Introduction

Most analyses of the short-run incidence of the personal income tax are very simple. The supply and demand shifts induced by changes in income tax policy are generally assumed not to affect the pre-tax wages of workers. Because workers then bear the full burden of the tax, investigations of the distributional consequences of personal income tax reforms need only be concerned with the direct effects of tax rate changes on workers. Redistribution from wage movements caused by tax policy innovations can be ignored.

But basic models of the labor market suggest that this assumption is potentially strong. In a simple framework, the pre-tax wages and incomes of workers are endogenously

* Tel.: +1-315-443-9063; fax: +1-315-443-1081.

E-mail address: jdkubik@maxwell.syr.edu (J.D. Kubik).

determined by tax policy. For an economy with workers of different skills, the pre-tax wage of each skill will depend on the quantity of labor supplied at all skill levels because the supply of one skill affects the marginal productivity of each type of labor. If a tax reform alters the quantity of labor supplied of at least one of the skill levels, the wage structure will change. The magnitude and direction of this shift depends on the size of the labor supply response to the tax change and the structure of the production process.

The goal of this paper is to measure whether changes in the personal income tax affect the US wage structure, using evidence from the Tax Reform Act of 1986. First, I estimate how the marginal tax rate of the median worker in each occupation changed because of the tax reform. Then, I track the wages of workers by occupation before and after 1986. Under simple assumptions about the labor supply response of workers to tax changes and the specification of the aggregate production function, the size of the wage change for workers in an occupation caused by the tax reform will depend on the magnitude of the marginal tax rate change of workers in that occupation compared to workers in other jobs. Therefore, I relate the wage changes of workers in occupations after 1986 to the tax rate change of the median worker in that occupation caused by the new income tax policy.

The Tax Reform Act of 1986 is particularly well suited for studying the effect of tax changes on the US wage structure. The legislation significantly lowered marginal tax rates for high-income individuals while low-income workers were relatively unaffected by the reform. To the extent that workers in the same occupation earn similar incomes and therefore face similar tax circumstances, workers in high-income professions experienced large marginal tax rate declines compared to workers in low-income jobs, providing useful variation for identifying the effect of the tax change on wages by occupation.

Using data from several years of the Current Population Survey, I find that the pre-tax wages of occupations whose workers faced sharp declines in marginal tax rates after the 1986 tax reform fell compared to the wages of workers in other occupations when controlling for trends in the wage structure by occupation over the 1980s. The estimates imply that an occupation with a median worker who experienced a 10 percentage point marginal tax rate decline after the 1986 reform, about the largest median decline caused by the tax change, encountered between a 1.3 and 2.5% decrease in its median wage. Also, the number of hours worked by individuals, especially by women, in these occupations increased significantly compared to other occupations, suggesting that shifts in the relative supply of labor caused these relative wage changes.

The results indicate that the gains to high-income workers of lower marginal tax rates after the Tax Reform Act of 1986 were partially offset by declines in the pre-tax wages of workers in high-income occupations. Therefore, this work suggests that it is important to take into account wage effects when evaluating distributional issues of income tax policy, both when reviewing the effects of a specific tax reform and in an optimal tax setting. To evaluate how personal income tax changes influence an individual, consideration must be given not only to the particular tax circumstances of the individual but also to how other people in the labor market, especially workers in the same occupation, are affected by the reform.

Also, there is a large literature that attempts to use tax reforms to identify behavioral parameters such as labor supply elasticities. Much of this work assumes that the tax reform does not alter the wage distribution of workers when calculating these parameters. My results indicate that such an assumption might be problematic in many situations.

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