EC355 Public Economics Term Paper

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Essay title: "The government should encourage philanthropy. While donors to charity get a positive 'warm glow' utility benefit, government spending requires taxing income, which lowers the incentive to work and reduces economic efficiency." Critically assess this claim, using both economic theory and empirical evidence.

Part A - Taxation

One of the most important developments of the 20the century has been the establishment of the "welfare state", which:

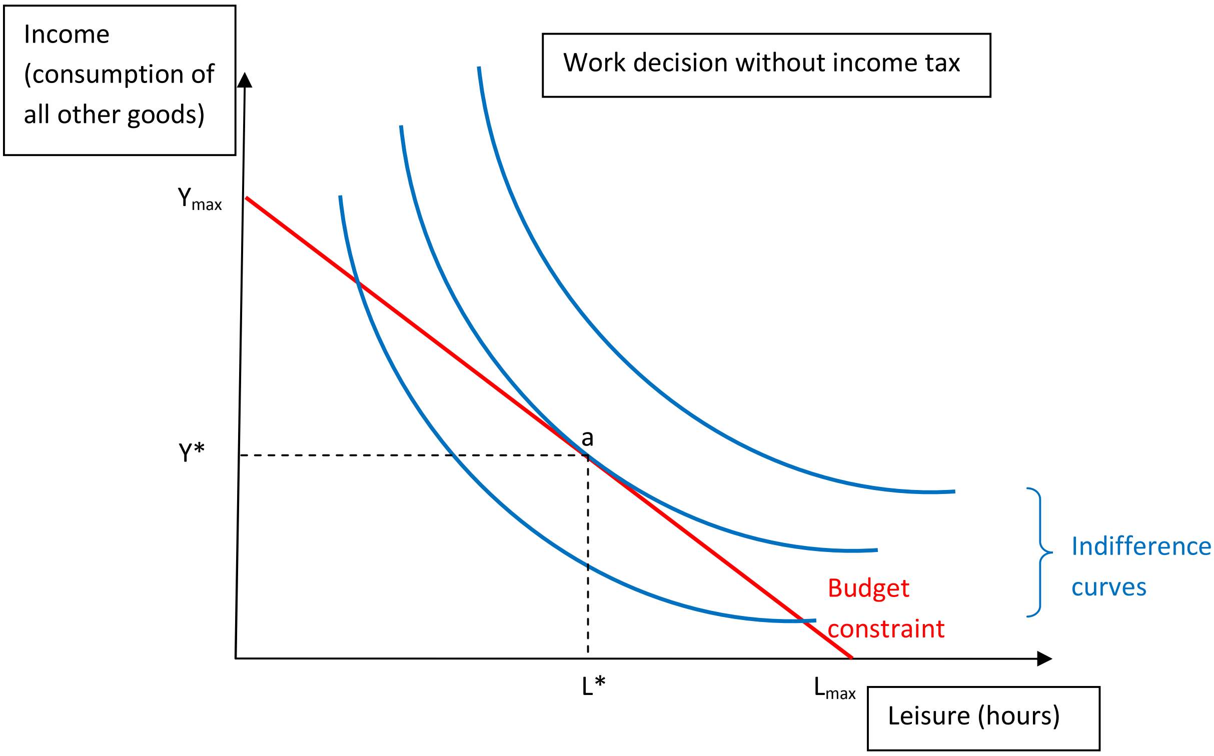
> *exists to enhance the welfare of the people who (a) are weak and vulnerable, largely by providing social care; (b) are poor, largely through redistributive income transfers; (c) are neither vulnerable nor poor, by organising cash benefits to provide insurance and consumption smoothing, and by providing medical insurance and school education.* (Barr 2004)

With the establishment of the welfare state, the role of government expanded significantly. The traditional "laissez-faire" attitude of the early 20th century limited the role of government to *fundamental activities* such as financing public works; protecting individuals and property; and offering assistance to the very poor. (Tanzi 2010) To finance these activities, the government did not need much revenue, and so taxation was low. It was only during the 1930's and especially after World War II that *social transfer*s – government expenditures aimed at redistributing income among groups of people and across time and at protecting citizens against risks such as unemployment, poverty, illness etc – became important aspects of the welfare state. The key factors behind an increased demand for social transfers were: (a) the universal suffrage which gave the non-affluent majority the political power to demand more redistribution; (b) the experience of high taxation during and after the two World Wars to service war debts and assist in the rebuilding effort. On through the 1960's, the demand for social transfers and the supply of resources from taxation kept increasing due to changing views of the role of the government, and changing economic structures (e.g. the growing share of wages in national income) (Tanzi 2010) During the 1980's, the *supply-side revolution* sparked a heated debate on whether income taxation policies actually damage economic activities and limit individual freedom.[1] It purported the existence of a trade-off between output and equity as a goal pursued by redistribution through taxation. It claimed that income taxation has negative effects on incentives to work: since the proportion of income people are left with after tax deductions keeps getting smaller, they lose the incentive to work more. However, previous and contemporary empirical research provided inconclusive evidence:

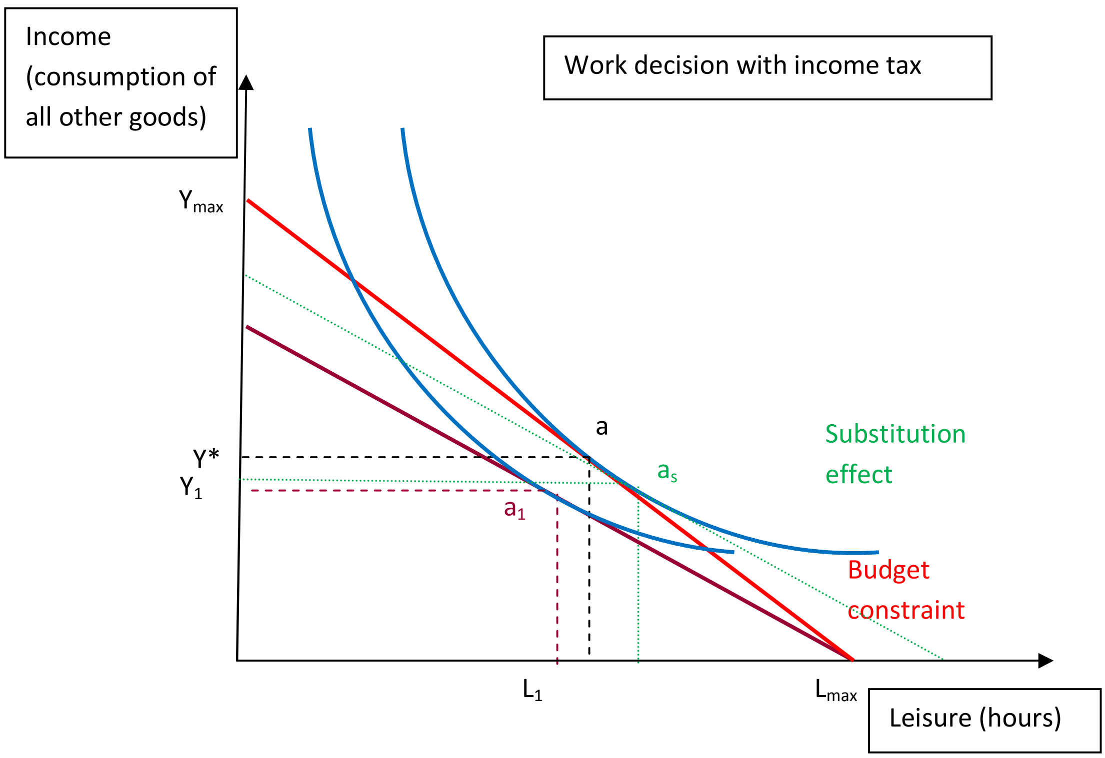
> *Whereas taxation certainly does tend to impair incentives by reducing the net monetary reward to be earned by an extra hour's work, it also exerts a quite opposite effect in that it lowers the taxpayer's disposable income and hence increases the pressure on him to earn more.* (Break 1957)

In order to determine what effects income taxation has on work incentives, it is necessary to distinguish between the income and substitution effects of direct income taxation. An individual decides how much time to devote between two goods: leisure (i.e. time not working) and a composite of all other consumption goods. Using indifference curve analysis we compare an individual's decision on how much to work with and without their income being taxed. The budget line shows the various combinations of leisure and consumption of all other goods an individual can consume at any given time. We assume the individual prefers both more leisure and more income, but they have to make a choice so as to maximise their utility (which is a function of their leisure time and income earned) subject to their budge constraint. Their total income is a function of an income endowment and the income they earn from working (T- L) hours (total time endowment – leisure hours) for the wage rate w: $I = I_U + w(T - L)$.

[1] Freedom is a debated concept. Some thinkers conceive freedom/liberty in a negative sense: being unconstrained, free from interference. Others conceive liberty as being able to realize one's potential; they emphasise positive rights to economic equality, economic assistance or equality of opportunity.



With the introduction of a tax on income earned, they are effectively keeping a lower proportion of their wage, and so are gaining less income for every hour worked. With $w_1 > w$, then the new BC becomes $I = I_U + w_1(T - L)$, and graphically it rotates inwards around L_{max} as now the same hours worked $(T - L)$ can only provide less income; the new decision point is lower at a_1.



The substitution effect happens in response to a change in the price of leisure, expressed as the opportunity cost of working an extra hour. With the introduction of the tax, an extra hour of not working = leisure involves sacrificing less income = consumption, and so individuals may be more inclined to substitute leisure for consumption and work *less*. This would mean a disincentive effect of taxation as individuals choose to work less as a result of taxation. The income effect happens because after the introduction of the tax, individuals have less disposable income to spend on consumption; if they want to maintain the same level of consumption they have to work more hours, and consume less leisure. The net effect of the tax depends on which one of the two effects dominates. In this diagram, the income effect dominated, and the individual will choose to work more hours (i.e. consume less leisure) to make up for income lost to taxation. The tax has acted as an *incentive*. It is impossible to theoretically accept or reject the statement that taxing income lowers the incentive to work and reduces economic efficiency, because this can only be determined by the interaction of the substitution and income effects of each individual's budget constraint and indifference curves.

The relative size of the income and substitution effects is likely to differ for different types of people. The net effect largely depends on the underlying preferences of individuals, and their taste for leisure. The slope of the budget constraint depends on the wage rate and the tastes for leisure: low tastes for leisure will result in more shallow indifference curves, which will more likely create weaker responses to the substitution effects; high tastes for leisure will result in steeper indifference curves. In his research, Break (1957) underlines the different groups of people who are likely to be particularly sensitive to tax disincentives[2]:

a) the self-employed[3] and those having alternative income-earning opportunities outside their regular jobs;

[2] For the following categories of people the substitution effect is likely to dominate the income effect.
[3] It is important to keep in mind that most people do not have all that much control; the work they do dictates the amount of hours they work, irrespective of changes in taxation – it is mostly the self-employed who can actively decide to increase/decrease their work hours in response to changes in taxation.

b) those with "low commitments": the single, those with no family, or the second income earners[4] in families;
c) those who respond more strongly to the attraction of lower price for leisure resulting from higher marginal tax rates[5] than they do to maintaining given levels of disposable income;
d) those whose marginal utility of income does not change rapidly when income itself changes; if an individual's income is already quite high, then presumably changes in it will not have huge impacts on the utility, due to decreasing marginal utility – i.e. the more affluent are more sensitive to disincentives.

On the other hand, the people who are more likely to be affected by tax incentives[6] are:

a) those with long-term commitments: with families, with mortgages and other debts, that would be forced to work more in order to maintain their consumption and service their obligations;
b) those on higher incomes, for whom an increase in tax rates represents a substantial decrease in income. So, in regards to individuals earning high levels of income we cannot be sure whether they work more or less due to income taxes. Do they make them work more to maintain a given high level of consumption or do very high marginal tax rates discourage them from working harder or seeking promotion because at the end of the day they cannot keep a large portion of the fruits of their labour?

Fields and Stanbury (1970) repeated Break's earlier study but the results showed that there had been little change in the effects of taxation on incentives over time, with the exception of some increase in the number of respondents reporting disincentives. (James and Nobes 2000)

From another empirical research project on evaluating the effect of income taxation by comparing the difference between the amount of overtime hours worked when tax was identified

[4] This expectation is verified in Brown and Levin's work discussed below, where, unlike that of men, the proportion of women claiming that tax has made them work less is smaller than the proportion claiming that it has made them work more.
[5] The rate that people pay on an additional unit of income. In most countries there is progressive taxation, meaning that the marginal tax rate increases in bands as people earn more.
[6] For these types of people, the income effect is more likely to dominate the substitution effect.

as an influence over the overtime decision and when it was not identified as a relevant factor, they reached the broad conclusion that:

> *...the effect of income tax on overtime working is, in the aggregate, small. First, a large majority of men and women [said] that taxation does not influence the amount of overtime they work. Also, of those who [did] claim a tax effect on overtime, some [were] led to work more while others are led to work less. There is, however, some evidence to suggest that those who claim to work more overtime because of taxation are on the whole more plausible than those who claim to work less.* (Brown and Levin 1974)

For men who were unconstrained in their working more overtime[7], 60% claimed that they were unaffected by income taxation. It is, nevertheless, impossible to know whether this apparent lack of effect was due to the substitution and income effects cancelling each other out, or due to taxation really being irrelevant to working overtime decisions. Thus, we have so far reached the unhelpful conclusion that we do not exactly know what effect taxation has on incentives and work effort because of theoretical ambiguity and contrasting empirical evidence. What we know is that there exist some factors that may be affecting the interaction between taxation and incentives: level and alternative sources of income, obligations, age, preferences for leisure etc. The purported disincentives resulting from taxation supposedly decrease the supply of hours worked, i.e. the supply of labour, which in turn reduces the national output produced, and creates a loss of efficiency. This inefficiency can also be tied to the fact that like any tax, taxation of income distorts the individual's trade-off (i.e. the marginal rate of substitution) between the two "goods" considered in the decision-making model (leisure and income – consumption of all other goods).

Part B - Philanthropy

The most immediate response to the suggestion that government should encourage philanthropy instead of pursuing coercive and distorting income taxation is that in the absence of coercion, "encouragement" might not be enough to motivate people to donate the resources

[7] Constraints considered included: being obliged to work more/less as a condition for employment; having age unaffected from working more hours; being prevented from working longer hours due to personal reasons.

needed. If we accept that one of the major disincentives of taxation is caused by people's "dislike" of having part of their income taken away, why would we expect them to be more willing to give it away voluntarily? Another pressing question regarding the effectiveness of philanthropy is the danger of free-riding. Let us consider charity as a public good (in which people "invest"): non-excludable in the sense that it is impossible to exclude individuals who have not contributed from enjoying the positive outcomes of perhaps a more equal and coherent community; and non-rivalrous in the sense that another person's contribution or receipt of the benefits from charity does not diminish their enjoyment by everyone else. Even if we accept that there are "good" people who do want to offer philanthropy because they get positive utility from it, a "warm glow", we cannot safely rely on them (a) to cover all the needs for income support and resource redistribution that a society might have; (b) to be able to evaluate and respond appropriately to social needs; and (c) to willingly give away as much of their income as would be taken under state taxation – their altruism may be latent after all, not sufficient to flourish on its own. The "warm glow" applies only to individuals who have altruistic underlying preferences, but we cannot assume they all do. Especially if we take a rather pessimistic view of human nature, and see humans as self-interested we can expect that very few people will display consistently altruistic preferences. And even if they do, in interacting with others and trying to coordinate action, they are more likely not to cooperate.[8] Finally, even if we successfully bypass all the implementation problems of getting people to contribute to charity, we can definitely not ignore the potential dangers in having the rich help the poor directly. They might use their (arbitrary) economic power to gain political power, might discriminate among different groups[9] in need. Thus, the government is needed as an impartial centralised distributor of help.

Nevertheless, if we take a more hopeful view, we can hope that people might eventually recognise not only the moral dimension of charity, but the pragmatic one as well. Perhaps the problem of charity should not be structured as a market failure regarding public goods, but as one regarding the non-existence of markets for the social good of equality and social cohesion.

[8] Non-cooperative collective action game outcome.
[9] Ethnic/religious/ideological etc. Take the example of Greece: as the crumbling state fails to provide for the disadvantaged, non-state charities step in. Most of them do good, but extreme right-wing groups discriminate against foreigners and advertise that they give help only to registered Greek citizens.

Research has shown that individuals benefit greatly from living in a more equitable, less unequal, divided, and unsafe society. These, however, are benefits which cannot be easily quantified and assessed. We could argue that "social conditions" (such as equality, incidence of poverty, equality of opportunity etc) do largely affect the utility of individuals but are not owned or controlled by any market structure[10] – they are just the result of aggregating the individual and collective activities of members of society.[11] From our short examination of the historical development of the welfare state, we could conclude that after the 1930's people demanded that this be changed: they demanded that the government step in and create this "market" and coerce people into "consuming" the "goods" (consume "social equality" or general improvement of the social conditions via their tax contributions). Those who oppose this government intervention might claim that instead of being coerced individuals should be left free to determine the level of charitable contributions they want to make to the "social good", yet there is the ever-present danger others might free-ride, as well as the uncertainty that under imperfect conditions, such as incomplete information on the benefits from a more equal society, they will not know what is in their best interest. What is might largely be a topic of normative debate, yet there exists concrete evidence that various health and social problems are more frequent in more unequal societies. (Wilkinson and Pickett 2010)

In critically assessing the claim that government should do away with taxation as a means for funding government expenditure and encourage private philanthropy instead on the grounds that "voluntary" philanthropy does not distort individuals' incentives or decrease their economic activity like income taxation does, we conclude that the existing empirical evidence on the effect of income taxation on incentives to work does not provide a definite answer. Indeed it might be argued that it shows that income taxation forces some types of individuals to work *more* so as to make up for the income lost via taxation and keep up their consumption Thus, the critique against income taxation on the grounds of its creating disincentives for work does not stand. Neither does the recommendation to use philanthropy as an alternative means for income

[10] Perhaps this idea could be discussed both as a positive externality and as missing markets for it.
[11] This situation is parallel with the situation of the environment.

redistribution because of its vulnerability to free-riding and the danger of manipulation for political goals.

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