Taxing Questions

BY DOUG CAMPBELL

"Implications of Some Alternatives to Capital Income Taxation." Kartik B. Athreya and Andrea L. Waddle, Federal Reserve Bank of Richmond *Economic Quarterly*, Winter 2007, vol. 93, no. 1, pp. 31-55.

Households face many forms of taxation. There are taxes on property, capital income, labor income, and consumption. Economic theory suggests that capital income taxation is probably the worst of the lot. A world with taxes on earnings from investments is a world where people have to set aside more today to receive a given amount of resources tomorrow. Young households interested in building retirement nest eggs, for example, must save enough to overcome the repeated taxation of their investment proceeds, a cost that grows as the household's planning horizon lengthens.

Economists have looked for ways to shift the tax base away from capital income, thinking almost anything is likely to be better for general consumer welfare. But in a new paper, researchers at the Richmond Fed sound some cautionary notes about a wholesale switch of the tax burden.

Kartik Athreya and Andrea Waddle build a model that tests some intuitive notions about placing taxes exclusively on either labor income (the income taxes filed April 15 each year), consumption spending (usually sales taxes), or some combination of both. The authors examine a world in which households face real risks; people may be laid off or get sick, and unable to work for some time. Lacking comprehensive insurance, the only way to protect against these risks is to accumulate wealth. In such a world, different tax regimes have different risk-sharing repercussions. The authors search for taxation arrangements that raise a required level of revenue but yield the least possible pain for households.

Athreya and Waddle's most important finding is that there are systematically different effects for welfare across wealth levels. In a world with low risks, for example, wealthy people would welcome a move away from capital income taxation and toward either purely consumption or labor income taxation. In a high-risk world, poor households dislike a pure labor tax, much more so than their wealthy counterparts who don't rely on jobs for the majority of their income.

There are no across-the-board conclusions, however. "You can't draw stark conclusions on which regime is best," Athreya says in an interview. "The usefulness of this paper is to illustrate that even in a relatively simple environment, uninsurable risk has to be taken seriously in evaluating any tax system."

"The Young, the Old, and the Restless: Demographics and Business Cycle Volatility." Nir Jaimovich and Henry E. Siu. Federal Reserve Bank of Minneapolis Research Department Staff Report 387, March 2007.

Economists often have attributed the economic stability the United States has experienced since the mid-1980s to three forces: structural change, effective monetary policy, and luck. In a new paper published by the Minneapolis Fed, economists Nir Jaimovich and Henry Siu add a fourth factor — demographics — which, they argue, explains as much as one-third of the reduced volatility experienced during the so-called "Great Moderation."

The authors note that young workers experience much more volatility in their employment status than the middle-aged, while near-retirees experience something in between. "When an economy is characterized by a large share of young workers, all else equal, these should be periods of greater cyclical volatility," they write. The demographic profile of U.S. workers since the mid-1980s has tilted away from the "volatile age group," thus contributing to economic stability.

"Identifying Asymmetry in the Language of the Beige Book: A Mixed Data Sampling Approach." Michelle T. Armesto et al. Federal Reserve Bank of St. Louis Working Paper No. 2007-010A, March 2007.

Evidence on whether the Federal Reserve's Beige Book — the anecdotal summary of regional economic conditions published eight times a year — accurately reflects actual economic activity has been mixed. In a new paper published by the St. Louis Fed, a foursome of economists build a model that "not only confirms the predictive power of the Beige Book, but also provides a sense of the asymmetry underlying the language of the Beige Book."

The "asymmetry" the authors refer to involves the different sorts of information conveyed by optimistic or pessimistic language. They used linguistics software to assess the degree of optimism and pessimism in each Beige Book edition. At the national level, they find that optimistic language sends signals about high frequency fluctuations in economic output while pessimistic language helps to tell us where the economy is in the underlying business cycle. At the regional level, the linguistic style of individual Reserve banks is important. For some regions, pessimistic language is the "key component relating the Beige Book to district employment. In other regions, optimism — or both characteristics — reflects the state of the economy." **RF**