Why Tax Cuts Fail

The December quarterly jobs report once again found Wisconsin in the bottom third of the country in job growth. It should be clear by now that the Governor's program of tax cuts is not working to stimulate the state's economy. But how can that be? Isn't it common sense that lower taxes should increase economic growth?

To understand why that common sense is incorrect, you need to know two things. First, taxes affect us because they change prices. Those could be the prices of things we buy (sales taxes), or the wage rates and rates of return we earn on our labor and savings (income taxes). And second, we respond to those price changes in not one way, but two. We respond because of the “income effect”, and because of the “substitution effect”.

Suppose this last Christmas you were thinking of buying one of those curved screen TVs, until you saw they were selling for $1800 and up. $1800! Who has $1800 to spend on a TV? That's the income effect – what is affordable. Besides, you could buy four laptop computers for that same $1800. That's the substitution effect – looking at the alternative uses of your money. Both effects make us less likely to buy at high prices.

So what does that have to do with taxes? Suppose you're working 35 hours a week, making $20 an hour – so about $36,400 a year before taxes. But the government is taking 20% of you paycheck, leaving you with $16 an hour, or about $29,100 annually after taxes.

Now suppose your tax rate is cut to 10%, meaning you'll now clear $18 an hour after taxes, $2 more than before. You have an incentive to work more hours per week, right? That's the substitution effect – you get $18 for every hour you give up, rather than just $16. When people talk about taxes affecting incentives, they're talking about the substitution effect.

But that's only half the story. Because if you're now clearing $18 each hour you work, you can bring home that same $29,100 annually by working just 31 hours a week. Since you're making more per hour, you can afford to work less – the income effect.

When we look at people's actual behavior, we see both effects at work. Given a tax cut or a wage boost, some people respond by working more, and some respond by working less. Mostly though, most of us don't hardly respond at all, working pretty much the same amount. That suggests that for most of us, the two effects pretty much cancel out. And that says the predictions that look only at the incentive effects of a tax cut – the substitution effects – are generally going to be totally wrong.

Interestingly, there is one group in the population that consistently shows a strong substitution response to tax cuts – mothers of young children. For most of us, staying at home and not earning a paycheck is a lousy substitute for having a healthy bank account. But for moms, staying at home is a very good substitute for a job. After all, if they took that 35 hour a week job netting them $16 an hour after taxes, they'll have to spend a major portion of those earnings paying someone else to watch the kids. Netting $18 rather than $16 an hour might be just enough to make taking the job worthwhile.

That's why child care tax credits or deductions are good tax policy – they greatly improve the work incentive for moms. But for the rest of us, tax cuts have virtually no impact whatsoever.