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# Tax Bases, Tax Rates and the Elasticity of Reported Income

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## **Abstract**

Tax reforms usually change both tax rates and tax bases. Using a panel of income tax returns spanning the two major U.S. tax reforms of the 1980s and a number of smaller tax law changes, I find that the elasticity of income reported on personal income tax returns depends on the available deductions. This highlights that this key behavioral elasticity is not an immutable parameter but rather that it can be to some extent controlled by policy makers. One implication is that base broadening reduces the marginal efficiency cost of taxation. The results are very similar for all income categories indicating that the rich are more responsive to tax rates because tax rules that apply to them are different (their tax base is narrower). The point estimates indicate that the Tax Reform Act of 1986 reduced the marginal cost of collecting a dollar of tax revenue by 2 cents, with roughly half of this reduction due to the base broadening and the other half due to the tax rate reduction. As a by-product, the analysis in this paper offers a reconciliation of disparate estimates obtained by previous studies of the tax responsiveness of income.

*JEL Classification:* H2, H24, H31, J22, K34

# 1 Motivation

Complexity is often considered to be an undesirable feature of the tax system, but this is usually postulated rather than derived from an economic model and its relationship to other criteria for evaluating tax policy is unclear. A recent paper of Slemrod and Kopczuk (2002) offers a formalized treatment of the impact of non-tax rate instruments that are controlled by policy makers. In particular, their analysis provides a specific framework for analyzing the cost of complexity in the tax system by interpreting it in terms of the income tax base. A simple income tax is characterized by few deductions and, therefore, a broad tax base. Broadening the tax base increases revenue and affects administrative costs, but more subtly it is also likely to affect the excess burden of taxation: in their model, a broader tax base is associated with a lower elasticity of taxable income and therefore with lower excess burden. Thus, in that framework, simplicity of the tax system directly affects the efficiency cost of taxation.

In this paper, I evaluate the empirical value of such arguments by estimating the impact of the tax base, measured as a fraction of income subject to taxation, on the elasticity of income reported on personal tax returns. This elasticity is the key parameter necessary to evaluate the deadweight loss of the income tax. My results highlight though that it is not a structural parameter depending only on underlying preferences and technology,<sup>1</sup> but instead it depends on a non-rate aspect of the tax system (tax base) that can be manipulated by policy makers. This effect is not just theoretically possible, it also turns out to be empirically relevant. Consequently, the results indicate that the marginal deadweight loss of taxation can be controlled by policy makers. In particular, and as an illustration, I can assess potential efficiency gains resulting from a change to a broad-base low-rate tax system.

# 2 Context

The central importance of the elasticity of taxable income for public finance questions follows from two simple realizations. First, by the envelope theorem, the marginal tax

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<sup>1</sup>Of course, the elasticity need not to be constant in general and may be instead a function of income and tax rates. This is a caveat for any analysis of behavioral elasticities that attempts to identify the elasticity rather than deeper preference or technology parameters.

rate ( $t$ ) affects welfare of an individual in proportion to her taxable income ( $I$ ). The analytics of the response are irrelevant. Second, with just income taxation in place,<sup>2</sup> the marginal effect on revenue is  $\frac{dR}{dt} = t\frac{\partial I}{\partial t} + I$ , again depending only on the total taxable income. Therefore, having a measure of the responsiveness of  $I$  is crucial for any attempt to measure the efficiency cost of income taxation.<sup>3</sup> What is the relevant  $I$ ? The traditional approach was to define  $I \equiv wL$ , where  $w$  is the wage rate and  $L$  is labor supply. Under this assumption, the elasticity of labor supply can be used in place of the elasticity of taxable income. Apart from disregarding many forms of capital income subject to income taxation, this approach also ignores other potentially important types of response to taxation such as unobserved effort, tax avoidance, tax evasion and income shifting.

In order to address this concern, following Lindsey (1987) and Feldstein (1995), the literature has concentrated directly on income reported on tax returns (Auten and Carroll, 1999; Carroll, 1998; Goolsbee, 1999; Long, 1999; Sillamaa and Veall, 2001; Aarbu and Thoreson, 2001; Gruber and Saez, 2002).<sup>4</sup> Several authors argued that changes in the definition of taxable income provide an additional source of identification as exogenous limiting or expanding of deductions pushes taxpayers into different tax brackets. Understanding consequences of such changes is important, because they occur at exactly the same time that the tax rates change. An implicit assumption in the literature is that such changes do not have an independent effect on income and that the elasticity of response to marginal tax rates is not affected by them. This assumption is very strong. For example, the elimination of the non-itemizer charitable deduction by TRA86 changed the relative price of charitable contributions and might have had an independent effect on income. Similarly, a change in the standard deduction affects the decision to itemize and, through this channel, the relative prices of itemizable activities for taxpayers who change their itemization status.<sup>5</sup>

The effect stressed in this paper is that a change in the price of deductions, or more

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<sup>2</sup>In the presence of other taxes, the impact on other sources of revenue should be accounted for as well. One important example of such a response is income shifting between personal and corporate income tax bases.

<sup>3</sup>See Feldstein (1999) and Slemrod (1998) for discussions of this argument and its limitations.

<sup>4</sup>See Slemrod (1998) for a critical discussion of this literature.

<sup>5</sup>Triest (1992) analyzed the role of itemization on labor supply decisions and found that the impact of taxes through the relative price of deductible activities appears stronger than through the wage.

generally the price of legal avoidance or illegal evasion, is going to affect the behavioral elasticities. As argued by Slemrod (1994), taxable income is going to be more responsive when reducing it is cheap (e.g., because deductions are abundant), and it will be less responsive when it is expensive. This effect is conceptually separate from any effect on the level of taxable income and has far-reaching policy implications. Because behavioral elasticities measure the extent of excess burden, a policy that can affect the elasticities can also determine the extent of inefficiency of taxation. Understanding the empirical relevance of such policies is important from the optimal policy design perspective (Slemrod and Kopczuk, 2002). It may also be important from the political economy point of view. To appreciate possible implications, note that in the presence of these sorts of effects, supporters of the limited role of the government may have an incentive to pursue policies that make the tax system less efficient (and vice versa; Becker and Mulligan, 1998, make this point explicitly). Finally, understanding whether a broader tax base affects the deadweight loss of taxation is central for determining the potential or actual efficiency gains of changes of this kind such as the Tax Reform Act of 1986 or the increased reliance on the Alternative Minimum Tax projected as the consequence of recent tax reforms.

That income elasticity is a non-structural parameter may already be suspected based on the existing empirical literature. Gruber and Saez (2002) find that elasticities for high-income individuals are bigger than for the rest. Saez (2003) argues that only the responses in the upper tail of the income distribution are significant. Higher elasticities have been found for itemizers Gruber and Saez (2002) and those who are self-employed (Sillamaa and Veall, 2001). Saez (2003) also finds that responses to different tax reforms appear radically different: he found the evidence of significant responses to the TRA'1986 but not much action surrounding the Kennedy tax cut in the mid-1960s. While it is in principle possible that behavioral elasticities vary systematically with some personal characteristics,<sup>6</sup> it is also possible that differences in behavior result from differences in the tax and institutional environment faced by different individuals.

To address this issue, I concentrate on the behavior of a broad measure of income and

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<sup>6</sup>For example, individuals with a relative *preference* for tax avoidance may pursue career paths that allow for easier avoidance, such as self-employment. Kopczuk (2001) analyzes implications of this kind of behavior from the policy design perspective.

control for both changes in tax rates and rules. Measuring rules is of course difficult and it may explain why this issue has not yet been addressed. Even if this problem is somehow resolved, an additional daunting problem from the econometric point of view is to have enough variation in any such measure to credibly identify the potential effects. In practice, time-variation alone is unlikely to provide such a source of variation. The model presented in the paper (Section 3) introduces and justifies a quantifiable measure of the non-rate aspects of the tax system in place that varies both over time and in the cross-section. The idea is to use the tax base as a summary statistic for tax rules in place. I rely on the taxpayer-specific measure of the size of the tax base: the ratio of income that is subject to taxation to total income. This is an easily observable quantity that is affected by tax reforms in a mechanical way (although it of course varies also due to endogenous taxpayers' responses). Tax reforms induce variation in both tax rates and tax bases and therefore provide the opportunity to separately identify the two effects.

A few clarifications are in order at the outset. First, my broad income is the measure of all kinds of income reported on the tax returns that can be consistently observed over time. The alternative would be to use a measure of taxable income. This would be preferred from the theoretical point of view. Such a measure is easy to obtain; however, because its definition changes frequently, it is difficult to incorporate in the analysis. Second, the estimated response to the tax base reflects the degree of substitutability between (broad) income and deductible commodities. This intuition will be made explicit by the theoretical model of Section 3. Previewing the results, they indicate that broad income and deductible commodities are substitutes so that a decrease in the price of deductible commodities (higher tax rate) leads to a significant reduction in the level of broad income. Third, as in other papers in this literature, the major limitation of this approach is due its focus on personal income only. The important kind of response that should be incorporated when evaluating the overall efficiency cost of the tax system is the shifting margin between personal and corporate tax base. It will be argued below, however, that the results are remarkably stable across different income categories that are likely very diverse in terms of the ability to pursue the corporate income tax avoidance avenue. As a result, it appears unlikely that the overall response would be significantly affected by this consideration.

The plan of this paper is as follows. In the next section, I describe a simple model

that highlights the role of the tax base and underlies the empirical specification. I present details of the empirical implementation and discuss the data in Section 4. Apart from the proposed instrumental variable approach, the key question is how to control for trends in inequality and transitory components of income. Two issues are of interest in that context: the choice of control variables and the choice of sample used in analysis. In particular, I argue that different sample choices were responsible for differences in the results found in the previous literature (Section 5). Following this discussion, I present my estimates of the elasticity of income and the strength of its dependence on the tax base (Section 6).

The major contributions of this analysis lie in demonstrating that the elasticity of reported income varies systematically with the tax base and that this effect is quantitatively important. It also turns out that the results are similar for different income categories suggesting that the major aspects of tax environment relevant for taxpayers' decision are appropriately controlled for. The final section discusses some implications of these results.

### 3 Income Response to Tax Base Changes

Suppose that an individual has the total income of  $Y$  that can be received in a way reported on the personal income tax return ( $B$ ) or in the form that is not included on the personal tax return ( $F$ ). Examples of  $B$  are wages, salaries, dividends, self-employment income etc. Examples of  $F$  are fringe benefits, deferred compensation schemes, funds retained within a corporation, etc.<sup>7</sup> Compensation in the form of  $F$  is tax advantageous, I assume though that substitution from  $B$  to  $F$  entails the monetary cost of  $M(F)$ .<sup>8</sup> While  $F$  remains off the tax return and is not observable, broad income ( $B$ ) is observed. Taxable income is obtained from the broad measure of income by excluding certain non-taxable components, subtracting income adjustments, deductions, exemptions, accounting for the impact of tax credits and so on. I assume that deductions, adjustments and non-taxable components can be expressed as  $G \cdot D$ , where  $D$  is a typical deductible commodity and  $G$  is the number of deductible commodities. Critically,  $G$  may vary across individuals and over time. For example, non-itemizers with no adjustments to income would have  $G = 0$ , while others

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<sup>7</sup>I assume that definitions of  $B$  and  $F$  are not affected by reforms.

<sup>8</sup>See, for example, Mayshar (1991) and Slemrod (2001) for the analysis of individual behavior with this kind of avoidance technology.



would have  $G > 0$ . For simplicity, I assume a linear (or linearized) tax system. I denote by  $\bar{S}$  the applicable standard deduction (corrected to reflect the “virtual income” when the actual tax system is progressive). Consequently, the total after-tax income  $C$  may be expressed as

$$C = F + B - t(B - GD - \bar{S}) - M(F), \quad (1)$$

where  $Y = F + B$  and  $t$  is the marginal tax rate (I will also use  $\tau \equiv 1 - t$  to denote the net-of-tax rate). Assuming that  $M(F)$  is not affected by the tax reform, the tax system affects behavior through  $t$ ,  $\bar{S}$ , and  $G$ . The budget constraint highlights that the tax rate has two independent effects. First, it determines the relative price of  $F$  and  $B$ , which is  $\tau$ . Second, it determines the relative price of  $B$  and  $D$ . The latter effect is proportional to  $G$ . If  $G$  did not vary, the estimated tax elasticity of  $B$  would reflect the combination of these two effects. However, when  $G$  varies, there is no single tax elasticity, so that estimating it is not a well-posed problem. The value of  $G$  is affected by tax reforms that eliminate or introduce deductions and adjustments. Additionally,  $G$  varies cross-sectionally: it depends on such things as the itemization status (which is chosen by the taxpayer), health shocks (that influence whether medical expenses exceed the floor for claiming deductions), home ownership (via mortgage deductions), taxes imposed by state and local governments, etc.

From equation 1 it is evident that  $G$  affects individual incentives only through its interaction with the marginal tax rate. This suggests that it makes sense to pursue an empirical specification in which both the tax rate and its interaction with  $G$  would be controlled for. However, measuring  $G$  explicitly is not practical. To motivate the proposed solution, consider the following setup that abstracts from sheltering but models the role of deductions. Let  $D_i, i = 1, \dots, N$  be commodities. Assume that the utility function is separable between these consumption goods and determinants of the broad income (such as labor supply), and that the utility from consumption is given by

$$v(D_1, \dots, D_N), \quad (2)$$

where  $v(\cdot)$  is “symmetric”, so that the order of  $D_i$ ’s does not matter for the value of utility.<sup>9</sup> Denote the generic relative price of broad income  $B$  by  $w$  and the price of good  $i$  by  $p_i$ . In the interest of simplifying the notation, assume that in the absence of taxes all prices are

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<sup>9</sup>Formally, it is assumed that for any vector  $D$  and its permutation  $P(D)$ ,  $v(D) = v(P(D))$

equal to 1. Expenditures on  $G$  ( $G < N$ ) commodities are deductible from income. Due to the assumed symmetry, without any loss of generality, deductions may be taken to be the first  $G$  commodities. Therefore, the after-tax prices are given by  $w = \tau \equiv 1 - t$ ,  $p_i = \tau$  for  $i \leq G$  and  $p_i = 1$  for  $i > G$ . The demand for  $B$  is a function of all prices and the non-earned income. The elasticity of  $B$  with respect to the net-of-tax rate has to reflect the impact of all relative prices that are affected by the change. In order to incorporate nonlinear tax schedules, I additionally allow for varying virtual income  $R$  (so that the response to  $R$  represents the income effect). Thus,

$$\begin{aligned} \Delta \ln(B) \Big|_{\Delta R, \Delta \tau} &\approx \left( \frac{\partial \ln(B)}{\partial \ln(w)} + \sum_{i=1}^G \frac{\partial \ln(B)}{\partial \ln(p_i)} \right) \Delta \ln(\tau) + \frac{\partial \ln(B)}{\partial R} \Delta R \\ &= \left( \frac{\partial \ln(B)}{\partial \ln(w)} + G \frac{\partial \ln(B)}{\partial \ln(p_1)} \right) \Delta \ln(\tau) + \frac{\partial \ln(B)}{\partial R} \Delta R. \end{aligned} \quad (3)$$

The last step makes use of the assumed symmetry of all deductible commodities. This formula depends on  $G$ , the number of deductible commodities which is unlikely to be observed. However, using the Slutsky identity, the symmetry of the Slutsky matrix and  $p_1 = \tau = w$  yields

$$\Delta \ln(B) \Big|_{\Delta R, \Delta \tau} \approx \left( \frac{\partial \ln(B^*)}{\partial \ln(w)} + \frac{GD_1}{B} \frac{\partial \ln(D_1^*)}{\partial \ln(w)} \right) \Delta \ln(\tau) + \frac{\partial \ln(B)}{\partial R} \left[ \Delta R + \Delta \tau (B - GD_1) \right], \quad (4)$$

where the superscript “\*” denotes the compensated effect. The first two terms form the compensated elasticity of  $B$  with respect to the tax rate: it depends on the elasticity with respect to own price  $w$  as in the standard analysis, but it also depends on the cross elasticity of deductible goods with respect to  $w$  multiplied by the share of deductible goods.

So far, the response to changes in  $G$  was ignored. However, it may be analyzed in a similar manner. Consider an increase in  $G$  by  $\Delta G$  (the case of a decrease would be analyzed identically). It corresponds to prices of goods  $G+1$  to  $G+\Delta G$  falling from 1 to  $\tau$ . Therefore, assuming that  $\Delta G$  is small relative to  $N$ ,

$$\begin{aligned} \Delta \ln(B) \Big|_{\Delta G} &\approx \sum_{i=G+1}^{G+\Delta G} \frac{\partial \ln(B)}{\partial \ln(p_i)} (\ln(\tau) - \ln(1)) \approx \frac{\partial \ln(B)}{\partial \ln(p_{G+1})} \ln(\tau) \Delta G \approx \frac{\partial \ln(B)}{\partial \ln(p_1)} \ln(\tau) \Delta G \\ &= \frac{\partial \ln(D_1^*)}{\partial \ln(w)} \frac{D_1 \Delta G}{B} \ln(\tau) - \frac{\partial \ln(B)}{\partial R} t D_1 \Delta G. \end{aligned} \quad (5)$$

Combining equation 4 and 5 provides an expression for the response of broad income to a change in the economic environment. To express it succinctly, define  $\gamma \equiv \frac{GD}{B}$ . Then,

when evaluated at the original point,  $\Delta(\gamma \ln(\tau)) = \frac{D\Delta G}{B} \ln(\tau) + \gamma \Delta \ln(\tau)$ . Consequently, the response of  $B$  can be expressed as

$$\Delta \ln(B) = \frac{\partial \ln(B^*)}{\partial \ln(w)} \Delta \ln \tau + \frac{\partial \ln(D^*)}{\partial \ln(w)} \Delta(\gamma \ln(\tau)) + \frac{\partial \ln(B)}{\partial R} [\Delta R - \Delta T], \quad (6)$$

where  $\Delta T$  is a change in the tax liability.

This analysis has two important implications. First, the response to tax changes depends on  $G$ . Second, the impact of deductions is measured by the cross-elasticity and it is proportional to the (observable) share of deductions in the total income  $\gamma \equiv \frac{GD}{B}$ . This suggests using a natural specification where one controls for both the tax rate and its interaction with the share of deductible commodities, attempting to identify both  $\frac{\partial \ln(B^*)}{\partial \ln(w)}$  and  $\frac{\partial \ln(D_i^*)}{\partial \ln(w)}$ . Of course,  $\gamma$  is endogenous but it also reflects the exogenous parameter  $G$ . As long as  $\gamma$  responds to changes in  $G$ , the two parameters can be separately identified.

Without assuming that the utility function is symmetric, it can be demonstrated that the interaction term in equation 6 should be replaced by

$$\frac{\partial \ln(D_{G+\Delta G}^*)}{\partial \ln(w)} \frac{\Delta G \cdot D_{G+\Delta G}}{B} \ln(\tau) + \left( \sum_{i=1}^G \frac{D_i}{G\bar{D}} \frac{\partial \ln(D_i^*)}{\partial \ln(w)} \right) \frac{G\bar{D}}{B} \Delta \ln(\tau),$$

where  $G+\Delta G$  is the index of a marginal commodity that becomes taxable,  $\bar{D} = G^{-1} \sum_{i=1}^G D_i$ . What is required for  $\Delta \gamma \ln(\tau)$  to measure the effect of deductibility as in equation 6 is that  $\frac{\partial \ln(D_{G+\Delta G})}{\partial \ln(w)} = \sum_{i=1}^G \frac{D_i}{G\bar{D}} \frac{\partial \ln(D_i)}{\partial \ln(w)}$ : the marginal deductible commodity should react to the price of leisure as the average one does. This assumption is implicit in the empirical work that follows.

Motivated by the model, therefore, instead of measuring  $G$  explicitly, I rely on the share of broad income that is spent on non-taxable commodities  $\gamma \equiv \frac{GD}{B}$ , and I control for both  $\tau$  and its interaction with the tax base  $\gamma$ . Note that  $\gamma$  is affected by tax reforms through their mechanical effect on  $G$ . On the other hand,  $\gamma$  also varies in the cross-section. My goal is to estimate parameters  $\varepsilon$  and  $\beta$  of the following generic specification

$$\ln(B) = \varepsilon \ln(\tau) + \beta \gamma \ln(\tau) + \text{other terms}. \quad (7)$$

where other terms may include income effects as well as other control variables. In this specification,  $\varepsilon$  is the elasticity that would prevail if  $\gamma = 0$ , i.e. if no deductions were available. The actual size of the elasticity is  $\varepsilon + \beta\gamma$ : if policy affects  $\gamma$ , it changes this

elasticity. The interpretation of  $\beta$  that follows from the model described above is as the average cross-elasticity of deductible goods with income, so that both positive and negative  $\beta$ s are consistent with the theory. More generally, any response of broad income will also reflect reallocation of income between reported and non-reported forms.

Because  $\gamma$  has never been, to my knowledge, considered in the literature, it should be pointed out that from both the theoretical and the econometric point of view this variable can be thought of in the same way as the marginal tax rate. This quantity is affected by policy changes and it constitutes a parameter of the taxpayer's problem just as the tax rate does. It is clearly endogenous as well, but that will be dealt with in the empirical work just like any potential endogeneity of tax rates must be dealt with.

It also should be stressed that the specifications I consider do not include the direct (i.e., not interacted with the tax rate) effect of the tax base. This is because changes in the tax base have any impact only to the extent that an individual is subject to taxation to begin with and, therefore, there is no theoretical reason to include non-interacted tax base. Other than restrictions implicit due to the parametric character of the analysis, the main assumption is that rules are fully characterized by the single parameter  $\gamma$ .

## 4 Data and Empirical Strategy

The data used in this paper comes from a panel of tax returns. Before it is described in Section 4.2, I briefly discuss prior approaches to identifying the effect of taxes on taxable income focusing on my proposed modifications, including those necessary to simultaneously identify the effect of the tax base.

The identification problems in this setup have been discussed extensively by Moffitt and Wilhelm (2000). The impact of unobservable demographic characteristics whose effect stays constant over time and that are time-invariant can be eliminated by first-differencing the regression specification. Therefore, indexing individuals by  $i$  and denoting the time index by  $s$ , I specify my model in the first-differenced form as

$$\Delta \ln(B_{is}) = \varepsilon \Delta \ln(\tau_{is}) + \beta \Delta [\gamma_{is} \ln(\tau_{is})] + \eta \Delta \ln(B_{is} - T_{is}) + \Delta \delta^v Z_i^v + \delta^h \Delta Z_s^h + \Delta \theta_{is}, \quad (8)$$

where  $\tau$  is the marginal net-of-tax rate,  $\gamma$  is the share of deductible consumption,  $T$  is the total tax liability and  $Z = [Z^h, Z^v]$  is the vector of other relevant characteristics. The

objective is to directly estimate the elasticity with respect to the net-of-tax rate  $\tau \equiv 1 - t$ . For the reasons discussed above, the tax elasticity depends on deductions and therefore the coefficient on  $\ln(\tau)$  is allowed to depend on  $\gamma$ . This is the minimal extension of specifications considered in the prior literature that allows for testing the constancy of the elasticity. The parameter  $\varepsilon$  is the broad income tax elasticity when  $\gamma = 0$ , that is for the comprehensive tax base. Equivalently, this is the response of broad income motivated by substitution away from items reported on the tax return toward leisure, fringe benefits and other types of income. One can test whether  $\beta = 0$ , in which case there is a single tax elasticity. In principle, depending on whether deductible goods are substitutes or complements for the broad income, both positive and negative  $\beta$ 's are consistent with the theory. The parameter  $\eta$  measures the income effect. Finally,  $Z^v$  is the set of time-invariant variables whose effect changes over time and  $Z^h$  is the set of time-specific variables whose effect stays constant over time.

All reported regressions include dummies for the single marital status, sex (these are  $Z^v$ 's) and the full set of year effects ( $Z^h$ ). The dataset contains no age information other than age exemption for those older than sixty-five, but observe that linear age effects are controlled for by including year dummies in the first-differenced specification. The effect of any other variables is not controlled for and they are subsumed in the  $\Delta\theta$  term.

#### 4.1 Endogeneity and Instruments

As in any econometric analysis of the impact of taxes on income or labor supply, one has to worry about endogeneity of the key right-hand side variables. Both the marginal tax rate and the tax base depend on a realization of income. The tax rate is the direct function of the total income. The tax base is not a direct function of income, but it may depend on it. Furthermore, given that only limited demographic information is present in the dataset, one has to worry about any systematic relationship of omitted variables that are relevant for income with the tax base. For example, people with temporarily high income may be willing to invest more in tax avoidance. On the other hand, people with temporarily low income due to, e.g., medical conditions will have a lower tax base as they qualify for the medical deduction. The tax base is, similarly as the marginal tax rate, an endogenous time-varying variable, exogenously affected by policy shocks.

To consistently estimate  $\varepsilon$  and  $\gamma$ , what is necessary are instruments for  $\Delta \ln(\tau_{is})$  and  $\Delta\{\gamma_{is} \ln(\tau_{is})\}$  that are uncorrelated with  $\Delta\theta_{is}$ . I construct and use as my instruments the changes in the values of  $\ln(\tau)$  and  $\gamma \ln(\tau)$  absent any change in behavior (which I refer to as “predicted” changes).<sup>10</sup> Only information as of time  $s$  is used to construct the predictions of the time  $s + 1$  variables. In other words, the predicted tax base and the predicted marginal tax rate differ from the original ones only to the extent that there were changes in tax law. This eliminates the effect of behavioral response between time  $s$  and time  $s + 1$ , although it still leaves the individual-specific component. In constructing the predicted tax base, I account for changes in the medical deduction,<sup>11</sup> changes in the tax treatment of charitable contributions by non-itemizers (a deduction was present between 1982 and 1986), deductibility of interests on personal debt that was phased out after 1986, changes in the IRA limits, the elimination of the second-earner deduction by TRA86 and the change in the treatment of moving expenses (the TRA’86 changed their status from an adjustment to an itemized deduction). As a part of the process, the predicted itemization status is determined by comparing predicted deductions with the corresponding standard deduction. All calculations are CPI-adjusted and thus account for changes in itemization incentives due to “bracket-creep.” Performance of the predicted tax base is illustrated in Figure 1 using the 1985 data to predict the 1988 values (this change is mostly due to the Tax Reform Act of 1986).

The marginal tax rate instrument is constructed analogously. I adjust all period  $s$  quantities for inflation and compute the period  $s$  measure of taxable income accounting for changes in its definition. The new itemization status is predicted and the new tax schedule is applied to the result.<sup>12</sup> The income instrument is constructed as in Gruber and Saez

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<sup>10</sup>In general and apart from the orthogonality assumptions, with just two years of data what is required for identification of both parameters is that the effect of at least two of the variables used in computing the marginal tax rate and tax base stayed constant over time so that they don’t enter specification (8). With multiple years of data and multiple tax reforms, this assumption can be somewhat weakened: I can still identify the effect if *trends* by at least two characteristics stayed constant over time.

<sup>11</sup>Until 1982, medical expenses above 3% of AGI were deductible, until 1986 - above 5%, after 1987 - above 7.5%. There were minor changes regarding how health insurance affects the calculation in 1982 and 1983.

<sup>12</sup>The results are not sensitive to a few other ways of constructing the tax rate instrument. For example, neither using inflated first-period capital gains as a component of the predicted income nor ignoring

(2002): it is simply  $\ln(B_s - T_s^P/p_{s+1}) - \ln(B_s - T_s)$  where  $T_s$  is tax liability in period  $s$ ,  $T_s^P$  is the tax liability predicted for period  $s + 1$  by applying the tax law as of period  $s + 1$  to the period- $s$  values, and  $p_{s+1}$  is the inflation factor between periods 1 and 2. As was the case with the other two instruments, the income instrument relies only on the values of variables as of period 1.

**Validity of Instruments.** Are instruments based on the time  $s$  information likely to be uncorrelated with the error term? Two reasons for the failure of this assumption have received attention in the literature. The first one is the regression to the mean effect. Transitory components of income cannot be differenced out. Because, by construction, transitory components of income as of the first period do enter instruments, this leads to a violation of the orthogonality assumption. Carroll (1998) provides evidence that this effect is important. The second source, discussed by, e.g. Goolsbee (2000), has to do with trends in inequality. There is extensive evidence that relative incomes of the rich were rising in the 1970s and the 1980s. Failure to control for such (potential) non-tax trends will almost certainly lead to a bias in the tax coefficient given that changes in both tax rate and tax base were not independent of income. To motivate the following discussion, suppose that  $\Delta\theta$  can be expressed as

$$\Delta\theta_{i,s} \equiv \theta_{i,s+1} - \theta_{i,s} = \xi_{i,s+1} + (a - 1)\lambda_{i,s} + \phi_{i,s+1},$$

where  $\xi_{i,s+1}$  is the income trend between period  $s$  and  $s + 1$  for individual  $i$ ,  $\lambda_{i,s}$  is the transitory component of income in period  $s$  and  $a$  is the constant reflecting the degree of its persistence,<sup>13</sup> and  $\phi_{i,s+1}$  is the income innovation that is uncorrelated with any of the period  $s$  variables. When dealing with the tax rate, the worry is that both  $\xi_{i,s+1}$  and  $\lambda_{i,s}$  are not independent of the time  $s$  income, although this is due to two distinct reasons.  $\lambda_{i,s}$  is a component of income and its correlation with  $\ln(B_{i,s})$  is mechanical. In the presence of differential trends by income groups,  $\xi_{i,s+1}$  is correlated with the permanent income (the group indicator), and through this channel it is correlated with  $\ln(B_{i,s})$ . A correlation

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adjustments of the definition of income subject to taxation made a difference.

<sup>13</sup>When  $a = 1$ , shocks are permanent and, therefore, their impact will be eliminated by first-differencing. If  $a = 0$  so that shocks die off after one period, the problem is most pronounced.

between the error term and the initial income almost certainly invalidates the tax rate instrument that is a function of income, even though it takes the form of first difference.

Moffitt and Wilhelm (2000) suggested including income as of time  $s$  to control for the regression to the mean effect. This procedure can be understood by interpreting the transitory income component  $\lambda_{is}$  as an omitted variable. Because the time- $s$  income is correlated with its transitory component, it can be used as a proxy for it. This procedure has been accepted and used in most of the recent work (see e.g., Auten and Carroll, 1999; Sillamaa and Veall, 2001; Gruber and Saez, 2002). Gruber and Saez (2002) appear to suggest that this approach also addresses the inequality trend issue. In general, however, one cannot control for the two omitted variables  $\xi_{i,s+1}$  and  $\lambda_{i,s}$  using a single control variable unless its relationship to the omitted variable can be reduced to the dependence on their sum  $\xi_{i,s+1} + (a - 1)\lambda_{i,s}$ .

Gruber and Saez (2002) experimented with flexible spline income controls in the first-period income, and concluded that such nonlinearities are important. Allowing for nonlinearities in the level of income does not address the issue of two different sources of correlation, though. At the same time, nonlinearities in permanent income may be important to appropriately control for unobservable trends ( $\xi$ ).

Carroll (1998) constructs his instrument relying on a proxy for the permanent income. The idea is that such an instrument should be uncorrelated with the transitory component  $\lambda_{i,s}$ ,<sup>14</sup> but it is still likely correlated with  $\xi_{i,s}$ . Carroll (1998) does not control for the total income, but in some specifications he controls for the initial (1989) income from financial assets (the sum of dividend and interest income). The latter is likely to be correlated with both  $\xi$  and  $\lambda$ . As the result, this control variable will partly reflect residual correlations with both of these variables and it is unlikely to appropriately control for  $\xi$ .

**Strategy.** The tax rate is a function of taxable income, and demographic characteristics (such as the state of residence, marital status, number of dependents, or age). Effectively then, the tax rate is a function of broad income, the structure of deductions/adjustments

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<sup>14</sup>His proxy for the permanent income is the average income between 1989 and 1995 and his empirical strategy involves comparing 1989 and 1995 levels of income. This proxy may still be correlated with the transitory component as of 1989.



and demographic characteristics. In constructing the predicted tax base I rely on taxable income, deductions and tax adjustments. As a result, the tax base is affected by individual-specific and transitory components present in each of them. As examples of such influences, one might list tastes for charity (that affect charitable contributions), own health status (affecting medical deduction), home ownership (affecting real estate tax and home mortgage deductions), credit history (affecting personal interest deductions) and unobservable income shocks (affecting state tax liability and, through this channel, the itemization status). The effect of the tax base on income can be identified to the extent that at least some of these characteristics are either (1) time-invariant with their effect staying constant over time or (2) they do not independently affect income (in which case they need not be time-invariant). In either case, it implies that such characteristics can be excluded from equation 8. Determinants of the tax base whose independent effect on income is not differenced out may be subsumed by either the transitory effect ( $\lambda$ ) or the group-specific trend ( $\xi$ ). If these were the only sources of the correlation of the error term with the instruments, the consistency of estimates would rest on these effects being appropriately controlled for, exactly as it does in the analysis of the tax rate effects. Many individual characteristics can be expected to fall in this category. For example, own health status is likely a determinant of the transitory component of income while home ownership is likely closely related to permanent income and the group-specific trend. The assumption that I make is that the effect of unobservable person-specific determinants of deductions that do not stay constant over time is fully accounted for by  $\lambda$  and  $\xi$ .

Because I rely on instruments constructed using information as of time  $s$ , I must address their possible correlation with both the group-specific trend ( $\xi$ ) and the transitory income component ( $\lambda$ ). The above discussion suggests that I should include two additional control variables to account for the impact of  $\xi$  and  $\lambda$ . In order to control for  $\xi$ , I need a measure of the individuals' ranks in the income distribution. I will use for that purpose the level of income as of the first year (1979) of the twelve-year panel.<sup>15</sup> I exclude the observations for

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<sup>15</sup>An alternative strategy would be to follow Carroll (1998) and construct a measure of permanent income by averaging income over all years when the individual is observed the sample. This is problematic for two reasons. First, such a permanent income measure will reflect any tax response. Second, it is unclear how it should be constructed for the unbalanced panel. For a critique of the approaches based on lags of income

1979 from the sample used for estimation. I define the transitory income component as the difference between current and 1979 income. I use this variable to control for  $\lambda$ . I experiment with the 10-piece splines in logarithms of both the 1979 income and the “transitory” component to allow for potential nonlinear effects.<sup>16</sup> Nonlinearity in the permanent component allows me to account for trends in income varying across different income classes. In principle, the transitory component can be controlled for in a linear fashion. However, because my measure of the temporary income is a proxy and therefore certainly includes a measurement error, allowing for higher-order effects may aid in eliminating the residual correlation and the resulting bias.

## 4.2 Data

I use the Statistics of Income/University of Michigan panel of tax returns that were selected every year between 1979 and 1990, according to the last four digits of the social security number. There are usual pros and cons of relying on the data from tax returns: the dataset contains little demographic information, but it includes detailed information about tax returns. The latter is crucial here, because it allows for constructing a measure of the tax base.<sup>17</sup>

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such as the one presented here and an alternative approach (in the context of charitable gifts) see Auten et al. (2002).

<sup>16</sup>This strategy does not fully eliminate current income differences as a source of identification, contrary to the specification of Gruber and Saez (2002) who allowed for flexible splines in the current income. To see that, note that I allow income to enter as  $S_1(y - y_{79}) + S_2(y_{79})$  where  $y$  is the logarithm of current income,  $y_{79}$  is the logarithm of 1979 income and  $S_1, S_2$  are 10-piece linear spline functions (i.e., continuous functions linear within deciles of the distribution of the argument). Only in special cases (such as  $S_1$  being linear) is it possible to disentangle the effect of  $y$  and  $y_{79}$ . The identification from this source therefore arises to the extent that the distribution of the transitory component of the tax rate (i.e., generated by transitory income shocks) is not independent of permanent income. Absent an economic argument for including current income explicitly, this is a desirable feature of my specification.

<sup>17</sup>There is one practical concern: as elaborated earlier, the instrument for tax base that I use is the predicted change in tax base. Constructing it is a feasible task when deductions are removed but it is not possible to be done exactly when they are introduced. The ERTA’81 introduced several new deductions, so that predicting post-1981 tax base for pre-reform data exactly is not feasible. Still, an instrument relying only on the pre-existing deductions remains a valid instrumental variable as long as it remains correlated with actual tax base.

I follow Gruber and Saez (2002) in comparing differences between observations three years apart. In other words, when differencing, I subtract observations for 1979 (1980, 1981, ..., 1987) from the corresponding observations for 1982 (1983, 1984, ..., 1990). The three year spread was also used by Feldstein (1995). Using a longer spread allows for estimating the permanent elasticity, while short-term differences can be significantly affected by income shifting over time. Using a much longer spread would confound the effects of ERTA'81 and TRA'86 that were just five years apart. For example, the four-year window would include the 1982-1986 pair that adjoins both of the major tax reforms.

The panel is not balanced. There are almost 300,000 observations that translate into close to 100,000 three-year differences, but not all observations are used in the analysis. Unless otherwise stated, the sample for estimation is selected as follows. For reasons discussed earlier, I use only post-1979 observations of individuals who are observed in 1979 and whose marital status in 1979 and the considered year is identical. There are 54,374 such three-year differences. Additionally, I exclude those who claim the age exemption in either of the two years (9,932), those filing as the "head of household" (2,674), those with non-positive income in 1979 or either year of the pair (540), those whose state of residence is unknown (33)<sup>18</sup> and some tax returns with missing data. This procedure leaves 41,442 differenced observations.

Details of the definitions of variables are given in the appendix. The major issue is the definition of the left-hand side variable. The ideal variable to use would be taxable income, but its definition changes with the tax reforms. As a result, researchers have made compromises by accounting only for these components of taxable income that are observed before and after the reforms. Various definitions have been used in practice. The prevailing approach is to use a broad definition of income that includes all components of income that were reported on tax returns under all considered tax regimes.<sup>19,20</sup> As suggested in

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<sup>18</sup>There is a small number of predominantly rich taxpayers whose state of residence is not reported in the dataset (for confidentiality reasons). For most of them, I do have information about their state of residence in one of the prior years and this is what I use, implicitly assuming that they have not relocated in the meantime.

<sup>19</sup>In practice (and here as well), capital gains are often excluded.

<sup>20</sup>Auten and Carroll (1999) and Gruber and Saez (2002) also considered stylized definitions of taxable income. The definition of Auten and Carroll (1999) accounts for few deductions and thus it leads to result

Section 3, this is also the approach that is employed here.<sup>21</sup> I construct and use as the dependent variable the measure of broad income consisting of almost all income that had to be reported every year, regardless of whether it was taxable or not.<sup>22</sup> The only type of income that is excluded (following most of the previous studies) are realized capital gains. This is due to the lump-sum pattern of their realization.

Marginal tax rates and tax liabilities were computed by applying the NBER TAXSIM<sup>23</sup> calculator to the actual AGI. Both state ( $t_s$ ) and federal income ( $t_f$ ) tax rates are used. The effective marginal tax rate is calculated as  $t_f(1 - t_s) + t_s$  for itemizers who claim state tax deductions and as  $t_f + t_s$  for all others.

Spending on deductible commodities is defined to include total adjustments to income, total deductions for itemizers, charitable deductions for non-itemizers between 1982 and 1986 and non-taxable but reported components of income (as in footnote 22). The value of  $\gamma$  is defined as the ratio of such spending to the broad income measure. Note that, consistently with the model described earlier, inelastic exemptions and the standard deduction are not a part of the definition of  $\gamma$ . For the purpose of constructing  $\gamma$ , deductions need not be enumerated, because the tax base can be mechanically constructed by dividing the taxable income observed on the return through a measure of the broad income. The extent and similar as in the case of broad income. Gruber and Saez (2002) subtracted from the broad income some of the itemized deductions using a constant definitions of applicable floors and limits. In the presence of endogenous itemization decisions, deductions are not observed in all years for individuals who changed their itemization status. Consequently, their estimated taxable income elasticities partly reflect the mechanical effect of disappearing deductions when individual is no longer itemizing (and vice versa).

<sup>21</sup>The preferred approach of estimating the response of taxable rather than broad income is left for future research. One might expect that, when compared to broad income, taxable income is both more responsive (because its response would reflect the response of deductions) and that its response is more sensitive to the size of the tax base (because the responsive components can be added/subtracted from it), although it is possible to construct cases that are different. The econometric framework allowing for estimating taxable income would have to be considerably more sophisticated in order to allow for variation in the definition (both over time and in cross-section due to itemization differences) of the left-hand side variable.

<sup>22</sup>Reported nontaxable components include exempt dividends and interests (e.g., from municipal bonds) and a part of unemployment insurance.

<sup>23</sup>The calculator is available at <http://www.nber.org/taxsim/> and described in Feenberg and Coutts (1993). It handles various features of the tax code including Earned Income Tax Credit and AMT. It also allows for computing state tax rates.

sources of variation in  $\gamma$  will be discussed in what follows.

Table 1 shows basic summary statistics for the sample used in estimation. The average reported income is about \$45,000 dollars, compared to the average initial (i.e., 1979) income of about \$40,742 dollars. 32% of the population is single and 86% are males (virtually all tax returns filed by couples list male as a primary taxpayer). Slightly more than one half of population itemizes. The average marginal tax rate for the whole sample is 26.4% in period 1 and 24.7% in period 2, while the tax base  $(1 - \gamma)$  in both periods is on average the same at about 0.865.

### 4.3 Variation in the tax base.

There are two major aspects of the tax system that are responsible for determining the broadness of the tax base. First, deductions and adjustments explicitly exclude parts of income from taxation. As they vary, the tax base of the taxpayer varies. Second, tax bases of itemizers and non-itemizers are different. Changes in both the standard deduction and the availability of itemized deductions affect relative payoffs from being in different itemization regimes and, therefore, affect the individual itemization status even in the absence of other behavioral responses.

Importantly, the effects of such changes also vary cross-sectionally. Changes in the standard deduction affect the itemization status (and therefore the tax base) only of those individuals whose gains from itemization are small enough. The elimination of charitable deduction for non-itemizers affects the tax base of people making charitable contributions but not of the others. Changes in the medical deduction affect the tax base of itemizers who have high enough medical expenses. These effects can interact suggesting that the tax base effects are not simple functions of income (and, therefore, aiding in the identification of the effect). For example, following the repeal of the pre-1986 non-itemizer deduction for charitable contributions, a non-itemizer who relied on it may (but need not) change his itemization status. If he does not change it, his tax base will increase. If he changes the itemization status, his tax base will likely fall as deductions available to itemizers are taken advantage of.

Table 2 presents descriptive statistics showing the degree of variation of the key variables over the years for the whole sample (note that this table is based on more observations than

actually are used in the estimation — most importantly, only individuals observed in 1979 are used in the analysis). The temporal pattern indicates that tax reforms of the 1980's affected the tax base. The tax base was falling before 1986 and was sharply increased by the Tax Reform Act of 1986. Columns 7 and 8 show that the identical pattern is present for both itemizers and non-itemizers. The proportion of itemizers fell sharply following the TRA'86. If only the standard deduction had changed, the remaining itemizers would be people with relatively small tax bases. Nevertheless, the average tax base among itemizers increased sharply indicating that these changes were not simply caused by changes in the standard deduction.

Column 8 of Table 2 shows that non-itemizers do not automatically have  $\gamma$  equal zero (the tax base equal to one),<sup>24</sup> although it is not far from that. The tax base of non-itemizers was on average lower following the ERTA'81 mostly due to the availability of a deduction for charitable contributions by non-itemizers. The cross-sectional changes are illustrated in Figure 2. It shows the distribution of the tax base in 1980, 1982, 1985 and 1988 (only individuals in the sample used for estimation are included). In every year, the distribution is bimodal corresponding to groups of itemizers and non-itemizers. The ERTA'81 shifted the whole distribution to the left, while the TRA'86 shifted it back to the right.

Although I account for many changes in the tax base as discussed in Section 4.1 and enumerated in the appendix, empirically the major source of variation in the tax base is due to changing incentives for itemization caused by both reforms and periods of bracket creep. In fact, none of the results in this paper are affected in a major way if the tax base instrument would be constructed to account for the change in the itemization status only without adjustments for other changes in the definition.<sup>25</sup>

Table 3 shows mean changes and standard deviations of the key variables and instruments for the three-year pairs used in the estimation.

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<sup>24</sup>Observe that the standard deduction and dependent exemptions do not enter the definition of  $\gamma$ . Consistently with the model in Section 3, subtractions from the broad income in the numerator of  $\gamma$  include only items that can be potentially adjusted by the taxpayer.

<sup>25</sup>These results are not included in this paper. The simplified instrument was constructed by (1) comparing first period itemized deductions with the future standard deduction to determine the predicted itemization status and (2) using first-period deductions in the definition of the predicted tax base if itemization is indeed predicted by step (1) and ignoring them otherwise.

## 5 Results — Tax Rate Effect Only

I begin by considering specifications that control only for the marginal tax rate and do not include the interaction of the marginal tax rate and the tax base. By doing so, I am able to identify the source of differences in the results obtained in previous studies and present directly corresponding estimates obtained using my approach. These estimates serve as a reference point for the discussion of the role of tax base in the next section.

**Income controls.** In order to highlight the importance of the choice of income controls, I present in Table 4 estimates of the net-of-tax coefficient (i.e., the coefficient on  $\Delta \ln(\tau) \equiv \Delta \ln(1 - t)$ ) using the full sample and various means of income controls.<sup>26,27</sup> The first specification excludes income controls and leads to a significant negative coefficient. The following two specifications are as in Gruber and Saez (2002): controlling for the current income has a huge impact, but allowing for nonlinearities reduces the estimated elasticity to about 0.2. The same result was obtained by Gruber and Saez (2002).

The following four specifications highlight the importance of both the permanent and the transitory component of income. Controlling for just the transitory or just the permanent component has relatively little impact on the estimated elasticity, which remains significantly negative. This is so regardless of whether nonlinearity is allowed for. The last panel allows for both types of income controls entering in different combinations of linear and nonlinear effects. Allowing for nonlinear effects in each case significantly reduces the estimated elasticity, as in Gruber and Saez (2002). However, even when both income controls are allowed to enter in a nonlinear fashion, the estimated elasticity remains as high as 0.57. The final specification allows for separate nonlinear controls of transitory components by year (deviations from 1979 income may include aggregate trends and life-cycle effects),

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<sup>26</sup>As discussed later, these specifications are not directly comparable to the results of Gruber and Saez (2002) and Auten and Carroll (1999), because these papers additionally restrict samples used in estimation.

<sup>27</sup>All reported results come from the IV regressions. There is no evidence of the weak instrument problem for the tax base and the tax rate instruments, although the income effect instrument has low explanatory power in some specifications. Estimates of the tax and base effects are robust to not controlling for the income effect. Observations for the same individual can be present multiple times in my sample, so that I report the Huber-White standard errors clustered by individuals that are robust to non-independence of the error terms for the same individual (as well as heteroskedasticity). Only post-1979 observations are used.

and it shows that it has virtually no impact.

The second panel of Table 4 shows the results for married individuals only. Qualitatively, the results are as sensitive to the choice of income controls as in the case of the full sample. However, all of the estimated elasticities are smaller, although still significant, when any permanent-transitory mix of controls is used. The elasticity when splines in current income are used is 0.12 and insignificant, while the elasticity when splines in 1979 income and deviation from it are used is estimated at 0.26. The sensitivity of the results to restricting the sample to married individuals only is further investigated in what follows.

**Sample Selection.** As discussed above, it is important to control for the mean reverting components of income. Apart from controlling for the current level of income, earlier papers also restricted their samples by excluding certain individuals with low incomes. Gruber and Saez (2002) exclude “taxpayers whose income is below \$10000 in year 1 [in 1992 dollars], to avoid very serious mean reversion at the bottom of the income distribution.” Feldstein (1995) excludes taxpayers with tax rates below 22 percent. Similarly, Auten and Carroll (1999) limit their sample to “taxpayers with incomes at or above the threshold for the 22% marginal tax rate in 1985.” Carroll (1998) excludes taxpayers with income below \$50,000 in 1989 (approximately \$56,000 of 1992 dollars).

By relying on the realized tax rate, the selection rule used by Feldstein (1995) and Auten and Carroll (1999) likely excludes higher income individuals with low taxable income. These papers find larger elasticities than the other two papers that base their sample selection on the income directly. That this is not a coincidence is illustrated in Table 5. I use the same dataset as Gruber and Saez (2002). This dataset constitutes about 20% of the dataset used by Auten and Carroll (1999). The rest of their sample oversamples rich individuals and is not publicly available. They state that they obtain very similar results when they limit the sample to the public subset (p. 692, footnote 2). They analyze 1985-1989 difference only. Because the Feldstein (1995) and Auten and Carroll (1999) restriction depends on the tax system in place, I present the results for the 1985-1988 change only, using logarithm of income in 1985 as a control for the mean reversion problem.<sup>28</sup> Coefficients estimated based on the full sample are extremely large, suggesting that the mean reversion problem

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<sup>28</sup>Auten and Carroll (1999) report results with log income control only.



at the bottom of the distribution may be indeed important. Using the Auten and Carroll (1999) restriction to taxpayers with taxable income qualifying for at least 22% tax bracket in 1985 brings the elasticity down to about 0.8.<sup>29</sup> The Gruber and Saez (2002) restriction to individuals with current income above \$10K reduces the elasticity to less than 0.4,<sup>30</sup> while the further restriction to those with current income above \$30K makes it essentially zero (with a sample size similar to the A-C specification). These results closely track the results obtained in the corresponding papers: it appears that different sample choices played the crucial role. Compared to these differences, the effect of excluding older individuals and those subject to the AMT (cf. the first and second panels of Table 5) is minor.<sup>31</sup>

Splitting the sample according to either current income or the marginal tax rate is influenced by transitory and permanent components of income as well as individual effects. Additionally, splitting the sample according to the level of the tax rate is affected by the itemization and tax avoidance behavior. If the parameter of interest is constant, the sample selection bias will be present to the extent that factors determining selection are correlated with the error term and are not separately controlled for. Were transitory and permanent components of income and other determinants of selection appropriately controlled for, the sample selection bias should not be present. In that case, if the underlying parameter of interest is indeed constant, how the sample is split should not affect the results, contrary to the results in Table 5. The results in that table suggest a misspecification. Although in principle it is possible that one of such arbitrary restrictions will yield correct results, it is hard to a priori defend any particular choice.

The decision to split the sample may also be motivated by the belief that the underlying

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<sup>29</sup>The Auten and Carroll (1999) estimate in the directly comparable specification is 0.67.

<sup>30</sup>Mimicking the specification of Gruber and Saez (2002) (Table 4) by using the full panel, their sample restriction and weighting by income yields the tax coefficient estimate of 0.29 (with the t-statistic of 2.08), somewhat higher than their estimate of 0.17. A few small changes in the definition of total income are responsible for this minor difference.

<sup>31</sup>Although not reported here, including current income splines as in the preferred specification of Gruber and Saez (2002) renders tax coefficients in all specifications in Table 5 insignificant. With a single difference and just one tax change, allowing for nonlinearity in income eliminates income as the source of identification. This is not a problem for Gruber and Saez (2002) and this paper, because with multiple years of data one need not rely on identification off the cross-sectional variation in tax rates. However, this is the major source of identification in the context of Feldstein (1995) and Auten and Carroll (1999).

parameters vary in population. This was likely the implicit motivation of previous research that did not consider the low-income group as a valid control for high-income people who experienced the largest tax changes. Differences in behavior of the rich and the poor can be ascribed to either tastes or technology. In the framework of this paper, taste differences are accounted for by allowing for individual effects and thus should not affect the results. Differences in available technology are allowed for by controlling for the tax base. The case for the elasticity of income to vary across different groups is therefore weaker than in prior research. Therefore, I investigate how sensitive are my estimates to the sample selection and consider stability of estimates as a testable prediction of my approach.

In Table 6, I report estimates of the specification with the tax rate using my preferred specification (i.e., controlling separately and nonlinearly for the level of and deviation from 1979 income) and alternative ways of splitting the sample. The estimated elasticity for the whole sample is .57 while estimates for subsamples are all smaller and usually imprecisely estimated. However, estimates obtained by splitting the sample using 1979 income are consistently larger than those obtained by splitting the sample according to the contemporaneous income level. Results remain sensitive to the sample selection suggesting a possible specification error. The evidence for married individuals is more supportive, although none of the estimates for subsamples is significant.

## 6 Results — Tax Rate vs. Tax Base

The previous section offers a mechanical explanation for the differences in results found in previous papers. Relying on the insights regarding the relevance of sample selection and income controls, I turn now to the main question of this paper: the impact of the tax base on reported income.

Table 7 repeats the exercise reported in Table 4 while allowing for both tax rate and tax base effects. Estimates of the direct tax elasticity are as sensitive to the choice of income controls as the ones when only the tax rate is controlled for. In every specification, the interaction effect is positive and significant, but its value is also sensitive to the choice of controls. I conclude that allowing for flexible income controls is important and, in what follows, I allow for splines in both permanent and transitory components.

The main results are shown in Table 8. Estimates for the whole sample indicate that both direct tax elasticity and tax base effects are important. The direct tax elasticity is 0.441 while the coefficient on  $\gamma \ln(\tau)$  is 1.04. Evaluated at the average tax base of 0.913 (i.e.,  $\gamma = .087$ ), this corresponds to the tax elasticity of 0.53. In the sample used for estimation, following the Tax Reform Act of 1986 the average tax base increased from 0.880 in 1985 to 0.927 in 1988, so that  $\gamma$  declined from 0.120 to 0.077. Consequently, the point estimates imply that the elasticity of broad income at the average tax base fell from 0.57 to 0.52, or by about 9%.

For each way of slicing the income distribution, the direct tax elasticity is always insignificant though a little sensitive to the choice of subsample, while the effect of interaction is usually large and significant. Comparing these results to those in Table 6 reveals that estimates of the direct tax elasticity are usually smaller than those obtained when tax base effects are ignored. Combined with the interaction effect, however, the implied elasticities evaluated at the average tax base for the whole sample (which is roughly 0.9, i.e.,  $\gamma \approx 0.1$ ) are always quite close to estimates that ignore the tax base effects. Consequently, the quantitative importance of these results lies not in correcting the bias (although it does that as well), but rather in pointing to the non-structural character of the estimated parameter.

The next two panels of Table 8 show results by marital status. While one might argue that variation in marital status variations provide an additional source of identification, this is a difficult point to make, because it implies that the same behavioral model applies to both types of households. Furthermore, single individuals are likely to be predominantly young and therefore experiencing large changes in income following completion of their education. Such reasoning led Auten and Carroll (1999) to exclude individuals younger than 25 from their sample. In the absence of more detailed demographic information (in particular, having no information about age), I am not able to control for such considerations explicitly. However, splitting the sample by marital status allows to assess the relevance of this problem if most of the young individuals are single.

Table 8 reveals that results for single and married individuals are vastly different. The results for the singles are all over the map. While the estimate of the direct tax elasticity is significant and large for the whole sample, it is not significant and varies between  $-0.5$  and 1.4 for subsamples. It is very likely that many individuals in this group are working

part-time or entering the labor force while in sample, so that changes in their income are not tax motivated. Given my inability to control for other demographic characteristics of these individuals, I believe that results for single individuals are not meaningful.

The results for the sample of married individuals are, however, remarkably stable. The direct tax elasticities are always insignificant and close to zero. At the same time, the effect of the interaction is quite precisely estimated at 0.94 for the full sample and this point estimate is within one standard error of estimates for each of the considered income groups.

With very few exceptions, income effects are close to zero and insignificant.

In Table 9, I repeat the same exercise for the full sample and separately for the sample of married individuals, while controlling for splines in the current income only as in Gruber and Saez (2002). The results using full sample are in some cases sensitive to this change, but the results for married individuals are quite consistent with previous conclusions.

Table 10 shows results for restricted subsamples (using both permanent and transitory splines). The first column presents the results obtained when the sample is limited to individuals who were observed in all years. Estimates for married individuals only are essentially identical as those in Table 8. When both married and single individuals are included, the direct elasticity becomes insignificant but the interaction effect remains unaffected. This pattern reinforces the impression that unobserved heterogeneity among single individuals is not appropriately controlled for and strengthens the case for concentrating on the results for married individuals only.

The following specifications in Table 10 show the results when the sample is limited to rely on selected tax changes only. Using only differences starting between 1980 and 1982 eliminates the Tax Reform Act of 1986 from the analysis, while using 1983-1987 eliminates the ERTA'81. Results in both cases qualitatively resemble those obtained earlier although point estimates are sensitive. It should be reminded here that extensive controlling for income makes identification based on a single reform tenuous.

All the specifications up to this point included years directly adjacent to the reforms. This is potentially a problem, because income in these years may reflect short-term re-timing responses. In principle, such responses should be controlled for by my strategy for dealing with the impact of transitory shocks and should not affect the results. As an alternative and an informal specification check, the fourth specification limits the sample to just two

three-year differences: 1980-1983 and 1985-1988 that span both major tax reforms, but do not include years immediately before or after them. It is comforting to see that these results are essentially identical as the results based on the full sample (although standard errors are predictably larger).

The last two specifications show the results using either only 1980-1983 or 1985-1988 differences. None of the tax elasticities are significant anymore. These results suggest that the effect is difficult to identify based on a single reform, and moreover it probably cannot be identified at all without a few years of data: without multiple tax law changes, conditional on permanent and transitory income measures there is very little variation in the instruments left.<sup>32</sup>

## 7 Discussion and Implications

I interpret the results as indicating that, apart from the difficulty controlling for transitory and permanent shocks in income, previous studies suffered from two additional problems. First, the model was mis-specified due to ignoring the effect of the tax base. Second, the results indicate that mixing individuals with different marital status while identifying the effect of taxes on income is suspect (at least, given scarce demographic information).

Tables 8, 9 and 10 contain the major results. Results for married individuals are consistent across all considered specifications: the direct effect of the tax rate is small and insignificant while the interaction term is in most cases of the order of 0.9 and comfortably significant. The results based on the full sample are not reliable, although they also appear to indicate that the interaction term plays an important role. Therefore, I concentrate on

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<sup>32</sup>A number of other specification checks was performed as well. One possibility is that functional form restrictions cause the tax base variable to pick up the impact of the tax rate so that the results are spurious. In order to test the role of linearity, the specification with the marginal tax rate squared (with the instrument defined accordingly) was estimated. The coefficient on the tax base interacted with the tax rate was 1.15 for the full sample and .95 for the sample of married individuals, significant at 1% level in both cases. The tax coefficients were insignificant and very small for the sample of married individuals. For the full sample, only the squared rate was significant, the estimated tax part of the equation was  $-0.24[\text{std. error:}.29]\Delta \ln(\tau) - .85[.28]\Delta \ln(\tau)$ . Evaluated at the mean log tax rate of  $-.29$ , the implied elasticity is  $-.002$ . Despite this (weak) evidence of possible nonlinearity in the tax rate, I conclude that the linearity assumption does not appear to affect the results in an economically way.

the results for married individuals in developing normative implications of the results. I use the results for all married individuals, i.e., the first specification in the second panel of Table 8. The estimated direct tax elasticity is 0.086 while the estimated effect of the interaction with the tax base is 0.942. These results imply that an individual who has no access to any deductions would not respond to changes in the tax rates. The more deductions are available, the stronger the response.

Are these results reasonable? As highlighted by the theoretical model, the strength of estimated response reflects the degree of substitutability of broad income and deductible commodities. The estimated coefficient indicates that broad income and deductible commodities are strong substitutes: a decrease in the price of deductible commodities (higher tax rate) leads to a significant reduction in the level of broad income. Thus, for example, the results are consistent with lower prices of charitable contributions or medical care leading to less labor supply and, therefore, less income reported on the tax return.

As Table 2 shows, the mean marginal tax rate fell from 0.212 in 1985 to 0.184 in 1988, while the mean average tax base increased from 0.880 to 0.927. The estimated results suggest therefore that the Tax Reform Act of 1986 reduced the elasticity of reported income to the tax rate at the mean tax base from 0.199 to 0.155.<sup>33</sup> There are two reasons for the change. First, the tax reform had a mechanical effect on the tax base, absent behavioral response. Second, under the new tax environment taxpayers adjusted their behavior and, consequently, there has been some endogenous change in the tax base. The last effect could be present even if only tax rates changed but it would have been ignored by the standard analysis.

One simple implication of this result can be described by using the marginal cost of funds (MCF). The simple formula for the MCF of the linear income tax is  $MCF = \frac{1}{1 - \frac{t}{1-t}\pi}$ , where  $t$  is the marginal tax rate and  $\pi$  is the elasticity of taxable income. I proceed by replacing  $\pi$  by the estimate of the reported income elasticity at the mean:  $\varepsilon + \bar{\gamma}\beta$ . Evaluating this formula at the mean tax rates yields the 1985 value of the  $MCF$  of 1.057 and the 1988 value of 1.036. Interpreting these numbers, they imply that the social cost of collecting a dollar of revenue fell by 2 cents per dollar. Alternatively, given estimated null income response,

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<sup>33</sup>I find no evidence to conclude that the income effect is different from zero, so that compensated and uncompensated income elasticities are assumed to be equal.

it directly translates into a reduction in the marginal excess burden by 36%, from 0.057 cents per dollar to 0.036. Holding the tax base constant at the initial level, the same change in the marginal tax rate would have reduced the MCF to just 1.047, resulting in the 50% smaller excess burden reduction. While these are not definitive calculations, they illustrate the potential quantitative importance of understanding the role of non-tax instruments in evaluating the efficiency cost of tax policy.

These results also indicate that the elasticity of reported income may well be different for different groups, to the extent that their tax bases are different. The results in Table 8 indicate (using the average tax base in each group and the estimates for the full married sample) that the elasticity of income for people below the \$30,000 threshold was 0.157 while the corresponding elasticity for people with incomes above \$100,000 was 0.285. These differences are much smaller than estimated by Gruber and Saez (2002). Even though they still systematically vary with income, they do not necessarily imply that tax rates at high incomes need to be adjusted to account for stronger behavioral response: the differences in elasticities are themselves a function of policy. Finally, accounting for the tax base effects offers a positive framework for understanding differences in behavioral elasticities across countries: estimates for different countries may vary reflecting different tax systems in place.

To be sure, there are complicating factors that are in no way addressed in this paper and that may be very relevant. To the extent that the estimated response merely reflects shifting from other tax bases such as the corporate or capital gains tax, the elasticity of reported income should be supplemented by losses or gains of revenue from other sources. Accounting for such responses could undermine calculations performed above.

Additionally, the elasticity of income determines only the cost of taxation, while any complete analysis of policy requires understanding benefits as well. There may be trade-offs involved in the choice of tax base to the extent that deductions from the tax base are socially beneficial on, for example, redistributive grounds. Also, a broader tax base may feature different administrative costs (Yitzhaki, 1979; Wilson, 1989).

The response estimated in this paper reflects the response of broad income rather than its taxable component: what is estimated is the elasticity of  $B$  rather than  $\gamma B$ . A proper estimation of the response of taxable income would require accounting for changes in its

definition on the left-hand side of the estimated relationship. A more complex econometric framework that models, *inter alia*, itemization decision is necessary for that. There is, however, evidence that at least some of deductions (e.g., charitable contributions) respond strongly to tax rates. By eliminating such responsive components from the tax base, the elasticity of taxable income can be reduced beyond the effect analyzed in this paper but, while they remain taxable, the elasticity of taxable income is likely higher than the broad income elasticity. For that reason, caution should be exercised in interpreting the results in this paper as providing the complete measure of the cost of taxation. It is intuitive to expect that the taxable income elasticity is both larger and more sensitive to the tax base, although theoretically the reverse is also possible. Estimating the taxable income elasticity directly should be an interesting area for future research.

The bottom line is that any analysis of the cost of taxation should not ignore the fact that the crucial elasticity of taxable income is endogenous to the size of the tax base and, more generally, to other aspects of tax system. Putting these results in a broader perspective, this paper lends empirical support for the theoretical ideas advanced by e.g., Mayshar (1991); Slemrod (1994, 2001) and Slemrod and Kopczuk (2002). The cost of taxation is not merely a function of marginal tax rates, consumer preferences and technology, but rather it crucially depends on a broader tax environment and the structure of tax policy. Therefore, economic analysis of the optimal tax policy has to incorporate tax avoidance and administration.

Finally, the non-tax-rate effect stressed in this paper can be relevant for any analysis of the effects of taxation on other economic variables. As a general lesson, one should be careful in making the standard assumption that tax reforms are natural experiments that can be used to identify the effect of taxation on economic variables. Such exercises usually assume that the elasticity of response is constant, while major changes in the tax system are likely to invalidate this assumption: tax elasticities are fundamentally non-structural parameters. As demonstrated here, acknowledging this issue does not necessarily eliminate usability of tax reforms as a source of variation, but it calls for a more comprehensive account of the changes that they induce.



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## A Data.

The dataset used is the panel extract of the SOI Tax Model collection of individual income tax returns available from the University of Michigan Office of Tax Policy Research. The documentation of this dataset can be found online at <http://www.nber.org/~taxsim/iit-docs/>. The definition of broad income includes wages, dividends and interest income (with excluded components), unemployment income, pensions, annuities, IRA distributions, alimony received, state tax refunds, partnership and S-corporation income, Schedule C income, farm income, rental income and royalties, and other income. Capital gains are not included. Passive losses are added back because they are not consistently observable before and after TRA'86. Income adjustments and total deductions include all items reported on the tax returns. The marginal tax rates are obtained by applying the TAXSIM calculator to the actual AGI (including capital gains and reduced by non-itemizer deduction for charitable contributions between 1982 and 1986), total itemized deductions and claimed exemptions. The tax base  $1 - \gamma$  is computed as the ratio of broad income less total adjustments and total deductions (excluding state and local income tax deduction but including non-itemizer charitable contribution deduction) over broad income. Low income individuals with no tax liability who do not claim any deductions have the tax base of 1.

Not all variables from the tax returns are present for all years. Some effort was undertaken to correct certain missing values. Past state of residence, if known, was used if state of residence is missing. Standard deduction was used to recover age and blindness status if missing. Total Schedule E income is missing in 1981 but can be constructed from its components. Royalty and rental income are not available in 1987 but can be approximated based on other Schedule E variables.

While constructing instruments, all variables were inflated using the three-year CPI change. The predicted marginal tax rate was computed by applying the TAXSIM calculator for the second year in the pair to broad income, total adjustments and deductions recalculated using the new definition, and claimed exemptions. Capital gains were not included. The results are not sensitive to the inclusion of capital gains and to not adjusting deductions. The predicted tax base was calculated by first recalculating total adjustments and total deductions using the new definition and then calculating the ratio as before. Changes in the tax base that were accounted for include changes in the threshold for medical deduction, changes in the deduction for health insurance, changes in the rules governing deductibility of personal interest expenses following TRA'86, changes in the threshold for theft and casualty loss deduction, changes in the non-itemizer charitable contribution deduction, changes in the IRA deduction and changing status of moving cost income adjustment to a deduction following TRA'86. The computed predicted value of deductions was compared to the new standard deduction to determine predicted itemization status. For individuals before 1984 who were predicted to change their status to non-itemizers, the non-itemizer charitable deduction was instead allowed for. The total and predicted tax liability used in constructing the instrument for income effects was taken from the corresponding TAXSIM results.

Table 1: Summary Statistics

Variable	Mean	Std. Dev.	N
Current Income (1992 dollars)	44815	61322	41442
Income in 1979 (1992 dollars)	40742	34665	41442
Single	0.324	0.468	41442
Male	0.859	0.348	41442
Itemizers	0.516	0.500	41442
$t_1$	0.264	0.111	41442
$t_2$	0.247	0.101	41442
$1 - \gamma_1$	0.864	0.164	41442
$1 - \gamma_2$	0.866	0.165	41442
$\Delta \ln(B)$	0.038	0.625	41442
$\Delta \ln(\tau)$	0.026	0.122	41442
$\Delta \ln(\tau^P)$	0.032	0.058	41442
$\Delta \gamma \ln(\tau)$	0.005	0.040	41442
$\Delta \gamma^P \ln(\tau^P)$	0.009	0.019	41442
$\Delta \ln(X)$	0.043	0.578	41388
$\Delta \ln(X^P)$	0.011	0.059	41425

$\tau$  denotes the marginal tax rate.  $1 - \gamma$  is the tax base.  $B$  represents broad income and  $X$  is equal to broad income less the tax liability. Subscripts  $i = 1, 2$  refer to the first and second year in each three-year difference. The “ $P$ ” superscripts mark instruments (predicted values of variables) as defined in text. Definitions of other variables are as follows:  $\Delta \ln(B) = \ln(B_2/B_1)$ ,  $\Delta \ln(\tau) = \ln(\tau_2/\tau_1)$ ,  $\Delta \ln(\tau^P) = \ln(\tau^P/\tau_1)$ ,  $\Delta \gamma \ln(\tau) = \gamma_2 \ln(\tau_2) - \gamma_1 \ln(\tau_1)$  and  $\Delta \gamma^P \ln(\tau^P) = \gamma_P \ln(\tau^P) - \gamma_1 \ln(\tau_1)$ ,  $\Delta \ln(X^P) = \ln(X^P) - \ln(X)$ . Sample includes all 3-year differences used for estimation.

Table 2: Means of Selected Variables by Year of Filing

Year	Number	$t$	$1 - \gamma$	$t(1 - \gamma)$	Share Item.	Tax Base Item.	N-Item.
1979	45393	0.225	0.926	0.205	0.284	0.762	0.991
1980	45781	0.234	0.920	0.213	0.306	0.760	0.990
1981	46250	0.243	0.913	0.219	0.328	0.756	0.990
1982	9445	0.229	0.897	0.203	0.350	0.735	0.984
1983	18833	0.216	0.891	0.190	0.363	0.731	0.982
1984	9862	0.213	0.884	0.186	0.384	0.729	0.981
1985	19878	0.212	0.880	0.184	0.390	0.724	0.980
1986	10285	0.211	0.874	0.182	0.388	0.720	0.972
1987	21002	0.191	0.919	0.174	0.338	0.776	0.992
1988	21553	0.184	0.927	0.170	0.292	0.770	0.992
1989	22031	0.185	0.928	0.170	0.287	0.767	0.993
1990	21977	0.184	0.922	0.169	0.288	0.756	0.989
Summary	292290	0.215	0.913	0.195	0.325	0.753	0.988

Definitions of variables are as in Table 1. All observations present in the dataset (not just those used in the estimation) are used.

Table 3: Means of Selected Variables by Year of Filing.

	N	$\Delta \text{Item.}$	$\Delta \ln(B)$	$\Delta \ln(\tau)$	$\Delta \ln(\tau^P)$	$\Delta \gamma \ln(\tau)$	$\Delta \gamma^P \ln(\tau^P)$
1979-1982	5277	-0.060 (0.154)	0.086 (0.724)	-0.016 (0.135)	-0.016 (0.042)	-0.011 (0.037)	-0.001 (0.009)
1980-1983	9286	-0.073 (0.151)	0.048 (0.679)	0.025 (0.128)	0.024 (0.042)	-0.008 (0.037)	0.004 (0.013)
1981-1984	4322	-0.074 (0.147)	0.034 (0.643)	0.046 (0.128)	0.043 (0.048)	-0.006 (0.040)	0.007 (0.017)
1982-1985	4057	-0.016 (0.108)	0.058 (0.634)	0.019 (0.122)	0.025 (0.036)	-0.004 (0.036)	0.005 (0.011)
1983-1986	3827	-0.007 (0.108)	0.073 (0.635)	-0.003 (0.120)	0.007 (0.030)	-0.008 (0.039)	0.002 (0.010)
1984-1987	3631	0.046 (0.127)	0.053 (0.633)	0.025 (0.120)	0.047 (0.060)	0.018 (0.038)	0.014 (0.022)
1985-1988	6867	0.060 (0.131)	0.025 (0.610)	0.041 (0.118)	0.052 (0.076)	0.024 (0.040)	0.019 (0.024)
1986-1989	3278	0.063 (0.137)	0.014 (0.574)	0.040 (0.119)	0.054 (0.078)	0.028 (0.043)	0.022 (0.027)
1987-1990	6174	0.004 (0.128)	0.009 (0.548)	0.012 (0.110)	0.013 (0.054)	0.003 (0.032)	0.006 (0.018)
Summary	46719	-0.013 (0.146)	0.044 (0.637)	0.021 (0.124)	0.026 (0.058)	0.003 (0.040)	0.008 (0.019)

Columns show mean differences of variables. Standard deviations are in parenthesis. Sample includes all 3-year differences used for estimation and 1979-1982 observations selected using the same rule. Definitions of variables are as in Table 1.

Table 4: Tax Rate IV Regressions Using Different Approaches to Controlling for Permanent and Transitory Components of Income

	$\Delta \ln(\tau)$	T-value
Full Sample		
No income controls	-0.80	-10.99
Logarithm of current income	1.44	10.19
Splines of log current income	0.21	1.89
Logarithm of 1979 income	-0.32	-3.71
Splines of log of 1979 income	-0.59	-7.14
Deviation of log current income from log 1979 income	-0.52	-6.47
Splines of the above	-0.45	-5.75
Log of 1979 income and log of deviation from it	1.37	9.90
Log of 1979 income and splines of deviations	0.93	7.46
Splines of log of 1979 income and log of deviation	0.89	7.24
Splines of log of 1979 income and splines of log-deviations	0.57	4.89
Splines of log of 1979 income and yearly splines of log-deviations	0.55	4.78
Married individuals only		
No income controls	-0.34	-4.10
Logarithm of current income	0.90	6.34
Splines of log current income	0.12	1.07
Logarithm of 1979 income	-0.25	-2.66
Splines of log of 1979 income	-0.32	-3.41
Deviation of log current income from log 1979 income	0.03	0.36
Splines of the above	-0.06	-0.66
Log of 1979 income and log of deviation from it	0.76	5.76
Log of 1979 income and splines of deviations	0.32	2.75
Splines of log of 1979 income and log of deviation	0.62	4.86
Splines of log of 1979 income and splines of log-deviations	0.26	2.26
Splines of log of 1979 income and yearly splines of log-deviations	0.26	2.26

Sample size is 41,442 for the full sample and 28,025 for the sample of married individuals (1979-1982 pair is excluded). All regressions include gender and marital status (where applicable), as well as the full set of year dummies. “Splines” refer to a flexible piecewise linear functional form (10 components). The tax rate instrument is described in the text.

Table 5: Tax Rate IV Regressions — Sensitivity to Sample Selection Using 1985-1988 Data and Previous Methodology

	Restricted Sample (A+C)				Full Sample (G+S)			
	All	A+C	G+S	G+S 30K	All	A+C	G+S	G+S 30K
1985-1988 Only								
$\Delta \ln(\tau)$	2.343 (.263)**	.882 (.237)**	.387 (.199)	.011 (.191)	2.721 (.237)**	.845 (.205)**	.347 (.167)*	.0008 (.161)
$\ln(B)$	-.503 (.022)**	-.115 (.027)**	-.127 (.02)**	.009 (.025)	-.488 (.021)**	-.108 (.025)**	-.081 (.017)**	.014 (.024)
N	11280	5203	9052	5659	13621	5982	11073	6513

The restricted sample excludes couples with at least one age or blindness exemption and subject to the AMT (for comparability with Auten and Carroll (1999) and Gruber and Saez (2002)). Compared to other specifications in this paper, this sample does not exclude individuals who are not observed in 1979, those filing as the “head of households” or those with non-positive 1979 income. The specification marked: (1) “all” does not impose additional restrictions; (2) A+C removes taxpayers with federal tax rate below 22%; (3) G+S eliminates taxpayers with total income below 10,000 (1992 dollars) (4) G+S 30K eliminates taxpayers with total income below 30,000 (1992 dollars). All regressions include gender and marital status (where applicable), as well as the full set of year dummies.

Table 6: Tax Rate IV Regressions — Sensitivity to Sample Selection Using Controls for Permanent and Transitory Income Components

	NR	Current income		1979 income				
		> 10K	> 30K	< 30K	> 10K	> 30K	> 50K	> 100K
Full Sample								
$\Delta \ln(\tau)$	.568 (.116)**	.195 (.101)	.083 (.107)	.434 (.237)	.306 (.11)**	.244 (.119)*	.376 (.147)*	.258 (.265)
N	41442	37295	25180	17158	35627	24284	12602	1529
Married Individuals								
$\Delta \ln(\tau)$	.259 (.115)*	.157 (.108)	.035 (.113)	-.088 (.249)	.205 (.113)	.165 (.121)	.254 (.141)	.254 (.262)
N	28025	27361	21954	6066	27509	21959	12078	1448
Single Individuals								
$\Delta \ln(\tau)$	1.113 (.335)**	.244 (.275)	.121 (.369)	1.046 (.456)*	.634 (.355)	.410 (.442)	1.031 (.791)	1.522 (2.309)
N	13417	9934	3226	11092	8118	2325	524	81

All regressions include gender and marital status (where applicable), as well as the full set of year dummies. 10-piece linear splines in 1979 income and in deviation of the current income for 1979 income are used. Instruments as described in text.

Table 7: Tax Rate and Tax Base IV Regressions — Sensitivity to Sample Selection Using Controls for Permanent and Transitory Income Components

	$\Delta \ln(\tau)$	<b>T-val</b>	$\Delta \gamma \ln(\tau)$	<b>T-val</b>	$\Delta \ln(X)$	<b>T-val</b>
Full Sample						
No income controls	-0.86	-9.06	0.53	2.19	0.08	0.54
Logarithm of current income	1.18	4.53	2.02	5.58	-0.02	-0.14
Splines of log current income	0.04	0.40	0.70	3.11	0.10	1.47
Logarithm of 1979 income	-0.47	-5.96	0.94	3.43	0.08	0.54
Splines of log of 1979 income	-0.68	-8.07	0.65	2.55	0.07	0.52
Deviation of log current income from log 1979 income	-0.60	-7.24	0.51	2.09	0.03	0.25
Splines of the above	-0.54	-6.93	0.65	2.97	0.04	0.59
Log of 1979 income and log of deviation from it	1.17	4.73	1.89	5.48	-0.04	-0.29
Log of 1979 income and splines of deviation	0.70	4.13	1.61	5.71	0.01	0.05
Splines of log of 1979 income and log of deviation	0.81	4.30	1.30	4.25	-0.06	-0.51
Splines of log of 1979 income and splines of log-deviations	0.44	3.15	1.06	4.08	0.01	0.13
Splines of log 1979 income and yearly splines of log-deviations	0.41	3.04	0.97	3.73	0.04	0.49
Married Individuals Only						
No income controls	-0.42	-5.28	0.42	1.51	0.10	0.52
Logarithm of current income	0.59	2.77	1.45	3.81	0.08	0.53
Splines of log current income	-0.10	-1.09	0.92	4.02	0.19	3.06
Logarithm of 1979 income	-0.35	-4.08	0.50	1.75	0.10	0.53
Splines of log of 1979 income	-0.41	-4.75	0.51	1.76	0.09	0.44
Deviation of log current income from log 1979 income	-0.09	-0.83	0.65	2.26	0.05	0.36
Splines of the above	-0.18	-2.07	0.62	2.61	0.11	1.80
Log of 1979 income and log of deviation from it	0.53	2.91	1.31	3.81	0.05	0.38
Log of 1979 income and splines of deviation	0.13	1.16	0.94	3.70	0.11	1.75
Splines of log of 1979 income and log of deviation	0.45	2.55	1.28	3.70	0.01	0.07
Splines of log of 1979 income and splines of log-deviations	0.09	0.78	0.94	3.67	0.10	1.55
Splines of log 1979 income and yearly splines of log-deviations	0.08	0.75	0.89	3.45	0.12	1.87



Table 8: Tax Rate and Tax Base IV Regressions Using Controls for Permanent and Transitory Income Components

	NR	Current income		1979 income				
		> 10K	> 30K	< 30K	> 10K	> 30K	> 50K	> 100K
$\Delta \ln(\tau)$	.441 (.139)**	.150 (.115)	.091 (.123)	.410 (.293)	.219 (.124)	.109 (.117)	.162 (.133)	-.028 (.214)
$\Delta \gamma \ln(\tau)$	1.045 (.26)**	.528 (.231)*	.613 (.279)*	.997 (.664)	.771 (.26)**	.890 (.255)**	.902 (.313)**	.712 (.411)
$\Delta \ln(X)$	.010 (.082)	.014 (.084)	-.067 (.104)	-.036 (.154)	.003 (.084)	.061 (.079)	.114 (.078)	.255 (.075)**
N	41388	37248	25143	17147	35578	24241	12574	1517
$\bar{\gamma}$	.128	.139	.167	.076	.143	.174	.194	.211
Married Individuals								
$\Delta \ln(\tau)$	.086 (.11)	.046 (.106)	-.020 (.115)	-.232 (.192)	.049 (.108)	.044 (.119)	.096 (.132)	.022 (.226)
$\Delta \gamma \ln(\tau)$	.942 (.257)**	.713 (.234)**	.793 (.267)**	.896 (.616)	.867 (.26)**	.889 (.27)**	.889 (.329)**	.670 (.452)
$\Delta \ln(X)$	.099 (.064)	.098 (.068)	.015 (.092)	.282 (.103)**	.094 (.066)	.043 (.085)	.077 (.088)	.191 (.094)*
N	27978	27319	21919	6058	27464	21920	12051	1436
$\bar{\gamma}$	.164	.167	.175	.118	.165	.179	.194	.212
Single Individuals								
$\Delta \ln(\tau)$	1.364 (.573)*	.414 (.388)	.384 (.483)	1.43 (.806)	1.126 (.656)	.171 (.384)	.184 (.622)	-.530 (.975)
$\Delta \gamma \ln(\tau)$	.811 (.837)	-.171 (.634)	-.682 (.723)	.704 (1.165)	.042 (.819)	.855 (.767)	1.321 (1.13)	2.730 (1.983)
$\Delta \ln(X)$	-.153 (.208)	-.148 (.171)	-.172 (.175)	-.22 (.248)	-.313 (.247)	.213 (.155)	.31 (.136)*	.633 (.079)**
N	13410	9929	3224	11089	8114	2321	523	81
$\bar{\gamma}$	.07	.084	.127	.054	.091	.141	.183	.197

All regressions include gender and marital status (where applicable), as well as the full set of year dummies. 10-piece linear splines in 1979 income and in deviation of the current income for 1979 income are used. Instruments as described in text.

Table 9: Tax Rate and Tax Base IV Regressions Using Splines in Current Income

	NR	Current income		1979 income				
		> 10K	> 30K	< 30K	> 10K	> 30K	> 50K	> 100K
$\Delta \ln(\tau)$	.044 (.106)	.026 (.105)	.034 (.118)	.047 (.241)	.003 (.105)	.022 (.108)	.066 (.125)	-.099 (.207)
$\Delta\gamma \ln(\tau)$	.692 (.227)**	.522 (.217)*	.626 (.271)*	.194 (.565)	.719 (.237)**	.884 (.239)**	.845 (.295)**	.711 (.392)
$\Delta \ln(X)$	.104 (.072)	.065 (.08)	-.047 (.106)	.03 (.118)	.095 (.078)	.132 (.076)	.143 (.071)*	.272 (.07)**
N	41388	37248	25143	17147	35578	24241	12574	1517
Married Individuals								
$\Delta \ln(\tau)$	-.101 (.094)	-.079 (.097)	-.09 (.107)	-.263 (.191)	-.141 (.093)	-.048 (.109)	-.004 (.121)	-.062 (.216)
$\Delta\gamma \ln(\tau)$	.918 (.229)**	.730 (.215)**	.812 (.247)**	.935 (.572)	.877 (.233)**	.883 (.25)**	.826 (.303)**	.658 (.429)
$\Delta \ln(X)$	.189 (.062)**	.152 (.062)*	.064 (.087)	.317 (.104)**	.177 (.065)**	.125 (.086)	.131 (.077)	.214 (.092)*
N	27978	27319	21919	6058	27464	21920	12051	1436

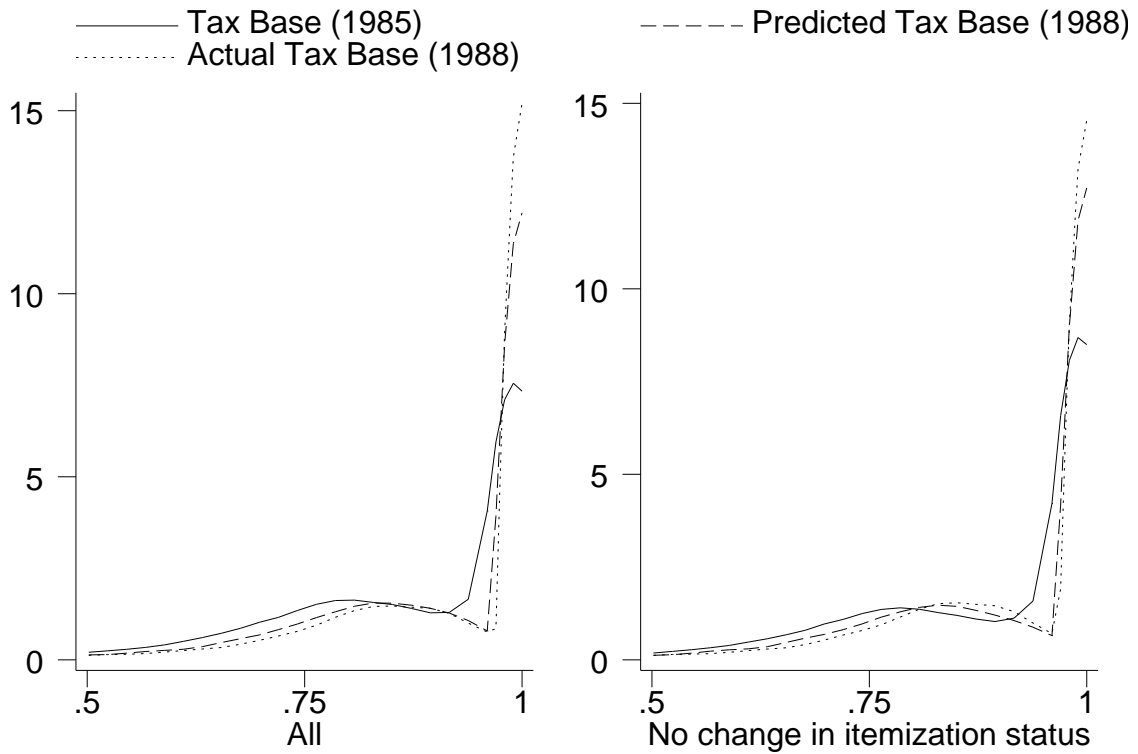
All regressions include gender and marital status (where applicable), as well as the full set of year dummies. 10-piece linear splines in current income is used. Instruments as described in text.

Table 10: Tax Rate and Tax Base IV Regressions — Subsamples

	Balanced panel	Difference with the initial year in . . .				
		1980-1982	1983-1987	1980 and 1985	1980	1985
Full sample						
$\Delta \ln(\tau)$	.213 (.158)	.086 (.17)	.535 (.174)**	.407 (.199)*	-.023 (.181)	1.008 (.735)
$\Delta\gamma \ln(\tau)$	.935 (.289)**	.998 (.531)	.814 (.281)**	.948 (.388)*	.643 (.72)	.911 (.724)
$\Delta \ln(X)$	-.01 (.105)	.031 (.119)	.068 (.081)	.072 (.115)	.198 (.085)*	-.295 (.548)
N	24649	17653	23735	16136	9280	6856
Married individuals						
$\Delta \ln(\tau)$	-.027 (.126)	-.063 (.154)	.064 (.134)	.179 (.214)	-.075 (.202)	.076 (.299)
$\Delta\gamma \ln(\tau)$	.969 (.269)**	1.273 (.558)*	.62 (.266)*	.922 (.465)*	.665 (.811)	.508 (.528)
$\Delta \ln(X)$	.105 (.07)	.092 (.134)	.167 (.062)**	.039 (.216)	.187 (.176)	.106 (.314)
N	18091	11431	16547	10689	5891	4798

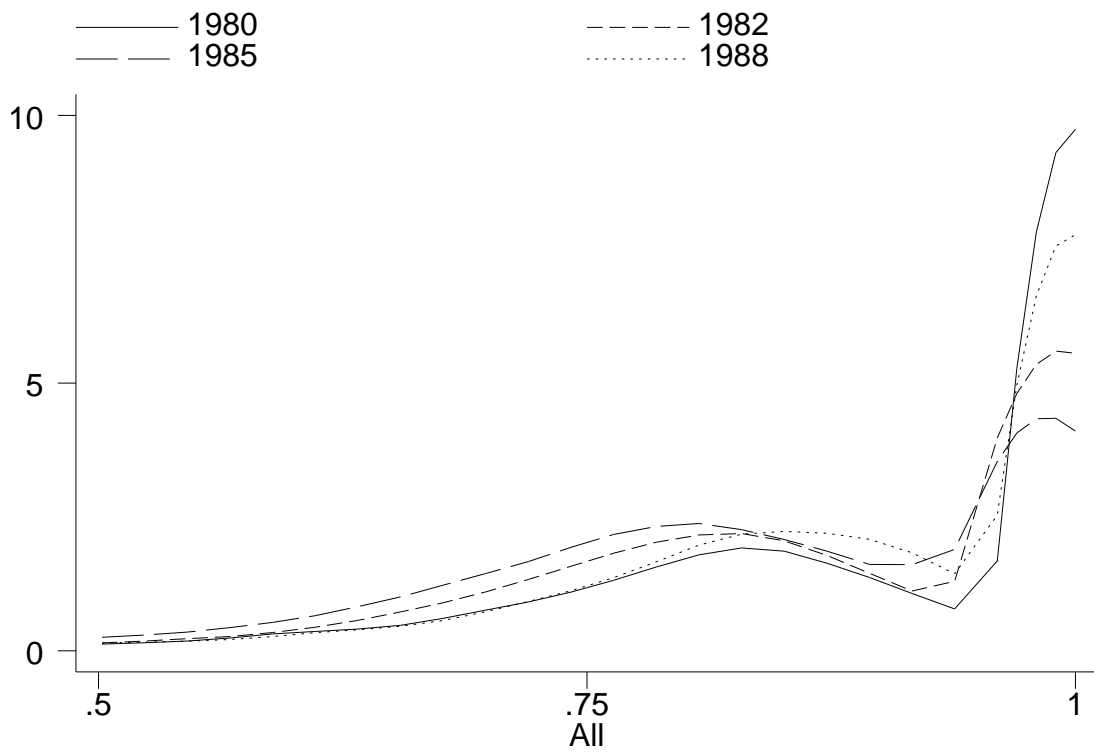
All regressions include gender and marital status (where applicable), as well as the full set of year dummies. 10-piece linear splines in 1979 income and in deviation of the current income for 1979 income are used. Instruments as described in text.

Figure 1: Distribution of the Actual and Predicted Tax Bases in 1985 and 1988



**Notes:** Tax base is represented on the horizontal axis. The tax base varies between 0 and 1, as defined in text, the graphs are however truncated at 0.5 because few observations have values smaller than 0.5. The vertical axis represents the estimated density value. The probability distribution functions were estimated using kernel density estimator with the Epanechnikov kernel using Stata 7 default “optimal” setting of bandwidth (procedure *kdensity*).

Figure 2: Distribution of the Average Tax Base in 1980, 1982, 1985 and 1988



**Notes:** See notes corresponding to Figure 1.