

FIGURE 21-1 Taxation and the Consumption-Leisure Trade-Off • Before taxes are introduced, Taylor loses \$15.00 worth of consumption for each hour of leisure she takes. After tax $\tau = 0.3$ is imposed, Taylor's after-tax wage is $\$15.00 \times (1 - 0.3) = \10.50 . Because some of Taylor's wages go to pay taxes, she they now get less consumption ($C_2 = \$11,500$) for the same amount of work/leisure.

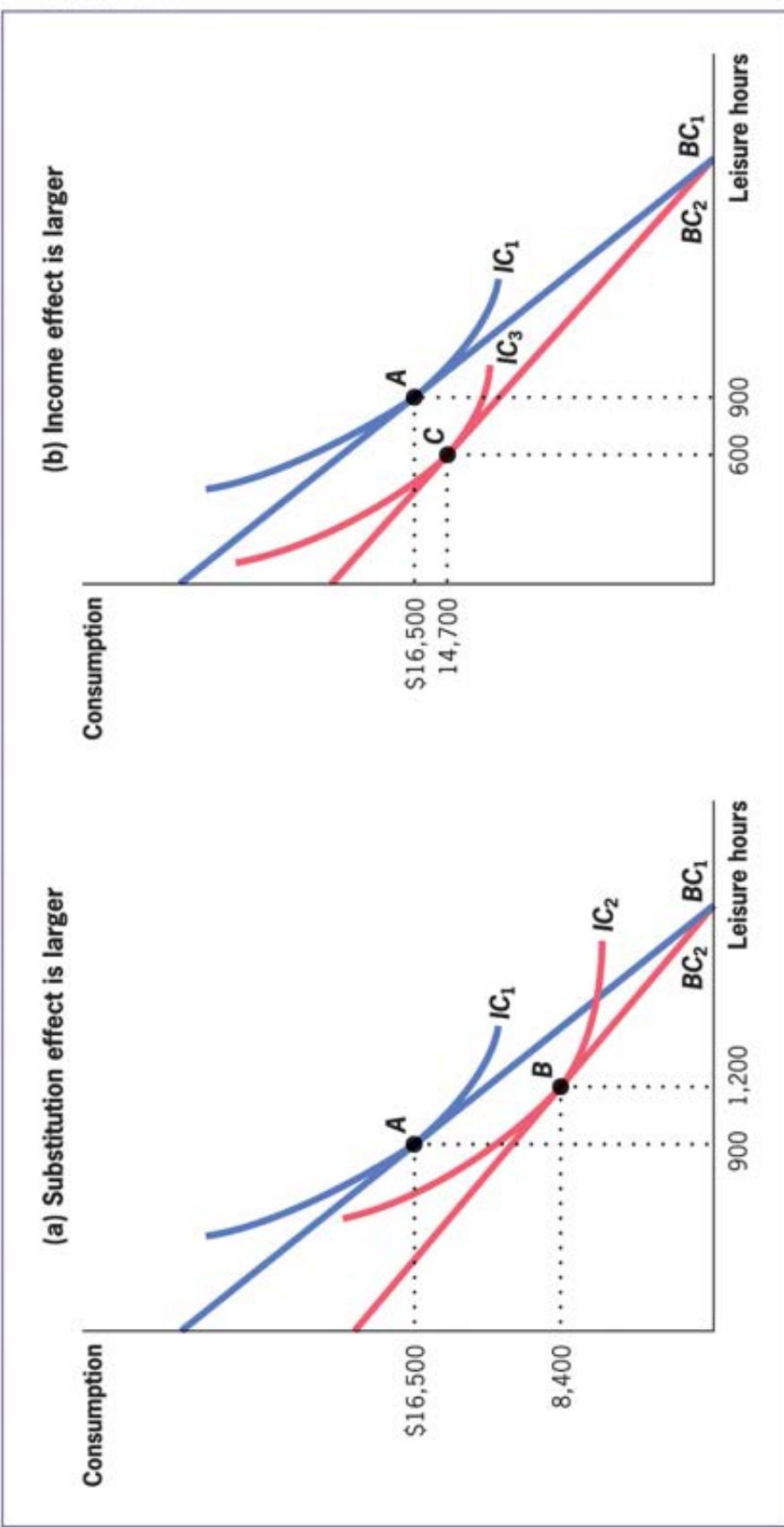


FIGURE 21-2 Substitution Effect Versus Income Effect • In both panels, a tax on labor income shifts the budget constraint inward from BC_1 to BC_2 . (a) If the substitution effect of the change in the after-tax wage is larger, work is less attractive, and Taylor chooses to have more leisure, moving to 1,200 hours of leisure at point B. (b) If the income effect is larger, Taylor feels poorer and thus reduces her leisure (increases her work hours) in order to regain some of that lost income, moving to 600 hours of leisure at point C.

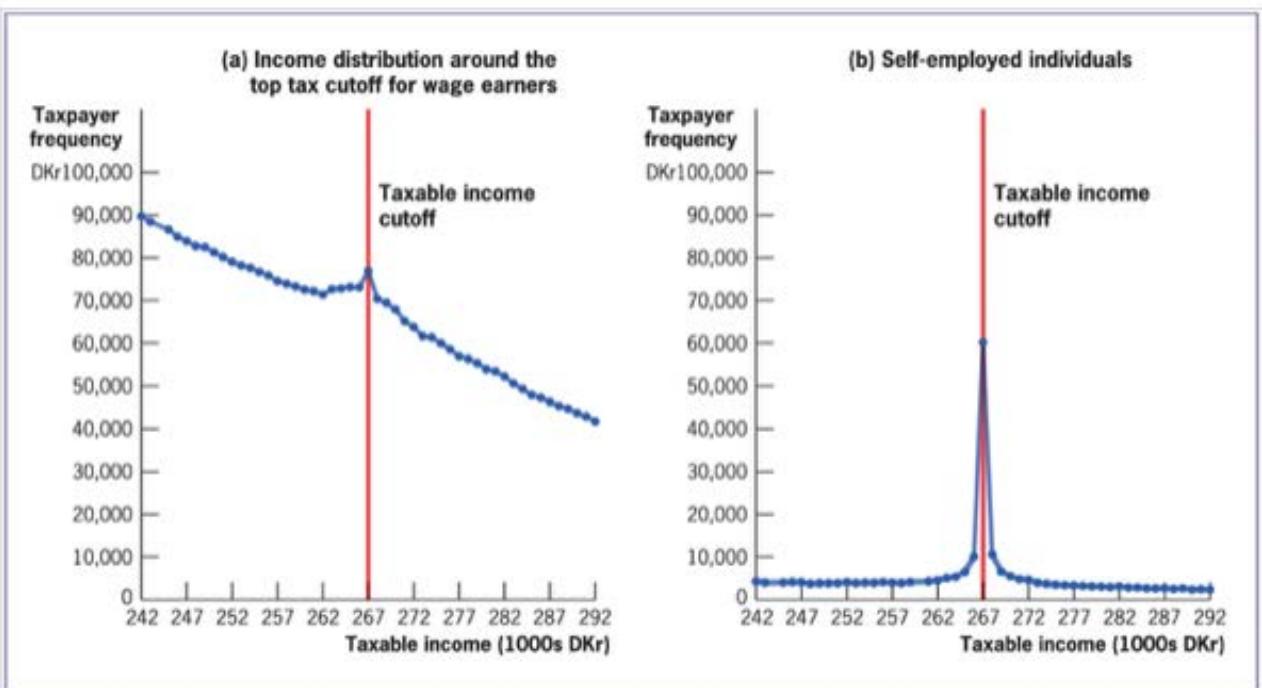


FIGURE 21-3 Distribution of Incomes Around a Tax Rate Increase • This figure illustrates the effect of taxes on labor supply by showing how earners “bunch” their earnings right before taxes increase to minimize the amount of taxes they have to pay. In panel (a), we see that the number of wage-earning taxpayers with taxable incomes steadily decreases as incomes grow larger. However, there is a break in the trend between those earning 262,000 Danish kroner (DKr) and those earning 267,000 DKr, the income at which the tax rate increases, with a sizeable “bunching” of taxpayers right before that cutoff. Panel (b) shows that the number of self-employed taxpayers filing with high incomes is relatively low compared to wage earners, but they show far more responsiveness to the tax rate increase.

Data from: [Chetty et al. \(2011\)](#).

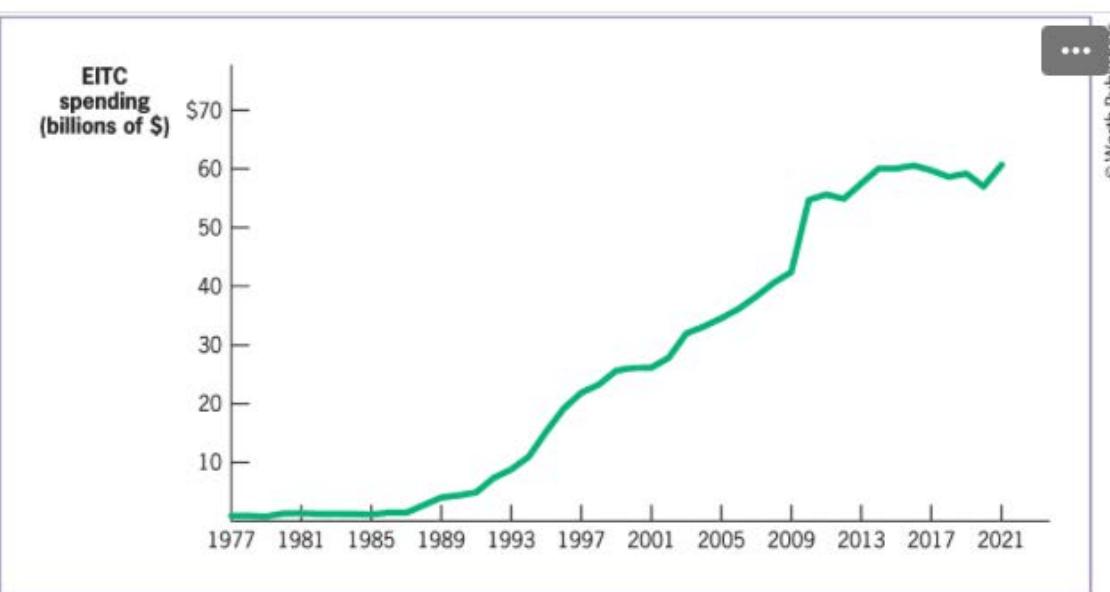


FIGURE 21-4 The Growth of the Earned Income Tax Credit • The EITC program has grown from less than \$1 billion in 1976 to over \$60 billion today. Numbers are measured in current dollars.

Data from: [Office of Management and Budget \(2021d\)](#), Table 8.5.

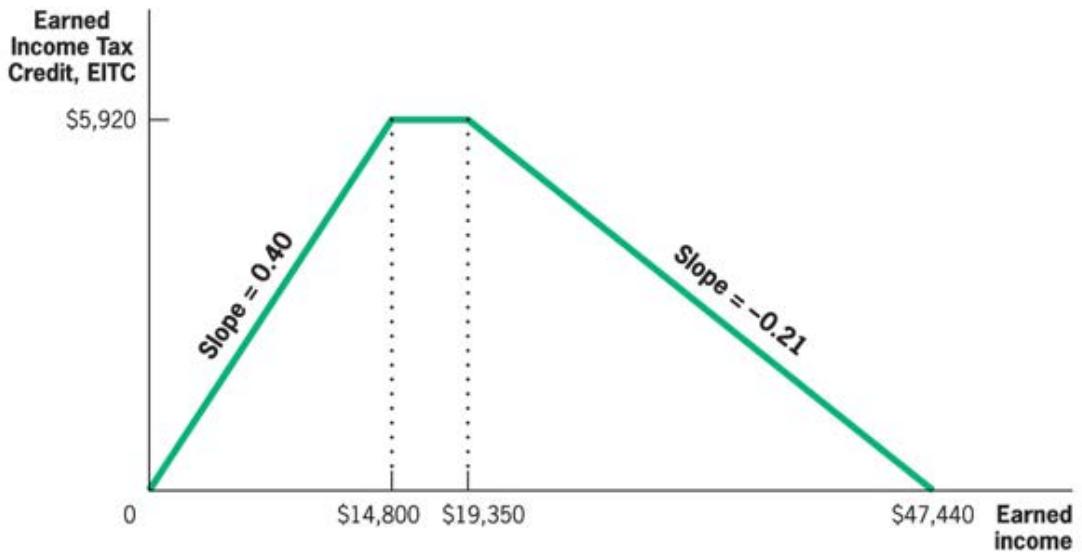


FIGURE 21-5 The Earned Income Tax Credit • For the first \$14,800 of earned income, Stephan receives an EITC payment of 40¢ per dollar of earnings, to a maximum of \$5,920. Between \$14,800 and \$19,350 of earnings, the EITC payment is flat at \$5,920. From \$19,350 to \$47,440 of earnings, the EITC payment falls by about 21¢ per dollar earned, until it reaches zero.

Data from: Internal Revenue Service. 1040 and 1040-SR Tax and Earned Income Credit Tables. [Tax Year 2020](#). Available at <https://www.irs.gov/pub/irs-pub/1040tt.pdf>.

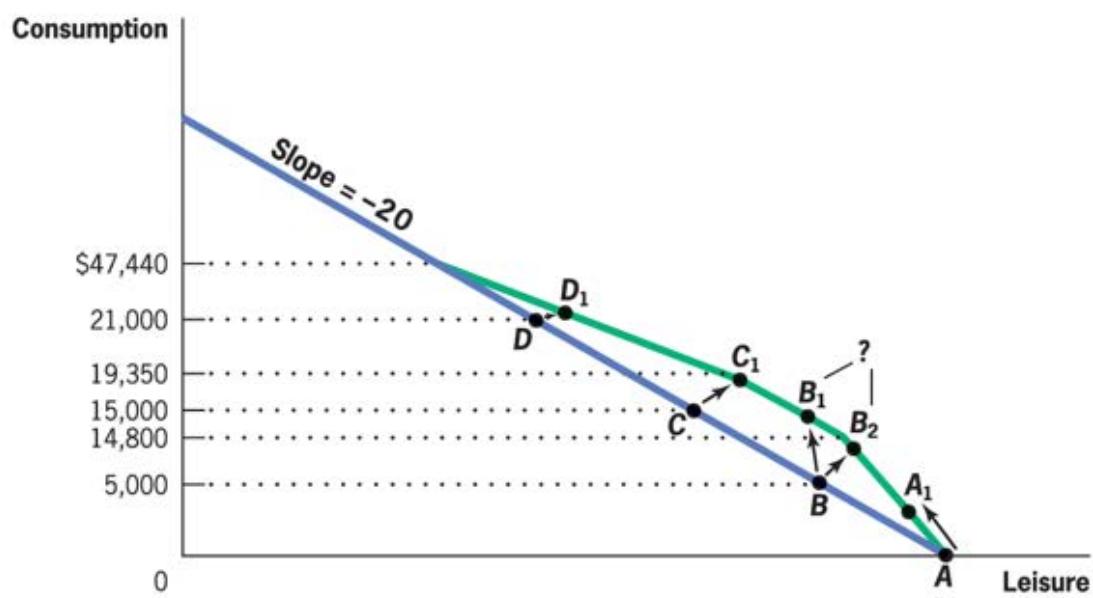


FIGURE 21-6 EITC's Effect on Labor Supply • The EITC unambiguously raises the labor supply of those not working (such as person A, who moves to point A_1); has an ambiguous effect on the labor supply of those with low earnings, who receive the wage subsidy (such as person B, who may move to either point B_1 or point B_2); reduces the labor supply of those on the flat maximum subsidy (such as person C, who moves to point C_1); and reduces the labor supply of those on the phase-out portion (such as person D, who moves to point D_1). Note that the figure is not to scale.

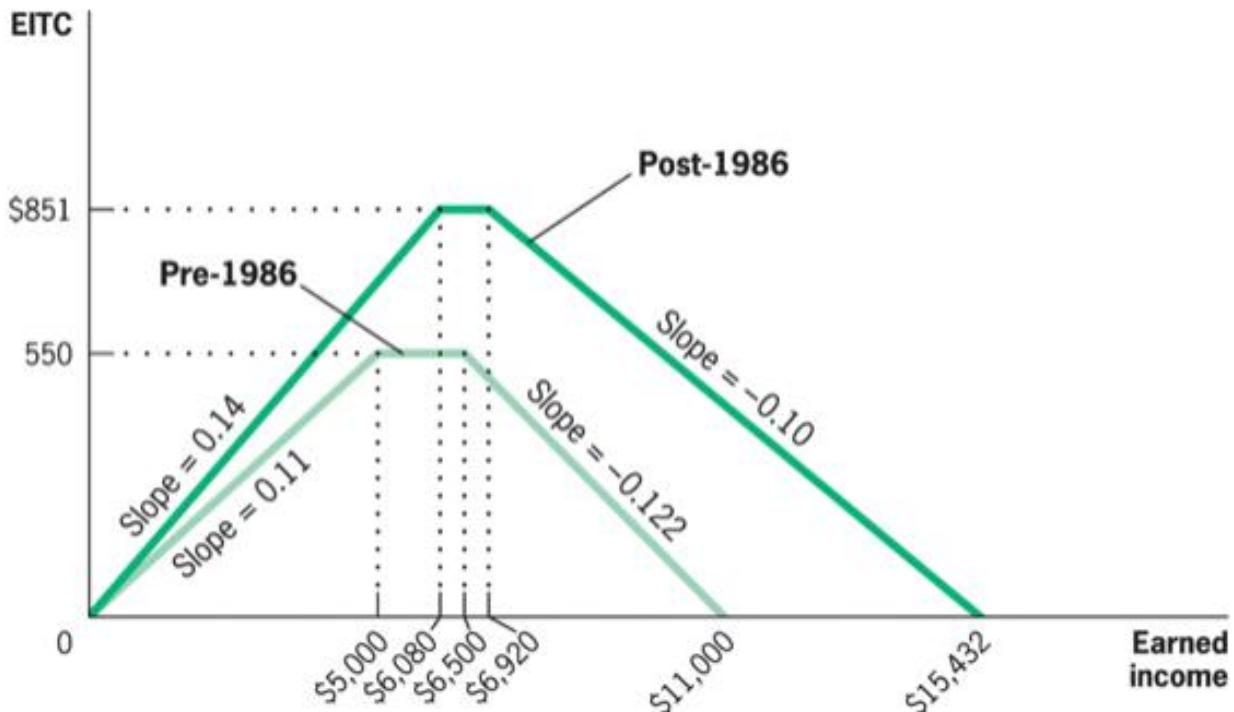


FIGURE 21-7 Changes in the EITC Structure • The Tax Reform Act of 1986 changed the structure of the EITC, raising the subsidy rate, increasing the maximum rate, and reducing the phase-out rate, so that a wider range of earnings was eligible for the subsidy. These changes in turn allowed economists to test the effects of the EITC by comparing those who were affected by these changes to those who were not.

Data from: Eissa and Leibman (1996).

TABLE 21-1 Child Care Choices

	Pre-tax, Pre-Child-Care Earnings	Child Care Costs	Child Care Deduction	Imputed Earnings	Taxes Owed if Work Tax Rate = 50	Taxes Owed if Home	After-Tax Value of Work	After-Tax Value of Home
Base	\$1,000	\$600	0	0	\$500	0	\$500	\$600
Impute	\$1,000	\$600	0	\$600	\$500	\$300	\$500	\$300
Deduct	\$1,000	\$600	\$600	0	\$200	0	\$800	\$600

In the first row of this table, when individuals work, they earn an after-tax wage of only \$500, but they have to pay a pre-tax cost of \$600 for child care, so they won't work. In the second row, the value of child care delivered at home is imputed as income, so after-tax income is higher if individuals work (\$500 versus \$300). In the third row, child care costs are deductible from taxable income, so after-tax income is also higher if individuals work (\$800 rather than \$600).

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