probably would see more people declining some labor opportunities if they could, choosing to work 30 hours per week, or 25, or whatever, if that choice were freely available to them. But most jobs—at least the good, well-paid jobs that people want for a career—are packaged up in full-time bundles, take it or leave it.

But overtime is different. In many cases, it is optional. In particular, it sounds as if the Sarkozy proposal contemplates mostly voluntary overtime. (If it weren't voluntary, there would be no need to encourage it through tax incentives.) That means that the affected worker really may be making a close choice at the margin. The choice is not the easy one: do I want a job, or do I want my family to starve? It's more like: do I want to take a bike ride with my family this Saturday, or would I rather work that day so I can buy them better bikes? Close choices are easily distorted by taxes, so if we want to avoid distorting the overtime choice, what better way than to get the tax out of the way?

For reasons related to these fundamentals of welfare economics, optimal tax analysis has long maintained that the most efficient tax structure is not one in which graduated marginal rates march upward as income does, even though that is the rate structure that most advanced economies have embraced. A more efficient structure, even if a society wants to have a tax system that is progressive overall, is to have a large exemption from tax, followed by rates that either ascend rather gently, or don't ascend at all.

It has been convincingly argued, however, that it is very difficult to achieve enough progressivity in a tax system if the system refuses to use significantly graduated rates. But the Sarkozy proposal is not one that would lower marginal rates in the upper and middle income brackets generally. Rather, it would be targeted exclusively at those workers making those last marginal choices about the shape of their work week.

There may be some important practical problems in designing the overtime exclusion so that it is available only in genuine overtime situations. And to achieve workable rules, there may be inequities, as there always are when administrative concerns dictate outcomes. (For example, the system would be easier to design if its rules favor someone who works 45 hours per week for a single employer over one who works 35 for one employer and 10 for another.) These inequities might well doom any practical proposal.

There is, of course, a major equity concern about any tax system that exempts what may be significant slices of the incomes of some, but not other, taxpayers. It violates first principles of equity to create a system in which one taxpayer with a $45,000 income from "regular" work pays more tax than another who has an income of $50,000, composed of $40,000 from regular work and $10,000 from tax-free overtime. But those equity concerns will be muted by the realizations that:

- There are natural limits to the proportion of one's income that can come from overtime;
- Taxpayers who earn a substantial amount through overtime do take a non-trivial lifestyle hit; they will not necessarily be envied by their relatively overtaxed but underworked fellow citizens (especially, one imagines, in France);
- This is, after all, income from labor, and, for the most part, from the middle and lower parts of the distribution. Executives, athletes, actors, professionals, and capitalists would be unlikely to benefit from any reasonably well-designed program along these lines; because of that, it's even possible that tax-free overtime would improve progressivity, albeit in an admittedly erratic way;
- If overtime opportunities are or become widely available, taxpayers will decide for themselves how much overtime they wish to work, according to their work/leisure preferences, so everyone will live happily ever after.

Or maybe not, but it seems worth a try.

COUNTERPOINT

Creating Tax Unfairness

By Michael J. McIntyre*

President Nicolas Sarkozy's promise to change the famously relaxed French way of life by inducing French workers, through a tax exemption for overtime pay, to spend more time in paid employment presents two public-policy issues. The first, of great concern to France, is whether a tax subsidy for overtime pay will benefit the French economy. The second, of major concern to me here, is whether such an exemption can be squared with legitimate concerns for tax fairness.

In evaluating a tax subsidy, the first step is to determine its expected cost in forgone tax revenue. I have no good idea of that cost and suspect no one does. The amount would include the tax currently raised from taxing overtime pay, plus the amount that would be lost from workers and employers restructuring their work arrangements to make regular pay appear to be overtime pay. There also would be some lost tax revenue from employees electing to work more overtime, thereby displacing in some cases other workers. I think that latter cost is likely to be low because I'm very skeptical about the effectiveness of a tax subsidy for overtime pay in inducing French men and women to work longer hours.

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There is substantial evidence that full-time workers generally do not work longer hours when offered higher pay (or its equivalent, tax-free pay). Economists speculate that this inelasticity of hours worked is due chiefly to the inability of most full-time workers to control their work week. That is, workers generally must decide whether or not to work, and, if they work, they typically are required to work the standard amount, no more or less. Some economists suggest, nevertheless, that if workers were offered a practical option of working overtime, they might do it if they were given a sufficient economic incentive. The Sarkozy plan would make overtime more lucrative for workers. It would do nothing, however, to remove the structural obstacles to working longer hours. As long as those alleged structural obstacles remain, I see no basis for a belief that the plan would be effective in changing the behavior of French workers.

Computing the value of the benefits of the Sarkozy plan is even more difficult. Frankly, I do not understand why Sarkozy wants to induce French workers to spend more time at their job. The French unemployment rate is fairly high, typically in the range of ten percent overall and double that rate for young workers. Longer hours for some workers would tend to reduce the jobs available for other workers, particularly younger workers. In addition, increasing the labor supply would have a tendency to depress wages. I'm not sure why these results are desirable at all, never mind being results that the government would want to spend good money to achieve.

The alternative to a government subsidy for overtime would be a decentralized program whereby employers who were facing a particular labor shortage would pay workers higher wages for overtime. The classic formula is time and a half for normal overtime and double pay for holidays. The advantage of this market approach is that it is highly flexible, it links the subsidy to specific needs of employers, and it costs the government nothing. The disadvantage is that no one would believe a candidate for president of the French Republic who contended that the plan would rejuvenate the French economy. Tax incentives do not have economic magic, but they do seem to have some political magic.

As noted above, I am mainly interested in discussing the fairness of the Sarkozy plan—actually, its serious unfairness. That unfairness is nicely summarized in the mantra of the Carter Commission, coined over 40 years ago, which proclaimed that "a dollar is a dollar is a dollar." (See REPORT OF THE ROYAL COMMISSION ON TAXATION, Canada, 1966.) The obvious point is that a euro earned from working overtime has the same spending power and the same savings power as a euro earned from working normal hours. As a result, overtime pay should not be treated favorably in a tax system that seeks to distribute tax burdens with respect to a taxpayer's market consumption and savings.

The classical argument, once endorsed by France, for giving a preference for income derived from wages over other forms of income is that workers must sacrifice their leisure in order to obtain their income, whereas investors need not get up from their chairs to collect their dividends, interest, and royalties. France abandoned that position years ago, however, when it repealed its differential tax rate for earned income. I never liked the theory because the investor also can claim to have given something up—the right to current consumption. Indeed, anyone engaged in a market exchange gives up something. In a traditional income tax, a taxpayer must have basis in the thing given up to get a tax benefit, and no one has a basis in their leisure or in their right to consumption.

Whatever the merits of that "giving up" argument (for leisure or for consumption opportunities), it is not a good argument for not taxing workers named Jacques, or, in Mr. Sarkozy's case, for not taxing individuals on income generated by overtime work. The obvious example of inequity is the person making $500 per hour who works overtime and the person making $5 per hour working overtime. They both give up the same leisure, but the tax benefit to one is huge and to the other is trivial.

An alternative way of looking at the equity problem is to speculate on who would take up the offer of a tax subsidy for overtime pay. Again, I'll give two extremes. Nicole has three children and four dogs, and her household falls apart if she works more than 35 hours a week. It may even be in serious trouble with her working more than 20 hours a week, but she needs the money. Louis has so much time on his hands that he spends 60 hours a week engaging in angry discussions of the Iraq war on the Internet. Nicole will not respond to the subsidy offer, whereas Louis would grab it in his teeth and never let go. Nicole is already giving up far more, in terms of the value of her leisure, than Louis. Why, exactly, should Louis (rather than Nicole) get the tax benefit, if the value of leisure forgone is the new test of taxable capacity?

Of course, if we are prepared to assume that everyone makes the same amount of money aside from overtime pay and everyone has the same preference for leisure, then we can see the beginnings of the equity argument for giving a tax benefit for the assumed value of leisure. Only in economics class, however, is credit given for making counterfactual assumptions. In the world we actually live in, the primary tax problem arises from the huge disparities in income between the rich and middle classes. It is not helpful in addressing that problem to simply assume that those disparities do not exist.

I do acknowledge that Mr. Sarkozy could reduce the unfairness of his proposal by limiting his proposed exemption to taxpayers who are all in the same tax bracket. Such a move, while mitigating the unfairness, would be an acknowledgment that a general exemption is unfair. Press accounts have not suggested that Mr. Sarkozy intends to introduce any such limitations on his proposal.

Although there are ways to reduce

somewhat the unfairness of the exemption for overtime pay, there is no way to eliminate that unfairness. In the end, the exemption causes individuals with the same money income to be taxed differently simply because one individual obtained the income from working overtime and the other earned the same amount from working normal hours. That basic unfairness is not removed or even mitigated by the existence of some inverse relationship between leisure and hours worked.

I have not tried to deal here with arguments that call into question the underlying principles of income taxation. In evaluating the Sarkozy plan on fairness grounds, I think it is proper to start with the assumption that France generally intends to impose an income tax on its taxpayers and is considering a limited departure from that goal in the special case of overtime pay. It is not contemplating the substitution of a consumption tax or an optimal tax or an endowment tax for an income tax. Those arguing for an adjustment to market income on account of some sacrifice of leisure or consumption opportunities or endowment are basically challenging the foundations of the income tax. Interesting issues, to be sure, but they are beside the point, in my view, in evaluating the merits of the Sarkozy plan.

Much of tax policy is deciding what differences in well-being don't matter in assessing tax liabilities. In an income tax, we properly ignore lots of things that might matter in making an overall assessment of an individual's economic position. For example, we ignore wealth, talent, and an ability to eat like a horse without gaining weight unless those attributes are used to produce market gains. For the reasons given above, I believe that different preferences for leisure and different sacrifices of leisure should not matter in assessing tax liability under an income tax. If I am right, then the Sarkozy plan is indefensible on fairness grounds.

A Reply to Professor McIntyre

By Richard L. Schmalbeck

It is far from clear that the Sarkozy plan would provide the stimulus he seeks, and unclear as well whether the plan would have the unfortunate effects on the French labor market that Professor McIntyre predicts. If adopted, the plan would be appropriately viewed as an experiment, and its consequences would require close monitoring. It may also require, as Professor McIntyre suggests, some complementary changes in the French labor laws (which might not be altogether bad).

But I do not share his pessimistic views on this. He seems to have in mind something of a zero-sum labor market in which overtime work by some must deprive others of opportunities to work. That is not impossible, but neither is it inevitable. Unemployment and underemployment usually result from a combination of constraints on market-clearing pricing (e.g., minimum wage laws), and a mismatch between the skills found in the labor pool and the skills sought by potential employers. So it is perfectly plausible that exempting overtime pay could yield higher total output at no loss in either employment or tax revenue. And the secondary effects of greater output—more disposable income and higher profits, for example—could actually lead to greater employment and revenue.

As for the equity issues, the tax policy advice of long-time Parisian Gertrude Stein—that a dollar is a dollar is a dollar—is the best background principle of taxability. But every tax system finds it wise to make some exceptions. In this case, the proposed exemption of overtime pay targets a decision point that is often a source of significant distortion. Relief of that distortion, rather than equity improvement, is the primary purpose. Still, its effects on taxpayer equity don't seem so bad.

I am not troubled, for example, by Professor McIntyre's comparison of Nicole and Louis. Nicole has extraordinary claims on her "leisure" time (by which we mean simply time not spent in market labor). She is already treated favorably by an income tax that does not impute income for the value of the services she provides to her own household. If her circumstances seem to merit further tax relief, it can be achieved by devices like child-care credits, personal exemptions, earned-income credits, and the like.

This example in fact highlights one important respect in which the Sarkozy proposal would improve equity: A person who works, say, ten hours of overtime each week has that many fewer hours available to provide services to his household. Had he provided those services to his household—perhaps generating higher levels of cuisine, garden care, and housekeeping—he would not have been taxed on the value thus generated. Exempting overtime achieves a similar tax-free result, producing more equitable treatment between those who provide marginal services at home, and those who provide marginal services in the market.

Finally, as I noted before, concern about the distributional consequences of this proposal is mitigated by the fact that high-income taxpayers—capitalists, actors, athletes, professionals, and executives—rarely work on an hourly basis, and would therefore be largely ineligible for the overtime exclusion.

So the first-order benefits of this proposal would be enjoyed largely by ordinary wage-earners roughly at or below the middle ranges of the income distribution. If it succeeds in stimulating the French economy, of course, the benefits would be more general. The French seem willing enough to experiment with their tax system—witness their on-again-off-again wealth tax over the last twenty years—and this experiment has more promise than most. ■