

POINT & COUNTERPOINT

Tax-Free Overtime Pay

With the highest number of French voters going to the polls in 40 years (84%), Conservative Nicolas Sarkozy defeated Socialist Ségolène Royal in France's presidential election in May. Sarkozy's platform for France was one of change, attempting to spur economic growth that was 2.1% last year, an increase that ranked tenth of the twelve European countries that utilize the euro.

To stimulate the economy, the world's sixth largest and second in Europe to Germany, Sarkozy proposes the elimination of a 2000 French law that mandated a 35 hour workweek, a law designed to help create jobs for more people and give current workers more personal time. Sarkozy claims that the law did not create additional jobs but instead created expectations of current workers to do more in less time. To encourage French workers to work more and to improve the slumping French economy, Sarkozy proposes to make overtime pay tax free.

In this Point & Counterpoint, Professors Richard Schmalbeck and Michael McIntyre debate the merits of taxing labor income. Professor Schmalbeck offers his view that Sarkozy's plan offers a genuine choice between work and leisure. Professor McIntyre argues that his plan raises significant policy issues of tax fairness.

The *NewsQuarterly* encourages readers to submit responses or comments to these essays, which may be published in a subsequent issue.
—Christopher M. Pietruszkiewicz, LSU Law Center, Baton Rouge, LA

POINT

The Sarkozy Proposal is Worth a Try

By Richard L. Schmalbeck*

There is much to be said for this plan on grounds of efficiency. Oversimplifying more than a bit, one can say that taxes tend to be less efficient if they distort people's choices. So if people buy a second-choice good because of a stiff tax on their first choice, or pass up an opportunity to make some extra cash working an occasional Saturday because of an

income tax rate that's too high, there is a loss in consumer welfare.

Economists generally think that taxes on income from employment are acceptably efficient, because they do not seem much to prevent people from engaging in employment. This is in part, however, because of rigidity in labor markets. We

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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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