Spring 2017

The Marginal Propensity Out of After-Tax Income and Implications for Tax Policy

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The election of President Trump, coupled with Republican control of Congress, makes significant tax reform in the U.S. more likely than at any time in at least a generation. While Paul Ryan and Congressional Republicans have their own ideas for optimal tax policy, there are other arguments as to how tax reform can help reduce income and consumption inequality in the United States. My paper explores the marginal propensity to consume out of after-tax income as one factor that determines the economic effect of tax changes. Using data originating from the Panel Study of Income Dynamics between 1998-2012, I estimate the marginal propensity to consume (MPC) for income quintiles. Households in the sample are split into five groups based on their after-tax income for a given year. The MPC is estimated from a fixed effects regression that controls for demographic factors. The estimated MPC is 1.0 for the quintile with the lowest income, which includes households with up to $30,500 in after-tax income (in 2012 dollars). The MPC steadily declines for each successive quintile, with an MPC of 0.78 for those with income above $93,244 (in 2012 dollars). The dataset does not adequately capture those at the top end of the income spectrum (the highest single income observation is $6,324,707), and thus the MPC cannot be estimated for the highest earners. Given the inverse relationship between income and MPC, it is reasonable to assume that the MPC would be even lower for the true top tail of the income spectrum. Nevertheless, my results suggest that tax reform, if aimed at boosting short-run aggregate consumption, should target those at the bottom of the income spectrum.