

My Weekend Tax policy with and **Nick and** **Adam** other willful misunderstandings

by Leonard Burman and Joel Slemrod

The following is an imaginary debate between partisans in the modern tax policy wars. The goal is to try to tease out economists' honest differences and maybe find some common ground. Although we've heard real people make every one of the arguments expressed here, our characters are fictional. — LB and JS

I'm an economist and a tax expert, but you'll never see me on the CBS Evening News. For I am a two-handed economist ("on the one hand ... on the other hand ..."), the kind that Harry Truman hated and TV news show bookers avoid like SARS. I see two sides of almost every policy issue. In short, I am not constituted to enlighten in 30 seconds or less.

But I'm the exception; one-handed economists abound. I (naturally) have mixed feelings about these folks. As an economist and a teacher, I am always thrilled to see economics explained to the innocent. Yet, those insights seem to take the true believers places even Captain Kirk has never been before.

Thus, it is odd that I ended up spending a January weekend alone



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with two one-handers. Nick, the son of Russian immigrants, is almost religiously committed to free markets and has a visceral aversion to government. Adam, a native of Brooklyn and the son of labor organizers, believes government is there to help the oppressed. Ironically, these guys have been friends since grad school. The fact they've never changed each other's mind on a single issue hasn't dampened their ardor for debate.

Let me explain how this weekend came about. I teach at a small college. Every January, I join other professional colleagues at the economists' annual conference, which this year was in Pittsburgh. I ran into Nick and Adam at the airport. But they were fighting tooth and nail, and I didn't want to interrupt their fun.

Two hours into the flight, the pilot announced that a nasty storm had made Pittsburgh an impossible dream. We ended up in Nashville, to find the airport packed and no room at the inn. As I was denouncing my fate, Adam waved me over. Seems he had arranged to borrow his cousin's nearby cabin, and Nick had scrounged the last rental car available.

The little car from Seoul or Jakarta or someplace was too small for the three of us, and the roads were slick. But even more disconcerting, my companions were soon at each other's throats over the latest tax bill from the Bush administration.

"You people are shameless," accused Adam. "Our country is facing a fiscal emergency, and

your solution is to borrow more money to pay for tax cuts for the rich! How can you look your children in the face?"

"No problem," Nick sneered. "You liberals are interested in fiscal responsibility only when it comes to tax cuts. If the President had proposed going into debt to finance national health insurance, subsidies for child care or more college scholarships, you would be leading the parade. And that would leave our kids in the poorhouse."

"Whoa!" I protested. "You guys sound like you're not even from the same species, never mind the same profession. If economics is a science, how can you two reach opposite conclusions about almost everything?"

Serious economists across the ideological spectrum really do agree about many of the basics. For example, we agree that tax policy plays a crucial role in economic policy and in government operations more generally.

Or do we?

"The impact on incentives is always overrated by right wingers like Nick," Adam explained. "As Charlie Schultze, Jimmy Carter's chief economic adviser, likes to say, 'There's nothing wrong with supply-side economics that dividing by 10 wouldn't cure.'"

"Come on! There are two centuries of evidence that people respond to incentives," purred Nick.

I asked my traveling companions if they agreed that, in raising revenue, it would be best to level the playing field – that is, not penalize one activity more than another or favor one sector over another. That is, to let the market decide.

"Ah, the market!" Nick rhapsodized. "The invisible hand will always do better than the bureaucratic, arm of government."

"Sure, markets are amazing under certain conditions," Adam conceded. "But those conditions are violated again and again in the real

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world. Yes, a market can efficiently allocate, say, rights to pollute – but only after government establishes those rights and creates a way to enforce them. Left to its own devices, the free market would allow cowboy capitalists to make the earth uninhabitable. Nor can the market guarantee that hard-working people will be able to afford basic needs – decent health care, housing, retirement security.”

We were lost (literally), and I was starting to worry that I would be found dead – wedged into a tiny rental car with two guys who would no doubt be frozen for posterity in mid-epithet. I resolved that, if we survived the night, I was going to find some common ground for my old classmates.

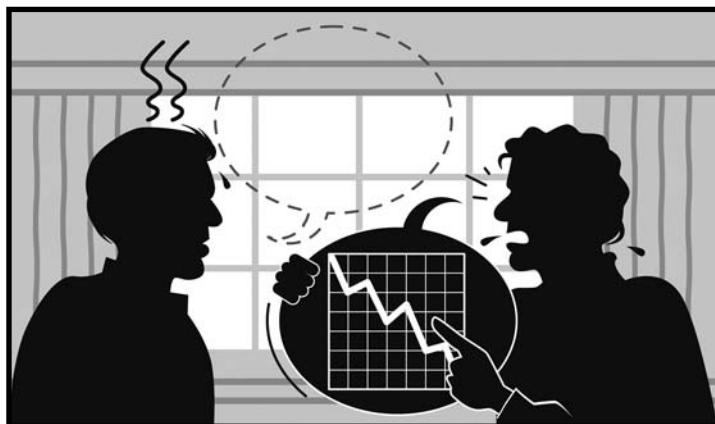
Miraculously, we found our bearings – and the cabin. More miraculously, the cabin had central heating and food to last the weekend.

By morning, it was clear that there would be no way back up the driveway, let alone to the economists’ convention.

So I set about playing mediator for my companions. Over breakfast, I began, “Do you agree there are three criteria for judging tax policy: equity, efficiency and simplicity?”

Adam nodded. “The burden of taxes should be shared equitably according to society’s standards. Americans want this burden to be higher for those of greater means and want those with more income to pay a larger percentage in tax than those with less.”

“There are three goals, Adam – not one,” Nick rejoined. “You liberals don’t give a damn about efficiency or simplicity. You are willing to make everyone worse off just so the most productive people don’t get to keep much more than the slackers. And your ‘refundable’



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tax credits – spending programs in drag – complicate taxes horrendously. It's not just that you want the tax system to be progressive; every single provision must be targeted to people with lower incomes! That's ideology, not principle."

Adam bristled. "Lots of differences in earning capacity have to do with luck rather than skill or hard work. If you didn't know you were going to be one of the lucky few, you would surely want to live in a society with a safety net. And don't tar me as the ideologue around here! You claim high tax rates discourage work and saving, but your motive could just as well be pure greed."

"I prefer to think of it as the laudable desire to provide for one's family," Nick replied. "I do admit, though, that I am not as troubled as you are by inequality, as long as the game is not rigged – and I don't think government should be in the business of second-guessing outcomes."

Adam responded that Nick really opposed all taxes; indeed, all government.

"Not true!" laughed Nick. "I'm happy that the government operates the military, courts, federal prisons and maybe interstate highways. We could probably pay for all that with a flat 5 percent income tax."

"Now we're getting to the heart of the matter," Adam exhorted. "Folks like you above all want smaller government. But you don't believe that you can achieve that goal directly, so you seek to 'starve the beast,' as Reagan's budget director, David Stockman, put it."

"Bingo!" Nick said as he jumped up from his chair. "If we hadn't cut taxes in the last two years, you Democrats would have piddled the surplus away on spotted owl reserves."

I wondered out loud whether the argument wasn't really as much about the appropriate size of government as it was about how

we should pay for it.

"That's part of it," Adam concurred. "The Republicans are trying to starve government so that we will have to slash funding for welfare, education, Social Security and Medicare."

"Maybe," responded Nick, "but we could get a lot of the savings by eliminating waste, fraud and abuse."

Adam sighed theatrically. "You're not going to eliminate these massive deficits by trimming fat. You're going to have to cut deep into the muscle. Your real political problem is that most people like the programs conservatives want to slash."

"People like free services and monthly checks in the mail," Nick responded. "But people don't realize the true cost – not just in terms of higher taxes, but in lower productivity. And slower growth will hurt our kids a lot more than deficits."

"There's no compelling evidence that taxes at the level we pay – just about the lowest in the industrialized world – have much effect on work, savings or investment," Adam said. "Besides, why assume away the positive role that government can play in fostering economic growth? Think of all the government dollars shelled out to protect property rights, provide infrastructure and support education."

I found my chance to intercede. "Why is it that so many liberals believe the effect of taxes on incentives is small, while their conservative counterparts believe that taxes create huge distortions? Since this is an empirical question, you'd expect the conclusions to be independent of one's politics."

"Not necessarily," Nick responded. "Some conservatives are skeptical about government because we view the costs of paying for it as very high."

"Do any Republicans believe that taxes don't affect behavior much?" I asked. "Do any Democrats believe that taxes are costly?"



Nick and Adam agreed there must be some, but couldn't name any. In science, there are truths. In economics, at least as practiced in Washington, there are advocates who claim to be custodians of ideologically convenient truth.

I asked again if we could agree that the debate about taxes is largely about the size of government. My fellow campers agreed. Then I asked if starving the beast works.

"Absolutely," Nick was quick to reply. "Larger deficits lead to trimmer government."

"Not always," Adam said just as quickly in rejoinder. "In the 1980s, Reagan slashed taxes, but never reined in spending."

"That was the fault of the Democratic Congress!" Nick countered.

"But Reagan never came close to proposing a balanced budget. So we got monster deficits and a huge run-up in debt. The process was reversed in the 1990s, when two tax increases were paired with spending restraint. That, in combination with the strong economy, vanquished the Reagan deficits," Adam said.

"I'm surprised there's no patriotic music playing in the background," sneered Nick.

"The fiscal discipline of the 1990s was a direct consequence of the deficits of the 1980s. Congress passed Gramm-Rudman-Hollings and the Budget Enforcement Act – both signed by Republican presidents – which ultimately got spending under control. The Stockman Effect worked."

"If deficits don't constrain spending," I asked Adam, "why do you always bring up Social Security, Medicare and homeland security as programs that would be underfunded during times of deficit?"

"Well, if deficits got big enough – "

"I get it now," I volunteered. "Republicans favor tax cuts because they think cuts constrain spending. Democrats oppose them because they fear that the Republicans are right."

We helped Nick make lunch with treasures unearthed in our host's pantry – fettuccine tossed with sun-dried tomatoes, porcini mushrooms and estate-bottled olive oil. "Not all Republicans," I allowed, "rely on barefoot wives for food."

Alas, my feeble attempt at humor quickly segued to a heated discussion about the welfare state and the cycle of dependency –

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whether the 1996 welfare reforms were a success or a failure, and whether the Democrats or Republicans deserved the credit (if it was, indeed, a success). I washed dishes and tried to visualize world peace. It didn't work.

I asked Nick if he was troubled about saddling future generations with debt. Running deficits is a way to put off burdens without specifying who will bear them, I noted. And if low taxes and high deficits unleash greater economic activity now, won't the higher taxes needed to cover the interest payments squash economic activity in the future?

"We'll take that chance," said Nick, while sipping espresso. "When the time comes, we'll be arguing for less government spending, rather than higher income taxes. And for privatizing Social Security and Medicare rather than shoring it up with higher payroll taxes."

I crept away for a nap. When I woke up, Adam and Nick were having at it about the "jobs and growth" tax cuts just passed by Congress. Adam was gleefully rattling off statistics about the numbers of jobs lost since President Bush took office.

"Can we talk about what should be done now?" I asked. "Are tax cuts the right policy?"

Nick swung hard at this soft pitch. "Yes, a thousand times, yes. For one thing, tax cuts put more money in people's hands, and when they have more, they spend more. That raises demand, so companies hire more workers, and so forth. For another, lower marginal tax rates give people more incentive to seek the jobs that are out there, and give businesses more incentive to invest."

"Everyone who ever passed Economics 101 knows that government spending is probably more effective at stimulating the economy than tax cuts," interjected Adam.

"But only tax cuts can reduce marginal tax rates," said Nick.

"Can I interject here?" I interjected. "I've taught Economics 101 for many years, and even been around the block a few times with Econ 201. Most economists think monetary policy works better for short-term stabilization than either tax cuts or spending, because it can be better timed."

"You're right, as far as it goes," said Adam, "but voters expect more than easier credit."

"I asked an economics question, and you gave me a political answer. Maybe it's time to fess up that we really don't have a clue about how to micromanage fiscal policy."

"And why are you suddenly so quiet, Nick? How can a supporter of limited government be for government intervention to prop up the economy? Are you all Keynesians now?"

"I guess we are," admitted Nick, "but mostly because it serves our larger purpose of cutting taxes and, ultimately, downsizing government. You may have noticed that the Bush tax cut proposal of 2001 was first made in December 1999, well before anyone smelled recession in the air. Once the economy began to slip, we changed the rationale without changing the proposal. Some wag called it the 'tax cut for all reasons.'"

"Hey, don't forget that it was the Democrats who insisted that the tax cut begin with those tax rebate checks, targeted at middle-income families," Adam bragged. "Giving money to people who are short on cash is much more effective stimulus than tax breaks for zillionaires. Lower-income folks are more likely to spend their tax rebates than the corporate CEOs and coupon clippers."

"Actually," said Nick, "evidence from the 2001 tax rebate shows no such thing. Low-income families were no more likely to spend the rebates than other families. Truth is, Democrats know that, once enacted, tax 'expenditures' are difficult to reverse. Tax cuts targeted toward low-income people serve



their core constituency.”

“You make it sound like helping poor people during hard times is somehow sinister,” complained Adam. “We’re proud that the tax rebate was not just abstract macroeconomic ‘stimulus.’ It helped struggling families to pay their bills. Single mothers clearly needed the boost more than did the BMW crowd – though the latter drove away with the loot.”

“Actually, the same study suggested that most people didn’t spend their rebate checks at all, but saved the money or paid down debts,” I interjected. “So the tax cut didn’t provide much stimulus at all.”

I avoided the line of fire by making dinner. Later, I fell asleep and dreamed of moderates driving snowplows. The next morning the weather had much improved and I was able to book a flight to Denver. Adam tussled with the airline about the \$100 rebooking fee, complaining that this never happened before airlines were deregulated (in the 1970s). Nick

responded that Adam’s ticket would cost three times as much if airlines were still under the government’s thumb. I tuned out the entirely predictable argument that followed.

On the way back to the airport, I made one last attempt to find common ground. “Surely we can agree that everything possible should be done to make tax-paying simple and straightforward.”

“Actually, I’m not sure about that,” said Nick. “It may seem hypocritical to rail against inefficient government, and then turn around and oppose the IRS’s efforts to become more efficient. But I have to admit I want taxpayers to feel the pain of taxes – I don’t want the burden hidden. That’s why conservatives opposed income tax withholding when it was first introduced during World War II and why our first flat-tax proposals would have eliminated employer withholding. I guess I’m willing to accept an inefficient tax collector if the end result is less government.”

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"I'm glad that you have mixed feelings about that," I said, "because I find it very troubling to think of sabotaging the tax system to achieve other government objectives. An archconservative, one closely aligned with the Bush administration, told me that he favored the pointlessly complex alternative minimum tax because it made people hate the income tax.

"Let's try another tack," I suggested. "Maybe because of the return of deficits, and the pressure to support our troops under fire, tax evasion is back in the news. What do you think about the 'tax gap,' which the IRS estimates to be about \$200 billion per year? I'd think you'd both be able to support a crackdown on tax cheats."

Adam agreed. "Tax evaders are stealing from honest taxpayers and our children. Hell, Nick has always supported the death penalty for drug dealers and murderers, two groups apparently immune from its deterrent effect. But if we fried a couple of tax cheats, that would create a very cost-effective deterrent."

"You're not serious," I said, taking the bait.

"No," he answered, "but I do think we should come down hard on people and businesses who cheat on their taxes."

Nick agreed, but with reservations. "Let's not forget that the main reason for cheating is high tax rates."

"Why is it that in your eyes draft evasion is tantamount to treason, but tax evasion is practically the duty of every American?" rejoined Adam. "OK, I take that back, but it infuriates me that the IRS seems to spend as much of its energy tracking down abuses of the earned income tax credit for the working poor as it does to shut down tax haven scams worth billions more. Indeed, the IRS is planning to spend millions making some low-income people prove in advance that they are

eligible for this credit – something no other group must do."

"The EITC is welfare paid out through the tax system, mostly to people who owe no income taxes," Nick complained. "If we can't move welfare out of the tax code, at least we can cut down on its rampant abuse."

"The EITC is basically a work incentive that is the antithesis of welfare," Adam responded. "It's a Republican idea – Milton Friedman suggested it 30 years ago, before Republicans got mean."

An argument about the Republican agenda and compassionate conservatism ensued. I was relieved to arrive at the airport and say farewell to my argumentative friends.

On the flight home, I tried to make sense out of what I had heard and learned about our profession. Here it is, unvarnished; I hope it doesn't sound two-handed:

Economists agree that taxes should be fair, simple and promote efficiency, but we can't agree about how to balance these sometimes-conflicting objectives. Deep disagreements about how taxes affect economic behavior, uninformed by the empirical evidence, are the rule.

To complicate the debate further, conservatives and liberals usually seek enlightenment in the evidence most consistent with their respective positions. Conservatives argue that taxes exact huge costs in terms of lost productivity; liberals deny it. The rest of us admit our ignorance.

In large part, the tax debate is not about who should pay or about how to kick start the economy, but about the size and scope of government. No economist believes that running large and growing deficits is sustainable policy. But conservatives are willing to run deficits for a while if doing so will starve the metaphoric beast. Liberals say that starvation doesn't work, but they fear that it will. **M**