INTERVIEW WITH
EUGENE STEUERLE
by Jasper L. Cummings, Jr., Raleigh, NC and Alan J.J. Swirski, Washington, DC

INTRODUCTION: Dr. C. Eugene Steuerle, one of the country's pre-eminent tax economists, recently published a new book, Contemporary U.S. Tax Policy (Urban Institute Press, 2004), in which he surveys the history of the income tax in the postwar era, mainly since 1980, and predicts future trends. Dr. Steuerle was the economic coordinator and original organizer of the Treasury's tax reform effort in the mid 1980s and was Deputy Assistant Secretary of the Treasury for Tax Analysis from 1987 to 1989. Dr. Steuerle has also written The Tax Decade (Urban Institute Press, 1992); he is a fellow at the Urban Institute and a frequent contributor to Tax Notes. Contemporary U.S. Tax Policy is available online through www.uipress.org.

Q From recent history, one would think the main function of the federal tax system is to provide a base for tax cutting. Have we lost sight of the role of taxes?

A The main purpose of a tax system is to provide revenues to support government functions. It is not to cut taxes! At the same time, one wants to create a tax system that supports efficient and fair government and to distort as little as possible the behavior of individuals who are subject to tax. It is hard to argue that tax cuts or tax increases per se are good. They are devices to try and make adjustments over time to that optimal level of taxation, and that optimal level can vary quite dramatically with the optimal level of different government functions.

It is obvious that in wartime we have to change taxes, but the needs of society, the purpose of the government, and the wishes of the community also appropriately affect the level of taxation. The community may want a larger government at one point in time and a smaller government at another point in time. There is no inherent reason that its desires are wrong on the basis of size alone.

In many of our debates we tend to imply a need to create one tax system that’s right for all times. We economists are especially good at playing that game. I think we make a lot of mistakes when we think that way. We usually make comparisons between one imperfect permanent type of tax system and another permanent type of tax system and imply that we should adjust tax policy in that way. But even in absence of mixed-up politics, society needs to make tax adjustments all the time, hopefully in a good way.

Q You point out that there have been at least three varieties of tax cuts in the last fifty years: (1) the “Kennedy tax cut” was at least intended to stimulate the economy countercyclically; (2) prior to the end of the bracket creep in 1981, periodic tax cutting generally was a win-win exercise that operated to offset bracket creep and serve political purposes; (3) the various Reagan and Bush tax cuts have been made in the absence of bracket creep and without regard to Keynesian principles; instead they have been motivated by “supply side” ideas, which always see economic stimulation in reduced taxes. What is the proper role of tax cutting today?

A Again, the role of both tax cuts and tax increases is to move toward some optimal level of taxation needed for this time and place. But that optimum level is affected by a wide range of considerations. As I noted in my book, people now use the tax system for a wide variety of reasons—really, too many. Certainly pursuing macroeconomic policy through tax changes can be a legitimate goal. Unfortunately, that goal has been overemphasized relative to such goals as equal justice and simplicity. Politicians always seem to be able to claim we are in a recession, going into a recession, or just coming out of one. Thus, in practice, macroeconomics has been more an exercise in economic apologetics than in economic reasoning.

There certainly is a case to be made for adjusting taxes or expenditures over economic cycles, although most economists today would argue that such adjustment is probably better done through monetary policy and automatic fiscal policy. The automatic changes—their occurrence because taxes grow or decline with the economy—are usually of a larger magnitude than discretionary changes when it comes to short-term adjustments, and the former have the additional advantage of usually working well on the upside, as well as the downside, of the economic cycle.

The politics of macroeconomic policy went through several stages. The Keynesians argued that we wanted to use taxes for macroeconomic purposes to create demand in the economy. The supply-side argument came later. In the
U.S., it was used to advocate almost identical types of tax cuts to what
President Kennedy first put forward, only now promoted as “supply-side”
incentives for work and investment.

Both Keynesian and supply-side politics had many common ele-
ments—the most common of which was that they were used mainly to
push only for tax cuts. Little attention
was paid by either the economists or
politicians on what to do on the other
side of the cycle. (Witness in the mod-
ern period the lack of attention in the
investment incentives adopted in 2002
and 2003 to their elimination at the
beginning of 2005, which, by some
strange coincidence, is right after
Presidential and Congressional elec-
tions.) A related neglect was in paying
attention to budget policy over the
long term. So both the supply side and
the Keynesian appeal in the political
context typically skip over crucial
details such as the economic cycle as a
whole and who pays for the changes
over time in the budget.

I am not suggesting that there is not
a decent theoretical case for adjusted
government demand over the econom-
ic cycle or worrying about incentives.
But let’s not be naïve; for the most
part, these “theories” were used loose-
ly as apologetics for politicians who
wanted to cut taxes and were looking
for excuses to do it.

Any good economist worries about
the balance sheet of government as a
whole and how one pays for tax cuts
or spending increases in the long run.
The issue was clearly less important in
the 1950s and 1960s and even 1970s
because the budget was mainly discre-
tionary in nature and there was also
significant bracket creep to pay for tax
cuts. I call this the Era of Easy
Finance. That era is long gone, mainly
because today entitlements have taken
over most of the budget and are grow-
ing continually faster than the econo-
my and revenues, while inflation can
no longer raise taxes through infla-
tionary bracket creep.

Q Would it be fair to say that the
so-called “Kennedy tax cut”
was perhaps the last major macro-
economic use of a tax cut?

A Not exactly. Supply-siders, for
instance, claim that their tax cuts
are also macroeconomic in nature. The
period surrounding the Kennedy tax
cut represented the heyday of
Keynesian policy, in terms of political
acceptance. Walter Heller, who was in
Treasury’s tax office before becoming
head of the President’s Council of
Economic Advisors at the time of the
Kennedy tax cuts, was very much of a
political economist. At that time
Keynesian economics was riding high
in the academic world because World
War II (still the primary example of
demand stimulus during a deep eco-

momic downturn) had brought us out of
the Great Depression. President
Kennedy was sold on the use of tax
cutting to stimulate the economy.
Again, however, this was a period not
only when most spending was discre-
tionary and there was significant
bracket creep, but the decline in the
defense budget as a percent of gross
national product left a lot of leeway for
Congress to cut taxes and increase
domestic spending without facing any
long-run budgetary consequences even
if deficits did rise over the short run.

In many ways it didn’t matter
whether the Kennedy tax cuts worked
or not. If the Keynesians were right,
the budget under a “current” or “con-
stant” law moved back in the balance
after two years or so, and, if they were
wrong, it went back into balance after
three years or so.

Q David Stockman has reported
that President Reagan’s tax
cuts were basically un-thought-out,
in both concept and effect, and yet
they represented a major inflection
point in the tax and fiscal policy of
the country. Subsequently people
such as Charles Walker, Ernest
Christian, Newt Gingrich and
Grover Norquist, and the organiza-
tions they represent, stepped in to
push various tax cuts. How much
has the post-1981 tax cutting
process actually been in response to
these organized political efforts?

A In the mid-1970s some supply-
side advocates, led by Jude
Wanniski, began arguing on the editor-
ial pages of The Wall Street Journal
for what they called a “two Santa
Claus” policy. The Wanniski-WSJ
argument was roughly the following:
“Democrats get to propose spending
increases, which Republicans enact,
and then Republicans have to come
in later and figure out how to get the
budget into some sort of reasonable
order. Republicans are then trapped
into choosing between tax increases
to promote good budget policy or
opposing spending increases before
they occur. That’s a losing political
strategy. What Republicans need to
do is to be able to give away money
to the public as well as the next
person—in particular, advocating tax
cuts without paying for them.”

Now, in fairness, there was some
correlation to a legitimate argument
that a smaller government and lower
tax rates would be more efficient. And,
so, in the long run, I presume there
was some hope that eventually smaller
spending increases would result and
that the more efficient economy would
make the number of tough decisions
required less than otherwise would be
necessary. Of course, the issue of what
had to be covered after feedback
effects were taken into account really
wasn’t engaged, and a few supply-
siders hinted or actually stated that the
tax cuts would pay for themselves.

Regardless, we’ve now moved from
Wanniski’s “two-Santa-Claus policy”
to what I call a “two-Santa-Claus-at-
the-same-time” policy. It’s hard
enough to believe in Santa Claus when
one shows up, then another. But when
two show up at the same time, then
there’s trouble. We have a political
game going on now where Democrats
and Republicans are united in playing
an impossible game of chicken.
Essentially, no politician wants to be identified with making people recognize the cost of government. Neither party wants to be known as having increased taxes or having cut expenditures. Particularly as we moved out of the deficit-cutting era that ran from about 1982-1997, we have been on a domestic spending spree (counting both tax cuts and domestic spending increases) unlike any this nation has ever seen. The primary deficit (the deficit excluding interest payments) increased by about 7 percentage points of GDP—that’s one-third or more of the size of the federal government, as measured by total taxes or spending. To add to the extraordinary nature of this shift, domestic spending and tax cuts have been very large even while there have been significant defense outlays, whereas most of the growth in domestic spending during the post-World War II era was paid for by declines in the defense budget.

With two-Santa-Claus showing up at the same time, there is no way left to pay for tax cuts or spending increases because both sides of the ledger are being neglected. But the bigger problem—largely ignored by the focus on the deficit per se—is that there is no flexibility or slack left in the budget to respond to some new emergency or to vote to do something different without abandoning past budget promises. Today the number of promises that have been made well into the future has grown quite significantly as a percentage in terms of the total budget pie. We start each year with an excess amount of promises even before new ones are made. We have no slack in the budget at all to do anything. You could and should make a case for a number of spending increases or tax cuts—I don’t believe in a static set of government policies, and I personally would like to do a lot more for our children—but there is little flexibility to do much of anything without starting to recognize who pays for government. And neither political party will step up to the plate. Thus, we get Presidential campaigns now where the candidates make promises that just don’t add up. It’s not that their promises are that much greater than those made in earlier campaigns in our nation’s history. It’s that never before in our history have so many promises already been made without the money to fulfill them.

We have a political game going on now where Democrats and Republicans are united in playing an impossible game of chicken. Essentially, no politician wants to be identified with making people recognize the cost of government.

Again, this trap has been dug deeper over the years mainly because of the automatic growth in programs already enacted. Look at the entitlement side of the budget. There alone we’ve already spent all the revenues that the government would have 100 years from now, even if they quintuple. Suppose that President Taft and his Congress had enacted a budget that predetermined today how we were going to spend all the revenue that the government was going to have—and then some. You might find that preposterous, but we have done the equivalent to our posterity.

Q: It is now common to read that “younger academics generally favor shifting to a consumption tax.” Do you find this to be true, what is the reason, and does it matter?

A: The increased support of a consumption tax has a basis in both politics and economic “conventional wisdom.” You know economics, like a lot of professions, goes in cycles. Herb Stein once remarked that he thought we often had to shift from one view to another simply so each generation could be identified with something new and different. There is a bit of that going on.

At the same time, I believe some of consumption tax theory is basically correct and hard to deny. It derives as much from an equity argument as an efficiency argument. The core argument is that if you earn exactly the same amount of income and we are really equal in terms of all measures of ability and need, but you save and I don’t, you are going to end up paying a lot more taxes to society under an income tax than I am. In a sense, you are going to be supporting me even though we start off with the same ability to pay. Once you save, you are going to be taxed again on the earnings from those savings and I am not. I think that the fundamental equity (and a related efficiency argument) for a consumption tax is pretty solid.

However, that is only one piece of the puzzle. There are a lot of issues that deeply concern me about the broader consumption tax movement. I believe that tax systems largely follow good accounting systems. A major reason we have an income tax is that in the modern industrial or post-industrial economy, good income accounting has been required to run the modern firm well. Income accounting from a financial standpoint allows us to decide where to shift resources so we can maximize output, profit, productivity and efficiency—all those things that make the industrial and post-industrial economy work.

We did not have an income tax that worked very well prior to the 20th century because for the most part, business was not large enough to provide the more complex accounting system required. In effect, there was not good income accounting on which to place the tax. Most world citizens were farmers. If you read back into the economics literature (perhaps the legal literature as well), there were a lot of debates about what was good or bad about tariffs. But one reason that tariffs were such a mainstay of the revenue system of the world for millennia was that when the ship docked and unloaded, a bill of laden was required. The buyer would open the boxes and crates, at least enough to insure that everything was being delivered. In
effect, there was an accounting system in place. The tax authority could assess a tax at that time because there was an accounting system that could be trusted or at least was moderately reliable.

It seems to me that if we start switching towards a consumption tax, we really have to be very careful. The argument that we can abandon income accounting is, to me, exaggerated. We still need good financial accounting. And if the tax system were based mainly on good financial accounting for income, it is not clear to me that tax accounting for income would necessarily add that much cost to the system. We should want to measure depreciation anyway, even if we do not do it for tax purposes. And we would probably keep income accounting for welfare systems, earnings subsidies, food stamps, educational subsidies, and a whole host of other items unless we want to pay for benefits to millionaires with low levels of consumption. A lot of the mess of our tax system has nothing to do with the income accounting it imposes over and above the income accounting needed for all these other places.

In moving towards a consumption tax, we are trying for the most part to exclude from tax the normal return on saving. But we may still want to tax “winners” in society—those who get above-average returns or accrue large amounts of wealth through a combination of luck, skill, or just being in the right place (like America) at the right time. Thus, if we do not tax capital income, then we need to think even more about related issues such as the need for an estate tax.

Unfortunately, the movement toward a consumption tax so far has tended to forgive first the tax on the big winners in society but keep the tax on those with only modest returns to their saving. Our changes so far in our hybrid system forgive most the tax imposed on the most successful people. There may be an average return of a few percentage points to saving, but there are some people who get very large winnings, some who have normal returns, and some who have had losses. Some of the more thoughtful consumption tax economists have tried to figure out how to move toward a consumption tax that would still tax winners and attempt more to forgive tax on more normal returns to saving.

**Consumption taxes are touted as increasing the incentive to save. At the individual level this means putting more money into passive investments, presumably for the purpose of driving down the return to those investments, assuming U.S. tax policy can have any impact on rates of return in a worldwide economy. At the business level this means expensing capital purchases, which is supposed to would stimulate the purchase of productive goods, but should also mean taking borrowed funds into income. Can either of these responses to a consumption tax really be expected to increase GDP substantially?**

There is a case that if you can lower the tax on capital, you could modestly increase GDP. But I question seriously whether to get there one should place most of the tax forgiveness on those people who are the winners in society. And that has been a real dilemma in moving toward a consumption tax. In fact, I can make a solid case that a society with a more unequal distribution of income is one that will have a lower rate of growth, since that type of society gives fewer people the opportunity to participate in consumption of those many modern goods and services for which there are substantial economies of scale in consumption (that is, low cost for each additional consumer).

You’ve also mentioned the issue of borrowing. To date, the movements towards a consumption tax have not been effective because they have not been complete. If we are going to provide an incentive—for instance for putting money into retirement accounts and 401(k) plans and other saving vehicles—there is no reason we should allow people who borrow on the other side to get those tax breaks. In effect, today we have a lot of incentives for only gross savings, or if you want to, for making deposits. But we do not have incentives to save.

**In effect, here we have another fascinating aspect of the consumption tax debate: its refusal politically to recognize that if we really want to move towards a consumption tax, the main thing we need to do is to put some limits on the extent to which we can arbitrage the system through borrowing.**

Today we all engage in different forms of arbitrage of the tax system—getting tax breaks for saving without actually saving. Most of us don’t necessarily think about it because we don’t usually go to the bank, borrow money and immediately put money into our 401(k) plan. What we do is to put money into our retirement plan, and, then, as the years go by, keep our mortgage a little higher. Sometimes we take out a second loan or reduce equity when we move. In effect, here we have another fascinating aspect of the consumption tax debate: its refusal politically to recognize that if we really want to move towards a consumption tax, the main thing we need to do is to put some limits on the extent to which we can arbitrage the system through borrowing.

Still another problem is that we are moving toward a consumption tax in tiny little pieces. Pamela Perun and I have published a diagram of current saving through retirement plan incentives that make the Clinton health plan diagram (the one used to mock and eventually defeat this plan) look simple. The net result of this complexity is that we pay large sums of money to salespeople, administrators, human resource managers in firms, lawyers and accountants and others—thereby reducing substantially the net return to saving.
If the goal is to move toward a consumption tax, simply patching on another saving or retirement incentive is probably not the way to go there. A very first step is to simplify existing savings incentives so that people can figure out what they mean.

You point out that to carry the theory of a consumption tax to its logical conclusion, the savings a person dies with that have not been taxed upon consumption during life should be taxed at death as the “final consumption,” lest they miss taxation entirely. Why have we not heard much about this idea in the consumption tax discussions, and how critical is it to a consumption tax?

Again, your question is more one about politics than economics. If you look closely at some of those contributing to institutions that advocate for consumption taxes, they often turn out to be some of the wealthiest people in society who want to avoid the estate tax. Even mainstream research institutions and think tanks can often get more money if they just happen to turn out material in favor of consumption taxes, especially consumption taxes that do not leave an estate tax in place.

So, my first answer is politics and the way that research is financed. At the same time, let me be clear that there are many people whom I respect who favor consumption taxes, and these are more likely to engage the issue of an estate tax, as well as the issue I raised above—how to tax above-average returns to saving and the winners in society. Of course, once you add in an estate tax to a consumption tax, what you really have done is to adopt a lifetime income tax—one based on lifetime income but, in a sense, avoiding additional tax on interyear transfers during one’s lifetime.

Skipping through all the details, the fundamental dilemma over consumption taxation is how to maintain some amount of progressivity in the system. That is what the fight is all about. Since I find it hard to believe that at some level we are going to exclude the really big winners in society, I find it disheartening that we can’t work on how to create a more efficient system for those who do have substantial saving, rather than, on the one side, trying to tax them any way possible, and, on the other, trying to exclude them from tax in any way possible.

A related issue is whether we can be happy with a consumption tax, assumed to be permanent for all time, that somehow restores equity by taxing, say, great-great grandchildren on their eventual consumption out of their forebears’ economic success. Some consumption tax advocates suggest that future tax on heirs in some present value sense pays for their forebears’ obligations to society. But think for a moment about taxes as benefit taxes rather than taxes on ability to pay.

If one is living in society today and benefits from the institutions of government and society, aren’t those benefits current? To argue that those benefits are only related to the level of consumption is a bit of a stretch. Finally, to suggest that the consumption of heirs a hundred years from now is going to make up for some tax deferral on benefits received today dodges the simple fact that tax systems change all the time and populations are mobile across boundaries.

Please compare and contrast the “tax shelter” activities of the late 1990s with those of earlier periods and tell us how important a problem you believe them to be and whether the government’s responses to date have been sufficient.

There are always incentives to arbitrage the tax system. One can arbitrage differences in tax rates among countries and states or in different measures of the tax base. One can arbitrage to the extent to which some capital is taxed only when realized, whereas other capital income or expense is recognized currently. One can arbitrage between the tax systems facing the profit-making sector and the non-profit or governmental sector (as witnessed recently by the attempt to sell and lease back subway systems in Europe and in the United States).

Lawyers and accountants have become very, very good at finding these opportunities. Not only good, but also they have learned ways to market or sell shelters efficiently in ways that can be repeated. They have also learned how to leverage the system, which is different from just simply helping people invest money in a preferred asset.

Most of the shelters we were worried about in the 1980s involved one particular type of arbitrage. That was mainly the arbitrage between (1) the tax on interest, which included at that time a very hefty tax on inflation on the receipt side and a hefty subsidy on the deduction side because the inflationary component of the interest rate is included in income the same way as is the real component, and (2) the tax on other assets. In the latter case, taxes often could be avoided by simply not realizing the income.

To be more concrete, most of the shelters in those days involved heavily leveraged purchases of real estate, oil and gas, and a few other assets. They were promoted among individuals and professionals—lawyers, doctors, and economists—as negative returns to partnerships that could be used to offset taxes on wages, self-employment, or other partnership income. We were largely successful in removing those shelters through the variety of devices. Sometimes people think that this success was due only to items like passive loss limitations or the alternative minimum tax. But a lot of the juice was taken out of those earlier shelters simply by the fact that we lowered tax rates and inflation. Without going into a lot of detail, the subsidy for borrowing was roughly equal to the tax rate times the inflation rate, so when both came down, so also did much of the tax shelter industry.

We did remove many of these shelters, though not all. A taxpayer could still buy a preferred asset directly, and many businesses were still able to
reduce taxes on returns to one investment with leveraged purchases of other assets elsewhere.

For the most part these are not the types of shelters we talk about today. Arbitrage is still at the heart of the matter, but it has expanded in all sorts of ways—mainly within the business sector, and not so much as an offset to wages or other self-employment income. A large percentage of these modern shelters involve international movements of funds. This diffusion of shelter possibilities has made it a much tougher issue for Treasury and the IRS because the issue is not as well defined, is broader, and harder to measure. However, we have not done enough, and Congress has sometimes blocked even the moderate efforts that were being put forth by the Treasury and IRS.

Q Your book ends on a surprisingly optimistic note, despite your polite but clear observations that tax and fiscal policy has been on a rather steady decline for some time now. What events do you see as creating the crisis that will bring forward some major reform, what is that response likely to be, and when?

A I need to be careful about using the word “crisis,” even though I am as guilty as the next person of sometimes using the word imprecisely. Sometimes we define a crisis by what is happening to society, sometimes by the attention we are paying to a particular problem. There are many books on politics that argue that democracy basically reacts only when the crisis comes. The argument is that democracy only works “so-so” in good times, but in bad times it seems to come around.

We did succeed in enacting tax reform in the early 1980s, and especially 1986, in moderately good times. I suppose one could argue that there was a crisis of governance in that the tax system really was falling apart in some ways and the IRS could not handle the shelters of the day. But, perhaps more importantly, an opportunity arose because there was a vacuum in policy making.

The Reagan Administration by 1984 was still mainly fighting to protect its 1981 tax and expenditure changes, while Congress was unsure what it wanted to do. But legislators still love to legislate, no matter what the time or circumstances. In some sense, we were simply able to capture the agenda. Did we have enough of a “crisis” I do not know. In the grand scheme of things, there were significant problems, but certainly not worse on the budget front than what we face today. Yet today some claim that we have to wait for a bigger crisis before we can act.

Of course, as we move toward 2008 and beyond, there are some potential “crises” that are looming. My colleague Rudy Penner and I did use the term “crisis” in an article called “Budget Crisis at the Door.” I have already noted how we have increasingly been spending away all future revenues—and then some. Under some scenarios, large deficits can cause a financial crisis, and while that potential problem is containable, we are playing with fire on the budget front.

Another forcing issue, ironically, is that Congress has now boxed itself in—in the sense that it cannot do anything new without finally facing up to the budget issue. You can detect some of this in the recent Presidential campaign, where both candidates promise to do more but have no money with which to do it.

I’ll give you an example. If you take just the existing commitments for health, retirement, defense, and interest, alone, they will absorb all revenues by about the year 2013. The rest of government, whether it is the environment or the Justice Department or the IRS or welfare or housing or community development—you name it—is really getting squeezed.

On the tax front, I also see another possible forcing event—the extraordinary growth in the Alternative Minimum Tax (AMT). There is at least

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