THE TYRANNY OF DEAD IDEAS

LETTING GO OF THE OLD WAYS OF THINKING TO UNLEASH A NEW PROSPERITY

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TAXES HURT THE ECONOMY (AND THEY'RE ALWAYS TOO HIGH)

In which it becomes apparent that taxes are going up in the next decade no matter who is in power, and that the economy will be just fine

In 1883, Adolf Wagner, a combative forty-eight-year-old German economist, was puzzling over the way modern societies evolved. It had been two years since Otto von Bismarck had persuaded the emperor William I to send an extraordinary message to parliament that by decade's end would lead to the creation of the first modern system of social security. "The healing of social wrongs must be sought . . . by positively advancing the well-being of the workers," William wrote, with uncharacteristic empathy. "Those who are disabled from work by age and invalidity have a well-grounded claim to care from the state." Bismarck, as canny and brutal a statesman as existed in the nineteenth century, was hardly a softheaded liberal, but he came under vicious attack from the right for promoting such left-wing ideas. "Call it socialism or anything you like," Bismarck sputtered at his critics, who didn't grasp his plan to blunt the more radical agenda of Karl Marx and Friedrich Engels. "It is all the same to me."

The whole controversy got Wagner thinking. As people grew more affluent, he reasoned, they'd want more of what only government could provide—a strong military, public order, good schools, and assorted welfare benefits, services that private citizens would have trouble arranging for on their own. As a result of these desires, Wagner predicted, the development of an industrial economy would be accompanied by an increased share of public expenditure in gross national product. This simple insight, known as Wagner's Law to economists today, explains much that we've observed in the century or so since. Industrial nations have much higher taxes, measured as a percentage of their economy, than do poorer nations, and similarly they have higher spending on health care, schools, pensions, police, and so forth. As it turns out, no one sent the memo about Wagner's Law to the modern Republican Party. Which is roughly how a Reagan foot soldier named Bruce Bartlett came to be excommunicated from the conservative movement in 2003.

In the fall of that year, Bartlett was stumped. A former economic aide in the Reagan White House and a Treasury official under George H. W. Bush, Bartlett was a libertarian, small-government think tank scholar who had watched with amusement as the debate raged over adding a prescription drug benefit to Medicare. He presumed that President George W. Bush's support for the bill was insincere; the sausage the Republican Congress was cooking up would be such an unprecedented budget-buster, costing trillions in the decades ahead, that Bush had to be playing his part in a classic Washington minuet. Everyone knew the drill: the Senate and House would pass different versions of the measure that couldn't possibly be reconciled; the drug bill would thus die an unavoidable but "regretted" death; all sides would claim credit for having supported fresh aid for America's seniors; they'd return to fight the good fight another day. This had to be what was going on, Bartlett

reckoned, because the White House was sending signals that it would sign any bill that passed. No president could be that fiscally reckless, Bartlett knew.

But President Bush, who wanted to be reelected in 2004, saw things differently. Bush knew in his political gut that Adolf Wagner was right, and that the moment had come to give struggling seniors the public help they sought for costly medicines. "I suddenly realized, this wasn't a game at all," Bartlett recalls. "They wanted to get this thing passed and they didn't care what was in it. It was like a cold slap in the face." Like many conservatives, Bartlett was outraged when the president signed the pricey new benefit into law. Then, like any good policy wonk, he sat down to think through what it all meant.

The government already faced about $40 trillion in unfunded liabilities for programs such as Social Security and Medicare. Bush and the Republican Party had just put their imprimatur on trillions more. Bartlett's conclusion was merely mathematical. "We cannot avoid a massive tax increase sometime in the near future," he recalls realizing. For a Republican to think such a thought was bad enough. Then Bartlett committed his real crime. He began laying out this thinking in public, first in his syndicated column and then in magazine articles. Bartlett argued that it was now clear beyond disputing that the Republican Party, despite its rhetoric, would never slow spending growth: after all, it had just enacted the biggest new health care entitlement since the 1960s, even as it balked at cutting a few billion dollars from the next trillion in planned Medicaid spending for the poor. Since tax increases would therefore be necessary before long to avoid untenable and debilitating deficits, the country needed to think about how to raise new revenue in ways that would be least distorting for the economy. To Bartlett, that meant it was time for an American version of the national sales tax favored by many European governments: a value added tax, or VAT.

Conservative Washington went berserk. Bartlett was summoned to a meeting at the Heritage Foundation, where several right-wing analysts castigated him for his heresy. Why are you endorsing tax increases, they demanded to know. To Bartlett the accusation was surreal. I'm not *endorsing* tax increases, he replied; I'm forecasting them. You know the facts as well as I do. "They simply refused to accept those realities," Bartlett recalls. "They refused to confront the numbers as they exist." Before long, Bartlett became persona non grata on the right, a man without a party. His banishment stood as a warning to others not to stray from the party line on taxes, no matter how detached from reality the orthodoxy became.

"I'm not in favor of higher taxes," Bartlett told me several years later, still smarting. "I'd be all in favor of slashing government so that it was not necessary. But I'm not stupid. I can see that we're not going to do that. We're not going to cut tens of trillions of dollars out of future spending from large constituencies of voters who are dependent upon these programs. It just isn't going to happen. And anybody who thinks it is, is living in a dream world."

DESTINY AND DENIAL

Some Dead Ideas, like the idea that "Your Company Should Take Care of You," represent a response to broad historical forces that alter our institutions and over time become entrenched in popular consciousness as "the way things work." But others, like the notion that "Taxes Hurt the Economy and They're Always Too High," have different origins. This idea, which in various forms has recurred throughout human history, is born in the self-interest of the small number of people who typically control most of the resources in a society, because, given the choice, they would prefer to avoid sharing those resources with others. Though Wagner's Law suggests that from history's viewpoint, society's "haves" may

be fighting a losing battle (and, in addition, that the broad middle will happily tax itself for services it comes to want), that doesn't mean the wealthy can't win important skirmishes along the way. Indeed, the fact that taxes remain relatively low in America (compared to other advanced nations), when the top 5 percent of the population control half or more of the nation's wealth but wield only 5 percent of its votes, suggests how powerful the antitax idea has been. Partly that's because the "haves" hire skilled propagandists to persuade the public that taxes of any kind are destructive. Partly it's because at some level, taxes do distort incentives and hurt the economy—as was the case with the 70 percent marginal income tax rates that applied before Ronald Reagan took office in 1981. For thirty years in the United States, the conservative movement, aided by liberal excess and ineptitude, has successfully shaped political debate along these lines. But now, as a conservative like Bruce Bartlett realized when he penciled it out, the antitax idea is doomed. What's more, as we'll see, if we do things right, the economy will be as strong as ever (and in many ways stronger) as taxes rise in the years ahead.

To see why the modern antitax idea is dead, we must first understand that taxes are going up *no matter who is in power.* Don't take my word for it. Listen to some of today's preeminent Republican budget analysts. Like every Republican who aspires to serve in a public role, they've been schooled by the party's antitax police to avoid saying things too definitively, or to leave themselves an "if we only got tough on spending" escape hatch, a ploy we've seen is a charade thanks to Republicans' repeated refusal to trim spending when they actually controlled every corner of Washington. So there's no mistaking what these folks are saying.

"If you do nothing on the spending side, you're going to raise taxes whether you're a Republican, a Democrat, or a Martian," says Douglas Holtz-Eakin, the Republican-appointed director of the Congressional Budget Office from 2003 to 2005, who served as the

top economic adviser to John McCain's presidential campaign. "It's arithmetic." Federal revenue today is 18.8 percent of GDP and federal spending is 20 percent. Holtz-Eakin observes that "the pressures are there" to lift spending and taxes to 23 or 24 percent of GDP by around 2020, and to as much as 27 percent if health costs remain out of control. Note that in the context of a $14 trillion economy, he's predicting (at the low end) a $550 billion to $700 billion tax increase per year, in today's dollars.

David Walker is a Republican who served as comptroller general of the United States from 1998 to 2008, when he left to run the Peter G. Peterson Foundation. As head of the Government Accountability Office, he was part of a national "Fiscal Wake-Up Tour" in recent years that called attention to our long-run budget woes, a campaign he is expanding in his new role. Walker told me when we spoke in his government office that taxes would grow to 20 to 25 percent of GDP within twenty years, depending on how "radical" we get about spending cuts. Since, as we've seen, serious spending cuts are unlikely, it's fair to interpret Walker's projection as being closer to 25 percent of GDP than to 20 percent.

Over lunch one day during the recent presidential campaign, I spoke with another highly respected economic analyst in John McCain's circle. (The ground rules for our conversation were that I could not attribute these comments to this person, because a "straight talker" like McCain could not be seen to be advised by someone who actually talked straight on taxes!)

Are taxes going up? I asked.

"Yeah," the McCain adviser said. "I think it is inevitable."

"If you were a betting man at this point, are taxes going to be higher as a share of GDP in 2020?"

"Definitely."

"How much higher?"

"I don't know."

"Ballpark?"

"Twenty-two [percent of GDP]," this person replied. "But 2020 is still a little bit at the front end of the boomers. You can figure twenty-four, twenty-five by 2030."

"Let's say we're at twenty-two in 2020, up from eighteenish today," I said. "Is that some disaster for the economy? Will it really make a big difference?"

"Probably not," the adviser said. "Depends on how you do it, of course."

So: the consensus of three professional Republican budgeteers is that taxes will rise by between 4 percent and 7 percent of GDP over the next ten to twenty years, translating (in today's dollars) into $550 billion to $1 trillion more in new annual taxes. You heard it here first: the Republicans have a secret plan to raise taxes. So do the Democrats, of course, and well beyond the rollback of the Bush tax cuts for the top they felt safe discussing during the 2008 presidential campaign.

The gap between our destiny and our denial on taxes is one of the most consequential chasms in American public life. Not to mention curious. If higher taxes are inevitable (and, as we'll see, the economy will do just fine in spite of them), how did we get to the point where the prevailing idea in the American mind is the opposite—that taxes hurt the economy and they're always too high?

TAX WARS: THE BRIEF HISTORY

Tax debates may be the purest example history offers of the truth of Ambrose Bierce's wonderful line in *The Devil's Dictionary,* where he defines politics as "a strife of interests masquerading as a contest of principles; the conduct of public affairs for private advantage." An impossibly brief (and therefore highly selective) review of Everything You Need to Know About U.S. Tax History yields three important lessons. First, the arguments over taxes never change. Second, the economy has grown larger and more productive even

as government spending and taxes have risen. Third, it generally takes a war or other national crisis to bring significant changes in the way we tax ourselves.

Let's plunge in. More than two thousand years ago, Aristotle noted that in a democracy the masses might use their numbers and political clout to gang up on the rich and redistribute their wealth, but for most of history this hasn't happened. If anything, its been plunder from above. The United States has been no exception, though our evolving tax regime has been misleadingly described. Modern conservatives like to say that a country born in a tax revolt comes by its tax loathing naturally, but that's a gross misreading of the Boston Tea Party and the founders' ideas. The colonies resented taxation *without representation,* not taxes generally; Americans matter-of-factly raised revenue for roads, schools, and other common purposes. Early antitax sentiment was less about innate American revulsion than about specific interests who feared the prospect of federal authority. The leading examples, as the historian Robin Einhorn of the University of California, Berkeley, has shown, were large southern slaveholders, who wouldn't sanction any federal power that might permit the national government to tax slavery out of existence. Einhorn argues that the slaveholding class's shrewd campaign against big government in America's early decades, whose propaganda featured threats to iconic yeoman farmers at the hands of the overbearing feds, was the first case of financial elites cynically (and successfully) posing as tribunes of the common man to preserve their own prerogatives.

Partly as a result, federal taxes from Alexander Hamilton's days as secretary of the Treasury all the way up to World War I were basically regressive—meaning that the lower and middle classes shouldered a larger proportionate burden than did those at the top. Throughout the nineteenth century the federal government's revenue came primarily from tariffs on imported goods, which raised prices across the board and were thus effectively paid by ordinary

citizens. The federal government also imposed excise taxes on goods like alcohol and cigarettes. Among other things, this so upset small farmer-distillers that it sparked the Whiskey Rebellion in 1794, during which President George Washington personally led twelve thousand troops into western Pennsylvania to put down the insurrection and assert the authority of the young national government.

To be sure, the tariff system designed by Hamilton proved effective. As we've seen, the protection it offered helped nascent American industries develop. It enabled the United States to pay off the national debt (incurred during wars) by 1835. It generated enough revenue thereafter to support internal improvements like canals, and to let Uncle Sam offer federal lands on generous terms to low and middle income settlers, boosting western growth and providing opportunity for millions. In the 1850s, 92 percent of federal revenue came from customs duties imposed on imports.

Still, despite these successes, trouble was brewing over how the tax burden was borne, sentiment that spilled into politics during the decades-long battle over whether America should have an income tax. Steven Weisman, the author of *The Great Tax Wars* (a superb chronicle that informs much of the account below), argues that these historic debates involved a showdown between two values: justice and virtue. Justice meant seeing the income tax as a kind of leveler, not necessarily redistributing wealth (it wasn't seen this way early on) but softening the edges of inequality as unprecedented industrial fortunes emerged. By contrast, opponents of the income tax spoke of virtue—of the hard work, thrift, ingenuity, and risk taking that formed the foundation of capitalism. In this view, taxing people at higher rates if they earned more was tantamount to punishing virtue, and distorted the incentives on which prosperity rested. Sound familiar?

The first great clash came during the Civil War, when the federal government needed enormous new sums to wage war and secure massive loans. There were practical limits to how much

money tariffs could raise, and fairness concerns as well. It was uncomfortable enough in a democracy that wealthy men could pay to avoid service in the Union army. But would the rich, including the many manufacturers making a fortune from the war effort, be permitted to contribute little to its colossal cost? Wartime inflation pinched the man in the street while the makers of guns, medicines, and uniforms raked in millions. An article in *Harper's* magazine entitled "The Fortunes of War" catalogued the speculators and federal contractors who were getting rich on the general misery, adding that the cost of a dinner at Delmonico's in New York could "support a soldier and his family for a good portion of a year." The brewing resentment would contribute to an explosion in 1863, when four days of draft riots in New York led to the deaths of a thousand people. Six thousand federal troops had to be called in to restore order.

An income tax—a new idea—emerged as part of the answer to the inequity. But policy makers knew they were crossing into uncharted territory. Representative Justin Morrill of Vermont, of the House Ways and Means Committee, quoted John Milton's *Paradise Lost,* comparing the American taxpayer to Adam and Eve, driven by necessity "from our untaxed garden." But Morrill also spoke of fairness. "Ought not men . . . with large incomes, to pay more in proportion to what they have than those with limited means, who live by the work of their own hands or that of their families?" Thaddeus Stevens, the abolitionist chairman of the committee, wanted an income tax with graduated rates scaled to "the ability to pay." "It would be manifestly unjust," he said, "to allow the large money operators and wealthy merchants . . . to escape from their fair proportion of the burden." The *Chicago Tribune* was more direct: "The rich should pay more than the poor." The law finally enacted had two rates: 3 percent on income above $600, and 5 percent on income above $10,000. (Remember, this was 1862.) The Confederacy, unwilling to raise taxes, was in financial turmoil;

it printed money to pay bills, creating disastrous inflation. "For God's sake, tax us!" cried the editor of the *Richmond Enquirer.*

Yet efforts to make the federal income tax a little more progressive two years later met with resistance even from supporters of the previous measure. It was "vicious" and "unjust" to enact a "punishment of the rich man because he is rich," Thaddeus Stevens now said, adding that unequal tax rates were "no less than a confiscation of property." Rich men would leave the country rather than pay the tax, foes added. Not everyone agreed. "Go to the Astors and Stewarts and other rich men of the country and ask them if in the midst of a war [the income tax] is unreasonable," countered one lawmaker during the House debate. "I could not advocate anything else in justice to the middle classes of the country." Some made the audacious argument that higher rates on the rich diminished the standing of poor men, as if being left out of the income tax would hurt their feelings. "It is seizing property of men for the crime of having too much!" one senator said. Another senator, while acknowledging that richer folks could afford to pay, nonetheless argued that "an odious and ungenerous discrimination against the rich" could wreck American prosperity.

UPS AND DOWNS

Once the wartime emergency passed, wealthy forces mobilized, and the income tax (along with a wartime inheritance tax) was repealed within seven years. At its peak in 1867 the income tax raised 24 percent of federal revenue. Most historians say that only about 1 percent of Americans were ever subject to the tax. Repeal meant that the huge federal debt left over from the Civil War, held mostly by well-to-do Americans, had to be serviced by tariff revenues whose burden was felt almost entirely by average citizens.

Yet even as debate over repeal of the income tax raged between 1870 and 1872, the logic for its resurrection was being laid. Senator

John Sherman of Ohio, later of antitrust law fame, said the burden imposed by tariffs and excise taxes was simply wrong. "We tax the tea, the coffee, the sugar, and the spices the poor man uses," he said in 1870. "We tax every little thing that is imported from abroad, together with the whisky that makes him drunk and the beer that cheers him and the tobacco that consoles him. Everything that he consumes we call a luxury and tax it; yet we are afraid to touch the income of Mr. Astor. Is there any justice in that?"

The battle lay dormant for a generation. Then the Panic of 1893, and the lengthy depression that followed, sparked fresh outrage over the deprivation of ordinary people compared to the grandeur enjoyed by the wealthy few. Unemployment reached 20 percent. Industrial unrest grew. Farmers reeled from price declines. And stunning revelations appeared in the press about how the rich were shirking their share. An article in *Forum,* a leading magazine, entitled "The Owners of the United States," profiled the handful of families that now owned a greater share of the national wealth than did Britain's upper crust: the Vanderbilts, Huntingtons, Morgans, Drexels, and their ilk. While federal taxation had increased sixfold since 1860, the article explained, the tab had been picked up primarily by lower income Americans. The magnitude of the inequity was captured by a stunning fact: as one expert testified to Congress, an income tax of just 2.5 percent would allow for a 25 percent reduction in tariffs, hugely aiding middle and lower earners. William Jennings Bryan took up the cause, crying on the House floor in 1894 that opponents of an income tax "weep more because 15 millions are to be collected from the incomes of the rich than they do at the collection of 300 millions upon the goods which the poor consume."

Foes of the tax said it would discriminate against the (wealthier) north; encourage fraud (because people would lie about their income); depress real estate; kill the stock market; and hurt business. They also said (again) that the rich would flee the country—to

which Bryan replied famously "Whither will they fly?" citing income taxes that by then existed in countries across Europe. Senator David Bennet Hill insisted that the tax was an idea imported to America by "little squads of anarchists, communists and socialists." Yet many proponents urged it paradoxically as a conservative step that could help keep a lid on rising class anger and resentment. Representative Uriel Hall, a Missouri Democrat, called it "a measure to kill anarchy and keep down socialists." When the dust cleared, the measure that finally passed in 1894 would have affected only 2 percent of Americans, imposing a 2 percent tax on incomes over $4,000. Then the Supreme Court (for reasons too arcane to detain us here) ruled the measure unconstitutional. The *New York Tribune* said "the fury of ignorant class hatred has dashed itself in vain against the Constitution." The *New York World* called the court's decision "a triumph of selfishness."

THE HIGHER TAX CENTURY

To make a long story short, it took eighteen more years of debate before a constitutional amendment was enacted in 1913 that made the income tax legal. Democrats, suspicious of increasingly concentrated wealth and power, saw their campaign against the protective tariff and in favor of the income tax as two planks of the same general policy: the measures offered relief for ordinary Americans, and struck a blow against corrupt practices by business elites that effectively picked the little guy's pocket. Republicans, for their part, said taxation according to "ability to pay" would punish enterprise, savings, and investment; give rise to an intrusive army of tax bureaucrats; and pit rich against poor. Businesses thriving under protectionism also privately feared that the income tax would prove so attractive a revenue source that there would be pressure to end the system of tariffs altogether. In the debate over the constitutional amendment, the *Albany Evening Journal,* a Repub-

lican paper, said that the tax would "divide the population into two classes, the class which contributes to the support of the Government, and the class which does not contribute," a ludicrous argument given that the supposed deadbeats actually paid the bulk of federal taxes via customs duties and excise levies. (This rhetorical strategy was a forerunner of what we see on the *Wall Street Journal* editorial page today, which routinely claims that the rich pay the lion's share of federal revenue, ignoring the giant payroll tax paid mostly by middle and lower income citizens.) But as the historian W. Elliot Brownlee points out, when President Woodrow Wilson finally signed into law an income tax that could pass constitutional muster in 1913, virtually none of the tax's proponents thought it would become a major, permanent source of revenue in the federal system.

The two world wars changed all that. On the eve of World War I, tariffs and excise taxes brought in 90 percent of federal revenue. Then federal spending rose from $742 million in 1916 to almost $14 billion in 1918, with the income tax funding the rise. The federal budget for a single year had suddenly grown nearly equal to all the spending the federal government had done from 1791 to that time. Effective income tax rates on wealthier households jumped from 3 percent to 15 percent, with marginal rates for the wealthiest topping 60 percent.

But World War II witnessed the truly epochal shift. Before Social Security was enacted in the mid-1930s, it would have been impractical to administer a mass income tax; the federal government simply didn't have the information it would have needed on taxpayers and incomes, or a method like withholding with which to enlist employers in efficient revenue collection. Now it did. The war took the number of Americans paying income tax from 4 million in 1939 to 43 million in 1945; revenues rose from $2.2 billion to $35 billion. Needless to say, this represented an extraordinary change for the nation, and was accompanied by a massive public

relations campaign. Irving Berlin wrote a patriotic song entitled "I Paid My Income Tax Today." The federal government commissioned a short film from Disney called *The New Spirit,* in which Donald Duck, stunned by his new income tax bill, has a headache and takes an aspirin before learning that he can handle it all. He travels to Washington and learns that the money is being used to build warships to defeat the Nazis. In the end, Donald is glad to pay his taxes. Similar messages were stitched into popular radio programs like *The George Burns Show.* By all accounts, the pitches were effective.

Federal receipts rose from 7 to 21 percent of GDP during the war, as spending surged from between 8 and 10 percent of GDP in the late 1930s to more than 43 percent of GDP by war's end. Far from hurting the economy, these increases powered the country out of depression. They also set the stage for the massive postwar boom, which took place with the federal government consuming permanently higher levels of revenue and spending (these settled in the mid to high teens as a percentage of GDP by the late 1940s and early 1950s). Just as important, both parties tacitly agreed to keep the new tax regime and levels, and to embrace the use of fiscal policy as a form of macroeconomic management. As we saw in chapter 1, the economy thrived, even though top marginal tax rates in the 1950s were as high as 87 percent, and stood at 70 percent after 1964.