THE TYRANNY OF DEAD IDEAS

REVOLUTIONARY THINKING FOR A NEW AGE OF 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 Republican 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.

BACKLASH

By now, the backlash against taxes and "big government" that emerged in the 1970s and 1980s is a familiar story. Growth slowed. Oil shocks and inflation, combined with a growing sense that liberals had been ineffectively throwing money at the poor, left an increasing number of voters weary and frustrated. The payroll taxes that funded Social Security and Medicare continued their stealthy rise; a system funded originally with payroll taxes of 2 percent of wages was (thanks to ever-rising benefits) on its way well past the 10 percent level that politicians worried would lead to taxpayer resistance. With pocketbooks pinched and wages stagnating, and with inflation pushing people into higher income tax brackets, resentment simmered. Then California's Proposition 13 showed in 1978 that taxes could spark a potent political brushfire. The Republican Party leaped to seize the issue.

The seminal change was in Republican thinking. Traditionally, the party had been fiscally conservative and made a virtue of balanced budgets. But the new Republican stars, like Jack Kemp and Ronald Reagan, saw the tax cut message as a tremendous political opportunity—never mind that Reagan had passed the biggest tax increases in state history while serving as governor of California. They also thought tax reductions could help jolt the anemic economy. But rhetoric aside, the politicians certainly didn't want to be bothered with the unpleasant work of cutting spending as well. Luckily for them, intellectual justification suddenly emerged for saying "Deficits be damned." Economists like Milton Friedman and editorialists like Jude Wanniski of the *Wall Street Journal* argued that "starve the beast" was a perfectly defensible way to limit the size of government. Cut taxes first, they counseled, and spending would eventually have to come into line. And if it didn't, well, that was no big deal either. It might even be salutary, since deficits would put new political restraints on the amount of spending that would otherwise occur. The economist Arthur Laffer sketched his notorious curve on a napkin to show that cutting taxes might actually increase government revenue. Though these assertions turned out to be bogus, they proved irresistible to Republican politicians, and the party's love affair with tax cuts began. Soon a well-funded infrastructure of conservative think tanks and institutes made sure that the new thinking on taxes permeated every corner of the capital.

The Republicans were particularly successful in the 1980s and early 1990s in demonizing the tiny fraction of the budget that went to welfare. They also deftly separated the idea of taxes in the American mind from the popular things (health care, pensions, schools) that tax revenues paid for. This schizophrenia was a stunning conservative achievement. As one angry senior citizen cried to a senator in the 1990s, "Don't let the government get its hands on my Medicare!"

By the turn of the century the debate had settled into well-worn grooves. Republicans were for more tax cuts no matter what: in bad times they were the road to recovery; in good times they were critical to keep a boom rolling. When I worked in the White House in the early 1990s, President Clinton told his advisers that the Republican tax message worked. He described how economically strapped voters reasoned, as follows: "We can't trust any of these damn politicians, but at least the Republicans will give me some of my money back." In an era of wage stagnation, this hard-bitten logic has proved a powerful lure. Even if most tax cuts went to the top, the average guy still got a few bucks. Republicans designed their plans to be sure this was the case. Democrats, meanwhile, knowing how powerful the issue was for families who felt squeezed, were afraid not to be "for" tax cuts, too. So they offered "targeted" tax cuts (for kids or for savings, for example) in the hope that this would still leave enough money in the till for programs they liked. And there the debate still stands—with both parties, for different reasons, unwilling to discuss the certain tax increases in America's future.

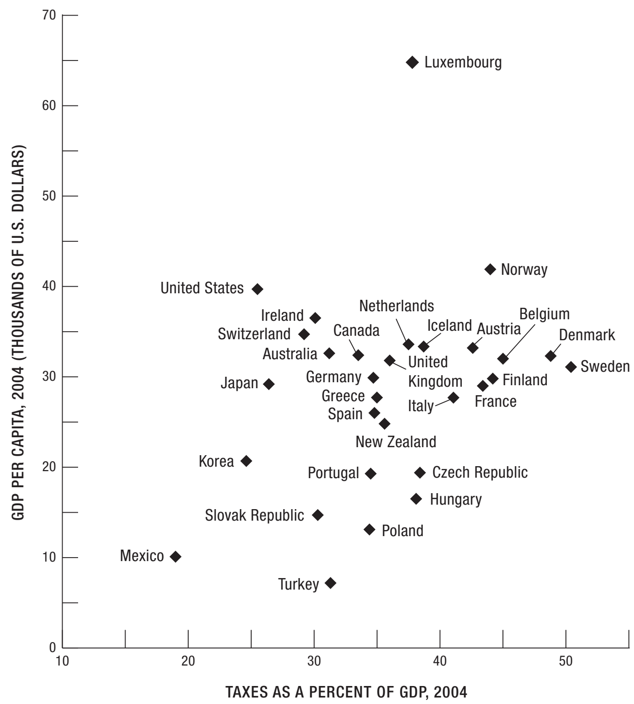
THE EVIDENCE, PLEASE

So what do we need to know about the impact of taxes on the economy—and, in particular, about the impact of higher aggregate taxes than we have today, since that's what's coming? Economists distinguish between micro effects and macro effects. Micro, which deals with the impact of taxes on how much people work and save, or how much research and development firms do, tends to get the lion's share of the profession's attention. The conclusions, shorn of the fancy math, aren't hard to understand. Incentives matter. If you lower the financial return on an activity, some people are going to be dissuaded from doing it. If unemployment benefits are too generous, people are less likely to work. If marginal tax rates are 90 percent, ditto. David Stockman, Ronald Reagan's budget director, said Reagan's own experience had seared into him the truth of this lesson. After World War II, Reagan told Stockman, when marginal rates hovered around 90 percent, he would stop making movies when he hit that bracket, and take it easy for the rest of the year. "You want to take seriously what the economic cost is of having high taxes," says Joel Slemrod, an economist at the University of Michigan and a coauthor of the book *Taxing Ourselves*. "The micro effects can be important in some situations, but they're overstated in general in the U.S. policy debate."

Yet while economists quarrel about the precise micro impact of taxes on various activities, the more interesting macro story gets no attention at all. The question here is: What is the effect of higher aggregate taxes and spending on the level and growth rate of national income? The fascinating truth is what Adolf Wagner predicted 125 years ago: wealthier nations tend to have higher taxes and spending. And America's taxes and spending can rise substantially from where they are today with little or no impact on the economy.

This can be seen from several angles. The first, which we've touched on indirectly in our march through America's tax wars, compares today with our past. In the last century or so, America's living standards, as measured by output per person, have increased sevenfold. Yet, as we've seen, taxes and spending as a share of GDP were very low in the nineteenth century, and now hover around 19 or 20 percent of GDP. The 1950s and 1960s, the period of our fastest growth in productivity, were also the era of our highest marginal

FIGURE 1

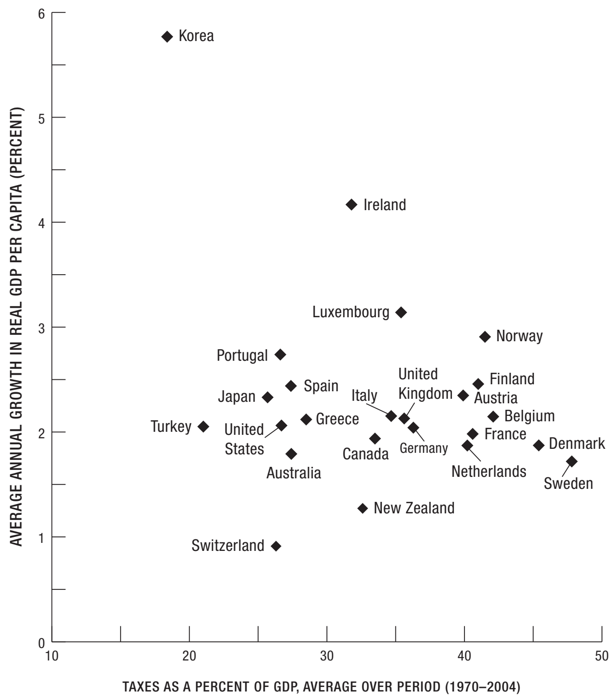


Source: Joel Slemrod, University of Michigan

tax rates. That obviously doesn't mean these tax rates caused the growth, but it suggests that other forces are much more important in driving the economy.

Then there are international comparisons. First, let's compare the level of taxes in the advanced nations with their incomes. Figure 1 does just that; on the left axis you see real income per person (or GDP per capita); on the right, taxes as a percentage of GDP. If higher taxes spelled the death knell for prosperity, we would expect to see the points clustering on a line that starts on the upper left and heads sharply down and rightward from there. That would mean higher taxes go together with lower standards of living. But

FIGURE 2



Source: Joel Slemrod, University of Michigan

there is no pattern like this at all. Some wealthy nations, like the United States and Japan, have relatively lower taxes (less than 30 percent of GDP), but others, particularly Scandinavian countries, have incomes nearly as high or in some cases higher than ours, with taxes of 45 or 50 percent of GDP.

So taxes seem to have no real effect on income levels. But what about their effect on economic growth over longer periods? As you can see, figure 2 compares the tax levels of many countries with how fast they've grown over the last three decades. Some low tax nations, like South Korea, did terrifically over this period, and some high tax countries, like Sweden, did relatively poorly. But the low tax United States performed *below* average. And a number of countries with higher taxes than ours had better long-term growth rates, including Austria, Finland, Norway, the United Kingdom, Luxembourg, and Ireland.

Research by Peter Lindert, an economic historian at the University of California, Davis, confirms these findings over longer periods. "Nine decades of historical experience fail to show that transferring a larger share of GDP from taxpayers to transfer recipients has a negative correlation with either the level or the rate of growth of GDP per person," he writes in *Growing Public,* a major study published in 2004. "The average correlation is essentially zero." Lindert notes further that by the late 1990s, a number of European countries had actually caught up to the United States in output per labor hour despite their higher taxes and spending as well. (Output per hour is a more accurate measure of labor productivity than output per person, since in Europe, workers work fewer hours each year).

"There's just no question that higher income countries have higher taxes," Michigan's Joel Slemrod says. "Now, what that tells about causation is not clear. But what it clearly tells us is that high taxes are by no means the kiss of death." Slemrod recalls a trip he took to Sweden right after he completed graduate school at Harvard, where he studied under the legendary conservative economist Martin Feldstein. "When I stepped off the airplane in Stockholm for the first time, I sort of expected to see the Stone Age," he says with a laugh. "Yet they're doing quite well. They've managed to find a way to have significantly more extensive government and more taxes than we do, and keep step prosperity-wise."

THIS IS NOT SWEDEN— REPEAT, THIS IS NOT SWEDEN

Let's write this in neon: ***no one is saying American taxes and spending will rise (or need to rise) to Scandinavian levels.*** But the reassuring news, which is utterly absent in our political debate, is that even if they did, the experience of other countries shows that this is perfectly consistent with a thriving economy. Despite passionate arguments to the contrary, history and current experience show that social spending and the taxes that fund it have not materially weakened economic incentives and growth. How can that be?

For starters, the higher spending made possible by higher taxes often contributes to economic growth. Good schools, government-sponsored basic research, and high quality systems of health care, for example, make a nation's citizens more productive.

In addition, it turns out that high-spending welfare states have tax structures that are more pro-growth than those of the lower spending, lower tax countries. These nations seem to realize that if they're going to tax more, they'd better be extra careful to do so in ways that don't kill the golden goose of the economy. They therefore rely more on consumption taxes (like the VAT) and "sin" taxes on addictive substances like alcohol, tobacco, and gasoline, and less on corporate taxes or double taxation of dividends. It may seem paradoxical to American ears that higher tax countries are actually *smarter* about taxes than we are, but if you think about it for a moment, it makes perfect sense, because the stakes of getting the tax balance correct are so high. Moreover, the higher tax countries tend to be more open economies, meaning that trade comprises a greater share of their GDP; with their firms exposed to more international competition, their operations, and thus the economy broadly, become more efficient.

Assuring a strong economy even as taxes rise means getting other things right as well. For example, the restrictions many European countries place on the ability of firms to fire workers makes companies understandably cautious about hiring them in the first place. These "labor market restrictions" help explain why Europe has shown so little job growth in recent decades (and why it has high unemployment) while American job creation remains the envy of the world. Conservatives often try to lump together the prospect of higher taxes with these wrongheaded labor market approaches and dismiss the whole supposed package as "the discredited European model." But this criticism misses the point. America doesn't have to adopt Europe's ideas about labor markets; and our inevitably higher taxes, especially if implemented wisely (we'll discuss how in chapter 10), simply won't hurt overall growth.

Some leading conservative thinkers acknowledge at least parts of this macro story. I asked Kevin Hassett, the director of economic policy studies at the American Enterprise Institute and an adviser to John McCain's presidential campaign, what the impact would be if we shifted health care costs from business payrolls to government, and raised taxes by the same amount to accommodate the transfer of responsibility. "If in one of these scenarios we call the health expenditure 'government' and [in] the other we don't," he said, "what does it matter?" He added: "It's hard to imagine [that] that would have the [negative] growth effects" normally ascribed to tax increases in the economics literature.

BRAND MANAGEMENT

In general, however, when it comes to taxes, the conservative mind is caught in the past. Republicans cherish the political triumphs their tax cut mantra has delivered, and naturally resist the idea that its time is passing. But, as Ronald Reagan often said (quoting John Adams), "Facts are stubborn things." Lowering the top marginal tax rate from 70 percent toward 30 percent, as the Republicans did under Reagan, was a major economic and political achievement. Going downward from the mid-thirties, where the rate stands today, wouldn't be nearly as big a deal, and the boomers' imminent retirement makes it a moot question anyway.

So why does tax cutting mania persist among Republicans, I asked Douglas Holtz-Eakin, the McCain adviser—given that the impact can't be great at today's much lower tax rates, and that, as Holtz-Eakin himself explained to me, taxes will soon have to go up substantially in any event?

"It's the brand," he said. "And you don't dilute the brand."

The moral of the story? We've reached a moment in the history of American capitalism where our reflexive "Me-Tarzan-you-Jane-taxes-bad" mind-set is one of the biggest obstacles to pragmatically positioning the American economy for success in a global era.

There's been a kind of unwritten law since the 1950s under which taxes hover between 18 and 19 percent of GDP. When they inch higher, pressures seem to build to cut them. This pattern is sometimes cited as proof that the American people, in their mystical wisdom, won't tolerate taxes above this norm. The problem is that this metaphorical iron law is about to collide with the real iron law of mathematics, and the metaphor will have to give. Just as wars permanently altered the level of taxes and spending in the past, so will a lesser national emergency—the baby boomers' retirement, along with efforts to strengthen the safety net for the nonelderly in an age of rising economic anxiety—soon force taxes to new levels as well. This won't mean we become Sweden or France. And the economy, as all evidence suggests, will be fine.

"There's a broad-based understanding among experts who follow this that there's no way that we're going to be able to maintain tax levels at 18 to 19 percent of GDP," says David Walker, the former comptroller general. "The only question is: what higher level of taxation will we go to, when, and how are we going raise the related revenues?"

11

ONLY THE (LOWER) UPPER CLASS CAN SAVE US FROM INEQUALITY

"We should tax the shit out of these guys."

That's what a well-known and otherwise mild-mannered Ivy League economics professor (and member of the Lower Upper Class) told me regarding the sums that CEOs, private equity honchos, and assorted other banking and financial types have been earning. "My argument is that these super-rich people are earning classic rents," he explained. To economists, "rent" refers to the difference between what a factor of production is paid and what it would need to be paid to remain in its current use. Rents are present in situations where some form of market power is exercised—as in monopoly power, political power, even "star power." Say a football star is paid $100,000 a week to play for his team when he'd be willing to do it for $20,000. The excess $80,000 is "rent." Since reducing rents doesn't affect what people actually choose to do, economists say they can be taxed without hurting the real economy.

This was the professor's point. "These CEOs would do exactly what they did if they were paid half of what they're paid," he said. "The deals in Wall Street would go through if the investment bankers earned half. So these are classic rents and we can tax them to take the edge off of today's growing inequality. I find it more productive not to argue the question of whether the system is 'rigged,' or whether their compensation is really produced by 'market forces,' but to ask whether the supply of those services would be any less if those people were taxed at a fifty percent marginal rate." His voice was rising on the phone, betraying a touch of anger. "To me that's the crucial issue—these earnings are pure rents!" he went on. *"So we should tax the shit out of these guys!"*

Yes, it's a fancier argument than your average Lower Upper might make. And it may seem far-fetched to think the rebellion against extreme inequality will be led by tenured professors ready to march beyond the ivory tower—or for that matter by posh Lower Upper professionals roiling with resentment in their six-room Park Avenue apartments. But the truth is there's an opening for a "comeuppance agenda" aimed at the ultrarich that would be immensely satisfying to Lower Uppers—and which would fit nicely with a security and opportunity agenda for everyone else.

PROGRESSIVISM: THE SEQUEL

The brewing revolt of the Lower Uppers is an instance of history repeating itself. Indeed, the historian Richard Hoftstadter focused on precisely this group in his classic 1955 history of the Progressive movement, *The Age of Reform*. "It is my thesis that men of this sort" helped lead the movement, he wrote, "not because of economic deprivations but because they were victims of an upheaval in status that took place in the United States during the closing decades of the nineteenth and the early years of the twentieth century. . . . In a strictly economic sense, these men were not growing poorer as a class, but their wealth and power were being dwarfed by comparison with the new eminences of wealth and power. They were less important, and they knew it."

Hoftstadter noted that the professional class felt it had "been ousted almost entirely by new men of the crudest sort." "If our civilization is destroyed," wrote Henry Demarest Lloyd in *Wealth Against Commonwealth,* an 1894 appraisal of the robber barons, "it will not be by . . . barbarians from below. Our barbarians come from above."

The journalist Walter Weyl's observations of social resentments in *The New Democracy,* written in 1914, sound uncannily like sentiments we hear a century later. "To a considerable extent the plutocracy is hated not for what it does but for what it is," wrote Weyl.

> Our over-moneyed neighbors cause a relative deflation of our personalities. . . . Everywhere . . . we meet the millionaire's good and evil works, and we seem to resent the one as much as the other. Our jogging horses are passed by their high powered automobiles. We are obliged to take their dust. . . . We are developing new types of destitutes—the automobileless, the yachtless, the Newport-cottage-less. The subtlest of luxuries become necessities, and their loss is bitterly resented. The discontent of today reaches very high in the social scale. . . . Our eminences have become higher and more dazzling. . . . Although lawyers, doctors, engineers, architects and professional men make larger salaries than ever before, the earning of one hundred thousand dollars a year by one lawyer impoverishes by comparison the thousands of lawyers who scrape by on a thousand a year [a healthy sum in 1914].

We are obliged to take their dust. Conditions like these, especially when wealth seems ill gotten or wildly out of proportion to the contribution those earning it have made to society, create kindling for popular brushfires ignited from above. In our own era, the most pertinent (if now tarnished) early sign of this trend was the nerve struck by Eliot Spitzer in his days as a crusading attorney general, before his unsavory fall. When Spitzer took on the shocking greed of men like Richard Grasso, who felt he deserved hundreds of millions of dollars for running the nonprofit New York Stock Exchange, or corrupt investment bankers who made millions touting stocks they privately knew were dogs, the public's outrage and its support for Spitzer's actions were close to universal. In 1906 a similar crusade against corrupt CEOs in New York's insurance industry vaulted Charles Evans Hughes, a Lower Upper lawyer, to the governor's mansion, and eventually to the Supreme Court and the Republican presidential nomination. Hughes's nationally reported investigation served as a harbinger for an era of progressive reform.

As was the case one hundred years ago, however, the broader reform possibilities inherent in these developments do not spring merely from Lower Upper resentment or from popular revulsion at industry excess. They stem instead *from the way the experience of humiliation and loss of status at the hands of the ultrarich expands the boundaries of Lower Upper empathy*. The energy for real reform is the altered outlook of this influential segment of society. "If the professional groups changed their ideas and took on new loyalties," Hofstadter wrote of that earlier time, "it was not in simple response to changes in the nature of the country's problems . . . but rather because they had become disposed to see things they had previously ignored and to agitate themselves about things that had previously left them unconcerned. . . . As men who were in their own way suffering from the incidence of the status revolution, they were able to understand and empathize with the problems of other disinherited groups."

FEELING THEIR PAIN: LOWER UPPERS MEET LUCK

With their noses pressed up against the glass of better clubs, homes, schools, planes, and resorts to which they no longer have access, today's hard-working Lower Uppers are experiencing the bitter taste of diminishment. The flip side of their loss of faith in "merit" will be a deeper appreciation for the role of luck in life. This awakening will have powerful political implications.

Luck is a shorthand term for those things that shape our lives that are entirely outside our control. In one sense it refers to the prebirth lottery: a person's inherited genes, race, wealth, looks, brains, and talents; the values and character of the family in which a person grows up; the education that comes (or doesn't come) in this package. Where you happen to be born is also critical here; whether you enter the world in Boston or Baghdad will go far in determining your life's possibilities. All these factors are outside our control. We can't take credit for them or be blamed for them. It's this sense of luck that inspired the famous thought experiment described in the philosopher John Rawls's 1972 book *A Theory of Justice.* The way to create the rules for a just society, Rawls argued, is to first imagine everyone in an "original position" behind a prebirth "veil of ignorance," where no one knows what their own traits will be—whether they will be rich or poor, beautiful or plain, smart or less so, talented or not, healthy or unwell. Then you'd see what kind of social order people would agree in advance was fair if they couldn't know what place they themselves were destined to occupy in it. From this vantage point, of course, qualities we often consider part of "merit" are really traceable to luck, since a person's brains, and to some extent their character (at least when they're young), are shaped by factors over which they have no influence.

In another sense, "luck" refers to things like natural disasters, events that befall people that their own actions and behavior can't affect. From the point of view of many Americans losing ground today, the accelerating effects of globalization and rapid technological change represent a searing case of bad luck.

Needless to say, the question of whether and how society should respond to luck's dominion has major implications for public policy. It's the bedrock dividing line in the moral outlooks of individuals and in rival political philosophies. Conservatives, worried that an honest admission of luck's role would sanction radical, economy-killing egalitarianism, have always ended up downplaying or ignoring luck. Liberals, while deeply concerned with luck, have typically been unwilling to craft efforts to ease the burden of bad luck in ways that preserve the best of capitalist innovation and the virtues of individual responsibility.

In the modern era, however, one of the most influential segments of society has largely stood apart from these questions, acting as if they didn't matter. Lower Uppers have been largely blind to the role of luck because it has been drilled into them, from their earliest successes jumping through the hoops of the American meritocracy, that they weren't "lucky" at all. They were "smart." They were "good." They were "hard-working."

Now that their second-tier status is awakening them to the fragility of "merit" as the source of their self-esteem and as the basis for where they "deserve" to stand in society, Lower Uppers will start seeing luck's hand elsewhere. They'll see it not only in their own story or in the fate of the ultrarich above them, but in the destiny of millions of their countrymen, now buffeted and struggling with rapid economic change. They'll be open to fresh appeals about what these powerful forces outside people's control should mean for society's basic arrangements. As a result they'll become stronger voices for equal opportunity, and for some set of minimal protections appropriate for citizens of a wealthy nation like the United States. Like their Progressive Era predecessors, and like our angry professor at the start of this chapter, they'll also see justice (and take satisfaction) in asking the ultrarich to kick a little more into the pot to make this happen.

For a glimpse of what the future will sound like, listen to Robert Crandall, the legendary, tough-as-nails CEO of American Airlines who retired in 1997 before upper end income really took off, and who spoke to the *New York Times* about his concerns in 2007:

> He is speaking out now, he said, because he no longer has to worry that his "radical views" might damage the reputation of American or that of the companies he served until recently as a director. The nation's corporate chiefs would be living far less affluent lives, Mr. Crandall said, if fate had put them in, say, Uzbekistan instead of the United States, "where they are the beneficiaries of a market system that rewards a few people in extraordinary ways and leaves others behind."

"The way our society equalizes incomes," Crandall went on to argue, "is through much higher taxes than we have today. There is no other way."

YOUR CROWN, MY LADY?

Historians caution that it is rare for economic resentment to get politically mobilized. To gauge the prospects for such a backlash, history counsels a look at several criteria, says Michael McGerr of Indiana University, one of the leading contemporary historians of the Progressive Era. One is to ask whether the ultrarich are taking steps to try to establish themselves as a kind of permanent nobility or plutocracy. (Might the drive to eliminate the estate tax fit here?) Another is whether the ultrarich are living in ways that are fundamentally alien to the rest of the country, or show radically different values than Americans hold generally. Compared to the pre–Progressive Era we may not have reached that point; even today's gaudiest hedge fund soirees are no match for the costume ball thrown by Cornelia Bradley-Martin at the Waldorf in the depression winter of 1897, when New York City's police commissioner, Theodore Roosevelt, ordered 250 cops to close down the block around the hotel (where his wife was dancing inside) for fear that "anarchists" might be moved by this symbol of excess to riot. Nor do we yet see anything quite like the Vanderbilt family, whose women took to wearing crowns in public to connote their superiority (and not just little tiaras, apparently, but heavy duty headgear). McGerr also notes that these social dynamics can take a generation to gestate; Gilded Age excesses that began in the 1870s and 1880s didn't ripen into something that provoked a political backlash until twenty-five years later.

But the night is young, as they say. And in the Internet age everything moves faster, including history itself. Karl Marx thought the envy of the proletariat would bring capitalism down. He was wrong. But before long the envy of the merely affluent will help pull today's übercapitalists down a peg or two even as it pulls everyone else up, thereby taking the edge off today's extreme inequality.