ECONOMICS U$A

Program #13

<u>PUBLIC GOODS AND RESPONSIBILITY: HOW FAR SHOULD WE GO</u>

AUDIO PROGRAM TRANSCRIPT

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PUBLIC GOODS AND TAXATION

(MUSIC PLAYS)

Announcer: Funding for this program was provided by Annenberg Learner.

FRANK STASIO: This program was originally recorded in 1985. Though times have changed, the basic economic principles presented here remain as relevant today as they were when the series was produced. Also, please note that individuals interviewed on this program may no longer hold the same titles they held when this program was recorded.

(MUSIC PLAYS)

FRANK STASIO: Economics U$A. One of a series of programs designed to explore twentieth-century micro and macroeconomic principles. The subject of this edition is Public Goods and Taxation. Our guest is Joseph Peckman, Senior Fellow at the Brookings Institution. I'm Frank Stasio

WALTER MONDALE: "By the end of my first term, I will reduce the Reagan budget deficit by two-thirds. Let's tell the truth. That must be done. It must be done. Mister Reagan will raise taxes, and so will I. He won't tell you. I just did."

FRANK STASIO: Former Democratic Presidential candidate Walter Mondale surprised a lot of people when he made higher taxes a campaign promise. Four years earlier, Ronald Reagan was swept into office on the promise to do just the opposite. And when Reagan did cut taxes, his popularity in most quarters of the country grew. For Mondale to say he would return to higher taxes seemed like political suicide. But Mondale didn't think so. The Reagan tax cut forced government to cut spending, and go more deeply into debt. Mondale was betting that Americans had begun to worry about that debt and would be willing to pay more in taxes rather than bear the huge cost of carrying the deficit over a long period of time. Also, Mondale was trying to appeal to those Americans whose benefits had been reduced or eliminated.

WALTER MONDALE: “We are living on borrowed money and borrowed time. These deficits hike interest rates, clobber exports, stunt investment, kill jobs, undermine growth, cheat our kids, and shrink our future. Whoever is inaugurated in January, the American people will have to pay Mister Reagan’s bills. The budget will be squeezed. Taxes will go up. And anyone who says they won’t is not telling the truth to the American people.”

FRANK STASIO: Mondale lost the bet. In the end, the country decided it wanted lower taxes and less government spending in some areas. Of course, there were other reasons for Ronald Reagan’s victory in 1984, but, clearly, the tax issue played a large part. The subject of taxes is always a hot topic because almost everybody pays them. Americans are not only sensitive about how much the government takes from them in taxes, but also they’re concerned about how the government spends their money. Still, everyone believes the government has some responsibility to get involved in the economy. Joseph Peckman is a Senior Fellow at the Brookings Institution.

JOSEPH PECKMAN: “Well, the government has to provide those goods and services that, uh, individuals need and which cannot be sold on the marketplace. So, for example, national defense, having an army, and a navy and an air force, is something that the people can’t provide for themselves. And what happens is, the government provides it. Moreover, such services and goods have the characteristic that they provide national defense for you and for me and for everybody else, without reducing the supply of national defense to…to anybody just, which is different from a good that is sold on the marketplace. If I buy a pair of shoes, you can’t buy it, you see, whereas if…if I benefit from police and fire protection, you also benefit from the same kind of protection. Since we don’t know, and no individual can evaluate, how much national defense or police and fire protection is worth to him or her, there would be no way you…you could create a market. On the other hand, to take shoes as an example, you and I, while we don’t think of it in those terms, you and I have some conception of how much a pair of shoes is worth to us. And if the pair, if the shoes are too expensive, we don’t buy them. If they’re just about right, we do.”

FRANK STASIO: Our willingness to pay taxes to support public goods hinges on the benefits we believe we derive from government programs. It's easy to see how everybody in the country benefits from some kind of national defense program, though there may be arguments about how much is enough. Other public goods and services may have less direct impact on the population as a whole. Although, as Joseph Peckman points out, in many cases the indirect benefits may be substantial.

JOSEPH PECKMAN: "There are many goods and services that are what are called 'mixed goods,' partly private and partly public. Two good examples of mixed goods that government provides are: health, and education. In both cases, obviously, the individual does– who receives the benefit– the individual does benefit from the service. And in that respect, there's a private benefit. At the same time, everybody else is benefited. If we can eradicate disease, for example, not only does the person who's diseased get the benefit, but society as a whole gets the benefit of…of the disease eradication. Similarly, if we educate a poor person that poor person will be able to earn income and, therefore, have a private benefit, but, in addition to that, you and I don't have to pay for welfare expenditures that we…we might otherwise have to pay. Those kinds of goods, the mixed kinds of goods, I think, other than national defense, constitute most of the budget."

MALE VOICE: "The victory for Proposition Thirteen is the opening battle and the new American Revolution. We have a new revolution against the arrogant politicians and insensitive bureaucrats whose philosophy, a tax, tax, tax, spend, spend, spend, elect and elect and elect, is bankrupting we the American people, and the time has come to put a stop to it."

FRANK STASIO: In a democracy, we have some voice in whether and to what extent education and national defense and other goods and services should be provided by the government. As Peckman has said, it is sometimes difficult to place a value on public goods. It can also be difficult to tell who benefits directly and who enjoys indirect benefits. But taxpayers keep a good deal of pressure on government to charge those who gain from government programs. Economists call this "the benefit principle."

JOSEPH PECKMAN: "The first thing the government should do is to levy benefit taxes, to the extent that is necessary. That is, people shouldn't get benefits from…from services provided by government, free of charge. If that's done, what happens is that they use too much of those…those services, and we're misallocating our resources. And there are many examples of the things, of things that government provides that…that are paid for, in fact, by individuals. The simplest example I can think…think of are parking meters in…in local governments. We use up space when we park our…our cars. That benefits us, and it clogs the highways and…and streets. So, we put up park…, the government puts up parking meters and charges a quarter or a half a dollar an hour. Whether this is an exact value of it, we don't know, but there's an attempt to do that. Similarly, business will use governmental facilities, for example, navigational facilities for…for aircraft. Fees are paid for those navigation facilities. In effect, the government is providing goods and services rather than the market, and if you can evaluate that, every public finance economist would say that you ought to require the individual who benefits from these services to pay for them."

FRANK STASIO: The government may also tax firms and individuals who create costs that would otherwise be borne by the public at large. Peckman says the government imposes environmental controls for this reason. So that businesses that pollute the environment will either pay for the cleanup or compensate for the damage.

JOSEPH PECKMAN: "If we don't tax or regulate pollution, the absence of the tax means that somebody else is paying for it in terms of polluted streams and…and air. And the…and the people who are paying for it are the consumers. And the, what economists would say is, that that's unfair. The consumer shouldn't pay that burden, shouldn't bear that burden, but the burden should be on the polluters and on the people who buy the goods and services produced by the polluters. And so, more recently, we have been imposing taxes on polluters, like the super fund that is being used to clean up chemical wastes and chemical dumps. We are now, actually, imposing taxes on people who pollute or destroy the property that belongs to all of us, you see. But the objective of such pollution taxes would be to impose the tax on the…on the people who…who actually do the polluting, and to moderate or eliminate the tax on people who don't have anything to do with the pollution."

FRANK STASIO: The government imposes benefit taxes where possible, but, in many cases, charging a user for the benefits they receive would be impractical or counterproductive. It's almost impossible to know the relative value to each individual of running the federal government or providing for national defense. Also, it makes little sense to charge poor people to participate in programs designed to improve their living conditions. Still, the government must collect taxes to pay for these programs.

JOSEPH PECKMAN: "The question is, how should these general taxes be levied? The history of…of most democratic countries indicates that the basic rule is that, we should tax ability to pay, in accordance with ability to pay. Now, there are difference of opinion about what ability to pay is, and whether you can define it. But I think most people believe that, the richer you are, the more ability to pay you…you have. And that the tax system should be progressive, which means that as you, as your income rises, you should pay not only a higher tax, but a higher proportion of your income in taxes. That's a definition of a progressive tax."

FRANK STASIO: Americans turn over more than three hundred billion dollars to the federal government every year in the form of income tax. As Peckman has said, the income tax is progressive. The 1981 tax bill set a ceiling for personal income at a rate of fifty percent. So, the rate at which income is taxed increases until it reaches fifty percent. Peckman says, there are certain consequences of income taxation that extend beyond simply financing federal programs.

JOSEPH PECKMAN: "One thing we know is, that, to a certain extent, much less than most people believe, the income tax makes the distribution of income after tax a little more equal than the distribution before tax; since we take more…more money from rich people, it…it affects the distribution of income. A second thing is that the income tax affects individual work and saving behavior, and investment behavior, and, to that extent, it may…it may have an economic effect. At one time, we didn't, we really had no basis for making judgments about these economic effects. More recently, I think economists have…have made some progress about measuring the economic impact of taxation."

FRANK STASIO: Throughout 1970s and '80s, a growing number of economists, like Arthur Laffer, began to argue that high taxes cut into productivity. They said that income taxes had risen so high that workers had less and less incentive to work.

MALE VOICE: "People don't work to pay taxes. People work to get what they can after tax. People don't increase the productivity of their capital, or their labor, or their production process, to give the money away to the government. They do it to make more profits, themselves. And when you cut the taxes, you increase their incentives for doing that activity, and you'll increase productivity, output and employment. Who cares about productivity when you don't get any benefits from it?"

RONALD REAGAN: "We move on to the individual, you and me, and my proposal is for a ten-percent cut in the income tax across the board, not a special cut for someone, while someone else, you know, rob Peter and pay Paul. We're all named Peter today. Ten percent, a ten percent in 1982, and another ten percent in 1983, a thirty-percent cut over a three-year period."

JOSEPH PECKMAN: "It turns out that, in our kind of society, it's very difficult for many people to vary…vary the number of hours they work because they have, they, most firms require you to work forty hours in…in the United States. However, there are people who work for themselves, doctors and lawyers and accountants, farmers, who are affected by…by taxation. And there are also secondary earners in the family. There's, mainly, working spouses whose income is not essential, not as essential as the primary income of the family and they…and they might vary their hours. Measurements of economists suggest that…that the tax, the income tax, and the payroll tax, provide much more of a disincentive to married women than to…to men."

FRANK STASIO: Corporations also pay income tax. The federal government has a claim on a portion of corporate profits the same as it has on individual earnings. But in the case of personal income tax, it's clear who pays the bill. It's the individual wage earner. Corporate taxes, however, are not borne solely by the owners of the corporation. Part of the cost is usually passed on to consumers, in the form of higher prices, and workers, in the form of lower wages. The question of who bears the actual cost of a tax regardless of who pays it is called "the incidence of a tax."

JOSEPH PECKMAN: "A good example of that is the payroll tax. Part of our payroll tax is paid by the employer, and the other part is paid by the employee. Everybody agrees that the employee's part is not only paid by the employee, but he bears the tax. There are differences of opinion, mostly by non-experts, about the employer's share. Some people believe that, somehow or other, the employer pays it out of…out of his profits. Well, I think that most economists would say that, even though the employer pays the, half the payroll tax, actually, the total tax is borne by the worker. Otherwise, the costs of the…of the payroll tax would increase the cost, of the employer, and he would tend to try to either, well, he would either not produce the…the goods or services he produces with that…that, the…the time put in by the worker. Or, he will try to cut back on the…on the wages of the employer. In some…, payroll taxation is a tax on workers even though part of it is paid by the…the employer. A lot of people believe that the…the tax paid by landlords on the property really is borne by the…the tenant. That is it's shifted in…in higher rents, but, again, there's a group of economists that believes that, in this particular case, that a landlord pays…pays the property tax and that is not shifted forward to renters. So, these are examples of cases where the incident of the tax…of the tax may not be the same as the person who pays the tax initially."

FRANK STASIO: What determines the ability of a particular business to pass on a tax? When is it easier to do that?

JOSEPH PECKMAN: "Well, it's easier to do it when…when consumers will…will buy the product, whether or not you increase the price. This is called "elasticity of the demand for…for a product." And a good example of…of a what is called "an inelastic demand" is the demand for liquor. At some price people won't…won't buy liquor, but if you only put a twelve-dollar tax on…on a gallon of liquor, which is what we do in the United States today, while some consumption of liquor is discouraged, there's still an awful lot of consumption. And we…we collect for the four million dollars of taxes from those, from such taxes. So, the, I would say that it is easier for a firm to pass on the tax, the greater the inelasticity of…of demand for the product."

FRANK STASIO: There are also sales taxes imposed at the state and local level which are assessed against manufacturers, but paid ultimately by consumers, and payroll taxes like Social Security and Medicare. These other taxes are regressive. That is, they're paid at the same rate, regardless of income.

JOSEPH PECKMAN: “ Even though we have an income tax, we also have some regressive taxes or taxes that take less proportionately from the wealthy, and they sort of balance out. And for the entire tax system, the federal, state, and local tax system put together, I find that there’s virtually no, very little progressivity left, even after you take into account the income taxes, at the federal, state, and local... at the federal, state level.”

FRANK STASIO: Another assessment levied by governments is the property tax. Property taxes are assessed at the local level, based on the value of one’s real and sometimes personal property. Property tax falls in the gray area between one that is based on the ability to pay, since it’s related to the value of the property, and one that is set according to the benefits received by the taxpayer.

JOSEPH PECKMAN: “There’s a long argument among public finance economists about whether property taxes are taxes or…or a, fees for benefits for received. My own view is that it’s…it’s part of both. Obviously, most people who pay property taxes do benefit from local services, like police, fire protection, and roads and so on. And in that respect, it’s a benefit tax, but we also pay for schools and health and so on, which are not directly given to…to many individuals in the community who are paying property taxes at the time. Over a lifetime, I think it sort of averages out, but, in any case, I think that’s a…that’s a good case, the property tax, where you might regard it as part of benefit tax, and partly a general tax.”

FRANK STASIO: Peckman says that many economists believe the tax system should not single out individuals, firms, or industries for special treatment or sanction. By selecting certain industries for various tax exemptions, the government encourages the misallocation of resources through the creation of tax shelters.

JOSEPH PECKMAN: “A tax shelter is simply an investment by, usually, by wealthy individuals or corporations, which, after one takes advantage of all of the special provisions in the tax law, turns out that the income from…from that activity is either not taxed or pays very little tax. And as a result of that, as a result of the existence of the tax shelters, of all sorts in many industries, there has been a lot of investment in those industries. And presumably, if we didn’t have those tax shelters, the money would have flowed into other…other types of investments, which the market would have evaluated on the basis of their…their before-tax-rate of return rather than on the basis of their tax advantages."

FRANK STASIO: Instead of creating tax shelters, Peckman and other economists argue that the tax code should be neutral. That is, taxes should not encourage or inhibit investment in any particular industry.

JOSEPH PECKMAN: "If we have an income tax, the income tax should bear equally on firms and people with the same income. That is not the case under the law in effect now. And as a result, we have more activity in certain industries and less in other industries, or consumers derive income from certain things they wouldn't derive otherwise because there…there are tax advantages. And what economists say is that we, the tax system should provide what is called 'a level playing field,' that people should…should all have the same advantages or disadvantages and not have more advantages than others. Again, the tax shelter illustration is…is exactly what I have in mind. As a result of tax shelters we have much more commercial construction in this country. I don't think people realize, but even hotels, and ski lodges, and vacation resorts, all of that kind of construction is usually constructed from tax shelter money. I don't, have nothing against ski…ski lodges and vacation resorts, but I don't think that people who construct such…such structures should get tax advantages out of them. And maybe we, if we had fewer of that, we would have more investment and more productive industries and we'd…and we'd grow faster. I think the major point is that we oughtn't discriminate. Once we…once we decide on what kind of tax we want, we ought to tax all people and all…all firms exactly the same way rather than to give some of them the option of getting out from under, either by tax evasion, which is bad, or by legal means, such as tax shelters."

FRANK STASIO: While there is widespread agreement that the tax code contains too many special preferences, attempts to create a neutral tax structure general meet with strong political resistance. This is because most individuals take advantage of one or more of these loopholes and can organize to keep their particular preference from being eliminated. Now, let's review some of the main points in our discussion about public goods and taxation. The government provides goods and services that it believes are necessary and would not otherwise be made available by the free-market system. Private industry may not be able to provide some services because of the difficulty in determining the value of the service to individuals and the practical problems firms might have collecting payment. There are some services, like national defense, that can be enjoyed collectively without reducing the benefit to any individual. There are two basic principles that determine how taxes should be levied. When possible, the government charges a fee for services as in the case of parking meters or landing fees. Such charges are based on the benefit principle. It is sometimes impossible to determine the direct beneficiaries of government services, or the beneficiaries may be unable to pay. So, the government must pay for them through general taxes such as income tax. Income tax is based on the ability to pay, and income tax is progressive, that is, the rate of taxation rises with the level of income. Other taxes like sales and payroll taxes are regressive. They're levied at the same rate, regardless of income. Both individuals and corporations pay income tax. In the case of individual tax, it's clear that the taxpayer bears the cost. With corporations, it's not so simple. Corporations may pass along their tax payment to the consumer in the form of higher prices. Corporate taxes may also result in lower wages. The question of who actually bears the cost of the tax, regardless of who pays it, is called "the incidence of a tax." Many economists argue that taxes should not single one industry over others for special treatment. By doing so, the government may encourage the misallocation of resources. Finally, attempts to create a neutral tax structure, eliminating special preferences for various investments, usually meets with strong political resistance. While there may be a general agreement that there are too many exceptions in the tax law, most individuals take advantage of one or more of these loopholes, and fight to keep their preference from being eliminated.

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FRANK STASIO: You've been listening to Economics U$A, one of a series of programs on micro- and macroeconomic principles. Our guest has been Joseph Peckman, Senior Fellow at the Brookings Institution. Economics U$A has been produced by the Educational Film Center in Annandale, Virginia. I'm Frank Stasio

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Announcer: Funding for this program was provided by Annenberg Learner.