TAX FOUNDATION

Tax Reform and Excise Tax Policy Fundamentals

Conference Proceedings

JANUARY 9-11, 1997

BAL HARBOUR, FLA.

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In 1937, civic-minded businessmen envisioned an independent group of researchers who, by gathering data and publishing information on the public sector in an objective, unbiased fashion, could counsel government, industry and the citizenry on public finance.

More than 50 years later, in a radically different public arena, the Foundation continues to fulfill the mission set out by its founders. Through newspapers, radio, television, and mass distribution of its own publications, the Foundation supplies objective fiscal information and analysis to policymakers, business leaders, and the general public.

The Tax Foundation's research record has made it an oft-quoted source in Washington and state capitals, not as the voice of left or right, not as the voice of an industry or even of business in general, but as an advocate of a principled approach to tax policy, based on years of professional research.

Today, farsighted individuals, businesses, and charitable foundations still understand the need for sound information on fiscal policy. As a nonprofit, tax exempt 501(c)(3) organization, the Tax Foundation relies solely on their voluntary contributions for its support.

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Since 1937

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Program Agenda

Thursday, January 9, 1997

7 p.m. **Opening Remarks:**
Dr. J.D. Foster
Executive Director, Tax Foundation

Thomas J. Donohue
President, CART

Speaker:
Dr. E. Barry Asmus
Senior Policy Adviser, National Center for Policy Analysis

Friday, January 10, 1997

9 a.m. **Welcome**
Thomas J. Donohue
President, CART

9:30 a.m. **Overview**
Dr. J.D. Foster
Executive Director, Tax Foundation

10 a.m. **Session One**
"Excise Taxes and Sound Tax Policy"

Speaker: Dr. John McGowan
Associate Professor, St. Louis University

Discussant: Stephen J. Entin
Resident Scholar, Institute for Research on the Economics of Taxation

11:30 p.m. **Congressional Viewpoint**
Speaker: Lori Peterson
Tax Counsel, Senate Finance Committee

2:15 p.m. **Session Two**
"Regressivity of Excise Taxes in a Life-Cycle Model of Consumption"

Speaker: Dr. Andrew Lyon
Associate Professor, University of Maryland

Discussant: Dr. Robert Tollison
Professor, George Mason University

7 p.m. Speaker:
The Hon. Philip M. Crane
Member of Congress

Saturday, January 11, 1997

9 a.m. **Session Three**
"The Use and Abuse of Earmarked Excise Taxes"

Speaker: Dr. Dwight Lee
Professor, University of Georgia

Discussants:
The Hon. Steven Symms
Former Member of Congress

Taylor Bowlden,
Vice President American Highway Users Alliance

10:30 a.m. **Session Four**
"Measurement of Externalities"

Speaker: Dr. Patrick Wilkie
Professor, George Mason University

Discussant: Dr. J.D. Foster
Executive Director, Tax Foundation

Thursday, January 9, 1997

DINNER

Opening Remarks: Dr. J.D. Foster

Thank you all for joining us this evening. I'm J.D. Foster, Executive Director of the Tax Foundation. I think it's important to give thanks this evening to Mr. Tom Donohue, President of CART (Coalition Against Regressive Taxation), and to Mr. Ken Stinger, the Secretary of CART, for their vision and support for this program. Without CART, we wouldn't be here to discuss federal excise tax policy over the next few days. Also, I want to give special thanks to Mr. John Dunham and Mr. Bob Reese of Philip Morris, who really helped push this program forward.

We are here to prepare ourselves for tax reform. Specifically, we're here to talk about the role of excise taxes in tax reform. Fortunately, I don't think anyone really expects tax reform to take legislative shape in 1997. Even Chairman Archer and Chairman Roth are only talking about holding hearings, and there is little hope at this point of legislation moving. So we're in the hearings, not "doings" stage, which is appropriate for what we're going to be doing. We have a rare opportunity to do some long-term planning and preparation for tax reform. CART had the foresight and the wherewithal to help us do that, to help us do what we all preach and rarely perform, which is getting ahead of the curve.

Tomorrow morning, we'll kick off early at 9:00 am. I think we have a great program for you tomorrow. You, of course, have to like the economics of excise taxes to think so. I happen to like it, so I think it's great. Tomorrow night, Congressman Phil Crane is going to speak to us at dinner. As you probably all know, but in case somebody doesn't, he is the second-ranking Republican on the House Ways and Means Committee. He's going to be telling us a little bit about what he sees happening in tax policy next year generally, and tax reform specifically. And then, of course, on Saturday we'll wrap up with two final sessions.

I will now introduce our speaker for the evening. Dr. Barry Asmus is Senior Economist at the National Center for Policy Analysis (NCPA) in Dallas, Texas. Let me just say a quick word about that organization. It's run by Dr. John Goodman. NCPA has done yeoman work in advancing important causes in this country. I think you can safely give them a large share of the credit for the fact that we now have medical savings accounts in the form that we do. That was John Goodman's genius that he pushed for years and years when a lot of us thought he was well-intended, but probably off base. It turns out he was well-intended and on base.

Barry Asmus was named by *USA Today* as one of the five most requested speakers in the United States, so we requested him to speak. He's been an economics professor for 15 years. He's heard weekly on a Los Angeles radio talk show. He's authored many books, including *Crossroads: The Great American Experiment* and has been nominated for the H.L. Mencken Award.

When I first came to the Tax Foundation, one of the very first things I did was go to Idaho to hire one of Senator Steve Symms' former staffers, Ms. Gaye Bennett, who has been instrumental in setting up this program. For the last four years, I've heard, on a regular basis, how much we needed to get Barry Asmus to speak at one of our events. So I'm really looking forward to what he has to say.

Speaker: Dr. E. Barry Asmus

Thank you. Most economists are just political pamphleteers. I don't care for them a lot because they're so negative. I mean, they'll always give you the "yes, but." "Yes, the stock market was up, but the bond market was down." "Yes, it was a Christmas buying season, but that's because there were three extra shopping days." They always give you the "yes, but," "yes, but." You know the old saw, "Economists have predicted eight of the last three recessions." You could literally gather most economists around a lake and they would witness Jesus walking on the water, and in the next *American Economic Review* the title article would be "Jesus Can't Swim."

This is a very, very interesting time we live in. Mankind has experienced really four great crossovers: the spoken language, the written language, the printed language, and now obviously the digital language. And this one is going to be a paradigm shift like none other. I mean, this one is going to affect everything, not that Thomas Edison's light bulb doesn't affect everything, or Henry Ford's horseless carriage. There have been other paradigm shifts. But the micro-electronic revolution that we're going through is indeed going to make the other ones look quite, quite pale by comparison.

When you really think about it, information is power, but it used to be just the kings and the queens and the presidents and the generals who had all the information and therefore all the power. That day is over. CNN, C-SPAN, Internet, World Wide Web, fax machines, photocopies, 100 million telephone calls an hour, spreading information/data, to the far ends of the earth. The point being, with a decentralization of information comes a decentralization of power.

Micro-electronics is pulling decision-making downward and outward from central authorities of all kinds. Government and politics has been the organizing structure of every country of the world for the history of man. I'd like to suggest that we're about to embark on a new era in government and politics, when we will move from centralism to decentralism. The top-down, command-and-control, socialistic model is no longer applicable because it's too bureaucratic. It's too clumsy at a time when we're moving into a world where the digital age is making the market more efficient with every passing minute. The digital age is literally driving transaction costs to zero. The information age is driving distribution costs down with every passing minute. Conclusion: every function of government is really a candidate for privatization and a return to the market.

I'm from Scottsdale, Arizona. If a home ever catches on fire, watch out. Because a privatized fire department will arrive on the scene. In 30 seconds they put the whole Pacific Ocean on the fire. You can't believe the water. You'll go over and say, "How did you do that? How did you do that?" And their answer would be, "Well, you know, see that fire truck?" "Yes." "I own it. It's mine." And you'll say, "So?" And he'll say, "Listen, pal, when you own the fire truck, when you own the fire company, every moment that you're awake, you're thinking about one of two things, fire and water. See that hose?" And you'll say, "Looks like a normal fire hose to me." "That's not a normal fire hose. See, government uses a 2-inch hose. That's a 5-inch plastic hose. It's amazing how much more water you can put on the fire using a 5-inch hose."

My point is, every fire department, with the exception of volunteer fire departments, is going to be privatized. That's going to be true for prisons. That's going to be true for the whole nine yards.

Again, watch the argument once again. With a decentralization of information comes a decentralization of power. Microelectronics is pulling decision-making downward and outward from central authorities of all kinds. This central power model no longer works.

The point is, we're going to go from a political model to an economic globalization model. Of course, nothing could make me happier. Politics — "poly" means many; "ticks," a blood-sucking insect. It's so interesting that government has been able to pull the wool over everybody's eyes for thousands and thousands of years. Indeed, there's no end to the good that do-gooders will do with other people's money. When it comes to politicians, their palms are soft, their grip lacks clout, yet they win votes with each handout. The fact of the matter is, every government job is constructed from the body parts of jobs slaughtered in the private sector. All they do is take from Peter to give to Paul. Take from Peter, give to Paul. Three main problems occur when you take from Peter to give to Paul. Problem number one, Peter becomes a Paul-bearer. Problem number two, Paul becomes an immovable object. (When you pay people not to work, they don't work.) Problem number three, piggyback replaces baseball as the national pastime.

I think it was H.L. Mencken who said that an election is just an advanced auction on stolen goods. So it's very exciting to see the government/political paradigm becoming more irrelevant with each passing day. This is not to say that it disappears tomorrow. This is not even to say that it disappears in the next decade. But I'd be willing to bet that as we look a decade into the future and further, this paradigm will truly move to the point of irrelevancy. Again, every function of government is a candidate for privatization and a return to the market. And what's so fabulous about the information age is this: The world has come to understand that the market is like gravity. You don't have to design the market, plan the market, or manage the market. The market just happens. The enlightened self-interest of human beings happens. And, the whole world is beginning to figure this out.

I'd like to suggest that not only is government in some disarray in the United States, but it's the same kind of phenommena taking place around the world,

The digital age in micro-electronics is affecting business, too. But the thing about business is they're well into letting it happen. Again, from centralism to decentralism, businesses understand the microchip never met a bureaucratic job it didn't like. Can any of you have imagined General Electric Corporation 15 years ago? If someone would have told you 15 years ago that GE could triple in size with half the employment, you'd say, "You must be crazy."

Micro-electronics pulling decision-making closer to customers. ODD — "O" for outsourcing, "D" for downsizing, "D" for decentralization. One pundit even said that the factory of the future will only have two employees, a man and a dog. The man will be there to feed the dog. The dog will be there to make sure the man doesn't touch the machinery.

The business world is moving from massification to de-massification, moving out of a world of mass markets, mass product, mass supply, mass education, to a world of market segmentation, market particalization, and then watch this, market customization. A set of golf clubs designed just for you. A magazine designed just for you. In Phoenix we have 7,000 employees at a Motorola plant. They make a pager in that Motorola plant. How do they do it? They make them in lots of one. Customized, customized, customized. It's the technology that has allowed all of that.

Alternatively, anything that has to do with government is opposed to customization. Think of public education — designed in the agricultural age for the factory age. But today, we're in the information age. Children need to be educated differently. But government educators don't see it that way. They want a few big mass models. It's a colossal failure. It's a top-down, command-and-control system. It's monopolistic, non-innovative, and not long for this earth. Why? Choice.

Don't you find it kind of interesting that parents can send their kids anywhere they want to school between the ages of 0 and 5, and after the age of 18, but between the ages of 5 and 18 the government says you've got to go to their choice of school. Parents are not going to put up with that nonsense forever. So another command-and-control, top-down, monopoly is toppling and crumbling and being washed out to sea. And by the way, the information technological age is going to make that scenario happen faster and sooner than you can believe.

Health care. The Clintons would like us to think that managed care is the model of the future. But managed care is not the model of the future, managed care is the model of the past. Managed care is for letting bureaucrats and accountants tell doctors how to practice medicine. This is insanity. The model of the future is a competitive medical marketplace. The model of the future is medical savings accounts, allowing people to spend their own money.

I get such a kick out of the Clintons. When we were really pushing medical savings accounts hard, Senator Phil Gramm and I flew to Hawaii to debate Paul Starr, who was one of the writers of the Clinton health care program with Ira Magaziner. The Clintons come from the position, "The problem in health care is it's costly and inefficient and too much paperwork." And, so what do they come up with? A system that is costly, inefficient, and too much paperwork? Government.

Say it: "Government cost control." Just let it utter over your lips: "Government cost control." That's the ultimate oxymoron. It's like saying "jumbo shrimp." It's like saying "Rapid City, South Dakota." You could give the government the Sahara and in 5 years there'd be a shortage of sand. Listen: The President has put an attorney in charge of making doctors cheaper. What are they thinking?

I came home from that conference in Hawaii and I told my wife, "Without question, Senator Phil Gramm is going to be the next President of the United States," because here's what I saw him do. The debate: Senator Gramm talked 20 minutes, I talked 20 minutes, Paul Starr and another person that was helpful in the Clinton health care plan each spoke for 20 minutes. And then we asked each other some questions. And then we threw it out to an audience of 3,000 people, and they asked some questions, and the debate just stagnated.

Senator Gramm kept getting cost questions, dollar questions, economic questions. And, finally, Paul Starr said, "Senator Gramm, health care is not about cost. Health care is not about dollars. Health care is about flesh and blood and caring for people." Senator Gramm slams his hand on the table and says, "Paul, Paul! Don't tell me that you care as much about my grandchildren's health care as I do." Paul Starr said, "Excuse me, Senator. But I do care about your grandchildren's health care." And Senator Gramm says, "What are their names?" It was the most fabulous moment in debating history.

But, anyway, medical savings accounts have now been signed into law by President Clinton. Is it a big deal yet? No. But is the camel's nose under the tent to make a competitive medical marketplace? In my opinion, indeed it is.

In fact, hold your horses, because demographics will soon be washing across 75 million post-World War II baby boomers becoming 50 and 60. Guess what you do in your 40s, 50s, and 60s? You save. We've been a low saving country. But mainly because we've had so many people who were in their teens and 20s. When you're in your teens and 20s and 30s, you're nothing but a parasitic little sucker. When you're in your teens, 20s, and 30s, "feed me, house me, clothe me, educate me, entertain me, educate me some more" — suck, suck, suck. Well, those little suckers are coming into the high saving time of life. But that's even going to be small compared to globalization.

Friends, the world in the next 25 years is going to produce more wealth than it's produced in the last 3,000 years. Gross world product now may be $25 trillion, and 30 years from now it's going to be $50 trillion if it's going to be a dime. We're going to have to triple world food production in the next 30 years. The United States is going to be one of the major players in unbelievable global growth, and we're going to have the global growth because the whole world is coming to understand freedom.

Country A, Country B. Fifty years ago, both poverty-stricken countries. Fifty years ago, less than $700 of annual per capita income. Fifty years ago, you wouldn't give a nickel for either one of them. Country A, 50 years ago, decides to follow the Soviet socialist model. Country A decides to raise tariffs, raise taxes, make it more difficult for business people to get into business. Government will produce the steel and the electricity.

Country B says, "No, no, no. We're going to lower tariffs. We're going to go to free trade. We're going to lower taxes, we're going to make it easier for business people to get into business. And government is not going to be the main producer of steel and electricity and those kinds of things".

Fifty years have passed. It's now 1996. Country A, $700 of annual per capita income. Country B, $5,000 of annual per capita income. Country A is India; Country B is South Korea. What's going on? What's going on? The world is coming to understand freedom. Freedom is the mainspring of economic progress, without question. For me the most poignant moment of the 1980s was to stand at Checkpoint Charlie, West Berlin. West Berlin, vibrant with economic activity. Come to Checkpoint Charlie, guns, dogs, moats. Now you're in East Berlin. It's gray, it's drab, there are no goods and services. Why? Why the marked contrast between West and East Berlin?

Harry Truman said, "If you could put a Sears & Roebuck catalog in every communist home on Friday, by Monday morning communism would be finished." That's what the information age has done! The Berlin Wall came down because of what? Information. The Soviet Union collapsed because of what? Information. Read it, look at it, see what's going on here. Micro-electronics is pulling decision-making down and outward. Decentralization of information leads to a decentralization of power. This model is becoming more inapplicable by the day, by the moment. The whole world is understanding that freedom is the mainspring of economic progress. There's only one little detail, then. If freedom is the mainspring of economic progress, what is the prerequisite for freedom? John Locke was asked over 300 years ago, "What's the prerequisite for freedom of religion." He said, "Private property. If you're going to have freedom of religion, then you have to buy the land, put up the church, worship as you please." Private property, the prerequisite for freedom of religion. Private property, the prerequisite for freedom of the press. What's the story there? You know it as well as I do. The whole world is becoming privatized.

Margaret Thatcher takes a unionized, socialized, cancerized economic system and privatizes two million housing units, brings one-third of the government work force to the private sector. Now Italy, France, and Spain are following suit. What are they seeking? Privatization. Eastern Europe, the former Soviet Union. Latin and South America are ready to become the economic miracle of the beginning of the 21st century.

You only have to look at Chile, a basket case 20 years ago. When you went down to Santiago, the poverty was God-awful no matter where you looked. In 1975, General Pinochet says, "Well, geez, I'm a military dictator, what do I do now? I didn't know anything about running this economy." And someone says, "General Pinochet, there are 10 economists here at Catholic University." All 10 were educated at the University of Chicago under Dr. Milton Friedman, eight of them Chileans, two of them Americans. They've got some ideas. They not only privatized Chile, but on November 4, 1980, the same day that President Reagan won election as President, they privatized Social Security. Now they've had over a dozen years of experience at this thing. The average Chilean will have over $1 million in their retirement account when they retire. When you're in Santiago or in the environs of Chile, everybody knows their savings rate. They all carry green books. They know to the peso how much they've been saving. They can choose one of 22 pension funds. The pension funds are bubbling with money. The entrepreneurship — downtown Santiago looks like downtown Honolulu of 10 years ago.

The Argentineans are asking: "What are the Chileans doing?" The Brazilians are asking: "What are the Chileans doing?" Are you ready for this? The economies in Latin and South America are taking off like a rocket involving 375 million people. This will be one of the economic miracles of the world, all based on privatization. And, here's the linkage. Freedom is the mainspring of economic progress. Private property is the prerequisite to economic freedom. The whole world is privatizing.

Ask yourself, is Deng Xio Ping a communist? Indeed he is. Here's the question, though: Is Deng Xio Ping a socialist? Well, even he argues that it doesn't work very well. So what does he do 17 or 18 years ago? He gives 30- and 50-year leases on the land. Does a 30-year lease on land sound like private property to you? It does to me.

There's an old Chinese proverb. It says, "Give a 100-year lease on a desert, people will turn it into a garden, but give a 1-year lease on a garden, they'll turn it into a desert." China has been growing at a 10 percent average annual rate of growth for the last 15 or 20 years. China, as we speak, might be the second largest economic system in the world. United States, number one; China, number two; and number three: a unified Germany.

So, I think you have to be just that much smarter than a brown bear to figure out that this world is embarking on globalization and economic growth like never before. And, interestingly, the United States will be one of the primary beneficiaries. Economic growth and trade is win/win. Ross Perot is wrong on almost everything, but on this one he's really wrong. He says that trade is about warfare. Would someone please tell him, "No, no, Ross, trade is not about warfare, trade is about mutual gains from voluntary exchange." Mutual gains from voluntary exchange.

The golden age is about to come to American agriculture. The fact of the matter is, the world must triple its food production in the next 30 years. The United States is capable of growing almost 20 percent of the tripling of world food production that will be needed. The crops will be fenceline to fenceline. One can criticize the 104th Congress all they want, but let's be honest: The 104th Congress began to move agriculture back towards the free market by getting government out. It's not going to be long before all farmers are going to want to get government out, because there are going to be so many fabulous opportunities as our exports go to $60 billion, $80 billion, $240 billion a year. Win/win. When they do well, we do well.

South Korea and Taiwan were third-world countries with no economic growth. But then South Korea and Taiwan began to grow economically. Who ranks now as our number four and number seven agriculture export countries? Taiwan and South Korea. Win/win. They do well, we do well. We do well, they do well. Mutual gains from voluntary exchange. Econ 101. Again, you don't have to be very smart to figure this out.

I was speaking to Coca-Cola not long ago, and what they said to me was, "What we've done in the United States is going to look like a blip on the computer screen compared to what's going to happen in Indonesia, India, and China." You don't have to make $30,000 a year to drink a Coca-Cola. I think I believe them. I spoke to the Motorola Company not long ago. Chris Gelvin, the third-generation president of Motorola Company, said to this audience: "Do you know that four out of five Chinese have never used a telephone?" That's about to change, folks.

This force called demographics, this force called globalization will change the way we do business. Now your competition comes from around the world, not just next door. You have two choices: Continuous improvement and/or re-engineering. General Motors looked at its operation. It went from 51 percent market share to 45 percent, to 40 percent, to 35 percent, to 31 percent. Folks, how smart do you have to be before you bring the Board together and say, "Hey, this isn't working; this continuous improvement is wrong. We've got to re-engineer this completely." And so they stopped producing cars off 17 platforms. They moved to start producing cars off 5 platforms. And they began to re-engineer.

Many companies have to re-engineer. Take a blank page, start over, how do you do this right from the beginning? A lot of what Jack Welch has done at General Electric was tremendous re-engineering. Business has no other choice but to go with continuous improvement — get better, day after day. What gets measured, gets managed. What gets measured, gets improved. Just-in-time inventory control, statistical process control, measurement, total quality management, continuous improvement, value added.

Business today realizes that it's all about service, service, service, service. Service is not a competitive edge. Service is *the* competitive edge. When it comes to service, there is no finish line. You can never stop thinking about it. Good enough never is. But wait. What firm does a better job in America than Nordstrom's when it comes to service? I met a lady one month ago. She and her husband live in Eastern Arizona. They work for Phelps Dodge. Phelps Dodge was putting on a big party. She went to Nordstrom's and bought a $300 dress. She went out to show it to her husband, caught it on a nail, and ripped the dress. She called Nordstrom's. Listen to this: They found out her size, got a helicopter, and helicoptered that dress down from the Nordstrom's in San Diego to Eastern Arizona, and landed at their place. Here's my point: service, price, quality.

Quality. Name me a better engineered motorcar than Mercedes-Benz. Losing market share. Well, price. I'll name you three discounters right now that are going out of business. Because it's not just price, it's not just quality, it's not just service, it's a value revolution. It's all three. And you listen. And you customize. You listen and you customize.

There's the world that we're going into. Every product, almost customized to the customer. Business is going to have to learn you've got to make a customer for life, and the way you make a customer for life is you know everything about them and you meet their whims and their needs in just the way they want it. That's the way it's all going. And the information/technological/digital age is allowing us to do that very thing. It's all a value revolution.

I was in Pittsburgh. We often think, to make it in this kind of an economy, it's sure nice to read *The Wall Street Journal*, *Forbes*, *Fortune*, *Business Week*, and have a degree or two. Those are the kind of people that will make it. I'm here to tell you anybody can make it who adds value. I was having my shoes shined in Pittsburgh. This guy was stuffing $5 bills in his pocket faster than any human being on the face of the earth. Every two to three minutes, $5. Here's why: You jump up in his chair. He slaps this stuff on your shoes. He gets a match. He lights your shoes on fire. Woo! And then it goes out. Then he cracks his buff rag. Buff, buff, buff, buff, buff. He snaps it! You look: Mirrors. And you hand him your $5. I said, "Sir, I'm an economist. I've never seen a guy stuff $5 bills in his pocket faster. How much do you make shining shoes here in Pittsburgh?" And he said, "This year I'll make about $50,000." Yes! Shoe-shining.

I got out of an airplane in Atlanta. The cab driver took me from the airport to a hotel. He told me everything about Atlanta I'd ever want to know. It was the most value-added cab drive I've ever had. He said, "Are you married?"

"Yes."

"What's your wife's name?"

"Mandy."

He sang "Mandy." I couldn't believe it.

"Do you have any children?"

"Yes, I do. Andy and Angela."

Gave a poem using Andy and Angela. Listen, folks: We got out at the hotel, $17 cab fare. I added $10 to it. I handed him $27. I said, "Sir, excuse me, excuse me. But I'm embarrassed. This is the greatest cab ride I've ever had in my whole life. I wish I could go back out to the airport with you and then we'll turn around and come back." I said, "Sir, if this cab ride was worth $27, it was worth $100." And he looks at me, buttons his coat, and says, "Excuse me, sir, but a lot of my customers do tip me $100." Value-added.

My brother is 50 years old. Thirty jobs in 30 years. It's always someone else's fault. This kid has caused more tears for my folks. He's living with my folks, of course. I say, "Lynn, you know what I think you ought to do? You ought to drive a cab. Develop a shtick and drive a cab." "Master's degree, piano player, artist, and you want me to drive a cab?" "Lynn, suit yourself. You've never held any other job." He begins to drive a cab in Greeley, Colorado. First year, $90 a day, working on his shtick. Second year, $180 a day, his shtick is coming along very well. Third year, another $100 on top of that — a day. My dad's 80 years old. Dad says "The most exciting time of our life is when Lynn comes home, 7:00, 8:00 at night, and he's got all this money in a brown paper bag and he drops it on the table and Mom and I and Lynn sit there and count it." Well, anyway, value added. Value added. Value added.

Quality, service, improvement, demographics, globalization, the devolving of government, the return to the market, the whole world understanding freedom. What a time! Just one caveat: Everybody has got to wake up. In a globalized world, where Japan and Germany have capital gains taxes that are almost non-existent and we tax capital gains at 28 percent, what are we thinking? In a world where we're taxing income at the point of production, point of output, point of supply, point of employment — what are we thinking?

Our country, in a globalized world, can no longer afford $300 billion worth of compliance costs, punishing capital, punishing savings, punishing economic growth. If you're an insular economy, it makes less difference. Tax all you want. But not in a globalized economy.

Medicare and Social Security have to be and will be addressed. I'll tell you this: I'll tell you what Western Europe is doing on Social Security. They're moving to privatization. Social Security is a ponzi scheme. It's an unfunded liability that cannot work, will not work, and so we have to do something.

There's encouragement around the world when it comes to Social Security. There's encouragement around the world when it comes to the welfare state. There's encouragement around the world when it comes to freedom and privatization.

But to compete, we've all got to be similar to that guy that walked into the trophy shop for the very first time. He'd never been in a trophy shop before. He looks around, he says, "Gosh, this guy is good." High expectations produce high results.

<u>Audience Questions & Comments</u>

Question/Comment: What can we do about the welfare state?

Dr. E. Barry Asmus: Given that the problem is so multi-faceted, it's definitely going to have multi-faceted answers. We've spent 30 years under a welfare state, spending $6 trillion. If you used that same amount of money, you could buy every Fortune 500 company in the United States and every piece of farmland in the United States and give it to the poor. So it starts, obviously, at the welfare state by creating the right sets of incentives. My daughter went off to the University of Arizona. What if I'd said to her, "Angela, by the way, at the university, if you get pregnant, honey, your dad will get you an apartment. If you have a baby, I'll kick in $800. If you have a second out-of-wedlock baby, count $1,200." Crazy? Yet that's the welfare state incentive. So, obviously, to devolve the welfare state is part of the answer.

At the same time, though, the private side has got to be involved. There go I but for the grace of God. With a $7 trillion economy, you can't just say, "Tough luck." We have to look at the mirror. It starts with us. I can moan and groan about the homeless, but we've got people in Phoenix, Arizona, right now sleeping down on the Salt River. Last night it got down to 30 degrees. What do you do? Moan and groan, and say, "Well, that's tough?" Or do you get some pickups and some blankets and you help? It starts with us. Do something.

Education is part of the solution. How can these kids make it without an education? The inner-city kids. Schools in West Phoenix stink. And guess what? Those kids want out of there. Those parents want other schools.

Question/Comment: How will technology and globalization affect democratic institutions?

Dr. E. Barry Asmus: I would say two things. One is that technology, in my opinion, is going to lead towards a free market democracy rather than an elected democracy as we have now. There are some good things about that and some bad things. The good thing, it would sure be nice to get elected officials out of Washington, DC, and get them back home, nose to nose with their constituency. I don't know what form government is going to take in this technological age but I think government is at its apex and we are going to see a pretty big de-evolving of government, not only in our country, but around the world. I think you just have to see that the market will make it happen, supply and demand determining prices, supply and demand determining wages, supply and demand determining interest rates. Profits and losses, giving signals.

The microchip never met a bureaucratic job it didn't like. Downsizing swept through the business sector. It's about two-thirds over. But in government, it hasn't even really begun yet.

Thank you.

Friday, January 10, 1997
WELCOME

Mr. Thomas J. Donohue

Good morning. I'm Tom Donohue, President of the American Trucking Associations (ATA) and President of the Coalition Against Regressive Taxation (CART). And my job is to welcome you this morning and perhaps get you awake before any of the comments of substance begin. I wanted to thank the Tax Foundation for organizing our seminar.

A new Congress has arrived. Folks are getting ready for their new appointments to the Cabinet. And while this is all going on, before they're even settled, people are already talking about ways to raise, reform, change, and alter the tax system. There is even a new task force, headed by Mac Collins, charged by the Chairman of the House Ways and Means Committee to consider what's going on with excise taxes.

Now let me just take a minute to talk about CART. About 11 years ago, ATA and a number of other organizations realized we needed to deal with the Congress's appetite for excise taxes and for the way they'd like to change them. We were a strange lot. We were folks who would just as soon have seen each other get taxed as not. But we decided that we were much better off together than we were apart. So we came together, not on all the subjects that we might disagree on, but on one subject: That excise taxes had a role in this country, but certainly not the role that was envisioned by the government at the time.

You might remember that Senator Bob Packwood, then the Chairman of the Senate Finance Committee, had this strategy to cut income tax rates without eliminating business and personal tax breaks. And the way he wanted to do it was to end the deductibility of excise taxes and tariffs. His plan took money from anyone who drove, made phone calls, bought toys and clothes, imported, fished, smoked, drank, drove trucks, drove cars, or did a hundred other things. And we finally got together and said, "Slow down." In record time, more than 100 organizations met to form CART. We quickly got a majority of the Senate to sign a letter to Packwood asking for a hearing on his proposal, which he had initially wanted to bring directly to mark-up. He reluctantly scheduled a hearing, which clearly brought out how heavily his plan would weigh on lower- and middle-income folks. Before long, the Senator withdrew that proposal and produced a new package that formed the basis for the bill which the majority of the Senate voted for and which President Reagan signed into law.

I represent the trucking industry. I was telling our friends from the oil industry that truckers spend $58 billion every year buying fuel. It's between a third and a fourth of all their business. I must tell you, we're very happy to pay excise taxes on diesel fuel if they're used as intended. But we are absolutely in unison and in partnership with others in opposing allowing excise taxes to be used in a punitive way or for regulating social policy. If the tax has a purpose, like going to build a road, that's okay. We'll pay them. They'll build the road.

There is today a special group looking at excise taxes. Over 150 new House Members and 30 Senators have taken their seats since the last vote on raising excise taxes occurred in 1993. Even members who have served for a long time are now looking at taxes from new vantage points, as new Chairmen of committees or as people that have made commitments to provide some other largesse to the population. They are trying desperately to find a way to meet those commitments. Therefore, my view is, let's take nothing for granted. The temptation to raise excise taxes has overwhelmed both parties at times because you can say it's not really a tax, it's a user fee. The fuel tax is pretty simple. If they just say, "Well, we're building a road," then it would be all right if they would build the road. But we've got 4.3 cents right now that's going into deficit reduction. They are holding our money hostage so that the budget looks better. We're beginning to hear folks that say, "Let's up the fuel tax." And I say, we'll pay whatever fuel tax it takes to build the roads we need. We're going to increase the miles trucks drive in the next 4 or 5 years by 30 percent. But when you start using it for every other purpose other than what it was intended for, then you're going to have some trouble with us.

So as the new debate begins on taxes, we come back to recommit ourselves to a philosophy. It's not a philosophy of family aid; it is a philosophy of mutual survival. And so we are, again, together figuring out how we can deal with the dilemma of a Congress which has promised far more than they have the ability to deliver. We are trying to figure out how to deal with a Congress that today is collecting from the American people more taxes as a percentage of their income than they ever have before, and yet have promised, (a) to reduce those taxes, and (b) to expand the largesse that they promised the American people.

You can have all the lobbying reform you want, all the political campaign reform you want, and the Supreme Court is always going to come down on one fact — the right to petition this government is Constitutionally guaranteed. And our job is to figure out the way to deliver that argument on behalf of our constituents in a way that is honest and compelling and carries the day. And that's why we're here.

I represent 9 million people, 350,000 small companies, that get up every day and try to deliver goods in this country. And so, I'll fight overbearing taxes that are not required to build the roads or improve the bridges, that are put on these companies so that some other constituents can get a largesse that somebody promised them when they ought to be getting for themselves through hard work, or that they ought to be getting on the local level.

We're here today, collectively, to reexamine our arguments, to follow up on the many studies that we have done in the past, to listen to people who have thought through these economic arguments.

And so I encourage you today to be like the pantomime. Recall the last time you went with your children or your grandchildren to the theater. Recall the pantomime, who is desperately looking for a hole in the wall. We are looking for holes in the wall. We are looking for legitimate, honorable, compelling arguments that say, in a simple way, that excise taxes have their place, but not to create a method where government can say, "That is not really a tax." Where government can say, "It is really an instrument of social policy." Where these arguments can be applied to any industry or to any group of people, simply to increase the amount of dollars going into government coffers.

Remember, we're the pantomimes. We are looking for a series of arguments that are honorable and compelling, and we are looking for ways to deliver them. I wish you all a good conference.

OVERVIEW

Dr. J.D. Foster

Well, if that didn't wake you up, coffee's certainly not going to help. I want to take a moment if I may, to tell you a little about the Tax Foundation. Many of you are very familiar with our organization; some of you may be just meeting us for the first time.

The Tax Foundation was set up about 60 years ago. It was set up because a group of businessmen got together and realized the government and the public really didn't have the information they needed to understand what was going on with their own government — federal, state, and local. We hold a wide range of events every year. Last year we started a program of press roundtable discussions, which are "off-the-record." We invite all the major reporters of tax policy to a luncheon and we go over some issue of tax policy for a couple of hours. The roundtables have been extremely successful. All the major news networks show up and they get a chance to hear a battery of economists, in an off-the-record environment, debate amongst themselves.

We have seminars on Capitol Hill for the staff of the tax writing-committees, to review various issues in tax policy, usually oriented towards international tax. We do a number of international conferences. Last year we sent two delegations of senior Congressional staff to Europe to go over international tax and trade issues.

We hold four or five state conferences every year, focusing on tax policy issues relevant to particular states. This coming year we're going to initiate a new program. The European programs have been so successful, we're now going in the other direction: We're going to Asia in the summer with about 10 of the staff of the tax writing-committees.

Initially, the Tax Foundation was involved only with research, and we still do a great deal of research. You're probably familiar with "Tax Freedom Day," which we do every year, and have done for quite some time. We do a lot of work on the federal budget. We do specific projects, as we did last year, on the effect of differential excises on cross-border shopping for cigarettes. We spend a lot of time on various state and local issues, as well.

We are strictly a non-partisan organization. We don't lobby. We just try and put information out and let people make their own decisions, which fits in with this program very nicely. This is, in part, an opportunity to do the pantomime, to try and find the holes. But it's also an opportunity to have a discussion based on economic principles, an opportunity to work with some new authors, to encourage their research in these areas, and to get that research out into the public policy circles.

Which brings me to the topic of this conference. When you think about our tax system, we started off with a bunch of excise taxes in the federal code. They are a classic way for governments to raise revenue, customs duties included. Our income tax for that matter is a rather elderly beast. It was designed about 100 years ago. It's been around in one form or another for about 80 years. It has been, shall we say, "perfected" since 1916. It's now unknowable to anyone or any 100 of the best tax lawyers in the country.

We've been trying to find ways to make it work better for quite some time. The last time we tried was about 10 years ago. The federal income tax is the last of its kind among our major trading partners. We're the last country in the world, of the major nations, to have a classical income tax where you are taxing corporate and personal income with no direct mechanism to take care of double taxation.

So compare these two things. You've got great change in the world, great change in the economy, and a tax system that was designed 100 years ago. Now that strikes me as tax reform waiting to happen.

Eventually, our tax system is going to be compelled to change one way or the other. If the government doesn't do it, I suspect that the market economy will find a way to circumvent the problems in the tax code. But I think we would find it all more efficient if we just fixed the tax code itself. When you start talking about tax reform, it's very easy for people to become very cynical. The first thing you start thinking about, perhaps, is Gucci Gulch and all the special interests which, of course, just means people. There are no special interests. There are people who band together to represent their interests.

You can also become very cynical, believing that maybe it'll never happen. In fact, I was thinking about this after listening to Barry's remarks last night. When there's no tax reform in sight, economists tend to be some of the greatest advocates for tax reform, because we look at how the tax system saps our economy, how it distorts the way we allocate resources, hampers investment and saving, and so forth. But as soon as the tax reform momentum starts to build, we become the "yes-but"-ers that Barry mentioned. "Yes, that's all great, but for this, but for that." We economists, probably more than anyone else, start off as the big fans of tax reform to get it moving, and as soon as it starts moving we start to back off.

In a sense that caution may be well placed, because people have a tendency in tax reform debates to argue that this will, in fact, change the world overnight, which it clearly will not. But on the other hand, we tend to underestimate the value of incremental improvements in our growth rate of a tenth of a point, maybe two-tenths of a point if we did the tax reform correctly. A former colleague of mine and Drew's at the Council of Economic Advisers made a comment one time that I thought captured it well. He said, "Tax reform, done properly, is not going to cause a major improvement in economic growth, it will cause a minor improvement in economic growth." But no single change in federal policy can have the same impact as tax reform properly done. It's the number one thing we can do to improve economic performance.

About three years ago, as I came out of one of thousands of meetings on tax reform that I had to sit through, I had an idea. That same day, I was in another meeting about the BTU and the gas tax fight. I started thinking about the two topics together and it struck me that we need to be thinking about how excises are going to fit into fundamental tax reform. We talk about the new tax system replacing the income tax. The Nunn-Domenici plan also got the payroll tax into the mix. But no one had gotten into the excise taxes. And that struck me as rather peculiar.

And so I sent out a letter to a few dozen folks just raising this as a point, saying, "You guys need to think about this a little bit, this may be an opportunity for you. It certainly also may be a threat, but you need to get on it." The thrust of the letter was the following:

We are going to have a tax reform someday — I made absolutely no prediction as to when, thank God, but that it will happen some day. And when you have a tax reform moving from an income tax to a consumption tax, I think we can start, at least, as a proposition that the result could be a truly superior tax. Why go through the exercise if you're not replacing an inferior tax with a superior tax? So let's assume for a moment that tax reform succeeds and we have a superior tax that replaces the income tax.

Now presumably, unless this conference changes everything we've thought about excises over the years, this superior tax will, in fact, not be a new set of excises. It's going to be something else, maybe a national sales tax, maybe a value-added tax. Whatever it is, it's not going to be a set of new excises. And that means that, by definition, the excises are inferior to the new system. Well, if the excises are inferior to the new system, why don't we think about repealing some of the excises or scaling them back as appropriate, because as ways of raising revenue, they are inferior?

Unfortunately, the letter had no effect until about a year ago. John Dunham at Philip Morris started having the same thoughts and called me about them. And so, from those conversations, we are here today. That's the predicate for this conference: that tax reform will happen eventually; that it means a replacement of the income tax with a consumption tax of some sort, no predictions or preferences as to what that might be; and that as many inferior taxes as possible should be included in the exercise and replaced, or scaled back where appropriate.

Now I want to emphasize there are excises that are relatively well designed and targeted to particular programs. Of course, we're talking about the various fuel taxes that go into the Highway Trust Fund. As the nation focuses on tax reform, and on simplification, there's a unique opportunity here, and a unique challenge, to reassess the policies that undergird these programs. In the case of the Highway Trust Fund, tax reform offers the opportunity to reclaim what I regard as a bedrock proposition — that the federal gas tax should only go into the Highway Trust Fund and be spent only on highway programs. This proposition was violated in the 1990 Budget and has been violated again since then. We have an opportunity to reassert that basic proposition because in this sort of fundamental tax reform discussion, we can review in detail the rationale for "earmarked excises." If we define those programs properly, unless we all change our thinking on these programs, it will do two things. First, it will say an excise is appropriate to fund a highway program because that is well defined — you know where the money's going. And, second, it will say excises are inappropriate for nebulous kinds of programs, particularly if you're imposing a tax because there's an "externality" and the money is going into the great federal pot of all federal programs.

The flip side of the opportunity to reassess excises is also the concern that as tax reform stumbles — which it is certain to do, and one of the stumbling blocks is going to be revenue — if you don't make the case for why excises at the very least should not be raised, they are in fact going to be subject to an increase. Tax reform, if you're not on the offensive, is going to cause a problem. Excises could be called upon to lubricate the machinery of tax reform.

Success in tax reform for the companies involved with a commodity-specific excise is going to follow from preparation. This conference and the work that follows will help prepare the economic arguments involved in excise tax reform. We're looking here at fundamental issues. We're starting off with a basic proposition: Are excises sound tax policy? It's fine to go through all the downstream issues, but if you don't start off with bedrock proposition and analysis — "Are excises sound tax policy?" — you're not going to get very far. We're going to look into the regressivity of excises, a classic issue. We're going to look into earmarking where it's appropriate. And we're going to look very carefully at the externality arguments, which are often used, I think often used and abused, to justify increases in these taxes.

Now to put excise tax policy in perspective, just a quick run of some numbers. The federal government collects about $60 billion a year in excises other than custom duties. States raise about $55 billion; local governments about $10 billion. So in total that's about $115 billion in excises. They're not the centerpiece of tax policy, obviously, but that's not chump change either. In fact, it represents about 4 percent of total revenue, if you include the entitlement taxes in the base.

There are a lot of excises imposed by the federal government, and over time we'll want to engage all of the excise subjected groups into the program. Some of these excises may be well justified. Some of them are not. And that's what we need to break down. Over the next day and a half we're going to hear from a variety of economic and political experts about excises in the context of tax reform. This is just the first stage of our overall program. Following the conference, our main discussants are going to be writing papers on what they've learned here, and on what they've learned in their own research. The Tax Foundation is going to publish these papers, disseminate them, talk about them. Downstream we may have a follow-up conference in Washington to discuss these numbers further. We hope that this conference is just the beginning of a long-term program between CART and the Tax Foundation. The full harvest of the seeds we plant in the days and months ahead can only be reaped if we continue to tend the fields. This will be all for naught if it ends here. What we're looking for, as Mr. Donohue put it — I think this might just be the caption — what we do is honest, compelling, carry-the-day arguments. Hopefully, we'll develop some of those and succeed in putting excise taxes in their proper place in the tax reform environment.

SESSION ONE: "EXCISE TAXES AND SOUND TAX POLICY"

Introduction: Dr. J.D. Foster

Now our first panel will get into what is the most basic issue. Because if we can't make the case that excises are not really sound tax policy as a rule, we don't have anywhere to go in tax reform. Dr. John McGowan is our main speaker. He is the Gustave Klausner Associate Professor of Accounting at St. Louis University. He has provided international tax consultant services to other members of the Missouri Society of CPA's, and has produced a number of articles in the *CPA Journal, Tax Executive, Accounting Horizons, Journal of World Trade,* and *Oil and Gas Tax Quarterly.* The Tax Foundation was pleased to be able to publish one of his earlier works.

Steve Entin is Resident Scholar at the Institute for Research on the Economics of Taxation (IRET). He was an advisor to the National Commission on Economic Growth and Tax Reform, which was better known as the Kemp Commission. He was a former Deputy Assistant Secretary for Economic Policy at the Treasury Department, joining Treasury in 1981. Before that he was staff economist at the Joint Economic Committee of Congress. Each of these gentlemen are going to speak for about 20 minutes and then we would like to open it up for questions. This Conference will be most successful, and perhaps only truly successful, if there's a give and take of ideas and thoughts. So it's not just for the economists to speak *economista*, and for you to absorb what you can. They need to hear your perspectives. You spend a great deal of time thinking about excises in your various vocations and they need to hear your thoughts, as well.

Speaker: Dr. John R. McGowan

The basic general areas I'm going to be discussing in evaluating various tax proposals are the criterion that should be used.

First of all, in assessing a tax, tradeoffs must be made among the three goals of efficiency, equity, and administrability. Efficiency has to do with the economy producing the greatest amount of benefit from a given amount of resources. Equity involves an assessment of the fairness of the tax. To determine fairness, it is necessary to look beyond the statutory incidence of the tax to its economic incidence. When analyzing taxes earmarked for specific government expenditures, some suggest the benefit principle is an equitable basis of taxation. Others suggest that cost recovery or cost allocation is equitable. And, finally, the third area is administrability. It involves an assessment of the expense to the government and the taxpayer of collecting the tax.

Okay, those are the three criterion we're going to look at, and some of the the motivation. Why are excise taxes important to look at? A 1996 Congressional Budget Office (CBO) study reviewed a policy of increasing excise taxes. And, as was already mentioned by Mr. Donohue, there is a task force to review the excise taxes established by Chairman Archer.

So let's move on to excise taxes in the United States. In 1940, basically $2 billion in revenue was raised through excise taxes, out of total federal receipts of $6.5 billion, about 30 percent. So you can see the greater role that excise taxes had in the United States. In 1995, about $57 billion in excise taxes were collected by the federal government. About $50 billion were collected through state excise taxes, and another $10 billion were collected at the local level. So in the neighborhood of

$120 billion in excise taxes in total were collected, which amounted to about 4 percent of total revenues.

The long-term decline in the relative importance of excise taxes is easily explainable. Since 1940, individual income tax collections at the federal level have risen more than 500-fold, from less than a billion dollars to a fiscal year 1996 estimate of $590 billion. Similarly, payroll taxes and Social Security have escalated 200-fold. Corporate income tax revenues have increased by a factor of about 100. Now compared to these increases, the 20-fold rise in federal excise taxes seems small.

It's interesting to reflect on why the government did not rely on excise taxes to finance the huge increase in government spending in World War II and afterwards. Presumably, the reasons relate to fundamental problems with excise taxes: Their regressivity, and their negative impact on consumer and producer welfare. Basically, there are two types of excises at the federal level: One is directed to the General Fund, and the other is directed into one of the Trust Funds. The General Fund excise taxes are largely called "sin taxes" — levies on alcohol, on tobacco, and, to a lesser extent, on luxury goods. Currently there are 14 excise taxes directed to these special funds. The excises that finance the nature and transportation programs have often been called "user" or "benefit" taxes. Those that finance the health programs can be described as "liability" or "damage" taxes. User excise taxes are intended to approximate charges for the services provided by government programs. A major criticism is that an excise tax tends, by its nature, to be only a rough approximation of the appropriate price to be charged for a particular system. A system of detailed user fees could be more precise than excise taxes, but they can also be administratively more costly. Even though the excise tax is almost always an imperfect charge, there may be a few well-defined instances in which an excise would be preferable to having the taxpayers at large finance a program's costs. The conditions necessary to justify an excise tax are difficult to meet, and are in fact rarely met. I suspect we will hear more about this later in the program.

The 14 trust funds can be grouped into four base types: The nature conservation and recreation trust fund (of which there are four); transportation (four funds); environmental cleanup (four funds); and, fourth, health damage and compensation (two funds).

The Wildlife Restoration Trust Fund was created in 1937 and was the first nature conversation and recreation fund. The Federal Aid to Wildlife Restoration Trust Fund (1937) and the Land and Water Conservation Trust Fund (1965) have to do with nature conservation and recreation. The Airport and Airway Trust Fund (1970) is transportation, obviously. The Health, Black Lung Disability Trust Fund (1977) was the first involved with environmental cleanup. The Inland Waterways Trust Fund was created in 1978. The Deep Seabed Revenue Sharing Trust Fund expired in 1990 before any revenue was collected. The Hazardous Substance Superfund was created in 1980. The Post-Closure Liability Trust Fund is another that was scrapped in 1986 before any appropriations were made. The Aquatic Resources Trust Fund was created in 1984. The Leaking Underground Storage Trust Fund has to do with the environment. The Vaccine Injury Compensation Trust Fund is related to damages. It's interesting that the government says you have to get all these vaccines but then the government sets up a fund to pay any claims that are ensuing from the death or injuries in children due to vaccines. The most recent Trust Fund is the National Recreational Trails Fund of 1991.

There are factors that encourage the

use of dedicated excise taxes. The earmarking of revenues may provide a political buffer for introducing new revenue sources or for raising tax rates on existing sources. Taxpayers may be more sympathetic to a tax if the resulting revenues are to be earmarked for a particular program that is either deemed to be a worthy cause or corresponds to a service that is understandably related to the excise tax in its role as a charge. Indeed, in some cases, a constituency group may actively support a tax on itself if it can be assured that the additional revenues will translate into additional spending for its particular program. To better ensure that end, advocates would also like their earmarked revenue program to be covered by a permanent appropriation, so that it can bypass the annual appropriations process. However, among the funds financed by excise taxes, only two — the Federal Aid to Wildlife Restoration Fund and the Aquatic Resources Trust Fund — have a permanent appropriation. The other funds are subject to an appropriations process.

Other factors encouraging the use of dedicated excises include the fact that a particular excise tax can generate a large amount of revenue with relatively low tax rates. The tax on motor fuels is a good example because it has a large base and can raise a large amount of revenue at relatively low tax rate. However, it may be easier to extend or to raise the rate on a familiar revenue source rather than to introduce new taxes or fees on other activities related to the trust fund's purpose. Although the enacting legislation may call for subsequent evaluation of the appropriateness of a trust fund's revenue structure, it is common for the existing taxes simply to be extended or raised as part of a reauthorization. For example, the Omnibus Budget Reconciliation Act (OBRA) of 1990 extended Superfund taxes at prior rates and increased the rates on existing aviation taxes and on the highway motor fuels tax without congressional consideration of alternative tax sources for these trust funds.

The same tax base may be tapped for multiple purposes because it costs less, both administratively and politically, to piggyback a small incremental tax rate onto an existing base rather than to begin to tax an entirely new tax base. The prime example is the taxation of crude oil and refined motor fuels to finance several trust funds and the General Fund. The OBRA of 1990 temporarily increased the gas tax by 5 cents per gallon for five fiscal years, 1991 to 1995. Half of the increase was assigned to the Highway Trust Fund and other trust funds that received fuel tax revenues, and half to the General Fund.

Alternatively, rather than introduce a new revenue source, it may be tempting to earmark for special purposes an excise tax that has traditionally belonged to the General Fund. In recent years, there have been numerous proposals to dedicate revenues from cigarette and alcohol excise taxes to fund specific programs.

The past decade has witnessed particular controversy about both the overall level and composition of spending out of the Highway and Airport and Airway Trust Funds. The existence of cash balances in these and other trust funds has raised concerns in Congress about whether spending for trust fund programs was being restrained in order to offset the deficit in the General Fund. Some argue that if the monies are not being spent currently on the intended trust fund purposes, then the tax rates should be reduced. Others argue that there were valid reasons why the money could not be effectively spent at the rate previously planned, for example, because of delays in the ability to implement new technological developments for the Air Traffic Control System. Another way of diverting funding away from the original mandate of the trust fund has been to expand the statutory definition of permissible uses. In the case of the Highway Trust Fund, the concept of user taxes has been interpreted more broadly as a benefits tax, including indirect, or spillover, benefits. For example, a Mass Transit Account was established within the Highway Trust Fund by the Highway Revenue Act of 1982 to help finance capital expenditures for mass transit.

The main economic issue is efficiency. Excise taxes distort consumers' choices between taxed and non-taxed goods and services. This results in resource distortions and reduced economic welfare. As a general principle of tax policy, it is preferable to avoid selective or narrow-based taxes in favor of broad-based taxes. Raising an equal amount of revenue by using a broader-based tax, such as the existing federal income tax or payroll tax, or a new national sales tax or value-added tax, would have more neutral tax consequences. A broad-based tax would touch many more sectors of the economy, but each to a lesser degree than would an excise tax narrowly focused on a specific sector, particularly if the broad-based tax raised the same amount of revenue as the selective excise. Selective taxes distort the markets surrounding the taxed commodity and give an advantage to untaxed competitors. By raising the price facing the buyer, excise taxes discourage the purchase of the taxed item, and consequently, reduces production. In many circumstances, the price to the consumer rises by less than the full amount of the excise tax, implying lower returns to the factors of production: wages, lower rents, lower returns to financial investors. Some geographic areas of the country may be hurt more than by others in taxing a particular item. Areas where residents are heavy producers or consumers of the product will suffer a relative and absolute decrease in purchasing power.

How does this all come about? The imposition of an excise tax increases the prices for these goods relative to non-taxed goods, leading consumers to buy less of the taxed commodities and to substitute purchases of non-taxed goods. The tax adversely reduces the welfare of the consumer in two ways. First, if the individual buys a taxed commodity after the imposition of the excise tax, his or her income available for other purchases is reduced. And second, if the tax-induced increase in the price of the goods leads the individual to substitute a non-taxed commodity for the taxed one, the person's after-tax income is the same, but she is buying a bundle of goods that is suboptimal or less satisfactory. So the bottom line is that excise taxes introduce economic inefficiencies into the economy, which reduce productivity for producers and reduce welfare to consumers.

Another dimension of efficiency are the administration and compliance costs. The IRS budget of about $6 billion is only a small fraction of the total cost of compliance. The Tax Foundation and others have estimated the total cost of tax compliance in this country to be over $300 billion. Professor Don Fullerton of the University of Texas at Austin did a very interesting study in 1995, using an input/output model to show how the cost of compliance is passed from taxed industries to other industries. That is, Fullerton's study shows that the administration costs and the tax burden of excise taxes are often shifted.

Parenthetically, Fullerton's results regarding shifting are critical when excise taxes are imposed to offset externalities. Conceptually, externalities, or social costs, are supposed to be paid through the excise tax by the individuals that are responsible for creating these negative externalities. But if, as Fullerton shows, the tax burden of these externalities are shifted to other industries or taxpayers, then the externalities argument for excise taxes has some real flaws — the burden is really just passed to other industries and is not ultimately borne by the industry that the excise tax is imposed upon.

How about excise taxes and ease of implementation? Why are excise taxes likely to win approval more than other options? While several factors may be at work here, I believe excise taxes allow politicians to exploit the principle of "rational ignorance" more than alternative possibilities. Put differently, the political damage per dollar of tax may be less for excises. A proposal to raise one of the major taxes, such as individual income, Social Security, or the corporate income tax would receive enormous press coverage and could impact on virtually every citizen in ways that we would all know about. By contrast, a proposal to raise the same amount of revenue by increasing a couple of broad-based excise taxes, would likely affect far fewer taxpayers and would likely receive far less press coverage.

Regressivity and tax fairness are critical to the politics of excises. According to the widely-accepted "ability-to-pay" principle of public finance, the burden of financing governmental services should vary with one's financial condition. Under a set of plausible but unprovable assumptions, the nation's overall well-being may be improved by imposing larger tax burdens on the rich than the poor. These are classical notions that undergird the progressive income tax system. Specifically, if one accepts the view that a dollar's additional income brings more satisfaction to lower-income persons than to upper-income persons, then community satisfaction is enhanced by taxing the rich more than the poor since wealthy individuals will give up less satisfaction per dollar of tax than lower-income ones. Again, these are really classic arguments for a progressive income tax system. They also imply we should stay away from regressive taxes.

Quickly, two definitions: A progressive tax is one that absorbs a larger proportion of income from upper-income individuals than lower-income individuals and is consistent with the notion of diminishing marginal utility of income. There's an alternative school of thought that says that diminishing marginal utility of income is, or should be, irrelevant. They argue that taxes should be the same percent of income for individuals in all income classes, producing a proportional income tax. Fairness to these individuals means that everyone is equally treated, which translates into an equal proportion of income tax. Virtually no one, however, accepts the proposition that taxes should be regressive — definition number two — taxing the poor proportionally more than the affluent.

American excise taxes are presently viciously regressive. The three most important excise taxes — tobacco, alcohol and gasoline — burden lower-income Americans far more than upper-income ones. This has been demonstrated by numerous studies using consumer expenditure survey data. As income rises, average expenditures for these three products also rise, but they rise less proportionally than the increases in income. Less affluent Americans spend a significantly larger proportion of their income on these taxed items than do more prosperous Americans. The late Joseph Peckman of the Brookings Institution estimated that federal excise taxes took 13 times as large a proportion of the income of the poorest 5 percent of the population compared with the richest 5 percent. Moreover, the estimates also almost certainly underestimate the regressivity of many of these excises in the United States, including the tobacco and alcohol excises, since the federal tobacco taxes are not ad valorem taxes. Wealthier individuals may smoke no larger quantity of cigarettes or cigars than poorer persons, but they pay more for each cigarette of cigar smoked since they buy more expensive brands. But since the tax per package of cigarette is the same regardless of price, the actual tax paid by rich cigarette smokers may be little different in actual dollars than that paid by poor smokers, meaning the tax has similar regressive qualities as a head tax.

In some people's opinion, including many scholars in the field of public finance, the most intellectually respectable argument for imposing an excise tax is that an activity imposes a negative externality, that is, it imposes a cost on society not borne by the user of the good or service. But, as mentioned earlier, Professor Fullerton at the University of Texas at Austin showed that the excise tax burden is largely shifted to other industries, so even the externality argument has some flaws. Nevertheless, such arguments are used in explaining several forms of government intervention in market processes, for example, environmental regulation. It is argued that, because much of the cost of pollution is borne by residents of the community where the product is produced, these costs are not fully reflected in the supply of the product, and therefore, intervention in the form of an excise tax is justified. But there are severe problems with imposing excise taxes to take account of social costs of activities that are not reflected in market prices.

For example, consider an excise tax on wine. It might be argued that heavy wine consumption can impose external costs, such as when a drunk driver injures an innocent third party. Yet the American legal system provides amply — and some would say too amply — for injured individuals to be compensated for damages imposed by over consumption of alcohol. Beyond that, there is some evidence that even very moderate consumption, a glass or so, of wine a day, may be medically beneficial; that such consumption imposes absolutely no social cost; and that there is, therefore, no justification for discouraging moderate consumption on external-cost/health-risk grounds. An excise tax that discourages that form of consumption is clearly non-optimal. Yet it is impossible to impose a tax that reaches only the abusive consumers of wine without burdening the moderate consumers. Thus, even if one could envision situations where an excise tax might serve to improve resource allocation, it is virtually impossible, to implement such a tax without having some accompanying negative resource allocation effect. If the studies on wine, beer, and spirits are correct, then the excise tax on alcohol beverages discourages both beneficial, moderate consumption and harmful, excessive consumption.

Discussant: Mr. Stephen J. Entin

John's done an excellent job of going over the economic damage done by excise taxes. It is a pleasure to be here. I want to go over some of the flaws in the use of excise taxes. We've heard about efficiency from John; I call it neutrality. He's talked about equity and fairness; I'm going to try and redefine that concept a little bit along the lines he hinted at. He mentioned administrability in his paper, but he's also talked about the costs of compliance, and I feel more for the people trying to comply with these taxes than those who are trying to administer them. I used to work with some of those people at Treasury, and although they're nice people in their private capacity, I'm not terribly worried about the difficulties they have in their professional capacity.

Since we're talking about whether or not excise taxes are sound tax policy, I thought I'd try to define sound tax policy before I start. I've done more writing on this in the background papers for the Kemp Commission report which I suggest might be helpful to you if you have a chance to look at them. First, what is not sound tax policy. Sound tax policy is not the Keynesian policy of raising and lowering taxes to try to even-out business cycles. Sound tax policy is not the social engineering approach of taking from the rich to give to the poor. A sound tax policy is the putting in place of a revenue system that has certain virtues. For example, it lets people know what government costs them, and then raises the amount people want to spend, being fully aware of the cost of government. And it raises that money with minimum economic fallout. To accomplish these purposes, a tax system has to be visible to reveal the cost of government. It must fall on individuals, not on businesses or products. Businesses do not pay taxes. A glass of wine does not pay a tax. Only people pay taxes. It should not be supplemented by deficit finance, which is a hidden way of financing additional government.

The tax system should be neutral in two ways. It should provide equal treatment under the law for all citizens, and it should provide equal treatment of all economic activities. It should not be biased against one form of activity versus another. It should not fall more heavily on income used for saving and investment than on income used for consumption, the way the current income tax does.

It should not be imposed at rising rates on additional production and income, as is the current system of progressive taxation, which can really be described as a series of escalating excise taxes on additional units of income or additional units of production for which one is paid. That means that the added amount of wheat produced by the farmer who has already produced a lot of wheat is taxed more heavily than an added unit of wheat produced by a farmer who hasn't produced much wheat yet. Yet it's the same wheat and it feeds the same number of people and sells for the same amount on the market. It also treats two individuals differently under the law. It makes no sense economically.

Nor should there be higher taxes on the producers of one product versus the producers of another product. As you may have gathered, I don't think much of the current income tax or the excise tax system we have in place today.

Excise taxes, in particular, are both hidden and non-neutral. They're hidden in the sense that sometimes you don't actually see the tax that is imposed. When you buy gasoline, if you don't look carefully at the pump you might not know what the tax is. Some states don't ever let you show the price of the tax in the price of the product. You don't see it when you buy alcohol either. Even if it were listed on the sales slip at the bottom, you probably don't save your sales slips and add them up at the end of the year to find out how much you paid in total. They're nickel-and-diming you all along the way, and you never realize it even if they show you each nickel and dime because you never add it up.

Excise taxes obviously are not neutral, but some people say that's a virtue. Indeed, they're specifically designed to be non-neutral, with the best of intentions, and you know what highway is paved with that. So let's look at some of the rationales for excise taxes and see if we can't poke some fun at them. I'm going to be drawing on a book that Roy Cordato did for IRET a few years ago. He's now teaching at Campbell University. He pokes fun at a lot of the arguments for excise taxes, but he really goes after the externality argument, the social cost argument, which is the most popular fall back position for those who want the money.

I want to start by going back to the old-fashioned favorite argument for excises which was the "sin tax" argument. Many years ago there was a very clever, witty, educational, and perhaps therefore short-lived comic strip called "The Colonials." It was set in the Plymouth Colony, not many miles from where I grew up, and it featured Miles Standish, John Alden, Priscilla Mullens, Governor William Bradford, and the Preacher. One day the Preacher was depressed by his lack of progress in stemming misbehavior on the part of his flock. He went out and sat on Plymouth Rock and asked God for a sign, any sign, that he should nonetheless continue his labors. God responded by zapping him with a thunderbolt, which I suppose is how the rock got cracked. The Preacher, somewhat singed and apparently more than slightly dazed, chose to view this as a positive sign, and gave thanks to the Divine message, if not for its manner of delivery.

But what has this got to do with excise taxes? I'll get to that now. You see in the next day's comic strip, the Preacher, having been thus motivated by the highest spiritual authority, and with his hat still smoldering, sought the advice of the highest civil authority. Seated before Governor Bradford, the Preacher complained, "I have preached against sin. I have inveighed against sin. I have cajoled against sin. But the people still sin." And Governor Bradford cried out, "Then, by Jove, we'll tax it!"

Now I don't mean to quibble, please, over the question of whether a Pilgrim father would in fact have sworn by a heathen deity, Jove, or anyone else, but rather let me note that the cartoonist who had obviously studied public finance in college was making a very profound economic point. The Governor was not, as it may first appear, trying to help the Preacher stamp out sin. Rather, the Governor was himself thunderstruck by the exciting possibility that the Preacher had stumbled across the perfect tax base. That is, an activity that does not shrink in volume even in the presence of the rather steep tax of eternal damnation. What better way to raise revenue than to tax something that would never slide over the hump of the Laffer Curve. No worries here about dynamic revenue estimation. If you double the tax on sin, you're going to get twice the revenue every time.

In the real world, whatever means the government chooses to raise revenue must lead to a transfer of resources to the government from the public and to a cutback in the public spending on private goods and services. A tax evenly imposed on all goods and services, or one neutrally imposed on income in a manner that doesn't bias the situation against saving more than consumption, imposes the least collateral cost on the private sector for any amount of revenue that the government's going to collect. It lets the public choose which other goods to give up the most and which to give up the least, in accordance with costs of production and their own preferences. And, in the real world, there really is no product that has a completely inelastic demand or supply such that its quantity does not decline somewhat in the presence of a tax. If the tax burden falls most heavily on a particular product, it is generally the case that the tax will create distortions. It will cut production and consumption of the product by more than would be true for a generalized tax. And it would distort the consumer's pattern of normal consumption. But even if there were a product that had a very low elasticity of demand, the excise taxes collected on it would serve to reduce the income that consumers had available to save or to spend. It would force consumers and investors to cut back spending on all other products or services in whatever pattern best suited them. Even businesses not subject to the selective excise tax would suffer lost sales due to the presence of the tax on the selected product. In that special case of zero elasticity of demand, the tax would act very much like a broad flat rate consumption tax, such as a VAT; or a saving/consumption neutral income tax, such as the flat tax; or the saving deductible individual income tax component of Nunn-Domenici. In that case, why not enact the broad-based tax instead and avoid any chance of triggering a costly and inefficient distortion of economic activity?

We often see an uneasy alliance between the purveyors of social good and the civil authorities in collaboration to impose a tax on goods and activities considered socially or environmentally harmful or immoral. One wonders if fattening can be far behind. However, we seldom see the civil authorities intentionally setting the tax above the revenue maximizing point, beyond which it would choke off so much of the activity that the tax would raise little or no revenue. Nor is the government likely to ban an activity outright when it could tax it instead, however much the moralists might wish it. So there's a tension there. Of course, drugs are an exception, and of course that policy is succeeding about as well as did Prohibition.

Businesses may ally with the government to boost an excise tax, but usually on someone else's product. It would not be surprising to see one industry call for an increase in the excise tax on a competing industry, and for a cut in its excise tax. If, instead, they were to join forces to promote a major reduction in all of these taxes, they might succeed in helping themselves and their consumers. I think the message of looking at the history of sin taxes is this: Businesses and consumers have a vested interest in staying away from them, and not letting the government have an excuse to raise the revenue.

The main current rationale, of course, for revenue raising through excise taxes is correcting externalities. John has discussed this already. I have a slightly different take on it. I think there are stronger arguments that can be made that are sometimes not included. For example, doing social and moral good, or zapping the competition, are shaky foundations on which to base economic policy. Can we make an economic case for selective excise taxes? What about the case of market failure in which not all of the costs of production of a good or service are captured in the price, but are instead imposed on innocent third parties. Can such spillover costs, or externalities, be corrected by an appropriate tax and transfer payment? You'll hear more on this point later in the conference, but I want to mention Roy Cordato's conclusions. Roy is a fan of Austrian economics. I've never fully understood Austrian economics. It's not the same thing as the economics of Austria, and it uses a lot of jargon that on second or third reading finally begins clearly to be nonsense. But one perspective that the Austrian School likes to emphasize is that government never, ever has as much information at its disposal as the free market does about the wishes of consumers and the costs of production. Further, consumer preferences and conditions of supply are constantly changing. They conclude, therefore, that central planners are never able to outguess the market or improve on its results except by pure accident.

Let's consider the case of a cement

company that, in its process of production, creates some dust that drifts over and settles on the neighbor's laundry and the neighbor's cars, which makes it necessary for the neighbors to wash more frequently both their linens and their automobiles. How much damage is done here? You have to be able to measure that to figure out what to do about it.

It is virtually impossible to measure an externality, let alone offset it with precision. How much does this externality annoy the neighbors? This involves subjective feelings of individuals, or thousands of people, or millions of people. Collectively, how much would they pay to avoid the nuisance? It's virtually impossible to find out.

Furthermore, by the time the economy has finished shifting and distributing all of the costs of an activity, it's virtually untraceable. Even if one were to be able to determine how much people wanted to reduce a given activity; if one had the idea of how much these people would like to see it cut back and how much they would be willing to pay; and, if you were trying to put that kind of a tax on the firms, it's virtually impossible to figure just how high a tax would have to be imposed to cut production by the desired amount. And, if an appropriate tax were serendipitously levied today, changing conditions would render it the wrong level of tax tomorrow.

Furthermore, if the government were to impose an excise tax to reduce the production of a product assumed to have undesirable spillover costs, the pattern of production would be altered across the whole range of output in the economy. Factors of production used in the targeted industry would shift to the production of other goods and services. There would be a net gain to the society only if the value produced by these resources in their other, alternative, second best use, plus the value of the pollution reduction, were at least as large as the value of the original amount of cement that had been produced in the first place. And we can't measure that because we don't know exactly where the resources would go. And we can't measure the value of the pollution reduction. We simply cannot begin to guess at the net outcome. Furthermore, in their new use, these resources may be in an industry which, in turn, is producing some sort of externality or spillover cost. Government is never going to be able to figure this out correctly.

Now, of course, the impossibility of doing the job right through the government doesn't stop people from trying. And while every political party agrees that every other party is not competent at social engineering, every party also assumes that it, on the other hand, is a whiz at social engineering.

What's really going on here is a violation of property rights. This is not a matter for government intervention. Property rights is the issue. When the cement company dumps dust on its neighbor's laundry and cars, it's violating their property right. This should be a question for tort law and the courts. They should get together and deal with each other directly. And if there's any damage to be paid, it should go from the company to the victim. When the government steps in and says, "We're going to correct this for you, here's a tax to be slapped on you, and, by the way, we're going to keep all the money and you guys can keep doing your laundry." This doesn't fix the problem.

Using excises to address an externality problem is trying to fix a property right issue through a tax system. Instead of fixing the property right, instead of making the property right more explicit and more capable of being enforced, instead of fixing the market, in other words, we step in, ignore the market, leave the failure, and try and get the government to take corrective measures.

One implication of the excise tax approach is that some of the issues that are currently defined as social cost problems are mischaracterized, such as the issue of secondhand smoke from cigarettes on privately-owned premises, such as the work place, restaurants, and on airplanes. This should not be a public policy concern. There is no conflict over property rights. The owner of a restaurant, for example, makes a decision as to whether he wants the premises smoke-free, divided into smoking and non-smoking sections, or whether smoking should be permitted anywhere. This decision would be based on what he perceives are the desires of his customers, and if he gets this wrong, the customers take a hike. There's no need for the government to get involved.

Another example is the issue of drinking and seatbelt use. Of course, why should you put the excise tax on all people who drink when only those who misuse alcohol inflict the damage on others? Indeed, there's the problem of how do you correctly measure the damage, which goes even beyond the problems that John listed in this issue.

When externalities are raised as a rationale for raising excise taxes, I always suspect the real motive is just to raise money. A collateral issue is used for such things as mandatory use of seatbelts or the tax on alcohol or, in a more recent form, the efforts to go after the tobacco industry. These relate to the argument that injuries from these accidents or other activities may put a strain on public health care programs such as Medicare and Medicaid. In other words, there are social costs for taxpayers in the form of higher taxes needed to defray the greater government outlays under these programs.

In fact, however, these costs would be private but for the existence of the government programs. These programs were specifically designed to socialize the payment of health care costs. Their purpose was to take the costs that in a free health care market would be private and spread them to society as a whole. It is at the very least inconsistent, if not disingenuous, to put in place a system whose purpose is to socialize certain costs and then complain when those costs, are indeed socialized. Such social costs could be remedied by eliminating those programs. And you might think that's utopian, but we heard last night about the Medical Savings Accounts that have been enacted as a way to privatize this very market. Even if someone is too poor to open a Medical Savings Account, we could give them money, and then they could decide whether they wanted to buy an insurance policy that cost more because they smoke, or whether they wanted to give up smoking knowing the government wouldn't be in there deciding for them and taking away their freedom of choice.

Of course, it's not just taxes anymore. For example, the State of Florida was the leader in the movement toward figuring out some way to sue the tobacco industry over tobacco's supposed costs to the Florida contribution to the Medicaid program. They want to sue for reimbursement for the state's Medicaid outlays to treat indigent individuals for supposedly tobacco-related illness. And all this is to be done on the basis of general statistical analysis, without proving that a specific patient's illness came from tobacco use, or which brand was smoked, either first- or secondhand, or chewed.

I would be shocked if the revenues raised bore any relation to the actual damage inflicted. If the illness is not tobacco-related, there's no match at all. And even if the illness category being sued over really is tobacco-related, the damage must ultimately fall far more on the person suffering the illness than on the state budget office, and in fact must far exceed the cost of the medical treatment. But where does the revenue go? To the patient? No, to the state. Why is the state paying the bills anyway? Where is the recognition that the patient bears some responsibility for his or her smoking habit, and for the medical costs incurred? But the patient does not, by definition, have deep pockets. That is why the state has intervened to provide the treatment in the first place, and why it is suing the companies rather than the consumer. There is no mystery here. There is no need to "cherchez la femme." We already know her name is Susan B. Anthony. It would be very instructive to see whether state spending on Medicaid from other revenue sources is cut back by the amount of the tobacco industry fines, if any are ever collected, or whether the fines become just another revenue source for increasing general government spending.

If the motive is to raise revenue without raising the ire of the electorate, let every business and every worker beware. Automobiles cause injury, costing the state or federal government higher medical outlays for elderly or indigent victims through Medicare and Medicaid, and costing the government income in payroll tax receipts foregone due to lost wages of non-indigent workers. Why not tax automobiles, or tax them more heavily? Milk, eggs, and meat raise cholesterol, which can lead to heart disease in some people. Why not make everyone pay a tax on animal fat? And why not a tax on people fat? Being overweight is not healthy. Why not emphasize the cost by making it a financial drain as well? Where will it all end?

Let me now say a few words about progressivity and regressivity. Excise taxes of one type or another are often praised or criticized for being progressive or regressive. And I suggest to you that in the former instance, the claim is a bum steer, and in the latter, a bad rap. One cannot scientifically make interpersonal comparisons of joy and pain, which economists, even Austrians, call "utility." For example, if I were to place thumbscrews on all of you ladies and gentlemen from the audience and twist them with the utmost precision to place exactly the same amount of pressure on each person's thumb, which person would hurt the most and which the least? How do you tell? If A screams louder than B, has A a lower pain threshold or merely a louder voice? From a utilitarian perspective, progressive taxation has been advocated sometimes on the grounds that rich people get less utility from their added income than do poor people. Clearly, this is a subjective judgement. And just as clearly, it doesn't wash. Indeed, most economists have given up on it and prefer to justify their calls for progressive taxation on non-economic factors, such as philosophical and political preference which they try to call "fairness" which is an equally unmeasurable concept.

If you remember that income is the reward for the production of goods and services, and that these products and services are equally beneficial to consumers whether they were produced by a rich person or a poor one, an awfully good case can be made that the only fair tax is a flat-rate tax. So it is surely bad economics to applaud an excise tax on luxury items for being progressive, and condemn an excise tax on necessities for being regressive, because "progressive" and "regressive" are not valid economic criteria for selecting a tax policy.

However, it is not really possible to tell what is or is not progressive or regressive. One must first figure out who really bears the burden of the tax — the ultimate incidence, not just who simply sends the check into the government, or what's on the sales slip and who the customer is. The burden of a tax is not correctly measured by noting what various people have to pay to the IRS. The income distribution of this misnamed "tax burden" is the subject of endless discussion and finger-pointing and blather among politicians and journalists. It is, of course, nonsense. It pollutes the airwaves, misleads voters, interferes with reasoned political debate, and distorts the policy outcome. So, ignoring my own warning, I therefore declare that the analysis of the initial tax burden should be subject to an enormous excise tax or banned outright.

Semi-seriously, though, in the case of most of our taxes, people know more or less who was supposed to write a check to the IRS, and for about how much, and what their incomes are. Arcane provisions of the tax law and lawyers' errors and failure to pay adequate attention to regulations notwithstanding, we have some general idea of what the tax-writing obligation is. So we send the check to the government. But that is not who bears the ultimate burden or incidence of the tax. That is determined by the marketplace, which will shift the taxes to their ultimate resting places as producers and consumers respond to the changed price signals due to the tax and alter their economic activity accordingly. The ultimate incidence is the differences in economic conditions of various people after all the economic adjustments have been made, compared to what the situation was before the tax was imposed. And the change in people's conditions may be far greater than the dollar amount of the tax collections.

Selective excise taxes reduce the consumption and production of the taxed product. To some extent, the tax may be passed forward to consumers in the form of higher prices, and that is generally what is assumed when people start talking about "this tax is regressive," and "that tax isn't regressive," and so forth. But if there is a close substitute for the product, something else almost as attractive, then producers will not be able to raise their prices, lest consumers switch to the other product. In that case, the sales of the taxed product collapse and the tax is shifted back to the producers of the product, who are now forced to use their labor and capital to produce something else. Any capital that is useful only in the production of the taxed good, and which cannot be shifted to another use, experiences a sharp fall in income. Ditto for workers with certain skills that are specific to the taxed industry. Capital and labor that are useful almost anywhere, however, will quickly find almost identically rewarding jobs in other industries. Thus a tax on wine production may do relatively little harm to the grape pickers who will simply shift to picking artichokes when the vineyards are replanted for that use, or the truckers whose rigs can carry asparagus as easily as Asti Spumante.

But the wine maker who got a premium wage for his particular skill at sniffing out a good thing, or the landowner whose caves have no other use and whose sloping terraces in the best wine-growing micro-climates have no advantage over other land in the growing of other crops, may suffer losses. Therefore, to know whether a proposed excise tax is progressive or regressive, one must know far more than who currently buys the product and what their incomes are. One must know the income to the people who supply labor and capital to the production of the products, and how much their incomes would be curtailed if they are able to remain in their current employment, and how much their incomes would change if they had to seek other employment.

Consider, then, the supposedly obvious progressivity of luxury taxes versus the supposedly obvious regressivity of taxes on beer. The recent effort to impose a luxury tax on jewelry, fur, and expensive cars and boats hardly inconvenienced the rich. They cut back on jewelry, fur, and high-end car purchases, hopped on a plane, and went abroad to buy, sail and moor their new foreign-built yachts. The people who were hurt were those domestic workers who make jewelry, stitch furs and lining together and sew on the buttons, the car salesmen and mechanics, and the boatwrights and owners of the fifth-generation family-run shipyards that closed after a century of operation. The people in these occupations or endeavors are not, or not necessarily, very high on the income ladder. In particular, they may have been lower on the income ladder than the people who work at Anheuser-Busch or the yuppies who drink designer microbrews or even the "Joe Sixpacks" who come home from a hard day at the phone company. So which excise taxes are progressive and which are regressive? I don't know. And neither do the people who voted for them.

Let me very briefly talk about the excise tax as a user fee. Generally speaking, if you can put an accurate user fee together, you can privatize the entire operation. Why is the government doing it? The gasoline tax is supposedly a road user fee. Sounds fair. You drive, you pay. That's the principle behind turnpikes and toll bridges which are viable private sector alternatives to government road building, by the way. And once upon a time, the government built highways and bridges with some of the money and most of them went to good destinations that turned out to be economically useful. They were sometimes near the people who paid the gasoline tax, but sometimes they weren't. Sometimes the politicians got in and started moving roads around or putting more roads in one state than another. Who knows?

But the rest of the money went into a trust fund at the Treasury, which means that the Treasury borrowed the money and spent it on something else. The politicians liked that; the highway lobby didn't, and it's been trying ever since to get the Treasury to give the money back and build more roads, but the money isn't there any more. So a few years ago the Congress raised the tax, but only after agreeing to give part of the increase to Urban Mass Transit to get more voices to call for passage; and after earmarking some of it for deficit reduction, which the highway people didn't like; and which really means having the same deficit without having to cut other spending; and which the Congress didn't want to bother doing. All clear?

The airline ticket tax is supposedly an air travel user fee. It is very loosely connected to the costs of running the air traffic control system. It was once used to help localities build airports. Surpluses, when there used to be some, went into a trust fund at the Treasury. And guess what? I won't repeat myself. Note that Canada is privatizing its air traffic control system and that many U.S. localities are trying to sell off their airports but the feds won't let them unless they repay the old subsidy, so they're stuck. As W.C. Bureaucrat says, "Never give a market alternative an even break." Are these user fees or revenue raisers? You be the judge.

In conclusion, let me say that selective excise taxes distort the economy and are an unduly costly way of raising any given amount of revenue. The social cost argument is phony, and needs to be substituted with a policy designed to enhance property rights and get back to the free market. Selective excise taxes are the result of an electorate asleep at the switch. There are many high-minded excuses for an excise tax. Not everyone directly consumes the product, so some people don't object when Congress raises the tax, and they might even favor the tax hike, figuring they're going to get some government good and service paid for by someone else. Excise taxes tend to be hidden in the price; they hide the cost of government. They can often be raised or imposed without too much anger on the part of the voters. Selective excise taxes are the result of broadly-defined special interest pleading by politicians who have trumped up superficially plausible but ultimately insupportable rationales for getting money; by moralists and social engineers who, as Tom Lehrer put it, "do well by doing good"; or by various producers seeking either to curtail their competition or to raise earmarked revenue that the government is supposed to spend to prop up their businesses.

We have a few moments left if there are any questions or points that you all would like to raise about excises and the soundness of tax policies.

Audience Questions & Comments

Question/Comment: Let me ask Steve a question. I think you did a good job of demolishing most of the arguments for excise taxes, but some of those refutations came down to saying government shouldn't be doing these activities at all. If you accept for the moment that there are some valid governmental activities, should any of those be funded through excise taxes, or are excise taxes always an inappropriate means of raising revenue?

Mr. Stephen J. Entin: I can't think of any activity that was a true public good situation that the government is doing that ought not to be funded by a tax that covers the public, if it's a public good. You don't want to hit producers of a certain product, or consumers of a certain product, to finance something that's going to help everybody. You still want to use a general, broad-based tax system that's levied as neutrally as possible so that the economic fallout is minimized.

Question/Comment: I have one point to make and then I have a question for everybody. I think we have to differentiate between an excise tax on a general commodity like a cigarette tax or a liquor tax or the gas tax, when used for general budgetary purposes, and what is really a user fee, like the airline ticket tax. Where the tax is being used for a specific product that people are using, then it's really a user fee, it's not a tax per se. And I think we have to differentiate between that. It's not a good excise tax or a bad excise tax.

Mr. Stephen J. Entin: Most federal user fees are seriously flawed for a number of reasons. Either they're levied in such a sloppy manner that the people who use the service the most don't necessarily pay the most, so they're not proportional to use; or they cover something which could be done by the private sector and the government has no business being in the industry at all. Take the air traffic control system. Britain's privatized it. Canada is privatizing it. Britain has privatized its airports. We do this in a socialized manner, and we don't do it efficiently.

If you ever tried to fly out of Washington on an afternoon when there is a thunderstorm anywhere within 200 miles, you know that system is going to crash and you're going to be there 20 minutes or an hour and miss your connections. No one would be running that system in the private sector as inefficiently and badly as the government is doing. So why should I try to find a user fee to fund the government monopoly which is going to give me rotten service, when, if indeed it is something for which one can charge, it could be a private business and run efficiently, so I can get out of town promptly and make my connections in Pittsburgh for the West Coast. So, yes, there are things that are called "user fees," but they aren't tightly tied to the product, and if you can devise a good user fee then government shouldn't be providing the product.

I was visiting my relatives up in West Palm Beach and I went up to Disney World, Universal Studios, and to Sea World. I did five parks in three days, thanks to the very efficient private cab service that runs in the area. Those parks charge a hefty entrance fee and they maintain a spectacular system of attractions. The U.S. Park Service has a user fee which is abysmally low, the parks are mismanaged and much of the money is siphoned off. I suspect Yellowstone National Park would be a nicer place to visit if the Sierra Club were given the territory and told to manage it as a private, for-profit resort. I wouldn't necessarily want to give Yellowstone to Disney, but I might want to give it to some other private group. In fact, let them bid for it.

Dr. John McGowan: On the last point, I'm not so sure that for highway transportation, the user fee concept isn't appropriate. I'm all for privatization, but who's going to build and maintain the interstates? If we can think of a private market option for that, then fine. But it just seems that the motor fuel tax might have a reasonable application as a type of user fee.

Mr. Stephen J. Entin: If every interstate you now have, that goes to a community that would otherwise not have warranted a private toll road, then you can make that point.

Question/Comment [Dr. Dwight Lee]: I agree that if the government does it, it's going to be done in a sloppy way. But I think it's also important to recognize that the government does some things sloppier than it does other things. And I think it is useful to distinguish between excise taxes funding activities that won't do as badly. So, let's try to make some distinctions, not only conceptual distinctions, but practical distinctions, as to where government is going to err the least.

Question/Comment [Ms. Lori Peterson]: I think it's important to clarify some issues regarding user fees versus taxes. The revenues that go into the trust funds that pay for the highways and that pay for Federal Aviation Administration services, are from taxes. They are not user fees.

User fees are reasonably related to the pure costs of the program. They are levied directly on a group that avails itself of the government program, and they are used solely to finance that program rather than the government generally. And the amount of the fee charged to the payor generally may not exceed the costs of the program or the services being provided.

Also, since there is cross-subsidization in the highway program and in the airport and airway program, the revenues used to fund these programs are from taxes, not user fees.

As I mentioned earlier, we are now embroiled in discussions with the airline industry over whether we move to a user fee system or keep a taxing system.

Question/Comment: Our problem is: Is there a good excise tax? Is there a bad one? It's either got to be one or the other. We have a definitional issue here.

Mr. Stephen J. Entin: Please don't say there's a good excise tax. Because once you admit that, they're going to carry it forward to everything else. If you must be positive about tax, then describe it as a necessary evil.

Question/Comment: I'd like to address the methodological issues Steve Entin mentioned earlier regarding externalities. I share that point of view that externalities basically are a property rights issue and that you really don't need corrective taxation to resolve them. But I think you ought to recognize for the audience that the other mechanism that you propose, which is the definition of property and ownership, would take place in the judicial system, and that's not a very pretty place to negotiate either, depending on the judge, the jury, and how much you have to pay your lawyer. So there are costs to both systems. And while I'm willing to take your presumption that the judicial route is the relatively effective one, there are times when I wonder about that.

Question/Comment: I'd like to mention a program that presents a good example of when the externality argument is valid, and might not be able to be resolved through private markets. And this is the Vaccine Injury Program. Childhood vaccines in the U.S. have been one of the most effective government programs. I believe it's mostly required by state law before children enter public school. And, unfortunately, there are occasional adverse reactions to taking childhood vaccines. Based on scientific study it appears to be through no fault of the manufacturing process. Some people are just more susceptible to a bad reaction from the vaccine than others. Because of this private risk to the vaccine-maker of possible adverse reaction, there is an incentive for an individual not to become immunized. If 90 percent of the population is immunized, the risk of infection is almost zero for the non-immunized person. So the non-immunized person is really subjecting themselves to a large risk by taking the vaccine when the rest of the population is already immunized. So what we'd like to do is encourage immunization so that a substantial fraction of the population is immunized, but then protect the vulnerable individual against the rare outcome of an adverse reaction. That's what the government trust fund was established to do.

However, I also think this is an argument where the funding of the program could legitimately come out of general revenues. It may be somewhat perverse to apply an excise tax to vaccines to fund this program, because what does the excise tax do? It raises the cost of vaccines and, therefore, further discourages vaccinations. So, again, I think there's a valid purpose. It does show where there is this public good or positive externality associated with the product. Unfortunately, the idea of linking it to an excise tax, even in this case, is not valid.

Question/Comment [Mr. Thomas J. Donohue]: I think there are a series of common arguments that should be further developed that apply to liquor, telephones, cigarettes, highways, and that's the regressivity argument. There's a great debate going on about who ought to be paying the highway taxes. That's fine. We like that debate. The better you do it, the better we look. But the fact is, there's going to be a second debate between the states and the federal government on who's going to get the revenues and who's going to add on taxes. At that point, regressivity is a horse I want to ride. Successful businesses don't care that much about how much the gasoline tax is. But the people that are the folks that the Congress represents, two-family earners that have kids in school, right down to welfare mothers, are affected by hidden taxes, excise taxes, on everything from soup to nuts. And they are the most affected and the least able to pay. This is an argument we can make about every one of these taxes.

Let's find the common issues about excise taxes that make them undesirable, that make them hidden, that make them difficult for those people who have the greatest amount of votes in this country. What I'm suggesting is: Of all of these presentations how do we find the parts that make the most valid arguments? How do we highlight them? How do we communicate them? And how do we put a saddle on them and ride them up and down the street day after day after day, because saying it once is not going to help.

We've already got all kinds of people saying, "We ought to have more highway taxes." Well, maybe we should if we're going to build more roads. But not until we stop putting highway taxes into deficit reduction. If you build the roads, and you need more highway taxes, we'll pay the excises. But understand who's going to pay them. The people that are most affected. This is a political problem that's looking for an academic answer.

CONGRESSIONAL VIEWPOINT

Introduction: Dr. J.D. Foster

Our next speaker is Lori Peterson, Tax Counsel to U.S. Senator William Roth, who happens to be the Chairman of the Senate Finance Committee. Prior to joining Senator Roth's office, she practiced tax law at Vincent & Elkins. She received her J.D., that's juris doctor in this case, from Georgetown University Law Center. I think we're particularly fortunate to have Lori with us today because there's going to be a lot of tax policy discussion this year, not just regarding excises, but also tax reform. It's very important, while we are thinking great and lofty thoughts about the fundamentals of excises, that we keep in the back of our mind the political realities that our lofty thoughts are going to have to face.

Ms. Lori Peterson

Someone in the last panel asked, "What good are excise taxes?" At this point, probably the only thing they're really good for is keeping us all employed.

First, I would like to talk a little bit about tax reform. Tax reform in the 104th Congress was really on the front burner, especially in the Second Session. It was pretty much the hottest thing going. As Steve Forbes came out with his flat tax, however, people started to take a harder look at the flat tax and how it would affect them personally. Thereafter, the debate on tax reform seemed to die down, but it is far from dead.

President Clinton stressed during the campaign that his interest was in incremental reform and not in a major overhaul of the tax code. This position seems to continue to be true now, even though White House Press Secretary Michael McCurry recently said that the President and the Treasury Department remain open to tax reform. This new "opening" is somewhat encouraging, but for any tax reform effort to succeed, it must have strong support from the President. It must be one of his initiatives. We're not there yet.

What does that mean for the 105th Congress? Well, I think it's safe to say there will be no major tax reform proposal adopted in the first or probably second year of the 105th Congress. Although a major overhaul of the tax code isn't likely to be adopted in the next two years, I think the education process will proceed. Chairman Roth is very committed to holding hearings and starting that education process with the Finance Committee Members. I think Chairman Roth is strongly committed to moving forward with significant tax reform, either incrementally or as a major overhaul. The Chairman believes that the code as currently structured is too complex; is unfair; has an adverse impact on our ability to compete globally to save, and to grow economically. As I said, Chairman Roth does plan to hold hearings on the different major tax reform proposals. The timing of these hearings, I suspect, will probably be late spring or summer. First, we need to hold a number of hearings on the President's FY98 budget proposal, and then we'll get into the budget reconciliation process.

I would like to share with you some of the criteria that Chairman Roth plans to use when examining these major overhaul proposals. Chairman Roth believes that any reform should create a system that is simple and fair, that can be easily understood, that promotes economic growth, that encourages savings and investment, and that promotes American exports. In addition, Chairman Roth feels that the system must be stable. It should be one that the American people can rely on and plan for. And that means that any major reform proposal needs to be the product of a bipartisan effort. I don't think we'll get anywhere if the Republican-controlled Congress tries to push through a partisan reform effort. Really, we need to hold hands on both sides of the aisle and move forward with some type of proposal, again, with strong Presidential support.

As you are well aware, there are a number of reform proposals being analyzed — the USA Tax, the Armey-Shelby flat tax, the Schaefer-Tauzin National Retail Sales Tax, Congressman Gibbons' VAT. Most of these proposals only look at replacing the income tax, both on the individual and corporate levels, and for that reason, they ignore the excise tax area. The one exception is the National Retail Sales Tax, which does repeal a number of the excise taxes. This makes sense if you're going to have a general sales tax.

I think there are a number of problems, however, with a retail sales tax. As many of you are aware, it is regressive, there's the potential for a bigger underground economy for evasion, and there are a vast number of collection points, just to name a few problems. The National Retail Sales Tax isn't the only proposal with problems. I think each of the major reform proposals has strong points and negatives. We will be looking at all of these when the Finance Committee begins its hearings.

During these hearings, our goal is to flesh out all the positives and the negatives in these reform proposals. But it's important to remember that the tax reform proposals that people are discussing now really are aimed at encouraging saving and investment and discouraging consumption. Excise taxes are primarily taxes on consumption, and if we're trying to promote saving and investment, what does that mean for the excise tax area? I think that's an issue that you should really think about.

I'd like to talk about the tax bill this year in the 105th Congress, and what may be happening outside of major tax reform. There are a number of broadly supported proposals that were not enacted last year. They're really the big-ticket items: child credit, IRAs, capital gains, estate tax relief, AMT relief. These are issues that we'll be looking at again this year, however. Chairman Roth has said he plans to do a tax bill, and I think Chairman Archer is equally committed.

At this point, in the excise tax area, there are three issues we're looking at. 1997 is probably going to be the year of the excise tax. Who'd have thought? The three main areas are the Airport and Airway Trust Fund taxes, reauthorization of the Highway program — ISTEA2/NEXTEA, and Superfund.

Before I talk about these specific areas, I'd like to comment briefly on the House Transportation Excise Tax Task Force that Chairman Archer established. As you know, it's an informal, bipartisan task force charged with advising Chairman Archer on issues involving the taxation of various forms of transportation. Since October, the Members and staff have been going through an education process. The Members were briefed by the Federal Aviation Administration and the Government Accounting Office on the Airport and Airway Trust Fund taxes, in particular, the Group of Seven proposal to modify the 10 percent ticket tax. We are watching their progress and looking forward to their recommendations.

What's going on in the Senate? Chairman Roth did not appoint a task force. I am the task force. I am looking at all the transportation-related excise tax issues and keeping in close contact with the House Ways and Means and Joint Tax Committees. I welcome your comments and suggestions, and would appreciate any input, insight, changes, or technicals you may have.

Probably the hottest issue right now, or the one that's receiving the most attention, is the aviation taxes. The Airport and Airway Trust Fund is funded by five different taxes: the 10-percent ticket tax, which probably everyone's been hearing the most about; a 6-percent tax on international departures; a 6.25-percent tax on domestic freight; 17-cents per gallon tax on jet fuel for non-commercial aviation; and 15-cents per gallon tax on gasoline used in non-commercial aviation. All these taxes expired on December 31, 1996. The expenditure authority for the trust fund, though, is scheduled to expire after September 30, 1998, so now we have an authorized program with a lapse in funding, and we're losing approximately $500 million a month, or $6 billion a year in tax revenue.

The debate over user fees versus taxes has really heated up. The Department of Transportation and the FAA are generally in favor of moving toward a user fee system. The FAA Reauthorization bill created a 21-member task force to look into all the costs of the FAA, including a possible new funding mechanism. So there is real interest in trying to move from a tax system to a user fee system, to better match the cost that the various sectors of the aviation community put on the FAA. The Secretary needs to report these findings to Congress by early October 1997. The Finance Committee will have to act probably sometime in early 1998. Meanwhile, we're losing $500 million a month, so it's very likely that the Finance Committee and Ways and Means Committee will need to act before these recommendations are set in front of us.

As you probably know, the seven largest airlines have proposed an alternative funding mechanism for the 10-percent ticket tax, and we are studying it. The proposal dramatically shifts costs to the low-cost carriers. We are, however, working to find some type of medium ground, if possible. Any modified proposal, however, would be structured as a tax, not a user fee.

I think it's very important to understand what a true user fee is, and that it's very difficult to move from a tax to a user fee. So let me just give you an overview of what a user fee is. A user fee is a charge that's levied on a class that directly avails itself to a government program. It's used solely to finance the program, rather than to finance the cost of government generally. The amount of the fee charged to the payor generally may not exceed the cost of providing that service. And there must be a reasonable connection between the payors of the fee and the agency receiving the fee. I suspect that there will be a lot of discussion about these factors in the context of this Group of Seven proposal, and possibly the commission's proposals.

The next big issue is reauthorization of the Highway program. Although the excise taxes expire at the end of fiscal year 1999, the program needs to be authorized by the end of this fiscal year. We have been working in close conjunction with the authorizing committees, and I think there are a few issues that are likely to arise when the Finance Committee looks at the excise taxes which will continue to fund the highway programs. One issue, which was raised last year and has been raised before, is tax parity for alternative fuels. Specifically, there was an effort made last year to drop the rate paid that liquified natural gas (LNG) pays to the rate of compressed natural gas. I expect that effort will continue. I know that methanol and propane and LNG are all trying to work together to find some type of proposal that everyone can live with. I'm not sure what's going to happen with Ethanol. It's a hotbed, as you probably know. I think the next issue is transferring the 4.3 cents per gallon motor fuels tax from the General Fund to the Highway Trust Fund. As you're probably aware, Senator Dole talked about repealing the 4.3 cent tax. That did not come to fruition. At the end of the year, Senator Byrd and Senator Roth joined forces in an effort to transfer the 4.3 cents to the Highway Trust Fund, although that didn't happen either.

Amtrak also will definitely be an issue this year. It's one of Chairman Roth's top priorities, and we're looking for alternative means of funding it. The Finance Committee reported out a bill last year that would have created a separate trust fund for Amtrak and would have transferred a half cent from the Mass Transit Account to a new Intercity Passenger Rail Account, with protections that there had to be adequate funding for the Mass Transit Account before Amtrak could receive its half cent.

I'm sure you all saw in *The Washington Post* on the Federal Page a couple of days ago that Congressmen Schuster and Oberstar are looking to move the transportation trust funds off budget, with the promise of secure funding for Amtrak. This is going to be a very heated debate.

The next issue is Superfund. For two years now, we have not had a Superfund program. I think efforts to reform the Superfund are high on Senator Chafee's list. Senator Roth very much would like to see some type of Superfund reform enacted. I think it's unlikely, however, that we will reinstate the Superfund taxes before the reforms look like they have a good chance of passing. There are a number of sticky issues in the Superfund reform that may hold it up again: retroactive liability relief; joint and several liability; and natural resources damages. As the authorizing committees begin to look at Superfund reform, we will be looking at the taxes. I don't think there's a lot of controversy about the base of the taxes, but I have had earlier discussions with people who would like to change the base. And, again, I'm willing to talk with anyone who's interested in Superfund tax issues.

There are some other taxes that could be reinstated, possibly when Superfund is reauthorized, or possibly earlier, such as the Oil Spill Liability Trust Fund excise tax, which is a 5-cent-per-barrel tax, and the Leaking Underground Storage Tank Trust Fund tax, which is a one-tenth of a cent tax that expired on December 31, 1995.

I would just like to take a moment to mention the issue of retroactive reinstatement of excise taxes. This is often an issue of concern. Congress has, however, set some precedent on this issue when we reinstated the Airport and Airway Trust Fund taxes. When we reinstated these taxes, we did so on a prospective basis. These taxes are transactional taxes, and it's very difficult to go back and collect a tax on a transaction that has been completed. We definitely did not want to stop people at the airport and tell them they owed another $50 on their ticket. So, I think reinstating excise taxes will probably be on a prospective basis only.

These are the main areas in the excise tax arena that I believe the Finance Committee will be looking at. I know you have a number of other issues that you probably are concerned about, so I'd be more than happy to answer any questions you have about any of these.

Audience Questions & Comments

Question/Comment: Regarding transportation excise tax recommendations you mentioned before, one of the difficulties I have is trying to figure out where it's going. We're being told they'll give recommendations to Chairman Archer in March. It's not clear at this point whether there'll be hearings later, after a proposal is developed, or whether it will just go to a bill. And the effort to seek our advice beforehand leads me to believe maybe they might just go to a bill without hearings. My question is, if that develops, do you think the Senate would adopt that bill and go through a formal hearing process at that point? Or would you wait for the House to act even if it took until May, June, or July for them to act.

Ms. Lori Peterson: I don't think we're going to wait for the House to act. We plan to hold a hearing on the Airport and Airway Trust Fund taxes in early February. I can't say whether or not the House will draw up a bill, but, based on Chairman Archer's first comments when he was establishing the Transportation Excise Tax Task Force, I think the recommendations will be informal. And, then, of course, Chairman Archer will decide, what he plans to do.

Question/Comment: Would you discuss the Democratic package on Medicaid and the possibility of an excise tax funding source? And, second, would you tell us about the corporate welfare reform?

Ms. Lori Peterson: Well, I'm not sure exactly what the Democrats have planned for their Medicare funding source. But, as you know, Senator Kennedy is very interested in children's health care and has announced that he will probably introduce a bill on it this Congress, paid for by an increase in tobacco taxes. At this point, the Finance Committee is not looking at any options or proposals to raise the tobacco tax, but you never know where this issue's going to come up in a debate. We do know that there's probably going to be an effort similar to Senator Kennedy's in the House. It's not necessarily a partisan issue, so we're monitoring what's going on.

Last year the President's budget included a number of revenue raising proposals, and it was pretty much dead on arrival. Last year, since we closed up the most egregious provisions, for example Section 936 and a number of provisions in the foreign area, we don't have a lot of pay-fors left. We do have the ticket tax. That's a good $6 billion a year, but to do a tax bill anywhere near the size that Senator Lott is talking about, we will need to look at all types of revenue raisers. We haven't looked at anything in the excise tax area.

Question/Comment: What do you see happening on deferral?

Ms. Lori Peterson: We don't expect Senator Dorgan to go away. I think it's going to be a tough issue. We need to educate the Members on what deferral means. Senator Dorgan clearly has the 30-second soundbite on moving jobs overseas, so I think we have a lot of work to do. A lot of work was done last year, and I think the process will continue. Where the debate will lead, though, I'm not sure.

Question/Comment: Do you think the Chairman is committed to a fuel tax as a way of paying for Amtrak. And, second, what timetable do you see for dealing with Social Security reform?

Ms. Lori Peterson: I don't think using the fuels tax to pay for Amtrak is the only option. I think the Chairman's open to other options. We're trying to work with the authorizing committees.

Last year, we moved from direct spending to contract authority, to try to put Amtrak on a similar playing field as other transportation modes. If we do that, we may not need to use the fuels tax.

Social Security? Good question. The Social Security Commission came out with three different proposals. I think we're probably going to wait to see what the President has to say about Social Security. I don't think we're going to rush into anything.

Question/Comment: How about death taxes?

Ms. Lori Peterson: Well, as you know, in 1995, we provided some targeted relief to family-owned businesses in the Balanced Budget Act of 1995, but the bill was vetoed. Right now, we have two camps: complete repeal of all estate taxes; or, targeted relief. There's still a strong interest in providing some type of estate tax relief.

Question/Comment: When we started this exercise, I had in the back of my mind what I thought was an ace in the hole. I'd like to turn over the card and get your judgment on whether it's an ace or a deuce. The non-trust fund excises total about $35 billion annually. Tax reform, we all know, is very complicated. One of the complications is whether or not we're going to allow a change in the distribution of the overall tax burden. These excises are very regressive, at least as estimated by Joint Tax. The tax reform proposals that we dealt with — flat tax, sales tax, so forth — have tended to be far less progressive than the current income tax law. The only important exception to that was Nunn-Domenici and they had to strain to the breaking point so that it wouldn't be less progressive than current law. So, you've got a group of excises, which are deemed to be regressive. We have a current progressive income tax system and we have tax reform proposals which are less progressive than the current system. So, it struck me that one way out of the political jam is, in fact, to repeal these $35 billion or so non-trust fund excises as part of tax reform and this would solve a good deal of the political problem in the distribution tables of tax reform.

Ms. Lori Peterson: Well, I think it's a reasonable analysis. It makes sense. I think there is a concern that excise taxes are very regressive. I think the problem is, though, where are we going to find $35 billion? But it's something we need to discuss.

SESSION TWO: "REGRESSIVITY OF EXCISE TAXES IN A LIFE-CYCLE MODEL OF CONSUMPTION"

Introduction: Dr. J.D. Foster

I didn't realize it at the time, but this is sort of a Council of Economic Advisers (CEA) reunion panel. Our main speaker is Dr. Andrew Lyon. He's a principal consultant with Price Waterhouse and Associate Professor of Economics at the University of Maryland. He has served as Senior Staff Economist at the CEA in both the Bush and Clinton Administrations. He came on board in the last part of my tenure there and carried on through. Dr. Lyon received his Ph.D. in economics from Princeton University.

Also commenting on this panel is Dr. Robert Tollison. He's a Duncan-Black Professor of Economics and General Director of the Center for the Study of Public Choice, George Mason University in Fairfax, Virginia. He previously held academic appointments at Cornell University, Texas A&M, Virginia Tech, and Clemson. He has twice served in government, once as Senior Staff Economist at the CEA, and once as Director of the Bureau of Economics at the Federal Trade Commission. He is past president of the Southern Economic Association and author of a best-selling economic principles textbook for college students. Gentlemen, I look forward to your discussion.

Speaker: Dr. Andrew Lyon

Thank you, J.D. I'd like to talk about one of the topics that was mentioned in the overview this morning, tax regressivity of excise taxes. And I'd like to put it in a slightly different dimension. Most of the incidence analysis that is done for Congress by the Joint Tax Committee, the Congressional Budget Office, the Congressional Research Service, and the private groups in Washington really focuses on a single dimension of tax incidence.

There are several shortcomings to this approach. First, as Steve Entin mentioned, one shortcoming is that we only focus on the consumer burden of excise taxes and simply ignore what's happening on the producer side.

There's a well-known joke about economists. There was a drunken economist walking down the street, and he loses his watch. He keeps on walking and finally reaches a street lamp and begins to search under it. Someone comes by and says, "What are you doing?", and the guy says, "Well, I lost my watch." And, the person says, "Well, where'd you lose it?", and he says, "Well, down the street." The person asks, "Why are you looking here?" The economist responds, "Well, the light's better here."

Why do we typically only study the consumer side of tax incidence? Well, the light is better there. We know more how to analyze that. But we neglect, as a result, incidence effects stemming from the producer side.

In the same way, the incidence analysis that is typically done usually focuses on a single snapshot view of the consumer or of the household. In the case of excise taxes, analysts observe the consumption at a single point in time for a household and compare it with the income of the household at that point in time. I refer to this annual incidence analysis as a snapshot view of tax incidence. The shortcoming with this view is that, over time, people change income classes, but their consumption patterns may or may not change as much as their income patterns do.

There has been a large debate in Washington on the distribution of income in society, and one criticism of that debate is that there is a great deal of income mobility. So looking at an income distribution at a point in time doesn't really tell you how unequal income is distributed over our lifetimes.

The same criticism on income distribution applies here to the area of tax incidence. If incomes are changing a great deal over the life of a consumer, perhaps a more appropriate view of tax incidence is knowing how much taxes are paid by an individual over his lifetime, relative to the income earned by that individual over his lifetime.

Now, back to the street lamp analogy. It's much harder to conduct a life cycle study than an annual study. If I began a 60-year study of life cycle tax incidence today, I would not be able to report back to you for 60 years.

The shortcoming with annual incidence analysis is, again, that current income can be a poor predictor of living standards. If individuals have any ability to borrow, then when their income is low, they might easily consume more than their current income. When saving for retirement, an individual's income exceeds his consumption. Upon retirement, consumption typically exceeds income. Income of the elderly can be a very poor indicator of their living standards. Wealth of the elderly might be a better indicator of their living standards, but the best indicator might have been their income over their entire lifetime.

This is not a new idea, obviously, that life cycle income gives us a better understanding of the income standard of an individual. Milton Friedman was one of the first to point out the problems of looking at annual consumption and annual income measures. He is known for the formulation of the Permanent Income Hypothesis. His idea was simply to examine how consumption changes in response to temporary fluctuations in income. For example, Friedman observed that if someone becomes unemployed for part of a year, even though that is a large reduction in the annual income to the individual, his consumption will not drop as much.

A related idea is age-related consumption smoothing. Franco Modigliani is credited largely with the idea that people aim to consume similar amounts over their lifetime despite life cycle trends in income. This diagram is a stereotypical view of what we believe is happening to income over a lifetime. For educated individuals, college education and higher, age-income profiles tend to be fairly steep, peaking in middle age. They tend to be flatter for people with education levels of high school or less.

What then is the problem if we try to measure the regressivity of, for example, an excise tax using annual data? In some instances, there might be no problem. This figure shows a commodity where it's assumed that, at every age, consumption is proportional to income. So, here, the relationship is that consumption is one-fourth of income at any age. For a consumption item like this, if we measure tax incidence at a point in time using an annual income measure, or using the life cycle measure, we're going to get the same answer. Assuming that people who have lower levels of income (at every age) also consumed one-quarter of their income at every age, we're simply going to find that the tax on this commodity is proportional to income.

The problem comes when there is consumption smoothing over time, and so I've assumed in this new diagram that the individual aims to hold consumption constant at every age, even though income is varying over time. Now, we're going to get a big difference in a study which measures regressivity on an annual basis compared to one which measures it over the life cycle.

Using annual studies, we're going to find high-income people, those who are in their middle years of life, consume less than their income, whereas low-income individuals, people at the early stages of their life or at the later stages of their life, consume more of this commodity than their income. And, so, a tax on this commodity is going to be a regressive tax based on the annual measures. However, if we find the same pattern here for individuals of all different lifetime incomes, we might simply conclude, on a life cycle basis, that this tax is proportional to income and, therefore, it is not regressive. This is why it's important to look at the life cycle dimension.

The obvious assumption is, when we're focusing on the life cycle model, that individuals have the ability to borrow out of future income for their current consumption. The criticism of the life cycle approach is that many households don't have an ability to borrow against future income. Also, if you look at savings among households, there is a significant fraction of households who have very low savings. It's been estimated that, perhaps, 20 percent to 25 percent of the population is fairly constrained in their ability to borrow. This is a limitation of the full life cycle approach. On the other hand, just because it may not fully apply to 20 percent of the population doesn't mean we should totally reject the life cycle approach either. There is a significant amount of borrowing that takes place in the form of home mortgages, student loans, car loans, and credit card debt. So there is a large ability to borrow against future income. There is a larger ability to handle transitory fluctuations, short-term fluctuations in income. And, also, people who prepare for retirement and save, obviously people with accumulated wealth, have the ability to consume more than their current income.

Even if you believe that there are limitations to the life cycle view, it may change our feelings of equity toward a tax that might appear regressive in a snapshot, annual view, but is not regressive over the life cycle. An analogy could be made, for example, to a military draft, which only affects 18-year-olds. In a snapshot view, perhaps, it looks very unfair that only 18-year-olds are subject to the military draft. However, if you take the lifetime view, you know that everyone in society has served in the military at one point in time. Even though at age 18, there's no ability to avoid the draft and it looks unfair relative to a 30-year-old, over a lifetime, everyone has paid that burden. So, in the same way, a tax may at a point in time be regressive, yet be proportional to lifetime income.

As I mentioned, I would love to begin a 60-year study of life cycle income. Without such a study, the question is how do we estimate it? One shortcut method that has been used by Jim Poterba at MIT and by the Congressional Budget Office uses only a single year's annual data. But it looks at the total consumption of the household in that year and then compares the consumption of certain items such as tobacco, alcohol, and gasoline expenditures to the total consumption of the household. The idea is that the total consumption of the household might be a good proxy for lifetime income. Assuming that total consumption is smoothed out over time, total consumption may be similar to lifetime income.

The best method of measuring life cycle tax incidence is to follow the same households over time. Clearly, we're not going to have a study that has followed households for 60 years of adult life, but there is a data set, the Panel Survey of Income Dynamics, which has been following households since 1968. There now are nearly 30 years of data following the same set of households. This data set has been used by a series of authors. Don Fullerton and Diane Rogers have a Brookings Institution publication on life cycle taxation. Howard Chernick and Andrew Reschovsky have a paper dealing with gasoline tax regressivity over the life cycle. And Bob Schwab, a colleague of mine at the University of Maryland, and I have a paper looking at alcohol and cigarette taxation over the life cycle. I'll focus on the work that Bob Schwab and I have done.

At the time we began our study, we were limited to 20 years of household data on income, and based on that 20 years, we were able to project out the rest of the household's income. Even though we only have 20 years of true data on income, we can estimate the income for the remaining years of adult life and for the years before the adult entered the sample.

The Panel Survey of Income Dynamics is really meant to study income. It has very little information on consumption. Fortunately, between 1968 and 1972 this survey did look at consumption of alcohol and cigarettes. So we do have expenditures on alcohol and cigarettes for that five-year time period. Chernick and Reschovsky use the survey to impute gasoline expenditure for about 11 years based on miles driven by the household. Fullerton and Rogers only used the income data from the survey and, then, tried to match it up to other consumption items.

Now for the results of our analysis on alcohol and cigarette tax regressivity. I'm putting up a slide showing an annual analysis of tax incidence from this data set, subject to a couple of caveats. First of all, as I mentioned, we're only looking at the consumer incidence of the tax. The second caveat is that alcohol consumption is measured only as an expenditure. As a result, we can really only analyze the effect of an alcohol tax that is proportional to alcohol expenditures. As was discussed in the first session, the alcohol tax is actually levied on a unit basis, based on alcohol content. So a very expensive bottle of wine has the same unit tax as a very cheap bottle of wine. Therefore, the regressivity of the tax based on expenditure is understated. In other words, the true tax is more regressive than our analysis is showing. The differences in magnitude between annual and life cycle regressivity is what I want to focus on.

First we rank households by quintiles, groups of 20 percent of the population, looking at their alcohol consumption relative to income for a single year. As has been found in other studies, on an annual basis, the alcohol tax looks quite regressive. In terms of magnitudes, the poorest quintile spends more than twice as much on alcohol as a fraction of their income than the richest quintile. Across all income groups, the poor spend a greater fraction of their income on alcohol than richer quintiles. This is a perfect representation of a regressive tax, with the limitation again being that this is being examined on an annual income and consumption basis. For cigarettes, the differences look even more dramatic. The poor spend about a four times larger fraction of their income on tobacco than the richest 20 percent of the population.

As I mentioned, the data set that I used looks at actual consumption for a 5-year period between 1968 and 1972. So, without doing any elaborate econometrics, I can simply look at five-year consumption relative to five-year income. For people who aren't comfortable with a life cycle view of borrowing and smoothing consumption over time, you might be a little more comfortable with a five-year horizon. For alcohol consumption, this remains a quite regressive tax, the poor, again, spend a significantly larger fraction of their income on alcohol than the richest 20 percent of the population. It's not quite twice as much, though, as it is in the annual data. For cigarette consumption, again, the annual story of regressivity continues to hold quite strongly. And, comparing these figures for quintiles other than the poorest, there is almost an exact match relative to the annual data. There is a slight reduction in expenditure shares among the poorest, but again, one could still classify it very easily as a very regressive tax, the poor bearing a larger proportion of their five-year income in tax liability than the rich.

To go beyond five years of data, I've got to do a lot of econometric estimation, as I do to estimate income outside of the 20-year period. Rather than explaining the methodology here, I'll simply switch over to the results. What I've done here with my co-author, Bob Schwab, is to estimate lifetime income and lifetime consumption of alcohol and cigarettes. Lifetime income was based on the 20 years of actual data that we had for a person. Actual consumption is based on the five-year period between 1968 and 1972, which may not be representative of consumption patterns today, but it was the best we could do. Then we projected out, based on that five-year period, what their lifetime consumption profiles would look like. Organizing households by quintiles for alcohol, the lifetime poor are in the first quintile, the lifetime rich in the fifth quintile. The results show this is a regressive tax. The lifetime poor are spending a larger fraction of their income on alcohol than the lifetime rich, although the regressivity has been diminished relative to the annual data. In the annual snapshot, the poor spend about 125 percent more than the rich on alcohol as a share of their income. Here, the poor are spending about 40 percent more of their income on alcohol than the rich. So one would still quite firmly classify this as a regressive tax. It's simply not as regressive as it appears in the annual data.

For cigarettes, the analysis shows even smaller differences between the annual income approach and the lifetime income approach. In the annual data, the poor are spending about three times as much of their income on cigarettes as the rich, and in the lifetime data, instead of 300 percent more, it's 260 percent more. So, given the amount of estimation and extension from a single year out to 60 years of an adult's lifetime, my co-author and I were really surprised that there was so little change in the measure of regressivity.

There are more formal ways of measuring regressivity other than the visual comparison of quintiles. Something that we use is called a "Suits" index which compares the tax incidence for each percentage of the population. By the calculation of this more formal measure, there is virtually no difference between the annual income measure of regressivity and the lifetime measure. Again, this is surprising because, as a first assumption, economists might think that consumption smoothing would be appropriate. If it is occurring, it's not enough to overturn the results that the annual data show in cigarette consumption. And, using this "Suits" index, the more formal measure of regressivity, for alcohol, it's cut roughly in half. So we might say it's half as regressive as we thought it was, but it is still firmly a regressive tax.

<u>Audience Questions & Comments</u>

Question/Comment: Are you using after-tax income or pre-tax income?

Dr. Andrew Lyon: Pre-tax income.

Question/Comment: Here, we're looking at a lifetime cycle to measure taxes with respect to something that has a very short duration, the immediate consumption of alcohol or tobacco. It would seem to me the important thing is the burden of the tax at the time I'm poor and the burden of the tax on me at the time I'm wealthy, if I'm moving from poor to wealthy. Taking a lifetime cycle into account has the effect of taking the denominator and averaging it in a way which will shrink the effective tax rates. You're comparing life cycle income against the consumption of the moment. In a sense, a more reliable indicator is the measure of regressivity that you have on an annual basis.

Dr. Andrew Lyon: If you don't believe that there's any ability to borrow against future income, then the burden that you feel at a point in time is related to your current income. But, at the other extreme, if you have a full ability to borrow against that future income, there's no reason that your current consumption should not be more than your current income. And, I think the case is strongest in the case of the elderly individual who might have no current income but has a large amount of wealth. The income measure for an elderly individual consuming down his wealth is really meaningless as a measure of their well-being.

Question/Comment: Isn't this life cycle income approach counter-intuitive to the way public policies are formulated?

Dr. Andrew Lyon: Well, not to economists. I've heard Members of the Ways and Means Committee debate the elasticity of capital gains realization. They can understand these issues as framed by economists. There have even been Ph.D. economists on these committees. I think the staff is aware of these issues. When Alan Auerbach was the Deputy Chief of Staff of the Joint Tax Committee several years ago he helped put together a book which was intended to reflect some of the ideas behind lifetime income. So, at the staff level, it is something they are aware of.

The idea that I actually want to emphasize is, at least in terms of cigarette and alcohol, the view that these taxes are regressive is actually strengthened, because we're taking a richer approach to tax analysis. The fact is, the regressivity of the tax continues to hold up.

I would not expect this to occur for all consumption items. However, when Chernick and Reschovsky looked at gasoline, they were critical of the idea of looking over the lifetime of an individual for some of the reasons we've mentioned. So they restricted their analysis to an 11-year period. Well, it just so happens that miles driven was only measured by the data set for 11 years. They don't have to do any fancy econometric work, simply look at 11 years of gasoline consumption relative to 11 years of income for those households. Policy makers may not accept the idea over an entire lifetime, but they might be willing to accept some intermediate run period. The results, again, find that the gasoline tax is regressive over the 11-year period. The regressivity is diminished, but that is to be expected in any analysis like this, just as in questions of income distribution.

There are some issues to consider when you move to the life cycle analysis that don't come up with the annual analysis. I want to touch on a few of these issues. The founders of the Panel Survey of Income Dynamics hadn't really thought about how family composition changes over time, and they write in their manual that when they started thinking of how they were going to follow these households for 20 years, they had in mind that everybody was the "Leave It To Beaver" family, where everyone stays married for life — they marry at age 21, they die at age 80.

When we followed our households for

20 years, I think roughly only 40 percent of the families were intact after 20 years, so there's marriage, divorce, and premature death. Some spouses end up remarrying the same person that they divorced. The unit of analysis is more of a conceptual problem in the lifetime approach. Do we follow individuals over time? Do we mix households that consist of different spouses at different points in time? That's an issue to think about.

Another issue is that there are income-related differences in the longevity of households. The poor tend to die younger but, assuming they all live through their working years, the present value of their labor income is not affected by their longevity. On the other hand, they're going to have fewer years of consumption in post-retirement years, so these households may need to save less than households with longer life spans. Differences like that might be affecting consumption when they're young. We think of the poor not saving as much as the rich. That may be partly a rational response to differences in longevity.

In the consumption tax area, when we're looking at analysis of progressivity of consumption taxes, an interesting area to consider is bequests and inheritances and how those may differ across income groups. In our analysis, we simply assume that there are no bequests. People die at age 80. They know they're going to die at age 80, so there's no leftover money at that time. There's an interesting paper by Gib Metcalf in an American Enterprise Institute volume edited by David Bradford that considers whether a consumption tax would need to directly tax a bequest in order to continue the proportionality of a broad-based consumption tax. One of the ideas is that the bequest might not need to be taxed. If the idea is to give a certain amount of consumption to the next generation, the next generation will be taxed on the bequest when it spends it for consumption purposes. So, the bequest will buy less in consumption goods, even though it's not directly taxed under the consumption tax, because it is taxed when it is spent.

Another important point: The standard of comparison of what is a regressive tax and what is a progressive tax changes for all taxes when we move from the annual snapshot to the life cycle view.

For example, an income tax is progressive on an annual basis because we've got graduated marginal tax rates. But that progressivity is diminished over a lifetime because we've got people who are lifetime rich paying very low taxes at the beginning of their career. The progressive income tax looks less progressive over a lifetime, much more like a proportional tax. So, even if the regressivity of certain excise taxes is diminished, the progressive taxes also appear less progressive over a lifetime.

I suggest that the life cycle view provides an additional perspective. I'm not going to argue that it's the only perspective that needs to be considered, but I think it does help add to the analysis. It makes a somewhat richer analysis of the effects of these taxes. And, although we might anticipate that the regressivity of excise taxes would be greatly diminished under the life cycle view, for the taxes that I've looked at, regressivity isn't greatly diminished. For cigarettes, it's virtually identical. And, for alcohol, it is slightly less regressive, but I think one would argue that it's still firmly a regressive tax. Thank you.

Discussant: Dr. Robert Tollison

First, this is a good paper. It's not a problem-free methodology because we don't know that it actually describes real behavior. There's some idea about "borrowing constraints" floating around. Nevertheless, it shows that excise taxes are still very regressive. The technique does not defeat the argument you have right now, which is regressivity. If you threatened to raise these excise taxes in the 1960s, somebody like myself would go up and say, "Well, that's regressive, that hurts poor people," and, the people who proposed the tax would go scurrying for cover.

Today, that argument has been swamped by the externality paradigm and by the elasticity paradigm. So the regressivity argument carries less weight today, because the economists on the other side of the table will immediately bring up the externality argument and/or the elasticity argument. I may be the only guy here who's ever testified before the Senate Finance Committee against raising the tobacco excise tax. In fact, the way I presented the regressivity argument before the Finance Committee, after Senator Bradley had berated me rather soundly, was, "Well, Senator, look, if someone proposed a bill to take $300 worth of income a year from everybody earning under $40,000 in the United States and introduced it for a recorded vote in the Senate, nobody would vote for it." And, of course, they wouldn't vote for it, but that was in essence what they were trying to do with their tobacco tax increase.

Then, from the other side of the table, Professor Warner would chime in, "All these people are imposing social costs and, of course, it's optimal to tax commodities that have low elasticities of demand anyway." So, the regressivity argument is the best argument you've got right now, and it carries less weight in the legislative debate because of these other so-called paradigms that have grown up. As we heard this morning from our presenters, the externality paradigm's been examined fairly closely, both conceptually and empirically, and it doesn't wash. It doesn't exist empirically. For example, take the life cycle methodology and apply it to the use of social welfare programs by smokers and nonsmokers over their lifetimes. The answer you're likely to find is that smokers are a very nice source of profits to the state, and nonsmokers aren't because major medical costs come at the end of one's life, not from people who die early, for whatever reason. So, if you applied the life cycle methodology, the idea that smokers are imposing costs on nonsmokers through the fiscal system is just not true. It couldn't possibly be true. I've seen people run the numbers and do simulations, not only for the United States, but for countries like Switzerland, and it's just not true. Smokers are vastly overtaxed. They're not undertaxed. And, so, the externality argument falls of its own force empirically, and it has no good theoretical basis, as Steve Entin was pointing out to us this morning.

The elasticity argument is a little bit more arcane, but it exists in academic circles, and indeed, one of the guys who won the Nobel Prize in Economics this year was famous for the argument. It's called the "Theory of Optimal Taxation." It essentially says that, if you have to design a tax system, you should tax commodities that have very inelastic demand curves. That's efficient from some general concept of taxation because it doesn't affect the economy very much in terms of behavior. People don't alter their behavior very much in response to a tax. And so you should tax tobacco and alcohol, and you should tax them early and often if their demand is inelastic, according to the optimal tax paradigm. There's been very little work against that kind of argument among academic public finance economists.

I'm talking now primarily to my fellow economists, but I'll try to make it clear to everybody. Think about a commodity with a very inelastic demand curve. It also has an industry supply curve. Suppose we put a per-unit excise tax on the product, thereby shifting the supply curve. The excise tax is equal to the distance between the two supply curves. The optimal taxation people would say this is a good tax because the little triangle we've created is very small. This means the product that we lose to this tax is very small.

So, what do you say about that? Suppose that the guy you're taxing spends resources to fight back. According to modern economics, that is also a cost of this tax. So, if, in fact, the industry loses that much wealth, if it loses wealth as a result of the tax, then it has an incentive to resist the tax by spending up to that amount of wealth to resist it. That's also a social cost of the tax. So, now, this seemingly innocuous tax is more costly than it was under the optimal tax paradigm. This is no longer a cheap tax.

What do you do with the rule? The rule becomes: don't tax those industries that fight back. The fact that the demand curve is inelastic means that industry will probably organize and fight back, because there's a lot of wealth at stake in the tax. If they fight back, the cost of fighting back makes it an inefficient tax. It makes it inefficient to impose that tax on the industry. You should tax somebody who doesn't fight back, and who has a more elastic demand curve.

You have one thing going for you: regressivity. It survived Drew Lyon's analysis, so you're in good shape. The thing you have to fight is the externality argument and the argument that it's optimal in an economic sense to tax commodities like tobacco. We're much further down the road unraveling the externality argument than we are with the inelasticity argument.

Audience Questions & Comments

Question/Comment [Mr. Stephen J. Entin]: Regarding the effects of transfer payments, the Joint Tax Committee and all the others who do these income burden and distribution burden comparisons should start taking in-kind transfers into account. And they should stop double counting income that is paid out in taxes by one group and, then, received as income by another, as if it was income to both groups at the same time. This is not something Drew Lyon is doing wrong. It's something the Joint Tax Committee does wrong. The life cycle approach, taking the present value of income, is absolutely standard in the profession. It is a present value of your whole lifetime income. But if you want to think of income in terms of a moment in time, just remember that, if they've got access to money that enables them to buy the cigarettes, they also have access to enough money to pay the cigarette tax, because they feel they can. That's why they buy the product. We observe that people do feel the way Drew Lyon described them as feeling regarding their lifetime income. That's why this analysis came into being. We had to explain why people were doing what they were doing. So, don't doubt it. It's quite valid.

I'd like to reinforce something Bob Tollison said. There are three kinds of attacks, and you need to address all three. You've got the regressivity argument. I should point out that the analysis we've seen assumes the tax is passed forward in higher prices. But what if the tax is passed back to the producer and the producer is rich rather than poor, or poor rather than rich. The issue becomes rather vague. You can't just assume it's being pushed forward onto the consumer. And, indeed, here Professor Tollison is showing the industry is going to fight back, because it's bearing some of the burden, and some of its shareholders may be wealthy. Some of them may not be. So, the regressivity argument can be a little bit vague.

But you absolutely do have good arguments against the externality nonsense and the social cost nonsense that's being thrown around.

And you have to defeat the elasticity paradigm. You come back to the academics and say, "If you have this perfect thing to tax, and consumers don't change their activity at all, and you're not distorting anything because consumption does not fall, all you're doing is taking money from people." They're cutting back everywhere else across the board, so why not just institute an across-the-board tax and not run the risks of distortion, and not run the risk that the industry will fight back. There is no case for this kind of tax that makes economic sense. You have good answers to come back with, if you practice them.

Question/Comment: I agree this paper is good. In the trenches where this battle is going to be fought, the proponents of excise taxes are going to bring up the cycle model of income and argue that the regressivity is largely eliminated. A study like this is helpful to say, "No, regressivity is not eliminated, it's only marginally or modestly reduced." This is helpful in the overall debate.

My question: I think you were suggesting that the area can be used by industries that might fight back. Why would the government care that the return to the industry is reduced? They don't care, do they, that the return to the industry is going to be less?

Dr. Robert Tollison: You're quite right. They don't care. The point is that economists care. Academic economists care, because this framework is utilitarian. Does the tax impose more cost than the associated gains from revenue? Or, is it the less costly tax relative to the next tax you might choose? A redistributionist doesn't care.

Question/Comment: You could make the argument that this life cycle approach weakens the case against excise taxes, because it weakens the argument on regressivity. But, it weakens the case for excise taxes as well. If you get the opposition, or the politicians who are listening to the opposition, who want excise taxes hiked on cigarettes and alcohol, to take a life cycle perspective, then much of the other arguments for increasing excise taxes, in particular, the health issue, just vanish. They're no longer there. So, instead of discouraging this kind of life cycle perspective, it should be encouraged because, on balance, it weakens the case for these excise taxes.

In state-by-state lawsuits, even without doing a life cycle analysis, what we find is that the estimated cost to Medicaid from smoking-related illnesses is swamped by the tax revenues.

Question/Comment: I'd like Drew Lyon to address Steve Entin's comment in more depth about the correct measurement of income. For Social Security transfers, for instance, you were looking at pre-tax income of wage earners, but you weren't adding back in the employer's share, so-called, of that tax. Steve also suggests that you should be counting in-kind transfers, and yet those are obviously paid for by taxes on somebody else. So, I'm not sure what you gain by counting some transfers and making an adjustment, or not making an adjustment, as the case may be, for part of the Social Security tax. Would it be better to go back to taxable income. Flawed though that is, it has a certain consistency in that it's omitting non-taxable transfers, whether in cash or in-kind, and it is picking up what people perceive is their pre-income tax disposal income.

Dr. Andrew Lyon: Yes, I think there is a lot of validity to using several definitions of income and showing how sensitive results are to the alternative definitions. I think there's a lot of sympathy to looking at what consumable income is, and that would add the value of in-kind transfers. As difficult as this analysis is, we're much further along at trying to value incidence of taxes than we are at thinking about the incidence of government expenditures. There are $1.5 trillion of government expenditures, and the only ones we know how to value outright are the cash transfers. How do we value national defense and attribute that across income classes?

Question/Comment: I don't know what the demand elasticity for motor fuel is, but if it is fairly low, then doesn't this negate some of the arguments that environmentalists want to make that by taxing gasoline we can change behavior and therefore improve the environment?

Question/Comment [Mr. Stephen J. Entin]: Yes, it does. If responsiveness is low, then you aren't changing behavior very much, and that is a good argument against this type of taxation.

Dr. Andrew Lyon: There's another issue to the incidence analysis that I didn't touch on that is worth considering. Unlike an income tax, where if you look at all the people who earn $40,000, for example, you're going to collect roughly the same amount from all of them. There's a tremendous deal of variability in collections of excise taxes among individuals of the same income group. In my data, roughly half of the population smoked, and roughly half drank. So even though I'm presenting averages across quintiles, you're going to have cases where someone with $10,000 of income pays for more tobacco tax than someone else with $10,000 who doesn't smoke. That variability is very important.

DINNER

Introduction: Dr. J.D. Foster

Last November, the Tax Foundation held its annual dinner in New York at The Waldorf-Astoria, and on that occasion presented the Private Sector Distinguished Service Award to Dr. Norman Ture, President of the Institute for Research on the Economics of Taxation, for a lifetime of work advancing sound tax policy. The same evening, we had the great honor to present our Public Sector Distinguished Service Award to The Honorable Phil Crane in recognition of his work on the House Ways and Means Committee. Tonight he is going to talk to us a little bit about what is going on in tax policy this year.

Phil Crane was first elected to the U.S. House of Representatives in a special election in 1969 to fill the vacancy created by the resignation of Donald Rumsfeld. He's been reelected in every succeeding year, and now represents the 8th Congressional District of Illinois. He was one of the first Members of Congress to propose indexation of the personal exemption and the standard deduction in federal income taxes. Indexation in the tax code is one of the most important developments that has occurred in tax policy in the last 20 years. He was also instrumental in having indexation included in the Economic Recovery Tax Act of 1981. He is currently the Vice Chairman of the House Ways and Means Committee and Chairman of the Trade Subcommittee. He is also a member of the Joint Committee on Taxation. He received his Ph.D. in History from Indiana University. Please join me in welcoming Congressman Phil Crane.

The Honorable Philip M. Crane

I want to thank J.D. for inviting me down here.

I am honored and flattered that the Tax Foundation would invite me to speak to you. I first ran for Congress in 1969 to replace Don Rumsfeld. Don had gotten elected in 1968, and then he resigned to head up the Defense Department at President Nixon's request. We had a wide-open race. I had campaigned ardently for a few people that I believed in, but I never intended to be a politician. I didn't even live in the district when the race started. Seven candidates had already announced in that race, and I thought: "Hey, that's fascinating. You know, it's a three-month investment. I've got a year off from teaching. I'd get hands-on experience to take back into the classroom." So, I persuaded my wife that I should run. She went along with it reluctantly, and so we rented a house in that congressional district. I ran, and I gave it my best effort. It was fun. It was an Irish Sweepstakes, winner-take-all kind of race. There were 11 candidates in the race to start, and we ended up winning by, I think, 2,300 votes. I was so excited that night at the victory party. I've never had a thrill in politics like that since. The next morning, I got out of bed, and I said, "Good grief, what have I done?"

To me, the Congress has always been the number one priority in terms of how our government functions, particularly the House. The fact of the matter is, taxes can only originate in the House of Representative constitutionally. And, more specifically, they can only originate in the committee on which I serve. So, that means, that 39 out of the 435 members of the House and the 100 members of the Senate have that exclusive jurisdiction to originate tax bills. All general appropriation bills have always originated in the House. If you've got taxes on the one hand and spending on the other, you've got the ball game, assuming you've got the proper direction.

That doesn't mean you're not going to have to make compromises and accommodations with the Senate and the President. So be it. You've inched forward. And you're right back to the drawing board, pumping and charging on the tax and spending questions. To me, those have always been the paramount issues. You know, the last time we had a budget surplus was that first year I got elected in 1969. We had a $3 billion surplus. Wow, that seemed awesome at the time — $3 billion. And I remember, as time went by, watching a steady deterioration on what was, to me, the paramount issue and reason for pulling a tour of duty in the District of Columbia addressing that deficit question. I remember watching the escalation of taxation. I made a commitment when I ran in 1969 that I would never vote for a tax increase short of World War III. And I have faithfully observed that. Taxes today are inordinately high. The average family pays more in taxes than they pay for their housing, and their clothing, and the feeding of their families. This is unconscionable, and it is something that needs to be reversed, but so does that awesome deficit.

I remember in the early 1980s, when, suddenly, we got the announcement that our national debt had gone to $1 trillion. We are over $5 trillion right now and, even if we reach our objective of a balanced budget by the year 2002, we will be pushing almost $7 trillion in national debt.

I was truly beginning to despair before the miracle of 1994. I say this, not to put down my Democrat colleagues, because we had a lot of them there fighting the good fight. But, even with those Democrats and Republicans, we couldn't prevail in biting the bullet and making some hard decisions on taxation and spending. The other thing that to me is of profound significance is the breakdown of religious and moral values. You know, we started out in this country on the premise that our fundamental inalienable rights to life, liberty, and the pursuit of happiness — and that was a paraphrase for property — were divine rights. The good Lord gave these rights to us. And what is the function of government except to guarantee the security and the protection of those rights? Instead it's become a trespasser. It's not guaranteeing the security and the protection of those fundamental rights, it's making a wholesale assault upon them and not because people are malicious necessarily. A lot of it is stupidity and ignorance. But a lot of it is the game, "Hey, you want to get elected? Okay, I'll give you what you want. And I'll give him what he wants. So what if we don't have a balanced budget?" You know, we haven't had a balanced budget in 28 years. To the degree that mentality prevails without recognizing its implications, I guarantee you we're threatening the survival of the world's last best hope. But the breakdown of religious and moral values is also a component, because Americans no longer recognize that this country was founded upon those premises. Those values must be transmitted. We must observe those relationships in our dealings with one another

Government's only purpose for existence is to protect us against trespass. At the national level, that's defense. At the local level, that's police and fire protection. Government has escalated dramatically beyond that. The founding fathers could only identify four departments of government at the national level that were legitimate: defense, state (because it's better to talk than fight if you can get away with it), justice (because we would be passing some laws that extend over state lines) and Treasury (because you might have to borrow in time of war). Period. We're currently up to 14 departments. Our founding fathers would be going ballistic right now over the degree of concentration of power in every one of our state capitols. That to them would be unconscionable.

All our ancestors came here for the same reason. This country offered hope and opportunity that was unprecedented in the span of recorded history, and we have all been the beneficiaries of this. But what it means is we've got some heavy lifting to do, we've got to make some hard decisions. Now, those hard decisions, to me, are basically in the arena of taxes first; secondly, spending; thirdly, decentralizing the federal establishment and getting these responsibilities bucked back home. And, that includes bucking them ideally not just to our state governments, but back to local communities.

Our whole system at the national level is predicated on redistribution of income. You take from the "haves"; you give to the "have-nots". I used to be infuriated when I knew that Illinois was sending, as a "have" state, two bucks to Washington to get a dollar back. Congressman Wilbur Mills once told me, "Phil, you don't realize how bad it is." He said, "Phil, we take that dollar of your taxes out of the State of Illinois, and 50 cents we send back to Illinois, and your naive citizens say, "Oh, isn't this great? We're getting manna from heaven. And, 25 cents of that," he said, "goes to my impoverished State of Arkansas, and the other 25 cents is kept here in this town to cover the cost of processing your tax dollar." That's unconscionable, and this is the sort of thing that has to be terminated.

One of the things that, to me, is most exciting about Bill Archer's chairmanship of the Ways and Means Committee is his intent to reform the tax system. I've been pushing for a flat tax for 27 years. My flat tax is the strictest of all. I just tax you at 10 percent on your gross income above the poverty line. All other taxes are totally eliminated: no taxes on passive income, no estate taxes, no taxes on business, and no excise taxes. Businesses don't pay taxes, they gather taxes. It's a cost, that you and I have to pay. They get a fair return or they're out of business. I had Bill Simon do a run on it back when Bill was Secretary of the Treasury, and he said, "Ah, Phil, that wouldn't do it; you'd need 14-1/2 percent." Hey, so be it. As far as I'm concerned, that's negotiable. I had Blumenthal do a run on it when Jimmy Carter was in the White House, and he reported back to me initially that 12.6 percent would do it. And, I quoted him publicly, and he panicked. And, he called me, "Oh, we made a mistake in our calculations, Congressman, it's 18 percent to 20 percent." Whatever the figure is, you would see, in my estimation, a vitalization that would be incredible.

I remember the debate we had on the Ways and Means Committee when we took the capital gains rate from 40 percent to 28 percent back in 1978. All of the experts that testified told us it was a major revenue loser. It produced a big increase in revenues, and in venture capital, upon which new business startups are dependent. That means more employees and more taxpayers.

When we went through that same procedure again in 1981, we took it down to 20 percent. Even Reagan's people were cringing when asked the question, "What's the revenue impact?" They answered, "Well, it might lose a little revenue over time." Quite the contrary, it produced even a bigger increase in revenues than the cut in 1978, and a bigger increase in the creation of venture capital. It had such a positive economic impact, it went on for virtually a decade.

Then we reversed the cut in 1986. I remember when we were sitting in Executive Sessions and this guy from Treasury is at my elbow. I'm looking through his leaflets, and I said, "Hey, you're taking the capital gains rate back up again, and you score that as a $25 billion revenue raiser over 5 years?" I say, "How can you do that when you know the history of what happened in 1978 and 1981." And, this little guy says to me, "Well, Congressman, you've got to understand that this doesn't become law until January 1st of 1987, and we anticipate, since the fiscal year starts October 1st, raising about $25 billion between October 1st and December 31st." And they were right on target. How cynical can I get?

You know, economists for years have argued that if your objective is to maximize revenue and maximize the creation of venture capital at the same time, the ideal capital gains rate should be somewhere between 9 and 12 percent.

You know, we had that head-locking confrontation last year over the budget. It was on tax issues, on spending issues, on Medicare reform, and on trade issues. Now, the President's in a situation where all he has left to run for is the niche in the history books. And, we want to cooperate and achieve positive results that continue us on that path to guarantee that we get that balance by the year 2002. But that's the opening round. It's going to take a generation after that to solve this problem. That means no more deficits after the year 2002, but it also means providing the economic stimulation through tax relief to overburdened Americans.

I favor the flat tax. And I know Bill Archer jumped ship on me. He's now for the consumption tax. And he has a good argument that with a consumption tax, you're pulling the IRS out by the roots. And, if he goes along with my flat tax proposal, later Congresses could start ratcheting it back up again, to be sure. And, yet, I think if you had a balanced budget amendment in place that called for a special majority for tax increases, that would serve as a major deterrent.

We had a Ways and Means Committee retreat, and there were a couple representatives there from Canada who told us about their experiment with the consumption tax. They explained there are only two Members of their Parliament who are still holding office who pushed the consumption tax through up there. Well, I don't care if they throw us all out. If we could make a real positive initiative in this area, whether it's a consumption tax or a flat tax.

The consumption tax involves the problem of how to deal with the working poor. The concern I have is that you can't be burdening these people for essentials like food and shelter, and clothing, and that means you've got to have some bureaucracy that's monitoring the poor. "Well, how much did you make? Look, we'll give you some earned income tax credit." You know the scandals that attended the earned income tax credit. How do we address those problems?

It's complicated, and it's not something that's going to happen overnight. The good news is that Bill Archer will be Chairman until the year 2000. And, he's committed to continuing the examination of what these options are and considering the alternatives. So we need all the input we can get from folks like you.

Let me just touch upon one other thing before I sign off. And that has to do with excise taxes. I used to be a traveling salesman back in the mid-1950s, and I always relished the opportunity of paying somebody's toll on a highway to use his highway. I could make faster time and it was safer driving. I have no objection to maintaining user taxes so long as those are specifically for users. But, now, they've started to divert Highway Trust Fund monies to general revenue. I mean, what is that? Why should people that have to drive to work be making an additional kind of contribution. If it is so specifically oriented that it is exclusively a user tax, those people who are users will pay their taxes at the airport to guarantee that they've got traffic safety for the airports and the airways. This I have no problem with. But I do have a problem with some of the rhetoric we're hearing today about using excise taxes as a means of trying to determine how you lead your life. That's not the function of taxes.

Let me conclude with a historic quote dealing with everything I've told you tonight from Woodrow Wilson, who was an historian before being elected President. Woodrow Wilson said, "The history of liberty is a history of limitation of governmental power, never the increase of it. When we resist concentration of governmental power," he said, "we are resisting the powers of death, for the destruction of human liberty has never been preceded by concentration of governmental power." In my lifetime, all I've seen is an escalation of concentration of governmental power, and I'm calling for a revolution. We can do it in a democratic way, but a revolution to preserve this great country.

Audience Questions & Comments

Question/Comment: Do you anticipate any changes in the budget process, given President Clinton's authority to a line-item veto? Do you think that will affect the process at all?

The Honorable Philip M. Crane: Well, as you know, there are some Democratic senators that still oppose the line-item veto. Frankly, I favored the line-item veto, because it doesn't prohibit Congress from overriding his veto on this pet project or that.

Question/Comment: Can he use that on taxes?

The Honorable Philip M. Crane: Oh, yes. Yes, but, of course, you have the override capability on anything that he prunes under the line-item veto.

Question/Comment: Some people talking about the objective of balancing the budget say that may not be the right target. What about the debate about the size of government?

The Honorable Philip M. Crane: That's a component part, too, as I mentioned. It's taxes, it's the deficit, and it's downsizing the federal establishment. It's starting to get it out of business. When President Clinton furloughed all those non-essential employees of the federal government, 99 percent of the employees at the Department of Housing and Urban Development (HUD) were defined as "non-essential". So they were all furloughed. But, if all HUD employees are non-essential, why do we have a HUD? Ninety percent of the Department of Education employees were deemed "non-essential". Why do we have a Department of Education? Of course, within those departments' jurisdictions, there may be some marginally legitimate functions, but you don't have to expand them into a whole department. I think that the shutdown was a good thing in that it gave us some guidelines on how many of those people are "non-essential." I think they were being very conservative in their estimates of who's "essential." I think the downsizing will be a priority issue.

Question/Comment: What do you think will happen, Congressman, with the potential adjustment of the Consumer Price Index (CPI)?

The Honorable Philip M. Crane: Well, it's a hot potato issue, of course, because the seniors groups, like AARP, see this as money out of their pockets. They're trying to panic seniors on what the impact will be to them. And it's not just AARP. These are huge groups. What is the membership of AARP? Fifty-odd million Americans? That's not to say that all of those people who belong to AARP agree with the people who control and manage AARP. But they use that figure constantly when they're lobbying on the Hill. "Fifty million Americans. You want to do this to your constituents?" Still, I think it's realistic to think we'll get it done.

You know, one of the things that is so sickening about Washington is they get these "experts" to tell us what will be the impact of these proposals. And, the "experts" come down, using static analysis. And they say, "If you use dynamic analysis, then it gets political and, you know, that can influence your decision-making." Well, going back to the capital gains tax reduction in 1978, the experts unanimously talked about the revenue losses. All the experts, except Reagan's people, who tried to make it look neutral, argued the same thing in 1981. They were wrong.

Saturday, January 11, 1997

SESSION THREE: "THE USE AND ABUSE OF EARMARKED EXCISE TAXES"

Introduction: Dr. J.D. Foster

This is a particularly important panel we're going to hear from on "The Use and Abuse of Earmarked Excise Taxes." We've danced around it. We've even danced on it from time to time in the course of this conference. How important it is that we properly define the uses where it's appropriate to have earmarked excises. We need to understand where abuses can arise. That's what we're going to get into here.

Our main speaker is Dr. Dwight Lee. He's the Ramsey Professor of Economics and Private Enterprise at the University of Georgia, a position he's held since 1985. He is also president-elect of the Southern Economic Association. He has held full-time tenured faculty positions at the University of Colorado, where we just learned recently we crossed paths without knowing it. He was a professor there when I was a freshman — not meaning to date you, sir, but that's the way it works. He has also taught at Virginia Tech University, George Mason University, and the University of Georgia. He's co-authored seven books and published hundreds of articles. He received his Ph.D. in economics from the University of California at San Diego.

You'll also hear from The Honorable Steve Symms, who served in the United States Senate, representing Idaho, from 1980 to 1992. Senator Symms served on the Finance and Armed Services Committees. He was also a member of the Environment and Public Works Committee and the Budget Committee. Prior to gaining his Senate seat, he was a member of the U.S. House of Representatives from 1973 through 1980. Currently, Senator Symms operates a consulting firm, Symms, Lehn and Associates.

We'll also hear from Mr. Taylor Bowlden, who's the Vice President for Policy and Government Affairs at the American Highway Users Alliance. Prior to joining the Highway Users in 1993, he worked for 10 years in the office of Senator Steve Symms.

Speaker: Dr. Dwight Lee

Thank you, J.D. Thanks too, for making me feel so old.

I'm glad to be here, and I wanted to thank you all for not telling too many economist jokes. I just hate those jokes. I haven't heard but one of them, and that was opening night, when Barry Asmus told one, and I particularly disliked that one. That's the one about how economists are people who are good with numbers, but just didn't have the personality to become accountants. Well, that's just blatantly wrong. The fact is there's three kinds of economists. There are economists who are good with numbers, and there's economists who aren't.

Let me get to my purpose, which is to talk about excise taxes, and in particular, the uses and abuses of earmarked excises taxes. And let me start by saying that, with very few exceptions, there is simply no serious economic case that can be made for excise taxes. And, even with the exceptions, extreme caution has to be exercised in how those excise taxes are implemented and used.

The primary purpose of taxes is straight forward, they're to raise revenue for essential governmental services. That's all taxes are for. And the objective should always be to raise that tax revenue in such a way as to impose as little cost on the economy as possible. Of course, you never get there all the way; you never have a zero-cost tax. All taxes are going to be distorting. When we talk about the cost of taxes, we're talking about the distortions, the economic inefficiencies they insert into the economy. All taxes are going to cause people to alter their choices away from those choices that would be best in an ideal world to choices that aren't quite as good but allow the chooser to minimize a tax burden. All taxes are going to result in people trying to make decisions, not on the basis of what creates the most value, the most wealth, but on what gives them the lowest tax bill.

That's the appeal of a flat tax structure. You have low marginal rates and you close off loopholes. With low marginal rates, you do very little to distort the decisions that people make with respect to work and leisure. You reduce that distortion. You don't eliminate it, but you reduce it. You eliminate the loopholes and, with the lower marginal rates, there's less motivation for people to make decisions where they can take advantage of a loophole. The decision doesn't make as much economic sense in terms of producing wealth, but it makes a lot of sense to the individual, because he or she avoids the taxes.

That's the appeal of not just the flat rate income tax, it's also the appeal of the broad-based consumption tax. And it explains why it is so hard to make a serious economic argument in favor of excise taxes, because what excise taxes do is exactly the opposite of what we want to do with an efficient tax structure. An excise tax picks out a few consumption items and imposes a heavy, discriminatory tax on those items; clearly distorting the decisions that people make. An excise tax is clearly and obviously out of sync with the idea of a broad-based consumption tax.

There is the argument, and Bob Tollison mentioned this yesterday, that goes, "But we can use excise taxes if we're careful in how we do it. We can apply those excise taxes to goods that have a very inelastic demand. It's not going to distort their choices very much. So we'll just apply excise taxes to those types of goods." I'm surprised they haven't come up with an excise tax on living. I can hear them now: "Despite the high cost of living, it still remains popular." There's lots of problems here. Some of them have already been mentioned, so let me just mention one that I don't think has been discussed. I don't want to be considered cynical here, but it is just possible that politicians will find an inelastically demanded good an attractive target for an excise tax for reasons other than economic efficiency. My guess is, there are a lot of politicians that are looking for things other than economic efficiency. They don't get excited when they see economic efficiency. They get excited about other things. It could be that the idea of an excise tax on an inelastically demanded good is politically attractive precisely because it can be used to raise lots of revenue. You can jack the tax up without reducing consumption a great deal, so it's a great source of revenue.

Now, there is a possible exception to the case against excise taxes, and that is when you can use excise taxes sensibly as user fees. There are cases when you actually want a tax to affect the decisions that people make by causing consumers to take the cost of their actions into consideration when they otherwise, without the tax, would not be taking those costs into consideration. There's the externality argument, but I'm not talking about that. That's the next session. I'm talking about when consumers are using something that is tied to the use of something else. Of course, the obvious example here is the gas tax where the funds are used for highways.

People impose a cost in the form of requiring more highway construction and more highway maintenance when they drive. It's often difficult, certainly inconvenient, to charge for the use of highways directly, so what you do is charge for that use indirectly with a tax on gasoline. But, even here, we have to be very, very careful. If such an excise tax is a user fee, it is important that the revenues generated are earmarked to a clearly designated use and, furthermore, that their use be clearly connected to the good being taxed. Of course, this is exactly what the gasoline excise tax accomplishes, if properly earmarked. The gasoline tax makes sense when it is earmarked to maintain highways, the use of which is closely connected to the use of gasoline.

There'd be very little justification, for example, for an earmarked excise tax on gasoline, if the revenues were earmarked to fund, say, more economic education at the university level. I'm personally in favor of such an earmarking scheme. I've been trying to come up with a sound economic justification for such a scheme, but I have to admit that I have failed so far. I should take a lesson from some other interest groups who have apparently been far more creative in this regard than I have. For example, an Indiana law earmarks a portion of the state's cigarette excise tax for day-care centers. In Chicago, a portion of their city's excise tax on cigarettes is earmarked to provide for the homeless. And, in Washington State, they earmark some of their cigarette excise taxes to clean up Puget Sound. Apparently they've come up with some economic justifications. I haven't seen these justifications, but I'm confident that, if I did, I'd be impressed with them. They'd be very, very creative.

There's another reason why it is important to earmark an excise tax on one good to the provision and maintenance of a clearly connected good. That reason has to do with the importance of making it absolutely clear what the revenues are going to be used for. If that's unequivocal, then you reduce political attempts by organized interest groups to get their hands on the revenue.

People often think of user fees as just like a market price. Economists sometimes talk about them as if they were market prices. But it should always be remembered that there's a fundamental difference between a user fee imposed by the government and a market price, which is that an excise tax being justified as a user fee raises revenues that are publicly owned. It's not clear who owns, who has control, who's going to benefit from those revenues. When a market price raises revenues, it's absolutely clear who has control of those revenues. There's no rent-seeking over control of those revenues. But in the case of a user fee, unless that user fee is clearly earmarked, you're going to have all kinds of rent-seeking as people try to gain control of the revenue.

That brings me back to the care that has to be exercised when applying an excise tax even to an inelastically demanded good. Even if you can justify the tax on efficiency grounds, even if politicians aren't using that just to come up with the most revenue, you still need to be careful. Even when you have an inelastically demanded good, the ideal excise tax on it, if it's positive, is lower than economists traditionally think of as being efficient because of the costly rent-seeking element.

Earmarking helps reduce this tension between what politicians would like to do with the tax and what efficiency actually calls for, because once you earmark it, then you eliminate a lot, not all, but you eliminate a lot of the rent-seeking. When you eliminate that rent-seeking, you've eliminated one of the costs associated with using the tax to get more revenues.

Let me mention another situation in which earmarking might be useful, not because it increases efficiency, but because it can prevent an inefficient situation from getting worse. Let's assume you have a product that is now bearing an excise tax. And let's assume further that the product becomes a target of a well-organized and energetic — indeed fanatic — political attack not for the purpose of raising revenue, but for the purpose of destroying the product. In such a case, if the opposition group becomes increasingly successful politically, it may make sense to earmark the revenues from the excise tax that is applied to that good. Earmark them to a well-organized interest group that has a lot of political influence. Let's assume that you earmark the tax to the group that wants to put the product out of business, the group that currently isn't interested in the revenues. They're not interested in that excise tax because it generates revenues; they're only interested in punitive actions against the industry. Obviously, if you earmarked the tax revenues to that interest group, the earmarking would pose a cost on those who, without the earmarking, pay absolutely nothing if the tax is increased to the point where, because of the decline in sales, you actually get less revenue. That interest group now would have a motivation not to go over, so to speak, the Laffer Curve hill; not to actually start reducing the revenues.

Now, this is very similar to a situation which has nothing to do with excise taxes, but it's kind of interesting and it makes the same point. It has to do with the Audubon Society. I think most of you are aware that the Audubon Society likes nature, and they're against drilling for oil off the coast of California. There are no precautions that the oil industry can take that are stringent enough to satisfy the Audubon Society. No drilling, this is precious, you can't drill.

Well, it turns out, the Audubon Society, owns some wilderness preserves. They own one in Louisiana, the Rainey Preserve, and it's just full of birds that the Audubon folks like to go out and look at. And it's full of all kinds of other nice creatures, too. It turns out that, underneath the Rainey Preserve, there's significant deposits of petroleum and natural gas. And guess what? The Audubon Society could prevent the oil companies from drilling. It's their land. But do they? Of course not. They don't prevent that drilling because, if they did, they would bear the cost. They would forgo the revenues. And so they have gas companies in there drilling like crazy. They're told not to harm the ducks and the birds and the alligators, and they don't. They do a pretty good job but they don't exercise any more caution drilling in the Rainey Preserve than when they're drilling off the coast of California. In fact, the Audubon Society lets them get by with fewer precautions on their own land. The point is clear, they would pay the cost of preventing that drilling. Just as if you earmark the taxes to a product that's under successful political assault.

Let me close by referring back to the title of my talk, "The Uses and Abuses of Earmarked Excise Taxes". There are very few efficient uses of excise taxes. You can look and look and look, you're not going to find many. But there's plenty of politically tempting abuses of these excise taxes. It's true that earmarked excise taxes can be, in a very few cases, a way of improving efficiency, but we should always be skeptical of their use, and of the justifications put forward on behalf of using them. With excise taxes, the best policy is always to assume that they are guilty until they are proven innocent.

Thank you very much.

Discussant: The Honorable Steve Symms

I would like to thank the Tax Foundation for putting this group together.

I enjoyed your remarks, Dr. Lee. I think you made some excellent points. As a former Member of Congress, I guess my job here is to see the political side. Any discussion of tax policy must begin with the spending side of the equation. When President Clinton ran in 1992, they had this slogan, "It's the economy, stupid." Well, when we start talking about tax policy, we should have a slogan, "It's the spending, stupid," because, if the government didn't spend so much money, we wouldn't have near as much pressure on us to raise revenue. They're spending money doing a lot of things they don't need to be doing. They're interfering with people's business.

Dr. Lee, you made a comment about states' earmarking cigarette taxes. When I was a congressman, a guy from Louisiana had a bill that he got a lot of us to co-sponsor because he thought it was going to get the federal government out of education. This was back in 1973 or so. He wanted to completely eliminate all references to federal aid to education from the federal government. There would be no spending by the federal government for any educational activities. Instead, all federal excise taxes on tobacco would go back to the states. There was enough money in tobacco taxes that each state, then, could pick up the difference in what they got in federal aid to education. They could pick it up and run it at the state level. It would be much more efficient, and a much better use of the taxpayers' money, to fund educational projects at the state level with excise taxes from tobacco, rather than by having the federal government do it. It never passed, of course, but it really was a pretty good idea.

I have about four points I want to make about excise taxes and trust funds in a general sense. I may go over the line on one of the points, about whether or not it's an excise tax, but I'll leave that up to you experts as to whether it is.

Market distortions, I think, are one thing we should be careful of. We have to remember that, fundamentally, government is force. So, when the force of government is used to make decisions in the marketplace, instead of allocating scarce resources by the free choices of free people through free institutions, the force of government allocates those scarce resources, whether it be transportation resources, natural resources, labor resources, or whatever. So, we are then relying on the government to do it. It's like the argument about smoking cigarettes and your health. It's very popular for people to say, "Well, we should have high taxes on cigarettes and alcohol because, after all, it hurts people's health and it costs all of us money." I always come back and say, "That's not the issue. What you're talking about is socialism." If somebody wants to smoke cigarettes and drink alcohol that's their business, not your business, not my business, and certainly not the government's business. My brother thinks there should be a tax on milk, because that raises people's cholesterol, and they should lower the tax on wine. He's lobbied the Idaho legislature for that. He hasn't been successful yet, but he makes that argument. He thinks they should have to put this on a bottle of milk: "This product could be harmful to your health if you have high cholesterol." And he thinks they should put on a red wine bottle: "This will lower your cholesterol".

The point is, it's socialism. If we share the cost of health to everybody in the community, then that's the problem. It isn't the problem of whether or not they are smoking or drinking or committing these so-called "sin tax" events.

Let's talk about the distortions in the market. The economy's been pretty good, in spite of government, in spite of Washington, D.C., in spite of the 1990 and 1993 tax increases, because of the free market. Given just a little bit of room, it's amazing what the miracle of entrepreneurship can do when combined with hard work and a lot of dedication by millions and millions of well-skilled and educated people, despite government interferences and distortions of the market.

Now I know we like to say that people pay taxes, businesses only collect taxes. My dear friend, Phil Crane, said that again last night. Barry Asmus said it Friday night. That's all well and good. But we can't avoid the reality that there is a distortion in the marketplace every time there's a tax.

Another one I would mention: If you get an excessively high tax on trucks, you have a distortion in the marketplace between trucks and railroads. If you get an excessively high excise tax on rail equipment and so forth, you get a distortion in the rail versus truck market. In Europe, they have a lot of high-speed rail. These are trains that travel 200 miles an hour or so. The Morrison Knudsen Corporation was trying to build a high-speed rail train in Texas. A 600-mile track in Texas took up less space than the Dallas/Ft. Worth airport. They couldn't get it through because by the time the Congress passed a tax code that put the rail beds on the same level playing field with selling airport bonds, the deal had fallen through. There's a distortion in the marketplace because of the tax code. We should always be conscious of that in the process of legislating and passing laws.

There's one other problem when we earmark excise taxes, and that's budget deception. In 1990, the "read-my-lips" tax bill was really the first time we put fuel taxes in a tax bill without dedicating them to a highway building program.

Phil Crane mentioned that his first term in Congress they actually balanced the budget. One of the ways that budget was balanced was that President Johnson withheld spending a billion and a half dollars in highway funds. So they balanced the budget because they just held the money back from spending it on highways. It made the numbers look like they'd balanced the budget. That has been going on ever since there's been an accumulation of so-called unspent, unallocated dollars in the Highway Trust Fund. And there's interest that accrues every year to the Highway Trust Fund. As long as the budgeteers use the process we now have, we're going to have a hard time ever getting our interest dollars back to be spent. And there's a good reason for that. The problem is there really isn't any money in the trust fund — it's IOU nothing. The federal trust funds are deception in budgeting the way the budget process works.

The granddaddy, of course, is the Social Security Trust Fund. There's $40 or $50 billion a year in Social Security taxes that's put into the Social Security Trust Fund that's actually spent on everything from Patriot Missiles to the Legal Services Administration. It's very difficult to get Members of Congress to understand this issue. It was very frustrating to me, talking to some of my best friends in the Senate, conservative Republicans all, who would argue with me when I would tell them we ought to cut the payroll tax, because we're funding Social Security more than we should be.

I think we're overtaxed as a nation. But we certainly spend more money than we receive in taxes. That's why I get back to my original point, that it's the spending that causes a lot of the problems in tax policy.

A good example of this is when the last highway bill, called ISTEA, passed the Congress. There were a lot of things in ISTEA to allow for market allocation, like HOV lanes, this type of thing, where people could make decisions as to what was the best use of their time and money. There wasn't one Senator that ever came down to the well during the two weeks that we had that bill on the floor that was interested in these things. In fact, the only two Senators that had a real good idea what was in it, besides Senator Moynihan and myself, were on the Environment and Public Works Committee. What everybody in the Senate was interested in is: "How much money is my state going to get?"

We don't have a bankrupt budget because of trust funds. We have a bankrupt budget because of the intense pressure on Congress to spend more money all the time, and the fear that everybody has about correcting the budget and facing the wrath of millions and millions of this special interest group or that special interest group. There can be no rational discussion of tax policy that can be separated from spending policy.

Thank you.

Discussant: Mr. Taylor Bowlden

I want to begin by thanking the Tax Foundation for inviting me to discuss Professor Lee's paper in the context of the highway program. Professor Lee's paper, of course, is about earmarked excise taxes. Motor fuel taxes were once a good example of what Professor Lee calls an earmarked excise tax. They no longer are for three reasons that I would call "the deception," the "direct hit," and the "bow to the politically correct."

In 1956, Congress approved a plan to construct a border-to-border, coast-to-coast interstate highway system. Many thought that it would change the face of America by providing access to rural America, by making travel safer and more convenient for families, and by lowering transportation costs for U.S. businesses. To pay for the program, Congress raised federal gasoline taxes from two cents to three cents a gallon and created the new Highway Trust Fund into which revenues from the fuel taxes would be deposited and from which all federal highway payments would be made. By all accounts, there was a great sense of national purpose associated with the construction of the interstate system. The pay-as-you-go funding mechanism Congress established was treated with a good deal of reverence by federal elected officials for about a decade thereafter. All revenues collected from the fuel taxes and the other highway use taxes were deposited in the Highway Trust Fund and spent annually, primarily for the construction of the interstate system. Then, as Steve Symms just mentioned, with the budget pressures of the Vietnam War, President Johnson first withheld some highway funds in 1966, and thereafter, Congress and successive presidents have held spending in the highway program below the funding that the trust fund would support each year.

That's what I would call "the deception" — Congress raises fuel taxes, supposedly dedicated for improvements to highways, credits them to the Highway Trust Fund, but then uses a portion of the actual cash revenue for non-highway programs. So the balance in the Trust Fund goes up. In addition to the revenue that's credited to the Trust Fund and not spent in highways, there's also interest paid out of the General Fund for those Treasury securities that are credited to the Trust Fund. So the balance goes up on paper while the revenue not spent on highways is spent somewhere else. As you know, the government operates on a cash-in/cash-out basis. That's the deception.

The first "direct hit" at the principle of earmarked excise taxes as it applies to the gas tax was in 1982, when Congress created the Mass Transit Account. That year, Congress raised federal fuel taxes a nickel a gallon, created the Mass Transit Account in the Highway Trust Fund to receive revenues from a penny of the federal fuel tax. And, so, for the first time since 1956, highway use taxes were raised specifically to finance a program other than the construction and maintenance of roads.

Then, as has been mentioned, in 1990, President Bush's "read-my-lips" tax bill raised fuel taxes another nickel a gallon, half of which was to be deposited in the general fund for "deficit reduction." There was the 1993 Clinton 4.3-cent tax increase, all of which went into the General Fund.

And, by the way, when you refer to either the George Bush fuel tax hike or the Bill Clinton fuel tax hike, I wish you wouldn't call it "deficit reduction." It's no more deficit reduction than your income taxes or any other tax that goes into the General Fund. They all have the same affect on the deficit, and they're all used to pay for today's government programs. By the way, in 1993, Congress approved a provision to transfer the 2.5 cents of the George Bush tax hike from the General Fund into the Highway Trust Fund beginning in fiscal 1997. So today we have a 18.3-cent federal tax on gasoline and a 24.3-cent federal tax on diesel; two cents of all the fuel taxes going into the Mass Transit Account which, in 1996, raised $2.6 billion; 4.3 cents of the fuel taxes going into the General Fund, which in 1996, raised $6.5 billion; and the remaining 12 cents of the gasoline tax and 18 cents of the diesel tax and the other highway use taxes, mostly paid by truckers, are deposited in the highway account, which in 1996, raised $22.4 billion. That means that of the $31.5 billion that highway users paid in federal fuel and other excise taxes in 1996, about 30 percent was deposited in accounts that cannot be spent on highways. That's what I call the "direct hit" on the principle of earmarked excise taxes.

And, finally, we get to the "bow to the politically correct." In the last highway bill, the 1991 Intermodal Surface Transportation Efficiency Act, called ISTEA, Congress ensured that a lot of the requirements of the Clean Air Act, as well as a lot of nice, historical preservation projects and wetlands protection and such, would be funded with federal highway dollars. That's about $1 billion dollars a year set aside for what is called "congestion mitigation and air quality projects." An additional $600 million a year, or a little better, is set aside for what are called "transportation enhancement activities." Since transportation enhancement activities may not mean anything to most of you, I'll just give you a few examples of what that means. First of all, it doesn't ever mean anything to do with highways. That's one rule. But among the things those $600 million a year can be used for are: facilities for pedestrians and bicycles; scenic easements, which means you buy some land, so there's a nice view; and historic preservation, rehabilitation, and operation of historic buildings, structures and facilities, like historic railroad stations or historic canals. So in upstate New York, they're preserving a lot of nice canals. It means preservation of abandoned railway corridors, "Rails to Trails," and so we're spending a lot of highway taxes to purchase old railroad right-of-ways. It means archaeological planning and research, so we've actually spent a fair amount of highway taxes on archaeological digs. This is money that's set aside for these purposes only — a billion dollars a year for the congestion mitigation air quality projects and better than $600 million a year for transportation enhancement activities.

The states, in many cases, don't know what to do with this money, so they spend it on whatever somebody comes up with in many cases. The congestion mitigation projects have to be approved by the EPA, by the way. We took a Federal Highway Administration project-by-project printout of projects funded since fiscal 1992 with federal highway funds. In a quick five-minute scan to get a few examples for purposes of some congressional testimony, we found in one case, a city used its congestion mitigation monies to purchase 210 bus radios at a total cost of $1,165,920 — $933,000 of which was federal funds. Another case was the purchase of 48 bicycle storage lockers at 100 percent federal money, equaling about $13,542 per bicycle locker.

Regarding transportation enhancement activities for pedestrian and right-of-way and historic preservation, we've preserved a lot of lighthouses around the country with enhancement monies. About $400,000 was spent in southern Florida, as it happens, to enhance a jungle trail. There's a preservation of a Shaker barn in upstate New York and the dry docking of the *USS Cobia*, which was a World War II submarine, that somehow ended up in Wisconsin. And the restoration of the interior dome of the West Virginia State Capitol, was done with highway taxes. Those are some examples of what we're now doing with highway taxes, as a result of what I called the "bow to the politically correct."

There is a fundamental fairness question here, because, in addition to regressivity, there are geographic inequities involved. Whenever you raise a fuel tax, people out West are paying more of their income in tax, because they have further to go to get from place to place. And there are inequities among job types. If you have a job that involves a lot of driving, then a fuel tax increase is a bigger hit to you. When it's being used for road construction, of course, you're using the road more, and so you're paying more for the use of the road. But, and here's the point, when it's being used to finance a B-1 bomber or some social program, you're also paying more for no apparent reason.

<u>Audience Questions & Comments</u>

Question/Comment: Dr. Lee, the problem with earmarked excise taxes is they become trust fund oriented, which equals an entitlement program. They're talking about privatizing. To some degree, I think two out of the three recommendations privatize a portion of it. That's the problem. I don't give a damn who the recipients are. The road builders are over there beating the heck out of the truckers every time they come up for reauthorization and more money. The most prominent bill that was moving last year would take cigarette taxes and dedicate them to National Institute of Health (NIH) for biomedical research. They become a powerful constituency, but they're not paying the taxes. They're taking in the dough. That's the problem I see with earmarking.

Let me just say I don't see any justification at all for an excise tax on cigarettes. There's no user fee concept at all that makes sense in that regard.

Question/Comment: There will always be tension between the industries that want to have excise taxes reduced or eliminated and those which say there's a good excise tax and we ought to keep it. Furthermore, since it was raised above the levels that are being spent on highways, we'd like that extra 4.3 cents to come to us, plus the interest in the Trust Fund for the money that was borrowed, really stolen, from us in the past. If you want a united front, the best thing is to focus on the incremental increases in the taxes in recent years, and in those taxes with no justification whatsoever, and demand that they be rolled back. If you try to recapture your 4.3 cents for your, quote, "good use," you're going to split the message. You're going to muddle the message to Congress that excise taxes are too high and need to be rolled back. And, then, you're going to get nowhere.

I would particularly urge you not to try to recapture excise taxes that were stolen from you in past years for which an IOU from the Treasury was dropped into a so-called "Trust Fund". That money was spent. It's gone. If the Treasury is going to replace it, it's going to have to raise new money to replace it, and the most convenient way to raise the new money may be an increase in the excise tax. The interest that was paid into the pseudo Trust Fund is pseudo interest. It's not real, either. Treasury would have to raise money to pay the bond that it created to pretend to pay you the interest in the first place. Cut the excise tax on gasoline back down to the level of road building that we need.

Mr. Taylor Bowlden: On that point, we're collecting and depositing in the highway account about $22.4 billion a year. That's without any of the 4.3 cents that's going to the General Fund and, of course, excluding also the money going into the Mass Transit Account. The tax revenues paid into the highway account are $22.4 billion a year. The highway program itself is funded at about $20.4 billion in this fiscal year, so we're collecting about $2 billion a year more deposited into the highway account than we're actually spending in the highway program today. If Congress transfers all or a portion of the 4.3 cents into the highway account this coming year, the annual revenues deposited in the highway account will be substantially more.

Question/Comment: We've been talking about earmarking at the federal level. You're beginning to see around the country a tendency towards earmarking at the State and local level, as well.

Question/Comment: Where you do earmarking at the state level, there's a different kind of fungibility. In many cases where there's a nominal earmarking, it's there for political reasons, but it's really a cover. It's not the real thing. Funds that would have gone to that purpose now go elsewhere, and the earmarked funds move in. In effect, there is no earmarking. There is the illusion of earmarking unless there is a new function that wouldn't otherwise exist.

Question/Comment: In many cases, it's politicians playing on the ignorance of voters. They find it's easier to get a tax increase through if they earmark it to some noble cause. You very seldom find a tax where they say they're going to earmark it for the governor's slush fund.

Question/Comment: The important point to take from all of this is that you're going to be hard-pressed to find a better defined, better targeted trust fund/earmarked tax situation than the Highway Trust Fund. Nevertheless, out of that Trust Fund, monies are spent for bike racks. Nevertheless, monies originally raised through that excise get diverted to the General Fund. So even in the best-case scenario, eventually the system starts to break down.

SESSION FOUR: "MEASUREMENT OF EXTERNALITIES"

Introduction: Dr. J.D. Foster

Our final speakers are Dr. Pat Wilkie, who I'll be introducing, and yours truly, who will keep it short. Pat Wilkie is Assistant Professor of Taxation at George Mason University, where he teaches accounting and tax courses in five degree programs. From 1984 to 1991, he was Assistant Professor of Taxation at the University of Texas in Austin. He's an active member of the Tax Section of the American Accounting Association and serves as a member of the editorial board for the *Journal of the American Tax Association.* He earned his Ph.D in accounting from the University of Michigan.

Speaker: Dr. Patrick Wilkie

I want to talk about externalities and "green" taxes. The externality argument is used, from time to time, to justify imposing taxes or other sorts of charges on firms or individuals, as the case may be, to offset the cost imposed by externalities.

I want to talk about so-called "green" taxes, of which excise taxes are one example, and I want to emphasize that they exist in a variety of forms. If you focus too narrowly on excise taxes alone, you will miss the big picture. And the big picture is that there are a number of ways in which the government can and does affect behavior, or tries to affect behavior. Focusing too narrowly on excise taxes will get you in trouble.

The "green" tax philosophy, of course, is that the market system isn't working perfectly, and "green" taxes are intended to offset the externalities that exist. They exist because of so-called market imperfections. "Why is this important?" is the next question. To start, it's important, because these are substantial amounts. As was mentioned, the excise tax alone at the federal level is roughly $50 billion a year or so. And of course, the same thing is true at the state level. These taxes may increase over time and they can have a substantial effect on the allocation resources.

When an economist talks about an "inefficient tax," what he or she means is that it affects the allocation of resources. Does it change behavior? "Green" taxes are meant to be inefficient taxes. That is their purpose. They are designed to change behavior. That's the goal.

I want to review some of the methodologies that are used to measure or even establish that an externality exists. If you believe in market economics, you believe in externalities. It's been said here that there's no end to the good that do-gooders will do with someone else's money. That's exactly what environmentalists say. There's no end to the use that firms will make of other people's resources. If the resource is free, it will be used and abused. If you truly believe in the market system, you believe in externalities. The questions we want most to address are how well can you measure them, and what can be done about them.

The question is first, empirically, can you document an externality, and second, is there a reasonable way to offset the externality?

What are externalities? They are the costs or benefits that are not embodied in the price of the good in the private market. We rely on prices to make the correct signals in our economy. If the price doesn't embody the full costs of what's used, then it causes a misallocation of resources. So the purpose of offsetting the externality is to adjust the signal and make sure the price of the good embodies the full cost.

Externalities arise because of the coarseness of our property rights system. In other words, if we could, each one of us would have our own biosphere, and we would all keep track of our air and our water. And if we fouled our air or water, then we'd be the ones responsible, and we'd have to go buy it from somebody else. But, in fact, we can't do that. We have resources that are used by everyone. The question is, is there a price paid when someone uses that resource and then makes it not usable for someone else?

You see that all the time. For example, the government stepped in just recently with regard to the Grand Canyon. The problem was that people who had fly-overs with their airplanes and helicopters were making it so noisy that it ruined the Grand Canyon experience. So the government stepped in to limit the number of flights. Well, that's a tax, if you will. They could have imposed a tax on all the airplane operators but decided, instead, just to limit the number of flights. Regulation, a tax by another name.

We believe in the price system because it provides the best system available to provide incentives and signals as to what should be produced. The idea behind "green" taxes is to correct the mispricing of common resources. That's the idea.

Before I came to the conference, I talked to the IRS person who probably knows the most about excise taxes, Bruce Davy. He directed me to a paper he had written for the *National Tax Journal* in which he developed a taxonomy of taxes. Basically, his view was that few, if any, excise taxes are really directed at externalities. The only ones he could really come up with in his taxonomy were the gas guzzler tax and a part of the motor fuels tax. None of the other taxes really had as their intended purpose dealing with an externality.

About externalities — it's hard to come up with a single methodology for them. I want to direct your attention to a book that I ran across. It's called *A Mathematician Reads the Newspaper*, and it's about all the biases that exist in newspapers and biases that we all suffer from when we try and read the newspaper.

It says, "Ranking Health Risks, Experts and Laymen Differ: The Discalculea Syndrome." It's a made-up name. It says, "Health statistics may be bad for our mental health." One of my points here is that externalities are talked about, but their real measure is not. Often times, people label things as being terrible for you but, really, how big is the risk? This article says, regarding health risk studies, that, "Inundated by too many of them, we tend to ignore them completely, to react to them emotionally, to accept them blithely, to disbelieve them close-mindedly, or simply to misinterpret their significance." It goes on by saying, "The National Institute of Unchallengeable Statistics reports that 88.479 percent of us have at least five of these reactions 5.613 times per day, leading to 8 million cases of discalculea." The idea is that this is what you might hear in the newspaper giving you some sort of false precision, as if the precision thus means it must be right.

One of the things I want to point out is in the second paragraph where it refers to a psychological component of discalculea. In a country the size of the United States, an extremely rare condition that distresses say one in a million will still affect 260 people. You might see that it affects 260 people, but the United States is a big country. Most of us would be willing to accept risks at one in a million, but if you said 260 people are going to die from this, people would say, "Hmm, I'm not sure."

There's been a lot of talk about the

reason for taxing tobacco and alcohol. I'll tell you what I think the reason is. It's the inelasticity of demand. The federal government characterizes alcohol, tobacco, and drugs in the same category as dangerous substances. The question is, what do we do with those dangerous substances? We could let anyone do whatever they want; it's their life. But we don't do that with drugs.

The government tried its policy on drugs with alcohol prohibition. That didn't work. The costs were too high. And so, what it's done with alcohol and tobacco is say, "We will allow you to produce and market and use these goods, but we're going to charge you a franchise fee." Call it an excise tax, if you like, but it's a franchise fee. And so the government is then acting as a profit maximizing monopolist. It can set the price to maximize profits as if it were a drug lord.

One of the things that I think would be useful is not to avoid the externality argument or to deny the argument, but to say, "Look, the risks involved here are far less than other risks that aren't being addressed." One example of this involves highways. Most of the research I have seen indicates that if we maintained the highways better and painted the lines on the highways and roads better, we would save more lives than most of our efforts with regard to pesticides. In other words, the risks of dying from pesticides are small. The risks of driving off the road because it's poorly maintained are, relatively speaking, high. And, so, what we end up doing is committing statistical murder by misallocating resources to risks that are minuscule. That's where you want to go with the externality argument. Where is the evidence? How much risk exists? What's the dollar amount involved?

There are two types of studies used for externalities. The first is epidemiological studies that follow a sample of people over time. The problem is that they lack internal validity. That is, there are no controls over a whole host of other factors that might be contributing to the results, whichever way they go. Also, sample size tends to be really important, and often times sample size is relatively small and, so, we end up with weak results. And, even with large samples you can get a statistically significant result, but the result might not be meaningful. It may not be a real risk of any magnitude.

The second type of study are the biological studies. You know, what they do with the rats. Those studies have great internal validity. You can control everything. But they have terrible external validity. That is, how can you externalize the results from the rats to humans, especially when the dose amounts were 1,000 times what anybody would ever be exposed to? One example arose recently with saccharin. It produces cancer in rats. That's because it interacts with the urine that rats produce. Human urine is different, so the saccharin doesn't produce cancer in humans. That's an external validity problem.

"Green" taxes exist, whether they're excise taxes or regulations. Their purpose is to offset various externalities and to raise revenue. The measurement of externalities is often dubious, but that's one of the things that you have to do if externalities are to justify a tax. Instead of running away from the externality argument, I think it's important to say, "Yes, there are certain externalities, but can you measure them? How big is the risk really? And, thus, how much money should we spend to eliminate what may be a very small risk?"

What I would suggest you do is support some ongoing, unbiased research. Really, the only way to address this, is to say, "Look, we have studies by reputable people." And, an education program is important. For example, in Friday's *Wall Street Journal,* John Stossel had a story about junk science that discussed some research by an academic on relative risks. You know what the biggest risk of dying was? Poverty. Poverty would cut more days off your life than anything else. Things such as pesticides were on the order of 0 to 4 days. Poverty was on the order of 4,000 days. One has to define the real risks.

Thank you.

Discussant: Dr. J.D. Foster

I've long believed economics could be very helpful in the development of tax policy, that we could figure out what the best tax policy would be to help the economy grow more rapidly. Externalities, I'm afraid, is probably the one area where economics is more inclined to create a problem than to solve a problem, because we can all say externalities exist. There's no question, for example, that if you have a plant that has some sort of effluent and it gets into the water of the local population, then there's an externality involved. That's a well-defined problem. We can all say that it exists. The problem is, once you get past the first step, then the externality question as a guide to public policy collapses in practice.

We've also found that just measuring the externality itself is nearly impossible in most situations, particularly when you've got to distinguish whether this is a localized externality that's affecting one or two people, or is it something that is affecting large communities. Or is this something that is affecting society at large? Those are all very different issues and require very different sorts of measurements. If you're going to address the externality, assuming you're going to be able to measure it, and you're going to use some sort of excise tax to pay for it, then you're going to have the economic consequences of the tax itself. What are the distortions to the allocation of resources? How much production as a society are we giving up if we tax something too much?

Suppose we've got a definition for the externality. We've figured out the excise that we want to impose to deal with the externality. Now, who gets this money that gets raised from the excise? How often does the money end up going to the folks who suffer or the folks who use the product? The Highway Trust Fund is one great example where it used to work very well. But there's really no linkage between any of the proposed cigarette excise tax proposals and where the monies end up going. It's going to go fund NIH programs? Great. I thought NIH programs are already funded. That's as phony as it gets. There's no linkage there.

Steve Entin pointed out that what's really involved with externalities is a property rights issue. Somebody's property rights are being trampled on, and they need to be able to seek redress. Bob Tollison pointed out that's true, but our judiciary system isn't so great either. Maybe we ought to consider doing a cost-benefit analysis of whether a tax or the judiciary is or is not a better way of pursuing these property right issues. I don't know what the answer is, but I'll bet no one's looked at that in 20 years. But that's a fundamental issue. If it's a property rights issue, you'd better prove that you can address it better through an excise tax than you can through the judiciary. And I say that with full knowledge that this could result in a full employment act for the nation's attorneys, which is not something I look forward to.

The reality is the externality argument exists in part because the legislators believe it. The staff believe it. The press believe it. The American people, to one extent or another, believe it. If we can prove it's wrong, it's still going to be a generation or two before we get the notion out of the stream. What that means is, even if it's a terrible guide to public policy, you've got to deal with the externality argument. Even if the thing we're fighting is a shadow, we have to shadow box, because this shadow punches back.

I first started thinking about externalities in the days of the BTU fight. What really struck me were the externality arguments that the proponents of the BTU tax were using. And I started thinking about the other excises that are imposed based in part on externalities. And I realized that, in both cases, they never wanted to tell you what the correct excise was. They never wanted to tell you in quantified terms what the externality was that they were trying to capture or what the excise tax required to deal with that externality was. The only answer you would ever get from them is: "More, and be thankful we don't ask for more again, because we really think it should be higher than that which we are asking for."

They will never tell you how much the externality is, or how much the tax should be. They will only tell you: "More." How high should the tax be: "It should be higher." We'll come back and get more five years from now. They get away with murder by not having to answer the question: "How high?"

There's been a real breakthrough in research in externalities in the environmental area. A fellow named Don Fullerton is at the leading edge of this. He's trying to find a new way of measuring externalities. This methodology is either going to be good for you or good for the other side. Either way, you're going to have to understand what it is in order to deal with it. You need to find out what they're doing with the externality arguments in the context of "green" taxes, and then figure out how it applies to gasoline, to cigarettes, to beer and wine, and so forth, because eventually it is going to be applied. We're in the business in this conference of getting ahead of the curve. Well, here's where the curve is. It's in the "green" taxes. This is the leading edge, and we need to get on it.

Thank you.

<u>Audience Questions & Comments</u>

Question/Comment: J.D., let's kind of close the loop here. We're talking about tax reform. What do you see happening in the excise tax area of tax reform? What opportunities do we have?

Dr. J.D. Foster: Let's think back for a minute. Right after the Second World War, the Treasury Department issued a report that said, "We want to get rid of all the federal excises; these are not good ways of raising revenues; they distort economic decisions." Treasury issued the report, and there was legislation moving in the Congress to follow through. And, unfortunately, the North Koreans invaded South Korea, and we needed revenue. So it never happened. Treasury did another report getting ready for the 1986 Tax Reform Act, again suggesting that we ought to get rid of these things. So the basic economic arguments are on our side.

I also think that the basic arguments — simplification, efficiency, and so forth — driving tax reform are orders of magnitude greater in the context of excises than the externality arguments that the left uses to justify these excise taxes. So, on that basis, and the fact that the direction of tax reform is towards a consumption tax, we have a unique opportunity here to do what the Treasury said we should do 50 years ago.

I also think we have the ace in the hole that I mentioned yesterday. Most tax reform programs show up on the distribution tables as being less progressive than current law. All the excises show up as being regressive. I am taking as an axiom of tax reform that whatever we end up with is not going to be that dissimilar from current law in its measured distribution of the tax burden. I'm not saying the measurements are correct, but the tables that we will have — current law, new law — are not going to look that dissimilar. That being the case, since the sales tax, the flat tax, and so forth, are relatively burdensome to poor taxpayers, and the excises are relatively burdensome to poor taxpayers, you get rid of the excises, then the distribution tables are going to look a heck of a lot better. Lori Peterson asked where you get the revenue from. Well, you get the revenue from those upper-income folks who are getting a tax break under the new system, who were paying more tax under the old. That is the ace in the hole. This is the problem that none of the tax reform plans can solve without contorting themselves to where you can't recognize them anymore. Repealing the excises can solve the distribution problem for them.

Also if you don't go on the offensive in this, if you're not out there making the arguments to do exactly what we're talking about here, then when tax reform gets into trouble, the excises are going to be raised to lubricate tax reform.

Question/Comment: The argument is made that the costs of highway transportation — the highway program — are not defined yet in total because we don't take into account the external costs of transportation — the pollution effects, the noise effects, and such. And so we don't really know whether highway users are paying for the complete costs of the program that we're sponsoring. It seems to me, however, that if we're going to look at external costs, we ought also to look at external benefits and compare relative costs. If you put a lot of money into pollution controls, for instance, you may be diverting money away from safety improvements.

Dr. Patrick Wilkie: I agree. One of the things we must do is establish a burden of proof in terms of numbers. It's easy to say, "Well, there is this environmental problem. There is this externality." Somebody has to come up with a number. One of the things you can do in the tax writing committees is to say, "Well, what is the number?"

Question/Comment: Just a quick comment on looking at externalities. I find that, a lot of times, we tend to look only at what's important to our side. I was working at the Port of New York, and the environmentalists wanted us not to dredge the harbor in New York because it would bring up all these nasty dioxins. I did a really quick analysis that showed that, if we didn't dredge the harbor, more cargo would have to come into the New York region via truck and rail, which would make these folks extremely happy. But what's interesting is that the amount of dioxin produced by the trucks and the railroads was even higher than the amount that was in the water.

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