EconoFact Chats: Tax Policy Through the Ages

Michael Keen (International Monetary Fund), and Joel Slemrod (University of Michigan)

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Michael Klein:

I'm Michael Klein, Executive Editor of EconoFact. A non-partisan, web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

There's a saying that to a person with a hammer, everything looks like a nail. Along these lines, to a public finance economist, everything looks like a consequence of tax policy. Except maybe it is. As explained in a new and very engaging book by Michael Keen and Joel Slemrod entitled Rebellion, Rascals, and Revenue: Tax Follies and Wisdom Through the Ages. It will be published by Princeton University Press at the beginning of April. In this book, Mick and Joel point out that tax policy is associated with a 19th century war in Latin America, the founding of the Anglican Church, the design of ships, architectural choices, the size of cigars, and many other things. Joel and Mick are widely recognized as experts in tax policy. Mick is deputy director of the Fiscal Affairs Department of the International Monetary Fund, where he was previously head of the tax policy and tax coordination divisions.

Michael Klein:

Joel is a professor at the University of Michigan, and he serves as the director of the office of tax policy research in the business school there. He is also a past president of the National Tax Association. Joel and Mick welcome to EconoFact Chats.

Joel Slemrod:

Thanks Michael. Thanks for having us on.

Michael Keen:

Yep, thanks for having us.

Michael Klein:

So for our listeners, so you can tell the guests apart, Mick's accent reveals his British roots, and Joel's lack of an accent at least to my ears, shows that he's from New Jersey. Joel and Mick I really enjoyed your book and I was very impressed by the breadth of scholarship. The book also drove home the point that paying taxes or trying to avoid paying taxes is one of the central ways that citizens interact with their government.

Michael Keen:

Well, thanks very much for the kind words and I'll try to overlook your strange accents and carry on. So it's been a fun book to write, taken awhile. It really goes back several years, Joel and I have been working on tax issues for donkey's years, and for many years kind of exchange strange tax facts that we came across, and after a while it occurred to us that there was actually a lot of things then enough for a book, but not a book about fun facts about tax, but a book that uses kind of lively, interesting episodes to convey some basic ideas about taxation.

Michael Keen:

That's what we're really trying to do. And I think convey a kind of a key message that really what governments have been trying to do through the millennia, hasn't really changed that much. They've been trying to think how to raise revenue without actually destroying the tax base, how to try and make taxes at least fair enough that they're not going to stoke a rebellion. The technology has changed, but the core message that comes out of these stories and facts is this unchanging nature of the challenges that face governments.

Michael Klein:

Yeah, I was really struck in the book by the strong effort that you succeeded in, in not just offering interesting examples, but to use these to teach some very general economic concepts about tax policies.

Joel Slemrod:

Yeah, we confess that our profession has done a pretty bad job in conveying what is wise tax policy to inform the public debate. In the book, we try to convey tax policy wisdom in an entertaining and more digestible way with stories about weird and bizarre tax episodes of the past and present, but not just for the sake of those fun stories, but to pass along what lessons there are for tax policy. In the book, we don't push our own tax schemes, but we do offer in the last chapter, some lessons that history holds for current tax policy debates.

Michael Klein:

Okay. Well, let's start out with, for example, the government's ability to tax and who it chooses to bear the burden of taxation. What's some of the experience with this and what important underlying points do these experiences illustrate?

Joel Slemrod:

Well, it seems that throughout history, all governments would like to minimize the burden of taxes on their own citizens. In history, they've tried what they think of as taxes with no burden on their citizens, they've tried to tax foreigners, extract tribute. Sometimes that works, sometimes it doesn't. Also most governments want the burden that must fall on their citizens to fall on those most able to bear it. So in history, we see taxes explicitly tied to your social class. We talk at length about two poll tax episodes. Poll taxes being taxes on people, that don't vary by how much income or wealth they have. Two poll tax episodes in the UK, both of which were disasters and six centuries apart in the late 14th century, and the late 20th century.

Joel Slemrod:

And we talk about the nefarious use of poll taxes in the American South after the Civil War. Before the income tax governments tried to put the burden on high-income people in part by taxing items of consumption that only rich people would buy, like fancy hats. But eventually, governments have settled on the income tax as the primary way to assign tax burden as they like.

Michael Klein:

As a child, I learned about The Boston Tea Party and the slogan, no taxation without representation, was an animating cause of the American Revolution. But you point out that this is incorrect.

Michael Keen:

That's right. Strange, but true. I can certainly give you the British perspective on what really happened. So you probably remember from school that by the early 1770s, the British were imposing a tax on tea when it arrived in the colonies and they were doing that by then not really so much for the revenue, but to make the point that if they wanted to do it, this was the kind of thing they could do. Same time they had this problem with the colonies, they had a big problem with the East India Company, which was the precursor of all today's great multinationals, which had too much tea, unsold tea. So the idea was, well, how can we shift this tea? And the apparently brilliant idea came up. Well, if we think about shipping tea to the colonies, it not only pays the tax when it arrives in the colonies, it pays a tax in London before it gets shipped to the colonies.

Michael Keen:

So let's get rid completely of this tax that's paid in London. We'll leave the tax on tea and the colonies unchanged, and that means we can undercut and sell and expand the market for tea in the colonies, and colonies will be happy, they'll accept the tax we levy there, and they'll buy all this tea we want to ship. Oh, well what could possibly go wrong with this brilliant scheme? Well what could possibly go wrong was that the people who are going to be undercut were smugglers. And the smugglers were doing big business, and many of them were very prominent loyalists. The name John Hancock comes to mind and as well as some other measures of when with this cut in taxes, it was made easier for loyal tea sellers to undercut the smugglers, and therefore it was that the tax cut led to the tea being dumped in the harbor.

Michael Klein:

Well, that's a point we'll come to again, how there's the burden of tax is felt differently by different people, but Joel, you mentioned the income tax. April 15th is tax day although, this year it's been pushed back more than a month. And most Americans when they think about taxation, they think about in fact, the federal income tax. But your book points out that there was a lot of controversy about the income tax when it was first instituted, and in fact there was even a question of whether it was constitutional.

Joel Slemrod:

Yes, the U.S. income tax actually began during the Civil War, the North had income tax, but that was eliminated soon after the war. And then it was revived in 1894, but the next year, our Supreme court said it was unconstitutional. And it sat for 20 years as many people became more and more dissatisfied with how the federal government was raising revenue, mostly through tariffs and excise taxes, which are perceived to put the burden of tax mostly and too much on lower income people. So it came back, but it took a constitutional amendment to come back, the 16th Amendment to the constitution, which was ratified in 1913.

Joel Slemrod:

By the way, the same constitutional issue may come up if we ever have a serious debate about a wealth tax in the United States, some legal scholars think that would also be unconstitutional and would require an amendment, but we'll see how that plays out. And by the way, as you said, April 15th is our usual tax day, not this year, but it wasn't always that way, it was March 15th until 1955. And, if I might add, in the UK, the tax year, isn't the calendar year.

Michael Klein:

When is the tax year in the UK then?

Joel Slemrod:

That ends about sometime in April, right Mick?

Michael Keen:

April 5th, April 5-

Joel Slemrod:

That makes sense.

Michael Keen:

Which is a sensible thing, right? Which makes perfect sense.

Joel Slemrod:

That's what I would've guessed.

Michael Klein:

Sure why not? Well, you also point out in the book that taxes aren't just in place to raise revenue. Sometimes they represent an effort by a government to alter behavior. And we have, for example, a number of memos on the carbon tax by my colleague and friend Gib Metcalf, the carbon tax represents an effort to combat climate change, but taxes were also used to get, for example, men to shave off their beards.

Michael Keen:

Very true. So yeah, Gib obviously stole his ideas from Peter the Great. So Peter the Great, Tsar of the Russians, in the 1690s, wanted to turn the country westwards rather than eastwards, and as part of that, he wanted to change the way of life of the traditional aristocracy, the boyars, and a large part of that was... Their life, was these magnificent beards. So Peter the Great wanted to induce them to get rid of these beards, so he instituted a tax on beards, which meant you could carry on wearing it proudly, your beard, but only if you also displayed a rather humiliating token that showed you pay the tax. And indeed, I was a proud owner of one of these tokens that Joel has sent me, until recently revealed that in fact, it's a forgery, the one he sent me, but nonetheless, I don't hold that against him.

Michael Keen:

And there are all kinds of examples of this use of taxes [inaudible 00:11:19], Cleopatra, not known for being the first person allegedly to post a tax on beer, claims it was partly to address a drunken [inaudible]... I think one reason just to spend a moment on why this is an important point, is that when you think about what a good tax is, what might good taxes be? One thing you're going to come up with, they're going to be taxes that actually correct bad behavior. That you need not so much to raise revenue, but to make people do things that you think as kind of socially more desirable. So it was with Peter the Great, and so it was carbon taxes.

Michael Klein:

Well, this brings up an important point because taxes can alter behavior and economists call this the distortionary effect of taxes. In the book, you also mentioned that this is called the excess burden. Some people of course, think that paying any tax is an excess burden, but that's not what's meant by this term. Is it Joel?

Joel Slemrod:

No. The concept of excess burden occupies a central place in modern tax analysis. It's the idea that most taxes distort the decisions of individuals and businesses in an inefficient way. For example, people don't work as much as they otherwise would because of the income tax, businesses don't invest as much because of the corporate income tax, but it's a very difficult concept to convey, in part because it refers to something that didn't happen. You didn't work as much as you otherwise would, or you didn't invest as much as you otherwise would. In the book, we try to convey this difficult concept and illustrate it once and for all, by providing visual images of excess burden, I'll give just two examples. The British had a tax on windows a few centuries ago, as a way to try to quantify how luxurious and valuable a house was. The more windows it had, the bigger and more valuable it was.

Joel Slemrod:

Not a stupid idea. What happened? Well, lots of people boarded up their windows to reduce their tax burden. And you can still see illustrations of this today in houses in the UK. This is an excess burden because it's pretty clear no one would ever, if it weren't for taxes, build a house with windows and then break them up. Maybe the best example of all is our picture of a dog without a tail, which some people claim is due to the fact that there was, also in England, at tax on dogs, but dogs without tails were exempt. And sure enough, the story goes that some people cut the tails off their poor dogs in order to lower the tax burden. That's excess burden in a visual image.

Michael Klein:

And especially an excess burden for the dogs, I guess.

Joel Slemrod:

Absolutely.

Michael Klein:

Another targeted tax is one on luxury items, for example, on yachts. What's the experience with this? Presumably this is to try to get the rich to pay more, but does a tax on yachts really soak the rich? Sorry for the pun there.

Michael Keen:

We'll overlook look that. But yes, I mean the experience is really that, what you actually call a tax, doesn't have much to do with who ends up really bearing the burden of the tax. So we take tax on yachts, which as you say, is presumably intended to fall on the rich people who own yachts, there's a lot of evidence that a tax of this kind that the U.S. introduced, I think in 1990, really ended up falling on [inaudible 00:14:43], and people who were making the boats, not on the rich people who were buying them. And again, there are all kinds of examples of taxes that presumably are intended to fall in one place, actually falling somewhere else in terms of the real burden.

Michael Keen:

Another example is in my own country, the UK, Pitt the Younger in the 18th century, had a tax on female servants, which was presumably intended to [inaudible] reduce the real income of people who are rich enough to employ female servants. But in fact, again, there's a lot of evidence, anecdotal evidence, at least, that the tax ended up reducing the wages of the female servants themselves, and forced [inaudible] to look for other jobs. So this is this wider question of incidence, of who really bears the burden. And I think as Joel was saying early on, this is an issue or a set of challenges that really the profession hasn't done a very good job of thinking about, because I think we all still too often take at face value where the incidence of tax is going to fall, just looking at its name or its label, or how politicians present it.

Michael Keen:

And it's certainly a hard question to answer, who really bears the burden of the tax. We do have some general principles. We know that the harder it is for you to find an alternative to something that's being taxed, the harder it is for you to avoid the tax in terms of suffering a real burden, [inaudible 00:15:58] if you are rich yacht owner, and you find yachts are taxed, then well, maybe buy a private plane instead, you're not going to wind up bearing much of the burden of the tax, it's going to go to someone else.

Michael Keen:

So controversy remains, it's not easy to figure out where the incidence lies, but I think a big message of the book is really not to pay too much attention to names or the spin of how things are named or branded, and how politicians describe what they're trying to do, to think through where we think it's really going to fall, and just because for example, something is called a Robin Hood tax, that sounds great, but it doesn't mean that it's really going to fall on the rich. So be aware of labels, is a key message of the book.

Michael Klein:

Well, the Robin Hood tax brings us to a point that Joel, you raised a little bit earlier, the discussion of a wealth tax. In the book, Capital in the 21st Century by Thomas Piketty, which was one of the best-selling economic books of the 21st century, at least so far -- I hope that yours does as well -- he talks about a wealth tax and actually calls for that. Joel, what do we know, from historical experience about the ability of a wealth tax to raise revenue as well as to be a burden on the rich alone, as Mick was saying, the incidence of that kind of tax?

Joel Slemrod:

There is relatively recent history of experience with a wealth tax in Europe. A couple of decades ago, 12 countries had one. Now it's only three that have one, which in itself is not a good sign about how well it works, although maybe we could do better. There is though a much longer history of countries trying to tax the wealthy and their efforts to avoid or evade such a tax. In the book we tell the story of two British brothers, William and Edmund Vestey who in the early 20th century operated a meat production and distribution business on a truly global scale, and also very aggressively took advantage of loopholes in international tax laws. They were so successful at tax avoidance and perhaps evasion, that when the Queen was finally subject to tax in 1993, a descendant of William and Edmund said, "Well, that makes me the last one."

Joel Slemrod:

The lesson is that tax measures such as the wealth tax designed to place a burden on the wealthy, need to be accompanied by serious attention on how to enforce the tax. Because we know that many, maybe most of the wealthy will look for ways and find ways to reduce their tax burden. And that's one way that the burden can be spread to others because these avoidance and evasion schemes have costs to the economy.

Michael Klein:

So we've covered a lot of topics. We've talked about the fact that the name of at tax alone doesn't really reflect who bears it, we have this issue of tax avoidance. As experts in this field, I'd like to finish up the discussion on the politics of tax policy, economists like yourselves, have ideas about what makes taxes fair, what makes taxes help promote growth, or at least not kill growth and what makes taxes better at enhancing revenue. But to what extent do these ideas get distorted through the political process? Do taxes in practice look anything like what economists say they should be? What do you find economists like yourselves actually being able to do to have a bearing on tax policy when you're contending with lobbyists and entrenched political interests?

Joel Slemrod:

Michael it's undeniably true that governments often ignore the policy advice of so-called experts like Mick and myself. What we can point to some success. In the U.S., the Tax Reform Act of 1986 was widely held as the kind of thing that a good tax policy would look like. In the book though, we also talk about failures of tax policy, due to special interest capture. Two of my favorites are the taxes on margarine that were introduced soon after margarine was invented and promoted by, you can guess who, the dairy industries. First they had regulations such that margarine had to be pink rather than yellow, and when that didn't seem to stem the tide, they started to place taxes on them. And chain stores, mom-and-pop stores saw chain stores proliferating in the 1930s, tried regulations, but pretty soon there were these taxes on chain stores, that last episode certainly resonates today as the effect of remote sales, and Walmart, and Dollar Stores have on mom-and-pop businesses all over the country.

Michael Keen:

Maybe Michael, could I just add an optimistic note if I may? Just to say a word about the value added tax. So, just to explain, so the value added tax is a tax that basically all businesses have to charge it when they sell things, but they get a credit or a refund of the tax that they themselves have been charged on their inputs. Now, so this idea originated, I guess about a hundred years ago, and you can imagine this was a pretty bizarre and odd idea at the time, you're going to collect all this money but you're going to give a whole bunch of it back. So you might be giving 30% of the money you collect back to businesses in form of credit or refunds, particularly refunds.

Michael Keen:

And so this might seem a kind of pretty wacky idea, but nonetheless, over the last 60 years in particular, this tax developed by so-called experts as it were, now it's [inaudible] 160 countries or so around the world that raises... About a third or more of the world's tax revenue comes from this scheme, that was basically devised by people thinking about [inaudible] policy and persuading practical people, this is really a good idea, and so it has proved. So we end with a little bit of an optimistic tone.

Michael Klein:

Well, I'm very glad to end with that optimistic note and the fact that the ideas of careful thinkers like yourselves do have a bearing on policy. Joel and Mick, thank you very much for speaking with me today. You're kind enough to send me the galley proofs of Rebellion, Rascals, and Revenue: Tax Follies and Wisdom Through the Ages, and I've already pre-ordered my copy of the book. It's a great read, both for the engaging stories and for the insights into this really important set of topics. So thanks a lot.

Joel Slemrod:

Oh, you're welcome, Michael. Thanks for having us on, we appreciate it.

Michael Keen:

Thanks very much. Yep, it's been fun. Thanks a lot.

Michael Klein:

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