Laura Huxley once said: “Words enable us to behave like human beings, but also to behave more stupidly than dumb beasts.” Perhaps this is a good starting point for my talk today, which I call “The Use and Abuse of Fiscal Language.”

I will let my main themes emerge gradually. Eventually, we will get to the tax and budget issues that are at center stage in current politics – for example, the tax cuts of the last three years, along with other major recent budget-affecting legislation. So this is not just an academic talk, for those who would like to hear something concrete. But it will take me a little while to get there, because I want to address how we think about issues, rather than just supplying my own canned judgments about the bottom line.

Perhaps I should first define what I am talking about. The U.S. fiscal system has many components. It embraces the income tax, the payroll tax, various state and local taxes, Social Security and Medicare, Medicaid, TANF or welfare, and Food Stamps. It has programs in housing, transportation, farming, religion, waste disposal, and public and private school education. Indeed, it embraces all government programs that we can think of in terms of cash.

By fiscal language, I mean the terms that we use to describe the operations of the fiscal system. Examples of these terms include taxes, spending, user fees, entitlements, deficits, lockboxes, trust funds, universal programs, and means-testing.
Fiscal language inevitably has a dual character. It is both a tool of purportedly objective and meaningful description, and a weapon of political combat. But its use as a weapon is parasitic on its claim to offer meaningful description. For example, when President Reagan criticized “tax and spend” Democrats, the criticism would have had no force unless it purported to say something about the real substance of the policies the Democrats favored. No one would have cared if Reagan had been relying purely on some arbitrary convention for labeling Democratic policies, such as the font used in Democratic leaflets.

Suppose that, purely for aesthetic reasons, some government spending was done with green dollar bills and other spending was done with red dollar bills. It might be objectively true that one Administration spent more red money than another did. But this wouldn’t provide meaningful information, other than about that Administration’s aesthetic preferences concerning the color of money.

Unfortunately, the fiscal language we use is often no better than talking about green versus red dollar bills. The problem starts with the two most basic concepts in our fiscal language – effectively its subatomic particles, the terms “taxes” and “spending.”

These two terms are regularly used as if they were meaningful, in ways that they simply are not. And this is not just a matter of fooling the public. You also have public officials, and even leading economists, fooling themselves.

For cases in point, consider Milton Friedman and Gary Becker. Friedman has often said, and recently reiterated: “I never met a tax cut I didn’t like, although I like some better than others.” Becker argues that it is desirable for the tax system to be inefficient, because that leads to smaller government, as shown by lower government
spending. He has done empirical work with his fellow Chicago economist Casey Mulligan, purporting to establish that this is so. This work starts by rating the efficiency of tax systems, based on how much revenue they raise relative to their rates and bases. An inefficient tax system is one that raises low revenue relative to its rates and base, presumably showing that it has more loopholes. Becker and Mulligan find that the countries with more loopholes and less efficient tax systems also have lower government spending. This ostensibly shows that tax inefficiency pays off by helping to keep the government small.

Friedman and Becker are both Nobel Laureate economists. They deserve to be. I personally have learned a lot from their work, and from other work inspired by their work.

And their statements about tax policy reflect an underlying philosophy about government that is coherent and defensible, whether one fully agrees with it or not. I myself am not at the same point on the spectrum as they are, but I understand and sympathize with many of their reasons for being there.

That being said, I don’t want to pull my punches here. So let me say that, in discussing tax policy as they do, even in relation to their underlying aims, Friedman and Becker, those distinguished Nobel Laureate economists, show less economic understanding and sophistication here than you would expect from people babbling at a cocktail party.

Let me start with two examples to show the vacuity of the distinction they rely upon between “taxes” and “spending.” On both, I’d like to thank David Bradford for helping to stimulate my thinking.
After the examples, I will ask what really concerns Friedman and Becker, and how we might get a better handle on it.

My first example is from 1993, when President Clinton proposed deficit reduction through tax increases and spending cuts. Mindful of the Reagan-style critique of tax-and-spend Democrats, he proposed to cut spending at least as much as he raised taxes.

As the plan neared passage, Democrats claimed to have met this target, but Republicans cried foul. In particular, they noted that a provision increasing income taxation of people’s Social Security benefits had been counted as a spending cut, rather than as a tax increase.

Clinton’s defense was that this provision had the effect of cutting high-income people’s after-tax or net Social Security benefits. But Republicans were not alone in thinking that he was wrong. Clinton captured third place in the 1993 Doublespeak Awards, administered by the National Council of Teachers of English, for this maneuver plus his insistence on using the word “investment” whenever he proposed new government spending.

But then it turned out that, under President Reagan, the Republicans had done exactly the same thing. Introducing an earlier stage of income taxation of Social Security benefits, they, too, had called it a spending cut. And no one had cried foul back then.

Why was President Clinton wrong? He apparently was wrong, since I don’t want to quarrel with the English teachers. But he was only wrong semantically, not meaningfully. He was wrong in the sense that you would be wrong if you said that a given program used red dollar bills, when in fact it had used green ones. He was wrong because, in fact, the money was being collected via people’s income tax returns.
But suppose instead that the Social Security Administration had gotten to load the needed data from people’s income tax returns onto their computers, and then had issued Social Security benefit checks that were reduced by exactly the same amount as the added income tax liabilities under the actual Clinton plan.

Then Clinton would have been right, even though this policy would have been identical to the actual one. I say it would have been identical, because everyone would have ended up with the same amount of money, and faced the same incentives in making all of their personal and economic decisions. If that doesn’t make the two approaches identical, then I don’t know what would.

But perhaps it is just as well that Clinton couldn’t change net Social Security benefits in such a way as to make it “really” a spending cut within accepted conventions. If he had, we would have an identical state of the world with lower official measures of both taxes and spending, which, to Milton Friedman and Gary Becker, apparently would have been good. But he also would have violated our sacred covenant to keep Social Security as a universal program, witho means-testing that would violate our solemn commitment to supply it on the same terms to all Americans.

Under the alternate plan that people would have agreed was a spending cut, Social Security benefits, as measured by the checks people got, would have varied with income, which is the very definition of means-testing. So Clinton would have violated this sacred social compact, which evidently was unaffected by his doing exactly the same thing through income tax returns.

So apparently we have sacred commitments that we take very seriously, and yet we accept purely formal rules to decide whether they have been violated or not. This
sounds more like playing Simon Says, where the formula “May I?” – “Yes, you may” is all-important, than it sounds like making serious social policy.

Let me give another example of the vacuity of the conventional distinction between “taxes” and “spending.” Today we have huge deficits. If only I were the President, I could offer the following plan to reduce the deficit by $50 billion, while also cutting taxes. The plan has three components:

First, eliminate $60 billion of government spending on vitally needed weapons for the military.

Second, cut taxes by $60 billion, by enacting a new “weapons supplier tax credit” or WSTC. To quote David Bradford, whose plan I am adapting: “To qualify for the WSTC, manufacturers will sign appropriate documents prescribed by the Secretary of Defense (looking much like today’s procurement contracts) and deliver to appropriate depots weapons systems of prescribed characteristics.” Indeed, these will be exactly the same weapons as the ones for which we just eliminated government spending. That way, we get a tax cut and a spending cut without harming, or indeed having any effect whatsoever, on national defense. We still get the same weapons, and both the government and weapons suppliers end up with the same amount of money as previously.

So far, we have both a tax cut and a spending cut of $60 billion, although all that has changed is the labeling. But now it’s time to tackle the deficit. So we boost income tax rates sufficiently to bring in $50 billion. Overall, taxes are still officially down $10 billion, due to the $60 billion weapons supplier tax credit.

The net result is $50 billion of deficit reduction, even though we cut taxes by $10 billion, since we have also officially reduced spending by $60 billion through our re-
labeling of the defense program. But in truth, the only change that went beyond re-labeling was raising the income tax rates.

What would Milton Friedman think of this? It’s not hard to guess. This is a tax cut, and he has said he never met a tax cut he didn’t like. Indeed, he has never indicated that there could be a tax cut he wouldn’t like.

How about Gary Becker? He’d be delighted, not just by the tax cut, but by the new empirical evidence in support of his theory that inefficient taxes lead to smaller government. We made the tax system less efficient by adding a $60 billion tax preference for weapons suppliers, and sure enough, government spending declined by $60 billion. Wow, it looks like his empirical study with Casey Mulligan was even better than he supposed. But in fact a study that treats mere re-labeling as if it had really made the government smaller is not worth the paper that it is printed on.

Why are Friedman and Becker so confused? They have succumbed to what I call spending illusion, or confusing the size of government with the gross number of dollars that they see traveling either from people to the government or back the other way.

Suppose I pay $100 to the government in the morning, and get $100 back from it in the afternoon. Does this mean that taxes and spending were $100 each? It sounds to me like next to nothing has really happened.

Nearly everyone is a net taxpayer to the government during his or her life. You pay it money, and it gives you money plus a flow of in-kind services, such as through road construction and defense spending. Even if you get good value, you pay more than you get because of the in-kind nature of so much of what the government does.
Against this background, it makes absolutely no difference whether, at a given point in time, you give it a dollar more, which would labeled a tax increase, or it gives you a dollar less, which would be a spending cut.

What do Friedman and Becker really care about? Their concern is with the size of government, which is an empirical idea. But we need to ask ourselves what it really means. A lot of people think of the size of government in terms of how many bureaucrats there are, or how many government office buildings, or the overall spending line on the government budget. But this is much too narrow and formalistic. Even moving on from my taxes versus spending examples, think of the minimum wage. This is a government regulatory intervention in the economy, equivalent in some ways to providing an hourly wage subsidy for low-wage workers that is financed through a levy on the businesses that employ these workers. But it is totally off-budget, formally involving neither taxes nor spending.

Or think of President Clinton’s 1993 healthcare plan, which similarly would have relied on employer mandates, rather than on direct or formal taxes and spending. Did it thereby avoid being “bigger government,” as a matter of substance and not just hoped-for perception?

Two more examples. The income tax, even when broad-based, affects incentives to work and save. Isn’t that an important effect of government, even without regard to the number of IRS employees or the dollars in taxes actually paid? Indeed, aren’t the tax inefficiencies that Gary Becker celebrates, on the ground that they hold down spendable revenue, actually part of the size of government that he abhors? What makes him so sure,
without the slightest effort at empirical inquiry or even recognition of the issue, that one type of government action matters more than the other?

For a last example, suppose we have a tariff on all imports from France. We set it at one level and it raises $1 billion. Then we raise the tariff rate so prohibitively high that imports from France completely evaporate. Is it clear that we have made the government smaller, when now we are effectively forbidding Americans to consume French products, rather than simply raising the price?

In all of these examples, government policies have real world effects without requiring cash to flow into the government coffers and then back out again. Often the policies involve effectively outsourcing what the government does, through commands or incentive effects on the actions taken by people who are not government employees. It is clear, therefore, that a size of government concept must focus on the effects the government has – not on formal categories of dollar flows or employees or buildings.

For convenience, we can identify two main kinds of effects of government policies. *Allocative effects* concern how society’s resources end up being used. How much do people work and save, what work do they do, how do they invest, what leisure and consumption activities do they engage in, what goods and services do they use, what sorts of family groups and other households do they form, and so forth.

*Distributional effects* concern who ends up with how much in our society. There are all kinds of different groups. Rich and poor. Young and old. Men and women. The already sick and the temporarily healthy. Members of different races or religions or ethnic groups. People who live in different places, or do different types of work. The
government does lots of things that affect the distribution of wealth between these various kinds of groups, or that more narrowly affect particular individuals.

To me, the size of government, at least when we are talking about the fiscal system, is a function of its allocative and distributional effects. Now, assessing this requires a no-government or at least small-government baseline, raising difficult conceptual issues that I don’t have time to address today. But we all understand the spectrum of opinion about government that I referred to earlier when I said that I am not at the same point on it as Friedman and Becker, though I respect their reasons for being where they are.

This spectrum of opinion about government ranges between two poles. At one pole is the libertarian minimal state, where the government is limited to protecting property rights, with related functions such as providing police, courts, and national defense. The belief that markets work pretty well, and that government works quite poorly, are thought to counsel prudentially against letting the government do more. There may also be notions of rights to liberty, or of distributive justice based on entitlement to the fruit of one’s efforts, that provide grounds beyond just efficiency for libertarian dislike of a more active government.

The opposite pole could be called socialism, although that is a dirty word in U.S. politics. Allocatively, the idea is that markets work poorly enough, and political processes can work well enough, to justify extensive government intervention in the economy. Distributionally, the main idea is usually promoting greater equality, whether of outcomes or merely some set of opportunities. Needless to say, you can favor moving
closer to the socialism pole without being a socialist. Support for moving towards either pole does not logically imply support for going all the way there.

Milton Friedman and Gary Becker want our current policies to move closer to the libertarian pole. They believe that cutting taxes, in the hope that this will lead eventually to lower spending, will take us in this direction. So far, I have established only that they are mistaken in thinking that their aims are necessarily advanced by changes labeled tax cuts and spending cuts. I have not yet rebutted the possibility that they might be using a simple rule of thumb that, in practice, comes close enough. In today’s politics, is support for tax cuts that augur future spending cuts a reasonably good proxy for making the government smaller?

The answer is no. Friedman and Becker are wrong, in the sense that they misunderstand the relationship between the budget issues that are currently at center stage in our politics, and on which they have expressed opinions, and their own quasi-libertarian policy preferences. To show this, however, I need to cover 4 preliminary points.

FIRST, current U.S. fiscal policy is not sustainable. This is a matter of such universal agreement that even the just-published Budget of the United States for fiscal year 2005 says so in cold print. We have a long-term fiscal gap that, according to recent estimates, probably exceeds $70 trillion. Annual national income, by contrast, is only about $10 trillion.

To explain what the fiscal gap means, the no-free-lunch principle holds that everything must ultimately be paid for. Inflows, whether we call them taxes or not, must be equal over the long run, in present value or interest-adjusted terms, to outlays, whether
we call them spending or not. But current policy is on a course to fall $70 trillion short of paying for everything. That’s in today’s dollars. Put off addressing it, and it grows at the interest rate.

Depending on how you define the separate pieces, about 100% of the fiscal gap is due to Social Security and Medicare. The root causes of the fiscal gap are twofold. People are living longer, and healthcare costs are rising, in both cases making these programs more expensive.

When our current President took office, there was already a large fiscal gap, for these underlying reasons. How large I can’t say, because the estimates weren’t being done yet. But he, or his Administration and the Congressional leadership with which he is allied, have made things significantly worse. They have done this in two main ways. The first was the tax cuts of 2001 through 2003, which were huge, and if not for some brave Senate Republicans would have been even bigger. The second big budget change was the Medicare prescription drug benefit that the Bush Administration pushed through Congress last fall with no funding, and which the Medicare Trustees now estimate is going to cost $16.6 trillion. Historically, by the way, such estimates have almost always been too low, rather than too high.

Let’s consider the annual budget deficit for a moment. We normally think of it as a measure of how much worse our fiscal situation got in a given year. How much spending did we fail to pay for currently? But the right way to measure this year’s effect on the sustainability of our fiscal policy is by measuring the year’s increase in the fiscal gap, taking into account changes in our future commitments.
The President has been criticized for a 2003 budget deficit of about $500 billion. But, due to Medicare prescription drugs and the latest tax cut, the fiscal gap actually increased in 2003 by forty times as much. It went up by about $20 trillion, which is double our nation’s entire economic production for the year. That’s quite a spree for just one year by any measure. While President Bush may be cheered by his success in 2003 in getting Congress to adopt nearly his entire legislative agenda, I am reminded of the Greek general Pyrrhus, who said, after defeating the Romans, that one more such victory would utterly ruin him.

So that’s the first of my four points. We face an enormous and widening fiscal gap that must be addressed soon. The bond markets will not tolerate it forever.

SECOND, U.S. fiscal policy has resulted in huge transfers from younger to older generations. This is mainly due to Social Security and Medicare, which gave free benefits to older generations, at the expense of younger generations, at enactment and then, for decades, kept on growing. Pre-2001 measures of lifetime net tax rates, or people’s taxes paid minus their transfers received as a percentage of lifetime income, suggested that future generations would face double the lifetime net tax rates of current generations, mainly due to the fiscal gap. The transfer from younger to older generations has gotten a great deal larger in the last 3 years, although there are no updated measures. Medicare prescription drugs, for example, will hand current seniors more than $500 billion over the next ten years, without requiring them to pay a penny in extra taxes. But someone eventually will have to pay.

THIRD, there are only two ways to narrow the fiscal gap: increase inflows and/or reduce outlays. Economic growth cannot significantly narrow the fiscal gap. This is not
a case like England after the Napoleonic Wars or the US after the Civil War, where a seemingly crushing debt burden was simply outgrown. The problem today is that government obligations, such as under Social Security and Medicare, actually grow with the economy. So in this sense economic growth, while surely a good thing, does not help.

I like to analogize the current US policies that have created the fiscal gap to a divorce agreement between a spouse who works at a job and a spouse who stays home. Suppose the spouse with the job says: “I will pay you 30% of my salary, and you will get 50% of my salary.” Perhaps a court even ratifies this agreement.

Whether ratified by a court or not, we know that the plan laid out in this divorce agreement will not actually end up being followed. Fulfillment is impossible whether the working spouse’s salary grows or not. 30 percent cannot equal 50 percent whether the worker earns $10,000, or $1 million, or $50 trillion. That is essentially our fiscal system, given how Social Security and Medicare spending, among other variables, are pegged to the size of the economy.

As an aside, a slowing in healthcare growth actually would help the fiscal gap a lot, but there is no particular reason to expect it any time soon.

As a practical matter, making a real dent in the fiscal gap will require some combination of (1) raising income or payroll taxes; (2) adding new taxes such as a value-added tax or VAT like those in most industrialized countries; (3) imposing hidden or implicit taxes through inflation or default on the national debt; (4) cutting Social Security benefits; and (5) cutting Medicare benefits. That is where the money is.
FOURTH, I need to say a bit more about Social Security and Medicare, because they are where so much of the action will have to be. Let’s start with Social Security. This is a system that forces you to save for your own retirement, in the sense that it takes money away from you while you are working and then doles out a monthly stipend once you reach age 65.

In 2003, Social Security benefit payments exceeded $400 billion. If you are subject to spending illusion, this sounds like big government at work, if anything does. But in fact, Social Security is a surprisingly bland program allocatively.

Suppose for a moment that Social Security were actuarially fair – that is, that the value of everyone’s expected benefits at retirement equaled the Social Security taxes they had paid. Suppose as well that, if the program did not exist, everyone would save exactly as much for retirement as they actually do today in light of the program’s forced saving elements.

We would then have an annual $400 billion program that did absolutely nothing – that made no difference in anything, except for the modest administrative costs of operating the system. Under this scenario, there would be no transfers through the system, and no effects on when people consumed. And since, even as Social Security stands now, the benefits are paid in cash, retirees can spend what they get however they like. So Social Security, in this hypothetical scenario, would not change what anyone had or did at any point in time.

Now, it is not in fact the case that Social Security does nothing. It has resulted in huge transfers from younger to older generations, and to a lesser degree within generations in various ways. It sets a floor on people’s retirement saving, which may
often be good for them if they tend to be myopic about the future, like making them eat their broccoli. It affects various incentives, such as the incentive to work. And it appears to have significantly reduced national saving over time, because of the lifetime wealth transfer from workers who still needed to save for their retirements to seniors who were in the consuming stage of their life cycles. Take money from someone who still wants to save and give it to someone who is largely done saving, and you figure to reduce national saving, even though the recipient can use the money however she likes.

Despite all these important real effects of Social Security, the dollars spent in the program are not a good measure of the effects. After all, while my scenario where the program did nothing was not entirely true, it was not entirely false either. And we will see in a minute that cutting Social Security benefits in the future could make the effects that I have mentioned bigger, not smaller.

The Bush Administration has argued at times that the Social Security payroll tax is not really a tax, because you are paying for future benefits. Larry Lindsey, when he was the Administration’s chief economist, made this argument in support of excluding Social Security taxes from the tax distribution tables that the government used to publish. But if the tax is not really a tax because of the future benefits that it supposedly pays for, does getting the benefits still count as spending? And if you end up not getting the benefits because they are cut, doesn’t that mean that the tax really was a tax after all?

Let’s shift from Social Security to Medicare. Here, the same story holds to a degree, but not as fully because the benefits are in-kind. You can only spend them on healthcare. So, allocatively this is big government at work, to the extent that the recipients would otherwise have spent the money on something else. But I should note
that healthcare spending is generally less price-elastic than many other kinds of consumer spending. That is, people are much less inclined to forego needed medical care just because it costs a lot, than they are inclined, say, to scale back their restaurant dining or vacation plans if the price is high. So Medicare is not as different from giving seniors straight cash as you might initially think from its being an in-kind benefit.

We’re finally ready for the punchline. In the last three years, the Administration has enacted huge tax cuts, to the applause of people such as Friedman and Becker. Has this made the government smaller?

I would say no – it has made the government larger. Given the fiscal gap, the tax cuts of the last three years, not to mention the unfunded $16.6 trillion Medicare prescription drug benefit, will require enormous future tax increases, along with Social Security and Medicare cuts. How does the package of today’s enactments, plus the reversals that they will require in the future, affect the size of government over time?

Distributionally, the answer couldn’t be clearer. The Administration is cutting lifetime net tax rates for older generations, for whom the rates were already low, in exchange for raising lifetime net tax rates for younger generations, for whom the rates already figured to be high. So it is dramatically increasing the dominant mode of wealth redistribution in our fiscal system, from younger to older Americans.

For this purpose, it really doesn’t matter whether conventionally defined taxes are increased, or Social Security and Medicare benefits are cut. This choice affects which of the younger age cohorts will lose how much, but not the size of their collective losses at the hands of current seniors.
From an allocative standpoint, making tax rates more uneven by lowering them today in exchange for raising them in the future increases total economic distortion, and thus makes the government bigger. And tax cuts today in exchange for Social Security cuts in the future also probably increases the government’s effect on the economy.

Again, the benefits are just a cash grant, which people can spend as they like. So perhaps the dominant effect of the package is to reduce national saving even more, by transferring even more money to today’s seniors that they mainly will consume rather than save. In other words, we are phasing down Social Security the same way we earlier phased it up – by benefiting current seniors at the expense of future generations. We therefore get the same effect of reducing national saving through the effects of government policy.

Only when we get to Medicare is there any real ambiguity about the size of government effects of the Bush Administration’s fiscal policy. If you look just at the tax cuts, then it is true that an offset in the form of future Medicare cuts would likely reduce the government’s allocative interventions in the economy. But if you consider the unfunded $16.6 trillion prescription drug benefit, then it’s game, set, and match. The current Administration has increased the size of government in every dimension.

And so much, by the way, for Milton Friedman and Gary Becker. If their formalistic view of the size of government causes them to get wrong the central tax and budget issues that we face today, then they don’t have an adequate rule of thumb for dealing with these issues. They need to go back to first principles or, as a tax lawyer such as I might put it, to think about economic substance.

Now again, the point I just made is that, even just fiscally, the current Administration has increased the size of government in every dimension. For people who
are committed to small government as an end in itself, that is an important result. But other people may ask: Why focus on how big the government is by some measure? Isn’t the more important question how we evaluate the merits of what the government does? Isn’t big versus small government less important than good versus bad policy?

I quite agree with this point. I have spent as much time as I have on the pure size of government issue because I think we need to clear up public confusion. Once this is done, however, the better question to ask is what we think of the policy content of the recent enactments that I have been discussing.

We should have a public debate about the budget policy of handing billions of dollars to older Americans, at the expense of people who are younger or not yet born, evidently driven by differences in the age groups’ current political power.

And we should have a debate about reducing national saving at a time when increased life expectancy and costly new medical technologies make our society’s need for retirement saving greater than ever.

And we should have a debate about enacting new $16.6 trillion entitlements without any talk of funding from either political party. President Roosevelt, when Social Security was enacted in 1935, and President Johnson, when Medicare was enacted in 1965, wouldn’t have dared to propose those programs without funding, even though they had overwhelming legislative majorities. But something in our political culture has changed.

Finally, we should have a debate about whether it is worth it to risk squandering a track record of two centuries of fiscal credibility by heading down the road towards acute
fiscal crisis that countries such as Weimar Germany and 1990s Argentina have traveled before us.

But to have these debates, we need to persuade a lot of people that substance, not form, is what matters in government policy, and that the anti-tax rhetoric of our current political leadership is based on fundamental illusions.

As a baby boomer (though just barely), perhaps I should close by quoting one of the Beatles, George Harrison, who wrote in a song that, if you don’t know where you’re going, any road will do.

But perhaps there is still hope. To date, I am pretty sure that there has been no government spending – none at all – with red dollar bills. So at least, from a Friedman-Becker, pro-small-government perspective, we are doing one thing right.

And on that cheerful note, I am happy to address any questions.