TAXATION, PUBLIC GOODS, AND PUBLIC TRUST: IT'S NOT JUST ABOUT THE ECONOMY

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THIS IS A TIME FOR BIG THOUGHTS ABOUT OUR political system. The presidential election revealed a clear yearning for change. For many voters, it was a repudiation of the politics of the past and a search for something better.

There are a number ways this search for something better has manifested itself like new voters turning out in record numbers to vote; an increasing frustration on the part of those voters with the incivility of our political debates; and a clear mistrust of incumbents, and there are lots of arguments as to why this is the case from Vietnam and Watergate in the sixties and seventies to the culture wars of today. But I think at least part of the problem stems from the way we fund public goods.

There is, in fact, a connection between taxation and public trust – between tax policy and political legitimacy, and it runs through public goods. The problem is that we do not pay for the public goods we want. For the most part, we balk at paying for them not because we don't want to consume them, but because we believe the system used to raise funds for those public goods – our tax system – is unfair.

To a certain extent, this echoes Mancur Olson's argument that the allocation of public goods in an interest group-driven political system is skewed by the peculiar logic of collective action.[1] That logic, he suggests, induces groups to seek narrow returns for their members regardless of the cost – or returns – to the broader economy. This distortion in the demand for public goods ultimately leads to an under-provision of the public goods society as a whole needs. This hurts the economy.

But I believe such a system also leads to an under-provision of public trust. And this hurts our democracy by undermining the legitimacy democratic political systems need to thrive. So when it comes to taxation and public goods, it's not just about the economy. It's also about our democracy.

Let me begin with the issue of public trust. There is ample evidence that our citizens do not trust their government. For example the National Election Study asks a sample of Americans questions whether they "think they can trust the government in Washington to do what is right?" They have been asking this question every two years since 1958 (Stanley and Niemi, 2001, p., 141).

Up until the early 1970s a majority of the respondents said they believed that they could in fact trust the government to do the right thing. Since that time, the responses have been overwhelmingly negative.

The same is true of other questions in a similar vein. Does the federal government "care much about what people like me think?" (No) Is the federal government "pretty much run by a few big interests looking out for themselves?" (Yes) And does the federal government "waste a lot of money we pay in taxes?" (Yes). In other words, we do have a problem. This problem exists at the federal level as the National Election Study suggests. But it also exists at the state level as well.

Again I believe that this mistrust is connected to the way we raise taxes and allocate those taxes to fund public goods. I believe that because of what I have observed as Secretary of Revenue and because recent research in the field of behavioral economics lends some theoretical support to the idea.

Let me start with the way things are supposed to work. When I was in business I had two broad concerns when it came to public policy. I was certainly concerned about my company's tax burden. But I was also concerned about the adequacy of the public goods my business needed to function optimally.

I needed a fair judicial system to help mediate my relationships with customers, employees, and vendors. I needed good roads to receive or deliver products. I needed a good education system capable of giving my employees the basic skills I needed to run a twenty-first century business. And I needed to make sure my markets had healthy communities and strong environments that would attract – rather than repel – customers and employees.[2]

So I understood the trade-off – between taxation and public goods – my self interest demanded. I needed certain public goods. And I understood that I would have to pay for them. This, of course, is a naïve and apparently out of date idea.

We Americans have in fact done a phenomenal job over the past few decades of detaching these two issues. In fact we now ask ourselves two simple and separate questions where once we asked one complex and compound question. The first question asks, "Do you want higher or lower taxes?" The second asks, "Do you want more or fewer public goods?"

The answers to these two separate questions are obvious regardless of your political affiliation. Given the choice between higher and lower taxes, the rational person chooses lower taxes. And, given the choice between more and fewer public goods, the rational person chooses more public goods.

The problem is that neither of these questions is the right question. They are not separate and distinct questions. They are connected – inextricably – at least in the long run. The fact that we have politically disconnected them has led to a predictably bizarre result. Like Alice (Carroll, 2000), we have come to be able to believe two contradictory things at once – that we can have both low taxes and robust public goods.

Of course there is only one way to reconcile the un-reconcilable when it comes to public goods. We take a free ride. And we have developed some very creative and effective ways to do this.

We have practiced deferred maintenance. In the short run, we simply put off paying for public goods to some future date. For example, don't repair that bridge this year. We have also used cost shifting. We let someone else pay for the public good I want. For example we use debt to push the *full* burden of current investment in long-term capital goods to others: to future generations or to foreigners.

We free ride by demanding targeted tax cuts. Give me a tax credit for producing my products. Don't give one to someone manufacturing something else. Or we selectively eliminate certain public goods to get this free ride. We eliminate the goods or services someone else needs. But not the ones I need. For example, maintain and expand the highways I use, but let's forget about the mass transit system my fellow citizens in Philadelphia use.

We also export taxes. The states which typically do best on the Tax Foundation list of low tax burden states are Alaska and Wyoming (Tax Foundation, 2008). This is no accident. Both have big severance taxes on minerals and small populations. This means that both states export their tax burden to the people who consume the minerals extracted from within their borders. So who pays Alaska's taxes? Of course, we do every time we fill up our car with gas. (Hassell, 2008)

And, finally, we convince ourselves that we actually do pay for the public goods we use. This interesting example of political cognitive dissonance allows us to believe that government inefficiency keeps us from enjoying the public goods we pay for. This is the fraud, waste, and abuse line we all look for in every state budget. But as most people find when they go through government accounts, there is less here than we generally expect to find.

The point is, as a nation we have become adept at using all these means to get a free ride: to enjoy the public goods we need without actually paying for all of them. The question is how do we get away with it?

The answer of course is that in the long run, we cannot – and do not – get away with it. In the long run, these tricks don't work. In the long run, others will refuse to buy our debt or future generations will inflate the value of it away. In the long run the elimination of some public goods like education or long-term health care for our seniors will materially reduce the quality of our lives. In the long run, citizens of states paying the taxes of other states will rebel. Taxation without representation is no more legitimate today than it was in the eighteenth century. And, in the long run, selective denial of public goods will lead to serious and obvious dead weight efficiency losses for the overall economy.

But in the short run, these techniques actually seem to work. First, some of us are persuaded by the free market absolutists who tell us that we really don't need all the public goods we think we want. Of course even Adam Smith believed that there was a place for certain public goods.[3] And we have vivid recent examples of what societies look like when they do not have healthy public goods. Anybody want to move to Northwest Pakistan today? Or does anybody want to diminish our national security capabilities?

Second we desperately *want* to believe in the idea of a free lunch, and our system is full of political entrepreneurs eager to pander to this seductive delusion. In the era of the 30-second sound bite, it is easier to make a simple call for tax reduction than it is to call for a more sustainable funding base for the public goods we admit we want.

Measurement bias also sustains our short-sighted approach. We get what we measure and we can measure tax rates and tax burdens fairly easily. On the other hand, assigning clear values to public goods is more difficult.

We also sometimes mis-specify true tax burdens by ignoring the component of our tax burden buried in the cost of a private good we consume. Again, the Tax Foundation shifts Alaska's tax burden to non-Alaskans who consume Alaska's minerals thus explicitly under-specifying the state's tax rate.

Finally, the way we organize political representation in our democracy helps support our short-term approach to public goods. As Olson (1982) argues, the politics of particularism reflects and accelerates the decline of broad collective action. Interest group political systems tend to devalue public goods by promoting narrow private interests more effectively than broad public needs. For Olson (1982), the rewards of collective action are skewed and narrowed in an interest group political system.

This narrowing of the provision of public goods might also be the result of broader social changes. It might well reflect the declining levels of social capital. Public goods tend to do better in a political environment rich in social capital. The interstate highway system was built in an era when Rotary Clubs and Chambers of Commerce were strong. Perhaps we are less adept at recognizing common needs when we bowl alone (Putnam, 2000).

In any case we have sustained our short-sightedness and in the long run unsustainable approach to taxation and public goods by disconnecting them from each other. And we have done this because in the political and economic short run we can.

So what are the consequences of this decoupling? First, there are, of course the long-term costs of denying an economy of the public goods that would boost its efficiency. Our market-based economy would clearly be weakened by the lack of a robust legal and regulatory system or the kind of transportation or communications infrastructure we need. We could also see broad financial consequences of our penchant for cost shifting like the devaluation of the currency, higher long-term interest rates as foreigners refuse to buy our debt, or inflation as our children devalue the costs of their parents' profligacy away. As Olson (1982) argues, this kind of behavior has real *economic* consequences.

But there are *political* consequences as well. On the one hand free riding reflects the decay of political legitimacy. And on the other hand it reinforces that decay. Take the public goods games developed by behavioral economists. These simple experiments suggest that there are real political consequences of a short-sighted and selfish approach to public goods. First they reinforce the notion that human beings are generally predisposed to understand the logic of collective action when there are clear returns.[4] Second, however, humans tend to act punitively – sometimes even against their own self-interest – when they observe (or suspect) free riding on the part of others. And third, humans are more inclined to cooperate with others if they believe there is a fair and broadly shared system for sustaining public goods.[5]

This conforms to my view of the real world from the vantage point of the Pennsylvania Department of Revenue. People do understand that public goods make sense in a free market and democratic society. We understand that there are times when it makes sense to band together and act cooperatively in the creation and maintenance of a good or service.[6] We know that schools, roads, and courts of law are essential. And our inclination to support public goods comes from this basic understanding.

But as the public goods experiments show, we also care about the nature of the system that raises money for these public goods. We must believe the system to be fair. In other words, *how* we raise the funds is as important as *what* we spend the money on.

This has three *real* world implications. First a tax system – the system used to raise funds for public goods – that is perceived as unfair has an independent negative effect on citizens' willingness to pay for public goods. It leads people to withdraw support for public goods even when they are important and useful to them in the real world as in the experimental game. In other words, we are willing to punish the beneficiaries of Olson's (1982) tilted interest group system even if it means punishing ourselves.[7]

Second, the perception of free riding is self-reinforcing. The more people believe free riding is occurring, the more likely they are to take a free ride themselves. In Pennsylvania, the corporate net income tax rate is so high that state government economic development officials routinely encourage companies coming into the state to use aggressive accounting strategies to mitigate – or avoid altogether – that tax. This is legal – and rational – behavior.

Third, this free riding increasingly narrows the approach to tax reform. I see more and more taxpayers asking for targeted tax credits, esoteric changes in apportionment formulas and specific exemptions on existing taxes rather than broad-based reduction in the tax rates. This renders the tax burden progressively less equitably apportioned among various classes of taxpayers.

All of this just reinforces the sense among taxpayers that the tax system is unfair. This in turn accelerates the decline in the inclination of citizens to support the public goods they truly want which makes the government appear to be increasingly unresponsive to their needs. Ultimately it brings into broader question the system's very legitimacy.

This is my concern; that the real inequities in our tax code in Pennsylvania and at the federal level undermine broad and necessary support for the public goods our economy needs to thrive. And it undermines the trust that our democracy needs to survive.

This is not to say that we all need to agree on the specific public goods our public sector should supply and maintain. We cannot and we should not. We should embrace the idea of a never-ending debate over this question. It is after all one of the central questions in a democracy. But we should agree that the tax system that pays for public goods must be fair, broad based and adequate for whatever level of public goods we agree we want.

We can decide to do with only a minimal amount of public goods and thus ask very little of ourselves in terms of taxes. Or we can choose to have an abundance of public goods and ask rather more of ourselves in terms of financial support. What we can't have is what we have here and now: public goods we want to consume but that we don't want to pay for; not because we don't believe we ought to pay for them but because we don't trust the system we use to raise the funds to pay for those goods. This is an unsustainable course for any political system.

So what do we do about it? I believe we are at unique moment in time right now when it comes to tax policy. The economic crisis facing the states creates a real possibility of fundamental reform because right now we are being forced to look at our revenue streams. And the cynicism that exists about government in general and taxes in particular just now presents a compelling political reason to think about broad tax reform.

We should address the free rider problem in our tax codes; we must ensure that our tax systems are fully up to the challenges they face; we should ensure that they produce the revenues we need to support the public goods we want; and we must ensure that our tax system produces those revenues in a fair and equitable manner.

Let's engage in the kind of honest, comprehensive and complex public conversation healthy political systems need from time to time and work to produce a tax code that reinforces – rather than undermines – the legitimacy of our democratic system. Because in the end, it's not just about the economy; it really is also about our democracy.

Notes

1 Olson (1965).

2 Smith suggests that one of the duties of government "is that of erecting and maintaining those public institutions and those public works, which, though they may be in the highest degree advantageous to a great society, are, however, of such a nature that the profit could never repay the expense to any individual or small number of individuals." Smith (1776, pp. 329-330)

3 See Adam Smith's (1776, pp. 291-411) list.

4 This suggestion that human beings are not the purely selfish utility maximizers that neo-classical economic theory build its models upon echoes Adam Smith and his fellow Scottish philosophers who understood that we are actually motivated by a combination of passions, interests and norms. See for example, Holmes (1995, pp. 55-56). See also Evensky (2005, pp. 245-264), who attempts to reconcile the central tenets of Smith's (1776) with his earlier work (1759).

5 For example, see Thaler (1992, pp.9 – 20) and Gintis, Bowles, Boyd and Fehr (2005), Ostrom (2005).

6 As Adam Smith (1776) observed, "When the institutions or public works which are beneficial to the whole society, either cannot be maintained altogether or are not maintained altogether by the contribution of such particular members of the society as are most immediately benefited by them, the deficiency must in most cases be made up by the general contribution of the whole society." (p. 411)

7 In public goods experiments, when participants "are allowed to punish non-contributors, they do so at a cost to themselves." (Gintis et al., 2005, p. 16)

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