

Economists are from Mars, Lawyers are from Venus: The Tax Policy Implications of Communication Failure

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I. Lawyers and economists are different types of people who come together in the legislative and policymaking realm. Sometimes policymakers rely on economic analysis to make decisions. Sometimes policymakers use economic analysis to support decisions already made. In particular, economic analysis has played a large role in the formation of tax and budgetary policy. However, there is a problem. Not only do economists and lawyers communicate differently, they think, perceive, react and respond differently. They almost seem to be from different planets, speaking different languages. While both lawyers and economists use “stories” to persuade, economic analysis cloaks the story in a complex mathematical model, opaque to those without training in economic theory. The results of economic modeling can obscure the decisions that policymakers and the public need to make—about the direction of the tax system, the nation, and the economy. This article examines the roles economists and lawyers play in the development and implementation of the income tax system, in particular focusing on tax reform and its effect on inequality.

II. Economic models and the assumption of rationality.

A. Judge Richard Posner described economics as “the science of rational choice.” Richard A. Posner, *Economic Analysis of Law* 3 (6th ed., Aspen 2003). Economic theory assumes that people respond to incentives by altering behavior because they are “rational maximizers” of their own self-interest. Joseph Stiglitz notes that “belief in rationality is deeply ingrained in economics.”¹ Critics of law and economics have argued that people do not always behave as rational actors, that they do not carefully and accurately weigh the costs and benefits of their anticipated actions.

B. Whether an analyst wants to modify the rationality assumption to better reflect realistic human behavior is a question of the detail the analyst wants to build into his model. The model is an essential part of the economist’s analytic process. Any decision problem has four parts:

(1) an *objective function* which indicates the relative desirability of different possible outcomes; (2) a range of policy alternatives, or *instruments* . . . among which the decision maker must choose; (3) the *model*, which specifies the empirical relations connecting the instruments, the variables entering

¹ Joseph E. Stiglitz, *Freefall: America, Free Markets, and the Sinking of the World Economy* 248 (W.W. Norton & Co. 2010).

into the objective function, and other relevant variables; and (4) the *computational methods* by which the decision maker chooses the values of the instruments so as to maximize the objective function subject to conditions specified by the model.²

C. Economic modeling and the government. Uncertainty is a fundamental characteristic of government economic policy, which means that no model of government economic policy can achieve perfect predictability. Can lawyers (e.g., members of Congress) understand economic models?

III. Economic Theory and Tax Policy

A. Can economic modeling help tax policy attain the goals of equity, efficiency, and simplicity? Many commentators argue that economic modeling has reduced the three goals of tax policy to only one, efficiency. These scholars highlight (sometimes) hidden normative assumptions in economic modeling.

B. How to search for normative assumptions in economic modeling: the Lawsky prescription.

1. The model should explicitly state its goal.
2. The model should tie its observations to the “real world.”
3. The modeler should explicitly state the model’s assumptions and limitations.
4. The reader should determine if the model creates a “credible world.”
 - a. The model should be similar in relevant ways to the real world.
 - b. The model should show us results similar to what we see in the real world.
 - c. The model’s assumptions should fit naturally together.

C. Can a reasonably intelligent lawyer without economic training determine from available economic literature which tax reform proposals are likely to enhance the fairness of the tax system? Comparison of Thomas L. Hungerford, *Taxes and the Economy: An Economic Analysis of the Top Tax Rates Since 1945 (Updated)*, Cong. Res. Serv. Rep. 42729 (Dec. 12, 2012) with Robert Carroll & Gerald Prante, *Long-run Macroeconomic Impact of Increasing Tax Rates on High-Income Taxpayers in 2013*, Ernst & Young (July 2012). Conclusion: the economic model simply does not communicate to the lawyer what the lawyer needs to know to critically evaluate it.

² Kenneth J. Arrow, *Collected Papers of Kenneth J. Arrow: The Economics of Information* 44 (Belknap Press 1984).

	Hungerford	Carroll & Prante
Goal	To establish whether a relationship exists between top marginal tax rates and economic growth	To determine the long-run macroeconomic impact of increasing the top individual marginal rates to better understand the policy debate
Tied to “real world”?	Examination of historical data reveals no correlation between top marginal tax rates and economic growth over the past 65 years	Estimates the impact of four sets of tax increases, all of which were under political consideration at the time of the report: (1) the increase in the top two tax rates from 33 to 36 percent and 35 to 39.6 percent; (2) the reinstatement of the limitation on itemized deductions for high-income taxpayers; (3) the taxation of dividends as ordinary income and at a top tax rate of 36.9 percent and the increase in the top tax rate applied to capital gains to 20 percent; and (4) the increase in the 2.9 percent Medicare tax to 3.8 percent for high income taxpayers and the application of this tax to unearned income including interest, dividends, and capital gains.
Clarity of stated assumptions and limitations	Using data from IRS Statistics of Income, Bureau of Labor Statistics, Federal Reserve bond yields, and per capita gross domestic product (GDP) from the Bureau of Economic Analysis, model	Applies the presumed increase in government revenues in one of two ways: either to finance additional government spending or to finance an across the board reduction in tax rates.

	using two methods: <i>first, estimating the simple bivariate correlation through scatter diagrams and second using multivariate time-series regression analysis – not understood by this lawyer.</i>	The analysis uses the EY General Equilibrium Model of the U.S. Economy (EY GE Model) (<i>not understood by this lawyer</i>), and considers the sensitivity of the results to alternative sets of behavioral assumptions. Assumes that “households adjust labor-leisure choices to maximize utility in the fact of a lower after-tax reward from work” and that “firms adjust their use of labor and capital inputs in production to maximize firm value in response to reductions in the after-tax return from savings and investment.”
Credible world?	Yes. Finds no correlation based on examination of past data.	No. Unclear what weight placed on assumptions, shows normative bias towards work, unclear where increased government spending would lie.
Is model similar in relevant ways to real world?	Uses real world historical data.	Uses reasonable simplifications of the overall economy and consumer groups.
Does model show results similar to real world?	Model appears to extrapolate future results from past real world results.	Not when compared to Hungerford study, comes to opposite conclusion.
Do model’s assumptions “fit naturally together?”	Unclear.	Unclear.
Conclusion	Research appears modest and careful and the conclusions limited. No hidden normative assumptions detected.	Many assumptions stated, unclear weight placed on each assumption, and model is opaque.

D. Economists' recommendations for deriving policy prescriptions from economic models. Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, 25 *J. Econ. Persp.* 165 (2011).

1. Theoretical results are useful for policy only under three conditions:
 - a. "The result should be based on an economic mechanism that is empirically relevant and first order to the problem at hand."
 - b. "The result should be reasonably robust to changes in the modeling assumption." That is, the reader should "view with suspicion results that depend critically on very strong homogeneity or rationality assumptions." *Hard for a lawyer to assess.*
 - c. "The tax policy prescription should be implementable—that is, the tax policy needs to be socially acceptable and not too complex relative to the modeling of tax administration and individual responses to tax law."
2. Diamond & Saez recommend top marginal rates on top 1 percent between 48 – 76 percent. *Lawyer cannot understand underlying equations.* But Diamond & Saez's explanation seems credible.
 - a. *If redistribution is desirable, then* the social marginal value of consumption for top bracket taxpayers is small relative to that of the average person in the economy.
 - b. Elasticity of taxpayer response to rising tax rates includes not only "real economic responses such as labor supply, business creation, or savings decisions, but also tax avoidance and evasion responses.

E. Base-broadening tax reform: Economic analysis of tax expenditures

1. JCT analysis: the difference between the tax expenditure and revenue estimates.
 - a. Revenue estimates: JCT revenue estimates take into account taxpayers' likely behavioral responses to proposed changes in tax law. Behavioral effects can be broadly characterized as shifts in the timing of transactions and income recognition, shifts between business sectors and entity form, shifts in portfolio holdings, shifts in consumption, and tax planning and avoidance strategies. Consistent with economic theory, JCT tax models assume that taxpayers will largely behave rationally, while taking into account other behaviors as implicated by data and recent research.
 - b. The JCT calculates each tax expenditure separately, assuming that all other tax expenditures remain in the Code, and unlike with revenue estimates, assumes that taxpayer behavior remains unchanged for tax expenditure estimate purposes. Another unrealistic, but probably necessary, simplifying assumption made by the JCT that Congress's behavior would also remain unchanged if a tax expenditure were removed. If a tax expenditure provision were eliminated, Congress might choose to continue financial assistance through other means rather than terminate all Federal assistance for

the activity. JCT estimates of tax expenditures do not anticipate such policy responses.

c. Distributional analysis: Law professor Linda Sugin complained about lack of information with respect to the distribution of tax expenditures. JCT economists estimate the distribution of the following tax expenditures: the medical expense deduction, property tax deduction, state and local sales tax deduction, charitable contribution deduction, child care credit, earned income credit, untaxed social security benefits, child tax credit, education credit, student loan interest deduction, and mortgage interest deduction. Economists Eric Toder and Daniel Baneman of the Tax Policy Center note that distributional estimates of tax expenditures should be viewed with caution because the effect of repealing particular tax expenditures could more or less progressive, depending on how Congress decides to use the resulting revenue. Eric Toder and Daniel Baneman, *Distributional Effects of Individual Tax Expenditures*, Tax Policy Center (Feb. 2, 2012).

2. Framing effect and salience of tax expenditures. For some people, policies that are unacceptable when accomplished through direct transfers become attractive when labeled as tax reductions. In general, Americans seem to be much more favorably disposed towards government interventions through the tax code than through more direct channels. Jake Haselswerdt & Brandon Bartels, *Comparing Attitudes Toward Tax Breaks and Spending Programs: Evidence from a Survey Experiment* (George Washington University Department of Political Science Working Paper (Jan. 9, 2012). Far from being swayed by economic arguments about tax expenditures, citizens appear to be largely impervious to them. On the other hand, law professor Edward Zelinsky notes that the economic incidence of tax expenditures are significantly salient to rent-seekers, for example, the mortgage interest deduction to the real estate industry. Edward A. Zelinsky, *Do Tax Expenditures Create Framing Effects? Volunteer Firefighters, Property Tax Exemptions, and the Paradox of Tax Expenditure Analysis*, 24 *Va. Tax Rev.* 797 (2005).

IV. Numerical Fallacies and Conclusion

Numbers seem to give us objective and trustworthy answers to complex questions, but frequently fall short. Human minds are designed to detect patterns, which makes us vulnerable to mistaking correlation for causation. Humans, including members of Congress, are also vulnerable to a compelling story. Neither a good narrative nor a plethora of statistics necessarily tell the truth about any government policy. The tax system is complex, and interactions between taxes, spending, trade policy, and innovation can be impossible to untangle. Even without advanced math training, lawyers can read economic analysis critically. What are the stated assumptions? Economists can help by explaining the assumptions in narrative form

and giving at least general indications of the weights placed on each factor considered. Is correlation presented as causation? Does the analysis mix units of measurement? Are averages presented as typical results?