Letter from America: On Shoven and Wise and Tax Reform

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It is often noted that the links between economic research and economic policy are slow and unpredictable. Few doubt that academic research has important long-term effects, nor that economists working in Washington help shape the immediate debate. Particularly good examples of the latter are the central roles in the Asian crisis now being played by Lawrence Summers (number two at the Treasury, and arguably the most powerful economist ever to serve in the US government) and Stanley Fischer (number two at the IMF), both of whom were academic economists of the very highest caliber. Yet it is unusual to find examples where changes in the law can be traced to specific pieces of academic research, not only without a delay of many years, but even before the results have been published.

The economics profession in the United States is impressively open. Economists can become full professors at major universities when still young—Summers was tenured at Harvard in his twenties—and the rewards to such success come not only in academic status, but in cash. Competition from business schools has generated continuing real growth in the salaries of academic economists, even of those not in finance. New PhD’s are currently being recruited to business schools at a starting annual salary of nearly $150,000, and a the earnings of a young newly-tenured superstar in any branch of the profession could now be close to $200,000, with much more for specialists in finance. Such salaries, together with generous pension contributions and a rising stock market, have enriched many successful academic economists of the baby-boom generation. To take a high-end, but by no means impossible example, a 60 year old senior professor of economics, currently earning $200,000 a year, whose salary has grown at five percent real per annum, who has been a professor for 35 years, whose institution has always contributed 12 percent of salary, and who has invested the proceeds in the S&P 500, would currently have a pension fund of around $2.3 million. (The same trends would give the young 25 year old superstar more than $24 million at 1998 prices in her pension fund by age 60.) Of course, these amounts have never been taxed, and they are large enough to trigger exotic taxes that were originally designed to apply to the truly wealthy.

Shoven and Wise’s paper attracted an enormous amount of attention, not only among tax accountants and estate planners, but in the general press. There was widespread outrage that middle-class baby-boomers, whose only vice was thrift, should face confiscatory “success” taxes just because they’d had the foresight to put their money in the stock market. Last summer, when Shoven and Wise presented their work at a conference at a golf resort whose house-sized hotel rooms are disguised as giant boulders in the surrounding Sonoran desert, the thoughtful details included the provision of reading material in each bathroom, in this case Worth magazine, whose cover article warned the resort’s golfers and gourmets (and economists) of the imminent threat to their wealth. Esquire magazine bemoaned the fate of what it called “America’s new ‘underrich’—wealthy enough to boast seven-digit estates, but not enough to afford the estate planning that the real rich have enjoyed for generations,” and urged its readers to “take pencil in hand, write a couple of blunt letters, and send them to Senator Bill Roth and Representative Bill Archer, the chief tax legislators in Congress. Tell them you want these levies repealed, like, yesterday.” If not yesterday, at least the next day, and the “excess” taxes were repealed in last year’s budget, the Taxpayer Relief Act of 1997, which “scored” the repeal as a revenue increase, citing the incentive to make withdrawals and pay the deferred tax. The
voices of well-heeled baby-boomers are rarely ignored in Washington these days, and the 1997 budget also effectively abolished capital gains tax on the sale of owner-occupied homes. Until then, such gains could be rolled over but (subject to a limited exemption) were ultimately taxed; once again, it is hard not to see the preoccupations of the baby boom generation, whose time to pay capital-gains taxes on their homes would otherwise have been coming close. In such an environment, it is going to be very difficult to deal with the really big issues, such as the reduction in social security (retirement) and Medicare benefits that will almost inevitably have to be a part of the reform of the social security system.

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